

# CONJONCTURE IN FRANCE

MARCH 1998

## AUTONOMOUS GROWTH

*The 1997 upturn in French activity triggered a virtuous circle of growth.*

*At a time of favourable exchange rates, the combination of the recovery in Europe and the peaking of the cycle for the rest of the world has generated strong export growth. The resulting acceleration in activity has breathed new life into the various components of domestic demand. Industry was the first to benefit, followed by the other sectors of the economy.*

*The beginning of 1998 therefore finds domestic demand headed upwards. Consumption is benefiting from the growth in earned income, largely due to the improvement in employment, and from strengthening confidence on the part of households. Investment, after long hesitation, has picked up again and can be expected to accelerate as the strong growth outlook persists. The contribution from inventories remains positive, but not on the same scale as in past upswings because of the stagnation of producer prices.*

*The international environment is slightly less supportive, with the Asian crisis and the stagnation in Japan likely to hold back French*

*exports for some time to come. The United States could now follow the United Kingdom into an economic slowdown. As a result, despite the liveliness of the continental European economies, French merchandise exports can be expected to weaken, with their year-on-year increase falling back to less than 8% in mid-1998, as against 14% in mid-1997. With imports rising sharply since the revival of in domestic demand, foreign trade can be expected to cease contributing to growth in H1 1998.*

*All in all, GDP growth is likely to lose momentum but gain autonomy. Having passed a peak of 3.5 percent (annualised rate) in H2 1997, it is now likely to settle down at a rate of close to 3% a year. This would put France in phase with its future EMU partners.*

*Growth continues to be inflation-free. The fall in the prices of oil and other commodities is helping to keep the year-on-year price rise at around 1%. Job creations in the traded sector are accelerating, probably almost as numerous in H1 1998 (140,000) as for the whole of 1997. The unemployment rate would therefore continue to fall to below 12% in mid-1998.*

# Overview

## A less supportive international environment

Since the summer of 1997, the international environment has been marked by the financial crisis in South-east Asia, which has led to a sharp depreciation in the region's currencies, capital flight and a severe banking crisis. In order to shield themselves from payment defaults, several countries have launched stabilisation policies, in collaboration with the IMF. The impact of the sharp decline in activity on their demand for imports is likely to be all the greater in that their national currencies have depreciated. As a result, OECD countries and especially Japan can no longer count on this region, still highly dynamic until last summer, to attract their exports in 1998. With one-fifth of Japanese exports going to the countries affected by the crisis, Japan's growth is unlikely to derive more than weak support from foreign trade. Against a background of depressed domestic demand since the spring, as a result of the restrictive fiscal policy stance and the acute crisis in the financial system, the Japanese economy is in stagnation.

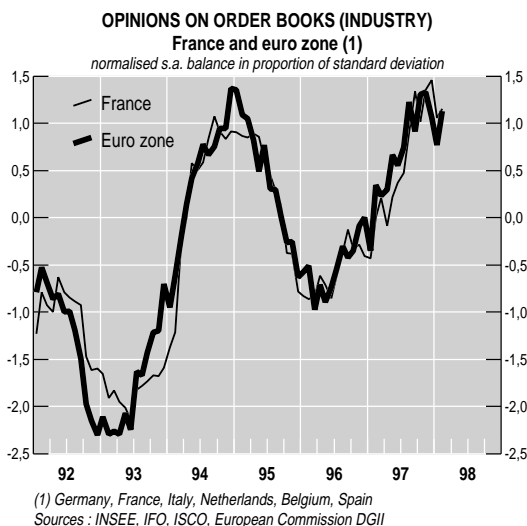
Thanks to exceptionally firm domestic demand, the United States economy in 1997 recorded its strongest expansion in nine years. Purchasing power gains made possible by massive job creation and the positive momentum of real wages, are behind the strength of private consumption seen throughout the year. Moreover, the wealth effects generated by the strong performance of equity prices have led to a decline in the saving ratio. Investment, stimulated by the buoyant

domestic climate and favourable monetary conditions, was also vigorous in 1997. In H1 1998, imports are likely to continue to be propped up by the strength of all components of domestic demand, whereas exports, hit by the distinct slowdown in demand from Asia and the continuing appreciation of the dollar throughout the past year, are likely to slow down appreciably. Foreign trade is therefore liable to initiate the slowdown in the economy.

In the United Kingdom, where the economic situation has long shown similarities with that of United States, the slowdown has already begun. The competitiveness losses associated with the appreciation of sterling have begun to hit exports. Private consumption was propped up in mid-year by certain windfall items. Even so, with many households carrying variable-interest-rate debts, there is a risk of a deterioration in domestic demand under the impact of the uninterrupted rise in interest rates seen since the spring. This monetary squeeze has been motivated by the rise in inflation, against a background of wage pressures and the unprecedented decline in the unemployment rate.

The outlook is better in continental Europe. Underpinned by exports throughout 1997, the upturn has now intensified as a result of an increasingly favourable orientation of domestic demand. In H1 1998, the various components of domestic demand are expected to confirm their recovery, whereas foreign demand is likely to weaken, affected by the drop in demand from Asia and, to a smaller extent, by the slowdown in the British economy, probably followed by that of United States.

The precise pattern and timing of the recovery in domestic demand differs from country to country. In Germany, for instance, against a background of worsening unemployment and modest wage rises, household consumption has been particularly depressed throughout 1997. Moreover, while productive investment has turned out to be fairly dynamic, total investment has suffered from the depressed situation in the building sector. All told, Germany domestic demand has remained slack throughout the year. However, a certain number of factors foreshadow an upturn in private consumption in H1 1998 : accelerated wage growth, stabilisation of unemployment and renewed confidence on the part of consumers. In the Southern European countries (Spain, Italy, etc.) the decline in unemployment and inflation and the relaxation of tax pressure should allow for continuing purchasing power



gains and thus prop up household consumption in H1 1998. In these countries, productive investment, which has been accelerating for several quarters, is likely to benefit from favourable monetary conditions and be stimulated by the increasingly intensive capacity utilisation in industry.

All in all, growth in the continental European countries, having been firm since the start of the winter, is now levelling off and the various support factors, from both home and abroad, are tending to even out. The marked return of confidence on the part of households and firms is also being fuelled, especially in Southern Europe, by the prospect of monetary unification, which is proceeding steadily and bringing with it low interest rates and stable exchange rates.

### Slower exports

In H1 1998, the confirmation of the upturn in France's neighbours is unlikely to offset the levelling off in demand from outside Europe. Demand in French export markets is therefore likely to come off the boil: in year-on-year terms, it peaked in mid-1997 (+10%), weakened slightly in the past winter (+9%), and seems set for a more marked slowdown in mid-1998 (+7%). Moreover, French exports will no longer have the benefit of the strong competitiveness gains posted up to August 1997. In line with world demand, growth in exports of manufactures peaked in mid-1997 at close to 15%, year on year. At present, their growth is heading for a lower rate of less than 10%.

### Broad-based growth

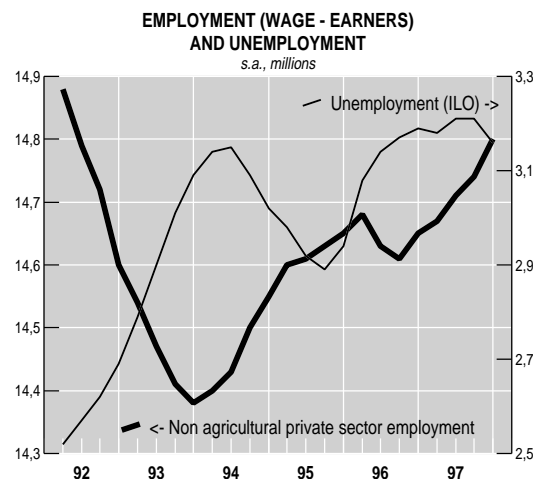
In H2 1997, the upturn that had previously been confined largely to industry extended to trade and services and, to a smaller extent, construction.

Wholesale trade in intermediate goods and capital goods, in particular, has benefited from the industrial upturn seen since the summer. In much the same way, business services have returned to strong growth thanks to temporary employment, followed by other business services, especially in the computer field. Merchandise transport, by rail in particular, also recovered in the second half of the year.

After reaching an annualised growth rate of close to 7% in Q4 1997, activity in manufacturing industry is expected to grow at an annual rate of slightly less than 6% in H1 1998. The contribution of exports to growth in industrial output, which had been very high in H1 1997, thereafter declined. This tendency is liable to intensify in H1 1998, leaving private consumption and investment as the principal growth motors.

The continuing growth in industrial output is likely to keep activity firm in wholesale distribution, where the prospects remain highly positive, as well as in business services and transport.

The progressive acceleration in household consumption has benefited, with some delay, the consumer goods industries. Consumption of services also strengthened in H2 1997, with a distinct recovery in air traffic



and rail passenger traffic. According to business surveys, activity in household services is likely to make further progress in the first months of 1998.

After falling further in 1997, activity in the construction sector is expected to rally, thanks to the upturn in the housing and non-residential buildings, especially for industry, to the continuing briskness of maintenance and renovation activity and to the beneficial effect of the upturn in local authority investment. In sum, the year-on-year rise in the output of the sector, which was zero at the end of 1997, is likely to reach 1% by mid-1998.

After strengthening throughout 1997, GDP growth achieved an annualised rate of close to 3.5% in the second half. In H1 1998, with the support of domestic demand, but feeling the effects of the slowdown in exports, growth is likely to return to a rate of close to 3%.

### Accelerating productive investment

The acceleration in productive investment in manufactured goods in 1997 (-1.7% in H1, followed by +2.6% in H2) is likely to continue, in the light of the continuing positive growth outlook. Investment in buildings will no longer decline, thanks, in particular, to the upturn in the construction of industrial buildings. In all sectors, signs of an upturn in investment are becoming more numerous. In manufacturing industry, business leaders in January reported major upward revisions in their investment plans for 1998. This revision may be a reflection either of the pressures that have emerged on productive capacity (for intermediate goods and, to a smaller extent, for capital goods), or an improved demand outlook (in consumer goods). In the service sector, the marked upturn in activity could be heralding a strong increase in investment. Moreover, the acceleration in the purchases of heavy goods vehicles in 1997 could be pointing to strong investment in the transport sector in coming months.

## Brisk job creation

Following a year of stagnation in 1996, employment began to pick up in the spring of 1997 and the movement has since intensified. Net job creations in the non-farm traded sector are likely to be almost as numerous in the first six months of 1998 (at around 140,000) as in the whole of 1997 (155,000).

Employment is accelerating appreciably in the service sector. In particular, there has been net growth in employment via the temporary agencies, which all sectors are now making use of. The improvement in employment is in effect general. In the building sector, the deterioration has slowed down progressively. In manufacturing industry, where numbers employed levelled off at the end of 1997 after falling for two years, net job creations are now likely. This improvement in employment is likely to be amplified by the "emplois-jeunes" government scheme as well as a smaller deterioration in independent employment.

Despite the firm growth in the labour force, the job creations in coming months should enable the decline in the unemployment rate that began in November 1997 to continue. This should bring it slightly below 12% in June 1998, as against 12.5% a year earlier.

## The impact on incomes and consumption

1997 saw household purchasing power rise by 2.3%, benefiting from, on the one hand, the growth in earned income as a result of the upturn in employment, the acceleration in real earnings linked to the disinflation

and, on the other, the appreciable re-adjustment in the minimum wage, the high level of social benefits and the tax cuts. In 1998, growth in purchasing power, now mainly dependent on earned income, is likely to continue.

The upturn in employment, by generating income, seems at the same time to have braced household confidence. Consumption has been accelerating since the end of 1996, with its year-on-year growth rising from 0.7% in mid-1997 to 2.2% at the end of the year, with 2.7% to be expected in mid-1998. Following the timid recovery in the car market in the summer, registrations have stabilised at around 150,000 vehicles a month. Households admittedly seem to be expecting a slight slowdown in income growth in 1998 but show no inclination to reduce consumption. Their reaction to the lower returns available on savings has been to keep substantial amounts in liquid form. This could also reflect purchasing intentions.

## Stronger imports

Ever since industrial output took off again, imports have risen substantially. As regards manufactures, imports seem likely to maintain a year-on-year growth rate of close to 10% until mid-1998. Following the sharp acceleration in exports, imports in 1997 were boosted by the slowdown in de-stocking in industry, by the upturn in investment in capital goods and by the strength of household consumption, cars excepted. This tendency seems set to continue in coming months.

## Gross domestic product (volume) by type of expenditure

(at 1980<sup>(1)</sup> prices, % change from previous period)

|                                           |        | 1996 |      |      |      | 1997 |      |     |      | 1998 |     | 1996 | 1997 | 1998<br>Carry-over <sup>(2)</sup> |
|-------------------------------------------|--------|------|------|------|------|------|------|-----|------|------|-----|------|------|-----------------------------------|
|                                           |        | Q1   | Q2   | Q3   | Q4   | Q1   | Q2   | Q3  | Q4   | Q1   | Q2  |      |      |                                   |
| <b>GDP</b>                                | (100%) | 1.3  | -0.1 | 0.8  | 0.3  | 0.3  | 1.1  | 0.9 | 0.8  | 0.8  | 0.7 | 1.5  | 2.4  | 2.6                               |
| Imports                                   | (29%)  | 3.0  | -1.2 | 2.2  | 1.6  | -0.1 | 3.8  | 3.3 | 0.2  | 1.6  | 1.7 | 2.8  | 6.6  | 5.6                               |
| (of which merchandise)                    | (26%)  | 2.4  | -1.6 | 3.3  | 1.5  | -0.2 | 4.0  | 3.1 | 0.5  | 1.6  | 1.7 | 2.5  | 7.0  | 5.9                               |
| Households' consumption                   | (60%)  | 2.4  | -0.8 | 0.9  | -0.6 | 0.4  | 0.1  | 1.0 | 0.7  | 0.5  | 0.5 | 2.1  | 0.9  | 1.9                               |
| General government consumption            | (19%)  | 0.6  | 0.4  | 0.5  | 0.5  | 0.4  | 0.4  | 0.3 | 0.3  | 0.2  | 0.2 | 1.7  | 1.6  | 0.7                               |
| Total investment (GFCF)                   | (20%)  | -1.0 | -0.3 | 1.5  | 0.0  | -1.5 | 0.4  | 1.3 | -0.1 | 1.0  | 1.2 | -0.5 | 0.2  | 2.6                               |
| Corporate sector <sup>(3)</sup>           | (11%)  | -1.1 | 0.0  | 2.4  | -0.3 | -2.0 | 0.5  | 1.1 | 0.1  | 1.4  | 1.7 | -0.8 | -0.1 | 3.5                               |
| Households                                | (5%)   | -2.2 | 1.2  | -0.4 | 1.0  | -2.3 | -0.1 | 2.4 | -0.4 | 0.3  | 0.4 | -0.2 | -0.4 | 1.5                               |
| Other sectors                             | (4%)   | 0.7  | -2.9 | 1.2  | -0.2 | 1.0  | 0.9  | 0.6 | -0.3 | 0.6  | 0.6 | -0.3 | 1.6  | 1.4                               |
| Exports                                   | (30%)  | 5.0  | -1.7 | 2.9  | 2.3  | 2.3  | 5.5  | 3.0 | 0.8  | 1.7  | 1.6 | 4.8  | 11.3 | 6.4                               |
| (of which merchandise)                    | (25%)  | 4.3  | -2.1 | 4.0  | 2.0  | 2.2  | 6.1  | 2.2 | 1.8  | 1.8  | 1.6 | 5.1  | 11.7 | 7.0                               |
| Domestic demand                           |        | 0.7  | 0.1  | 0.6  | 0.1  | -0.4 | 0.5  | 1.0 | 0.6  | 0.7  | 0.7 | 1.0  | 1.0  | 2.3                               |
| <b>Contributions to the growth of GDP</b> |        |      |      |      |      |      |      |     |      |      |     |      |      |                                   |
| Inventory changes                         |        | -0.7 | 0.6  | -0.3 | 0.3  | -0.4 | 0.3  | 0.0 | 0.1  | 0.2  | 0.2 | -0.5 | 0.1  | 0.5                               |
| Trade in goods and services               |        | 0.6  | -0.2 | 0.2  | 0.2  | 0.7  | 0.6  | 0.0 | 0.2  | 0.1  | 0.0 | 0.6  | 1.5  | 0.4                               |
| Domestic demand excluding inventories     |        | 1.4  | -0.5 | 0.9  | -0.3 | 0.0  | 0.2  | 0.9 | 0.5  | 0.5  | 0.5 | 1.5  | 0.9  | 1.8                               |

(1) National Quarterly Accounts evaluate growth at 1980 prices. Growth rates are usually slightly lower once calculated at the prices of the preceeding year.

(2) The statistical carry-over is the annual average growth rate that would result if growth were to be zero in Q3 and Q4 1998.

(3) Corporate and quasi-corporate enterprises (including unincorporated enterprises).

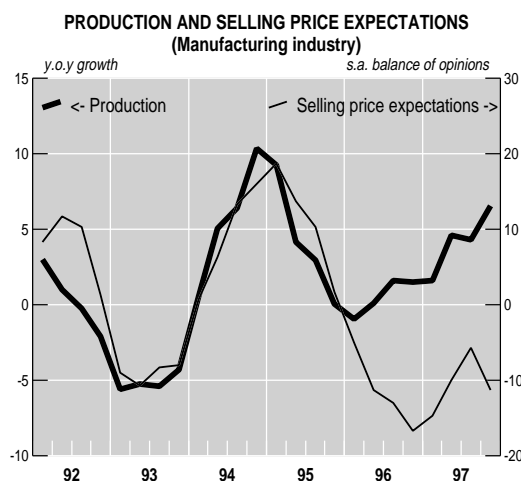
Forecasts

As a result, the contribution of foreign trade to GDP growth, which had been distinctly positive between mid-1996 and mid-1997, weakened appreciably in H2 1997 and is expected to disappear in H1 1998. This would mean a levelling off in the trade surplus at a high level, in excess of FRF 10 billion a month.

### Inflation free growth

In H2 1997, underlying inflation rose slightly with the stabilisation in car prices. Between end-1997 and June 1998 it is likely to show practically no increase. Business leaders' expectations are in fact for a downward tendency.

One reason for this is that the slight easing in unemployment is not as yet being accompanied by any notable wage pressures, and this is helping to keep inflation down in services. In addition, producer prices in manufacturing industry are stable. Furthermore the drop in the prices of oil and other commodities, especially since last summer, is keeping input prices restrained. And the productivity gains usually seen in this phase of the cycle are making it possible to contain the rise in wage costs.



The overall consumer price index seems likely to continue to show a year-on-year increase of the order of 1% in June 1998. ■

### The impact on the French economy of the falls in oil and commodity prices

The price per barrel of crude oil (Brent) has fallen from an average of \$19.2 in 1997 to \$14.2 in February 1998. In order to evaluate the impact of such a shock on the French economy, a simulation was computed of a 25% fall in the price of oil, using INSEE's AMADEUS model and the NIESR's NIGEM model. These simulations were made at constant exchange rates and interest rates in all countries except the United States, where it was assumed that the monetary authorities would set nominal interest rates in the light of variations in growth and in inflation.

A fall in the oil price very soon produces disinflationary effects. First, there is an automatic impact on import prices, which then spreads through to costs and hence producer prices and finally to consumer prices. The fall in consumer prices also stems from the fact that many of the goods consumed are directly imported. The fall in consumer prices has repercussions on wages and leads to a further decline in firms' production costs. In the end, the fall in prices induces a cash-balances effect for households and a rise in the level of consumption. The reduction in production costs raises corporate profit margins and incites firms to invest more.

In the rest of the world, the impact of the fall in the oil price differs according to whether the country concerned is an oil-importer or oil-exporter. Exporting countries, notably the United Kingdom, the Netherlands and the OPEC countries, suffer a loss of income and their demand for imported goods diminishes. For the oil-importers, on the

other hand, the consequences of the fall in the oil price are similar to those described for France. In particular, they experience an increase in domestic demand which encourages imports, including imports from France. The aggregate impact on demand in French export markets turns out to be slightly positive in the first year.

But French exports derive no benefit from competitiveness gains. This is because the fall in the prices of French export products made possible by the cost reductions is of the same amplitude as in the prices of France's principal trading partners. On the French market, the rise in domestic demand, combined with a fall in import prices that is greater than for producer prices, leads to an increase in import volumes.

When these various mechanisms are allowed for, inflation in the first year is 0.3 of a point lower than it would have been if the oil price had not fallen. The contribution of domestic demand to growth is more than 0.2 of a point of GDP, while the external contribution is slightly negative (-0.1 of a point), as imports increase more than exports.

This means that French growth owes slightly less to the international environment and slightly more to domestic demand, with the final impact on GDP positive but small (around 0.1 of a point). This impact is therefore a long way from making up for the consequences of the Asian crisis, which for the year 1998 are put at -0.5 of a point.