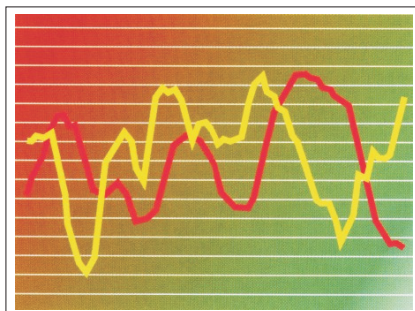


# CONJONCTURE IN FRANCE

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## The euro zone catching up

Activity at world level remained very brisk in the first half of the year, fostering a marked upturn in international trade. The euro zone, helped by a more favourable evolution in the currency, benefited to the full from this upturn, posting an annual growth rate of more than 3% for the half-year. Within this globally favourable situation, however, the United States economy was showing the initial signs of slowdown. The effects of the past tightening of monetary policy are in fact starting to be seen on the housing market, which has been declining substantially since Q2. American quarterly growth is therefore not expected to exceed 0.5% in H2.

This slowdown in the United States, combined with a loss of momentum on the part of certain emerging Asian economies, hit by past rises in energy prices, is having an adverse effect on world trade and consequently on the euro zone's external environment. Even so, growth in the zone is expected to remain solid (0.6% per quarter in H2) thanks to the persistence of robust domestic demand, driven by the need for renewal of the productive capital stock and temporarily towards the end of the year by an increase in German private consumption as a result of the bringing forward of purchases in anticipation of the VAT rise due on 1 January 2007.

In France, the favourable effects of the improvement in the international environment took concrete shape in the strong growth recorded in Q2, with industrial output finally taking off. The return to a more moderate evolution in activity in this sector is likely to mean less brilliant results in H2. However, with household demand showing no signs of losing momentum, being driven by purchasing power gains and a continuing decline in the saving ratio, and with continuing positive growth in corporate investment, France should be able to count on a growth base of 0.5% to 0.6% per quarter in H2 (2.3% for 2006 as a whole). This would enable the unemployment rate to continue to decline, reaching 8.6% in December.

The principal uncertainty in this forecast concerns the American economy, namely the risk - small but not entirely negligible - that the downturn in the housing market may lead to a harsh adjustment in household consumption. The euro zone seems capable of withstanding such an adjustment, given its low degree of trade openness to the United States, but there is no certainty about this capacity for resistance. Within the euro zone, by contrast, the renewed strength of domestic demand, if it were to trigger self-sustaining momentum, could permit firmer growth.

The French economy experienced a "mini-boom" in Q2 2006, with quarterly growth reaching 1.2%, a much higher rate than had been expected in the June "Conjuncture in France" report. This surprise came mainly from industry, benefiting fully and somewhat belatedly from the upturn in international trade and the ending of the appreciation of the euro seen since mid-2005.

### World trade less brisk in H2, notably because of the incipient United States slowdown

The world economy is still having to cope with high oil prices, but the virtually uninterrupted rise seen since 2003 may well have come to a halt. The Brent price fluctuated around 70 \$/barrel through into August, leading to a stabilisation of prices of petroleum derivatives. A more distinct easing of prices has been seen since mid-August, however. The forecast in this note is therefore based on a stabilisation of prices at around 65 \$/barrel on average in Q4. Non-energy commodity prices also seem to have peaked in recent months.

In any event, the energy price shock failed to stem an exceptional rise in international trade in the first half of 2006, leading to an equally remarkable rise in world industrial output. There were signs of imminent slowdown at the end of Q2, however. For the past eight months, the prospects for activity in manufacturing industry have stabilised at a relatively high level. However, the Purchasing Managers' Index for the services sector weakened continuously between April and July before stabilising in August. Growth in the leading industrial countries is therefore expected to show a slight slowdown in H2. After peaking in H1, the expansion of world trade is likely to level off gradually under the impact of the slowdown in activity expected in the industrialised zones, although world GDP growth is likely to remain close to 5%, year on year.

The general tightening of lending conditions, which continued almost everywhere in the world around the middle of the year, is now in fact acting as an appreciable brake on world expansion. In particular, the markets are expecting the European Central Bank and the Bank of England to carry out further hikes in key rates between now and the end of the year. This is the assumption adopted for the forecast in this note. In the United States, the time-out called by the Federal Reserve in August is likely to extend throughout this forecast's time-horizon. At the same time, the deterioration in the growth outlook can be expected to hold down long rates, meaning a continuation of the inversion of the interest-rate curve.

The impact of the monetary tightening is likely to be felt most strongly in the United States, through the rapid deterioration on the housing market it has produced since the Spring. In H2, United States growth is expected to weaken (quarterly rates of 0.5% and 0.4%, respectively, in Q3 and Q4). This would give an average of 3.3% for 2006 as a whole, compared with 3.2% in 2005. The tendency for household demand to ease that began in the Spring will probably continue, on the back of the fresh deterioration in the situation on the housing market - responsible for lopping 0.3 of a percentage point off growth in each quarter - and, to a smaller extent, the slowdown in job creation. The slowdown is likely to filter through to companies' investment decisions.

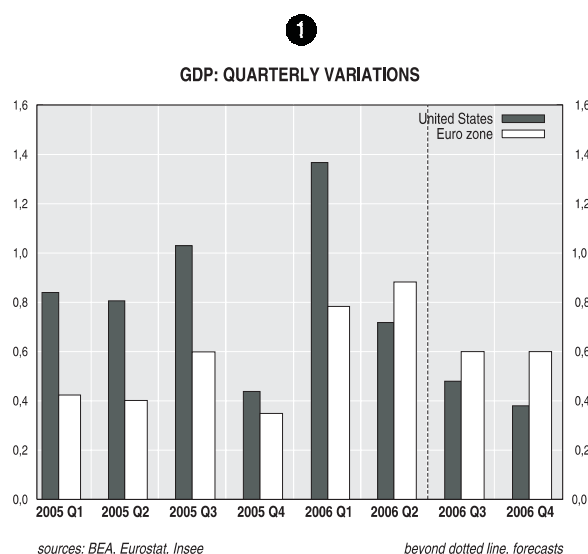
In the United Kingdom, the driving-forces underlying household demand should remain positively headed, with employment accelerating, wage growth being maintained and the housing market continuing its recovery. However, following a buoyant early part of the year, the GDP growth

rate is likely to level off somewhat in H2, to 0.6% per quarter (giving an annual average of 2.5% for 2006, compared with 1.9% in 2005). One reason for this is that household consumption is likely to be hit by the rise in inflation and in key interest rates, while the figures available for Q3 are pointing to a steep fall in UK exports (although the impact of this would be largely offset by a comparable decline in imports). At the same time, corporate investment is likely to suffer from this slowdown in sales.

Japan, meanwhile, should continue to benefit, as in H1, from lively domestic demand, testifying to the fact that the deflationary situation in which the country had been bogged down for almost eight years is now well and truly over. However, in several Asian countries such as Korea productive investment has posted a decline that can probably be linked both to the higher oil prices and to the past interest-rate hikes. The strength of Chinese growth, on the other hand, remains largely unimpaired, despite new cooling-off measures.

### In the euro zone, an upswing that is now based on domestic demand

The euro zone is expected to post growth similar to that of the United States (see Graph 1). Expectations of upturn found ample confirmation in the figure for Q2 (0.9%). However, the indications of a downturn provided by business surveys since July are already reflecting the levelling off in demand in the zone's export markets (for the purposes of the forecast, the dollar/euro rate is assumed to stabilise at 1.27). With less support from foreign trade than in H1, the European recovery is likely in H2 to be based on domestic demand, the result being GDP growth of 0.6% per quarter.



In Germany, the upturn in activity (highlighted especially by the upward revisions in growth estimates for the rest of the year) has mainly been thanks to buoyant output in industry, which benefited to the full from the expansion of exports, but also to the apparent final emergence of the long-awaited upturn in construction. In H2, it is households' anticipatory purchasing ahead of the rise in VAT that is likely to provide a temporary but appreciable boost to demand. Against a background of continuing slow wage growth, acceleration in employment is likely to give some small support to German households' purchasing power. At the same time, corporate investment is expected to go on accelerating, while construction is likely to con-

tinue its exit from crisis. As a result, Germany will probably post annual growth of 2.3%, the highest figure since 2000.

In Italy, too, figures for H1 2006 have confirmed the upturn that began at the end of 2005, but without any acceleration. The principal driving-force behind this recovery remains domestic demand, but there has also been a contribution from foreign trade. In H2, however, growth in activity is likely to level off slightly as the result of structural limitations (competitiveness and productivity weaknesses) from which the Italian economy continues to suffer, leaving it still lagging behind the rest of the euro zone: 1.7% annual growth in 2006, compared with 2.6% for the euro zone as a whole.

### Following the exceptional expansion seen in Q2, French industrial output is likely to return to a more moderate growth rate

French manufacturing exports rebounded strongly in H1 2006, reflecting exceptional growth in foreign trade in all countries. A new feature was that the market-share losses suffered by the French economy last year seem to have been halted, except in the automobile sector, where the erosion has continued.

The improvement in the capital goods sector (aircraft, in particular) has indisputably dominated all the other sectors, bringing the surge in manufacturing output in Q2 to 2.2%. However, the surge seems to have exceeded all the indications from business surveys, which have levelled off since June 2006, apparently heralding a return of industrial output to more moderate growth, with stagnation, at best, expected in Q3 followed by a rally of 0.5% in Q4.

This tendency seems to be explained mainly by the gradual slowdown in demand in French export markets, despite the German economy's regained solidity. Exports are expected to mark time, with growth of barely 1% in Q3 (although for the year as a whole growth in manufacturing exports is nevertheless expected to reach a record level of almost 11%). Moreover, there is confirmation of difficulties in certain sectors. The automobile sector is going through a bad patch, marked by stiff competition on the domestic market, and is progressively adjusting its production accordingly - not entirely smoothly, however.

In parallel, growth of manufacturing imports remains very brisk, being expected to reach 11.4% on an annual average basis. This rise in imports continues to be driven by price tendencies that are unfavourable to France and by the dynamism of certain items of household consumption.

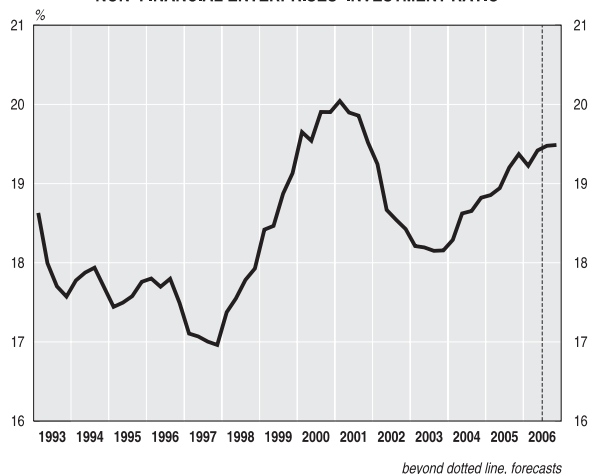
### Productive investment positively headed, accompanied by an upturn in public works

After seizing up temporarily at the very beginning of the year, corporate investment rebounded strongly in Q2, notably thanks to expenditure by firms on manufactured capital goods. At the same time, a partly exceptional acceleration in public works on the part of both general government and private firms has lent added strength to the overall upturn in investment.

In H2 2006, spending on capital equipment is likely to return to a more measured, but still solid, growth rate, leading to a further slowdown in the rise of the investment ratio (see Graph 2). The improved firmness of investment in construction and in public works is expected to be confirmed.

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NON-FINANCIAL ENTERPRISES' INVESTMENT RATIO



Even so, overall growth in investment remains slower than the rate normally seen during upswing phases, since total investment is expected to grow in 2006 at virtually the same rate as in 2005 (3.8%). This relative weakness can probably be attributed to the slackness of industrial activity in the period up to Q1.

### Led by employment in the market sector, job creation is expected to bring the unemployment rate to 8.6% in December 2006

Given the improvement in the economic situation, the further acceleration in private-sector employment seen in Q2 came as no surprise. Market-sector employment should continue to strengthen this year and the non-farm market sectors should create 169,000 jobs in 2006 as a whole (compared with 77,000 in 2005).

Following the 149,000 jobs created in the French economy as a whole in 2005, job creations this year should virtually double to 279,000. This rise would also partly stem from an acceleration in the non-market sector, where publicly-assisted employment is likely to increase slightly following last year's decline. Thanks to this recovery in numbers employed, the unemployment rate on the ILO definition is set to continue to decline (with a figure of 8.6% expected for the end of the year).

### An acceleration in household purchasing power, led by wages per head

The acceleration in the purchasing power of household gross disposable income (GDI) is expected to be based mainly on more rapid wage growth. Following a rise of 1.3% in 2005, growth in real GDI is expected to reach 2.3% in 2006, with real wages per head rising by 1.8%.

Evolutions in other components of real income should tend to give further support to its acceleration. These other components include, in particular, higher dividends and a marked recovery in the activity incomes of the self-employed.

Moreover, the year-on-year rise in the overall consumer price index is expected to fall back to 1.8% in December, with the pattern of inflation over time gradually reflecting the levelling off in energy prices. This moderation of in-

flation towards the end of the year would then tend to underpin the improvement in the purchasing power of GDI in H2.

However, the unexpectedly high levels of income and wealth taxes paid by households (a rise of 6.6% this year excluding the accounting effect of the abolition of the dividend tax credit, compared with 6.5% in 2005) are likely to reduce somewhat the growth in the purchasing power of gross disposable income.

### Household demand in the form of both consumption and investment remains the predominant driving-force behind French growth

The steady acceleration in household purchasing power is being reflected in consumption expenditure, whose solidity seems to strengthen with each quarter that passes.

Household expenditure on manufactures, in particular, is on an upward trend. Following rises of 1.1% and 1.5%, respectively, in Q1 and Q2, initial short-term indicators are pointing to a rise of 1.8% in Q3. Expenditure on services and energy is likely to continue to rise at a firm rate. Overall, household consumption is expected to rise by 0.8% in Q3 and 0.6% in Q4, giving annual growth of 2.9%. At the same time, housing investment is likely to show steady progress until the end of the year, with quarterly growth rates of 0.6%.

Taking the annual average, households will therefore probably have reduced their financial saving ratio substantially this year (by more than one percentage point, bringing it to a historically low level of 4.7%). This tendency is being reflected especially in the substantial rise in household borrowing.

### Output is being driven by distribution, construction and services, with industry somewhat less of an exception than before

Overall growth in French output set to accelerate to 2.6% this year from 1.1% in 2005.

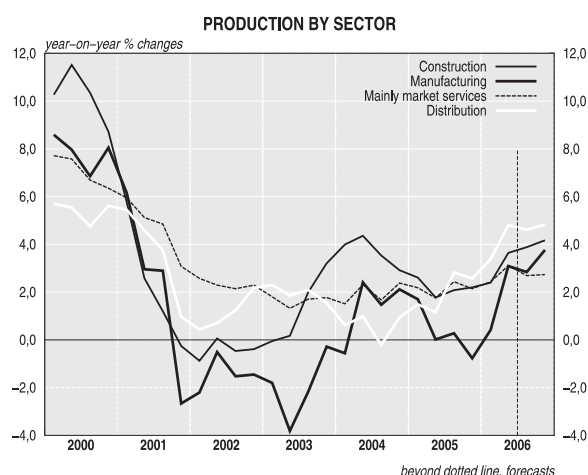
Whereas until now the industrial sector had been lagging behind the rest of the economy, the particularly sharp upturn posted in Q2 has brought it back more in line with the rest of the economy. French industrial growth is likely to be more modest in the final two quarters, however.

By contrast, activity in distribution, directly related to household consumption, is likely to continue to post quarterly growth rates of more than 1%, giving annual growth of 4.6%. Other market service sectors can also be expected to make progress as the result of the driving-force provided by consumption.

In construction, finally, the solid rate of increase is likely to remain firm until the end of the year. The upturns in social housing, non-residential construction and public works should further underpin the solidity of the branch.

In these circumstances, GDP growth is expected to come out at 0.6% in Q3 and 0.5% in Q4, giving growth of 2.3% for the year as a whole. ■

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Principal Editors: Éric Dubois, Karine Berger

Lay out: D. Michot, M. Diaz

Translated by: F. Wells

INSTITUT NATIONAL DE LA STATISTIQUE ET DES ÉTUDES ÉCONOMIQUES  
Headquarters: 18, boulevard Adolphe Pinard 75675 PARIS CEDEX 14 - FRANCE  
Publication manager: Jean-Michel Charpin