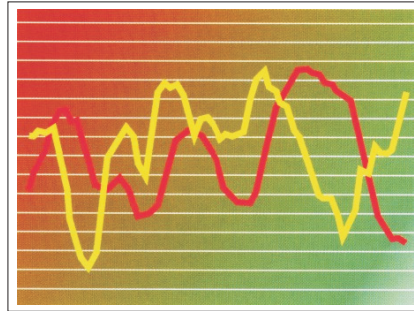


CONJONCTURE IN FRANCE



The European upturn in search of its second wind

The first half of the year saw growth in the euro zone accelerate slightly to an annualised rate just above 2%. This growth was based for the most part on exports to countries outside the zone and this was a source of differences between countries due to unequal capabilities of taking advantage of world demand. Germany benefited most from the highly supportive international context and thus made up for the persistent weakness of domestic demand. French growth was better than the euro-zone average (being of the order of 3% at annualised rate) thanks to particularly brisk household consumption, notably of manufactures, accompanied by an accelerated recovery in investment.

The post-vacation season finds the euro zone's international environment looking somewhat less vigorous. The American economy is returning to a growth rate of the order of 3%, the outlook for the Chinese economy is less brilliant and the developed countries in general are being subjected to the persistent drain brought about by the high oil price. As a result, growth in the euro zone is likely to cease accelerating in the second half, while at the same time there will be a shift in favour of domestic components of demand, thanks, in particular, to monetary and financial conditions that are still on the accommodating side.

In France, after a strong growth in H1, household consumption has returned since the summer to a more moderate growth rate, more in line with recent evolutions in purchasing power, which has been held back by the modest scale of the long-awaited revival in dependent employment, as well as by the maintenance of inflation at above 2% because of the direct impact of the higher oil price at a time of stabilised wage increases. The post-vacation period finds households' and companies' expectations cautiously optimistic. With corporate investment continuing to rise at a rate of 4%, but with private investment in housing weakening somewhat, French growth can be expected to return in H2 to a quarterly growth rate of 0.5 to 0.6%. This would bring growth for the year 2004 (working-day-corrected) to 2.4%, leading to a slight increase in dependent employment in the market sector. Because of a large number of retirements from active working life, the unemployment rate should decline towards the end of the year (to 9.8% by December).

The principal uncertainty lies in the evolution of the oil price. A further rise would flatten somewhat more the slope of the recovery, but without causing a downturn. Conversely, an easing of the oil price, combined with a possible reawakening of German consumers, could give the European economy the second wind it is currently seeking.

For the past year, it is external demand that has stimulated economic growth in the euro zone

Since mid-2003, GDP growth in the euro zone has reached annualised rates of around 2%. Three quarters of this performance is the result of the strength of exports to countries outside the zone (United States, CEEC, Asia...)

A substantial difference has emerged within the group of leading euro-zone countries between those with the highest growth rates (France and Spain) and the others (Germany and Italy). The former have benefited from fairly strong domestic demand, whereas growth in the other two countries has been based solely on exports. Accordingly, household consumption rose by 3.2% year on year in Q2 in Spain and by 2.7% in France but by only 1.0% in Italy and even fell by 0.8% in Germany. By contrast, exports have risen in the past year by 12.2% in Germany, 6.4% in Italy, 4.7% in Spain and 4.3% in France. In the case of Germany, the extremely brisk exports of capital goods are probably explained to a considerable extent by the requirements of subsidiaries of German firms set up in the CEEC countries and in Asia.

The euro-zone's international environment became somewhat less buoyant during the summer

The oil price is likely to remain high, but its impact on the overall price level and on world activity remains weak

Since June, the rise in the price of Brent has intensified. This is due to increasing scarcity of supply and to a perceived risk of interruptions to output at a time when demand remains strong. News regarding the supply of Russian oil has tended to crystallise these worries since the beginning of July because of the legal tribulations being experienced by one of the country's leading producers, Yukos. OPEC's move to raise production quotas on 15 September, which had been anticipated since mid-August, failed to stem the rise in the oil price other than temporarily, partly because commercial stocks in the consumer countries, notably the United States, are now low by comparison with historic averages.

The price of Brent is therefore likely to stay close to \$40 in Q4 as it has done in Q3. The consequences for world growth and for the evolution of consumer prices are for the moment difficult to grasp and are likely to remain on a small scale between now and the end of the year. The impact on consumer prices is currently being confined to the direct automatic effects without spreading to wages and overall producer prices (in other words, no second-round effects).

Financial conditions remain very favourable despite the recent slight monetary tightening

In the absence of second-round effects of the rise in the oil price on consumer prices, the raising of interest rates in the United States and in the United Kingdom is explained mainly by the desire of the monetary authorities to achieve a certain cooling-off of demand. The US Federal Reserve has raised its key rate by 75 basis points (bp) since June to 1.75%, while the Bank of England has raised its leading rate by 125 bp since November 2003, to 4.75%. Bond and equity markets have been holding their own, showing no marked tendency during the summer, indicating that financial investors' perception of risk remains very low despite the rise in the oil price.

The American and Chinese economies have already begun to slow down and that of the United Kingdom is likely to follow suit

In the United States, the tapering-off of the fiscal and monetary stimuli are likely to continue to contribute to the slowdown in activity, with the rise in the oil price making itself felt to a greater extent. GDP growth in Q2 came to 0.8%, compared with 1.1% in Q1, as the result of slower growth in consumption (down to 0.4% from 1.0%). The tax stimulus seems to be petering out and monetary policy has turned less expansionary. Other factors are also helping to slow down purchasing power growth. In the period since June, job creations have been on a smaller scale than in Q2 and are likely to remain so during the rest of the year, with wage growth accordingly remaining moderate. In addition, consumer prices can be expected to feel the effects of the high level reached by the oil price. As a result, household investment and consumption are likely to settle down for a considerable time at a more modest growth rate than in the early part of the year. Certain quantitative indicators now available for Q3 are pointing in this direction: housing starts are slowing down and retail sales for June to August have shown a three-monthly fall. Forward-looking information derived from business surveys is also showing a less positive tendency: household confidence is on the decline and the ISM activity indicators have slipped appreciably, probably reflecting worries associated with the oil price. Lastly, the prospects for investment remain good, albeit weakening slightly, as shown by the August fall in orders for capital goods. All things considered, United States GDP growth can be expected to remain at an annualised rate of 3% in H2, the same as in Q2.

In China, the declared intention of the ruling authorities to cool down the economy seems to be taking effect. Chinese imports have shown a tendency to slow down since July and this is probably a sign that domestic demand and activity are indeed cooling off.

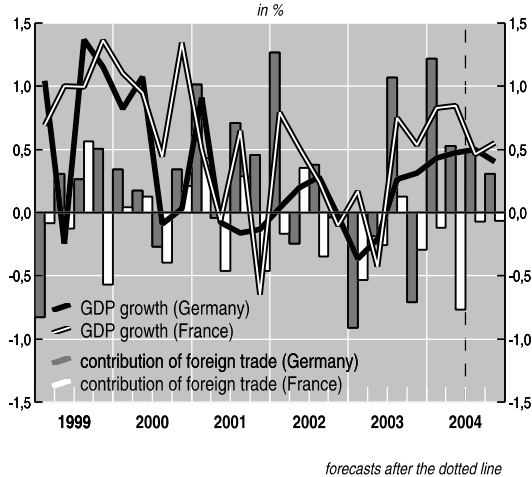
In the United Kingdom, the tightening of monetary and financial conditions, as well as the first signs of a downturn on the housing market, are starting to hold back growth. Apart from the rise in interest rates, house prices as recorded by the Halifax index fell in August. This means that households cannot expect to continue to take advantage of low-cost borrowing or from money derived from mortgage refinancing, the result being to slow down their expenditure.

A shift in growth in favour of domestic components is likely to operate in the countries lagging furthest behind in the cycle

Germany and Italy should continue to benefit from reinvigorated intra-zone trade, leading in turn to a slight improvement in growth in their domestic demand

Driven by demand from other euro-zone countries that are at a more advanced stage of the upswing, exports from Germany and Italy should remain brisk, growing at annualised rates of 9% and 6% respectively. In the case of Germany, the income derived from growth is likely mainly to benefit the corporate sector, as in the recent past, but households should finally also start to benefit and to increase their consumer spending accordingly. Firms will probably continue to restore their margins and to invest capital in their subsidiaries located in the CEEC countries and in Asia. In return, these subsidiaries will probably be attracting additional merchandise exports from Germany.

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GROWTH AND CONTRIBUTION OF FOREIGN TRADE
FOR GERMANY AND FRANCE



In Italy, the growth in household purchasing power, based notably on the rise in real wages since the beginning of the year, should fuel moderate growth in consumption.

On the other hand, growth is likely to become less strong in France and Spain after the good performance in H1

With domestic demand remaining robust, albeit slowing down, imports into France and Spain are likely to remain at a high rate. With their exports growing less fast than in Germany, the external contribution to growth in these countries can be expected to remain negative for the foreseeable future, in contrast to the situation in Germany and in Italy (see Graph1).

In France, following its very good performance in H1, household consumption is likely to return to a more moderate growth rate, in line with recent evolutions in the purchasing power of income

French household consumption, notably of manufactured goods, grew strongly in H1 (+3,5%). Growth in spending was particularly strong for durable goods, i.e. cars and household equipment. Spending on this last item in fact grew by an exceptional 6.8% in June, perhaps as a result of the impact of the European Football Cup and of milder weather than usual, at the same time when new measures were put in place to sustain expenses.

In July and August, consumption of manufactured goods weakened overall. This reversal also suggests that the June expenditure figure was partly the result of bringing forward the timing of purchases. In any case, it will influence the evolution of total consumption in Q3, which is likely to rise by 0.3%, compared with 0.6% in Q2 and 1.0% in Q1, and to return more in line with past evolutions in purchasing power. The latter rose by only 0.3% in Q1, notably as the result of the slow evolution in employment in the competitive sector. In the second half, purchasing power is expected to continue the acceleration seen since Q2, bringing its annual growth for 2004 to 1.8%. The effects of this acceleration on consumption should again be visible from the start of the final quarter, with growth in household spending accelerating to 0.5% in Q4.

Employment set to pick up gradually and the unemployment rate to decline

Despite the strong growth in activity posted since mid-2003, employment in the competitive sector has failed to pick up again, having declined by 0.5% in the year 2003 and stabilised in H1 2004. The discrepancy between growth in activity and employment nevertheless seems normal in view of the firms' usual behaviour, in which workforces are adjusted to production only after a certain time lag.

Employment in the competitive sector is expected to grow by 0.25% in H2 2004, meaning around 40,000 additional jobs. With employment falling slightly in non-market branches as a result of the reduced number of government-aided contracts, total employment should rise by 6,000 in H2. The new arrangements permitting workers with long careers behind them to retire earlier than under the previous system is encountering great success. Figures from the CNAV national old-age insurance scheme show that 89,900 requests of this kind were approved in August. As a result, the unemployment rate is expected to decline slightly towards the end of the year to 9.8%.

Inflation set to ease despite the impact of the energy price

The stabilisation of tobacco prices is likely to be a major factor in the easing of overall inflation from 2.4% in July to 2.0% in December. At the same time, the year-on-year rise in food prices should continue to decline because of the absence of unfavourable weather conditions this year. This is true in particular of fruit, which has suffered neither from late frosts this past spring nor from drought in the summer. The prices of mass-consumption manufactured goods should also benefit from the application of the agreements between manufacturers and large-scale retailers aimed at reducing prices of branded goods. On the other hand, energy prices can be expected to accelerate through the passing on of this summer's rise in the oil price. In total, however, factors tending to ease inflation are likely to win the day.

The improvement in purchasing power and the easing of inflation seem already to have been anticipated by households, whose confidence is improving

The August household survey shows an increase in the composite indicator of opinions regarding the standard of living, the financial situation and the timing of major purchases. Moreover, household opinion regarding the evolution of prices has been improving significantly.

In parallel with the slowdown in their consumer spending, households will probably also cut back on their investment in housing

The housing sector has seen a tendency for starts to decline during the summer after the buoyancy in the beginning of the year. In the business survey for the building sector, entrepreneurs are also indicating a downturn in the recent tendency and stability in the future outlook.

Firms are likely to maintain positive, albeit more cautious, investment policies

During the first half of the year, corporate investment continued to benefit from the firmness of household demand, from that of export demand since mid-2003 and from particularly favourable financial conditions. Investment growth was vigorous as regards manufactured goods, par-

ticularly transport equipment (motor vehicles and aircraft). On the other hand, investment in infrastructure remained flat, as did that in services (advice and assistance).

In the second half, the slowdown in demand is likely to contribute to that in corporate investment. Moreover, the rise in the oil price has probably reduced the profit ratio, as firms do not immediately adjust their sales prices to match this rise in costs. Investment in engineering and electronic capital goods is likely to remain positively headed, but transport equipment less so, in reaction to the strong first half.

The return of growth in domestic demand to more average rates will probably mean a slowdown in production in virtually all sectors

Production of manufactured goods should continue to grow at a firm rate in order to meet continuing strong demand from firms, despite the slowdown in household demand. There is nevertheless likely to be a substantial weakening in Q3 in the case of cars — Q3 saw a slight decline in registrations. In the September business survey, industrial leaders confirmed that economic activity slowed down during the summer, notably in the car sector, but they continue to take a positive view of the future outlook. Carmakers have in fact announced major recruitment plans for their French plants between now and 2005 (7000 in 2004 in the case of Peugeot-Citroen, 5000 in 2005 in the case of Renault). Growth in manufacturing output is thought to have slowed down to 0.8% in Q3, compared with 1.2% in Q2, but should accelerate slightly to 1.0% in the final part of the year.

Production of market services should remain positively headed, although slowing down slightly in parallel with household demand. This is the conclusion indicated by business leaders in this branch in the September survey (see Graph 2).

After experiencing strong growth in H1, linked to the vigour of household consumption, activity in distribution can be expected to return to average growth rates. The slowdown is likely to be more marked for non-specialised retailers, as suggested by their opinions regarding their intentions for future orders in the September retail distribution survey.

On the other hand, production of healthcare services is likely to have decreased in Q3. Seasonally-adjusted figures for reimbursement of health services by the CNAM (national medical insurance) are pointing in this direction for July and August. The last part of the year should see a return to a more normal tendency.

Construction output is likely to stabilise at a high level. In addition to the downward tendency in new starts, the public works industry also seems to be posting a slowdown. This is the conclusion, in particular, from the July quarterly survey of this sector.

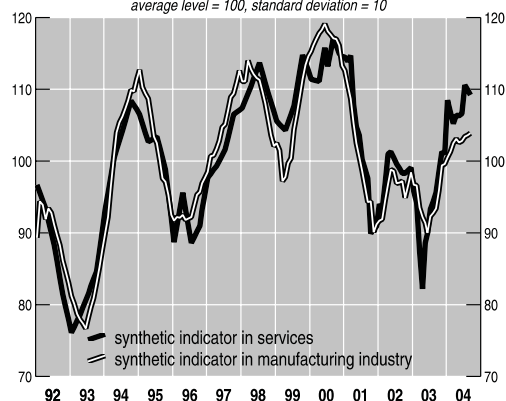
Production in the food sector also seems to be slowing down. Business leaders in the sector have shown reduced optimism in the September survey.

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BUSINESS CLIMATE IN MANUFACTURING INDUSTRY AND SERVICES

average level = 100, standard deviation = 10



All things considered, production is likely to show a distinct slowdown in the second half of the year. On an annual average basis, GDP growth in 2004 should come out at 2.4%, taking the definitions used in the quarterly national accounts (data adjusted for the number of working days). Given that the number of working days has been above-average in 2004, it is necessary to add roughly 0.2 of a point to this growth figure to correspond to the definition adopted for the annual national accounts (unadjusted data), which is expected accordingly to be 2.6% (see methodological note on quarterly national accounts available on the internet http://www.insee.fr/en/indicateur/cnat_trim/methodologie.htm)⁽¹⁾.

Unforeseen factors should not have any substantial negative impact on the forecast for annual growth in 2004

A higher oil price (the price of a barrel of Brent was \$46 on 27 September) should have only limited consequences for growth in euro-zone countries within the time-horizon of this forecast, reducing it by less than 0.1 of a point should the price reach 50 \$ (see box on pages 12-13 of the June "Conjoncture in France"). In the opposite direction, one cannot rule out the possibility that German households will start to spend more freely following their long period of restraint. Growth in the euro zone — in France, in particular — could then as a result move up again towards the end of the year. ■

(1) The corresponding impact on GDP growth between 2004 and 2005 would be nil, as the number of working days will again be high, with the 1 May and 8 May holidays both falling on a Sunday.

Completed on October 1, 2004

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