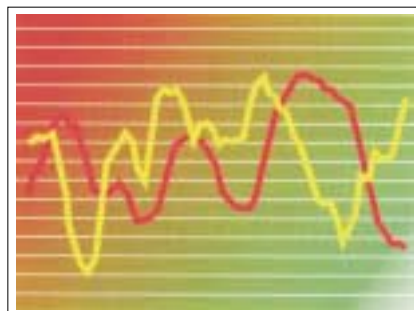


CONJONCTURE IN FRANCE

JUNE 2003



CONSOLIDATION

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CONSOLIDATION

After weakening towards the end of 2002, French growth turned moderately positive again in Q1 2003, thanks to the progress of consumption, which has been the mainstay of activity for the past two years. At the same time, the climate became one of high uncertainty in the waiting period before the war in Iraq. The rapid ending of military operations failed to produce more than a partial recovery in business leaders' and households' expectations. For the business leaders, the decline in activity in neighbouring countries and the rapid rise in the euro exchange rate provided two fresh sources of concern. For the households, the rise in unemployment still constitutes a major worry, slightly compensated by the decline in inflation linked to the easing of oil prices. Simultaneously, the impact on consumption of the purchasing power gains seen towards the end of 2002 decreased sharply. In these circumstances, activity is likely to have stagnated in Q2.

Just before mid-year, the euro zone's international environment remains unsupportive. In the United States, the awaited signs of increase of growth are still sparse. GDP growth also remains moderate in the United Kingdom. In the euro zone, activity continued to stagnate in Q1 and this tendency could well have continued into Q2, to judge by the latest business surveys.

For the second half of the year, the capacity for an upturn seems much more significant in the United States than in the euro zone. American fiscal policy is decidedly countercyclical and the Fed's monetary stance has long been accommodative. The process of repayment of corporate debt and the adjustment in employment are both longer-established than in Europe. Finally, the recent evolution in

exchange rates is favouring growth in the short term in the United States but having an adverse effect on European business leaders' expectations. In these circumstances, American growth can be expected to accelerate in H2, while remaining below its long-term trend. In the euro zone, growth in activity is likely to remain very moderate, with the rise in consumption limited by the budgetary context and by the continued adjustment in employment, while recovery in investment would remain slow because of the modest demand outlook.

The French economy, for its part, is likely to evolve in H2 in a manner very close to that of the euro-zone average. Consumption seems set to grow slightly faster than 1%, with purchasing power underpinned by the decline in inflation — the year-on-year price rise is in fact expected to be around 1.5% in December. With investment projects no longer frozen and with stocks making a slightly positive contribution (but external trade a negative one), French GDP should rise at an annual rate of close to 1.5% starting in Q3, bringing annual average growth for 2003 to 0.8%. Employment will probably continue to stagnate, resulting in a steady rise in the unemployment rate to 9.6% at the end of the year. If the dollar were to continue to slide, this would be cause for concern, notably via the threat this would pose to the German economy. In the other direction, a possible positive factor might be a rapid improvement in expectations in the euro zone under the influence of the American upturn and the interest rate cuts applied by the ECB, which would compensate for the unfavourable short-term impact of past movements in the exchange rate. ■

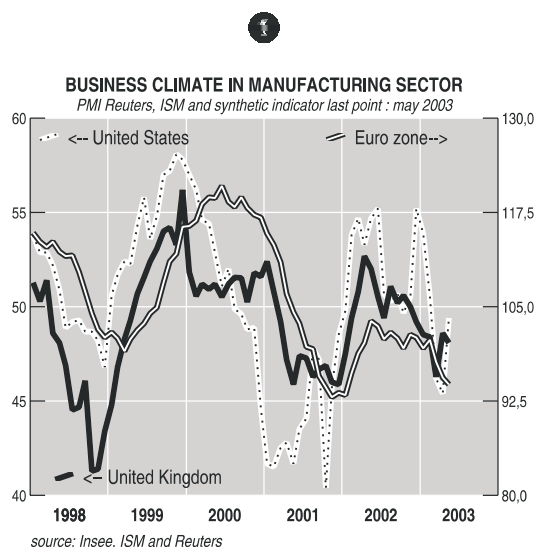
Until May, the situation in world industry was marked by the wait-and-see attitudes linked to the Iraqi crisis

United States growth came out below potential in Q1, mainly because of the wait-and-see attitudes provoked by international political uncertainties, an attitude which intensified at the beginning of Q2. The deterioration in the ISM composite index for American industry that had begun in January continued through April. In this uncertain environment, firms preferred to limit production levels, postpone investment projects and slow the rate of their stock build-up. This type of behaviour was even more pronounced in the United Kingdom, where GDP slowed down in Q1.

In the euro zone, the industrial production index rose in Q1 at the same rate as in the United States (0.1%). Business climate indicators in manufacturing show that this slackness has continued to persist in the euro zone during the spring, deteriorating further in May at a time when the United States index rallied strongly (*cf. Graph 1*).

The dissipation of uncertainties should breathe new life into the American and British economies

Several factors are likely to give a renewed boost to consumption in the euro zone's two principal partners. The fall in the oil price will benefit household purchasing power. After peaking at over 34 \$/barrel at the beginning of March, the Brent price fell by more than 10 \$ with the ending of the military intervention in Iraq. Falling more into line with its fundamentals, the oil price is likely to stabilise at around 25 \$/barrel until the autumn, before easing back



slightly towards 22 \$ by the end of the year. These tendencies would mean a decline in inflation. Consumption would be underpinned by the easing of the negative wealth effects linked to the steep falls in stock-market prices in 2002.

In addition, investment should resume its interrupted growth in both the United States and the United Kingdom, thanks to an improvement in expectations and especially to the easing of monetary and financial conditions. The recovery in stock-market prices and the decline in risk premiums reflect the more favourable perception of companies' financial situations on the part of the capital-providers. Expectations regarding the evolution in leading rates, which have already fallen to historically low levels, are still headed downwards, notably in the United States since the announcements made by the Federal Reserve at the beginning of May. All things considered, the present situation is one of easier borrowing conditions for firms, and this is propitious to an acceleration in investment.

FRANCE: GROSS DOMESTIC PRODUCT (volume) BY TYPE OF EXPENDITURE

(at 1995 prices seasonally and working-day adjusted data, % change from previous period)

		2001				2002				2003				2001	2002	2003
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
GDP	(100%)	0.6	-0.1	0.4	-0.3	0.7	0.5	0.3	-0.1	0.3	0.1	0.3	0.4	2.1	1.2	0.8
Imports	(27%)	-1.6	-1.6	-0.9	-1.3	1.6	0.8	0.9	-0.6	0.7	0.8	1.0	1.2	1.4	0.7	2.3
Consumption	(54%)	1.3	0.3	0.8	0.2	0.2	0.4	0.4	0.4	0.6	0.1	0.3	0.3	2.7	1.4	1.5
Public consumption	(23%)	0.6	0.6	1.3	0.6	1.4	1.1	0.7	0.7	0.1	0.6	0.6	0.6	3.2	4.1	2.2
Investment	(20%)	0.5	-0.9	0.1	-0.5	0.0	-0.4	-0.7	-1.1	0.4	0.2	0.3	0.6	2.1	-1.4	-0.4
of which:																
Non financial corporated and unincorporated enterprises	(12%)	0.4	-0.4	0.0	-0.8	-0.2	-1.4	-0.9	-1.7	0.5	0.3	0.5	0.9	3.5	-2.8	-0.9
Households	(5%)	1.1	-0.9	0.6	0.0	0.0	1.1	0.1	-0.2	-0.1	-0.2	0.1	0.1	0.8	0.8	0.0
Exports	(29%)	-0.3	-2.9	0.2	-1.8	1.6	1.8	0.8	-0.5	-0.7	0.0	0.2	0.8	1.8	1.2	0.1
Contributions to growth																
Internal demand ex. inventory changes		0.9	0.1	0.8	0.1	0.4	0.4	0.3	0.2	0.4	0.2	0.4	0.4	2.6	1.4	1.3
Inventory changes		-0.7	0.2	-0.7	-0.2	0.3	-0.2	0.1	-0.2	0.2	0.0	0.1	0.0	-0.7	-0.4	0.1
Net foreign trade		0.4	-0.4	0.3	-0.2	0.0	0.3	0.0	0.0	-0.4	-0.2	-0.2	-0.1	0.1	0.2	-0.6

Forecast

A moderate upturn in activity is likely to follow the improvement in demand from households and firms. The acceleration in growth in Q3 2003 is likely to be less pronounced in the United Kingdom (0.4%, compared with 0.3% in Q2) than in the United States (0.7% and 0.3%), as consumption will be less lively than in 2002, given that the resources derived by households from mortgage refinancing will have slowed down substantially.

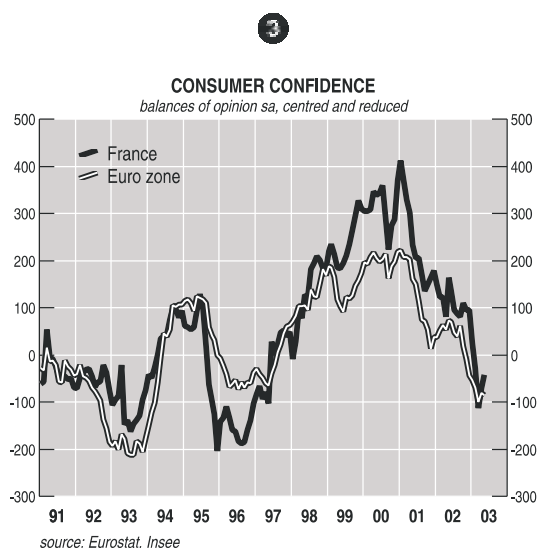
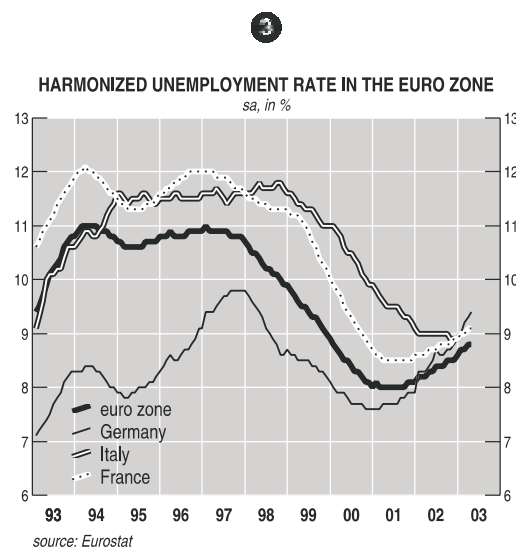
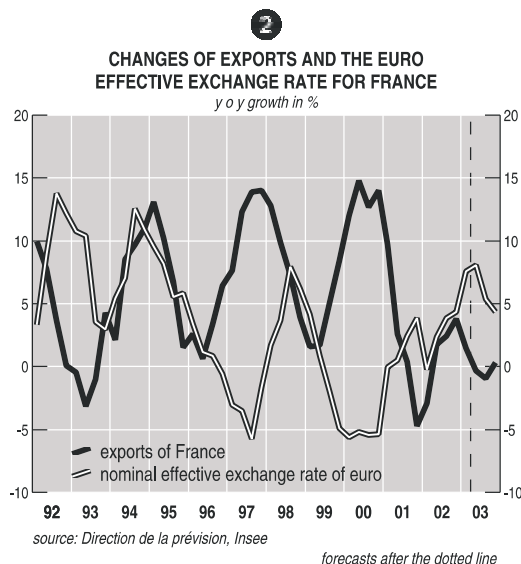
World trade should gradually benefit from this improvement in the American and British economic situations. The ending of the wait-and-see attitudes should bring about a revival in imports into both countries in Q2 and this would be bolstered by an acceleration in exports, helped by the recent depreciation of the dollar and sterling versus the euro.

The appreciation of the single currency means that the euro zone is unlikely to benefit greatly from the revival in world trade

Despite the more favourable international environment, foreign trade is unlikely to provide much of a boost to euro-zone growth in 2003. The contribution of foreign trade to growth, which was negative at the end of 2002 and nil in Q1 2003, is likely to remain close to zero until the end of the year. The virtually uninterrupted appreciation of the euro in the past year has in fact brought about a deterioration in the zone's price-competitiveness. As a result, exports to non-euro-zone countries would not benefit to the full extent from the recovery in the imports of the zone's two principal partners (United Kingdom, United States). Trade within the zone would have difficulty in making up the shortfall because of the slackness of demand within the zone. In France, it would be necessary to wait until Q4 before seeing any export recovery take shape, when demand from within the zone would become more buoyant (cf. Graph 2).

Under the impact of the deterioration on the labour market, household consumption in the euro zone is likely to rise only very moderately

Household consumption is not expected to permit a marked recovery in the euro zone, rising at a quarterly rate of 0.3% in the second part of 2003. This is because the slowdown in employment growth since the beginning of 2002 can be expected to continue to hold back household income. Moreover, the rise in the unemployment rate is likely to encourage precautionary saving (cf. Graph 3). After deteriorating during the winter, household confidence has risen slightly since April, following the ending of the conflict in Iraq (cf. Graph 4) but remains morose in many euro-zone countries.



Meanwhile, the fall in the oil price in Q2 should help to bring about a decline in inflation and this would bolster purchasing power. Taking the assumptions adopted for the oil price and assuming a stable exchange rate of 1.15 \$ to the euro, inflation in the euro zone can be expected to stabilise at around 2.0%, after peaking at 2.4% this winter. In the case of France, inflation should fall even more, to stand at 1.5% in December 2003 compared with 2.0% in June (cf. Graph 5), although a slight acceleration in the prices of manufactured products and food excluding seasonal produces is likely to bring about a small and temporary rise in core inflation in H2 2003.

As in the other countries of the euro zone, however, the decline in overall inflation would be too small to keep the French population's purchasing power rising at the same rate as in 2002. For one thing, earned income would be adversely affected by the deterioration on the labour market in the early part of the year. In fact, the unemployment rate is likely to continue to rise throughout the year, to stand at 9.6% in December. The sharp slowdown in job creation is unlikely to be compensated by the relatively rapid growth in wages due to past price rises and, to a small extent, to the adjustment in the minimum wage generated by the «levelling-up» of the guaranteed monthly wage and the hourly minimum wage rate. Another factor operating in the same direction is the fact that certain exceptional income rises in 2002 in the form of tax cuts and a substantial growth in social benefits will not be repeated in 2003. In particular, modifications to the unemployment benefit system can be expected to restrict the payment of claims. In the end, purchasing power growth is expected to be 1.2% in 2003, down from 2.0% in 2002.

Given this slowdown in incomes, growth in French household consumer spending will probably be moderate, close to the euro-zone average. This means a further diminution in what has been a specific feature of the French economy until now, namely stronger consumption growth than in neighbour countries. This introduces a contrast to previ-

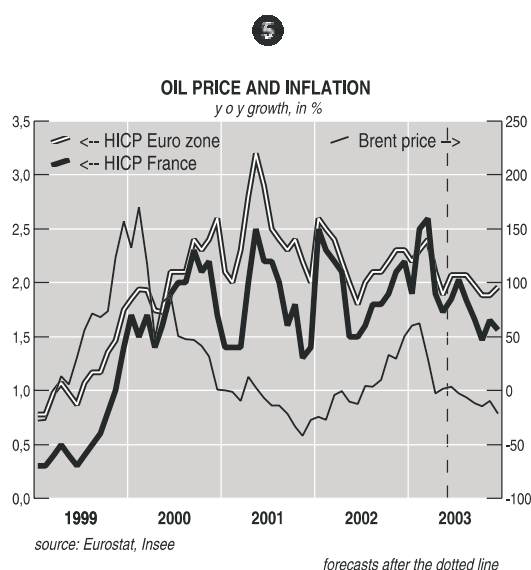
ous forecasts, which were based on a maintenance of this special feature. Household income turned out in fact not to be as high as was forecast in 2002, partly under the impact of a sharp reduction in income linked to the fall in stock-market returns and in interest rates. An additional factor was the greater-than-expected deterioration on the labour market in Q1 2003, as a result of the decline in GDP in Q4 2002. This means that consumption, after being bolstered in Q1 (a rise of 0.6%) by the energy consumption due to the cold weather and by the impact of the tax cuts in the previous quarter, can be expected to slow down, recording an annual growth rate of between 1.0% and 1.5% in H2.

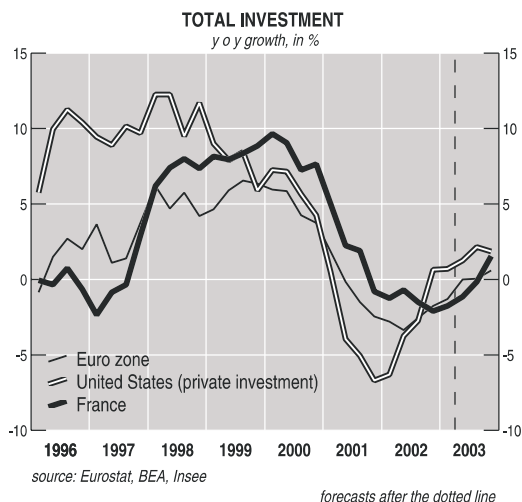
The improvement in financing conditions likely to mean a gradual recovery in investment

Despite the weakness of export demand and the moderate growth in household consumption, corporate investment is expected to recover gradually between now and the end of the year in all the euro-zone countries, although firms remain preoccupied by the need to put their balance sheets in order. The reduction in the uncertainties linked to the international political situation and the improvement in financing conditions should finally make up for the lacklustre short-term demand prospects.

Three factors have contributed to the easing of monetary and financial constraints in the euro zone. First, firms obtaining their finance on the bond market benefited in Q2 2003 from a decline in their risk premiums. Second, the easing of market rates, bringing about a decline in borrowing rates in Q1, is a positive factor for firms obtaining their finance through borrowing. Third, the rally on the stock markets between mid-March and end-May made up for the decline in the early part of the year. This stabilisation means that external financing via share issues or share exchanges is no longer being penalised. The improvement in stock-market prices is also a reflection of an improved profit outlook and this too is favourable to investment.

In France, firms are in fact more optimistic regarding their investment projects. Questioned in April 2003, business leaders in the industrial sector indicated that they were holding to their forecasts of a rise in their investment. In particular, the sharp rise in enterprise creation in Q1 2003 (a rise of 6.6% in the three months to April compared with the same period of the previous year) could be a further sign of the recovery in their expectations. Moreover, the upturn recorded in Q1 for IT investment could be the sign of a reversal of trend, as seems to be confirmed by the ordering intentions of IT wholesalers. Finally, after almost two years of declining investment, the trough seems to have been passed, as was already suggested by the upturn in Q1. Corporate investment is likely to rise throughout 2003 (cf. Graph 6).





The improvement in borrowing conditions should also encourage less restrictive inventory behaviour. In France, this financial easing is taking place at a time when firms are regarding their stocks as on the light side. This means that they should gradually be revising their behaviour towards inventories so that after two years in which inventory changes made a negative contribution to growth, the contribution should be slightly positive in 2003.

Corporate demand therefore likely to underpin production in H2

The combination of a one-off slowdown in domestic demand and an unsupportive international environment can be expected to lead to a distinct downturn in production in Q2 in the euro zone. This «bad patch» in Q2 is illustrated by the situation in France: production is likely to contract in manufacturing, transport and wholesale distribution, reflecting the decline in exports. Retailing and services, better sheltered from the hazards of the international situation, are likely to grow at what are still positive but less firm rates, reflecting the slowdown in consumption.

The recovery in corporate demand, reflected in the gradual acceleration in investment, should nevertheless make it possible to return as of this summer to firmer production rates, although still below potential. In France, in particular, first transport and then wholesale trade would benefit from this support. Manufacturing production would accelerate more gradually, in line with the recovery in exports, stimulated towards the end of the year by more vigorous exchanges between the euro-zone countries.

This improvement in production in the euro zone as a whole in H2 would also be intensified by the ending of the deterioration in the construction sector. Euro-

pean business surveys in fact indicated an improvement in the business climate in this sector in the early part of 2003. The recovery in private investment could bolster activity in this sector, following the low point reached in France in Q2 2003 (cf. Graph 7).

France and the euro zone set to remain in a consolidation phase until the end of the year

Against a background of continuing slowdowns in domestic demand and foreign trade, the euro zone's GDP is expected to rise at a rate of 0.2% per quarter in the second part of the year. Activity would be slightly firmer in France, with growth of 0.3% in Q3 and 0.4% in Q4, giving an annual average increase for 2003 of 0.8%, as against 0.5% for the euro zone.

There are a number of unknowns that could affect this scenario. The upswing in the economic cycle could be more pronounced, and activity firmer, if business leaders' expectations were to pick up faster than expected. In particular, the IT investment cycle could be the deciding factor for a more rapid upturn in total investment than the traditional determinants are suggesting. A more marked upward movement on the financial markets could have a similar effect.

Conversely, continued appreciation of the euro could curb exports to countries outside the euro zone and have a negative impact on European business leaders' expectations, and this would have an unfavourable effect on growth. ■

