Overview

Like the three previous years, 2006 was an excellent vintage for the global economy and world trade. Despite a slacker performance in H2, world growth averaged 5.0% for the year, up from 4.5% in 2005. The gradual loss of vigor of the U.S. economy—faced with the real-estate market downturn—was cushioned by the pick-up in the euro zone and the persistence of robust growth in Asia. This convergence of growth rates was accompanied by major adjustments in the currency markets, with the dollar and yen depreciating against the euro and sterling. One of the end results was a milder rise in the U.S. trade deficit.

Once again, the global economy proved highly resilient to the rise in energy prices. The oil price surged in H1 by a one-year average of $10/barrel, versus a $16 increase in 2005. This did cause consumer prices to accelerate, but without degenerating into an inflationary spiral. In this "end of inflation" setting, the monetary tightening widely implemented around the world had only a modest, delayed influence on the real economy, all the more so as only a part of the rise in short-term interest rates was passed on to long-term rates.

The combination of an attractive cost of credit and stronger corporate financial positions fostered the accumulation of liquidity, boosting global investment. Firms redistributed a portion of their earnings to shareholders, while mergers and acquisitions proliferated. The most emblematic was unquestionably the alliance between Mittal Steel and Arcelor, whose completion in June illustrates the rising clout of emerging countries. By their capacity to raise substantial funds through borrowing, investment funds also demonstrated their new role as key M&A players.

After two years of limp growth, the euro zone returned to a more vigorous path in 2006, its expansion quickening from 1.4% to 2.7%. Whereas household consumption had been the main driver in 2005, momentum shifted toward other domestic-demand components. Productive investment accelerated in almost all euro-zone countries, while better job-market conditions stimulated private consumption. European exports rebounded sharply, spurred by Germany's outstanding performance. In the end, external trade made a positive contribution to growth.

Within the euro zone, performances converged. Spain remained the front-runner. Its gross domestic product (GDP) grew 3.9%, driven by a still buoyant construction industry. Germany rejoined the lead pack at 2.7%; more modestly, Italy—the euro-zone laggard in 2005—came up from behind to post a 1.9% gain. The surprise factor was the German recovery, fueled by productive investment and exports. The vitality of German exports persisted thanks to firm international demand and the effects of a competition strategy based on labor-cost restraint. In contrast, private consumption merely regained some color after four anemic years. The Italian rebound, on the other hand, was more focused on wage dynamics, but at the cost of a persistently weak competitiveness.

After slowing in 2005, French growth regained some vigor in 2006. H1 was very promising, but the economy then had to cope with a less buoyant international environment. Average GDP growth quickened from 1.7% in 2005 to 2.0% in 2006, slightly below the euro-zone average[1]. Domestic demand provided the strongest stimulus. Private consumption continued to show resilience, and households' appetite for real estate remained intact. This upturn in domestic components—but also in external demand—accelerated business investment.

External trade made a less negative contribution to French GDP growth in 2006 than in the two preceding years, at -0.4 points of GDP compared with -0.6 points in 2005 and -0.7 points in 2004. This was thanks to the recovery in exports, whose growth rate moved up from 2.8% to 5.5%. Exports were boosted by the revival of foreign demand, and particularly by the economic upswing in Germany. At the same time, the pick-up in domestic demand and further penetration by foreign products accelerated import growth from 5.0% to 6.8%. In the end, the nominal trade deficit in goods and services widened by €10.1 billion—of which €8.5 billion in higher energy costs—to €25.8 billion in 2006.

France's productive investment remained buoyant, gaining 4.1% compared with 2.7% in 2005, but with wide inter-sectoral disparities: building and civil-engineering investment rose while investment in manufactured goods decelerated. With the cost of credit barely higher than in 2005, firms borrowed massively to fund their projects. As a result, their investment rate converged toward its 2001 record level prior to the bursting of the technology bubble.

The economic upswing was accompanied by faster growth of 0.8% in the non-farm job market, whereas in 2004-2005 French firms had met demand with a near-constant workforce. Job creations were concentrated in construction, stimulated by the real-estate market, and the tertiary market, driven by business services. In manufacturing, job losses persisted but at a more moderate pace, with the notable exception of the automotive industry. Employment also rose in non-market branches notably thanks to subsidized jobs. The total French economy created an average 189,000 jobs in 2006, up from 112,000 in 2005. In market branches, more particularly in industry, productivity gains partly offset wage rises, and the erosion in the corporate margin ratio was halted.

The labor-market improvement led to a further easing of the unemployment rate, which—according to provisional estimates on National Employment Agency (ANPE) data[2]—reached 8.6% at year-end 2006, down from 9.5% one year earlier. While all age groups benefited, the decline was pronounced for the over-25s. This downtrend and the economic rebound quickened the growth of the average wage per capita, significantly boosting earned income.

French inflation continued to ebb in 2006, with average consumer-price growth dipping from 1.8% to 1.6%. This good result reflected a milder rise in oil prices after their 2005 spike. The oil-price flare-up, which had been nearly continuous since 2003, stopped in H2 2006. By December, the barrel price had returned to its January level of $60. Higher oil prices have not had the same inflationary consequences as the oil shocks of the 1970s. Not only are the world's economies less energy-hungry, but the sudden

1. The working-day adjustment adds 0.2 point to the acceleration, raising French growth for 2006 to 2.2%.
2. It was not possible to benchmark these estimates to the Labor-Force Survey results using the standard procedure.

appearance of large emerging countries on the international scene has also exerted a powerful deflationary effect through lower prices of manufactured imports. The calm on the energy front sufficed to offset the rise in core inflation.

With their real-income gains quickening from 1.7% to 2.3%, French households did not need to tap their savings in order to preserve their vigorous demand. Consumption expenditures rose 2.1% versus 2.2% in 2005. This continued robust performance was spurred by consumer electronics and, more generally, housing-related goods and services. Housing investment, still buoyed by a low cost of credit, rose 4.5% versus 6.2% in 2005. Amid the persistent rise in real-estate prices, housing loans stayed on an uptrend, sending household debt to 68% of disposable income.

Because of the economic upswing, the growth in French general-government revenues registered only a mild slowdown from 5.8% to 4.6%. Income and wealth taxes, VAT, and corporate income tax were among the faster-growing items. As a result, the total ratio of compulsory levies moved up 0.4 points from 43.8% to 44.2% of GDP in 2006. Social contributions benefited from the acceleration in total gross wages. By contrast, other revenue items contracted, as 2005 had been marked by the one-time payment of an €8.4-billion lump sum (*soulte*) by the public electricity and gas companies in exchange for the transfer of pension commitments to the general social-security system.

Meanwhile, public expenditures recorded moderate nominal growth of 3.8%, down from 4.4%. With revenues outpacing expenditures, French public finances continued to adjust in 2006. The public deficit under the Maastricht definition shrank by €5.3 billion to €45.5 billion, easing from 3.0% to 2.5% of GDP in 2006. Public debt reached €1,142.2 billion or 63.7% of GDP at end-2006, down from 66.2% in 2005. ■

World growth still strong

*Laurent Clavel**

In 2006, the world economy confirmed its strong resilience to high commodity prices. The price of Brent crude oil stayed on an uptrend, gaining an average $10/barrel in one year; metal prices rose steeply as well. These surges caused an acceleration in producer and consumer prices in most countries at the start of the year, but without triggering an inflationary spiral anywhere. Amid this "end of inflation" scenario, the monetary tightening widely implemented around the world had only a modest, delayed influence on the real economy, all the more so as only a part of the rise in short-term interest rates was transmitted to long-term rates.

In the United States, despite clear signs of slowdown during the year due to the real-estate crisis, economic activity remained robust: GDP growth quickened from 3.2% to 3.3%. In Japan, the recovery gained strength. Growth accelerated from 1.9% to 2.2% thanks to foreign trade, fueled by the dynamism of Japan's main Asian economic partners and the yen's depreciation. Late 2006, however, saw a revival of concerns about whether the exit from deflation would be long-lasting. Asia as a whole remained vibrant. In the end, the persistence of high commodity prices had only a minimal impact on its industrial sector. The United Kingdom turned in a very good performance as well. GDP growth accelerated from 1.4% to 2.7%, driven by the investment recovery and the new-found vigor of household consumption. A final highlight of 2006 was the strong rebound in the euro zone, where GDP growth picked up from 1.4% to 2.7%. The most notable gains were in Germany and Italy, which had performed weakly in 2005 *(figure 1)*.

1. GDP growth in main industrialized countries and emerging Asia (%)

PIB	2004	2005	2006
Leading industrialized countries	**3.0**	**2.4**	**2,9**
United States	3.9	3.2	3.3
Japan	2.7	1.9	2.2
United Kingdom	3.3	1.9	2.8
Euro zone	2.0	1.4	2.7
Germany	1.2	0.9	2.7
France	2.5	1.7	2.0
Italy	1.2	0.1	1.9
Spain	3.2	3.5	3.9
Emerging Asia	**8.6**	**8.5**	**8.9**
China	10.1	10.4	10.7
South Korea	4.7	4.0	5.0
Taiwan	6.1	4.1	4.6
Singapore	8.7	6.4	7.9
Thailand	6.2	4.5	5.0
Philipines	6.0	5.1	5.4
Indonesia	5.1	5.6	5.5
Malaysia	7.1	5.3	5.9

Sources: Eurostat; national sources.

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Overall, after a mild dip in 2005, world growth returned to its buoyant 2004 pace in 2006. Last year also witnessed the start of a growth convergence between the major industrialized regions: the U.S. was slowed by the real-estate crisis, whereas activity picked up in the euro zone, particularly thanks to a vibrant German economy. This rebalancing of growth rates led to a major adjustment in the currency markets: the dollar and yen depreciated, whereas the euro and sterling strengthened. The U.S. trade deficit thus continued to widen but at a somewhat slower pace.

A dampened oil shock and an "end of inflation" scenario

After rising nearly $25 between 2003 and 2005, the price of Brent crude gained another $10/barrel on average in 2006. By mid-year, when it topped $75, the real price[3] was nearly back to its level after the second oil shock of 1979. Yet, in the end, the world economy did not relive the trauma of the oil shocks of the 1970s. The inflationary impact of the latest oil shock was limited by the decrease in energy intensity (ratio of energy consumption to GDP) relative to previous oil shocks, by heightened competition, and by a greater credibility of monetary policies. The growing integration of the main emerging countries—most notably China and India—in world trade and the resulting decline in manufactured import prices continue to restrain inflation in the industrialized countries.

The lessening of physical tensions in the oil market sent the Brent price on a sharp downtrend in September 2006. The easing of geopolitical tensions (especially regarding Iran's oil production) and expectations of a U.S. economic slowdown also promoted the price decline. This initial slackening in commodity markets at year-end allowed producer and consumer prices to ebb. The phenomenon concerned all regions. In emerging Asia in particular, inflationary pressures sparked by the past surge in commodity prices now seem under control. Nearly all over the world, disinflationary forces have largely outweighed the direct impact of the oil shock. The fallback in real wages continued to exert downward pressure on inflation—most notably in Germany, where it dipped from 1.9% to 1.8% in 2006. Ultimately, the only true sign of the shock in the past year is the widening of oil-importing countries' external deficits.

In this "end of inflation" scenario, the monetary tightening widely implemented around the world had only a modest, delayed influence on the real economy, especially as the rise in short-term interest rates was only partly transmitted to long-term rates (the U.S. Federal Reserve [the "Fed"] raised the Fed Funds by a total of 100 basis points [bps] in 2006, while the European Central Bank lifted its key rate by 125 bps in one year).

U.S. growth still vibrant despite the real-estate crisis

The U.S. economy experienced a genuine slowdown in 2006. From Q2 on, annualized quarterly GDP growth dipped to an average 2.4%, compared with over 3.0% in 2005.

The main reason for this shift is the downturn in the real-estate market that began at end-2005. Residential investment slipped 4.2% in 2006, with the fall in housing starts (down 12.4% in 2006) closely following that of sales of new homes (off 18%) and

3. Nominal price deflated by consumer price index.

existing homes (down 7.7%). The build-up of large stocks of unsold properties led to a sharp decline in real-estate prices, particularly in H2 and after two years of robust gains. As a result, a certain number of households defaulted—notably those who had obtained variable-rate mortgage loans on highly undemanding terms. This caused the failure of some financial institutions specializing in the "subprime" market.

Consistently with its approach in 2005, the Fed started the year with further hikes in the Fed Funds rate, lifting it by a total 100 bps in H1 to 5.25% in June 2006. U.S. monetary policy then eased and key rates held steady until year-end, amid the economic slowdown but with persistent inflationary tensions.

Despite higher inflation and sagging real-estate prices, U.S. consumer spending continued to fuel growth, thanks to major gains in real gross disposable income (up 2.6% in 2006 compared with 1.2% in 2005) and a significant decline in the saving ratio. By year-end, household debt had risen to over 132% of gross disposable income.

Despite signs of slowdown during the year, the U.S. economy therefore remained robust: GDP growth averaged 3.3% in 2006, up from 3.2% in 2005. Because of slacker productivity gains, GDP growth created 2.27 million jobs, particularly in the service sector, and stabilized unemployment at a low 4.5% by year-end. (It is hard say today whether the productivity pattern is just a short-term phenomenon or is also partly due to a structural downturn.)

Although U.S. imports slowed somewhat, they remained vigorous, gaining 5.8% compared with 6.1% in 2005. Given their preponderance in the GDP mix, their dynamics eventually outweighed that of exports. Overall, despite the dollar's past depreciation, the external deficit widened again, topping $760 billion or 6.7% of GDP. Meanwhile, progress in cutting the public deficit of nearly $250 billion in fiscal 2006 was timid. As a result, the U.S. twin deficit persisted in 2006.

Recovery confirmed in Japan

In 2006, Japan stayed on a recovery path, with GDP growth moving up from 1.9% to 2.2%, albeit with a rather volatile sub-annual profile. As in recent years, the main stimulus came from external trade, driven by the vigor of Japan's leading Asian economic partners. Moreover, the yen's effective depreciation boosted export competitiveness. Export growth quickened from 6.9% to 9.6% in 2006. However, household-consumption growth slowed from 1.5% to 0.9% despite robust job creations (up 0.4%, as in 2005) and faster growth in the average wage per capita (up 1.1% from 0.5% in 2005) thanks to the conclusion of wage talks by industry (Shunto). Investment stayed on its previous year's uptrend, rising 7.7% in 2006 compared with 6.6% in 2005. Momentum was provided by the brisk rise in foreign demand, greater pressures on productive capacity, and—in more structural terms—the obsolescence of existing plant and equipment.

Yet the deflation risk has not entirely vanished. In December 2006, the overall price index was up 0.3% year-on-year; the core index, which excludes food and energy, was down 0.3%. This increase in consumer prices, like that of housing prices, warrants continued caution. The Bank of Japan (BOJ) nevertheless decided to break with the monetary policy prevailing since March 2001, which consisted in injecting massive liquidity into the banking system. On July 14, 2006, after the publication of favorable economic indicators, the BOJ raised the key rate. Public finances continued to adjust but at a slower pace. The public deficit remained high, at around 4.6% of GDP compared with 6% in 2005. Concomitantly, the public debt topped 176% of GDP.

Emerging Asia still booming

The Chinese economy posted another vibrant performance in 2006, its growth rate moving up from 10.4% to 10.7%. Domestic demand gradually replaced exports as the main engine. Inflation remained relatively subdued, at 2.8% in December versus 1.6% one year earlier. For the year as a whole, investment continued to grow at a very brisk pace among businesses and households, the latter taking advantage of easier credit access. This unbroken vigor helped to stoke tensions on commodity prices. The trade surplus eventually topped $177 billion, or roughly 6.7% of GDP, in 2006.

Although these figures are high by comparison with most OECD countries, China's economy slowed mildly at end-2006. Industrial production showed signs of losing momentum. At the same time, spending by Chinese firms on capital goods has slowed. Both phenomena may be due, among other reasons, to the Chinese government's measures to restrain industrial activity, avoid overinvestment, and so curb the economy's potential overheating. In particular, the monetary tightening implemented since end-2003 through the gradual lifting of required reserves from 7% to 9% has helped to slow the growth in bank lending. However, the monetary tool has a reduced impact on the real economy owing to the structure of investment financing: Chinese firms are funding an ever-greater share of their investment projects from equity.

The other emerging Asian countries took advantage of the healthy Chinese economy. Growth remained relatively strong in South Korea (5.0%), Taiwan (4.6%), and the ASEAN group (7.9% in Singapore, 5.0% in Thailand, 5.4% in the Philippines, 5.5% in Indonesia, and 5.9% in Malaysia).

Core inflation remained stable in these countries. Intervention by monetary authorities was thus very subdued. Indonesia and Thailand, however, found themselves in distinctive situations. Both countries have a higher energy intensity than their partners; they had to cope with a steep rise in consumer prices in 2005 and early 2006 owing to their governments' gradual disengagement from oil-crisis management. Key-rate hikes in both countries resulted in a significant decrease in core inflation in H2 2006, from 9.7% in August to 6.0% in December in Indonesia, and from 2.7% in June to 1.5% in December in Thailand. The central banks of both countries were then able to ease their monetary policy by cutting key rates—from 12.75% in April to 9.75% in December 2006 for Indonesia.

Most countries in the region posted a budget surplus in 2006 as in 2005. The aggregate budget surplus for the emerging Asian economies came to 1.2% of GDP.

British economy driven by the real-estate market upturn

The U.K. economy performed very well in 2006, with GDP growth moving up from 1.9% to 2.8%. This rebound is attributable to the investment recovery and persistently brisk household consumption. With key rates held at an accommodative 4.5% from August 2005 to August 2006, the past effects of rate hikes were gradually erased, and the real-estate market stayed on the recovery track that it had been following since summer 2005. Housing investment accelerated, driven by the revival of expectations of higher prices and the persistence of low mortgage rates. These favorable financing conditions and vibrant household demand, as well as a buoyant international environment, put business investment on a very robust growth path in 2006, with increases ranging between 2.2% and 4.5% per quarter.

However, after easing in Q1 2006, inflation climbed during the year to 3.0% in December, one point above the Bank of England's target. This new price acceleration led to a monetary tightening, with rate hikes of 25 bps in August and again in November 2006. But their effect on the British economy was not perceptible in 2006 owing to transmission lags from monetary policy to the economy.

The year of German and European recovery

The year 2006 was marked by a strong acceleration of euro-zone GDP growth, evenly distributed between domestic and external demand. The upswing was particularly sharp in Germany and Italy, whose economies had performed very weakly in 2005. German growth quickened from 0.9% to 2.7%; Italian growth, from 0.1% to 1.9%. All other euro-zone countries experienced significant acceleration as well.
Construction investment enjoyed a powerful rebound, whereas equipment investment stagnated. The decisive event was clearly the end of the crisis in the German construction industry. However, the upturn in productive investment since the early 2000s remains slacker than in previous recoveries. The turnaround begun in 2003 stopped in 2006: after growing more moderately than in the recoveries of the 1980s and 1990s, equipment investment ceased to accelerate. The uncertainty on domestic and external demand trends in 2007 may thus have weighed on corporate investment decisions in H1 2006.

By comparison with other demand components, household consumption posted only a mild acceleration in 2006 under the impulse of Germany and Italy, whereas it generally slowed in the rest of the euro zone. While German and Italian consumption growth remains below the euro-zone average, the gaps narrowed in 2006. The job market registered further improvement in tandem with GDP growth, but the wage trend—still limp, notably because of Germany—continued to dampen the rise in households' earned income and purchasing power.

The slowdown in U.S. demand was gradually offset by the firming of demand from third countries (emerging Asia, oil-exporting countries) which traditionally make a smaller contribution to euro-zone export growth. However, the zone's good export performance is essentially due to Germany, which has regained its rank as the world's number-one exporter. By contrast, in the euro-zone's other leading countries, the external-trade contributions to growth were similar to those of previous years. The vibrancy of the German economy also entailed a sharp reduction in the country's public deficit in 2006. The deficit reached 1.7% of GDP, in line with the European Stability Pact criteria for the first time since 2002. German public debt held steady at 67.9% of GDP in 2006.

Like other regions, the euro zone suffered from the rise in industrial commodity prices in 2006. Inflation climbed to 2.5% between April and June 2006 before easing to 1.9% at year-end. The European Central Bank responded by repeatedly lifting key rates from 2.25% in January to 3.5% in December. This policy was also motivated by the sharp increase in the money supply and lending. The simultaneous rises in the euro exchange rate, notably against the dollar, and in real short- and long-term interest rates led to a tightening of monetary and financial conditions in 2006.

The French economy accelerates

*Laurent Gasnier**

After slowing to 1.7% in 2005, the French economy regained vitality in 2006. GDP grew 2.0%, or 2.2% after the working-day adjustment, which added 0.2 points [1]. The recovery was boosted in H1 by the global economic rebound, then continued at a milder pace as the external stimuli weakened. France's performance stands below the euro-zone average of 2.7%—and, specifically, below the average growth rate of Germany (also 2.7%), which has finally emerged from torpor.

Household demand remained the leading growth engine in France. The purchasing-power gains procured by higher earned income and asset income stimulated consumption, which rose 2.1% compared with 2.2% in 2005. Housing investment stayed on an uptrend, although at a more modest pace after a year of strong growth. Despite an increase in long-term interest rates, borrowing conditions remained attractive and housing loans expanded sharply, driving household debt to record levels.

External trade weighed less heavily on French GDP growth than in 2005, its negative contribution easing from -0.6 points to -0.4 points. Export growth quickened from 2.8% to 5.5%, spurred by resurgent foreign demand, and chiefly by the new-found vigor of the German economy. Unlike in 2004 and 2005, when French export price competitiveness worsened sharply, the euro's weak appreciation had little impact on the French competitive position. With the rise in the energy bill and the persistence of strong domestic demand, imports continued to grow briskly, gaining 6.8%. The trade deficit in goods and services widened from €15.7 billion to €25.8 billion.

Thanks to the brighter demand outlook, investment by non-financial enterprises and unincorporated enterprises accelerated from 2.7% to 4.1%. As a result, the investment rate came close to matching its 2000 cyclical peak, before the collapse of the technology bubble.

The employment turnaround begun in 2005 gathered strength in 2006. The average number of jobs created by the total French economy rose from 112,000 in 2005 to 189,000 in 2006. The job market, jump-started by the construction industry and services, was driven by the vigor of general economic activity. At the same time, the ramp-up of the Social Cohesion Plan stimulated the creation of subsidized jobs in the non-market sector. The pace of productivity gains broadly offset the faster growth in the average wage per capita, and the margin ratio of non-financial corporations stabilized.

The good inflation results of 2005 were confirmed in 2006, as the average rise in consumer prices eased from 1.8% to 1.6%. After a flare-up in H1, oil prices gradually receded, resulting in lower average annual energy-price growth than in 2005. Core inflation, by contrast, accelerated because of a surge in processed-food prices.

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Milder erosion of the external balance thanks to export rebound

The steady worsening of the trade balance in goods and services in the past four years—from a €26.5-billion surplus in 2002 to a €25.8-billion deficit in 2006—undoubtedly reveals a weakness in the French economy. This is not so much because of the higher energy bill, which nevertheless accounted for one-half of the shift, but to a continuous and comparable erosion of the trade balances in manufactured goods and in services. Import growth, which was on a par with that of France's main trading partners, does not appear to be the culprit. By contrast, since 2003, export growth (in real terms) has slipped behind that of the other euro-zone countries, particularly Germany. Despite the renewed vigor of its exports in 2006, France was unable to reverse the trend.

After a rather lackluster 2005, exports of goods and services accelerated briskly in 2006, notably in manufacturing and food. As imports did not slacken, the erosion of the external trade balance continued, but at a slower pace of €10.1 billion compared with €17.3 billion in 2005. In the end, however, external trade weighed less on GDP growth than in the two previous years, its negative contribution easing from -0.7 points in 2004 to -0.6 points in 2005 and -0.4 points in 2006.

The erosion of the trade balance was mainly due to the steep rise in the energy bill from €37.3 billion in 2005 to €45.8 billion in 2006. The surplus in services, which was running at over €18 billion in 2002, gradually melted away to €5.5 billion in 2005 and €2.6 billion in 2006. Thanks to the rebound in industrial sales, the manufacturing deficit registered a relatively mild increase from €3.3 billion to €4.4 billion. The revival in sales of agricultural and food products enabled France to rebuild its agrifoods trade surplus to a comfortable level of nearly €9 billion.

Export growth quickened from 2.8% to 5.5% in real terms, spurred by resurgent foreign demand. The main stimulus came from the euro-zone recovery, marked by the new-found vigor of the German economy. Sales to the euro zone, which absorb half of French exports, rose by a nominal 7% in 2006; sales to Germany were up 8.5%. Exports to emerging countries—which possess strong growth potential—were distinctly more buoyant, particularly to China (up 39%), as well as to the Near and Middle East (up 18%) and Russia (up 42%), which have reaped substantial oil revenues.

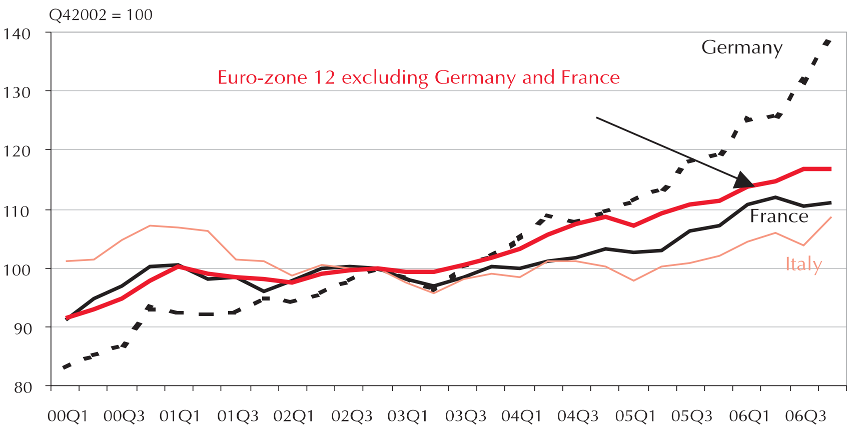
Import growth accelerated from 5.0% to 6.8% in real terms, a brisk pace largely reflecting the vigor of domestic demand. The erosion of import price competitiveness—that is, the fact that domestic producer prices have risen faster than import prices—also contributed to greater penetration by foreign products.

Export growth below that of the euro zone excluding Germany

In 2006, the euro-zone countries saw their exports take off thanks to the upturn in world trade. French exports of goods and services posted lower real growth than the euro-zone average excluding France and Germany, i.e., 6.5% including intra-zone trade. While slightly above the Italian figure, France's export growth again failed to match that of Germany (12.5%), which repeated its outstanding performance of the previous three years *(figure 2)*.

Since 2003, France's slippage has been particularly conspicuous with respect to

2. Euro-zone exports of goods and services (in real terms)



Sources: Eurostat; Newcronos

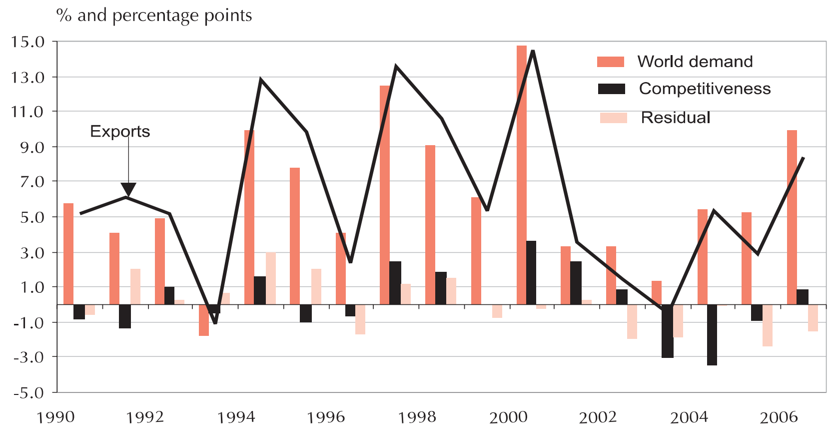
Germany, which in 2006 regained its former position as the world's leading exporter of goods and services, ahead of the U.S. and China. This German "supremacy" is hard to explain by traditional export determinants. Despite Germany's better positioning in the emerging markets, there is not much difference in world demand for French and German exports. Nor do the performance gaps between the two countries seem due to the erosion of the relative cost-competitiveness of French products, which has been preserved through substantial cuts in exporters' margins. Among other possible explanations, there is the "bazaar economy" thesis, which argues that Germany imports massive quantities of goods from low-cost countries to assemble them inside its borders for re-export. This mechanism does play a role, but a relatively limited one. More massive, by contrast, are the effects of a shift in German supply to external markets owing to the weakness of domestic demand.

Manufactured exports more buoyant except for automobiles

French manufactured exports, driven by capital goods and intermediate goods, rose 7.7% in real terms compared with 2.4% in 2005. They rebounded sharply in H1 before losing momentum in H2 as a result of the global economic slowdown. For 2006 as a whole, the revival in world demand for French exports was combined with an improvement in price competitiveness, but the latter was too weak to boost French exporters' market share *(figure 3).*

Sales of capital goods rose 14.3%, compared with 3.4% in 2005. Their surge was fueled by the resilience of global investment. They were boosted by a record level of aircraft shipments: the number of Airbus airliners delivered rose from 188 in 2005 to 256 in 2006, for a total value of €15.2 billion—a 15% increase. Growth in intermediate-goods exports jumped from 0.9% to 6.5%. By definition, these goods are used in the early stages of production processes, and their increase was in step with the revival of foreign industrial demand. Thanks to brisk consumption by European households, consumer-goods exports retained their previous year's momentum, gaining 8.1% compared with 7.7% in 2005. By contrast, the automotive industry faced persistent problems. Despite the recovery in spare-parts exports, car sales continued to decline, losing 0.9% compared with 1.3% in 2005. This result illustrates two phenomena: first, the lesser appeal of French brands, which have had difficulty renewing their models; second, the growing internationalization of French automakers, with the result that one in two vehicles produced by French automakers is now made abroad.

3. Contributions to change in manufactured exports (in real terms)



Source: INSEE, national accounts - 2000 base

After several years of strong moderation, manufactured export prices firmed slightly, rising 1.4% compared with 0.6% in 2005. Driven by the upswing in commodity prices, intermediate goods registered a price rise of 4.4%. Overall, manufactured exports moved up 9.1% in nominal terms.

Import growth similar to that of euro-zone countries excluding Germany

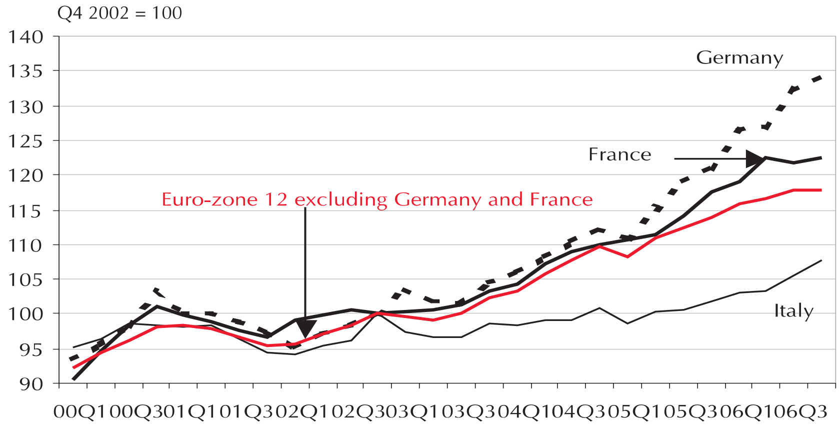
The greater buoyancy of domestic demand sent real growth in French imports of goods and services up from 5.0% in 2005 to 6.8% in 2006. The latter pace was comparable to that of the euro zone excluding Germany; in 2005, by contrast, France had greatly outpaced the latter group *(figure 4)*. The euro-zone average was driven up by the strong growth in German imports (11.1%). Germany's performance largely exceeded the scenario suggested by the domestic-demand curve: this reflects outsourcing mechanisms at the international level and the import content of German exports.

Italian import growth, which had been lagging the euro-zone average since 2003, rebounded to 4.3% but is having trouble hooking up to the European train. In Spain, imports continued to grow briskly, gaining 8.4% despite a slackening of domestic demand after outstanding performances in recent years. Outside the euro zone, imports jumped 11.8% in the U.K., where real income gains fueled household demand.

Strong acceleration of capital-goods and consumer-goods imports

Manufactured imports accelerated in real terms, from 5.9% in 2005 to 10.1% in 2006, mainly thanks to firmer domestic demand. The increase also reflected further losses of import price competitiveness, measured by the ratio of import prices to domestic-demand prices. Those losses contributed one percentage point to the rise in manufactured imports in 2006. Lastly, the vigor of imports was tied to the dynamism of exports, whose high import content attests to the active involvement of French businesses in globalization.

4. Euro-zone imports of goods and services (in real terms)



Source: Eurostat; Newcronos

The import expansion was chiefly due to the persistence of strong demand for capital goods, up 14.2% compared with 9.8% in 2005. The main stimulus was provided by aeronautical purchases from Germany (transfer of parts for Airbus production) and the U.S. (Boeing), as well as imports of producer durables and electrical and mechanical equipment. Household demand for consumer goods remained extremely vigorous, up 10.6% from 9.9% in 2005. Textile imports had been stimulated in 2005 by trade liberalization—which entailed the lifting of quotas—but in 2006 they stalled as a result of the adoption of mutually agreed limitations on certain sensitive categories of Chinese textile products. By contrast, households continued to show a preference for purchases of goods and services in the field of information and communication technologies, particularly consumer electronics such as plasma and flat-screen television sets, DVD recorders, GPS navigators, and portable video players (PVPs). Purchases of foreign automobiles—mainly from Germany and Japan—rose 5.2% compared with 3.8% in 2005. As a result, the percentage of imported vehicles registered in France reached 44.7%, up from 39.6% in 2000. The growth in intermediate-goods purchases quickened to 8.9% from 2.0% in 2005.

Despite a contraction in volume, energy imports rose sharply for the third consecutive year in nominal terms, gaining 20.1%. The easing of oil prices in H2 did not prevent an average annual increase of more than 20% in the price of energy purchases, compared with nearly 30% in 2005. As a result, the energy bill grew by a further €8.5 billion to €45.8 billion in 2006.

Further gains in manufacturing terms of trade

In 2006, the terms of trade for manufactured goods—i.e., the ratio of export prices to import prices—posted a further improvement, in line with the expected effects of the euro's appreciation. Faced with a rise in the euro's real effective exchange rate since end-2002 (apart from the 2005 interlude) and pressured by international competition, French exporters did raise their export prices but by a moderate 1.3%. At the same time, the euro price of manufacturing imports eased 0.7%.

Owing to slacker foreign demand for French cars, auto export prices fell for the second year in a row. Conversely, higher commodity prices and world tensions on productive capacity sent up prices of intermediate-goods exports. Meanwhile, import prices for consumer goods and capital goods fell 4% and 3% respectively.

Higher contribution of inventories to GDP growth, and an acceleration of investment

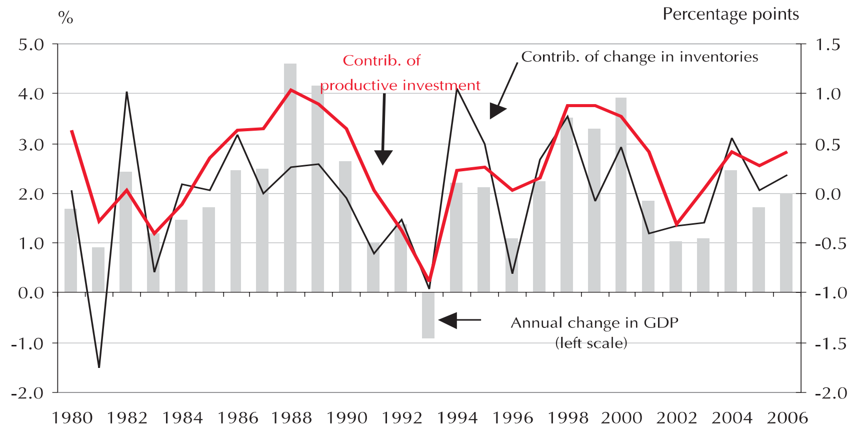
Inventory rebuilding

Changes in inventories, which had a neutral effect on GDP growth in 2005, made a modest positive contribution of 0.2 points in 2006.

Short-term inventory movements mainly reflect businesses' demand expectations. If firms foresee a lasting rise in demand for their products, they will have an incentive to build up inventories, while slacker demand is more likely to induce them to draw down inventories. However, when faced with an unexpected increase in demand, businesses may be forced to release their inventories—hence the value of building "buffer stocks" to smooth production. Other factors such as the firm's overheads, financial position, and warehousing costs can also play a role, but a smaller one.

This adjustment of inventories to expected demand has functioned rather well in France in recent years. Their fluctuations tended to accentuate business-cycle movements. Between 2001 and 2003, the economic slowdown was accompanied by massive inventory drawdowns, whereas the 2004 recovery coincided with inventory rebuilding *(figure 5)*. Changes in agricultural inventories intensified these swings. The summer

5. Contributions of change in inventories and of productive investment* to GDP growth



* Gross fixed capital formation (GFCF) of non-financial enterprises.
Source: INSEE, national accounts - 2000 base

2003 heatwave saw major inventory drawdowns, followed by inventory rebuilding on a comparable scale the following year. The 2005 drought triggered another large-scale inventory drawdown in agriculture, but this was offset by inventory rebuilding in manufacturing.

The 2006 pattern was consistent with the expected cyclical effects, as the acceleration in demand was met by an inventory build-up. The rise in manufactured-goods inventories was amplified despite drawdowns in the automotive industry, where producers preferred to tap their reserves rather than increase output. Energy inventories grew slightly. And the mild monetary tightening probably had little impact on the opportunity cost of warehousing.

Business investment accelerates

At end-2003, the economic upturn triggered a revival of investment by non-financial and unincorporated enterprises. The trend has gradually gained strength. In 2006, after a pause in Q1, investment accelerated. The main stimulus came from the upbeat demand outlook, notably in international markets, and to a lesser extent from the persistence of positive financing conditions. On an annual average basis, investment growth quickened from 2.7% in 2005 to 4.1% in 2006, in line with what standard determinants suggest.

This picture needs to be qualified, however, as the cycle was characterized by an unbalanced growth pattern combining a surge in construction investment with limp manufacturing investment. Capital spending on buildings and civil engineering was the main driver of gross fixed capital formation (GFCF) by non-financial enterprises in 2006. After a lackluster 1.0% increase in 2005, this category of investment expenditures rebounded 6.8% in 2006, thanks to government and private-sector demand. By contrast, investment in manufactured goods slowed, notably in the automotive and mechanical-engineering industries, despite a surge in purchases of electrical and electronic producer durables.

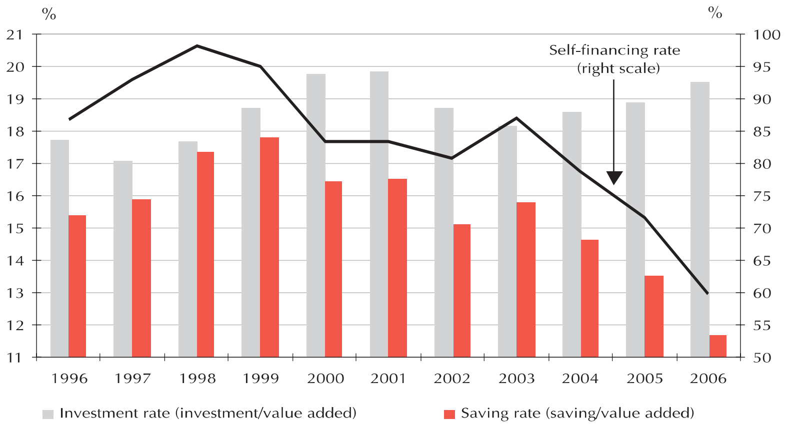
These good overall performances contributed to the rise in the investment rate (ratio of investment to value added) of non-financial corporations (NFCs). The indicator had peaked at 19.8% in 2001, prior to the bursting of the technology bubble. It had then lost momentum. In 2004, it started to climb back to a level close to its previous cyclical peak, reaching 19.5% in 2006. The investment figures would be even higher if research and development (R&D) expenditures were booked as GFCF and not as intermediate consumption, as is the case today. Yet the weak growth in French R&D spending in recent years—most notably by comparison with Japan and Germany—suggests that the investment effort has probably focused too little on the sectors capable of generating large productivity gains and sustainable growth in the long run.

Despite monetary tightening, financial conditions remained particularly attractive in 2006. Nominal medium- and long-term interest rates on business loans moved up by less than one point to 3.8%—a far cry from the 7% reached ten years earlier. As a result, and given their weak self-financing capacity, firms continued to finance their investment projects through borrowing. Loans by resident financial institutions to non-financial corporations stayed on an uptrend, and the corporate debt ratio posted a significant rise from 104.2% in 2005 to 106.5% in 2006.

The margin ratio of non-financial corporations, in decline since 2004, edged up from

30.3% to 30.7%, despite a growth in real compensation of employees close to that of labor productivity. This paradoxical result is the accounting consequence of the reform of the EU Common Agricultural Policy (CAP): by converting product subsidies into operating subsidies, the reform trimmed total non-financial enterprises' value added by 0.7 points. If this effect were neutralized, the margin ratio would be almost stable. In spite of the steady margin ratio and the acceleration in value added, the NFCs' saving ratio[4] continued to decline, moving from 13.5% to 11.7%. The reason is that the rise in the operating surplus was undermined by higher taxes (up 15%, excluding the impact of the elimination of the dividend tax credit [*avoir fiscal*]), interest expenses (rate hikes and debt growth), and dividend distributions as large as in 2005. For lack of savings and faced with heavier investment needs, NFCs saw their self-financing ratio decline for the

6. Financing of investment by non-financial corporations



Source: INSEE, national accounts - 2000 base

third consecutive year *(figure 6)*.

The recent performances of non-financial corporations measured here may come as a surprise when viewed against the highly publicized scores of French blue-chip companies included in the CAC40, the Paris stock-exchange benchmark index. One explanation is that the CAC40 corporations generate a large share of their sales abroad, whereas the national accounts confine their coverage to results of local business units operating in France. Moreover, these same corporations are the ones most heavily involved in external-growth transactions. Thanks to their higher self-financing ratios, but also their access to cheap liquidity, they have been engaged for the past two years in mergers and acquisitions that have largely contributed to the rise in outward direct investment.

Increased borrowing drives up interest expenses

The rise in interest payments by non-financial corporations jumped from 2.2% in 2005

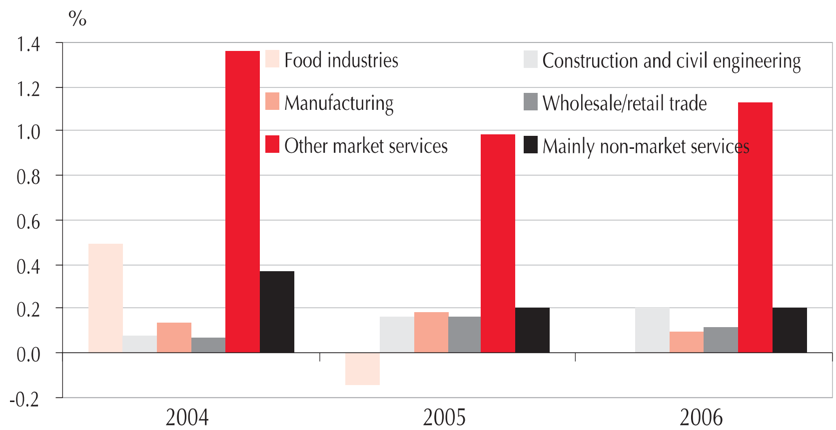
4. The saving ratio of non-financial corporations and unincorporated enterprises, which measures their gross savings against their value added, is a profit indicator. Its change may diverge from that of the margin ratio, for in order to "convert" gross operating surplus into saving, one needs to deduct such items as net interest payments, dividends, and corporate income tax.

to 10.7% in 2006. These consecutive annual increases break with the downward pattern observed in 2002-2004. While interest rates edged up, NFCs also borrowed more heavily. The share of interest payments in NFCs' gross operating surplus grew from 26.2% in 2005 to 27.7% in 2006. As the payments were not offset by a rise in interest received, the ratio of the net balance (interest paid minus interest received) to gross operating surplus moved up from 8.8% in 2005 to 9.9% in 2006.

Market services on a positive trend

In 2006, market services—which account for more than half of all-industry activity—remained the chief growth engine, with no shift toward manufacturing *(figure 7)*. Real value-added growth stayed at 1.4% in manufacturing but accelerated

7. Contribution by industry to growth in value added (in real terms)



Source: INSEE, national accounts - 2000 base

from 2.1% to 2.3% in mainly market services.

While French industry was fueled by solid domestic demand and brisk manufacturing exports, the negative performance of the automotive sector undermined the overall figure. The auto industry's difficulties persisted: its value added dropped 9.4% in real terms, compared with a 2.4% increase in 2005. On the domestic market, French automakers lost ground to foreign brands. Beyond the competitiveness losses, this weakening of French positions is due to obsolescent product lineups but also, at a more structural level, to the increasing transfer of production abroad. Nevertheless, the manufacturing sector was able to maintain a constant level of activity thanks to the brisk rebound in capital goods (up 6.1% compared with 2.2% in 2005)—particularly in the aeronautical industry—and a more modest expansion in intermediate goods. By contrast, activity in the consumer-goods sector slowed.

The "mainly market services" sector, which depends more heavily on the domestic market, was boosted by the upturn in real-estate activities and business services. In the past five years, business services have been the most dynamic component of market services, generating fully 40% of the sector's growth. Strong corporate and household demand for technology products explains the positive trend in telecommunications and

IT services. Personal services, meanwhile, were stagnant, edging up 0.6% compared with 2.5% in 2005.

Another fall in agricultural activity

The succession of major climatic events in recent years has led to abrupt drops in crop volume, not entirely offset by price rises. The summer 2003 heat wave, for example, caused a sharp decline in agricultural value added, followed by a rise in 2004. The 2005 drought triggered another steep fall in farming activity, with a loss of 5.8%. In 2006, output volume declined by a milder 2.2%. Values and prices have decreased as well, but these movements are artificial since they are due to the "decoupling" of CAP subsidies. If the latter are removed from the equation, agricultural output and prices effectively increased.

In the food industries, production growth quickened from 1.0% in 2005 to 2.3% in 2006 in real terms, with prices still trending down.

Construction industry spurred by recovery in public housing and non-residential real estate

The French construction industry (including civil engineering) posted 2.8% real growth, down slightly from 3.4% in 2005. Household and business investment provided the main stimulus. Housing starts broke a new record, rising by 421,000 units or 2.6%. This pace was slower than the previous year's 13.0%, because it is measured against very high initial levels. The increase was chiefly due to apartment housing, whose expansion reflects the succession of government measures to support this type of investment: loans to help public-housing tenants purchase or improve their dwellings (Prêts Locatifs à Usage Social: PLUSs), public land released for the construction of low-cost housing, and interest-free mortgage loans. In nominal terms, construction-sector value added grew by a very robust 14.1% in 2006, up from 8.6% in 2005.

The fall in central-government investment caused the growth in general-government construction investment to stall at 1.2%, down from 7.1% in 2005. By contrast, local-government investment, which accounts for over 80% of public investment, remained vigorous. This pattern matches the election cycle, the next round of elections being scheduled for 2008.

Residential investment by households, which includes maintenance and new-home purchases, posted 4.5% real growth in 2006, compared with 6.2% in 2005 and 3.4% in 2004. Amid a new acceleration in real-estate prices, household demand for new dwellings showed signs of weakening at year-end. Meanwhile, investment in buildings and civil engineering by non-financial enterprises rebounded sharply thanks to the positive trend in private-sector orders for offices and industrial buildings.

The mild slowdown in household demand, set against inadequate supply and a shortage of skilled labor, triggered a surge in prices of new dwellings. In the same period, prices of existing homes more than doubled, but their growth was slightly more subdued in 2006 at 9.6%, compared with over 15% in each of the two previous years. In the past eight years, residential real-estate prices have soared in the leading industrialized countries except Germany and Japan.

In France, financial conditions remained particularly attractive in 2006. The rise in key rates had only a modest impact on the cost of credit, which stayed low. This situation coincided with a set of positive factors including: tax incentives, easing of bank supply conditions through longer loan durations, and loosening of minimum down-payment requirements. As a result, housing loans continued to grow, gaining 15.0% compared with 14.8% in 2005. This surge drove up households' total debt, which is now approaching 68% of their disposable income (two-thirds of their debt is devoted to housing). However, this rate remains fairly moderate when measured against the euro-zone average of about 100% and the U.K.'s 150%.

Employment continues to recover

Between 2001 and 2003, France's economic downturn was accompanied by a slowdown in job creations. The 2004 recovery failed to provide an immediate jump-start. Firms initially responded to additional demand on a constant-workforce basis, preferring to achieve significant productivity gains first. The employment turnaround began in 2005 and was amplified in 2006. The total French economy created an average 189,000 jobs in 2006, up from 112,000 in 2005. These figures represent annual increases of 0.8% and 0.4% respectively. Employment in principally market sectors grew by 157,000 units and was driven by economic activity, whereas principally non-market services[5], which added 50,000 jobs, benefited from the ramp-up of the Social Cohesion Plan.

Payroll employment reached 23.1 million in Q4 2006, up from 22.9 million in Q4 2005. In the same period, the payroll workforce, expressed on a full-time-equivalent basis, posted weaker growth because of the rising number of part-time jobs. On an annual-average and full-time-equivalent basis, total employment rose by 80,000 or 0.3% in 2005 and by 181,000 or 0.7% in 2006.

This pick-up actually encompasses large-scale job creations and destructions: while 80% of persons in employment in a given year still hold the same job in the following year, the remaining 20% often experience several entries and exits during the same year, along with unemployment spells. These movements are due to domestic factors (change in the level and structure of demand, and technological change) and, to a lesser extent, international competition.

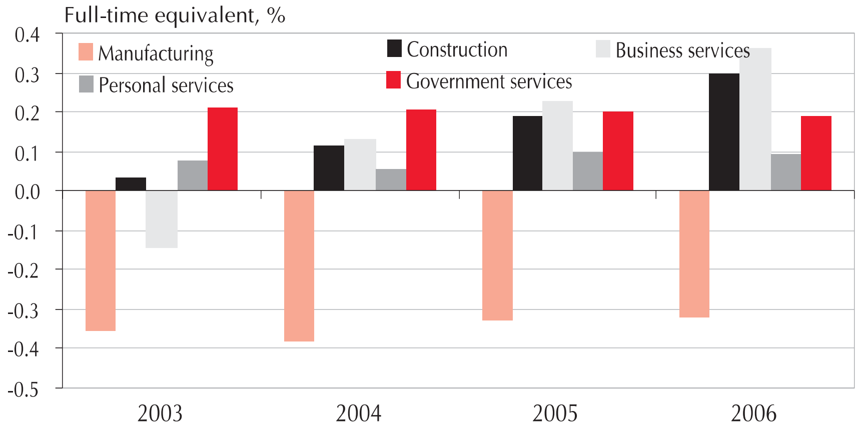
In 2006, the various official programs to support market-sector employment continued to produce positive effects. The strongest contributions to the growth in subsidized contracts in the market sector have come from (1) the new "Employment Initiative Contract" (Contrat Initiative Emploi: CIE), designed to enable persons in difficulty to return to long-term employment, and (2) contracts providing for alternate spells of classroom instruction and workplace experience (Contrats en Alternance, which include such programs as "Professionalization Contracts" [Contrats de Professionnalisation], "Apprenticeship Contracts" [Contrats d'Apprentissage], and "Skills-Acquisition Contracts" [Contrats de Qualification]). The "Professionalization Contract" aims to facilitate the school-to-work transition through the acquisition of occupational skills. It benefited from the provisions of the "New Hirings Contract"

5. Education, health, welfare, and administration.

(Contrat Nouvelles Embauches: CNE), which introduced greater flexibility by easing separation procedures in the first two years after hiring, in exchange for new guarantees for employees. The net effect of CNEs is, however, difficult to assess. Some may have been terminated. They may also replace other forms of employment. In the final analysis, a net addition of 5,000-15,000 jobs per quarter seems likely.

In 2006, creations of full-time payroll jobs were concentrated in the construction industry and services, while job losses in manufacturing slowed. In the construction industry—vitalized by the Social Cohesion Plan and the expanding real-estate sector—job growth accelerated from 2.5% to 4.0%. This represents a contribution of more than one-quarter of all jobs created in 2006 *(figure 8)*. Consistently with previous years, the tertiary market was responsible for the bulk of new hirings: job growth in the sector accelerated from 0.6% to 1.3% thanks to the positive trend in business services (up 2.3%) and greater reliance on temporary-agency labor[6]. Employment in personal services grew by a more moderate 0.9%. The manufacturing industry shed 2.4% of its workforce versus 2.9% in 2005.

8. Contribution by industry to change in total payroll employment



Source: INSEE, national accounts - 2000 base

Employment also rose in the principally non-market branches, gaining 0.6% on an annual average. Unlike the pattern since 2001, subsidized jobs contributed positively to job creation. In mid-2005, the government introduced a new set of contracts known as "Contracts for the Future" (Contrats d'Avenir: CAs) and "Employment Support Contracts" (Contrats d'Accompagnement en Emploi: CAEs) for persons with special difficulties in accessing the workplace, namely, recipients of basic welfare benefits (*minima sociaux*). Hirings under these new contracts replaced exits from previous contracts known as "Solidarity Employment Contracts" (Contrats Emploi Solidarité: CESs) and "Consolidated Employment Contracts" (Contrats Emploi Consolidé: CECs). By end-2006, 346,000 persons had been hired with CAEs, slightly more than the number forecast at the start of the year.

6. Temporary-agency work assignments are booked under operational services provided by the tertiary sector, not under the user activity sectors. "Temps" provided by agencies are most commonly employed in the automotive and construction industries, where they account for more than 9% of the workforce.

Productivity growth preserved

As usual in recovery phases, the lag in the adjustment of employment to economic activity enabled French firms to achieve productivity gains: in the non-farm market sector, gains totaled 1.6%—a figure close to the long-term trend—versus 1.8% in 2005 *(figure 9)*. This performance is, however, somewhat weak by comparison with the traditional productivity cycle *(figure 10)*. Typically, because of the workforce's lagged adjustment to output fluctuations, labor productivity tends to accelerate when the economy picks up; conversely, it decelerates in economic downswings.

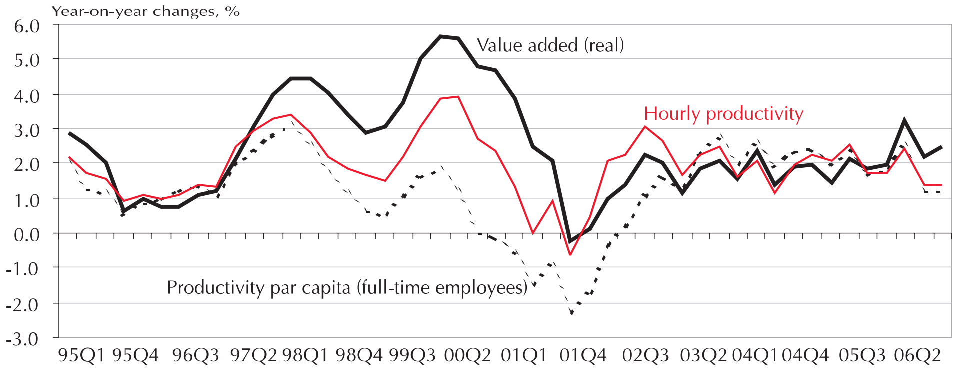
9. Wage per job, productivity, and unit labor cost

Annual changes, %

	2003	2004	2005	2006
Market branches				
Wage per job	2.5	4.1	3.3	3.4
Productivity per job[1]	1.4	2.8	1.8	1.6
Unit labor cost	1.3	1.1	1.4	1,6
Manufacturing				
Wage per job	1.8	4.6	1.1	3.6
Productivity per job[1]	4.0	3.7	4.4	4.5
Unit labor cost	-1.8	0.7	-2.5	-0.9
Other market branches				
Wage per job	2.7	4.0	3.9	3.4
Productivity per job[1]	0.8	2.5	1.3	1.0
Unit labor cost	2,2	1,2	2,3	2,2

1. Full-time equivalent jobs
Source: INSEE, national accounts - 2000 base

10. Productivity cycle in non-farm market sector



Source: INSEE, national accounts - 2000 base

Between 2000 and 2001, the activity slowdown had entailed a sharp decline in labor productivity, all the more pronounced as several factors were contributing in structural ways to raising the job content of economic growth: exemptions from social contributions on low wages, spread of part-time work, and the 35-hour work week. During this period, hourly labor productivity consistently outgrew productivity per capita. Owing to the spread of the shorter work week in 2002 and early 2003, and despite the recovery in value-added growth, productivity gaps persisted. Since then, the average work week has remained fairly stable at around 35.4 hours. As a result, the changes in hourly labor productivity and productivity per capita have become synchronous again.

Productivity gains in manufacturing are traditionally higher than those in the rest of the economy. Since 2000, their average growth has distinctly outpaced that of manufacturing value added. In 2006, the gains totaled 4.5% (up from 4.4% in 2005), a value approximately equal to their trend. Productivity gains were lower in the non-manufacturing market sector.

French hourly productivity is one of the highest in Europe, well above that of Germany and on a par with U.S. labor productivity. A significant reason for France's strong performance is the exclusion of low-skilled workers from the labor market. This finding on classifications in terms of productivity and living standards can, however, be qualified by applying more extensive concepts of wellbeing.

Compensation of employees: a dynamic pattern

The average wage per capita in the market sector grew at a relatively modest pace between 2001 and 2003 owing to the economic slowdown and the enactment of the shorter work week. In 2004, it firmed thanks to the economic upswing and the impact of adjustments in the minimum wage (Salaire Minimum Interprofessionnel de Croissance: SMIC). Despite encouraging results on the unemployment front and the convergence of minimum wages, the economic downturn in 2005 restrained pay raises. In 2006, the growth of the average wage per capita held steady at 3.4%. The continued decline in unemployment created more favorable conditions for employees in pay negotiations, while the economic rebound stimulated the award of bonuses and the use of overtime [7].

The minimum wage continued to fuel wage dynamics thanks to a 3.05% increase on July 1, 2006[8], which raised the monthly SMIC to €1,254.28. Its impact, however, was weaker than in the three previous years, during which the "Fillon Act" had led to average increases in the hourly minimum wage of 5.5% a year [3]. This system, introduced in 2003, called for the gradual convergence by 2005 of the SMIC and the various "monthly remuneration guarantees" (Garanties Mensuelles de Rémunération: GMRs) consecutive to the introduction of the 35-hour work week. Its total impact compared with the former mechanism is estimated at 0.2 points of average annual wage

7. The average wage per capita takes into account all forms of compensation of employees, particularly category-specific measures, individual promotion, and structural effects.
8. The SMIC is adjusted by decree on July 1 of every year on the basis of the rise in consumer prices excluding tobacco and the growth in the real basic hourly wage for manual workers. In some years, the government adds a "boost" (*coup de pouce*). In 2006, the first two effects accounted for 2.75 points of the increase, the government boost for 0.3 points.

growth between 2003 and 2005. The successive adjustments in minimum wages largely concerned the low end of the pay scale [4]. Owing to this knock-on effect, the monthly basic wage for manual workers rose faster than the average monthly basic wage in 2003-2005.

The acceleration in the average wage per capita helped to quicken the rise in market-sector unit labor costs[9] from 1.4% to 1.6% in 2006. In manufacturing, the wage per capita continued to grow at nearly the same pace as in the rest of the market sector. But, since 2003, the strong productivity gains due to workforce adjustments have caused a decline in manufacturing unit labor costs. Elsewhere in the market sector, productivity gains were more modest and unit labor costs grew faster.

After the large index-based adjustments in civil-service pay in 2005, the growth in the average wage per capita eased from 2.1% to 1.7% in 2006. The "index point" was adjusted by 0.5% in July, an additional point was granted to civil servants on November 1, and premiums were awarded to employees in categories A and B who had reached the top of their pay scale five years previously.

Further decline in the unemployment rate

The number of French unemployed fell in 2006 thanks to faster job-market growth, the ramp-up of the Social Cohesion Plan, and a fresh surge in business creations. The number of unemployed under the International Labor Office (ILO) definition, as provisionally estimated by INSEE from National Employment Agency (Agence Nationale Pour l'Emploi: ANPE) figures, fell from 2.62 million at end-2005 to 2.35 million at end-2006. The unemployment rate at end-December 2006 was estimated at 8.6% of the labor force, down from 9.5% at end-2005 and 10.0% at end-2004.

The decline in unemployment concerned all age groups. The unemployment rate among young people aged 15-24, which had risen sharply since 2001, began to ease in mid-2005. A larger proportion of this age group finds temporary employment: one in five young members of the labor force holds a non-permanent position, such as a contract with a temporary-work agency or a fixed-term job. In 2006, young people benefited from the economic upturn and emergency measures to stimulate employment such as hiring bonuses in ailing sectors, "New Hiring Contracts" (Contrats Nouvelles Embauches: CNEs), and personalized counseling at ANPE. The decline in the unemployment rate among the 25-49s, which began in early 2005, gained momentum in 2006.

The wave of retirements after long careers has been accompanied, since 2004, by a reduction in the number of unemployed aged 50+. The decline in this age group's unemployment rate quickened in 2006. This trend was also fueled by policies to help seniors return to the workplace. Official initiatives have taken two forms: on the labor-supply side, the 2003 pension reform to increase financial incentives to work beyond a certain age; on the demand side, incentives to make firms keep older workers, such as the creation of a fixed-term, 18-month contract renewable once, for the over-57s, an awareness campaign targeted at employers, and the gradual elimination of

9. Unit labor costs measure the ratio of labor costs (gross wages and remunerations + employers' social contributions) to real value added. Their growth rate can be approximated by the growth in the average wage per capita plus the social-contribution rate minus productivity growth.

the Delalande tax levied on firms that fire employees aged over 50.

The unemployment downturn is also due to the more moderate growth of the labor force by comparison with the high rates of the late 1990s. In the long run, population aging and the arrival of the first baby-boom cohorts at retirement age explain the weak growth in the number of economically active persons. In the short/medium term, economic conditions and public policies—notably with regard to pensions—generate fluctuations around such a deeply rooted trend. Since 2005, the decline in unemployment has thus incited more people to enter the labor market. Conversely, the increase in the number of beneficiaries of programs to promote withdrawal from economic activity (internships and early-retirement mechanisms [*préretraite* and *retraite anticipée*]) helped to reduce the labor force. One of the most successful measures allows early retirement before age 60 for "long-career" employees, i.e., persons who started working before 16 and have paid 42 years' pension contributions. These early exits from the labor force have not yet been offset by the effects of the 1993 and 2003 pension reforms designed to extend the working lives of older persons through an "extra contribution" system.

The notion that the decrease in the labor force (due to a reduction in the number of births and the acceleration of exits to retirement) is automatically accompanied by a decline in unemployment is, however, debatable. In the short run, this link seems to be corroborated by the accounting identity in which unemployment is equal to the labor force minus employment. Yet there is a fairly broad consensus that demographics are neutral with respect to long-term unemployment. Self-correction mechanisms, it is argued, return unemployment to its initial level. A smaller labor force means less domestic demand and therefore fewer jobs in the longer run. Similarly, the decline in unemployment due to slower labor-force growth can fuel wage and price rises, generating a feedback effect on labor demand and hence on unemployment [5 and 6].

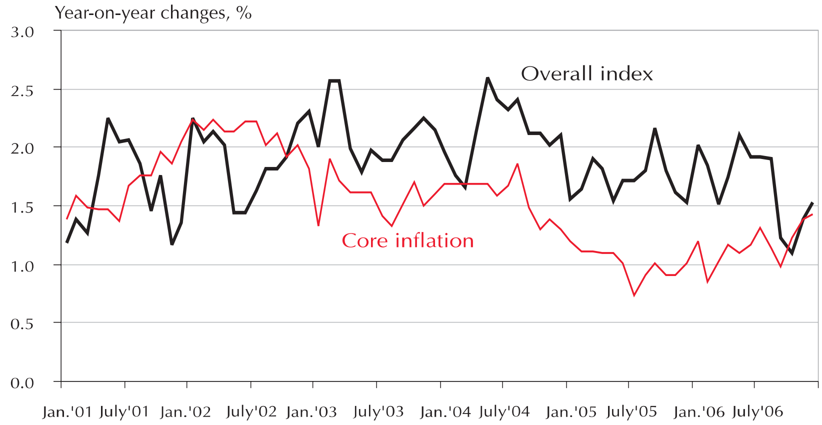
An oil shock without inflation

The French inflation downtrend begun in 2005 gained momentum in 2006, the average growth in consumer prices easing from 1.8% to 1.6%. Inflation rose in H1, driven by the surge in energy prices, peaking at 2.1% year-on-year in May before subsiding to 1.5% in December thanks to the sharp fallback in oil prices. The household consumption expenditure deflator, computed from the national accounts, accelerated slightly from 1.8% in 2005 to 1.9% in 2006.

The good inflation results are largely due to a milder increase in energy prices (6.5%) by comparison with the 2005 spike (10.1%). This moderation on the energy front offset the slight rise in core inflation[10] from 1.0% to 1.2%, due to the upswing in processed-food prices *(figure 11)*. The nearly unbroken climb in oil prices since 2003 stopped in H2 2006 thanks to a spate of good news, including the easing of geopolitical tensions, the relative abundance of U.S. inventories, and the restart of production in Prudhoe Bay (Alaska). As a result, by December 2006, the Brent barrel price was back to its January level of $60.

10. Excluding public-service tariffs and products with volatile prices, such as fresh produce, energy, and tobacco, adjusted for tax measures and seasonal variations.

11. Consumer prices



Source: INSEE

On an annual average, however, the barrel price gained more than $10 in 2006, an increase of nearly 20% in one year (compared with 42% in 2005). This represents a 270% rise since the 2001 trough. Yet the inflationary consequences of higher oil prices turned out to be rather mild. Not only is France's energy intensity (ratio of energy consumption to GDP) lower than in the past, but the sudden appearance of large emerging countries on the international scene has also exerted a powerful deflationary effect through lower prices of manufactured imports.

The increase in crude-oil prices was partly reflected in the "petroleum products" component of the consumer price index, whose growth slowed from 15.3% in 2005 to 6.8% in 2006. The component's contribution to overall inflation declined from 0.6 points to 0.3 points. The domestic tax on petroleum products (Taxe Intérieure sur les Produits Pétroliers: TIPP) dampens the impact of the decline in pre-tax prices of petroleum products on prices of products consumed by households such as gasoline, diesel oil, and domestic heating oil[11]. Faced with the rise in oil-product prices, households adjusted their consumption volume for the second year in a row. Much of the adjustment concerned gasoline expenditures, whose price elasticity has proved relatively high.

In 2006, service prices stayed on the rapid growth path they have followed since 2002, gaining 2.5% versus 2.6% in 2005. This persistent service-sector inflation reflects the dynamism of unit labor costs, with productivity gains too weak to offset vigorous wage rises. However, the overall pattern masks contrasting trends. Communication prices declined. Rent increases remained stable at 3.5% in 2006. And, after two years of moderate growth, healthcare prices moved up again because of adjustments in regulated fees for dental care and visits to general practitioners.

11. France levies two types of tax on petroleum products: VAT and the TIPP. Unlike VAT, the TIPP is assessed on physical volume, not on value, and this cushions the impact on prices at the pump. A considerable proportion of the tax-paid price is therefore insensitive to variations in the price of crude. It is in fact necessary to divide the variation in the pre-tax price by a factor of roughly four in order to obtain the estimated variation in the tax-paid price.

Prices of manufactured goods shed 0.3%, in line with their downtrend in recent years. The decline in healthcare-product prices gained momentum thanks to the growing use of generics and the consequent adjustment in prices of branded versions (princeps drugs). Heavy competition kept clothing and footwear prices stagnant, with a gain of only 0.2%.

The acceleration in food prices concerned both processed and unprocessed foods. The summer drought resulted in smaller harvests coinciding with rising demand. As a result, the growth in unprocessed-food prices quickened from 2.0% to 4.4%. Processed-food prices also firmed, posting 1.1% annual average growth after a 0.1% dip in 2005. The moderating effect of agreements between the government and mass retailers was offset by increases in producer prices in the food industry due to higher commodity prices. Between 1990 and 2003, processed-food prices had risen rather briskly owing to mass retailers' practices such as concentration and increases in "back margins" (*marges arrière*)[12], with the 1996 Galland Act, which tightened legal restrictions on selling below cost) [7]. A shift occurred in 2004 with the agreements between retailers and suppliers. This was followed by the August 2005 reform of the Galland Act, which encouraged retailers to continue their price-cutting efforts. In particular, the reform introduced a new method for determining the threshold for selling at a loss, with effect from 2006.

Household purchasing power strengthens

Purchasing power—a major concern for the French—occupied center-stage in 2006. The notion has very different meanings for the various economic players, particularly depending on their individual experience. In some ways, the debate crystallized dissatisfaction. Many households formed the impression that their purchasing power continued to weaken whereas, on balance, it rose in 2006. Beyond the statistical dispersion of individual profiles, a number of factors can explain this gap between the accounting measure of purchasing power and its perception by the general public. One is the belief—intensified by the switch to the euro—that prices rose faster than they actually did. Another is the fact that many households refer to a set of expenditures whose "mandatory" nature puts them outside the scope of ordinary consumption-allocation decisions.

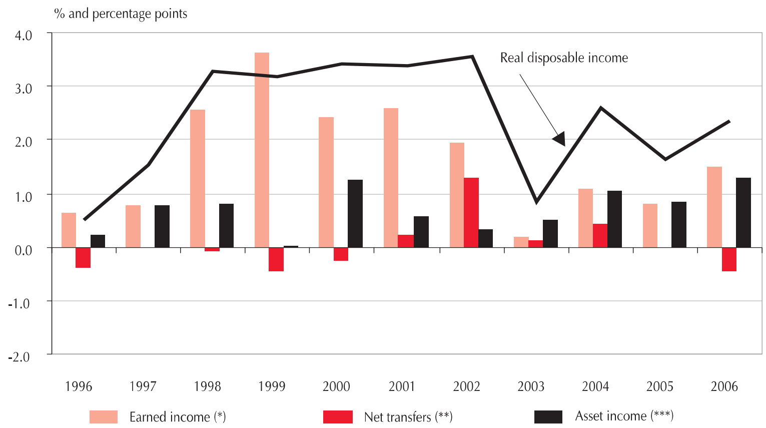
In 2006, households' gross disposable income (GDI)—i.e., their total available resources after taxes and social contributions—trended up. Driven by earned income, and with asset income still on a robust growth path, GDI gains accelerated from 3.5% to 4.3%. Meanwhile, the increase in the average price of consumption expenditures (i.e., the deflator) moved up from 1.8% to 1.9%. As a result, the growth in real disposable income (in other words, purchasing power) quickened from 1.7% to 2.3%.

This increase in household purchasing power, after a period of more erratic growth, brought its performance closer to the high rates of over 3% observed between 1998 and 2002 *(figure 12)*—a phase in which economic expansion drove up wage earnings. In 2002, earned income began to slow, but this was offset by higher net transfers to households, which consist of social benefits minus taxes and social contributions. In

12. Off-invoice discounts paid by suppliers to retailers in return for promotional services or prominent shelf spacing.

2003, earned income was eroded by the economic slowdown. The hesitant recovery that followed saw a fitful rise in purchasing power.

12. Contributions to change in real household income



*Earned income = gross wages and salaries + mixed income
**Net transfers = transfers received - social-insurance contributions and taxes. Excludes treatment of 2006 dividend tax credit (*avoir fiscal*).
***Asset income = financial income + gross operating surplus of households (rent received by property owners, including imputed rent). Excludes treatment of 2006 dividend tax credit (*avoir fiscal*).
Source: INSEE, national accounts - 2000 base

Earned income drives purchasing-power gains

In 2006, the acceleration in earned-income growth was the chief driver of French households' purchasing-power gains, contributing two-thirds of the increase. Growth in total gross wages and salaries—the main component of earned income—quickened from 3.3% to an even more vigorous 3.8%, thanks to the employment recovery and a stronger uptrend in the average wage per capita *(figure 13)*. In addition, gross operating

13. Total gross wages, wage per job, and number of jobs

Source: INSEE, national accounts - 2000 base

surplus of unincorporated enterprises rebounded sharply owing to the pick-up in agricultural selling prices and the good health of the construction sector.

In the general-government sector, the growth of total gross wages edged up from 2.4% to 2.5%. By contrast, index-based adjustments were less generous than in 2005, slowing the rise in the average wage per capita from 3.2% to 3.0%. In the non-farm market sector, the recovery in private-industry employment and a stronger uptrend in compensation sharply accelerated the growth in total gross wages from 3.4% to 4.2%.

The second engine of purchasing-power gains was asset income, which rose 5.0% versus 5.6% in 2005. This was due to the positive trend in households' gross operating surplus, which consists of income from housing rentals including imputed rents for owner-occupiers. "Pure" rents collected by property-owning households grew by a robust 7.8%, up from 6.6%. Financial income would appear to have lost momentum, but this impression is directly caused by the accounting treatment of the dividend tax credit (*avoir fiscal*). Without this reform, financial income would have registered a further strong gain of 7.5% instead of 1.7%. By contrast, the downtrend in net interest received by households persisted in 2006. While rate hikes had a positive effect on household income, the rise in interest payments—particularly on real-estate loans—continued to weigh on household budgets.

Taxes and social contributions, net of transfers received, weighed on purchasing power

In 2006, French public finances made an apparently positive contribution to purchasing power, but this impression is due to the accounting treatment of the dividend tax credit. When this impact is neutralized, social contributions and taxes, net of transfers received, continued to dampen the growth in household purchasing power *(figure 12)*.

Excluding the dividend tax credit, social contributions and taxes levied on households kept growing briskly in 2006, driven by social contributions (up 4.1% versus 4.2% in 2005) and income and wealth taxes (up 6.8% from 5.9% in 2005). The growth in revenues from social contributions and the general social-insurance levy on all taxable income known as Contribution Sociale Généralisée (CSG) reflected the dynamism of total gross wages in the private sector and the rise in contribution rates for the basic and supplementary pension systems. Income tax, assessed on vibrant 2005 incomes, was boosted by various factors in 2006. One of the most important was the end of the tax shelter for interest on saving plans known as Plans d'Épargne Logement. These are now taxable starting in their tenth year rather than at maturity. The dynamic behavior of real-estate markets and stock markets swelled receipts from other taxes as well: the occupancy tax (*taxe d'habitation*) and property tax (*taxe foncière*) at the local level but also the wealth tax (ISF) at the national level, owing to the rise in real-estate values.

The growth in social benefits in cash received by households, which had remained stable at 4% in 2004-2005, weakened to 3.6% in 2006. This slowdown reflects the decline in unemployment benefits, which quickened to 9.5% in 2006 owing to the fall in the number of jobseekers and in the proportion of unemployed persons receiving benefits from UNEDIC. By contrast, the ramp-up in the Young Child Allowance (Prestation d'Accueil du Jeune Enfant: PAJE) and the increase in early retirements contributed to the rise in family and old-age benefits.

Consumption, the main growth engine

Boosted by the increase in real disposable income, French household consumption continued to grow at a robust pace of 2.1%, compared with 2.2% in 2005. Between 2002 and 2005, despite purchasing-power fluctuations, household consumption growth had remained buoyant, consistently exceeding 2% a year. Over the four-year period, households had managed to preserve their consumption levels by adopting a standard smoothing behavior thanks to a cumulative 1.6-point reduction in their saving ratio.

In 2006, this downtrend in household saving was halted. The ratio edged up from 15.3% to 15.5%, in line with the rise in real disposable income. Conversely, several short-term factors exerted a likely downward pressure on saving. First, progress on the unemployment front, by easing uncertainties over income, may well have led to a decrease in precautionary saving. Second, the inflation slowdown no doubt exerted the same effect by increasing households' real cash balances. Third, the growth in real-estate values due to the steady rise in housing prices also presumably generated wealth effects conducive to consumption (although the phenomenon is largely virtual as it concerns assets that are often illiquid). In the opposite direction, the persistence of low interest rates probably discouraged financial investment, whereas consumer loans rose sharply.

The year 2006 saw brisk growth in personal expenditures on housing, particularly heating and lighting. Housing consolidated its position as the number-one budget item (25%), well ahead of food (18%) and transportation (15%). If we add current housing-related expenditures to investment expenditures, we find that French households devote an average of nearly one-quarter of their disposable income to their dwellings.

Growth in household consumption expenditures on manufactured goods slowed in real terms from 3.6% to a still buoyant 2.8%. However, the overall picture contains some contrasting patterns. The main impetus came from housing-related durables driven by consumer electronics, in particular such flagship products as plasma and flat-screen television sets, DVD recorders, GPS navigators, and portable video players (PVPs). By contrast, automobile purchases declined, as the uptrend in foreign brands did not make up for the loss of appeal of French brands. Household energy expenditures moved down 1.2%, the same rate as in 2005. Faced with repeated rises in fuel prices, drivers cut back on travel. Expenditures on services continued to grow at a lively pace, accelerating from 2.5% to 2.9%. The momentum came from the good performance of real-estate services,[13] telephony, and financial services. By contrast, spending on personal services rose by just 1.4%.

Moderation in expenditures by government on behalf of households

In 2006, expenditures for the benefit of households and financed by general government—known as "individual expenditures" because the beneficiary is easily identifiable—rose 3.8% in nominal terms and 1.4% in real terms. More than 80% of

13. Expenditures on real-estate services mainly comprise actual rents and "imputed" rents, i.e., those that owner-occupiers would pay if they rented their dwellings.

these outlays are devoted to education and healthcare. Since 2003, they have slowed. One of the factors that has promoted this moderation is the reform of the sickness-insurance system launched in 2004. Measures include a flat-rate contribution of €1 per medical procedure, an increase in the daily deductible for hospital stays, the introduction of a "coordinated healthcare pathway" supervised by a patient-designated primary-care physician, the non-reimbursement of drugs whose efficacy has been found inadequate, and an increase in fees for visits by patients who have not consulted their primary-care physician beforehand.

For the third consecutive year, individual expenditures grew more slowly than final consumption expenditures by households (financed by households themselves). They thus helped to dampen the rise in effective household consumption from 2.0% in 2005 to 1.9% in 2006 (effective consumption is the sum of individual expenditures by government and final consumption expenditures by households).

Further decline in the public deficit

In 2006, the French public deficit as defined in the Maastricht Treaty declined by €5.3 billion to €45.5 billion [8]. It thus moved down to 2.5% of GDP from 3.0% in 2005 and 3.6% in 2004—in other words, well below the 3.0% threshold set by the Stability and Growth Pact. This improvement was due to the fact that the growth in public revenues (4.6%) exceeded that of public spending (3.8%).

Revenues as a share of GDP rose for the third consecutive year, reaching 50.8% compared with 50.7% in 2005 and 49.6% in 2004. Compulsory levies, which include taxes and effective social contributions, increased. As a share of GDP, they gained 0.4 points to 44.2%. This rise was mainly due to the widening of assessment bases. Another, more marginal factor was the series of new measures that accelerated the effective increase in taxes and social contributions. The share of levies collected by central government declined by 0.8 points to 15.3% of GDP owing to transfers of tax receipts to the social-security system. However, these tax transfers were partly offset by strong automatic growth in central-government tax revenues. Thanks to the good health of France's leading business conglomerates, corporate income tax receipts rose by slightly over 17%. VAT receipts, up by approximately 4%, were boosted by the substantial growth in the assessment base due to robust household consumption. Personal income tax receipts rose by about 6%, lifted by the good results obtained from the taxation of capital gains on securities (up 16%), capital gains on real estate (up 27%), and pensions (up 6.5%).

Public-spending growth eased from 4.4% in 2005 to 3.8% in 2006, its share of GDP declining from 53.7% to 53.4%. Total wages and salaries paid out rose 3.0% compared with 3.2% the previous year. Social benefits in cash, up 4.4%, rose at the same pace as in earlier years, whereas benefits in kind continued the slowdown that began in 2003. Investment growth, while weaker, remained high at 5.7%.

The improvement in public finances came from central government. The State's borrowing requirement fell €5 billion between 2005 and 2006, with net lending by miscellaneous central-government units (MCGUs) up €4.3 billion. The MCGUs' structural surplus was boosted by the one-time payment of a €2.0-billion lump sum (*soulte*) by the French Postal Service to the new public agency set up to manage the pensions of postal workers (who belong to the civil service). The local-government borrowing requirement rose €1.2 billion to €4.6 billion. The deficit of the social-security system seemingly widened from €2.6 billion in 2005 to €5.6 billion in 2006, but this worsening is due to exceptional items in the 2005 accounts. In 2005, the system recorded a one-time payment of an €8.4-billion lump sum (*soulte*) by the public electricity and gas companies in exchange for the transfer of pension commitments. If the impact of this non-recurrent receipt is neutralized, the social-insurance accounts actually improved.

At end-2006, France's general-government debt under the Maastricht definition reached €1,142.2 billion, or 63.7% of GDP, compared with 66.2% at end-2005. This puts the debt ratio close to the EU average of 63.2% at end-2005. ■

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