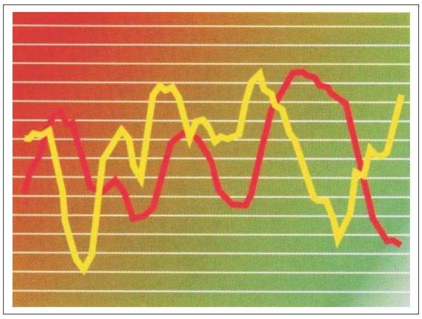
CONJONCTURE IN FRANCE



A cushioned oil shock

In contrast to the continuing strong activity at world level, year-on-year growth in the euro zone remained very modest in H1, at around 1.5%. Germany was alone in managing to derive a significant contribution to growth from international trade, while domestic demand everywhere remained generally slack. Furthermore, the short-term economic climate is still being substantially influenced by the climb in the oil price, which gathered pace during the summer to reach an order of magnitude similar to that of the first oil shock. Fortunately, however, the consequences to be expected are different: successive bouts of inflation leading to recessionary episodes are this time unlikely. The effects can in fact be expected to be limited to a reduction in growth, spread over time, and to an automatic rise in retail prices.

In the United States, growth is expected to remain strong in H2, coming close to 3.4% for the year as a whole. It may be temporarily disturbed by the effects of the hurricanes, but not to the point of breaking its momentum. Growth in Asia, too, is likely to level off, although remaining firm and so maintaining pressure on oil prices. The euro zone is likely to show continuing modest progress, with GDP growth for the year expected to come out at 1.3%.

In France, growth is likely to remain in phase with that of the rest of the euro zone. Household demand is expected to be slightly firmer than for the average of the zone, with an upturn in consumption in Q3 and continuing high levels of house purchasing. On the other hand, the contribution from foreign trade is likely to remain negative because of continuing strong imports. All in all, French GDP growth is expected to be 1.5% in 2005. This being so, dependent employment in the market sector is expected to show a rise of 50,000 for the year as a whole. Taking assisted non-market employment into account, this would mean a gradual decline in unemployment during H2. After falling back below the 10% level in July, the unemployment rate would be 9.7% at the end of the year. Influenced by energy prices, inflation is expected to move above 2% at the end of Q3 and stand at 2.1% in December.

The principal unknown factor liable to affect this prospect is the oil price, whose elasticity to fluctuations in demand has become very high. The approach of winter creates a context liable to generate further tension. On the other hand, the recent price rises could lead to signs of a slowdown in world demand for oil that would favour an easing of prices.

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The latest surge in oil prices, which was regarded as a potential negative factor in the June “Note de conjoncture”, materialised during the summer, with the price fluctuating in the past two months within a band above 60 $/barrel. While its short-term impact is already faintly perceptible, the scale of the consequences of this surge in prices should remain limited this year. By reason of this shock and because of its difficulties in deriving benefit from the continuing strength of international trade, the French economy is expected to grow by 1.5% in 2005, mainly thanks to domestic fundamentals that are still firmer than in France’s European partners.

The soaring oil prices have so far little impact on growth in the world economy

The Brent price rose through the 60 $ barrier on 1 August and by 1 September had reached almost 67 $. On top of the capacity difficulties experienced by crude oil production, there are now short-term difficulties concerning the supply of refined products: the refinery utilisation rate is now moving around 95%, the result being to increase the likelihood of incidents. Above all, the continuing strong world demand and the desire of certain OPEC members to keep the crude oil price high suggest that no notable easing of prices can be expected between now and the end of 2005. This means, on the assumption that the Brent price stabilises at around 62.5 $/barrel, that the average rise between 2004 and 2005 would amount to 20 $, following the already steep rise of 10 $ between 2003 and 2004.

This rise is weighing on the world economic situation, but so far without significantly hampering growth. It represents a transfer of wealth from the oil importers to the oil exporters of the order of 1% of world GDP over the two years 2004 and 2005. This «levy» still remains well below that seen at the end of the 1970s, since the proportion represented by oil products in the OECD countries’ trade balance in 2005 is, on average, half what it was at that time.

In H2 2005, it is the highly-industrialised emerging countries that are likely to be hardest hit by the rise in oil prices. The Asian region, in particular, which has already been recording a steady slowdown in industrial growth since mid-2004, could be the most affected, even though it is benefiting from a slightly more favourable tendency in the Japanese economy in the past few quarters.

In the United States, GDP growth is expected to come out at 3.4% for the whole of 2005, with a somewhat uneven pattern over time as a result of the hurricanes. The robustness of American growth and the inflationary pressures in the energy sector are likely to prompt the Federal Reserve to continue raising its interest rates, bringing them to 4.25% at the end of 2005. However, as has been the case since the beginning of the tightening phase, the rise in short rates is unlikely to have more than a limited impact on long rates. This means the possibility of an inversion of the yield curve towards the end of the year (with short rates exceeding long rates). As a result, household demand would weaken in H2 2005, hit progressively by higher inflation and the gradual rises in interest rates. The deteriorating outlook and the tightening of loan conditions would hold back corporate investment in H2.

The evolution in the euro/dollar exchange rate is still the result of an uneasy equilibrium between opposing factors. In H1 it was the factors giving support to the dollar that prevailed, but the exchange rate remained relatively stable during Q3. The conventional assumption being used for the time period of this forecast is 1.23 $/euro, its average level since 1 August.

European economies held back by their domestic demand

Following a somewhat slow first half, the euro zone’s principal trading partner, the United Kingdom, is likely to benefit from a gradual consolidation of its domestic demand, in line with the ending of the downward tendency in house prices and the cut in the Bank of England’s key rate. UK GDP growth is expected to be 1.7% in 2005, compared with 3.2% in 2004.

As a result, world demand for exports from the euro zone as a whole is expected to continue to grow moderately in H2. However, within the zone, the disparities in foreign trade performance are likely to intensify, in response both to demand differences within the zone and to evolutions in competitiveness. Germany, in particular, is continuing to build market share thanks to the cost-competitiveness gains derived from the decline in real wages, and this is pointing to an incipient upturn in German productive investment. In Italy, by contrast, the slump in exports is destabilising industry.

Unless and until the «second round» effects of the oil shock come into play, the ECB can be expected to leave its rates unchanged. European long rates are likely to rise slightly, in parallel with US rates. Their very low levels are, however, generating a sharp rise in money supply and in lending, notably for house purchase.

Even so, the apathy of household spending in France’s two principal partners, especially Germany, is likely to persist until the end of the year. This is because household income remains penalised by the slackness of employment (up 0.6% in 2005 in the euro zone). In addition, the acceleration in prices can be expected to reduce household purchasing power. Nor can public consumption be counted on taking up the running from private consumption, as control over public spending is likely to be strengthened in the framework of the Stability and Growth Pact.

In these circumstances, euro-zone GDP growth, marked by substantial differences in individual countries’ short-term economic tendencies, is likely to average 1.3% this year.

The French manufacturing sector has this year been running up against foreign trade difficulties and the initial effects of the energy shock

The morose European climate has been a factor holding back French foreign trade, but the disappointing H1 results (0.1% growth in manufacturing exports in Q2, following -1.1% in Q1) may be signalling competitiveness problems as well. In particular, the persistence of the euro/dollar exchange rate above $1.20 may have eroded price-competitiveness vis-à-vis countries outside the zone to a greater extent than previously expected. Even so, an upturn in manufacturing exports is expected in Q3. For the year as a whole, the hesitancy shown by exports, coming on top of the surge in the energy bill, means that a further widening of the French trade deficit is likely - especially as imports are liable to rise briskly in line with the liveliness of consumption. All in all, for the second year running, foreign trade would make a negative contribution of almost one point to French economic growth.

The seesaw evolutions in French industry in the past four quarters demonstrate the difficulties experienced by the sector in standing up both to the export difficulties and to the initial effects of the energy price shock.

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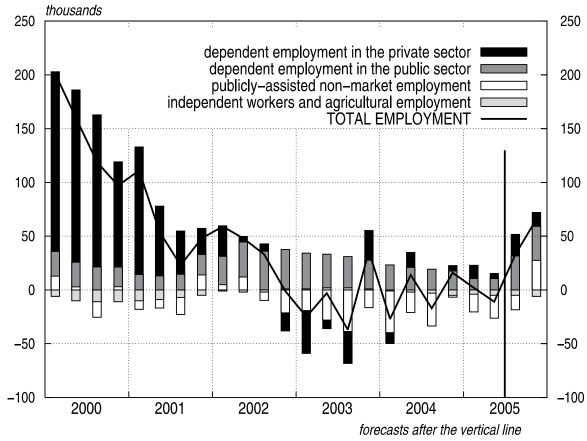
EVOLUTION IN EMPLOYMENT



Even though the decline in the industrial production index (IPI) in July may be partly the result of exceptional calendar factors, the somewhat fluctuating evolution in business leaders' opinions reflected in surveys during the summer point to stagnation, at best, in manufacturing production in H2. On an annual average basis, manufacturing production is expected to rise by only 1.1%.

An upturn in dependent employment, supplemented by an ambitious programme of publicly-assisted jobs, should bring the unemployment rate down to 9.7% by the end of the year

According to revised estimates of dependent employment in the non-farm private sector in the early part of the year (+17,000 for the half-year), 2005 would seem to be marking the start of an upturn in competitive-sector employment following the stagnation seen in 2004.

This tendency seems to have been confirmed in Q3, as shown by the decline in the unemployment rate below 10% seen in July. In addition, H2 could well see appreciable initial effects of the measures contained in the «Plan d'urgence pour l'emploi», notably the introduction of the «contrat nouvelle embauche» (a contract with a 2-year probationary period instead of the normal 3 months). For the year as a whole, net job creations in the market sector are expected to reach 50,000, compared with 5,000 in 2004. The principal branches creating jobs appear to be construction and the tertiary market sector, while the decline in manufacturing employment is confirmed.

However, in the second half of this year it is mainly the mechanisms for assisted employment in the non-market sector that would have a major influence on evolutions in the unemployment rate. Tertiary employment in the non-market sector is expected to rise sharply (by 61,000, compared with a fall of 9,000 en 2004[1]). Thanks to the «Plan de Cohésion Sociale», there would be a rise in the number of beneficiaries of a publicly-assisted contract, mainly because of the build-up of the «Contrat d'Accompagnement dans l'Emploi» (CAE) during the year: these arrangements would largely compensate for the exits from the labour market due to the ending of the previous CES and CEC contracts. The «Contrats d'Avenir», for their part, would account for roughly 30,000 entries during the year.

The upturn in private employment and the activation of publicly-assisted jobs in the non-market sector are expected to produce, in combination, a rise in total employment of 91,000 in 2005, compared with a fall of 15,000 in 2004 *(see graph 1)*. At the same time, the increase in the supply of labour is expected to accelerate very slightly in 2005 (+39,000, compared with +37,000 en 2004). In the end, the unemployment rate would return to 9.7% at the end of 2005.

The evolution in purchasing power is likely to be stemmed in H2 by energy-induced inflation

The most tangible effects of the surge in oil prices are being felt in consumer prices. Despite the weak growth in food prices and the decline in those of manufactures, inflation is expected to pick up to 2.1% in December 2005, under the impact of the rise in prices of energy products *(see graph 2)*.

This rise in inflation brings the evolution in household purchasing power to a quarterly rate of 0.7% in Q3 and 0.4% in Q4. On an annual average basis, growth in the purchasing power of gross disposable income is set to accelerate to 1.9%[2] from 1.6% in 2004.

This is because, in the wake of the steady consolidation of total employment during the year, total wages and salaries received by households are expected to pick up. In addition, taking the average for the year, the other components of income are also expected to accelerate. However, this dual tendency would be partly offset by the acceleration in tax payments by households following the rise in the rate of the General Social Contribution and the broadening of its base.

Particularly uneven tendencies in household spending

The somewhat erratic evolutions in household consumption do not seem to be explained by those of the purchasing power of income. After a sharp rise in consumption in Q1, household expenditure fell back markedly in Q2 (down 0.2%) but then seems to have picked up strongly again in

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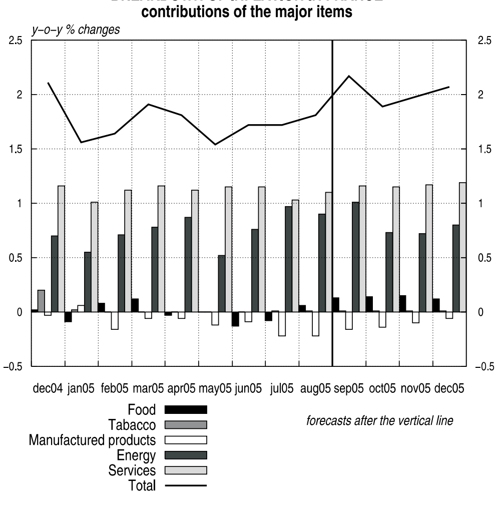
BREAKDOWN OF INFLATION IN FRANCE
contributions of the major items



(1) This figure is based on the assumption that the 80,000 additional CAE announced in the «Plan d'urgence pour l'emploi», contribute 26,000 entries to the labour market this year.
(2) The purchasing power of GDI is calculated using the deflator of household consumption taken from the quarterly national accounts.

Q3, notably in the form of spending on manufactures (+1,8%). In any case, an automatic correction in the rate of consumption growth can be expected in Q4, following what were probably partly exceptional evolutions in Q3.

All things considered, the annual average growth in consumption is expected to be 2.0%, corresponding to virtual stability in the saving ratio.

Meanwhile, the liveliness of household investment is showing no signs of weakening in 2005, buoyed up simultaneously by a demand for housing that is exceeding supply, historically low long-term rates and tax concessions for investment in housing intended for rental. In view of the latest figures for housing starts, housing investment in 2005 should remain firm, rising by 3.3% compared with 3.1% in 2004. The persistent liveliness of household investment is nevertheless bringing the financial saving ratio to historically low levels, thus increasing the possibility of a trend reversal.

Firms are accordingly hesitant regarding their investment outlook

While a downturn in productive investment was admittedly expected, the correction seen in Q2 went well beyond expectations, no doubt partly because of the deterioration in the industrial situation in the early part of year after the exceptional tendencies of last winter. In the second half of the year, in an uncertain international climate and with profitability eroded by the surge in prices of energy inputs, the investment ratio is likely to stabilise, overall, with a slowdown in productive investment (0.3% in Q3 followed by 0.5%).

Construction GFCF by non-financial firms is also likely to maintain its momentum, driven by house purchases (essentially public low-cost housing).

The ups and downs of domestic demand and the impact of the energy shock are likely to lead to divergent sectoral evolutions

In H1, production by the totality of branches weakened slightly (a rise of 0.7% compared with 1.0% in H2 2004). This slowdown is explained in the first place by the levelling off apparently being seen by manufacturing production, a tendency that can be expected to intensify in H2.

Another sector likely to have a negative impact on growth in Q3 is energy production, which is expected to stagnate in line with the evolution in manufacturing activity. The transport sector, too, will probably be badly affected by the acceleration in energy prices.

Evolutions are likely to be more positive in the other sectors. The output of market services should benefit from the persistent strength of household consumption, giving annual average growth of 2.1%. In the case of mainly non-market services, the moderate growth seen in H1 can be directly linked to the slowdown in healthcare expenditure. Q3 apparently saw household spending on healthcare recover sharply, pointing to an acceleration in this sector.

Finally, because of the simultaneous dynamism of investment by households, firms and the public sector, the construction sector should remain firm in coming quarters (a rise of 2.4% for the year).

During the year as a whole, total production is expected to rise by 1.8%. This would be made up of a distinct slowdown in manufacturing and the maintenance of growth rates in construction, services and distribution similar to those of 2004, i.e. above 2.0%.

All things considered, French GDP is likely to rise by 1.5% in 2005, but with the recovery limited towards the end of the year by the consequences of the surge in the oil price, so that GDP would rise by 0.4% in Q3 and 0.3% in Q4. ■

This document is available on the Insee Webserver, http://www.insee.fr *Completed on September 30, 2005*

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