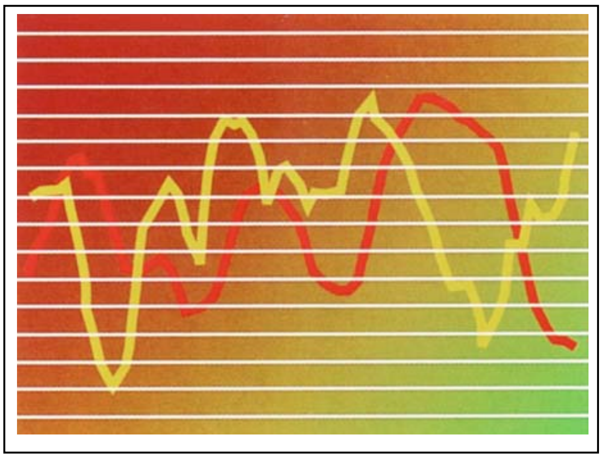
CONJONCTURE IN FRANCE

DECEMBER 2007



FRANCE: DAMPENING THE SHOCK WAVE

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The Q3 figures have exceeded expectations in many countries, suggesting that world growth has stood up rather well to the multiple shocks experienced in 2007. These include the so far unbroken slump in the U.S. real-estate market, the crisis in U.S. subprime home loans that has led to a general liquidity shortage since August, and the H2 surge in oil prices.

The effect of these shocks on the global economy should be more tangible in 2008. In all countries, business investment is likely to suffer from tighter financing conditions, and the inflationary levy exacted by agricultural and energy commodities should dampen household consumption. In the developed Anglophone countries, consumption will probably also be affected by falling real-estate prices and the drying-up of home equity loans.

Our scenario incorporates a sharp economic slowdown in the United States and United Kingdom, and a more limited one in the euro zone—as attested by the continuing confidence reported in the business surveys in recent months—and Asia.

So far, France has been immune to the general slowdown. The growth differential with Germany, as with its other European Union partners, had widened to France's detriment when euro-zone activity accelerated in 2006; it has disappeared in the past two to three quarters. French exporters' losses of market share appear to be diminishing and the rise in capacity utilization is stimulating business investment.

However, the French economy is unlikely to escape the global slowdown altogether. Absent the October-November transportation strikes, French GDP would have grown 0.6% in Q4 2007 and 0.4% per quarter in H1 2008. The strikes are estimated to have had a small impact on this profile, lowering growth by one-tenth of a point in Q4 and raising it by the same amount in Q1 2008.

The euro's sharp appreciation is likely to hamper exports at end-2007 and in early 2008. Business investment—still buoyant in late 2007 according to the confidence surveys—should be gradually slowed by tighter financing conditions and slacker foreign demand. Consumption will be subject to conflicting forces. In our scenario, the rise in energy and food inflation will affect households' real income but they will be able to preserve their current consumption pace by lowering their saving ratio, thus partly correcting its steep rise in early 2007.

We also expect a dip in job creation and a slower decline in unemployment. However, France's ILO unemployment rate should ease to 7.7% of the active population in Q2 2008.

The main source of uncertainty in our forecast is the scale and duration of the present liquidity crisis: if it persists, the liquidity shortage could block many investment decisions and the global economic slowdown would gain momentum; conversely, if it were to be solved rapidly, the easing of financing conditions that would ensue—amplified in the U.S. by the rate cuts already enacted by the Federal Reserve—could trigger a prompt rebound. The stability of the business climate reported in confidence surveys, despite the deterioration in the international environment, is a possible sign that France may possess domestic resources enabling it to withstand the general slowdown better than expected.

Growth rebounded in all industrialized countries in Q3

GDP growth in the industrialized countries as a whole quickened from 0.5% in Q2 to 0.9% in Q3. The U.S. economy, in particular, displayed surprising resilience, its 1.2% gain largely exceeding the forecasters' consensus. In 2007, the world economy will thus have remained buoyant. The strongest momentum has been provided by the emerging countries, principally China.

But the world economic outlook is darkening

Despite the Q3 rebound, however, annual average growth in the industrialized countries is likely to dip from 2.8% in 2006 to 2.4% in 2007, and the world economy should begin to slow at year-end. The U.S. real-estate crisis persists, the financial turmoil is hardly easing, the surge in energy and agricultural-commodity prices is stoking inflation, and investment cycles in the euro zone and in South-East Asian countries appear to have peaked in mid-year.

Money markets still in trouble

In spite of repeated injections of liquidity by central banks, the money markets are struggling to return to normal, as witnessed by the increased tensions in late November and early December. The spread between the 3-month money-market rates (USD-LIBOR) and the key U.S. rate stands well above its long-term average. In the euro zone as well, the spread between the 3-month money-market rate (Euribor) and the European Central Bank (ECB) key rate remains wide. Furthermore, the flight to quality seems to be continuing, with government-bond yields particularly low in the euro zone and the U.S.

The return to normal in the money markets is likely to be very gradual

The financial turmoil may take time to clear. Despite the banks' publication of their first quarterly results since the outbreak of the crisis, considerable uncertainty persists over the exact location of high-risk financial assets such as subprime home loans in the U.S. Lending conditions are therefore likely to remain tight in the quarters ahead.

Flare-up in energy and food-commodity prices

Oil markets still experiencing major physical tensions

These financial uncertainties are compounded by a double inflationary shock. After an initial surge in September, oil prices continued to climb in October and November. On November 23, Brent crude hit a record $96/barrel. These upward pressures reflect the current physical tensions on the oil markets: demand is surging, notably in the Middle East and China, and OPEC is not using all its spare capacity. These tensions have been exacerbated by rising geopolitical uncertainties and weather flukes that have disrupted oil extraction and transportation. Prices should therefore remain highly volatile in H1 2008, fluctuating around an average $90/barrel.

Commodity prices feed inflation

Inflationary tensions have been worsened by the behavior of food-commodity prices. On an uptrend since mid-2006, prices have truly spiraled since the beginning of 2007 because of short-term factors such as poor weather conditions, and for structural reasons such as the sharp rise in demand and biofuel production, which is reducing food acreage. These rises are now being passed on to consumer prices—a transmission that began in the summer.

U.S. economy expected to slow sharply

The real-estate crisis set to further undercut U.S. growth

Inflationary tensions and accumulated imbalances will hamper the world's largest economy. U.S. growth should remain modest in the months ahead, at 0.3%-0.4% per quarter, and the risk of recession is not negligible. At this stage of the cycle, real-estate market stabilization is not yet in sight: unsold housing inventories remain high, homebuilders are gloomy, and real-estate prices are poised for a further decline. Households' housing investment is thus likely to keep falling in the quarters ahead. Over this horizon, household consumption should be restrained by the drop in real-estate prices, which erodes wealth and borrowing capability, and by the slowdown in purchasing power, notably owing to the rise in energy and food inflation. Productive investment is also expected to weaken because of tighter financing conditions and the softer demand outlook. The vigor of external trade should, however, sustain the U.S. economy, keeping it on a moderate growth path. By improving price competitiveness, the dollar's steady depreciation has been promoting a positive contribution of external trade to growth for the past several quarters.

Domestic demand expected to weaken sharply in the United Kingdom

The British economy is also expected to decelerate after an unusually vigorous growth cycle. After rising from 2.8% in 2006 to an estimated 3.1% in 2007, average annual GDP growth should ease below 2.0% by summer 2008. Household demand should lose considerable momentum under the combined effect of slacker purchasing power and the current downturn in the real-estate market. The latest surveys show a deteriorating business climate—in particular, a sharp drop in industrial-output expectations.

Deflationary pressures persist in Japan

In Japan, deflationary pressures endure. In H2 2007, the economy will likely have been slowed by the drop in construction investment due to tighter building-permit regulations. In H1 2008, by contrast, growth should return to a somewhat more robust pace. Yet this revival is unlikely to be strong enough to trigger the increase in wage and core inflation that would demonstrate Japan's effective exit from deflation.

Emerging countries, particularly China, to stay on a robust growth path

Lastly, China's economic vigor should persist. While a mild slowdown is possible, annual growth is set to exceed 10% again in early 2008. Activity continues to be driven by investment and a continuing trade boom: the trade surplus has already topped $210 billion in the first ten months of the year, up 60% on 2006. For now, the price spiral is the only cloud over the Chinese economy, whose dynamism should benefit the countries of the region. Despite the dip in South-East Asia's productive investment, economic activity in the region should remain fairly brisk.

The exchange-rate appreciation undermines euro-zone price competitiveness but curbs imported inflation

Euro-zone trade performance likely to deteriorate

In addition to financial turmoil and the flare-up in energy and food prices, the euro zone is feeling the impact of its currency's appreciation to date (by convention, we have specified a constant exchange rate of 1.45 per € in our forecast). Amid slowing world demand, external trade should contribute negatively to euro-zone GDP growth.

Domestic demand on a slower growth path as well

Domestic demand should also grow more slowly. The investment cycle begun in 2003 seems to have peaked, with businesses reporting lower productive capacity utilization. Moreover, in several euro-zone countries—notably Spain, Finland, and Ireland—the risk of a real-estate downswing have risen significantly. Consumption growth, meanwhile, will probably stabilize. Although continuing to benefit from the recovery in wage earnings, it should be adversely affected by the inflationary impact of rising energy and food prices. However, this levy should be cushioned by the euro's appreciation.

Monetary policy likely to remain neutral in the short run

Euro-zone GDP growth is expected to have continued at a brisk pace in 2007, gaining 2.6% as against 2.9% in 2006, but the current slowdown should reduce the pace to a modest 0.4% per quarter in H1 2008, i.e., below the potential rate. One sign of this euro-zone slowdown is the decreasing optimism tracked by confidence surveys in industry since April and in the service sector since September. Despite the slowdown, the ECB is likely to keep its key rates unchanged owing to present inflationary tensions, which could have been more severe without the euro's appreciation.

A jagged profile for productive investment in Germany

German GDP growth is projected to weaken. We expect it to decelerate from an annual average still close to 3% in 2007 to only 0.4%-0.5% per quarter in late 2007 and early 2008. The investment profile, however, may be jagged. German firms will probably anticipate investment expenditures in late 2007 in order to take final advantage of the tax write-off provisions expiring on January 1, 2008.

By way of compensation, productive investment should decline in Q1 2008, with the situation returning to normal later. Construction investment is expected to be hit again by the scrapping of subsidies to home-buyers. In contrast, household consumption, fueled by higher wage earnings, should continue to drive demand.

Italian growth to stay limp

In Italy, the new deterioration in industrial confidence surveys seems to announce a persistence of weak growth. Our forecast puts the quarterly rate at no more than 0.3%. We estimate the annual average for 2007 at a modest 1.8%, despite a substantial overhang of 1.1% at the start of the year.

In France, external trade likely to keep making a negative contribution to growth

The appreciation of the euro's real effective exchange rate is undermining French price competitiveness

In the first three quarters of 2007, the growth of French manufactured exports remained consistent with world demand for French products. In Q4, however, the euro's real effective exchange rate will have appreciated by a further substantial 3.3%. As a result, French manufactured exports should decelerate faster than world demand. The loss of price competitiveness could cut growth in manufactured exports by one point in Q4 2007 and an additional point in H1 2008. Moreover, in a slacker international environment, notably in the euro zone, world demand for French products should slow as well.

Manufactured exports projected to slow

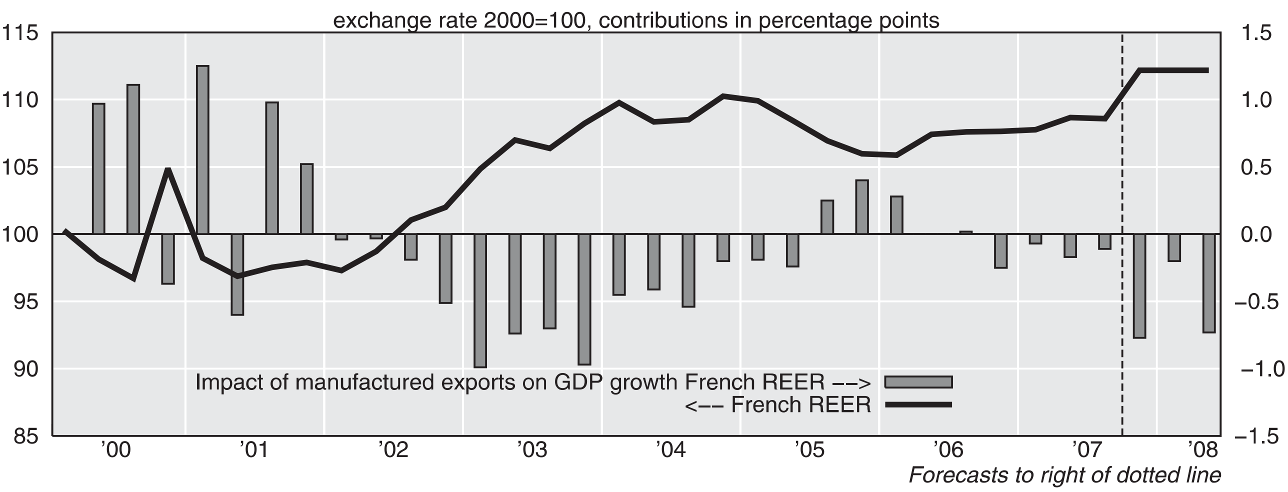
The average growth in French manufactured exports in 2007 is estimated at 4.2%, down from 8.4% in 2006. This slowdown is, however, artificially amplified by excess flows of mobile telephony in 2006—presumably due to massive fraud—which affected not only France but other European countries as well. Adjusted for these flows, export growth is estimated at 4.9% in 2007 versus 7.7% in 2006.

France's export slowdown, first observed in Q4 2007, chiefly concerns manufactured products. We expect it to be significant in Q4 and H1 2008, despite the likely persistence of growth in service exports.

Imports to be slowed by weaker demand

Growth in French manufactured imports is also likely to lose momentum as a result of softer household demand. However, the slowdown should be milder than of exports. First, energy imports are poised for a sharp rebound in Q4, gaining 3.5% after a 5.8% loss in Q3. Second, the appreciation of the euro's real effective exchange rate should stimulate imports of manufactured products and services. In early 2008, imports will probably expand at the same pace as in 2007, i.e., by an annual average 4.5%.

1 - FRENCH REAL EFFECTIVE EXCHANGE RATE (REER) AND CONTRIBUTION OF MANUFACTURED EXPORTS TO GDP GROWTH



Sources: DGTPE; INSEE; authors' computations

External trade still hampering growth

Overall, we forecast a negative contribution of external trade to French GDP in H1 2008. The balance in manufactured products will probably continue to worsen and the total trade deficit should widen again.

Production headed for a mild slowdown

Manufacturing output rebounded sharply in Q3

French production expanded by a brisk 0.9% in Q3. The strongest rebound was in manufacturing, which gained 1.3%. But this vigor mainly corrected a disappointing Q2. We now expect production to lose momentum in nearly all industries—particularly manufacturing, where the business climate has stabilized, and wholesale/retail trade, which will be affected by the demand slowdown. Optimism in manufacturing, however, continues to run high.

Strikes likely to curb transportation output in Q4 2007

The transportation industry should stall in Q4, on account of the mid-November strikes. By way of compensation, its output should rebound in early 2008. Starting in Q4, production of market services should move closer to its trend of the past two years, gaining 0.6% per quarter compared with 0.8% in Q3.

Construction output should, however, experience a temporary upswing

By contrast, construction-industry output is poised for a recovery at end-2007 after its weak Q3 gains. It should be stimulated by the 1.0% jump in household residential investment, consistent with this summer's rebound in housing starts. The investment upswing is projected to ease to 0.8% in Q1 2008 and 0.7% in Q2 2008, as housing starts and building permits are now leveling off. Energy production is estimated to have grown by a still-vigorous 1.1% in Q4, owing to unseasonably low temperatures in October and November. By way of compensation, we expect it to dip 0.2% in Q1 2008 before returning to its trend growth rate of 0.2% in Q2.

Total French production is poised for a slowdown, gaining between 0.4% and 0.5% per quarter over the forecasting horizon. We estimate its average growth for 2007 at 2.2%, versus 2.3% in 2006. The statistical overhang for production growth in 2008 should reach 1.7% by the end of H1.

Productive-investment growth should remain strong in Q4

Business investment is expected to stay firm in Q4, gaining 1.2% compared with 1.0% in Q3. Productive capacity still appears to be under strong pressure, and business executives surveyed in October were planning major capital-spending increases in H2 2007. Despite a transient weakness in Q2, we estimate that non-financial business investment accelerated mildly in full-year 2007, gaining 5.1% versus 4.6% in 2006. This translates into a further rise in the investment ratio to 18.7% in 2007 from 18.1% in 2006.

Slowdown to follow

We expect the growth in French productive investment to ease to 0.8% in Q1 2008 and 0.7% in Q2, as the economic slowdown will dampen the demand outlook. In addition, financing conditions seem far less favorable for undertaking new projects. According to the October 2007 quarterly survey of industrial investment, industrialists expect a further rise in the cost of credit in 2008. We believe that the investment slowdown will mainly concern investment in manufactured goods, which should rise 0.8% and 0.5% in Q1 and Q2 2008 respectively. The productive-investment cycle begun in 2003 should therefore peak at end-2007 in France, with a slight delay compared with its euro-zone partners.

High level of job creation in 2007

A clearcut improvement in the labor market in 2007

On the employment front, the data point to a clear improvement in 2007. The French economy added an estimated 348,000 jobs. This total exceeds that of 2006, when the labor market had already posted a very vigorous performance by creating 282,000 jobs. The gains are largely due to the increase in job creation by market sectors, most notably business services (106,000 new jobs), personal services (92,000 new jobs), and construction (64,000 new jobs). Manufacturing is likely to have continued shedding jobs, but at a more moderate pace than in

2006. The strong rise in employment in 2007 was also probably driven by the persistent uptrend in non-market sectors. This is despite the further decline in the number of subsidized contracts: exits from these job programs are believed to have exceeded entries in H2.

The trend should continue in H1 2008

In H1 2008, employment growth should continue at the same pace as in H2 2007, with 122,000 jobs added. Productivity gains should therefore remain moderate.

Given the slower growth in the active population, the high level of job creation should translate into a further decline in unemployment. The average ILO unemployment rate in metropolitan France is projected to reach 7.7% in Q2 2008, extending the downtrend begun in early 2006.

Slower growth in household purchasing power in 2008

Household income growth was particularly vigorous in 2007

The labor market's steady improvement in 2007 gave a powerful boost to wage earnings, which rose an estimated 4%. In addition, the government enacted a series of reductions in taxes and other levies, including a reform of income-tax brackets, an increase in the working tax credit (*prime pour l'emploi*), and a cut in social contributions due to the tax exemption on overtime earnings at year-end. These measures helped to significantly quicken the growth in real household income from 2.4% in 2006 to 3.3% in 2007.

Slower growth expected in H1 2008

After the 2007 changes in tax brackets, personal income tax is likely to capture a larger share of household income in 2008. Despite the favorable impact of the "TEPA" Act (French acronym for "labor, employment, and purchasing power"), nominal household-income growth should therefore slow in H1 2008.

Furthermore, inflation is brisk

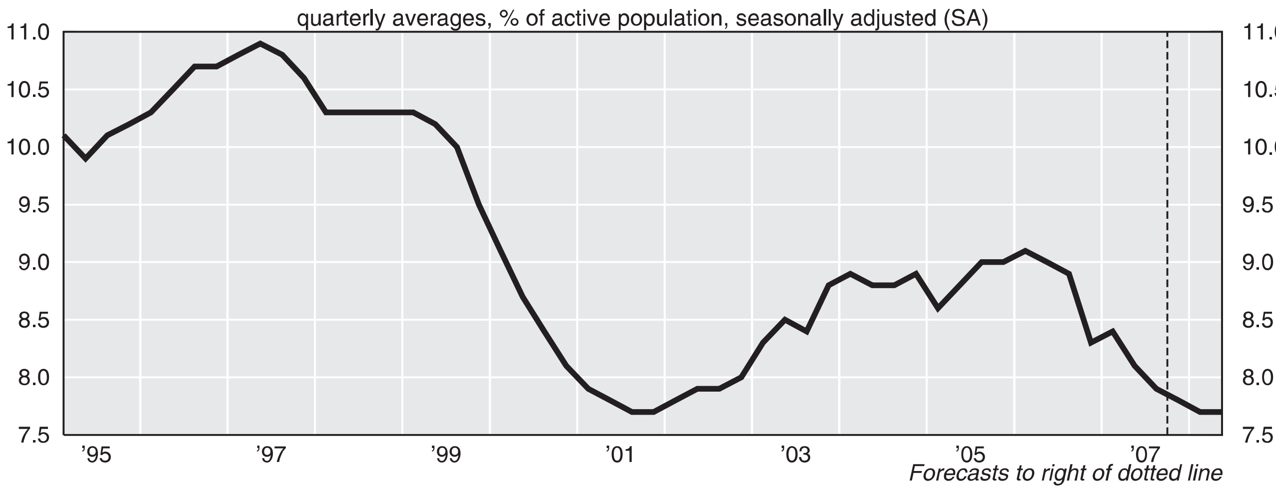
Meanwhile, the November rise in energy prices, plus that of food prices, will drive up overall inflation to a forecast 2.8% in February 2008.[1] However, given our assumptions on oil prices and the exchange rate, overall inflation should ease to 2.4% by the end of H1 2008.

Slower growth in households' purchasing power should not inhibit consumption

The sharp slowdown in household income and steeper inflation should therefore reduce the growth in household purchasing power to an annual average 1.2% in H1 2008. Nevertheless, after the Q3 2007 rebound, household consumption

1. Between July 2007 and June 2008, the surge in food-commodity prices, by impacting on the consumer prices of processed foods, will thus have helped to drive up inflation by an estimated 0.4 points.

2 - ILO UNEMPLOYMENT RATE



Scope of coverage: metropolitan France, household population
Source: INSEE, Labor-Force Survey

should keep growing at close to its trend of the past two years, gaining about 0.6% per quarter in H1. This is because households are likely to draw on their savings in order to smooth their consumption. One measure that will help them do so will be implemented in H1 2008, allowing early withdrawal of funds invested in employee savings plans. The saving ratio, estimated at an average 16.5% in 2007, should consequently dip to 16.1% in Q2 2008.

The French consumption profile is affected to some extent by the October-November transportation strikes, particularly as regards the consumption of transportation and manufactured products. Overall, consumption should rise only 0.4% in Q4 2007, before rebounding by 0.6% in Q1 and Q2 2008.

A very gradual economic slowdown

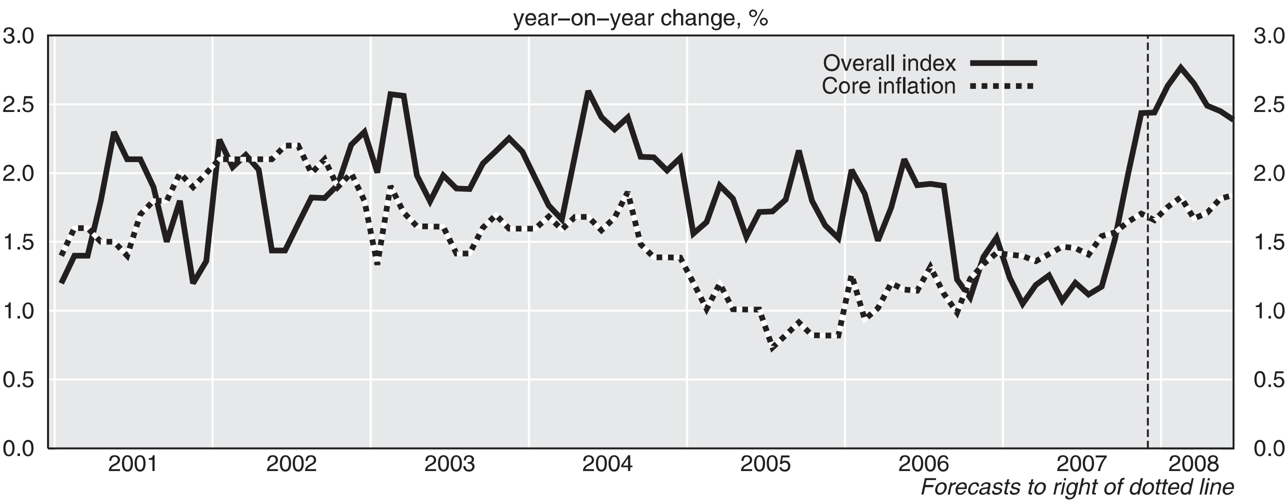
Year-end strikes likely to affect the growth profile

In 2007, the French economy should expand by 1.9%, a figure very close to its potential growth. After the 0.7% rebound in Q3—forecast in our October issue of "*Conjoncture* in France"—we expect a more moderate pace of GDP growth in the forecasting period. The growth profile will probably be marked by the November strikes. These trimmed Q4 growth by an estimated 0.1 points from 0.6% (excluding the strike effect) to 0.5%. However, GDP growth should mechanically regain 0.1 points in Q1 2008, reaching 0.5%. In Q2, it is expected to slow to 0.4%. Not counting the strike effect, GDP would have risen by an average annual 1.9% in 2007. The overhang for 2008 is projected at 1.7% by mid-year.

This forecast rests on the assumption that the worsening international environment will continue to have a limited impact on French growth. However, the impact may prove stronger. The slowdown in world demand for French products and the appreciation of the euro's real effective exchange rate could be steeper than forecast, putting an even more powerful brake on French exports. The persistence of financial turbulence and the prospect of slacker demand growth may also inhibit business investment more strongly.

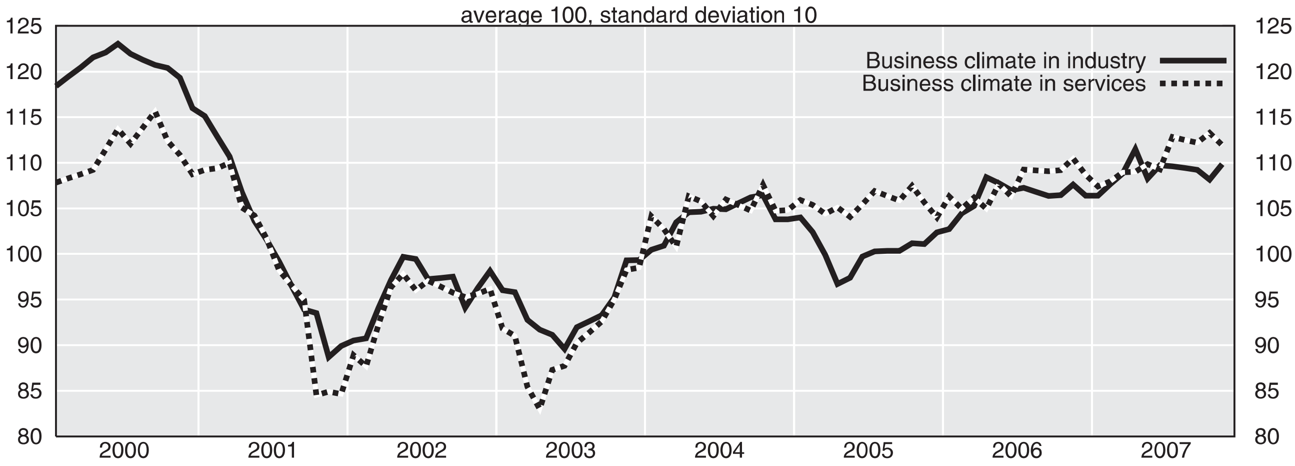
Conversely, the positive production outlook reported in confidence surveys suggests that French businesses are not feeling the impact—at least not yet—of the shocks currently affecting the world economy. While this perception gap does not mean that the French economy is definitely immune to the shocks, it may indicate that less visible positive factors are at work. If so, the expected slowdown of the French economy could be milder.

3 - FRENCH CONSUMER PRICES



Source: INSEE

4 - BUSINESS CLIMATE



Sources: INSEE, business surveys

France: supply and use table (in real terms)

at previous year's chain-linked prices, seasonally and working-day adjusted, quarterly and annual changes, %

	2006				2007				2008		2006	2007	2008 ovhg*
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2			
GDP	**0.7**	**0.9**	**-0.1**	**0.5**	**0.6**	**0.3**	**0.7**	**0.5**	**0.5**	**0.4**	**2.2**	**1.9**	**1.7**
Imports	0.9	3.0	-0.8	1.1	0.9	1.8	1.4	1.2	1.3	1.1	7.1	4.5	4.3
Household consumption	0.9	0.5	0.3	0.3	0.5	0.6	0.8	0.4	0.6	0.6	2.3	2.0	1.9
Public consumption**	0.5	0.5	0.3	0.4	0.3	0.4	0.3	0.4	0.4	0.4	1.4	1.4	1.2
Total GFCF	0.5	1.9	0.6	1.3	1.2	0.4	0.6	1.2	0.7	0.6	4.1	3.9	2.5
of which:													
NFEs	*0.2*	*2.7*	*0.8*	*1.9*	*1.4*	*0.5*	*1.0*	*1.2*	*0.8*	*0.7*	*4.6*	*5.1*	*2.9*
Households	*1.4*	*1.0*	*0.9*	*-0.4*	*0.3*	*0.4*	*0.1*	*1.0*	*0.8*	*0.7*	*4.5*	*1.3*	*2.2*
Exports	3.2	1.2	-1.3	1.0	1.5	0.7	1.7	1.1	0.8	0.7	6.3	3.6	3.2
Domestic demand excl. change in inventories	0.7	0.8	0.3	0.5	0.6	0.5	0.6	0.5	0.6	0.6	2.4	2.2	1.9
Change in inventories***	0.7	0.8	0.3	0.5	0.6	0.5	0.6	0.5	0.6	0.6	2.4	2.2	1.9
Net foreign trade	0.6	-0.5	-0.1	0.0	0.1	-0.3	0.1	-0.1	-0.2	-0.1	-0.3	-0.3	-0.3

Forecast
*ovhg: overhang
**Expenditures by general government and non-profit institutions serving households (NPISHs)
***Including acquisitions net of sales of valuables
Source: INSEE