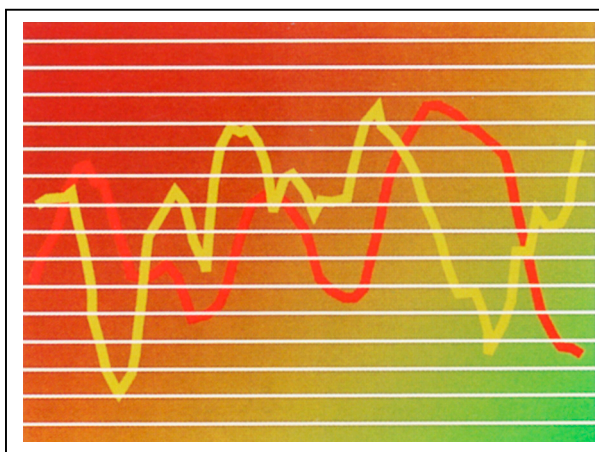


***CONJONCTURE* IN FRANCE**

THE EURO ZONE: BETWEEN RESILIENCE AND INFLATION RISK



MARCH 2008

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The euro zone: between resilience and inflation risk

The world economy is still slowing in early 2008. The rise in commodity prices is eroding household purchasing power. Investment is undermined by high risk premiums and the banks' more restrictive approach to credit demand.

The scale of the slowdown is not uniform, and divergences are widening between the major regions.

To begin with, the U.S. economy has practically stalled. The real-estate market is still correcting past excesses, and the fall in residential investment continues. Household consumption and business investment, which had so far held firm, are now slipping as well—because of weaker asset prices, tougher financing conditions, and rising commodity prices.

By contrast, the emerging countries are still enjoying vigorous growth. Helped by higher commodity prices or driven by a powerful catch-up momentum and an investment boom, they remain on a steep expansionary path.

The euro zone is in an intermediate position. Like the U.S., it is suffering from higher commodity prices and, to a lesser extent, tighter financing conditions. However, in the European countries that have undergone a real-estate market adjustment, the correction has been less severe than in America and has not triggered a contraction in total residential investment. Consumption is sustained by further improvement in the labor market. The slowdown begun in early 2007 should therefore continue in H1 2008, but euro-zone growth is still forecast at 0.4% per quarter.

In our scenario for France, growth will ease slightly in H1 2008 after its mild acceleration in H2 2007. GDP should therefore gain 0.3%-0.4% per quarter in Q1 and Q2. The global slowdown and the euro's appreciation will likely restrain exports. Business investment, which remained buoyant until end-2007, should begin to decelerate, as suggested by respondents' cautious outlook in the INSEE investment survey.

After its vigorous rise in 2007, real household income is projected to grow more slowly, curbing consumption growth. This spending slowdown may be attenuated, however, for households should adopt a "smoothing" behavior by tapping the extra savings that they accumulated in 2007.

Job creation is forecast to weaken slightly to 96,000 in H1 2008, while the unemployment rate may stabilize at 7.5%, after two years of nearly continuous decline and a further sharp drop in Q4 2007.

The main uncertainty weighing on this scenario concerns the behavior of the U.S. economy and commodity prices. So far, the U.S. slowdown has not had the customary effect of lowering commodity prices. On the contrary, they have kept rising. If this doubly adverse pattern for the euro zone and France persisted, it could undermine euro-zone and French growth even further. But French domestic demand may prove more resilient than expected, especially because the household saving ratio offers a strong downward potential after its nearly one-point rise in 2007.

General outlook

The advanced economies are still slowing

The advanced economies are now clearly experiencing a slowdown phase. As forecast in our December "Conjoncture in France," their combined growth did not exceed 0.4% in Q4 2007. There were, however, two surprises: Japan's robust 0.9% growth, fueled by an accidental rebound in business investment, and the decline in U.S. growth to a mere 0.2%. Most service-sector business surveys reported a gloomier outlook in January, suggesting a further slowdown of the advanced economies, notably the U.S.

Growth remains vigorous in the emerging countries

For the time being, the slowdown does not appear to have affected the emerging countries, where economic activity remains vigorous. China, for example, again registered double-digit growth in 2007, fueled by exceptionally brisk productive investment (up 26% year-on-year at end-2007) and a continuing trade boom (surplus up 45% to \$260 billion in 2007). This combination of massive investment and trade surplus perfectly illustrates the dynamics at work in the emerging economies. It has even enabled some countries such as Brazil and Russia to move from near-bankruptcy in the late 1990s to net-creditor status. This maneuvering room may allow emerging countries to weather the global slowdown and thus to attenuate it.

World inflation has been strong since fall 2007

While the emerging economies' robust performance should help to limit the expected global slowdown, it is also stimulating commodity demand and hence inflation. The latter has risen sharply in the advanced economies to an average 3% at end-2007. It is even higher in the emerging countries, where food takes up a large share of household budgets. In China, for example, inflation topped 8% in early 2008.

Supply-demand adjustment in the oil markets will remain very tense

Despite the global slowdown, the oil price may continue to fluctuate around \$95/barrel (for Brent crude) between now and mid-year. This forecast reflects the likelihood that the supply-demand adjustment will remain very tense. Oil demand is persistently strong in China, Brazil, and the Middle East. At the same time, potential output is growing weakly, and the OPEC countries are not tapping their spare capacity to the full.

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 ¹
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2			
GDP	0.7	0.9	-0.1	0.5	0.6	0.3	0.8	0.3	0.4	0.3	2.2	1.9	1.4
Imports	0.7	3.1	-0.9	1.3	0.7	1.8	1.0	-1.4	1.0	0.7	7.1	3.6	1.4
Household consumption	0.9	0.5	0.3	0.2	0.7	0.6	0.8	0.4	0.5	0.4	2.3	2.1	1.6
Public consumption ²	0.5	0.5	0.2	0.4	0.2	0.4	0.3	0.1	0.4	0.3	1.4	1.3	1.0
Total GFCF ³	0.4	1.9	0.6	1.2	1.2	0.4	0.8	1.0	0.4	0.4	4.1	3.9	2.0
of which:													
NFEs ⁴	0.2	2.7	0.8	1.8	1.4	0.4	1.1	1.0	0.5	0.5	4.6	4.9	2.2
Households	1.4	1.1	0.9	-0.5	0.3	0.5	0.6	1.1	0.1	0.1	4.5	1.6	1.3
Exports	3.0	1.3	-1.6	1.4	1.3	0.6	1.3	-0.6	1.0	0.5	6.3	2.7	1.7
Domestic demand excl. change in inventories	0.7	0.8	0.4	0.5	0.7	0.5	0.7	0.5	0.5	0.4	2.4	2.3	1.6
Change in inventories ⁵	-0.6	0.7	-0.2	0.0	-0.2	0.2	0.0	-0.4	0.0	0.0	0.1	-0.1	-0.2
Net foreign trade	0.6	-0.5	-0.2	0.0	0.1	-0.4	0.1	0.3	0.0	-0.1	-0.3	-0.3	0.1

Forecast

1. Overhang
 2. Expenditures by general government and non-profit institutions serving households (NPISHs)
 3. Gross fixed capital formation
 4. Non-financial enterprises
 5. Including acquisitions net of sales of valuables
- Source: INSEE

Commodity prices are surging, particularly for agricultural products

More generally, we expect tensions in the commodity markets to endure over the forecasting horizon, as illustrated in particular by agricultural products. One vivid example is the world wheat market. The wheat price on the Chicago exchange fluctuated between \$2 and \$4 a bushel for over a decade; in mid-2007 it topped \$5, climbing to over \$11 in late February 2008 (Chart 1). There are several concurrent reasons for this shortage. Harvests were poor in major exporting countries such as Australia, biofuels are diverting farmland from food production, and demand is very vigorous, particularly in India and China. As a result, world stocks have sunk to a 25-year low, and the current expansion of productive capacity is not expected to generate an increase in food-commodity supply until the summer. We therefore do not expect agricultural prices to ease in H1 2008.

Monetary policies in the developed countries are becoming more accommodative

Despite inflationary tensions, the Fed and the Bank of England are pursuing accommodative monetary policies aimed at stabilizing economic activity. Since January 2008, both central banks have trimmed their key rates by 125 and 25 basis points respectively. The European Central Bank (ECB) has shifted its public stance, pointing out the risks that weigh on euro-zone growth. The advanced countries are thus likely to continue their monetary easing, especially given the ongoing difficulties in the financial markets. Admittedly, the money markets seem to be moving back to normal, but the flight to quality persists, and stock markets remain highly volatile after their early-2008 drop.

The U.S. real-estate market is headed for a further fall

Uncertainty persists regarding the losses incurred by financial institutions, and the number of U.S. mortgage-loan foreclosures is expected to rise sharply in 2008. The real-estate market adjustment is not over. Housing sales are still falling, housing inventories stand at their highest level since the 1978 crisis, and housing starts have hit a new low. The slump in household residential investment should therefore continue to undermine U.S. growth. As the decline in household confidence shows, consumption should weaken as well. The job market is worsening, with 63,000 losses in February; inflation is eroding purchasing power; and access to credit is becoming more difficult. The only growth driver could be foreign trade, particularly thanks to the dollar's depreciation. The risk of entry into recession is therefore not zero, although it is not our baseline scenario, which calls for 0.1% growth in Q1 and 0.0% in Q2.

1 - Barrel of Brent crude oil and bushel of wheat



Source: Data Insight

General outlook

U.K. domestic demand is likely to run out of steam

The United Kingdom has experienced a real-estate market downswing as well. In our forecast, household residential investment will stagnate in H1 2008 and consumption will slow sharply. Business investment will lose momentum because of the recent deterioration in the economic climate. After two years of strong gains (2.9% in 2006 and 3.1% in 2007), we expect GDP growth to slow to a modest annual pace of about 1.5% in H1 2008.

Japanese growth posted a surprising upturn in Q4

The spurt in Japanese growth to 0.9% in Q4 2007 seems accidental. Admittedly, South-East Asia's dynamism is still fueling Japanese exports, but the main driver was the unusually sharp rebound in business investment. This phenomenon seems transient, however, and was likely overestimated in the preliminary national-accounts figures. We expect investment growth to slacken significantly in H1 2008, particularly on account of the lower earnings outlook for Japanese firms. But core inflation may turn positive again by summer 2008, despite the persistence of deflationary factors such as weak wage rises.

The euro zone is unlikely to escape the slowdown

Euro-zone growth is expected to remain moderate in H1

The euro zone is expected to grow at a moderate quarterly pace of 0.4%, as in Q4 2007. Residential construction investment will likely be affected by the downturn in Spain, Ireland, and Finland, while the equipment-investment slowdown begun in early 2007 should continue. External trade should contribute a negative 0.1 points per quarter to GDP growth in H1 owing to the global demand slowdown and the euro's appreciation. By contrast, household consumption should recover after its 0.1% contraction in Q4. The job market is expected to remain buoyant, and the stronger euro dampens the purchasing-power losses due to higher import prices.

Investment is likely to undercut German growth

Germany, the euro zone's largest economy, will probably suffer from the stagnation of productive investment in Q1 (0.0% in our forecast). The aggregate's 3.4% growth in Q4 2007 seems due to the fact that German businesses moved up their investment outlays to take advantage of the extended tax write-off provisions that expired on January 1, 2008. On the positive side, household consumption may sustain German growth again in H1. After the recent pay raises negotiated in many industries, wages and salaries are poised to grow somewhat more briskly.

The Q4 2007 figures for Italy will not be released until May 23. On the available statistics, however, we estimate a 0.1% contraction in GDP in that quarter. Despite the expected rebound after that surprising loss, growth will likely remain weak at 0.3% per quarter in H1 2008.

External trade is forecast to keep dragging down French growth

French exportations are faltering

In this sluggish global environment, demand from France's main export markets sagged in Q4 2007, dampening sales to the euro zone (up 0.9%), the U.S. (down 4.1%) and Japan (down 0.9%). The buoyancy of exports to the emerging countries did not offset this downturn, and total exports shrank 0.6% in Q4 2007. As a result, on an average annual basis, exports rose a modest 2.7% in 2007, or 3.1% adjusted for statistical bias due to VAT fraud. Our scenario calls for the export slowdown to persist in H1 2008. The decline should particularly concern sales of manufactured products, as suggested by the fall in international orders reported in INSEE's monthly industry survey in January.

French imports are poised to rebound in H1

French imports fell by a sizable 1.4% in Q4 2007. The downturn was especially pronounced for manufactured goods, in part because of the sharp slowdown in household consumption expenditures on manufactured products, down 0.2%

after gaining 1.9% in Q3. By way of compensation, total imports should rebound in H1 2008, but the phenomenon will be limited by the domestic-demand slowdown.

The French job market has distinctly improved

Sizable job creation recorded in 2007

France created more than 350,000 jobs in 2007. The figure is even higher than in 2006, when the labor market had already shown vigor by adding 283,000 jobs. The main momentum came from market sectors. The largest job creations were in business services (122,000), personal services (89,000), and construction (59,000).

The economy should add 96,000 jobs in H1

In our scenario, French employment growth will ease slightly in H1 for two reasons: first, economic growth will slacken; second, the exits from subsidized employment programs will continue to outnumber entries. By and large, the legislation to promote labor, employment, and purchasing power (TEPA Act) should weakly impact labor productivity over the forecasting horizon. Productivity gains are expected to remain below their long-term trend. The French economy should create a total 96,000 jobs in H1 2008.

Unemployment is projected to stay at 7.5%

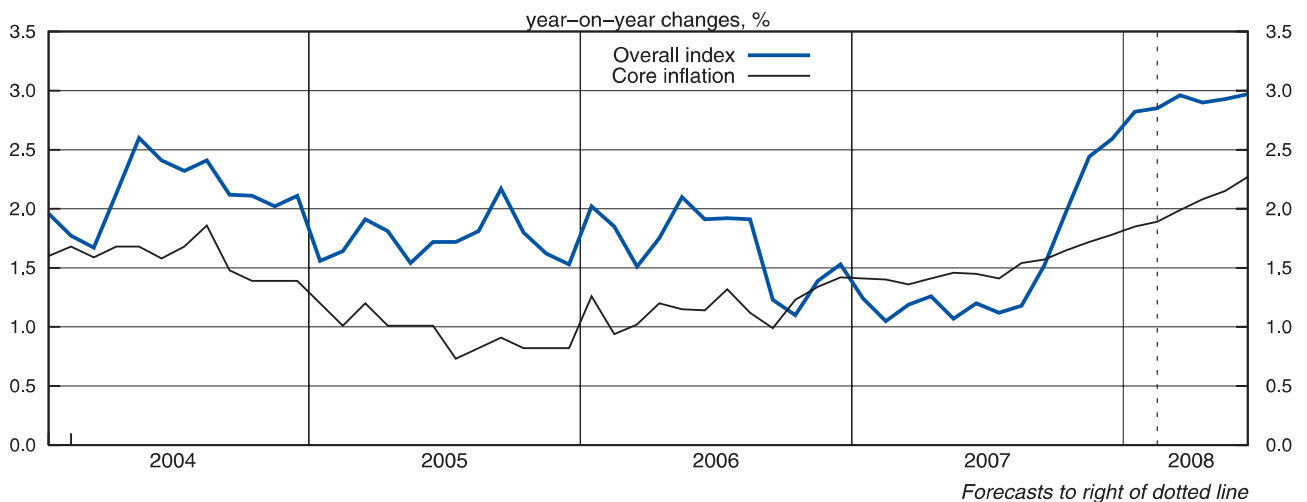
French unemployment fell more steeply in Q4 2007 than what net job growth and the uptrend in the active population would suggest. In H1 2008, despite the persistence of substantial job creation, we expect ILO unemployment to remain stable at 7.5% as the growth rate of the active population should return to a more sustained pace. Since early 2006, the unemployment rate has shed a total of more than 1.5 points.

Inflation is eroding French household purchasing power

French household income grew very briskly in 2007...

The steady improvement in the labor market since early 2006 has fueled brisk growth in gross wages and salaries. In 2007, these gained an estimated 4.1%. Nominal household income (i.e., before adjustment for inflation) rose an average annual 4.7%. This sharp acceleration was helped by tax measures to support purchasing power, including the reform of income tax brackets, an

2 - French consumer prices



Source: INSEE

increase in the working tax credit, and a reduction in payroll contributions through a tax exemption on overtime pay. Adjusted for inflation, real household income rose an estimated 3.1% in 2007.

...but is expected to slow in H1 2008

French wages and salaries should post further robust gains in H1 2008 thanks to the strong labor market. Household income should also benefit from the positive effects of the TEPA Act. However, the growth rate of income-tax receipts should move back more closely in line with income growth. On balance, household income should rise 1.9% in H1 2008.

Inflation should peak at 3% in February

Overall inflation eased very slightly in annual-average terms from 1.6% in 2006 to 1.5% in 2007. In year-on-year terms, however, it accelerated sharply during 2007 to 2.6% in December. Inflation should rise to 3.0% in March 2008 and stay around that level throughout H1 (Chart 2).

Food prices are surging

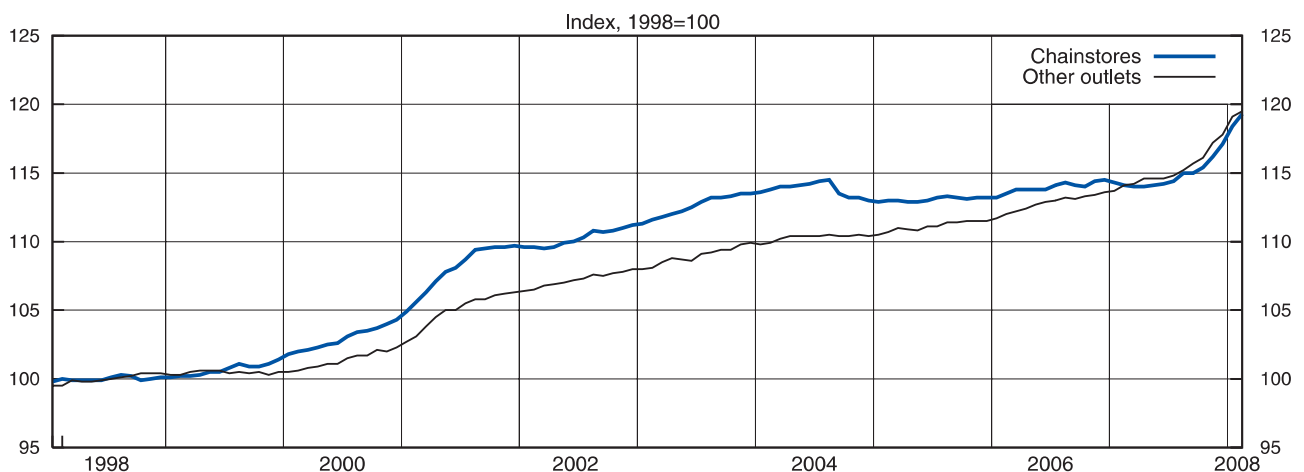
Assuming that the Brent oil price remains stable at around \$95, energy inflation should ease somewhat, although it will remain high. By contrast, the surge in food inflation is likely to persist. The spike in commodity prices will continue to impact consumer prices, contributing 0.7 points to inflation. For the twelve months between July 2007 and June 2008, we estimate that food inflation will contribute one point to total price growth.

The steady uptrend in core inflation since early 2006 is set to last, with 2.2% growth forecast in Q2 2008. The flare-up in agricultural commodity prices and the increase in oil prices will continue to spread to other products, as suggested by the steep rise in industrial producer prices on the French domestic market (4.9% in the year to January). Meanwhile, the effects of the reform of the Galland Act—which regulates retail pricing—seem to have faded since mid-2007. Prices have stopped growing more slowly in chainstores than in other types of outlets (Chart 3).

Our scenario calls for weak purchasing-power gains

Owing to the sharp rise in consumer prices and the loss of momentum in nominal income growth, real household income is likely to rise by a mere 0.1% or so per quarter in H1. French households should, however, cushion the impact of this purchasing-power slowdown on consumption by drawing on the extra savings accumulated in 2007.

3 - French retail prices at chainstores and other types of outlets



Source: INSEE

Consumption, however, should prove resilient

Consumption should therefore withstand the significant slowdown in real household income. In our forecast, it will grow at a pace slightly below its long-term trend, gaining 0.5% in Q1 and 0.4% in Q2. In Q1, it should be boosted by a catch-up effect in transportation and manufactured goods after the year-end transportation strikes. On the downside, consumption should be restrained by the introduction of a penalty charge on high-polluting vehicles, which caused a sizable fall-off in new car registrations in January. However, given the increase in registrations in February, the final impact on consumption of manufactured products in Q1 should be moderate. We therefore expect manufactured-goods consumption to rebound from a negative 0.2% in Q4 2007 to a positive 0.7% in Q1 2008.

French investment and production are on a slowdown course

Household investment is expected to stall

Housing investment—another pillar of French household demand—is likely to keep slowing after a short-lived rebound in Q4. Real-estate prices are still running high and credit access is tightening. The recent pattern of indicators for housing starts and building permits suggests that residential investment should stabilize, with zero change in both Q1 and Q2 2008.

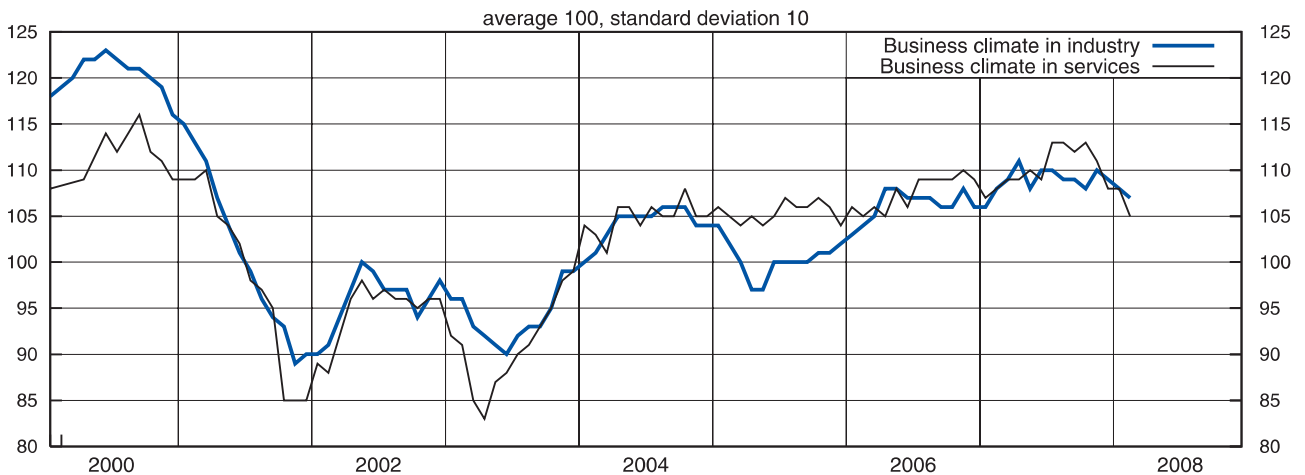
Business investment performed robustly in 2007

Business investment rose an average annual 4.9% in 2007, and the investment ratio continued to rise, reaching 18.9% in December. Investment in buildings and public works was particularly vibrant, gaining 7.3%. In Q4, however, total investment would have slowed sharply without the temporary rebound in capital spending on buildings and public works.

Conditions have become less favorable to investment

We forecast that French productive-investment growth will slow to a quarterly average of 0.5% in early 2008. Demand prospects will be dampened by sluggish economic activity, while financial turmoil has driven up the cost of private-sector borrowing relative to public-sector borrowing. Construction investment, particularly in public works, is set to slow sharply, as suggested by the growing pessimism of civil-engineering firms since end-2007.

4 - French business climate



Source: INSEE

Production is likely to keep slowing in H1

As we forecast in the December “*Conjoncture in France*,” French production lost significant momentum in Q4 2007. The aggregate grew only 0.4%, or 0.5% excluding the effect of the public-transportation strikes. The slowdown is likely to persist, with forecast increases of 0.4% in Q1 (0.3% excluding the impact of strikes) and 0.3% in Q2. Business optimism weakened in the industrial sector and fell steeply in the service sector in early 2008, sinking to its lowest level since December 2005. The production of market services will likely be affected by the mild easing of household-consumption growth. Manufacturing production should remain slack. In the energy sector, production is forecast to decline owing to unusually mild temperatures. The only sector whose output is expected to improve is transportation, thanks to a rebound from the late-2007 strikes.

GDP growth set to lose momentum in early 2008

After GDP growth of nearly 2% in 2007, the economic context will likely be less favorable in early 2008. This is suggested by business confidence surveys, which are starting to deteriorate, particularly in services. GDP growth already weakened to 0.3% in Q4 2007. We forecast that the French economy will continue growing at a moderate pace of 0.4% in Q1 and 0.3% in Q2.

Uncertainties: behavior of commodity prices and resilience of domestic demand

The main uncertainties in our scenario are the behavior of commodity prices and the resilience of domestic demand. A steeper rise in oil prices but also in food prices could undermine household consumption. Investment may slow more sharply if tighter financing conditions forced firms to postpone a larger volume of outlays. Conversely, the strong rise in the household saving ratio observed in 2007 enables households to tap their accumulated extra savings in order to “smooth” their consumption profile. The persistence of a high capacity utilization rate in industry may also incite firms to keep up their investment spending, despite the greater difficulties in financing it. ■