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Tense times in the Eurozone

Since last summer the world economy has been growing at a moderate rate, slowed down by several negative shocks: the rise in commodity prices, the economic consequences of the Japan tsunami, the tightening of fiscal policy both in Europe and in the United States, and lastly the tensions surrounding sovereign debt in the Eurozone.

Since the start of 2012, the effect of these shocks has differed widely from one country to the next: while activity is growing once again in Japan thanks to government support for the rebuilding process, the United Kingdom is now in recession and the Eurozone is not far away. The emerging economies and the United States are in an intermediate situation: their economies are growing, but at a slower pace than prior to the crisis.

Within the Eurozone itself there are also major divergences: while Germany saw strong growth in Q1, Spain and Italy went into recession. France is in the Eurozone average, with weak growth since last summer and none at all in Q1 2012.

The short-term data available point to a slowdown in the world economy in Q2, mainly under the effect of a new heightening of financial tensions in the Eurozone. Provided these tensions do not worsen, world growth should pick up somewhat in H2. It should be sustained most notably by an easing of monetary and fiscal policy in the emerging countries and a drop in the prices of commodities, particularly oil.

However, divergences between countries and zones should persist to the time horizon of this forecast. The Eurozone is still lagging behind the world economy and, within the Eurozone itself, Germany should keep growing while Spain and Italy remain in

recession. These two countries are likely to be handicapped by a wide-ranging fiscal consolidation process and the tightening of financing conditions caused by the rise in interest rates on their government debt.

After once again remaining stable in Q2 2012, French GDP growth looks set to pick up slightly in H2 (+0.1% in Q3, then +0.2% in Q4). Exports should accelerate somewhat under the effect of renewed world growth and the previous depreciation of the euro. Domestic demand should also pick up moderately. In particular, consumption should grow again, because the savings ratio of households is likely to fall in H2 after a transitory rise in Q2.

Due to the low level of growth, the unemployment rate should continue to rise, reaching 10.3% in France in Q4.

The main uncertainty surrounding our forecast concerns the future of the sovereign debt crisis in the Eurozone. Indeed, it depends not only on the evolution of the underlying principles of the Eurozone economies, but also on the responses that the national governments and European institutions provide. It also depends on the reaction from investors to these responses.

If the tensions surrounding the debt of the most exposed countries in the Eurozone were to intensify, activity could keep falling back until the end of the year in France and in the Eurozone. If, however, confidence in the ability of the Eurozone to overcome the crisis were rapidly restored, households and businesses may alter their spending behaviour faster than anticipated in our scenario and growth could pick up more sharply, both in France and in the Eurozone. ■

Activity accelerated slightly in the advanced economies at the beginning of 2012

Dynamic activity in the United States and Japan

Activity accelerated slightly in Q1 2012 in the advanced economies: +0.3% after +0.2% in Q4 2011. It was particularly dynamic in Japan (+1.2% after +0.0%) as the country's exports rebounded strongly on the one hand, and the effects of the stimulus measures passed after the March 2011 earthquake began to be felt, on the other. Growth in the US economy remained robust (+0.5% after +0.7%), buoyed up by private consumption and by investment, especially in construction.

A brighter spell in the Eurozone...

Activity merely levelled out in the Eurozone (0.0% after -0.3%). The easing of financial tensions at the start of the year had a favourable effect on the business climate, with the outlook improving in January and February (see Graph 1). Trade within the Eurozone stabilised after falling sharply at the end of 2011. Likewise, the slide in household consumption stopped. Private investment, however, fell again sharply, notably because financing terms remained difficult in some countries.

...but divergences are widening between European economies

Divergences between the trends within the Eurozone also widened in Q1 2012: activity rebounded in Germany (+0.5% after -0.2%) thanks to an upturn in household consumption and exports to emerging countries. However, activity continued to fall at a rate close to that in the previous quarter in Italy (-0.8% after -0.7%) and Spain (-0.3% after -0.3%).

Upturn in world trade in Q1 2012

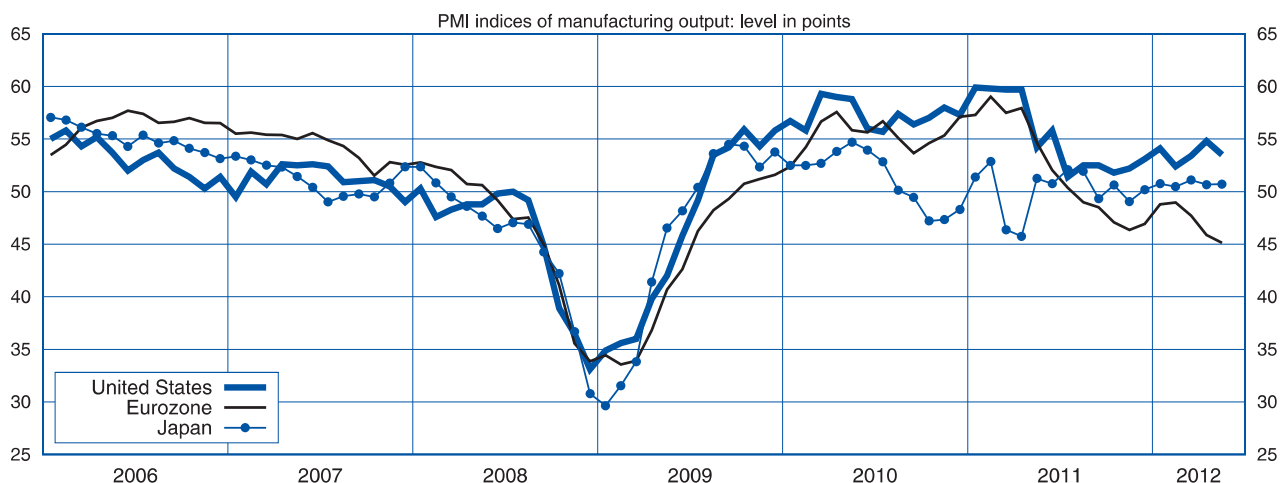
World trade saw a pronounced upturn in Q1 2012: it progressed by +1.6% in Q1 2012 after being stable (+0.1%) in Q4 2011. As the production shock caused by the floods in Thailand faded out, trade increased markedly in the emerging economies. However, these economies, and in particular China, have settled into lower growth rates over the last few quarters than their long-term average.

The advanced economies set to slow down in Q2 2012

Divergence between the outlooks in the United States and Europe

After the improvement at the beginning of 2012, the outlook has been worsening again in the Eurozone since March. At the beginning of June, it was well below the expansion threshold (see Graph 1). In Japan and above all in the United States, it remained above that threshold, however.

1 - The outlook has been worsening in the Eurozone



Sources: Markit

Activity in the Eurozone should therefore fall in Q2 2012 (-0.2% after 0.0%) while growth should remain sound in the United States (+0.5% after +0.5%). In Japan, activity is unlikely to keep up its strong progression of the start of the year, but should still continue to grow (+0.3% after +1.2%).

Slow down in world trade in Q2

World trade should slow down in Q2 2012 (+0.8% after +1.6%). On the one hand, weak activity in Europe should continue to weigh down on demand from the advanced economies. On the other, in the emerging Asian countries, trade is likely to be hit by the end of the catch-up effects at work in Q1, while the sluggish activity in China at the start of the year is likely to affect the activity of the country's neighbours.

Sharp fall in oil prices since March

After reaching a peak of \$125 in March 2012, the price of a barrel of Brent fell sharply, to \$111 on average in May. Through to the end of the year, it should fluctuate around \$100 and the fall in oil prices should have positive effects on world activity. In the advanced economies, consumer prices should slow down clearly from Q2, thus buoying up consumer purchasing power.

Domestic demand holding up in Japan and the United States

In the United States, the purchasing power of American households should also be buoyed up by a relatively dynamic labour market. Consumer spending should continue to increase at a good rate. US domestic demand should also be driven by the upturn in residential investment that has been visible for several months. However, the adjustment of public expenditure, notably on the local level, is likely to remain the main factor holding US growth back. In Japan, on the contrary, domestic demand should continue to be buoyed up by a resolutely expansionist fiscal policy.

Slight improvement in H2

Fiscal and monetary stimulus in the emerging countries

In the emerging countries, the fall in commodity prices is reducing inflationary pressures. This gives the authorities in these countries some monetary and fiscal room for manoeuvre to address the relative lack of dynamism of their economies. These expansionist policies were launched several weeks ago and should enable demand from emerging countries to improve clearly in H2 2012. In its wake, world trade should be boosted somewhat (+1.3% per quarter).

Slight acceleration in activity in the advanced economies in H2

This upturn in demand from the emerging countries should support activity in the advanced economies, which should accelerate slightly in H2 (+0.4% per quarter after +0.2% in Q2). The dynamism gap between the United States (+0.6% per quarter) and Japan (+0.4% then +0.5%) on the one hand, and the Eurozone (+0.0% then +0.1%) on the other, is set to remain wide. Domestic demand should progress more clearly in the United States and in Japan, while continuing to fall in the Eurozone.

Weak activity in the Eurozone

Financial tensions flaring again

With the action of the European Central Bank (ECB) and the commitment of the European States to make their public finances more sustainable, financial tensions eased again in early 2012. But returning doubts surrounding the financial stability of certain countries and political instability in Greece led to a further worsening of tension in the spring. In particular, Spanish and Italian sovereign rates have risen again sharply since April (see *Graph 2*) and volatility has increased on stock markets.

European domestic demand falls back

This upturn in tensions is likely to prevent any easing of financing access terms for European businesses through to the end of the year and investment should continue to fall back. Likewise, measures to control public deficits should weigh down on household revenues, already hit hard by the deterioration of the labour

market. Despite the marked slowdown in consumer prices, European households should see their purchasing power decline throughout the year and are likely to reduce their consumer spending. The Eurozone should therefore be at a standstill in 2012: activity should fall in Q2 (-0.2%) before rising again but only weakly in H2 (+0.0% then +0.1%).

Divergences accentuated

The overall trend should hide accentuated divergences within the Eurozone. In Germany, activity should be level in Q2 (+0.0%) but then return to a certain dynamism (+0.3% per quarter), buoyed up by household consumption and the upturn in Asian demand. German demand should buoy up Spanish and Italian exports, but domestic demand in these countries should continue to fall and the slide in activity should carry on for the rest of the year.

In France, activity set to be sluggish in 2012

In France, activity was stable in Q1 2012

In France like in the rest of the Eurozone, activity was stable in Q1 2012 (+0.0% after +0.1% in Q4 2011). Activity in services increased (+0.4% after +0.1%) but manufacturing output (-0.8% after +0.3%) and trade activity (-0.4% after +0.5%) fell. The cold temperatures in February boosted expenditure on heating, causing energy production to progress strongly over the quarter (+2.1% after -1.6%). On the other hand, the cold weather held back activity in construction (-0.2% after +0.4%).

Investment has fallen back

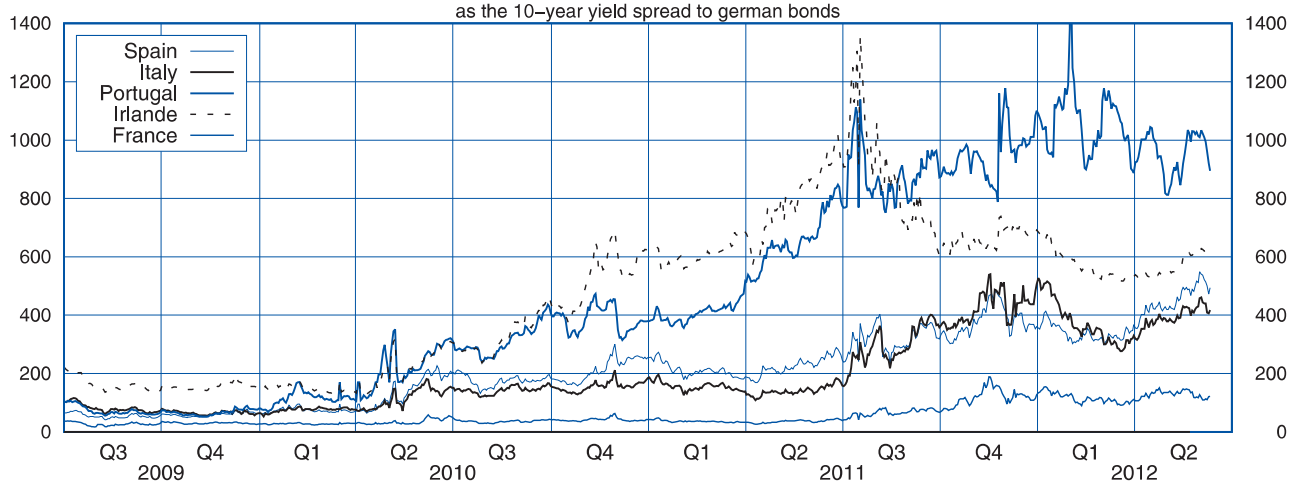
Investment by non-financial enterprises fell back sharply in Q1 2012 (-1.4% after +1.9%). With weak prospects for activity and tighter credit terms at the start of the year, the environment remained unfavourable for investment. Investment was also hit by one-off factors: the wave of cold weather in February restricted activity in construction and automobile purchases suffered a backlash after their great dynamism at the end of 2011, as businesses brought their purchases forward before the expected tightening of fiscal terms on 1st January 2012.

Consumption progressed modestly

Household consumption progressed at a moderate rate (+0.2% after +0.1%), buoyed by very high energy expenditure in February. Consumption of manufactured goods fell back (-0.5% after +0.4%) however, due notably to the fall in automobile consumption.

2 - Rise in tensions on the european sovereign debt

as the 10-year yield spread to german bonds



Source: DataInsight

Business tendency surveys showing a clear fall in May...

In services and in industry, the business climate as shown in the business tendency surveys deteriorated in May 2012. After the improvement in March and April, it returned to a level close to that in February (see Graph 3). In manufacturing industry, the business leaders' opinions of their overall order books and the general outlook for their sector took a marked downturn in May. Likewise, in services, opinions on activity forecasts remained well below their long-term average and their expectations of demand remained low.

...suggesting slow activity in 2012

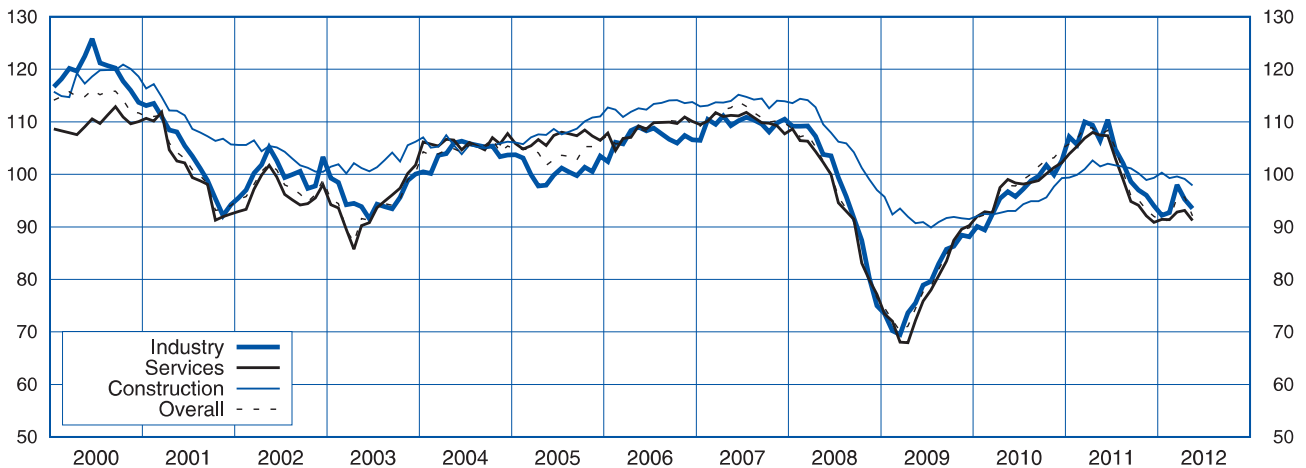
Activity should therefore remain slow in France through to the end of 2012. It should be stable in Q2 2012 (0.0%), then progress slightly in H2 (+0.1% in Q3 and +0.2% in Q4). Over the whole of the year, activity should progress by 0.4%. Manufacturing output should fall back again in Q2 2012 (-0.2%), before rebounding slightly in H2 2012 (+0.2% then + 0.3%) and production in services should grow weakly through to the end of 2012.

Marked fall in inflation through to the end of 2012

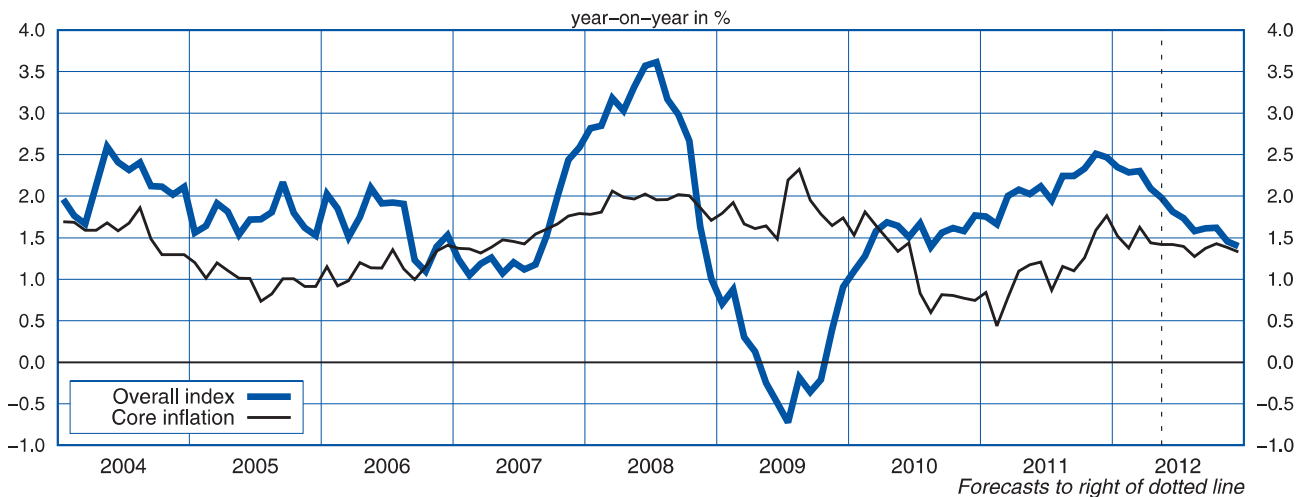
Energy inflation set to fall sharply

The high level of unemployment and limited utilisation rate of production capacities are keeping inflationary pressures down. Core inflation should thus remain below 1.5% in H1 2012 (1.3% in December). Headline inflation, meanwhile, should fall clearly: it should stand at 1.4% in December 2012, after standing at 2.1% in April (see Graph 4). Thanks to the sharp fall in Brent oil prices

3 - The business climate in France is sluggish



4 - Marked fall in inflation



in Q2, and on the assumption that they level out at \$100 through to the end of 2012, energy inflation should fall sharply to stand at +1.7% in December 2012 after +5.3% in April 2012.

Labour market situation likely to worsen

Market-sector employment should fall back in 2012

After falling markedly for two quarters at the end of 2011, employment in the non-agricultural market sectors rose in Q1 2012 (+18,000). But faced with weak activity, the fall in employment should resume in Q2 2012 then intensify in H2. Over the year as a whole, the non-agricultural non-market sectors should lose 25,000 jobs. The fall in employment should remain limited given the weak level of growth in 2012.

The unemployment rate should rise in 2012

The unemployment rate stood at 10.0% (9.6% in Metropolitan France) of the working population in Q1 2011. It should increase to 10.3% by the end of 2012 (9.9% in Metropolitan France).

Sluggish household consumption

Real wages should progress slowly in 2012...

Over the year as a whole, nominal wages should progress by 2.5% and real wages by 0.5%, slightly more than in 2011. The deterioration of the labour market should continue to weigh down on wage negotiations and hold back wage increases. However, nominal wages should be buoyed up by the gradual adjustment of remunerations to high inflation in 2011. In addition to this, employees on the minimum wage should benefit from a stimulus on 1st July 2012, announced by the Government.

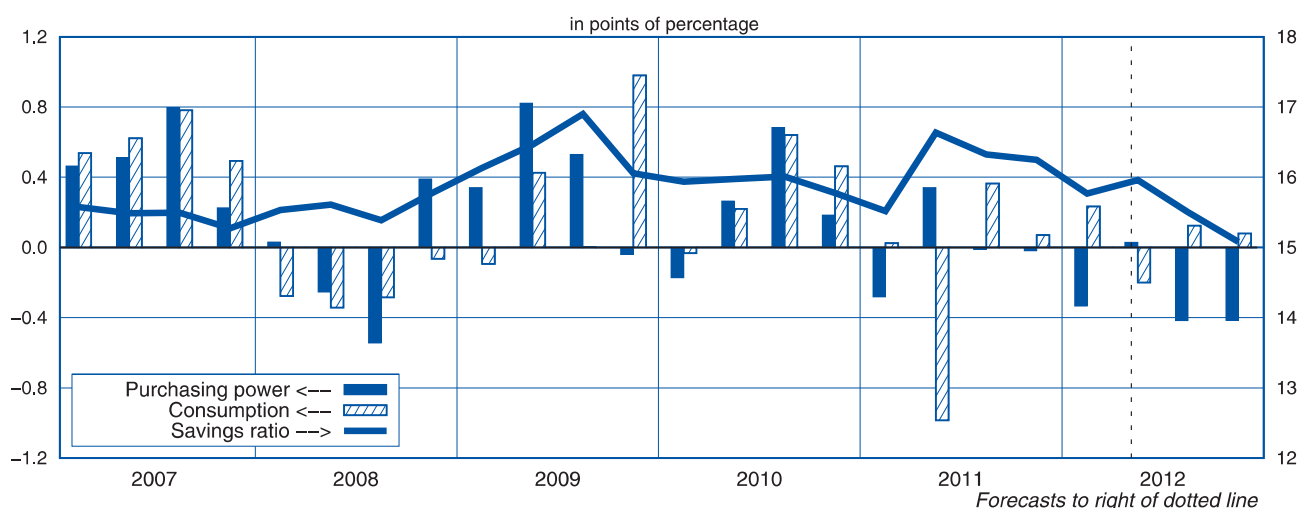
...but purchasing power should fall back

Household purchasing power slowed down in 2011 (+0.5% over the year after +0.9% in 2010) and this trend should continue in 2012: purchasing power should fall back by 0.4% in H1, then by 0.5% in H2. It should therefore be down 0.5% over the year. Purchasing power should benefit from the fall in inflation, but be penalised by the slowdown in earned income and by dynamic taxation driven by the measures passed in the Finance Act for 2012 and those announced by the government for H2.

The savings ratio should fall slightly

The household savings ratio stood at 16.2% in Q4 2011, a high level when compared with the average over the last twenty years. With worsening activity prospects, households have set aside precautionary savings since the beginning of the crisis in 2008 (see Graph 5 and "La consommation des ménages dans la crise", Note de conjoncture, June 2012). The new measures passed in the Finance Law are partly likely to affect income that usually goes into savings.

5 - Household savings and consumptions



Source: INSEE

Households are likely to soften the consequences of the fall in their purchasing power on their consumer spending by reducing their savings ratio: it should stand at an average of 15.6% over the year against 16.2% in 2011.

Household consumption sluggish

Household consumption should fall in Q2 2012 (-0.2%). Under the effect of below-normal temperatures, energy consumption progressed strongly in April and should therefore be up in Q2. In contrast, household consumption of manufactured goods should fall sharply. The data available through to April suggests a pronounced fall in automobile consumption and in the clothing-textile-leather sector over the quarter. In H2, the fall in the savings ratio should offset the decline in purchasing power, but household consumer spending should still only rise slightly (+0.1% per quarter).

Investment sluggish

Corporate investment set to be stable

The context should remain unfavourable for corporate investment through to the end of 2012: activity prospects are gloomy, the level of uncertainty remains high in the Eurozone and the margin ratio of businesses is at its lowest level in 25 years. Investment by non-financial enterprises should thus fall back slightly in Q1 2012 (-0.1%), then be stable in H2 (+0.0% per quarter). Investment in construction should bounce back in Q2 to catch up on the activity lost in February due to the cold weather. Once that effect is over, it should be stable in H2. Investment in manufactured goods should fall back all year long.

Household investment no longer progressing

After brightening considerably in mid-2011, household investment stalled from Q4 2011. The recent trend in housing starts suggests that it is likely to fall in each of the quarters in the forecast.

Exports should accelerate in H2

Fall in the Euro and acceleration in world trade

In Q2 2012, world trade is set to be sluggish and French exports are likely to suffer from the fall in demand from the Eurozone. They should therefore progress only slightly (+0.3%). Exports should then accelerate slightly in H2 (+0.8% in Q3 then +0.9% in Q4). On the one hand, world trade should become more dynamic, due to stronger demand from emerging countries. On the other, French exports should profit from the recent fall in the value of the Euro. The contribution of foreign trade to growth, which was slightly negative in Q2 2012, should become neutral through to the time horizon of the forecast.

Uncertainties: Financial tensions, oil prices, household savings behaviour

Financial tensions in the Eurozone

Financial tensions in the Eurozone have flared up again since April 2012, due to political instability in Greece and renewed worries as to the financial stability of several countries. If this trend should become stronger, it could weaken activity in Europe even further. Conversely, the implementation of measures likely to reassure financial markets as to the financial stability of the Eurozone could lead to a stronger upturn in activity.

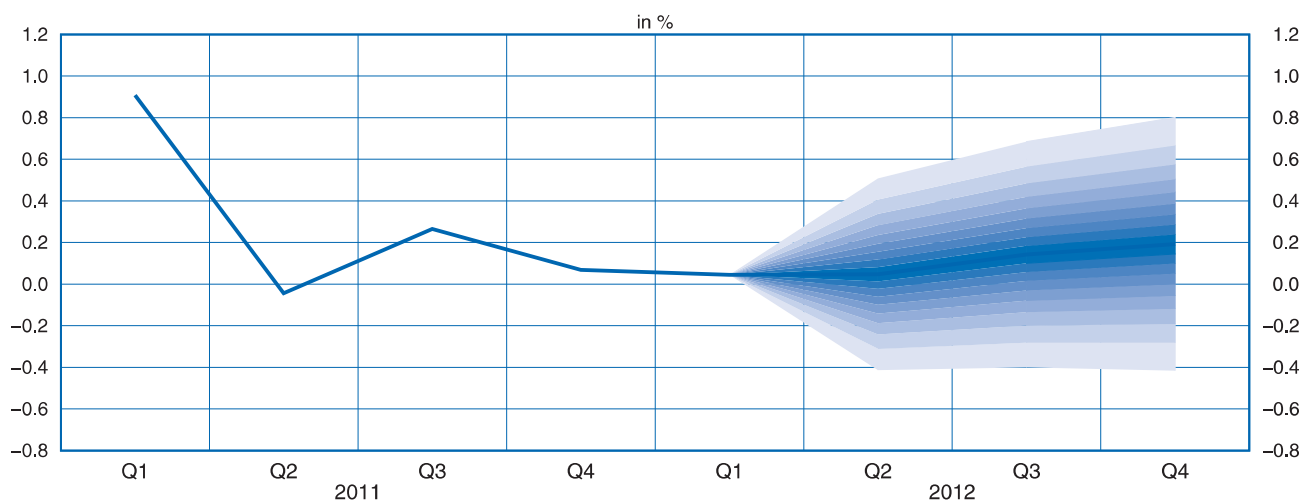
Oil prices

The price of oil has fallen back considerably since its peak in March 2012. It does still remain at a high level, however, despite the large surplus on the physical market and poor activity prospects, especially in Europe. A further fall in the price of oil to significantly lower levels than the assumption taken here (\$100) would boost growth in the developed countries and in France.

Household savings behaviour

Since 2008, the household savings ratio has increased: with weaker prospects for activity and the rise in unemployment, households have set savings aside as a precaution. The forecast is based on the hypothesis that households are likely to reduce their savings ratio to soften the impact of the fall in purchasing power on their spending. If the savings ratio should stay at the same level as at the end of 2011, then household expenditure and therefore activity in France would be weakened. ■

6 - Fan chart for *Conjoncture* in France



How to read it: the fan chart plots 90% of the likely scenarios around the baseline forecast (blue line). The first and darkest band covers the likeliest scenarios around the baseline, which have a combined probability of 10%. The second band, which is a shade lighter, comprises two sub-bands just above and just below the central band. It contains the next most likely scenarios, raising the total probability of the first two bands to 20%. We can repeat the process, moving from the centre outwards and from the darkest band to the lightest, up to a 90% probability (see *INSEE Conjoncture in France* for June 2008, pages 15 to 18). It can therefore be estimated that the first result published by the quarterly accounts for Q2 2012 has a 50% chance of being between -0.1% (lower limit of the fifth band from the bottom) and +0.2% (upper limit of the fifth band from the top). Likewise, it has a 90% chance of being between -0.4% and +0.5%. In Q3 and Q4 2012, the 90% confidence intervals is [-0.4% ; +0.7%] and [-0.4% ; +0.8%].

Source: INSEE

Key figures: France and its international environment

seasonally adjusted / working-day adjusted data (except for prices), quarterly or annual averages, as a %

	2010				2011				2012				2010	2011	2012
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
International environment															
Advanced economy GDP	0.8	1.0	0.6	0.3	0.0	0.1	0.6	0.2	0.3	0.2	0.4	0.4	2.8	1.3	1.3
Eurozone GDP	0.5	0.9	0.4	0.3	0.7	0.1	0.1	-0.3	0.0	-0.2	0.0	0.1	1.9	1.5	-0.3
Barrel of Brent oil (in dollars)	76.3	78	77	87	105	118	113	109	118	111	100	100	80	111	107
Euro-dollar exchange rate	1.38	1.27	1.29	1.36	1.37	1.44	1.41	1.35	1.31	1.27	1.24	1.24	1.33	1.39	1.27
World demand for French products	3.6	4.5	1.7	2.2	1.7	0.5	0.9	-0.6	0.4	0.0	0.5	0.5	12.7	6.0	0.9
France - supply and use															
GDP															
Imports	1.6	3.7	3.5	-0.1	3.1	-0.6	0.4	-1.4	0.7	0.6	0.8	0.8	8.4	5.2	0.8
Household consumption	0.0	0.2	0.6	0.5	0.0	-1.0	0.4	0.1	0.2	-0.2	0.1	0.1	1.4	0.2	0.2
Public and NPISH consumption	0.3	0.4	0.2	0.0	0.0	0.0	0.2	0.2	0.5	0.4	0.3	0.3	1.9	0.3	1.2
Total GFCF	0.0	2.3	1.2	0.2	1.3	0.7	0.2	1.3	-0.8	0.1	0.0	-0.1	1.0	3.5	0.5
of which: NFEs	1.6	4.4	1.9	0.8	2.0	0.3	-0.5	1.9	-1.4	-0.1	0.0	0.0	5.9	5.1	-0.3
Households	0.6	0.9	1.9	0.5	0.0	1.3	1.2	0.3	-0.2	-0.1	-0.2	-0.2	-0.3	3.2	0.7
Exports	4.1	3.1	2.3	0.8	1.2	0.9	1.4	1.1	0.3	0.3	0.8	0.9	9.2	5.5	2.9
Contributions (in point)															
Domestic demand excluding change in inventories (**)	0.1	0.7	0.6	0.3	0.3	-0.4	0.3	0.3	0.1	0.0	0.1	0.1	1.5	0.9	0.5
Change in inventories (**)	-0.3	0.2	0.2	-0.1	1.2	0.0	-0.3	-1.0	0.1	0.1	0.0	0.0	0.0	0.8	-0.7
Net foreign trade	0.6	-0.2	-0.4	0.2	-0.6	0.4	0.2	0.7	-0.1	-0.1	0.0	0.0	0.0	0.0	0.6
France - situation of households															
Total employment	11	30	40	43	64	43	-45	0	34	1	-24	-12	124	61	-1
Non-agricultural market sector employment	2	25	36	40	64	49	-28	-8	18	-6	-20	-17	103	77	-25
Unemployment rate Metropolitan France	9.5	9.3	9.3	9.2	9.2	9.1	9.2	9.3	9.6	9.7	9.8	9.9	9.2	9.3	9.9
Unemployment rate France	9.9	9.7	9.7	9.6	9.6	9.5	9.6	9.8	10.0	10.1	10.2	10.3	9.6	9.8	10.3
Consumer price index (*)	1.6	1.5	1.6	1.8	2.0	2.1	2.2	2.5	2.3	1.8	1.6	1.4	1.5	2.1	1.9
Core inflation (*)	1.6	1.4	0.7	0.6	0.8	1.2	1.1	1.8	1.6	1.4	1.4	1.3	1.1	1.1	1.4
Household purchasing power	-0.2	0.3	0.7	0.2	-0.3	0.3	0.0	0.0	-0.3	0.0	-0.4	-0.4	0.9	0.5	-0.6

Forecast

(*) Year on year on the last month of the quarter

(**) Inventory changes include acquisitions net of sales of valuable

How to read it: The volumes are calculated at the previous year's chain-linked prices, seasonally and working-day adjusted, quarterly and annual averages, as a %

Source: INSEE