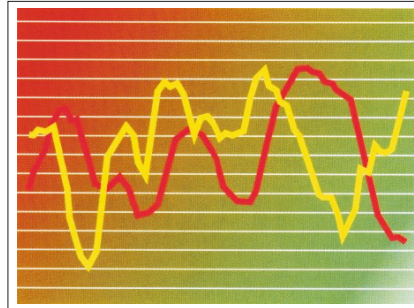


CONJONCTURE IN FRANCE



Growth stalls in euro zone

The world economy has been gradually losing momentum in the past year. The slowdown is largely due to three shocks: (1) the correction of the real-estate bubble has triggered a decline in household investment in many countries; (2) the steep rise in commodity prices until the summer has eroded household purchasing power; (3) the severe turmoil in the financial markets ignited by the subprime crisis is leading to tighter financing conditions, although these have not yet had a very visible effect on credit distribution.

The slowdown should persist in H2 2008. In our scenario, GDP in the largest advanced economies will edge up only 0.2% per quarter, compared with 0.3% in H1 2008 and over 0.5% in H2 2007.

In theory, the three shocks should have affected the United States more severely than its main partners. In practice, however, the U.S. has shown greater resilience—particularly thanks to the dollar's depreciation, which has given a strong impetus to trade in the past two years. After a 0.8% rise in Q2, GDP is forecast to stay on a growth path in H2, gaining 0.5% in Q3 and 0.2% in Q4.

In the euro zone, by contrast, activity weakened more sharply than expected in Q2. The GDP contraction recorded in that quarter should persist in Q3, followed by a stagnant Q4.

Similarly, our scenario does not see the French economy picking up in H2 (–0.1% per quarter). Average annual growth for 2008 is forecast at 0.9%. There are three major explanations for this.

First, French exports have been hit by the global slowdown and the effects of the euro's past appreciation.

Second, household investment is undercut by rising interest rates on mortgage loans and buyers' wait-and-see response to the sharp deceleration in housing prices.

Third, consumption is suffering from the decline in purchasing power. In H2, the worsening labor market and, more generally, the slowdown in earned-income growth should take over as the main causes from rising oil and food prices, which had cut purchasing power in H1.

French business investment should be hampered by softer demand and the easing of pressure on productive capacity already under way. However, investment was resilient in H1 and industrial firms were upbeat about their capital-spending plans in INSEE's July business survey. These signs raise hopes that the adjustment will remain moderate until year-end 2008.

We expect employment to keep adjusting to the economic downturn. Total employment should fall by 50,000 in H2 (reducing the full-year gain to 40,000) and the unemployment rate should edge up to 7.4% by end-2008.

The heavy uncertainty on the future of financial markets and financial institutions—especially in the U.S.—is clouding France's economic outlook. Over the forecasting horizon, the impact of rising uncertainty on GDP growth is more modest. This climate may, however, induce businesses to cut back investment expenditures more sharply than forecast. Conversely, if the decline in oil prices persists, it may strengthen consumption and economic activity.

The world economy slowed sharply in Q2 2008

The world economy continued to slow in H1 2008 (*chart 1*), particularly in Q2, which saw GDP decline 0.2% in the euro zone and 0.7% in Japan, and stagnate in the United Kingdom. The U.S. economy grew 0.8% in Q2, outperforming forecasts. This good performance, mainly due to foreign trade, was, however, accompanied by a sharp deterioration in the labor market.

Financial crisis deepens further

Real-estate markets are still in crisis but there are early signs of a return to normal in the U.S.

The real-estate crisis, now more than a year old, persists. In the U.K., prices have been shedding 5% per quarter and transaction volume is shrinking. In Spain, the building industry faces a severe slump, with massive unsold housing inventories and major players going bankrupt. Ireland's real-estate market is struggling as well. In France, the number of transactions is falling sharply. However, the U.S. market appears to be showing the first signs of a return to normal: the number of unsold homes has fallen substantially since March, and the decline in housing starts has eased.

However, the financial crisis is deepening

By contrast, the financial crisis triggered by the subprime mortgage crisis has worsened. The nationalization of Britain's Northern Rock bank in February was followed by the rescue of the investment bank Bear Sterns and the placing into conservatorship of the mortgage-refinancing entities Freddie Mac and Fannie Mae, whose combined commitments total \$5.2 trillion. The latest developments are the failure of Lehman Brothers and the bailout of AIG, America's largest insurance company. The crisis has also seen the failure of nine U.S. regional commercial banks such as Indymac. It has generated high volatility on stock markets and a general climate of distrust that prevents inter-bank markets from operating effectively, given the banks' strong reluctance to lend to one another.

Financing conditions are toughening

This loss of confidence in inter-bank markets has caused a flight toward government securities. Despite the central banks' massive liquidity injections, inter-bank market interest rates remain much higher than central-bank key rates. Rate spreads, i.e., risk premiums, have reached 70 basis points (bps) in the euro zone and 120 bps in the U.S. Conversely, yields on U.S. government securities, regarded as risk-free, fell sharply in September. This greater difficulty in obtaining bank finance affects loan distribution: financing conditions for businesses and households are set to tighten, although the consequences have not been very visible in credit statistics thus far.

Inflation still high everywhere but shows signs of easing

Worldwide increase in inflation in H1

Inflation is high in most countries. The main drivers have been food and oil prices, the latter climbing to a record \$147/barrel for Brent crude in early July. Also in July, inflation reached 4% in the euro zone, topped 4% in the U.K., and rose to over 5% in the U.S. Inflation surged in South-East Asia and China as well.

Oil prices, however, have eased significantly

Since July, oil prices have plunged. Brent crude briefly slipped below \$90/barrel in September. This easing is due both to an increase in Saudi Arabian capacity and expectations of slacker demand from OECD countries in the wake of their economic slowdown. However, we expect pressures to persist on the oil markets until end-2008, particularly with the winter increase in energy needs in the northern hemisphere. Oil prices are thus unlikely to post further decreases in Q4 2008, and should fluctuate around \$100/barrel until year-end.

Food prices are softening as well

After surging to record highs, food-commodity prices have eased sharply as well. Wheat and palm-oil prices have been nearly halved from their March 2008 levels, corn (maize) prices are down by over one-quarter since June, and rapeseed prices have lost one-third.

The likely effect: a substantial decline in inflation

This marked downturn in commodity prices is forecast to send inflation gradually lower by year-end, to just over 3% in the U.S. and just under 3% in the euro zone.

Further slowdown in global activity expected in H2

U.S. economy expected to slow sharply

After a surprising gain of 0.8% in Q2, U.S. GDP growth is projected to slow until end-2008, from 0.5% in Q3 to 0.2% in Q4. Investment will likely suffer from tighter financing conditions. The labor-market deterioration should dampen household consumption, which will also no longer be sustained by a tax rebate as in Q2. Exports—a strong engine of the economy in Q2—are expected to feel the effects of the global slowdown. By contrast, the U.S. real-estate market is showing early signs of improvement, and the collapse of household real-estate investment may be somewhat dampened. Our scenario puts average annual GDP growth in the U.S. at 2.0% in 2008, as in 2007.

U.K. domestic demand continues to weigh on economic activity

The U.K. economy has been strongly affected by the real-estate and financial crisis. Investment—both residential and non-residential—should stay on a downtrend. Household consumption is also forecast to decline in H2. By contrast, external trade should provide some stimulus to growth, thanks to the positive effects of the pound's past depreciation. Overall, our scenario calls for a mild decrease in Britain's GDP in H2.

A very brief rebound in Japan

After a severe contraction in Q2, Japan's economy is poised to rebound in Q3. However, beyond the quarterly volatility of GDP growth figures, the trend is slack and the economy is thus expected to stall in Q4.

China and emerging Asia slowing

The rest of Asia will likely suffer from the global slowdown, which should dampen exports and therefore erode business investment. Growth in China and the rest of emerging Asia should ease by year-end. This loss of momentum was already visible in Q2, when China's year-on-year GDP growth slipped to 10.1% from 12.6% twelve months earlier.

Euro-zone economy projected to contract in H2 2008

Euro-zone domestic demand has gone limp...

Our scenario sees euro-zone growth slowing from 2.6% in 2007 to 1.1% in 2008. Cramped by the global slowdown, external trade should provide only modest support—assuming a stable exchange rate of \$1.40 per euro. Weak household purchasing power, undercut by wage restraint and anemic job creation, will likely inhibit consumption. This slacker demand should keep business investment on a downward course. As a result, euro-zone GDP is expected to follow up its 0.2% contraction in Q2 with a further mild loss in H2.

...particularly in Germany

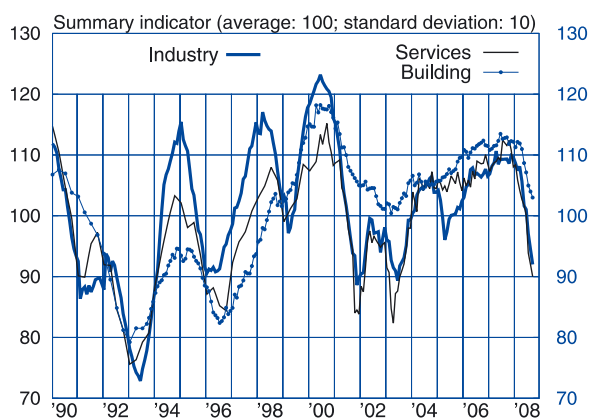
After its outstanding performance in Q1, the German economy retreated in Q2. The downturn is forecast to continue in H2. Under our scenario, exports will be undercut by limp foreign demand; slower growth in employment and wages will inhibit consumption, keeping it stagnant in H2; and investment will sink because of sagging demand and tougher financing conditions. Overall, thanks to the Q1

1 - Growth and Purchasing Managers' Index (PMI) in manufacturing industry



Sources: JP Morgan; national statistical institutes; IMF; INSEE estimates

2 - Business climate in France



Source: INSEE

upswing, the economy should grow 1.3% in 2008, compared with 2.6% in 2007. But German GDP is expected to begin 2009 with a negative statistical overhang of -0.3%.

No growth for Italy in 2008

After a GDP contraction in Q2, Italy is headed for a mild downturn in H2, as suggested by the weakness of business and consumer confidence. External trade will likely have a negative impact on GDP growth. Domestic demand should slip, as high inflation will erode purchasing power, causing consumption to fall. By contrast, the construction sector, which contributed to the Q2 decrease in GDP, should cease dragging down economic activity. We forecast zero average annual GDP growth.

Spanish economy a victim of the real-estate crisis

Spain's economy slowed sharply in the first half of 2008. GDP inched up 0.3% in Q1 and 0.1% in Q2. These figures reflect the steep fall in construction, which lost 0.4% in Q1 and 2.4% in Q2, and the severe slowdown in household consumption. Household purchasing power is being undermined by high inflation—averaging over 4.5% in January-August 2008—and job destruction in H1. The persistent effects of the real-estate crisis point to a GDP downturn in H2.

French exports hit by global trade slowdown

French exports likely to suffer from sluggish world demand

In this lackluster international environment, world demand for French products will probably register limp growth in Q3 and Q4—a modest 2% on an annualized basis—compared with gains of nearly 6% in 2007 and over 9% in 2006. Exports should also suffer from the residual effects of the euro's earlier appreciation. For all these reasons, we forecast that French exports will remain virtually stable in H2.

French imports equally slack

Weak domestic demand is likely to slow French imports in H2. Imports of manufactured goods, which already declined in Q2, are projected to slip 0.2% in Q3 and 0.1% in Q4.

Business investment marking time in H2

The slack economy is expected to weigh on business investment

After a further gain in Q1, French business investment fell sharply in Q2. In our scenario for the two quarters ahead, weak demand both at home and abroad, the likely fallback in production, and tighter financing conditions will restrain capital spending. Moreover, pressure on productive capacity has slackened considerably in recent quarters and the corporate investment ratio remains high. As a result, investment should decrease mildly in Q3 and Q4 2008. On an average annual basis, we project a modest 2.4% rise, down from 7.3% in 2007.

Continued decline in employment in H2

Total employment set to decrease despite stabilization of subsidized jobs

With the economy in slow motion, the labor market should post further job losses in Q3-Q4. After rising 89,000 in H1, total employment is forecast to decline by 52,000 in H2. This compares with gains of 175,000 per half-year in 2007. Non-farm market-sector employment is likely to shed slightly more than 100,000 jobs in H2. By contrast, the number of subsidized jobs, which fell in H1, should hold steady in the second half of the year.

Mild rise in unemployment

Despite the expected decrease in the active population in H2 2008, unemployment is forecast to edge up during the period. While ILO unemployment should reach 7.4% at year-end, that figure remains slightly below the end-2007 level.

Slack growth in real income likely to restrain French household consumption

Inflation on a downward path in H2

Real household income is expected to benefit from milder inflation. In our scenario, year-on-year inflation will post a sizable decline to 2.4% by December, thanks to falling oil and food prices. Average annual inflation should come to 3.0% in 2008. Core inflation ought to remain steady, at no more than 2% or so.

However, as in H1, household purchasing power is expected to weaken in H2

Despite these developments, real income is forecast to lose 0.4% in H2, as it did in H1. One of the main causes is likely to be the anemic labor market. Furthermore, new tax measures will provide a smaller boost in 2008 than in 2007. Purchasing power should record 0.7% average annual growth in 2008, but a 0.2% loss when measured in terms of consumption units.

Despite the dip in the saving ratio, consumption should remain stagnant in H2

Our scenario therefore expects household consumption to suffer from the continued decline in purchasing power. However, households will likely cushion this decrease by reducing their saving ratio from 15.7% of disposable income in Q2 to 15.4% in Q4, and consumption should hold steady in H2.

Housing investment expected to stay on a downward path

The combination of purchasing-power losses, tighter financing conditions, and difficulties in the real-estate market will probably result in a further decline in households' residential investment. This scenario is suggested by the sharp downtrend in the number of transactions, building permits, and housing starts.

Mild decline in French economic activity in H2

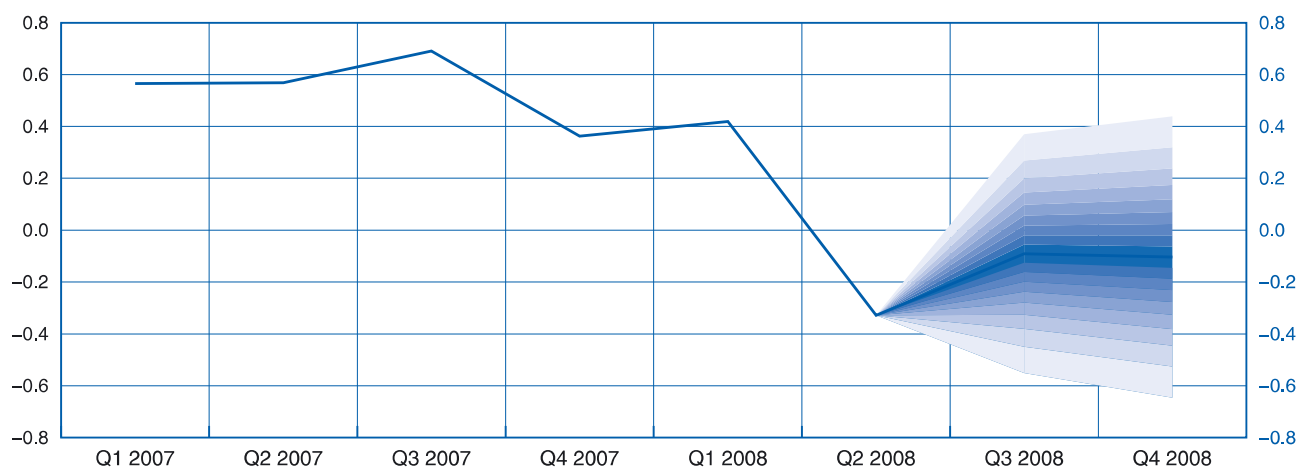
Industrial production should continue to decrease

We expect the main sectors of France's market economy to register lower activity in H2. In manufacturing, output fell sharply in Q2 and should continue to contract by 0.4% per quarter in H2. This forecast is based on the steep deterioration in the business surveys of industry (*chart 2*), despite the production rebound in July. The outlook is especially negative for the automotive sector, which faces a heavy decline in sales of new vehicles across Europe.

GDP set to grow only 0.9% in 2008

In our scenario, French GDP, after shedding 0.3% in Q2, will post a mild contraction of 0.1% per quarter in H2. Average annual growth should be a modest 0.9%. These figures assume that financial turmoil will not worsen and that households and businesses will not face an excessive tightening of banks' lending terms. Conversely, if oil prices continue to ease, French GDP growth may exceed our forecast. ■

3 - Fan chart for "Conjoncture in France" scenario



How to read this chart: the risk chart plots the set of most likely scenarios around the baseline forecast (black 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 out from the center to the exterior and from the darkest band to the lightest, up to a 90% probability. As the bands widen, they therefore cover an ever-larger range of possible outcomes.

We may therefore assume that the preliminary figure published in the quarterly accounts has a 50% chance of falling within -0.3% (lower boundary of fifth band from bottom) and +0.1% (upper boundary of fifth band from top) in Q3 and between just over -0.4% and +0.1% in Q4. Likewise, the preliminary figure has a 90% chance of falling within just over -0.6% and +0.4% in Q3 and between just over -0.7% and just over +0.4% in Q4.

For more details on the method, see "Conjoncture in France," June 2008, pp. 14-16.