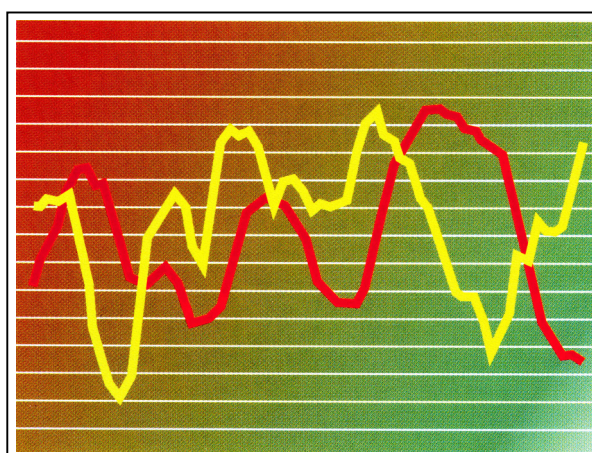


# CONJONCTURE IN FRANCE

---

JUNE 2006



THE FRENCH ECONOMY MAKING UP LOST GROUND

# **CONJONCTURE IN FRANCE**

**JUNE 2006**

**THE FRENCH ECONOMY MAKING UP LOST GROUND**

## THE FRENCH ECONOMY MAKING UP LOST GROUND

**S**ince the summer of 2005, the French economy has returned to more robust growth.

The figures for Q1 2006 have confirmed this tendency. Over and above the GDP growth of 0.5%, they highlight the continuing driving-force role played by household consumption and they tend to allay worries regarding the performance of French foreign trade. Admittedly, this first quarter was marked by strong growth at world level, in Asia and in the United States and even in the euro zone, where growth was 0.6%, the result being a sharp acceleration in world trade. In these circumstances, oil prices have continued to rise, fuelling a rise in inflation, although not to more than a moderate level, given the absence of second-round effects. Central banks were accordingly led to continue the gradual rise in their key rates, and this had repercussions on long rates.

In the euro zone, this monetary tightening is set to continue. Accompanying the recent rise in the euro exchange rate, this should counter-balance the impact on activity of slightly firmer domestic demand in the zone, due mainly to an upturn in Germany. The result would be to put growth in the zone on a path close to its long-term trend.

Similar tendencies are likely to be seen in France, with growth reaching 2% in 2006, despite the fragility of manufacturing output,

which is expected to rise by only 1%. As a counterpoint, the rise in household consumption is expected to be underpinned by a better tendency in purchasing power, on the back of a stabilisation of inflation at below 2% (1.8% in December). The other main factor underpinning the positive tendency in consumption is likely to be a continued decline in unemployment. The unemployment rate is expected to diminish continuously throughout the year to stand at around 9% in December. In addition to the less rapid trend rise in the labour force and a substantial contribution from assisted employment contracts, this evolution would be a reflection of a substantial acceleration in market-sector dependent employment. Furthermore, the vigour shown by the construction sector is unlikely to have been affected as yet by the expected levelling-off in demand for housing related to the rise in interest rates.

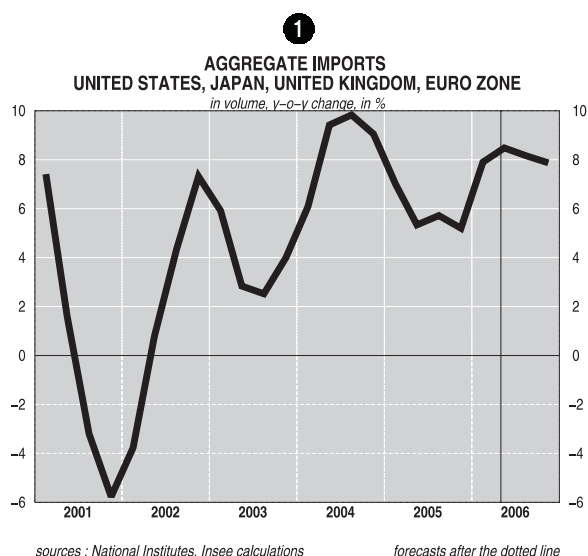
The principal uncertainty hanging over these future prospects lies in a possible intensification of the disequilibria at world level that are increasing the risk of a fall in the dollar liable to affect European business leaders' expectations. Conversely, however, the possibility cannot be ruled out that in the very short term the liveliness of the world economy could generate greater liveliness in the euro zone as well. ■

The French economy began 2006 with a medium but solid growth rate of 0.5%. Two new elements will probably affect coming evolutions in the economy: the European upturn and especially the upturn being seen in Germany are profoundly modifying the international panorama as seen from France; on the other hand, the continuing rise in commodity prices and the depreciation of the dollar are weakening the underpinnings of the world growth upswing.

### An exceptional year in terms of world growth, facilitating economic convergence between the major zones

What was identified in our previous forecast as a major risk has now materialised, namely the fact that the tendencies on the commodity markets that had been taking shape around the turn of the year have persisted. The oil price has continued to rise, with the Brent price in the end fluctuating around the \$70/barrel level (the level now being assumed for the rest of 2006), bringing up in its wake the prices of petroleum derivatives. Moreover, prices of all other commodities, notably metals, have tended to move upwards in the first part of the year. This evolution is tending to accentuate the disequilibria at world level, as the oil-exporting countries remain cautious regarding their use of the oil windfall (see box on p. 24), their propensities to spend the additional revenue on imports being much lower than at the time of the 1970s shocks (50% at present, compared with 75% previously, according to the IMF).

Even so, 2006 is already looking like an exceptional year as regards commercial trade flows, which seem to have reached a high during the winter and are ex-



pected to maintain relatively firm growth because of the expansion at world level (see Graph 1). Seen from this standpoint, the limited impact of the oil shock has yet again been confirmed. Moreover, the latest developments regarding inflation and wages are demonstrating the absence of second-round effects.

At the same time, however, the general tightening of borrowing conditions is continuing. Short rates have continued to rise in both the United States and the euro zone, while long rates, given the maintained prospects for growth and inflation, have risen in all the industrialised zones in the early part of 2006. The markets are expecting that the European Central Bank will continue its cycle of tightening until the end of the year and that the Bank of England will also be raising its key rates. For their part, the cur-

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

(at 2000 prices seasonally and working-day adjusted data, % change from previous period)

		2004				2005				2006			2004	2005	2006	
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3				Q4
<b>GDP</b>	(100%)	0.5	0.8	0.1	0.6	0.1	0.0	0.6	0.3	0.5	0.6	0.6	0.6	2.0	1.2	2.0
Imports	(28%)	0.8	3.2	1.6	0.9	1.2	1.4	2.4	2.2	1.1	2.3	2.0	1.7	6.0	6.5	7.6
Consumption	(54%)	0.7	0.8	0.0	1.2	0.6	0.0	0.8	0.4	0.9	0.7	0.5	0.5	2.5	2.2	2.6
Public consumption*	(24%)	0.5	0.7	0.3	0.2	0.1	-0.0	0.6	0.0	0.5	0.5	0.4	0.4	2.1	0.9	1.4
Investment	(19%)	-0.1	1.6	-0.1	1.1	0.8	0.8	1.6	0.9	0.2	1.1	1.0	0.9	2.6	3.7	3.5
of which:																
Non financial corporated and unincorporated enterprises	(11%)	0.4	2.5	-0.1	1.3	0.5	0.4	2.2	1.1	-0.1	1.4	1.1	1.1	4.2	3.8	3.8
Households	(5%)	0.7	2.1	0.8	1.2	0.7	1.3	0.6	0.7	0.5	0.6	0.7	0.6	4.0	4.1	2.6
Exports	(29%)	0.1	1.2	0.2	1.3	-0.5	0.7	2.9	1.0	3.0	1.3	1.1	1.4	3.3	3.2	7.4
<b>Contributions to growth</b>																
Internal demand ex. inventory changes		0.5	0.9	0.1	0.9	0.5	0.2	0.9	0.4	0.7	0.7	0.6	0.6	2.4	2.2	2.5
Inventory changes		0.2	0.4	0.4	-0.4	0.1	0.1	-0.4	0.2	-0.7	0.2	0.3	0.1	0.3	0.0	-0.3
Net foreign trade		-0.2	-0.6	-0.4	0.1	-0.5	-0.2	0.1	-0.4	0.5	-0.3	-0.3	-0.1	-0.7	-1.0	-0.2

Forecast

\* General government and NPISH's consumption expenditures  
Weight in 2000 in brackets

rency markets began at the end of April to react to the economic situation in the United States, with the dollar depreciating against both the euro and the Asian currencies. Stock markets fell back in sympathy. The euro/dollar exchange rate has stabilised at 1.27, this being its average for the first three weeks of May.

The year 2006 looks like being exceptional not only in terms of world trade, but also as marking the start of a phase of convergence of growth rates between the industrialised zones. While growth in the United States is expected to start to level off (3.5% for the year, the same as in 2005), that of the euro zone should accelerate on an annual basis to above 2% from 1.4% in 2005, while that of the United Kingdom is expected to be 2.4% compared with 1.8%. Meanwhile, the upturn in the Japanese economy is likely to be confirmed, with GDP growth of 3.2%, while momentum in the rest of Asia should be maintained. As regards corporate investment, a relatively clear gap should continue to be seen between the European countries, showing greater caution, and the United States and Japan. In this field, a risk is starting to emerge related to the surge in commodity prices, with a slowdown in productive investment being seen in emerging Asia since Q2 2004 that can probably be related both to the higher oil prices and to past interest-rate hikes.

### **Notable discrepancies within the euro zone despite the German upturn**

The most notable event seen in the euro zone in the early part of 2006 has been the string of signals reporting an upturn in the German economy. The strength of GDP growth in the euro zone in Q1 (0.6%) is mainly due to the recovery in Germany, and especially that of household demand. The sharp rise in exports also boosted European industrial output.

During the rest of the year, household consumption in the euro zone is likely to show signs of accelerating. Admittedly, this tendency would be partly due to temporary phenomena (notably in Germany, thanks to the organisation of the Football World Cup and to purchasing made in anticipation of the rise in VAT rates announced for 2007). However, at more fundamental level, the upturn would be due to an acceleration in employment growth and the continued decline in the saving ratio (*see special article on Germany, available in the French version only*). Moreover, foreign trade should no longer be making a negative contribution to growth. The improvement in the short-term economic climate is not expected to be reflected in any marked acceleration in investment, however.

Even so, there are marked contrasts among countries in the zone. Q1 saw GDP growth in Germany and France still below the zone average, while that of Spain remained very strong. In H2, the German and

French growth rates are expected to be in line with the zone average, with Italy continuing to lag behind.

### **The growth of international trade unlikely to give more than a partial stimulus to French industrial output**

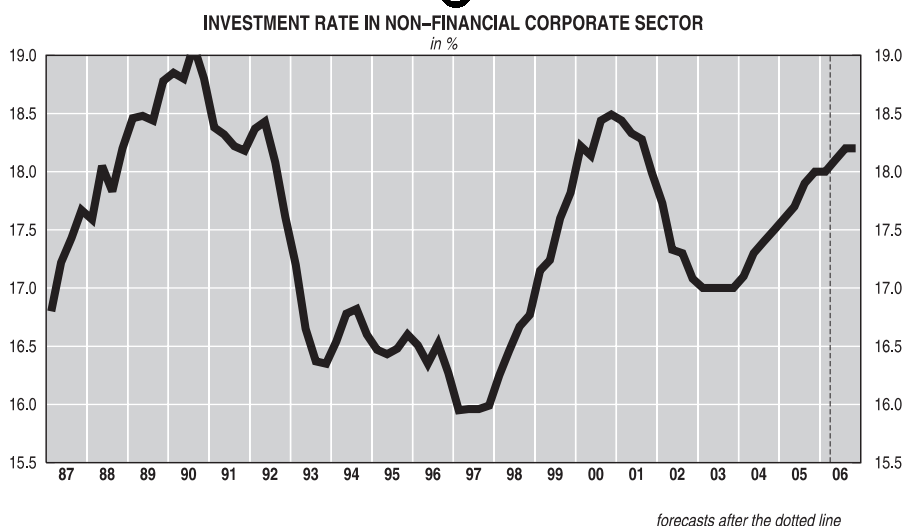
Partly as a reflection of the exceptional growth in foreign trade affecting all countries, growth in French exports of manufactures picked up strongly in Q1 2006. A new support factor also arrived to give support to French foreign trade, namely the upturn in German domestic demand. However, there remain major uncertainties regarding the capacity for resistance of French external and domestic competitiveness, at a time of sharp depreciation in the dollar of the kind seen in recent weeks. While the situation for capital goods is improving, the erosion of market share is still being felt in sales of cars and intermediate goods, the counterpart of this being a leveling-off in output in these two branches.

For the rest of 2006, demand from France's two principal customers, Germany and Spain, is set to accelerate further. However, the exceptional growth rate seen in Q1 is unlikely to be maintained, as it is probably partly the result of the phenomenon of intensification of world trade, linked to the higher import content of exports. For the year as a whole, growth of manufacturing exports in volume should nevertheless reach the record rate of 10.5%.

In parallel, the expansion of imports of manufactures is just as exceptional, with growth also reaching 10.5% this year. This import growth continues to be driven by price evolutions that are unfavourable to France.

Following the decline in Q4 2005, the 0.6% growth in manufacturing output in Q1 2006 stems in part from the liveliness of exports, especially of capital goods. Meanwhile, manufacturing activity was being held back by a substantial de-stocking movement, which may be reflecting slight lags between movements in domestic demand and imports, the slow growth in the latter in Q1 possibly representing an adjustment in response to the steep rises in the two previous quarters. However, there is also confirmation of the difficulties being encountered by certain sectors. The car sector, which is going through a bad patch marked by fierce competition on the domestic market, is adjusting its output through stock changes that have been particularly uneven from month to month. Industrial business surveys are suggesting that, starting in Q2, manufacturing output for the rest of the year should settle down at a quarterly growth rate of the order of 0.5%.

2



### **Firms investing more in construction than in manufactured goods**

The slackness seen in industry has had visible consequences for investment in the early part of the year. Following a lively last part of 2005, corporate investment stabilised, overall, in Q1 2006 (-0.1%), with the decline in spending on manufactures compensated by higher spending on construction.

The stabilisation of investment in Q1 2006 is set to be followed by an upturn in the following quarter, to judge by the evolution in replies by industrialists to the April investment survey. During this period, investment is expected to grow by 1.4%. In H2 2006, capital spending should return to an average rate that corresponds to the maintenance of favourable financing conditions and a slight rise in pressures on productive capacity. The recent recovery in investment in construction and public works seems likely to be confirmed.

Overall growth in investment nevertheless remains well below the level usually seen in an upturn, since total investment is expected to grow at the same rate in 2006 as in 2005, i.e. 3.8%. Even so, this rate is still compatible with the fairly slack growth in activity, as shown by the relatively high level that has now been reached by the corporate investment ratio (see *Graph 2*). This means that any strengthening of corporate demand is unlikely in coming months.

### **Growth in total employment set to bring the unemployment rate down to 9.0% in December 2006**

As regards employment, the weakness being shown by industry is being reflected mainly in the numbers of temporary agency staff employed. However, it is unlikely to stem the current upturn on the employment market.

Following 99,000 job creations in the French economy as a whole in 2005, this figure is set to double in 2006 to 196,000.

This growth would originate mainly from an acceleration in the non-market sector, where assisted employment is likely to rise strongly in the first half of the year. At the same time, since mid-2005 the growth rate in the market sectors has also turned upwards. On the other hand, the second half of the year will see the end of the build-up of employment under the Social Cohesion Plan and assisted non-market employment is then unlikely to continue to underpin growth in total employment.

Meanwhile, market-sector dependent employment is expected to maintain a stable growth rate throughout the year. On the back of robust economic activity, the market sectors are likely to create 76,000 jobs in 2006, compared with 63,000 in 2005.

Thanks to the combination of the upturn in employment and a gradual diminution in the rate of increase of the supply of labour in 2006, the unemployment rate on the ILO definition should continue to decline, reaching 9.0% by the end of the year.

## **An appreciable acceleration in household purchasing power, with all income components contributing**

With the upturn in employment remaining moderate at this stage, it is the evolution in wages and the stability of inflation that are driving the steady acceleration in the purchasing power of household disposable income, which rose by 1.3% in 2005 and will probably rise by 2.4% in 2006.

The evolutions in individual components of real income should all take the same direction this year. Taxes paid by households are expected to grow less rapidly; dividends seem likely to accelerate; earned income will probably still be pushed upwards by the average wage per head (+3.1% this year); and the operating surplus of individual entrepreneurs should post a distinct improvement.

Furthermore, although inflation in France picked up slightly in the early part of 2006 under the impact of the upturn in energy prices seen in Q1, the year-on-year rise in the overall index is expected to ease to 1.8% in December, with the time-pattern of inflation continuing to be dictated by evolutions in energy prices, with no notable second-round effects of the oil shock visible.

## **Household demand, in the form of both consumption and investment, is likely to remain the basic platform for growth throughout the year**

Evolutions in household spending have for several quarters been tracking those of the purchasing power of income. As a result, following a slight slowdown in Q4, notably in the case of spending on goods, a further upturn was recorded in Q1 2006, simultaneously affecting manufactures, food and energy and pushing household consumption up to reach a growth rate of 0.9%. Household expenditure is expected to continue to show firm growth in Q2, underpinned by the rise in purchasing power and the

gradual decline in the unemployment rate. It should return to a quarterly rate of 0.5% in the second half of the year, while for the year as a whole it is expected to rise by 2.6%.

Another positive factor is that, to judge by the latest figures for starts, housing investment should continue to rise steadily until the end of the year, without however reaching the growth rates seen in 2004 and 2005.

## **A distinct acceleration in overall production, despite the levelling-off in industry**

Overall, growth in French output is expected to accelerate to 2.1% this year from 1.2% in 2005, but this recovery would be mainly the work of distribution and construction.

For one thing, while manufacturing activity has indeed returned to a growth rate more in line with the indications given by business surveys in the early part of the year, this improvement is likely to be short lived, with the growth rate levelling off in coming quarters. Energy output can be expected to show a similar evolution.

By contrast, growth in distribution activity, directly linked to household consumption, is likely almost to double, from 2.0% in 2005 to 3.8% in 2006. Other market services should also progress, although held back slightly by business services.

In construction, finally, the robust growth rate is likely to be consolidated until the end of the year, with the recovery in social housing and non-residential construction making up for the very slight slowdown in households' housing investment.

In these circumstances, GDP growth should settle down at a rate of 0.6% per quarter until the end of the year, giving growth on an annual average basis of 2.0%. ■