Overview

In 2007, the world economy faced several shocks: a surge in oil prices, an increase in agricultural commodity prices, and a real-estate crisis in the United States. The latter culminated in the subprime financial crisis that erupted in the summer, degenerating into a global bank-liquidity crisis. Despite these shocks, world growth proved resilient. The U.S. economy slowed from 2.9% to 2.2% without eroding the performance of the rest of the world. Asia's emerging economies—China and India in the lead—remained vigorous. Euro-zone GDP growth stayed firm, moving from 2.7% in 2006 to 2.6% in 2007.

The steep rise in energy and food commodity prices fueled inflation in most countries. However, faced with simultaneous financial turmoil, central banks acted flexibly. The abrupt, widespread contraction of bank liquidity was triggered by a collapse of confidence in the risky subprime segment and by uncertainty over who was actually carrying the risk. Central banks responded by injecting liquidity and shifting to a more accommodative monetary policy. The U.S. Federal Reserve (the "Fed") cut its key Fed Funds rate three times, from 5.25% in January to 4.25% in December. The European Central Bank (ECB), which lifted its key rate to 4.0% in May 2007 from its end-2006 level of 3.5%, has refrained from further rate hikes since the summer.

Despite the good health of European Union (EU) economies, several factors undermined their vigor during the year. Productive investment showed momentary signs of weakness in certain countries. In Germany, the January increase in value added tax (VAT) caused a drop in household consumption and trimmed GDP growth from 2.9% to 2.5%, but the country posted another outstanding export performance. Lastly, the slowdown in world demand and the euro's appreciation curbed exports, particularly in France and Italy.

The French economy nevertheless proved resilient, with GDP growth holding steady at 2.2% in 2007. Domestic demand stayed firm and the sharp rise in employment kept unemployment on a downtrend. By contrast, the contraction in exports to France's EU partners gained momentum and the trade deficit in goods and services posted a further steep increase.

The main drivers of French growth were market services, notably business services and real-estate services. Their value added rose 2.8% in 2007 compared with 3.1% in 2006. The construction industry posted another year of vigorous growth as well, gaining 3.8%. Manufacturing output, which is more heavily dependent on export performance, continued on a weak growth path, edging up from 1.1% to 1.2%.

In all, external trade contributed a negative 0.7 points to French GDP growth in 2007, compared with a negative 0.2 points in 2006. Export growth slowed from 5.4% to 3.1%, largely because of slacker world demand for French products and competitiveness losses due to the rising euro. This pattern is evidenced by the substantial widening of the industrial trade deficit, particularly with the rest of the euro zone. The latter gap is the sole cause of the growth in the goods and services trade deficit, whereas the energy bill stabilized at a high level.

The domestic-demand revival offset France's poorer trade performance. Total investment stayed on a robust uptrend. Pressures on productive capacity throughout 2007 quickened the rise in business investment from 4.9% to 7.4%. The investment rate of non-financial corporations actually topped its previous peak, reached in 2001. At the same time, a surge in public-works projects—a standard phenomenon in the run-up to municipal elections—stimulated local-government investment. These two engines more than offset the sharp slowdown in households' residential investment from 7.1% to 3.0%, after three years of buoyant growth.

Consistently with the previous five years, French consumption stayed firm, thanks to the substantial increase in household disposable income. Thanks to strong gains in employment and relatively favorable wage dynamics, the growth in gross wages accelerated from 3.9% to 4.5%. Tax cuts, mostly resulting from the revision of income-tax brackets, provided an even greater stimulus to household disposable income growth. Moreover, inflation remained subdued in annual-average terms, despite its revival starting in late summer due to the surge in energy and food commodity prices. Overall, real disposable income growth accelerated from 2.6% to 3.3%. This had a positive impact on consumption growth—which moved up from 2.3% to 2.5%—and led households to lift their saving ratio from 15.1% to 15.8%.

These real-income gains remain significant when measured against population growth expressed in consumption units or after factoring in the changes in "pre-committed" expenditures (i.e., of a contractual nature). Yet confidence surveys show that many French households believe their living standards have declined. This gap may reflect a timing effect, as the sharpest upswing in inflation was triggered at year-end by price increases for staple goods such as gasoline, milk, and bread.

Cuts in compulsory levies (taxes and social contributions) reduced general-government revenues. With public expenditures still rising, France's public deficit grew from 2.4% to 2.7% of GDP. General-government debt under the Maastricht definition reached €1,209.5 billion or 63.9% of GDP at end-2007, up from 63.6% of GDP one year earlier. ■

World growth still vigorous

*Laurent Clavel**

The year 2007 was marked by major economic shocks. The barrel price of Brent (North Sea) crude oil climbed from around $55 in January to over $95 at year-end. The rise in agricultural commodity prices was as unexpected as it was spectacular, fueled by a combination of accelerating demand from emerging countries and a fall-off in supply due to weather conditions and a crowding-out of food crops in favor of biofuel crops. Lastly, the U.S. real-estate crisis, beyond its direct impact on U.S. growth, sparked an international crisis in the summer.

Despite these shocks, world growth proved resilient in 2007. The slowdown chiefly affected the U.S., and was essentially due to the worsening real-estate market *(figure 1)*, but U.S. household consumption did not sag. The emerging countries performed vigorously. Japan's growth was driven by the dynamism of its Asian partners, while domestic demand remained slack. Euro-zone GDP growth stayed above its potential rate; consumption posted only a mild slowdown, despite the German VAT hike and the year-end inflation surge.

U.S. real-estate crisis and international financial crisis

The U.S. real-estate crisis begun in late 2005 worsened in 2007: residential investment fell nearly 17% on an annual-average basis, after slipping 4.6% in 2006.

1. Growth of gross domestic product (GDP) in main industrialized countries and in emerging countries

Raw data, % change on previous year

	2005	2006	2007
Advanced economies	**2.6**	**3.0**	**2.6**
United States	3.1	2.9	2.2
Japan	1.9	2.4	2.1
United Kingdom	1.8	2.9	3.0
Euro zone	1.6	2.7	2.6
Germany	0.8	2.9	2.5
France	1.9	2.2	2.2
Spain	3.6	3.9	3.8
Italy	0.6	1.8	1.5
Emerging Asia (excluding China)	**4.9**	**5.4**	**5.8**
India	9.1	9.7	9.2
China	10.5	11.7	12.0
Brazil	**3.2**	**3.8**	**5.4**
Russia	**6.3**	**7.3**	**8.1**

Sources: Eurostat; national sources

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The swift and deep deterioration in the real-estate market raised fears of an abrupt slowdown of the U.S. economy via contagion to other domestic-demand components. The increasing difficulties in the U.S. subprime mortgage segment—the market's riskiest—ignited a global financial crisis in mid-August, as the use of financial instruments had spread the risk to many players. The rise in foreclosures in this narrow segment of the credit market led to a general loss of confidence in the financial markets. Money-market liquidity shrank, driving up money-market rates, while a massive flight to quality depressed yields on government securities.

The central banks reacted to the crisis first by injecting liquidity, then by loosening their monetary policy. The U.S. Federal Reserve (the "Fed") cut its key Fed Funds rate three times, from 5.25% in January to 4.25% in December. The European Central Bank (ECB), which had been raising its key rates, decided in the summer to refrain from further hikes.

The financial turmoil persisted in H2 2007. It even intensified at year-end, as attested by the widening spread between 3-month money-market rates and key lending rates in both the U.S. and the euro zone. The U.S., British, Canadian, EU, and Swiss central banks took coordinated action to inject liquidity on December 12, and the Fed set up a new Term Auction Facility. These moves eased money-market tensions at the close of 2007.

Flare-up in commodity prices and world inflation

After easing in 2006, the barrel price of Brent crude oil climbed from around $55 in January 2007 to over $95 at year-end. This behavior was prompted by physical tensions in the oil markets. Demand surged, particularly in China and the Middle East, even as producers curbed supply. OPEC did not tap its spare capacity to the full, and weather flukes occasionally disrupted oil production and transportation. These factors were compounded by the aggravation of geopolitical tensions.

Agricultural commodity prices, which had been trending up since mid-2006, began to surge in early 2007 because of short-term developments (weather conditions) and for structural reasons (brisk growth in demand, rising biofuel production at the expense of farmland dedicated to food crops). Despite a perceptible downtrend in the world economy, the flare-up in food commodities, combined with higher oil prices, has stoked inflation in the developed countries and even more so in the emerging countries.

Dynamism of the emerging economies

China's economy remained vibrant in 2007: GDP growth was still running at over 10%, driven by robust productive investment and the continued buoyancy of external trade. The Chinese trade surplus topped $260 billion or 8% of GDP in 2007, up nearly 45% on 2006. Export growth did, however, weaken somewhat in H2 owing to softer U.S. economic activity and the yuan's appreciation against the dollar.

Chinese business investment, which is largely self-financed, continued to expand vigorously despite the succession of monetary-tightening moves by the country's authorities: between January and December 2007, the central bank raised its key rate 135 basis points and increased commercial banks' required-reserves ratio from 9.5% to 14.5%.

By contrast, Chinese inflation began to surge in the summer, chiefly owing to higher food prices. Year-on-year inflation rose to nearly 7% in December, its highest level since 1996.The other Asian economies remained vigorous in 2007, with GDP growth quickening from 5.4% to 5.8%—despite a leveling-off of investment growth in H2. Further strong performances were also recorded in India and Russia (with annual average growth of around 8%) and Brazil (annual average of 6%). In sum, the slowdown was confined to the advanced economies.

Slowdown in the United States

U.S. GDP growth slowed from 2.9% in 2006 to 2.2% 2007, mainly because of the accelerating real-estate slump. Residential investment fell by an annual average 17%. All indicators recorded spectacular drops: on an annual-average basis, housing starts fell 30%, new-home sales 26%, and existing-home sales 13%. Real-estate inventories stood at 9.5 months of sales at year-end, their highest level in over 25 years. Real-estate prices weakened in H2. These conditions spurred an increase in mortgage-loan foreclosures. In the riskiest segment—variable-rate subprime loans—the default rate topped 20% at year-end.

Despite the inflation surge and the decline in real-estate and financial-asset prices, U.S. household consumption expenditures continued to fuel GDP growth. They rose 2.9% in 2007 (compared with 3.1% in 2006), thanks to substantial gains in real gross disposable income, up 3.0% (as against 3.1% in 2006). The latter gains were fueled by the persistence of strong job creation and relatively brisk wage increases. This resilience of the U.S. labor market is not surprising, as employment usually responds to economic downturns with a few quarters' lag.

Import growth slowed sharply from 5.9% in 2006 to 1.9% in 2007, owing to softer demand from businesses and the dollar's depreciation. As a result, the trade deficit posted a mild contraction from 5.8% to 5.1% of GDP.

Japanese growth resilient

The Japanese economy posted another robust performance in 2007, its GDP gaining 2.1% after the previous year's 2.4%. The main driver was external demand, still fueled by the vibrancy of Japan's main economic partners in Asia. Export growth remained brisk at 8.7%, compared with 9.7% in 2006, while imports registered slack gains owing to softer domestic demand. This reflects the fact that, despite the robust 0.5% increase in job creation (up from 0.4% in 2005 and 2006), slower growth in real wages dampened the rise in household consumption from 2.0% to 1.5%. Meanwhile, the tougher legislation on building permits passed in June 2007 caused major delays in housing starts. As a result, residential investment sank 9.3% in 2007 after rising 0.9% in 2006.

Consumer prices continued to decline, the consumption deflator losing 0.5% on an annual-average basis. At year-end, however, higher energy and agricultural commodity prices caused inflation to turn positive again. Amid brisk economic growth, the Bank of Japan lifted its key rate to 0.5% in February.

Growth persists in the euro zone

After accelerating from 1.6% to 2.7% in 2006, euro-zone GDP growth held steady at 2.6% in 2007. But this practically stable annual-average figure conceals a slowdown during the year. Since the start of the upswing in late 2003, the divergence in growth mixes among the leading euro-zone economies has barely narrowed. Export performances are uneven, ranging from very good in Germany to significantly weaker in the other countries. The patterns of domestic-demand growth are also highly variable: consumption is weak in Germany, but robust in Spain and France; construction investment is surging in Spain, but slack in Germany.

Three factors have weighed on euro-zone growth: a tax shock in Germany due to the VAT hike, an investment slowdown during the year, and softer world demand for euro-zone exports.

On January 1, 2007, Germany raised its standard value added tax (VAT) rate from 16% to 19%. Ahead of the increase, German households had anticipated their expenditures at end-2006. As a result, their consumption fell sharply in Q1 2007. Since then, and despite the brighter job market, German households have engaged in precautionary saving. On an annual-average basis, German household consumption continued to lag the rest of the euro zone, losing 0.5% after a 1.1% gain in 2006.

After four years of brisk growth, euro-zone productive investment, while still posting a firm annual average gain in 2007, gradually slowed during the year. There are three main reasons for this. First, a lesser effort is now needed to match capacity to demand. Second, real-estate investment has showed signs of weakening in countries where prices had risen to demand-constraining levels. Third, the financial turmoil due to the U.S. subprime crisis has tightened credit access in the euro zone since summer 2007, with adverse effects on investment.

Euro-zone exports, while losing momentum, have weathered the global demand slowdown and the euro's appreciation with reasonable success. However, this resilience is largely due to Germany's still outstanding performance outside the zone. Although all EU countries posted an export slowdown, the negative shock from external demand chiefly affected those countries that, for structural reasons, had least benefited from the global-trade expansion of recent years. They include Italy, Spain, and, to a lesser extent, France.

French economy still resilient

*Laurent Gasnier**

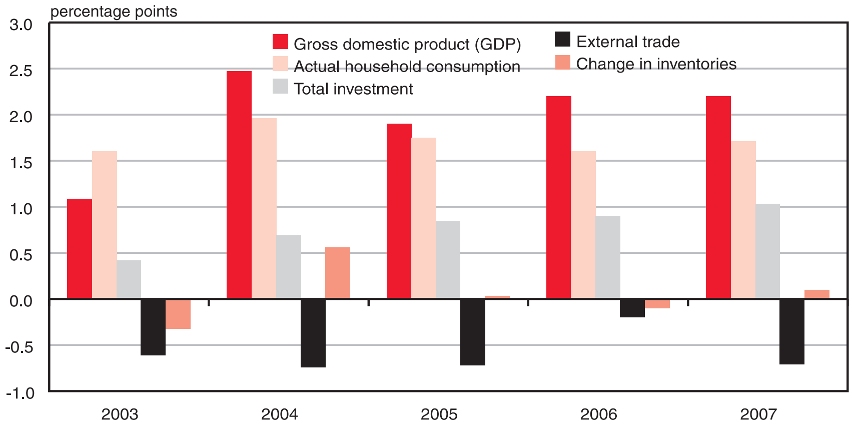
Amid the accumulation of external shocks, the French economy held up well, with GDP growth steady at 2.2% [1].[1] The trade deficit widened, reducing annual average GDP growth by 0.7 percentage points *(figure 2)*. In contrast, domestic demand remained vigorous. Total investment growth stabilized at a lively pace: the sharp acceleration in productive investment from 4.9% to 7.4% offset the slackening of household-investment growth from 7.1% to 3.0%. At the same time, the large number of new jobs, the persistent rise in the mean wage per capita, and sizable tax cuts sustained household purchasing power (driving up its growth from 2.6% to 3.3%) and consumption (whose growth rate picked up from 2.3% to 2.5%).

Slower export growth and a further widening of the trade deficit

The year 2007 saw a further worsening of France's goods and services trade balance, a trend that began in 2003: the total trade deficit (FOB/FOB)[2] rose €13.6 billion to €36.4 billion. After quickening to 5.4% in 2006, real export growth slowed to 3.1% in 2007, while import growth eased from 6.1% to 5.5%. As a result, the national accounts registered an increase in the negative contribution of external trade to French GDP from -0.2 points in 2006 to -0.7 points in 2007.

From a substantial €26.5-billion surplus in 2002, France's trade balance in goods and services has since deteriorated steadily, moving into deficit in 2005. In the past five years, one-half of the widening gap has been caused by the increased energy bill, the other half by the worsening balance in manufactured goods and services. In 2007, the increase in the

2. Contributions to GDP growth



Source: INSEE, base-2000 national accounts

1. Adjusted for working days, annual average growth did, however, decelerate mildly from 2.4% in 2006 to 2.1% in 2007.
2. Free-on-board (FOB) figures do not include the costs of carriage between the trading partners' borders.

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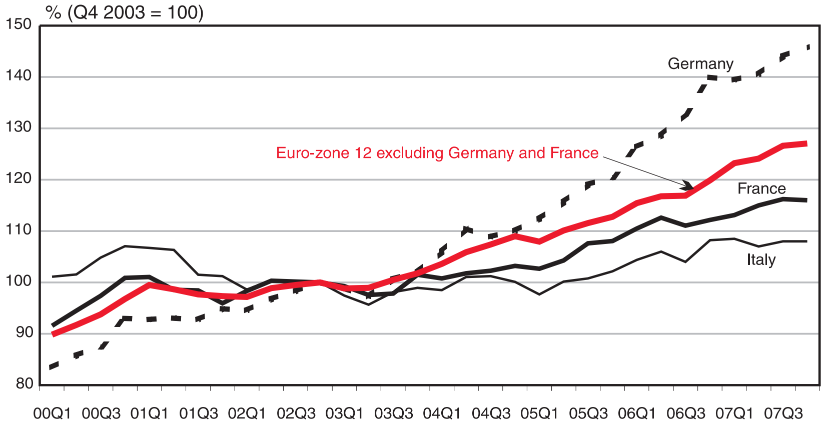
goods and services trade deficit was due almost entirely to the steep rise in the manufactured-goods deficit to €16.4 billion. The energy bill continued to weigh on the trade balance, contributing a negative €44.8 billion, but its upward drift has been halted by the decline in the volume of energy imports. Lastly, the surplus in services continued to shrink, reaching €2 billion compared with a peak of €18 billion in 2002.

Since 2002, nearly two-thirds of the widening trade gap in goods has been caused by the rising deficit with other EU countries, and one-fifth by trade with Asia. In 2007, France's bilateral deficits with both zones grew. The deficit with the EU rose €9.0 billion to €27.9 billion, of which €18.0 billion with Germany. The deficit with Asia increased €2.3 billion to €26.0 billion, of which €19.5 billion with China.

Persistent lag in French exports compared with the rest of the euro zone

In the 1990s, France often outperformed Germany and the rest of the euro zone on the export front. Since 2003, the opposite has been the case: French exports of goods and services have averaged nearly 3.0% growth a year in real terms, versus 8.0% for Germany and 5.0% for the euro zone excluding Germany and France *(figure 3)*. While the global economic downturn in 2007 has slowed trade throughout most of Europe, the export growth gap between France and its partners has widened further. Exports of goods and services by the euro zone excluding France and Germany gained almost 7.0%. Despite slowing from 12.9% to 8.0%, German export growth remained vibrant. Italy, which faces recurrent competitiveness problems, is the only euro-zone country to post a lower figure than France, at 2.1% versus 3.1%.

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



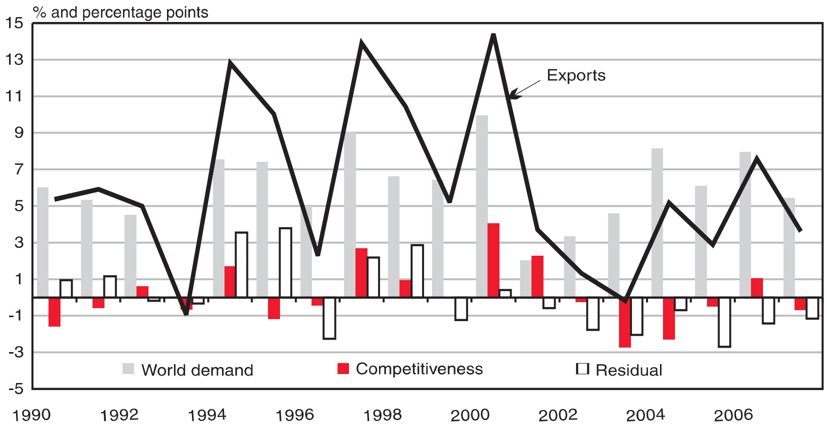
Sources: Eurostat; Newcronos

The analysis of the reasons why French exports have fallen behind those of Germany has spawned an abundant economic literature. The consensus view is that the traditional determinants of exports—demand world and competitiveness—play a relatively limited role. German exporters are admittedly better positioned in high-growth emerging markets, such as Central and Eastern Europe and China, but international demand for German exports is increasing barely faster than demand for French products. Also, the more positive trend in German competitiveness costs offers only a partial explanation, for French exporters offset this disadvantage by trimming their margins heavily. As a result, price competitiveness is improving at the same pace in both countries. However, it is possible that some French firms may not have succeeded in exporting because they have not made the effort to squeeze margins. Other factors have undoubtedly played a role but are hard to identify. We can offer two examples: (1) the “bazaar economy” thesis, which argues that Germany imports semi-finished goods from low-cost countries to assemble them locally for re-export; (2) the effects of a shift in German supply to external markets owing to inadequate domestic demand. These analyses suggest that France’s trade problems may be partly due to the very structure of the French export sector. First, the number of exporting firms is relatively small and has been declining since 2003. It fell from 117,000 that year to 98,000 in 2006 and 2007,[3] a figure representing less than 4% of French-based enterprises. Second, only 5% of French small and medium-sized enterprises (SMEs) are exporters, compared with 11% of their German counterparts.

Sharp slowdown in manufactured exports

In the long run, the growth of French manufactured exports is determined chiefly by the change in world demand for French products[4] *(figure 4)* and, to a lesser extent, by the change in export price competitiveness. Despite the gradual build-up of foreign demand for French products since 2004, the recovery in manufactured exports has been fitful. The accumulated competitiveness losses due to the euro’s appreciation led to a significant deceleration in export growth in 2005, followed by a rebound in 2006 thanks to improved economic conditions in Europe. In 2007, world demand for French products slowed from 8.8% to 5.5%, and competitiveness deteriorated. These two factors again undermined manufactured exports, cutting their growth from 7.0% to 3.6%.[5]

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



Source: INSEE, base-2000 national accounts

However, French exports registered contrasting performances in different geographic areas. Exports to the EU, which account for two-thirds of French sales abroad, gained only 2.6% in nominal terms. Exports to the U.S. fell 5.5% owing to the U.S. economic slowdown and

3. Data from Directorate-General for Customs and Excise.
4. Average imports by France’s main partners, weighted by French market share in each market.
5. These changes do not factor in the intra-EU VAT fraud known as “carousel” fraud, which led statisticians to remove approximately 0.5 points from the 2007 figures for French manufacturing export and import growth.

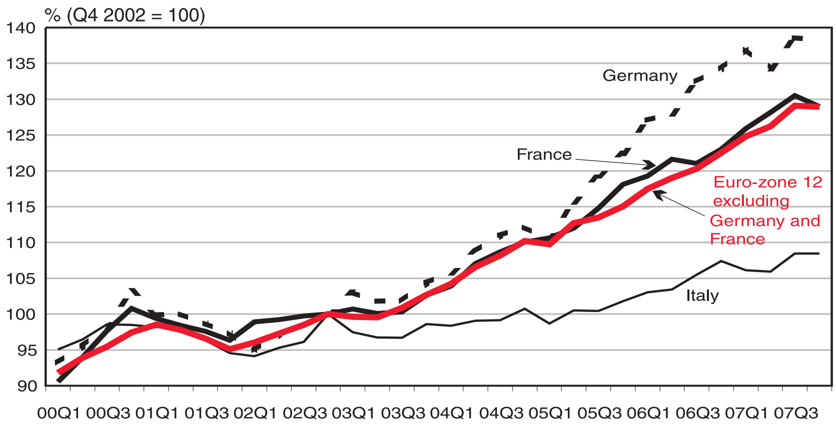
the hard-hitting effects of the euro's appreciation. By contrast, the shift in French trade toward emerging countries with high growth potential continued, thanks to the strong momentum of sales to China, India, and Russia.

On a disaggregated basis, the fall-off in manufactured exports in 2007 was mainly due to slower sales of capital goods and intermediate goods. Aircraft deliveries reached a record high—the number of Airbus airliners delivered rose from 256 to 277—but their increase was more modest than in 2006. Exports of electronic capital goods slowed as well. By comparison, the growth rate for sales of consumer goods remained fairly brisk, quickening from 6.0% to 7.3%. After a two-year contraction, automobile exports posted a mild increase of 1.7%, with automakers trimming their margins significantly. Nevertheless, as imports did not weaken, the automobile trade balance deteriorated further, nearly returning to the break-even point in 2007 after running large surpluses in the early 2000s. At a more structural level, this slippage also reflects the growing internationalization of French automakers, who now assemble a majority of their vehicles abroad.

French imports somewhat slacker than those of the other euro-zone countries

After gaining a robust 6.1% in 2006, French imports grew by a milder 5.5% in real terms in 2007. In recent years, the growth profile of French imports of goods and services has been similar to that of the euro zone excluding Germany. This performance is consistent with the fairly comparable profiles of domestic demand *(figure 5)*. Paradoxically, the slackness of German domestic demand did not prevent brisk import growth, which partly reflects international outsourcing patterns. In 2007, the deceleration in EU economic activity dampened the rise in euro-zone imports. Their growth nevertheless exceeded that of French imports by almost one percentage point, while German imports increased somewhat more slowly than the zone average. Of the leading euro-zone countries, Italy—whose economy is having trouble recovering—registered the most moderate import growth at just over 2%.

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



Sources: Eurostat; Newcronos

French manufactured imports still firm

The lively growth in manufactured imports that accompanied the French economic recovery in 2003 and after is partly responsible for the worsening trade balance. While their growth rate eased from 8.2% to 7.3% in 2007, their persistent vigor is due to the accumulated losses of import price competitiveness, as domestic producer prices again outpaced import prices.

Import growth was particularly steep in the automobile sector, accelerating from 3.5% to 8.2%. This reflects the allure of foreign brands and the intensity of intra-group flows: as French automakers have opened plants in the new Member States and Turkey, imports from these countries have increased. The influx of foreign cars, notably big-engined models, quickened at year-end as consumers anticipated the introduction on January 1, 2008, of a penalty tax on high-polluting vehicles. Imports of consumer goods continued to fully benefit from vibrant household consumption, gaining 9.6% versus 9.7% in 2006. In particular, consumer-goods imports from low wage countries surged, contributing to brisk nominal growth in total imports: imports from China and India rose 17.2% and 11.6% respectively. China (including Hong Kong) thus became France's number-one supplier outside the EU, just ahead of the U.S. Meanwhile, capital-goods imports slowed.

The contraction in energy imports in real terms accelerated from 1.5% to 4.5% in 2007. The decline resulted from a consumption adjustment to higher energy prices during the year and from a particularly mild winter, which trimmed heating expenditures. As a result, and despite higher import prices, nominal energy imports posted a mild 2.0% loss in 2007 after the previous year's 19.0% gain. The energy bill declined by €0.8 billion to €44.8 billion in 2007.

End of gains in manufacturing terms of trade

Between 2002 and 2006, the terms of trade for manufactured goods—i.e., the ratio of export prices to import prices—posted a further improvement thanks to the euro's appreciation. The pattern ended in 2007, as prices of manufactured exports declined slightly while those of manufactured imports remained stable. The main reason seems to be that French exporters responded to the stronger euro by substantially trimming their margins. Another likely explanation is that the export industries of South-East Asia absorbed the surge in commodity prices.

Neutral effect of inventories and robust growth in investment

Neutral contribution of inventories to GDP growth since 2006

With the stabilization of French economic activity, changes in inventories have had little impact on growth in the past two years. Their contribution to GDP growth moved from slightly negative at -0.1 points in 2006 to mildly positive at 0.1 points in 2007.

Inventories enable producers to adjust to demand swings. If the economic climate worsens, businesses are more likely to draw down inventories. Conversely, when firms expect an improvement, they will have an incentive to build up inventories. For instance, between 2001 and 2003, inventory behavior had a negative impact on growth, trimming it by one point of GDP. By contrast, the 2004 recovery coincided with inventory rebuilding. Changes in inventories have therefore generally accentuated cyclical fluctuations. Other factors such as warehousing costs and price expectations can also play a role, but in practice it is a smaller one, at least at macroeconomic level.

Business investment accelerates sharply

In the past decade, productive investment moved in a distinct cyclical pattern driven by fluctuations in economic activity and returns on capital.[6] Between 1998 and 2000,

6. Return on capital is defined here as the difference between the capital profitability ratio (gross operating surplus divided by nominal fixed-capital stock) and real 10-year interest rates. If capital profitability is lower than the interest rate, the enterprise may prefer to reduce its debt or purchase bonds rather than invest.

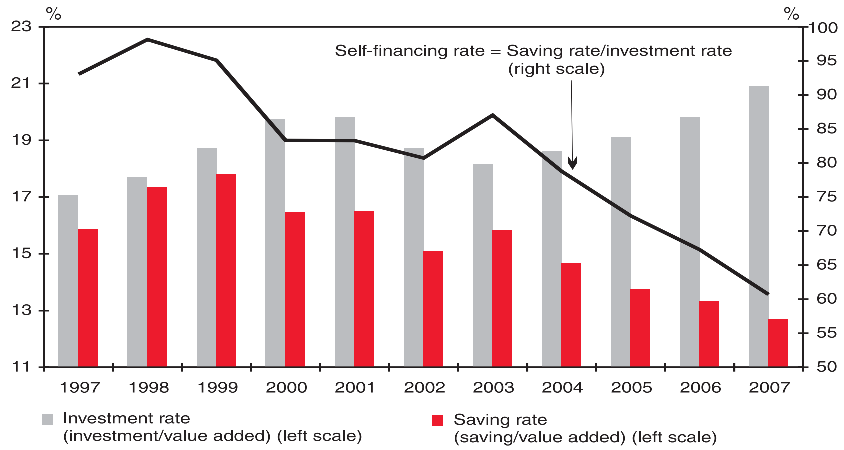
economic expansion went hand in hand with brisk investment growth, amplified by over-optimistic expectations on the profitability of new information and communication technologies. The bursting of the "technology bubble" in 2000 sparked an abrupt correction, followed by debt reduction. The recovery in investment by non-financial enterprises began in late 2003, stimulated by exceptionally low real interest rates. The pattern continued in 2007, despite rising interest rates, amid the persistence of an upbeat business climate. Productive-investment growth actually quickened from 4.9% to 7.4% to relieve the emerging pressures on capacity.

In this broadly favorable environment, the investment rate (ratio of investment to value added) of non-financial corporations (NFCs) stayed on the growth path that it has been following since 2004. In 2007, it reached 20.9%, its highest level since 1991 [2]. Capital spending on buildings and civil engineering was the main driver, contributing nearly one-third to the acceleration in NFC investment. Capital-goods investment gained considerable momentum as well.

After a steep increase in the mid-1980 due to the reverse oil shock, NFCs' margin ratio remained practically stable for fifteen years, moving up to 31.1% in 2006. In 2007, it posted a further rise to 31.2%, as productivity gains per capita were roughly comparable to the increase in the real wage per capita. The NFCs' saving ratio nevertheless retreated from 13.3% to 12.7%, owing to the substantial growth in net interest payments (caused by higher interest rates and rising indebtedness), dividends, and corporate income tax.

As a result, NFCs' self-financing rate (their saving/investment ratio) fell from 67.3% to 60.7% *(figure 6)*, a more than twenty-year low. The rate's decline in the past ten years seems mainly due to the rise in dividend distributions and, more recently, to the increase in interest payments. Despite the tightening of credit access in 2007, non-financial enterprises continued to finance a major share of their investment through debt. The conjunction of robust investment growth, a declining self-financing rate, and the persistent buoyancy of dividend distributions therefore suggests that financial markets have provided the resources for French businesses to fund their projects. Their debt ratio (debt/value added) rose for the fourth consecutive year, moving from 103.7% to 106.9%.

6. Financing of investment by non-financial corporations



Source: INSEE, base-2000 national accounts

The average financial position described here encompasses a wide variety of profiles. In recent years, French SMEs have tended to increase their cash position rather than borrow and invest more. For their part, the blue-chip corporations listed in the Paris CAC40 index continued to engage in external growth, thanks to high self-financing rates and access to cheap liquidity.[7]

Satisfactory business solvency

The financial-risk exposure of French non-financial corporations due to their rising indebtedness seems limited for the time being, as suggested by their persistently low insolvency ratio—i.e., net interest expenses divided by gross operating surplus, which measures their capacity to meet financial commitments. The ratio, which was still at 21.4% in 1993, later declined sharply as interest rates eased, reaching an all-time low of 6.1% in 2002. The growth of corporate debt, followed by the rise in interest rates, then drove the insolvency ratio to 9.8% in 2007.

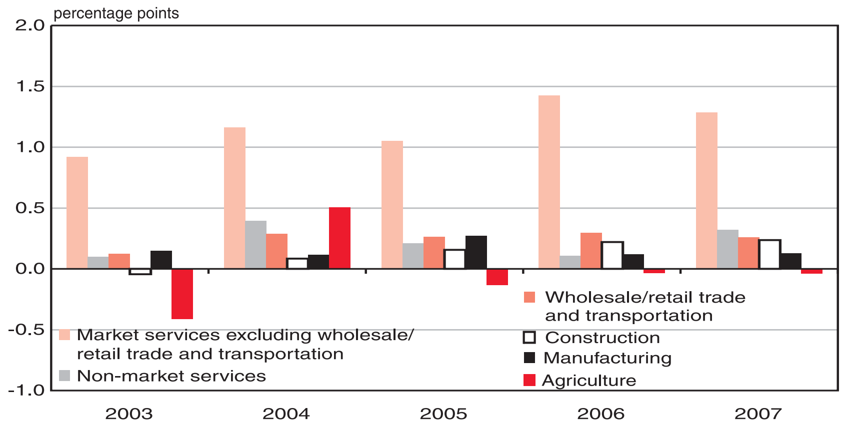
The asset position of French businesses confirms this positive assessment of their financial health. Their assets (physical capital and financial assets) stand at more than eight times their debt, a level comparable to the 1991 peak. This overall figure should, however, be qualified, as it aggregates a considerable variety of individual situations.

Market services and construction: the main drivers of the French economy

Since 2003, market services have been the main engines of France's economic recovery. They have posted annual average growth of 2.6%, versus only 1.4% for the manufacturing industry *(figure 7)*. The most dynamic components of market services have been financial, real-estate, and business services. Wholesale/retail trade and transportation rank second. Manufacturing has been slower to recover, notably because of negative export performance. Growth in the construction sector has quickened significantly since 2005.

Market services are more dependent on the domestic market. After growing 3.1% in 2006, they continued to expand at a robust albeit slightly milder pace of 2.8% in 2007.

7. Contribution by industry to real growth in value added



Source: INSEE, base-2000 national accounts

7. French companies listed in the CAC40 index may generate a major share of sales abroad, whereas the French national accounts incorporate only the results of local units engaged in economic activity in France itself.

Manufacturing output posted weak gains of 1.1% in 2006 and 1.2% in 2007. The situation in the automotive industry remained difficult. For the third consecutive year, real value added fell sharply, losing 6.8% after shedding 8.2% in 2006 and 4.8% in 2005. While domestic demand did revive, it primarily benefited foreign brands. Exports were also undermined by the euro's steep appreciation, which eroded the competitiveness of French automakers. These exchange-rate fluctuations, combined with the wage-cost differential between France and certain emerging countries, have prompted French automakers to concentrate on expanding productive capacity abroad.

Persistent vigor of the construction industry

The French construction industry (including civil engineering) posted a third year of robust growth, gaining 3.8% in 2007 after 3.9% in 2006 and 2.9% in 2005. However, this overall vigor masks contrasting trends: government investment in public works rebounded and business investment rose sharply, but residential investment by households slowed.

After losing 2.3% in 2006, government investment in public works grew 1.8% in 2007. This rebound was triggered by the run-up to the municipal elections in spring 2008. Investment by local authorities, which realize more than 80% of public investment, traditionally follows the election cycle.

Residential investment by households—which includes new-home purchases, maintenance, and repairs—weakened in 2007 after three years of vigorous growth, gaining 3.0% versus an annual average 5.4% in 2004-2006. Between 2004 and 2006, French households benefited from very low interest rates and easier credit access to finance their home-buying: loan durations were lengthened, in some cases up to thirty years, and minimum down-payment requirements were loosened. As a result, households' total debt surged to over 70% of disposable income in 2007, up from 55% four years earlier. The monetary-policy tightening since 2005 and the accompanying gradual increase in the cost of credit began to impact the real-estate market in 2007—all the more so as the banks' refinancing difficulties, triggered by the subprime crisis, have led them to curb their credit supply. As a result, the growth in housing loans started to ease, moving from 14.7% in January to 12.7% in December.

Slacker household demand for housing has been matched by an easing of real-estate prices. Existing-home prices, which had more than doubled since 1997, saw their growth halved from an average 12.1% in 2006 to 6.6% in 2007. This pattern is visible in all EU countries that experienced a price surge, particularly the United Kingdom and Spain (where real-estate prices had tripled since 1996).

Yet fears of an abrupt U.S.-style adjustment in the French real-estate market failed to materialize in 2007. Indeed, the U.S. experience does not seem wholly reproducible in France. On the supply side, there is no subprime market in France, and credit institutions exercise tighter risk control. Borrower solvency is a prerequisite for housing-loan issuance, and most loans are taken out at fixed rates. On the demand side, housing needs remain strong, as French households often seek to become home-owners.

The flare-up in agricultural prices is sustaining nominal agricultural production

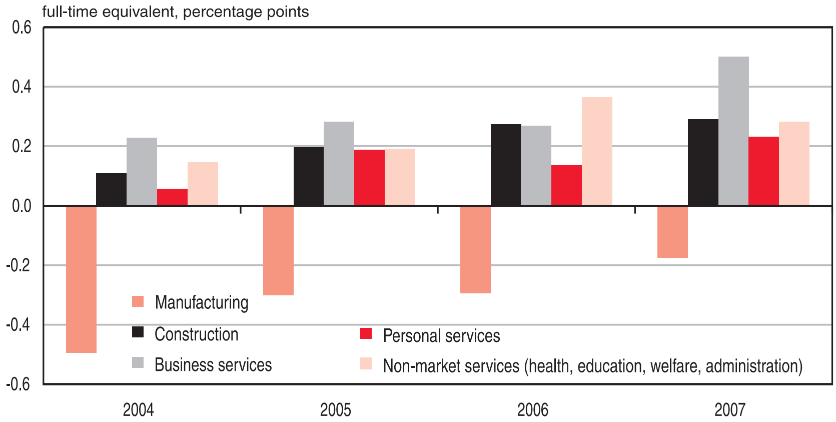
Real agricultural value added has registered steep falls in the past five years owing to a heatwave (2003) and drought spells (2005). These volume losses have been offset by higher agricultural prices. Agricultural production declined 1.8% in 2006 and another 1.5% in 2007, because of poor crops caused by adverse weather conditions. However, nominal agricultural production was driven up by the surge in prices of cereals and oil and protein crops, compounded by the scarcity of global supply in the face of persistently strong world demand. Food-industry output, up 0.7% in real terms in 2006, gained a further modest 1.0% in 2007.

Brisk rise in employment

The employment recovery that began in mid-2003 has been slow to consolidate. As typically occurs in economic upswings, firms with productivity reserves delayed hiring new manpower. Employment growth did not accelerate significantly until 2006. In 2007, the uptrend gained momentum. New jobs rose from annual average 241,000 (representing 1.0% growth) in 2006 to 339,000 (1.3% growth) in 2007 (the year-on-year changes were more significant); these figures translate into 198,000 and 343,000 full-time-equivalent jobs added respectively.

The main accelerator of employment growth was market services, where job creation rose from 0.9% in 2006 to 2.2% in 2007—thanks to the sharp rise in temporary-work services,[8] business services (from 1.6% to 2.9%), and personal services (from 1.6% to 2.8%) *(figure 8)*. Personal services are a major focus of employment policy. A framework act of June 2004 sought to promote them by introducing the "universal service-employment paycheck."[9] The category comprises a wide variety of services, such as maintenance, housekeeping, help for the elderly and disabled, homework help, and "intermediation." [10] Their growth is a response to large-scale social trends including population aging, the rising female activity rate, and the break-up of families, all of which generate strong demand. Personal services are, however, hard to identify using current economic classifications.

8. Contribution by industry to change in total payroll employment



Source: INSEE, base-2000 national accounts

Job additions in the construction industry were fueled by the sector's robust activity. Employment growth quickened from 4.2% in 2006 to 4.4% in 2007. Since 1999, it has consistently outpaced the rise in total French employment. Faced with a chronic shortage of skilled labor, the construction industry has increasingly relied on temporary workers, whose proportion has doubled in ten years to 8% of its labor force—or one-quarter of temporary jobs in the entire economy.

8. 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.
9. Chèque Emploi Services Universel (CESU), a system that simplifies reporting and social-contribution payments for individual employers, coupled with tax deductibility.
10. "Intermediation": agencies and organizations mediating between personal-service workers and persons seeking their services.

By contrast, job creation has been slacker in mainly non-market services[11] owing to the decrease in the number of subsidized jobs. In 2006, subsidy programs had made a one-time contribution to job creation, adding 20,000 jobs. In 2007, their contribution turned negative again because the number of new "Contracts for the Future" (Contrats d'Avenir) no longer offsets the termination of other programs, particularly "Employment Support Contracts" (Contrats d'Accompagnement vers l'Emploi: CAEs).

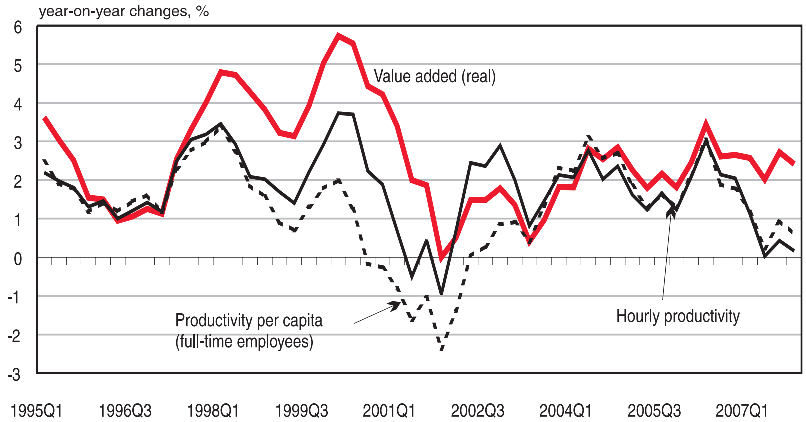
The downtrend in manufacturing employment persisted, but at a more moderate pace: the industry's workforce fell 2.3% in 2006 and 1.4% in 2007.

A host of measures to promote employment had been taken in 2005 under the Social Cohesion Programming Act and the Emergency Employment Plan. Other measures were introduced in October 2007 under the TEPA Act to promote labor, employment, and purchasing power, which notably called for a tax exemption on overtime pay.[12] However, the specific impact of these initiatives for full-year 2007 cannot be measured yet.

Sharp slowdown in productivity gains

Vibrant employment growth went hand in hand with slower productivity gains in 2007. In the non-farm market sector, these fell from 2.1% to 0.9%, i.e., below their long-term trend *(figure 9)*. Such a weakening does not seem due to the classic productivity cycle, in which employment adjusts to fluctuations in economic activity with a lag of several quarters.

9. Productivity cycle in non-farm market sector



Source: INSEE, base-2000 national accounts

Productivity gains in manufacturing declined from 4.1% to 2.9% in 2007, but remain far higher than in the rest of the economy *(figure 10)*. Since 2000, they have greatly outpaced the growth in manufacturing value added. In non-manufacturing market sectors, which are less exposed to competition and concentrate the largest share of job creation, productivity gains eased from 1.5% to a very moderate 0.4%.

11. Education, health, welfare, and administration.

12. The main purpose of this arrangement is to increase the employee's net earnings without raising the labor cost for the employer. The minimum overtime premium was raised to 25% in enterprises with fewer than 20 employees. Employees are exempt from social contributions on overtime pay up to 21.5% of their gross earnings. For employers' social contributions, a flat exemption is applied.

10. Wage per job,[1] productivity, and unit labor cost

Annual changes, %

	2003	2004	2005	2006	2007
Market branches (total)					
Wage per job	2.4	4.0	3.4	3.8	3.1
Productivity per job	1.9	2.0	1.8	2.1	0.9
Unit labor cost	0.7	1.7	1.2	1.8	2.0
Manufacturing					
Wage per job	1.8	5.3	3.6	4.0	3.5
Productivity per job	4.1	4.3	4.8	4.1	2.9
Unit labor cost	-1.9	0.8	-1.2	0.2	0.2
Other market branches					
Wage per job	2.7	3.8	3.4	3.7	3.1
Productivity per job	0.7	2.2	0.9	1.5	0.4
Unit labor cost	2.2	1.3	2.1	2.4	2.5

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

In level terms, France's hourly productivity remains one of the highest in the EU, well above that of Germany and equal to that of the U.S. This performance does not stem from a notably vigorous investment and innovation effort; rather, it seems to be a consequence of short working time and weak employment rates. On an equivalent employment-rate and working-time basis, French hourly productivity would probably fall below the U.S. level [3].

Compensation of employees still on a dynamic growth path

Between 2001 and 2004, the growth of the average wage per capita[13] in the non-farm market sector gradually firmed from 1.8% to 4.0%. It was initially fueled by strong productivity gains; since 2003, it has been stimulated by the economic recovery and successive increases in the minimum wage [4]. Since 2005, the average wage[14] per capita has grown by more than 3.0%. While the ebbing of inflation has put pressure on earnings, the employment recovery and the decline in unemployment have had a positive impact. In 2007, the growth of the average wage per capita eased from 3.8% to 3.1%. A contributing factor was the July 1 increase in the minimum wage, restricted to the 2.1% minimum stipulated by law for 2007.

The 2007 profiles of average wages per capita in the manufacturing industry and market services were very similar to the previous year's. At a more detailed level, the situations

13. Salaire Moyen Par Tête (SMPT). This is the mean wage per job on a full-time-equivalent basis. The mean wage per capita incorporates all structural effects (changes in skills, share of part-time employment), short-term effects (overtime level), and seasonal effects (bonuses).
14. Salaire Minimum Interprofessionnel de Croissance (SMIC). 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*). Between 2003 and 2005, the Fillon Act led to average annual increases of 5.5% in the hourly minimum wage. The Act 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. In 2007, the SMIC increase was capped at 2.1%, with no "boost," putting the monthly minimum wage at €1,281.

diverged between industries, reflecting heterogeneous employment and working conditions [5]. In the construction sector, the combination of a labor shortage—particularly of skilled workers—and an increasing reliance on overtime helped to keep wages on a robust growth path. In financial services, wages per capita, which had risen sharply in 2005-2006, lost some momentum. In the automotive industry, wages have been climbing sharply since 2006, but at the cost of heavy job cuts.

The growth in unit labor costs in the non-farm market sector quickened slightly from 1.8% to 2.0% in 2007, as wages outpaced productivity gains. This was due to the upward drift in market-service costs from 2.2% to 2.5%. By contrast, the persistence of high productivity gains in manufacturing, although down from 2006, kept the growth in unit labor costs to a far more modest 0.2%.

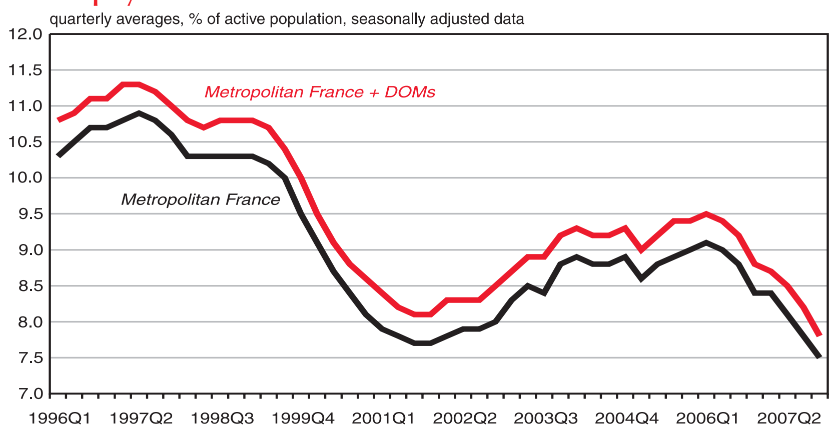
In the civil service, the total "index point" rose 0.8% on February 1, 2007, and the minimum guaranteed wage was raised by three points on July 1. In addition to these measures, the government decided at the end of the year to allow civil servants holding "time savings accounts" (Comptes Épargne Temps: CETs) to convert them into 1-4 days' paid vacation. Total growth in the civil-service average wage per capita quickened from 2.5% to 2.7% in 2007.

Further decline in unemployment

Since early 2007, France has been estimating its unemployment rate under the International Labor Office (ILO) definition using a new method more consistent with the assessments published at EU level. In particular, the concept of "job-seeking" has become more restrictive: re-registration at the National Employment Agency (Agence Nationale Pour l'Emploi: ANPE) is no longer regarded, per se, as proof of active job-seeking.

According to this new estimation, the number of ILO unemployed for all of France (metropolitan France and overseas *départements* [DOMs]) reached 2.1 million at end-2007. Thanks to faster employment growth in the market sector, the unemployment rate moved on a downward path in early 2006, easing from 9.5% in Q1 2006 to 7.8% in Q4 2007 *(figure 11)* [6]. The most significant gains concerned the young and seniors, who face the greatest difficulties in entering the labor market. The active population (total persons in employment or out of work) rose by 120,000, the same figure as in 2006. This

11. ILO unemployment rate



Scope of coverage: Metropolitan France (mainland + Corsica) and overseas départements *(DOMs), household population, persons aged 15+*
Source: INSEE, Labor Force Survey

pace is weaker than the annual average increase of 158,000 for the five years between 2003 and 2007. During that period, several factors had stimulated the growth of the active population: a vigorous demographic expansion characterized by the rising proportion of persons aged 55-64 born in the large postwar cohorts; an increase in the female activity rate; and the recent strength of employment growth, which induced a larger number of economically inactive persons to enter the labor market.

Since 2006, youth unemployment has declined. After peaking at 23.7% in Q1 2006, the unemployment rate among the 15-24s in metropolitan France fell to 18.9% by end-2007, a faster downturn than in other age groups. This improvement was driven both by policies in favor of the young and by the economic cycle—to which the young are traditionally more exposed. Despite these gains, however, unemployment among the 15-24s is still running more than three points above the euro-zone average and seven points above the German average. This phenomenon is caused by two factors: French youth enter the labor market late, and they generally begin their careers with a succession of temporary jobs (via temporary-work agencies or on fixed-term contracts) and frequent exits from employment.

Unemployment among the 55-64s also declined, from 6.5% in Q2 2006 to 5.0% at year-end 2007. The latter rate is lower than that of other age groups, but the average unemployment spell for seniors is longer than the all-ages average, and their return to the workplace is often problematic. The fall in senior unemployment is connected to the faster pace of retirements after long careers. A recent decision allows early retirement before age 60 for employees who began working before age 16 and who have paid 42 years of pension contributions. The measure has proved highly popular. For the moment, these early retirements have not been offset by the effects of the 2003 pension reform. The latter raised financial incentives to work beyond a certain age and encouraged firms to keep older workers, notably by introducing a fixed-term, 18-month contract, renewable once, for the over-57s.

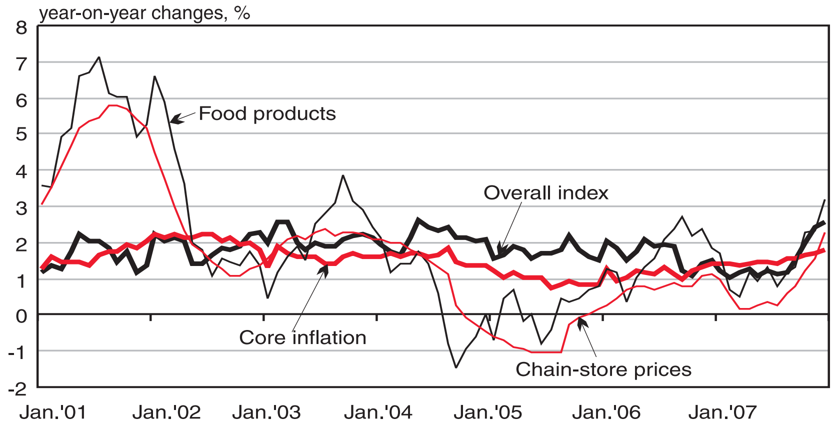
Despite these improvements, French unemployment at end-2007 was still above the euro-zone average (7.2%), equal to the new, revised rate for Germany, but far higher than that of the Netherlands (2.9%), Denmark (3.1%), and the United Kingdom (5.2%). Moreover, the employment rate (ratio of population in employment to population of working age) is particularly low in France (63.8% in 2007). This largely explains the gap in GDP per capita with the United States [3].

Inflation resurgent at year-end

Despite rising energy prices, France recorded tangible progress on the inflation front until summer 2007. After hitting a year-on-year peak of 2.6% in spring 2004, consumer-price growth gradually eased to a stable pace of 1.2% during the first eight months of 2007 *(figure 12)*. This decline was helped by the euro's appreciation and strong international competition, which dampened import prices. Yet some signs pointed to an incipient turnaround. In particular, core inflation,[15] after bottoming out in mid-2005, was gradually gaining momentum as higher oil prices spread to the rest of the economy and wage growth accelerated. In fall 2007, two shocks caused prices to jump: a surge in energy prices—in an oil market rocked by severe physical tensions—and a flare-up in food commodity prices. Year-on-year consumer inflation climbed from 1.2% in August to 2.6% in December (core

15. Excluding public-service tariffs and products with volatile prices, such as unprocessed foods, energy, and tobacco, adjusted for tax measures and seasonal variations.

12. Consumer prices



Source: INSEE, base-2000 national accounts

inflation rose from 1.5% to 1.8%). Annual average inflation, however, eased from 1.7% in 2006 to 1.5% in 2007. The household consumption deflator—calculated from the national accounts—slowed mildly as well, from 2.2% in 2006 to 2.0% in 2007.[16]

The barrel price of Brent crude oil hit a new high in 2007. After starting the year on a relatively subdued note, it started to climb in October toward an all-time high of $100. By December, it reached an average $91.2, five times its 2002 price of $19. The surge has been driven by persistent geopolitical tensions (Iraq, Iran, and Nigeria) and growing demand from emerging countries (mainly China and India), even as OPEC has refrained from using its full spare capacity. So far, however, the industrialized countries have been able to absorb the extra oil cost through energy savings and the decline in prices of manufactured imports.

In France, the impact of rising Brent oil prices on total oil-price growth has been dampened by the stronger euro and by the mechanism of the domestic tax on petroleum products (Taxe Intérieure sur les Produits Pétroliers: TIPP).[17] The growth in the dollar price of oil actually eased from 19.7% in 2006 to 11.3% in 2007. In euros, the 2007 increase was only 1.5%. The total rise of French energy prices slowed sharply from 6.4% in 2006 to 0.9% in 2007. This moderation single-handedly explains the dampening of inflation in 2007.

The oil shock was compounded by tensions over prices of food commodities (such as milk powder, cereals, soybean, and cocoa) from summer 2007 onward. The tensions were triggered by short-term developments (weather conditions) and structural factors (diversion

16. National accounts use the consumption expenditure deflator to compare income to inflation and determine the gains in household purchasing power (real income). The deflator rose 2.0% in 2007, i.e., 0.5 points more than the consumer price index (CPI) in the same period. Most of the gap is due to prices of financial intermediation services indirectly measured (FISIM): these prices, which lie outside the CPI scope of coverage, contributed 0.4 points to the deflator's rise in 2007. Their robust increase in the past two years reflects the growth in banks' margins on customer deposits: the interbank rate at which banks obtain funds is rising, whereas interest paid to depositors is more inert. Furthermore, rents have a higher weighting in the national accounts because the accounts include imputed rent, and this added 0.2 points to the deflator's growth.

17. 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 large proportion of the tax-paid price is therefore insensitive to variations in the crude-oil price. 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.

of farmland from food crops to biofuels). Wheat prices posted one of the steepest increases, owing to a global supply shortage. The rise in commodity prices was passed on to processed-food prices and—at the end of the supply chain—to overall food prices, whose year-on-year growth accelerated from 0.8% in July to 3.2% in December 2007. On an annual-average basis, however, food inflation eased from 1.7% to 1.5%.

Service prices remained the fastest-growing component of French annual average inflation in 2007. They rose 2.4%, their average pace of the past five years. Rent prices, which are partly inflation-indexed, posted only a moderate decline, from an annual average 3.5% in 2005-2006 to 3.2% in 2007. Health-service prices gained 2.5% in 2006 and 2.4% in 2007. Their continued rise was due to the July 1, 2007, increases in the fee for an office visit to a primary-care physician from €21 to €22, and in the prices of certain procedures performed by self-employed nurses. Telecommunication prices decreased far more moderately than in 2006, by 0.9% versus 5.3%. After a two-year contraction, prices of manufactured goods firmed slightly in Q4 2007, but remained stable in annual-average terms.

Acceleration in household purchasing power

While unemployment and purchasing power have long ranked together among the main concerns of the French, the labor-market improvement gradually shifted the focus of dissatisfaction toward real income. The end-2007 surge in prices of staple goods such as gasoline, bread, and milk simply strengthened households' belief in a loss of purchasing power. This perception is evidenced by the widening gap between actual inflation and consumer opinions on prices as expressed in confidence surveys. Such a gap, incidentally, is not specific to France: it is observed in most euro-zone countries. Amid these developments, the government introduced a package of measures on October 1, 2007, aimed at "restoring work in its full role as a tool for improving purchasing power." The measures included reductions in social contributions on overtime pay, a tax shield to cap income-tax payments, cuts in estate and gift taxes, and tax deductibility of loan interest.

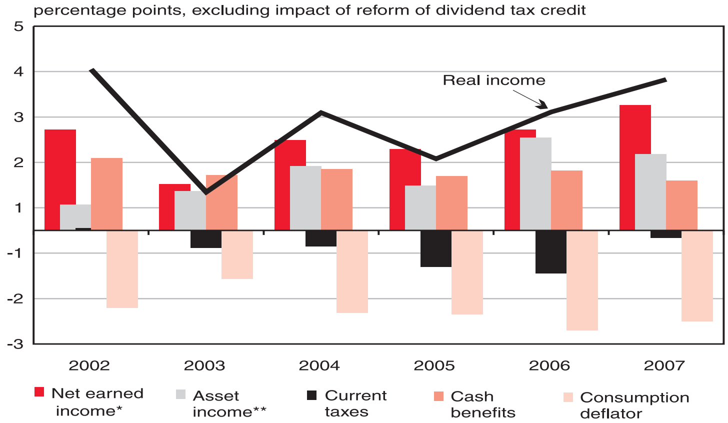
Yet, while the impression of a relative impoverishment of households may be substantiated for certain sections of the French population, it is not corroborated by the macroeconomic data of recent years. Admittedly, households' real gross disposable income—i.e., their total available resources net of taxes and social contributions, adjusted for the rise in consumer prices—grew at a weaker pace in 2003-2006 (by an annual average 2.2%) than in 1998-2002 (3.4%). But the aggregate has gradually regained vigor thanks to firmer growth in wages and rising asset income. In 2007, household purchasing power registered a further acceleration from 2.6% to 3.3%, returning to its brisk pace of the early 2000s *(figure 13)*.

Purchasing-power growth concerns households in the aggregate. To assess the average variation at individual level, it needs to be adjusted for demographic change. This is done by dividing purchasing power by the number of consumption units, a ratio that takes into account the change in the number of households and in their composition. On this "equivalent income" measure, purchasing-power growth accelerated from 1.7% in 2006 to 2.4% in 2007.

Statisticians also track real "discretionary income," i.e., disposable income minus "pre-committed" expenditures, which are incurred under contracts that cannot easily be revised in the short term. The growth in "pre-committed" expenditures has caused real discretionary income to rise more slowly than disposable income in the long run—by an annual average 1.9% versus 2.2% since 1974. However, the two aggregates' annual variations are generally similar. In 2007, real discretionary income accelerated sharply as well, outpacing real disposable income.

The 0.7-point increase in the growth rate of French households' real disposable income in 2007 breaks down as follows: the rise in earned income, largely due to employment growth, contributed 0.5 points; cuts in compulsory levies contributed 0.8 points. By contrast, social benefits and asset income made negative contributions of 0.2 points and 0.4 points respectively.

13. Contributions to change in real household income

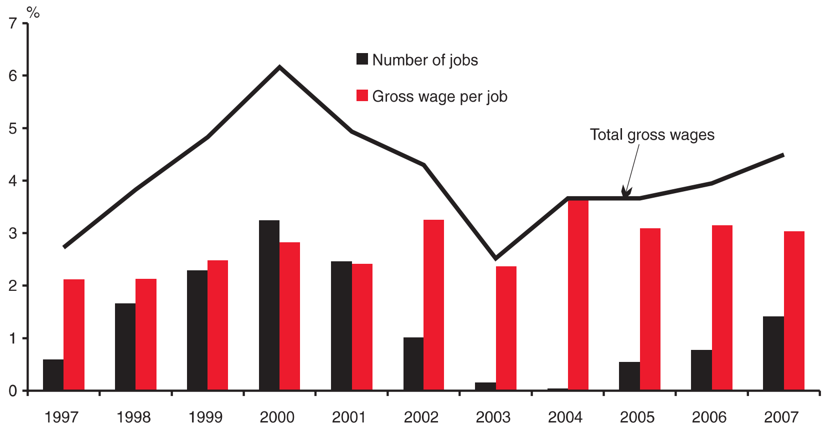


*Earned income = gross wages and salaries + mixed income
**Asset income = financial income (interest + dividends) + gross operating surplus of households (rent received by property owners, including imputed rent)
Source: INSEE, base-2000 national accounts

Purchasing power driven by rising earned income

In 2007, French purchasing power was boosted by the acceleration in earned income. This aggregate, which includes gross wages and salaries plus unincorporated-enterprise income, accounts for about 70% of households' disposable income. Gross-wage growth quickened from 3.9% to 4.5%, thanks to the faster rise in employment and the persistence of comparatively robust gains in the mean wage per capita, up 3.0% *(figure 14)*. The growth in gross operating surplus of unincorporated-enterprise income, fueled by the brisk increase in farmers' income, also accelerated from 4.2% to 5.2%.

14. Total gross wages, wage per job, and number of jobs in non-farm non-market branches



Source: INSEE, base-2000 national accounts

In the non-farm market sector, gross-wage growth topped 4.8%, driven by the recovery in private-sector employment combined with a stronger uptrend in wages. In the mainly non-market sector, gross-wage growth edged down to 3.9% because of the deceleration in employment to 1.0%.

After gaining 9.2% in 2006, asset income rose by a still-robust 7.3% in 2007. The growth in actual rents (from rentals) and imputed rents (computed for owner-occupier households) quickened from 6.7% to 7.2%, while net property income slowed. Net interest income registered a smaller increase due to larger interest payments by borrower households, amid rising interest rates and growing indebtedness. Dividends paid to households rose faster than in 2006.

Additional stimulus from tax cuts

In addition to robust earned-income growth, French households benefited from a sharp slowdown in social contributions and taxes. The rise in social-contribution payments eased somewhat from 4.6% to 3.9%, while the growth rate of income and wealth taxes fell from 7.2% to 1.2%, excluding the dividend tax credit (*avoir fiscal*). In Q4 2007, the TEPA Act to promote labor, employment, and purchasing power exempted households from social contributions on overtime pay. The rise in current taxes was restrained by the revision of personal income-tax brackets and the increase in the working tax credit.[18] By contrast, other categories of taxes continued to rise sharply, in particular the occupancy tax (*taxe d'habitation*), property tax (*taxe foncière*), and wealth tax (ISF), driven by strong growth in housing prices.

The growth in social benefits in cash received by households weakened from 4.4% to 3.7%. The rise in old-age and sickness benefits (daily allowance) quickened, but family benefits posted moderate growth with the end of the ramp-up of the Young Child Allowance (Prestation d'Accueil du Jeune Enfant: PAJE). Unemployment benefits declined thanks to the improvement in the labor market.

Purchasing-power gains promoted household consumption and saving

In recent years, faced with the somewhat abrupt fluctuations in their purchasing power, French households tended to smooth their consumption by adjusting their saving ratio. This behavior continued in 2007, since strong purchasing-power gains led households to boost consumption (by 2.5%, up from 2.3%) as well as to raise their saving ratio from 15.1% to 15.8%.

The positive stimulus to the saving ratio from higher real income outweighed the negative factors such as declining unemployment and slacker inflation. By easing uncertainties on future income, the decrease in unemployment provided an incentive to reduce precautionary saving in 2007. Likewise, the inflation slowdown tended to lessen the need to rebuild real cash balances. Beyond the weak rise in share prices in 2007, the wealth effect seems to have been limited. In theory, it could have depressed the saving ratio, as the rise in value of households' equity and real-estate portfolio has a positive effect on their consumption. However, while the wealth effect is proven in the U.S. and the U.K., its influence seems far more marginal in France [7], for two reasons. First, French households are more risk-averse and therefore invest a smaller share of their wealth in risky assets. Second, a very large proportion of their assets consists of real estate, chiefly for domestic use and thus hard to convert to cash in order to finance increased consumption. This situation is very different from that of U.S. households, who, if their real-estate assets go up in value, can take out consumer loans far more easily by putting up their homes as collateral.

18. The working tax credit is deducted from income tax due.

Last year's mild acceleration in French household consumption expenditures was largely due to the rebound in automobile purchases from a negative 2.3% in 2006 to a positive 3.3% in 2007. The brisk consumption gains were also sustained by purchases of goods and services in the information and communication technologies (ICT) sector, up 15.4% in 2006 and 13.7% in 2007. Driven by television sets and computer equipment—particularly laptops—ICT purchases accounted for one-quarter of the total rise in household consumption, even though they represent barely over 4% of household budgets.

Expenditures by government on behalf of households grew more slowly than households' final consumption expenditures

Expenditures for the benefit of households and financed by general government are known as "individual expenditures" because the beneficiary is easily identifiable. More than 80% of these outlays consist of public spending on health and education.

For the fourth consecutive year, individual expenditures by general government grew more slowly than final consumption expenditures by households, financed by households themselves. They thus helped to restrain the rise in actual household consumption from 2.1% in 2006 to 2.3% in 2007 (actual consumption is the sum of individual expenditures by government and final consumption expenditures by households).

Nevertheless, individual expenditures by general government posted mild gains in 2007, rising from 3.7% to 4.2% in nominal terms and from 1.5% to 1.7% in real terms. The main driver was the increase in expenditures on primary health care, including fees charged by physicians, dentists, and medical auxiliaries.

Public deficit rising

The improvement in France's public accounts observed since 2004 was halted in 2007. The public deficit as defined in the Maastricht Treaty rose €7.7 billion to €50.3 billion *(figure 15)* [8]. It thus moved from 2.9% of GDP in 2005 to 2.4% in 2006 and 2.7% in 2007. This change was due to the fact that the 4.0% growth in expenditures outpaced the 3.4% growth in public revenues, compared with 3.4% and 4.5% respectively in 2006. The acceleration in expenditures reflected robust growth in compensation of employees, particularly in local government, the heavier burden of interest payments on the debt, and the faster pace of public investment. Nevertheless, the ratio of public expenditures to GDP declined from 52.7% to 52.4%.

15. Main public-finance aggregates

% of GDP

	2003	2004	2005	2006	2007
Expenditures	53.3	53.2	53.4	52.7	52.4
Revenues	49.2	49.6	50.4	50.3	49.7
Deficit under Maastricht definition	-4.1	-3.6	-2.9	-2.4	-2.7
General-government debt	62.9	64.9	66.4	63.6	63.9
Compulsory levies	42.9	43.2	43.6	43.9	43.3

Sources: INSEE, base-2000 national accounts; Directorate-General of Public Accounts (DGCP); Directorate-General of the Treasury and Economic Policy (DGTPE); Bank of France.

The ratio of revenues to GDP fell from 50.3% in 2006 to 49.7% in 2007. This moderate slowdown reflects the decrease in compulsory levies (which comprise taxes and actual social contributions) of 0.6 points of GDP, after three consecutive annual rises. Many reductions were introduced in 2007, especially concerning personal income tax: a bracket reform, an increase in the working tax credit, and a rise in tax credits for sustainable development and for child care outside the home. Revenues from personal income tax fell 7.4%.

At end-2007, France's general-government debt under the Maastricht definition reached €1,209.5 billion, or 63.9% of GDP, compared with 63.6% at end-2006. ■

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