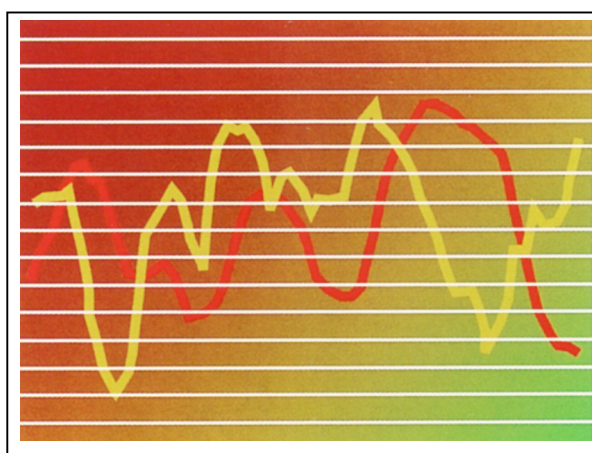


***CONJONCTURE* IN FRANCE**

JUNE 2007



**EURO ZONE:
CONSUMPTION TAKES THE LEAD**

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Euro zone: consumption takes the lead

The global economy stayed on a robust growth path in early 2007. The U.S. slowdown was sharper than forecast in H1, yet it did not undermine the dynamism of the rest of the world. Germany's VAT hike had a greater-than-expected negative impact on household consumption at the start of the year, but German growth was again surprisingly firm, particularly thanks to a spectacular surge in business investment.

The overall prospects for H2 are even brighter. In the United States, the improved economic climate—visible in both manufacturing and services—and initial signs of stabilization in the real-estate market point to a gradual pick-up in activity.

The euro zone, still stimulated by major investment needs, should also benefit from quicker consumption growth. In this scenario, job creations will keep fueling household income, and wage rises will steepen—especially in Germany, where the sharp fall in unemployment is finally allowing wages to recover.

Indeed, this incipient upswing in German wages is one of the major events of 2007. As long as it does not trigger a response from the European Central Bank (ECB), it will benefit Germany's euro-zone partners for two reasons: first, because it is sustaining German domestic demand; second, because it should halt Germany's competitiveness gains relative to its European partners.

In this persistently upbeat international environment, the French economy's performance may have seemed somewhat disappointing in early 2007. Yet exports are improving and business investment has accelerated. This time, however, household consumption has slipped—beyond the decline in energy expenditures due to the exceptionally mild winter.

But the slackness of French consumption is unlikely to last, as households should enjoy a substantial rise in purchasing power in 2007. In line with an excellent Q1, the number of new jobs is forecast to rise to about 300,000 this year. Wage growth should remain lively. Most decisively, the reduction in taxes and social contributions on households, combined with an easing of inflation from 1.6% in 2006 to 1.2% in 2007, should in itself boost real-income growth by nearly one point this year.

This real-income gain has probably started to fuel French consumption in spring 2007 without, however, entirely canceling the rise in the saving ratio observed in the past year. Business investment should remain brisk. But external trade is expected to undercut GDP growth again, owing to stronger household demand and the euro's appreciation since the start of 2007. In all, GDP will probably register a mild acceleration this spring, its growth quickening to 0.7% per quarter in H2. This would put the French expansion on a par with that of Germany and the euro zone as a whole. On an annual average, however, French GDP is expected to keep growing at a pace comparable to that of 2006 (2.1%), and the gap with European partners should thus persist.

Two major uncertainties weigh on this scenario. The first concerns oil prices: the build-up of geopolitical tensions and OPEC's resolve to restrain production could revive the uptrend of recent years. The second concerns French and German household consumption. If consumers maintain their cautious behavior of early 2007, then their spending rebound could prove far more modest than our projection. If so, the acceleration in French economic activity that we expect might fail to occur. Conversely, the increase in the purchasing power of French and German households could drive up their consumption, and hence GDP, far more steeply than we have forecast. ■

French growth eased to 0.5% in Q1 2007, hampered by specific short-term factors, particularly the decline in energy expenditures due to unseasonably mild weather. GDP should accelerate to 0.6% in Q2 and 0.7% in Q3 and Q4.¹ Average annual growth for the year is projected at 2.1%.

This scenario assumes that the French economy will benefit from the persistence of robust domestic demand. Household consumption should be sustained by brisk gains in real income resulting from a vibrant labor market, tax cuts, and lower inflation. French exports should gradually benefit from the expected recovery in German household spending, helped—for the first time in five years—by a rise in real wages (Chart 1).

A slowdown in the international environment confined to the U.S.

Growth in the industrialized countries is expected to ease in 2007, but only because of a slacker U.S. performance. Elsewhere, GDP should rise at a very similar pace to that of 2006 (Chart 2). In all regions, productive investment is projected to remain on a brisk uptrend, while household consumption should accelerate thanks to stronger purchasing-power gains, notably generated by weaker inflation.

In the U.S., the impact of the real-estate market downturn on overall economic growth will probably fade by end-2007. Meanwhile, the halt in the cycle of key-interest-rate hikes and the resilience of household consumption, driven by solid real income, should help to sustain the economy. U.S. growth may well remain below its potential in 2007, but should gradually pick up. Average annual GDP growth is projected at 1.7% this year, down from 3.3% in 2006.

Japan should register more moderate growth, with business investment showing signs of slowdown after the brisk rise of recent years. The country may have trouble exiting from deflation for good. In our scenario, core inflation will stay negative, wage weakness will persist, and bank lending to businesses will remain rather vulnerable. South-East Asia, by contrast, should experience further robust growth in the rest of the year. The countries of the region will likely continue to benefit from vigorous exports, and some large emerging players such as China, India, and Russia are forecast to keep expanding at a lively pace.

1. Until now, the real (i.e., volume) forecasts in "Conjoncture in France" were given at constant prices. Henceforth, they are formulated at year-earlier chain-linked prices, consistently with the change made in the quarterly national accounts. For more details on the impact of the switch from constant 2000 prices to chain-linked prices, see the article "From constant prices to chain-linked prices: what consequences?" in this issue.

After a robust performance in early 2007, growth in the United Kingdom should dip slightly in H2 owing to the current monetary tightening. In particular, we expect British household consumption to grow somewhat less vigorously.

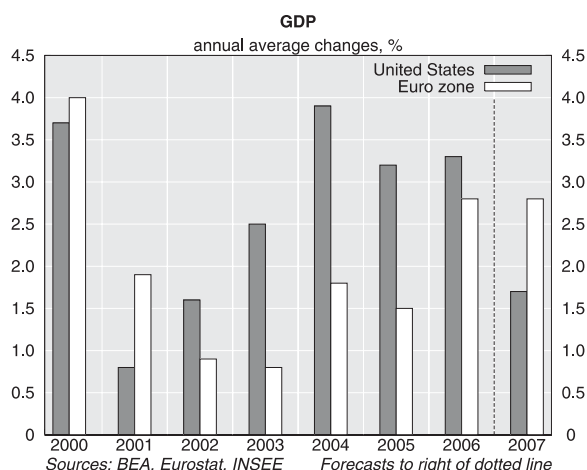
Solid domestic drivers in the euro zone, especially in Germany

The euro-zone economy should grow 2.8% in 2007, the same brisk pace as last year. The decline in household consumption, due to the January 2007 hike in Germany's standard VAT rate, should be offset by year-end. Driven by the past economic acceleration, the job market's expected further improvement should start to put upward pressure on wages, as illustrated by the spring wage agreements in the main German industries. The upswing in the euro zone's total wage bill should, however, be dampened by a slowdown in Italian pay raises, particularly in the civil service. Tax policies in the leading euro-zone countries should be neutral in terms of the contribution of net levies

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to household income growth by comparison with 2006. Overall, purchasing-power growth is set to quicken this year, sustaining household consumption.

Productive investment should be fueled by persistent brisk growth in demand, the need to boost productive capacity, and still-favorable financial conditions for businesses. German firms are also likely to complete certain investment projects in H2 2007 in order to take advantage of more generous write-off provisions before they lapse in early 2008. In Italy, with the end of the decline in the corporate margin ratio, productive investment should stay on a strong growth path. On an annual average, equipment investment should accelerate slightly in 2007.

French exports poised to benefit from resurgent European demand in 2007

Without repeating its outstanding 2006 performance, growth in foreign demand for French exports—stimulated by euro-zone dynamism—should return by year-end to a somewhat quicker pace than its long-term average. After a vigorous 2.6% rise in Q1, manufacturing-export growth should ease to around 1.25% in H2, a shade below the increase in foreign demand. The euro's appreciation will probably cause a mild loss of competitiveness.

This upturn in external demand during the year is unlikely, however, to send French industrial production back to its early-2007 pace. After steadily improving in the first four months of the year, manufacturers' optimism declined somewhat in May. The "synthetic" business-confidence indicator, however, has been running consistently above its long-term level (*Chart 3*). In addition, business owners describe their order books as still well filled, although down slightly. Manufacturing output should therefore keep growing in the last three quarters of 2007, but at a more subdued pace of 0.3% in Q2 and 0.5% in Q3 and Q4.

In early 2007, French energy imports dropped 10.9%, partly because of the strike that blocked the Marseille oil terminals from March 14 to April 1. The situation is expected to return to normal in Q2, allowing inventory rebuilding. Manufactured imports, which surged in early 2007, will probably have risen at a milder pace in the spring, owing to the expected slowdown in household consumption expenditures on manufactured goods. Once growth in these expenditures subsides to a rate more consistent with income gains, manufactured imports should recover.

Lively job creation in market sector

In Q1 2007, payroll-job creation in the French non-farm market sector quickened sharply to 108,000, particularly thanks to a surge in "temping." This pattern is likely to consolidate in the months ahead, spurred by the pick-up in economic activity. The market sector is thus expected to add 240,000 jobs this year, up from 155,000 in 2006. The strongest job creation is likely to occur in market services. We expect a slight loss of momentum in the construction industry, while manufacturing may shed fewer jobs than in recent years.

Employment in non-market sectors—excluding government-subsidized programs—will stay on its trend growth path. By contrast, the net contribution of subsidized jobs is projected to become negative in 2007. Last year, the build-up in contracts introduced under the Social Cohesion Plan was still under way, helping to lift employment. But this year, despite their continued increase, the number of "Contracts for the Future" (Contrats d'Avenir: CAVs) will probably fail to offset the many exits from other types of subsidized contracts, in particular the "Employment Support Contracts" (Contrats d'Accompagnement en Emploi: CAEs).

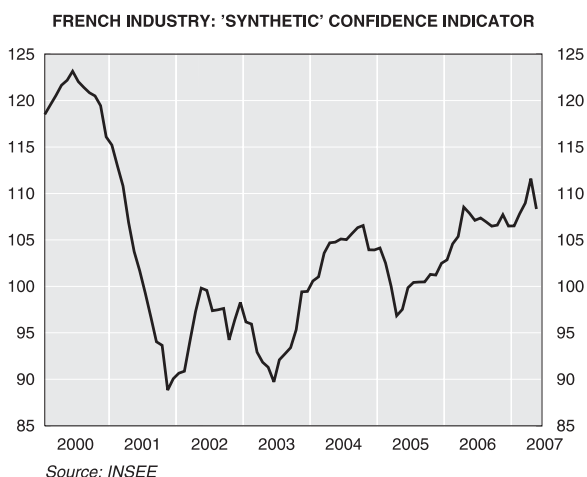
The French economy should create a total of about 300,000 jobs this year, up from 256,000 in 2006.

Purchasing-power gains fueled by lower taxes and inflation

French households' purchasing power is forecast to improve thanks to stronger wage income, higher social benefits, tax cuts, and milder inflation.

Average annual inflation should ease from 1.6% in 2006 to 1.2% in 2007. Assuming an average price of \$65/barrel for Brent crude oil in H2 and a steady exchange rate of \$1.35 to the euro, the energy component will be far smaller in 2007 than last

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year. In this scenario, year-on-year overall inflation will decline until August then move up again, reaching 1.4% in December (Chart 4).

Purchasing power should also be sustained by the growth in wage income due to accelerating employment, with the average wage per capita rising at almost the same pace as in 2006. Despite lower inflation, the average wage will likely be buoyed by the stronger labor-market and sizable distributions of premiums and bonuses in early 2007. Another stimulus may come from greater use of overtime in industries affected by major labor shortages—such as construction—when the tax exemption on overtime pay comes into effect.

In addition to the persistent vigor of earned-income growth, two further factors should help to quicken the rise in household income. First, social benefits are projected to stay on their present uptrend: old-age benefits will expand at a robust pace as the first baby-boom cohorts reach retirement age. Second, and more importantly, the reform of income-tax brackets should put a powerful brake on the growth in taxes paid by households: the increase in the latter is forecast to slow from 6.8% in 2006 (excluding the accounting restatement of

the dividend tax credit [*avoir fiscal*]) to just 0.9% this year. In Q4, the elimination of social contributions on overtime pay should also have a similar effect.

Overall, the growth in French households' real gross disposable income is set to quicken from 2.4% in 2006 to 3.2% in 2007.

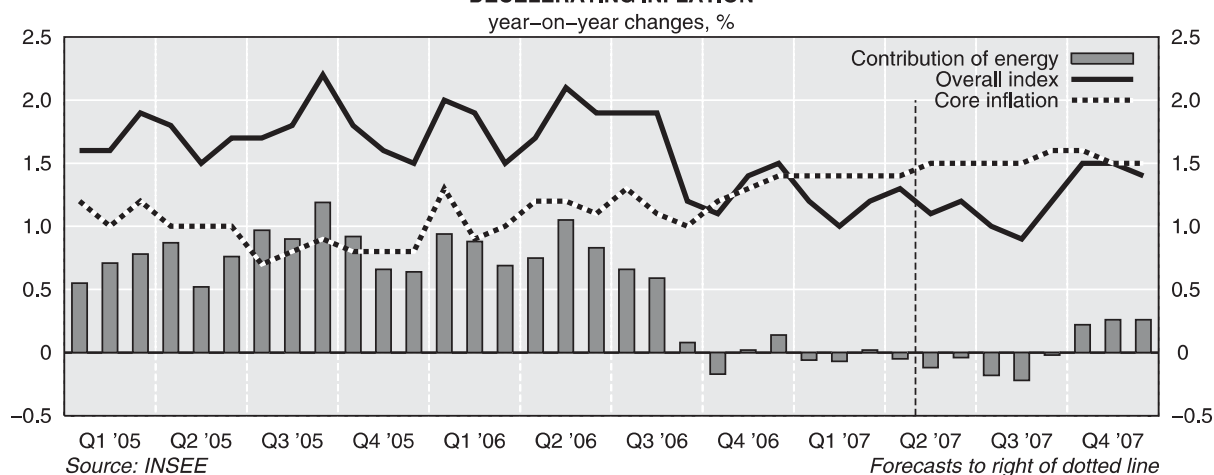
Households: accelerating consumption but weaker investment

Household consumption remained fairly slack at the start of the year, edging up from 0.2% in Q4 2006 to 0.3% in Q1 2007. Once again, it was dampened by the decline in energy expenditures due to the persistence of unseasonably mild temperatures. More unexpectedly, spending on services also lost considerable momentum in early 2007, particularly in the accommodation and restaurant sectors.

Limp consumption combined with the fairly brisk rise in income to boost the saving ratio in Q1. But, if the standard pattern applies, households will consume the extra income thus saved (Chart 5),

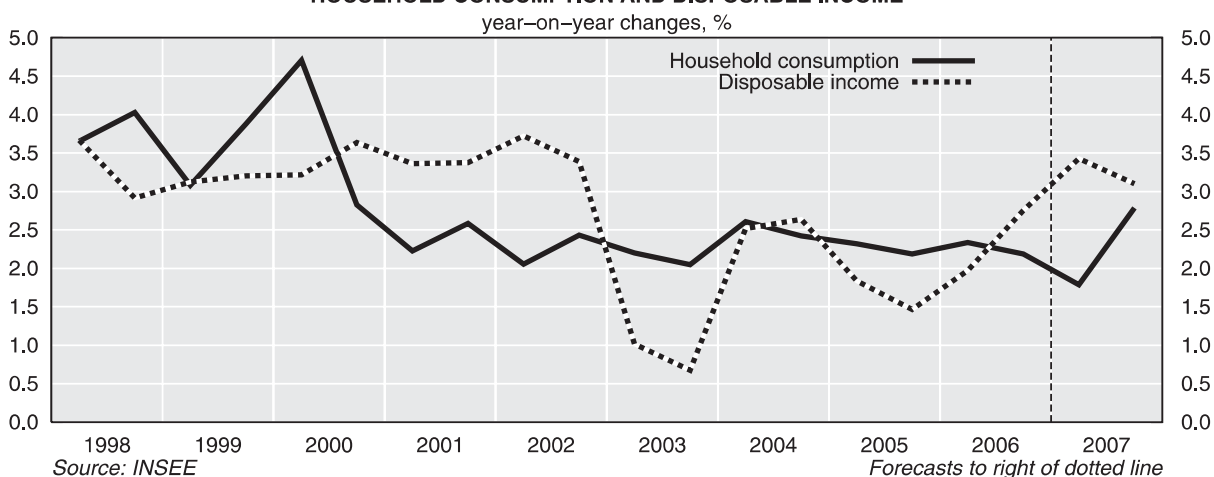
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DECELERATING INFLATION



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HOUSEHOLD CONSUMPTION AND DISPOSABLE INCOME



and their saving ratio will gradually return to its average level of recent years. With household confidence running high, we therefore expect consumption to rebound by 0.9% in Q3 and Q4 2007.

Despite a modest 0.2% pick-up in Q1 2007, household investment has been clearly trending down since early 2006. High real-estate prices and tighter financing conditions have succeeded in slowing the vigorous rise in demand. The early-2007 fall in housing starts portends a decline in investment in Q2. The new tax deductions on mortgage-loan interest later this year should sustain demand and may put household investment back on a mildly positive growth track of 0.2-0.3% per quarter.

Business investment heading toward moderate growth

After ending 2006 on a lively note, French business investment kept its momentum in Q1 2007, gaining 1.4%. Expenditures on manufactured products grew briskly thanks to purchases of aeronautical, naval, and rail equipment. In addition, the unseasonably mild winter allowed rapid progress in building and civil-engineering projects. With conditions returning to normal, construction spending will likely undergo a correction in Q2.

While demand is expected to remain firm, tougher financing conditions should entail a gradual slowdown in capital spending on manufactured goods to 1.2% in Q4 2007. This downturn should, however, be mild. The average revision indicator—a fairly reliable estimator of short-term growth in investment—remained significantly positive in the April business survey. Also, capacity

utilization in manufacturing is still relatively high. Industrialists should therefore have an incentive to boost capacity in the months ahead. In our scenario, business investment will register brisk average annual growth of 5.4%, and the investment rate will stay on an uptrend, rising from 18.1% in 2006 to 18.7% in 2007.

Output rising in all major industries

France's all-industry production continued to accelerate in early 2007, gaining 0.8% in Q1 notably thanks to the manufacturing rebound and lively wholesale/retail sales. The business climate—broadly positive in April-May according to the confidence surveys—points to further output growth in the months ahead, albeit at a milder pace of 0.6% per quarter.

Throughout the year, firm household demand should fuel the wholesale/retail and service sectors. By contrast, the energy-production profile is expected to be more chaotic. In particular, the return to normal weather conditions should trigger a rebound in energy consumption, driving up production in Q2.

Conversely, after two quarters stimulated by mild temperatures, construction output is forecast to dip in Q2 2007. However, as business surveys indicate, order books are still well filled. This should enable construction-sector growth to move closer to its trend in H2, in line with the slight upturn in household investment.

After a two-year decline, production in French agriculture and food industries is forecast to grow 1.1% in 2007. ■

France: supply and use table (in real terms)

at previous year's chain-linked prices, seasonally and working-day adjusted, quarterly and annual changes, %

	2005				2006				2007				2005	2006	2007
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
GDP	0,2	0,2	0,6	0,4	0,7	0,9	0,1	0,5	0,5	0,6	0,7	0,7	1,7	2,2	2,1
Imports	0,7	0,6	2,5	3,0	1,3	2,9	-0,8	0,6	0,6	2,0	1,5	1,6	5,4	7,0	4,1
Household consumption	0,5	0,0	0,7	0,7	0,7	0,5	0,5	0,2	0,3	0,9	0,9	0,9	2,3	2,3	2,3
Public consumption*	0,1	0,2	0,4	0,0	0,5	0,5	0,3	0,5	0,3	0,6	0,5	0,5	0,8	1,4	1,8
Total GFCF**	0,8	0,7	1,8	0,6	0,5	1,7	0,6	1,3	1,2	0,4	0,7	0,7	4,1	4,1	3,8
of which:															
NFEs***	0,1	-0,2	2,5	0,5	0,3	2,4	0,9	1,8	1,4	1,0	1,0	1,0	2,7	4,6	5,4
Households	1,2	2,4	0,7	1,3	1,4	1,0	0,9	-0,4	0,2	-0,5	0,2	0,3	6,2	4,5	0,4
Exports	-0,5	0,3	3,0	1,0	3,2	1,0	-1,3	0,6	1,5	0,9	1,1	1,1	3,2	6,0	3,1
Domestic demand excl. change in inventories	0,5	0,2	0,8	0,5	0,6	0,7	0,5	0,5	0,5	0,7	0,7	0,8	2,2	2,4	2,5
Change in inventories****	0,0	0,0	-0,3	0,4	-0,5	0,7	-0,3	0,0	-0,3	0,2	0,0	0,0	0,1	0,1	0,0
Net foreign trade	-0,3	-0,1	0,1	-0,5	0,5	-0,5	-0,1	0,0	0,2	-0,3	-0,1	-0,2	-0,6	-0,3	-0,3

■ Forecast

*Expenditures by general government and non-profit institutions serving households (NPISHs) **Gross fixed capital consumption (GFCF)

Non-financial enterprises *Including acquisitions net of sales of valuables

Source: INSEE