

FRANCE: LOW-GEAR RECOVERY

*Forecasts for the French economy 2004-2005**

Following near-zero growth in 2003, recovery has picked up in 2004 with an expected GDP increase of 2.5%. Consumption constitutes the main engine for growth despite hesitant real incomes: households, helped by low interest rates, have resorted to borrowing and to spending their previously accumulated savings. For growth to last through 2005, interest rates will need to be kept down, while investment and job creation are expected finally to catch up. The present corporate financial health should allow 2.6% GDP growth in 2005, which will in turn reduce unemployment and boost wages. Significant uncertainties remain, however, both internationally (major oil crisis, global downturn...) and, albeit to a lesser extent, internally (accelerated deficit-targeting fiscal crunch, or bursting of the house price bubble).

2004, a year of recovery ...

The rebound has gathered momentum in 2004. Whereas in 2003 the French economy posted the slowest growth since the 1993 recession (0.5%, annual rate), it is expected to reach 2.5% this year (table 1).

TABLE 1: CONTRIBUTIONS TO GDP GROWTH

Annual percentage change	2002	2003	2004	2005
GDP	1.1	0.5	2.5	2.6
Household consumption and investment	1.0	0.9	1.5	1.6
Corporate investment	-0.5	-0.2	0.5	0.8
Public consumption and investment	1.1	0.8	0.7	0.5
Changes in inventories	-0.2	-0.2	0.8	0.1
Total domestic demand	1.5	1.4	3.5	3.0
Net exports	-0.4	-0.8	-1.0	-0.4
Euro area GDP	-0.8	0.5	1.9	2.4

Sources: INSEE, quarterly accounts, OFCE forecasts, e-mod.fr model from Q4 2004.

* This article is a summary of the study by the OFCE's Analysis and Forecasting Department that was published in *Revue de l'OFCE* n° 91. The team was headed by Eric Heyer and consisted of Valérie Chauvin, Guillaume Chevillon, Gaël Dupont, Matthieu Lemoine, Hervé Péléraux and Mathieu Plane. The forecasts include information available up to 15 October 2004.

The upturn has been mainly driven by household consumption, with the support of capital spending in the second quarter of 2004. In a context of lagging real disposable income, resulting from a lifeless labour market and a pick-up in inflation caused by the oil-price hike, the dynamism of consumption was underpinned by a strong decline in the saving ratio.

The French economic outlook is the resultant of two opposing forces. On the one hand, domestic demand is brisk, with households, companies and general government, by means of their consumption and investment, allowing France to grow faster than most of its neighbours in the Euro Area. On the other hand, foreign trade makes a very negative contribution, thereby holding back the ongoing recovery.

Such a dichotomy, present since 2002, has been particularly pronounced this year. This is mostly the consequence of the appreciation in the effective exchange rate of the euro, which began towards the end of 2001 and which affected competitiveness as of 2003. However, exchange rates do not explain the huge discrepancy between France and its Euro Area (EA) partners, who took advantage of a buoyant world demand in 2003 and 2004. This year, foreign trade will have reduced French growth by 1 percentage point, whereas it will have provided support amounting to 0.4 of a point to growth in activity in the EA.

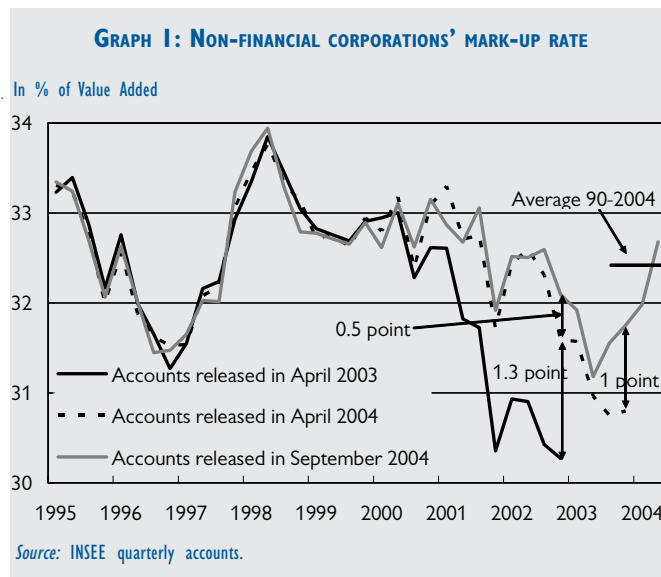
In part, this discrepancy is the counterpart of the differences in domestic prospects: imports have grown much faster in France, driven by the vibrant domestic demand, than in other EA countries. But the poor French performance is also the outcome of its geographical and sectoral specialisations. France mainly exports its EA neighbours. Hence, in contrast to Germany, for instance, French exporters have not benefited from the rapid rebound in the USA, and especially in Asia and in Central and Eastern Europe, as of mid-2003. France also suffered from its specialisation in aircraft, a sector in recession since September 2001.

... stronger than previously expected

GDP growth forecasts for 2004 have been revised upward by one percentage point from what was expected six months

ago. Apart from a positive revision of the 2003 annual growth rate, which turned out to be 0.5% rather than the 0.2% initially predicted, the main factors behind this improvement include a consumer spending spree, some government expenditure slippages and a much improved corporate financial situation. We had therefore expected a more erratic recovery path.

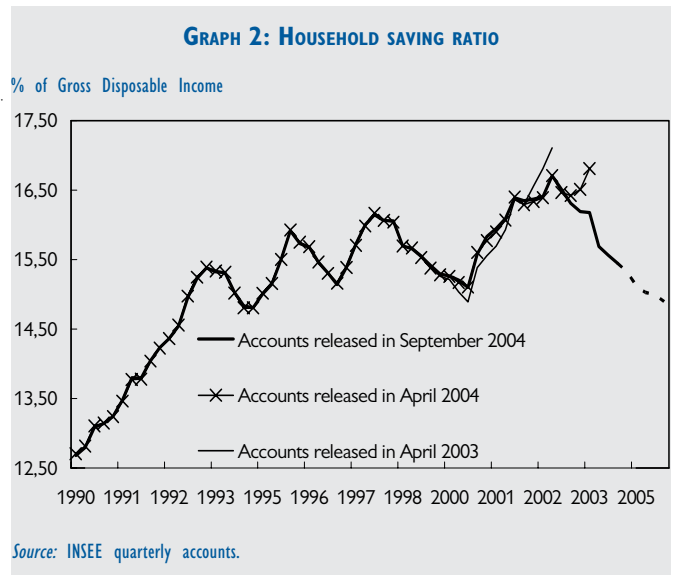
According to the national accounts available last spring, companies were undergoing a strong deterioration in their **mark-ups** (graph 1). In the final part of 2003, the mark-up rate of non-financial corporations had supposedly reached its lowest level since 1986, and we expected them to adopt wait-and-see attitudes in a period during which they would be loath to invest or recruit, in order to restore profit margins.



According to the latest version of the quarterly accounts, the slide in the mark-up rate since 2001 has been much smaller than initially stated, and bottomed out as of mid-2003. The previous version had been misleading for economic diagnosis as well as for the political orientations to choose. In the middle of 2004, the mark-up rate was higher than its average for the last fifteen years. With their finances in such a healthy state, corporations were poised to resume investment spending and recruitment, if demand remained steady. It was therefore no wonder that investment speeded up in 2004 Q2.

Another pleasant surprise in the early part of 2004 was the vigour of **household consumption**, despite a lacklustre labour market and a pick-up in inflation. After a two-year rise until the end of 2002, the household saving ratio has edged downwards ever since, instead of picking up again in 2003 Q3, as was announced in the latest Q2 quarterly accounts (graph 2). Over the year 2004, the saving ratio is expected to show a fall of 0.6 percentage points from 15.8 to 15.2 % of disposable income.

The dis-saving «binge» stemmed partly from sky-high house prices. First, consumption by landlords has been bolstered by their surging wealth. Moreover, the housing market has been a very efficient transmission belt for monetary policy. Low interest rates have made house purchase profitable in comparison with renting, and they have improved the creditworthiness of households keen to acquire properties, new or old. Banks have granted loans generously, sheltered as they were by the existence of collateral. These liquidities have in turn fuelled consumption.



Another reason for the buoyant outlook in 2004 was a **fiscal impulse** that was somewhat less restrictive than might have been expected on the basis of government plans. On average, since 2000, the fiscal stimulus has been 0.4 GDP percentage points higher than predicted, most of the discrepancy being the result of slippages in health expenditure. In 2004, measures included in the Finance Acts implied a 0.3 GDP point surge in the structural primary balance, but this is likely in fact to have remained unchanged.

What scenario for the year 2005?

After a wait-and-see spell, which deterred them from investing and building up inventories, companies have taken advantage of low interest rates to improve their financial outlook and profitability. In the absence of any excess capacity, there now seems to be nothing to impede a brisk upturn in productive investment if prospects continue to be headed upwards. As of mid-2004, capacity indicators, outlook surveys and national accounts were converging to indicate a rebound. In this event, internal demand would consolidate and the French economy could well exceed 3% growth, thereby quickly closing its output gap.

Unfortunately, the trajectory we predict is somewhat shakier: the outlook is for an easing over the second half of 2004, with only a gradual speed-up over the course of 2005.

The fall in the saving ratio will probably no longer be sustaining growth: the household saving ratio is expected to decline only slightly from 15% today to 14.9% at end-2005. The reasons for this stability include the persistent weakness of the labour market and the rise in social contributions following the social security reforms recently introduced. In consequence, household consumption, which has recently propelled French economic growth to exceed that of her neighbours, will slow down somewhat.

Corporate investment, which accelerated in Q2 2004, will take over as a driving force for the economy, being expected to grow by 4.5% in 2004 and 6.9% in 2005, which is a timid rebound in comparison with recent upturns: in 1998-2000, when the annual growth rate of corporate investment reached 9%.

TABLE 2 : USE-RESOURCE BALANCE OF SALEABLE GOODS AND SERVICES (IN VOLUME, 1995 PRICES)

	Level (bn € 95) 2000	Quarterly % change								Annual % change		
		2004				2005				2003	2004	2005
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
GDP	1 357	0.8	0.8	0.4	0.6	0.6	0.7	0.7	0.8	0.5	2.5	2.6
Imports	371	1.1	3.8	1.9	1.9	1.9	1.8	1.8	1.8	0.3	7.7	8.1
Household consumption	726	0.9	0.7	0.5	0.7	0.6	0.6	0.6	0.6	1.7	2.5	2.6
General government consumption	308	0.6	0.8	0.1	0.2	0.6	0.5	0.5	0.5	2.5	2.5	1.7
Gross fixed capital formation :	279	0.8	1.9	1.0	1.0	1.2	1.2	1.4	1.5	0.1	3.8	4.9
of which : - Companies	172	0.9	2.1	1.4	1.3	1.5	1.5	1.7	2.0	-1.5	4.4	6.3
- Households	63	0.9	1.9	0.7	0.9	0.7	0.8	1.1	1.1	0.7	3.3	3.6
- General government	44	0.2	1.2	-0.2	-0.2	1.0	0.5	0.4	0.4	5.5	2.5	1.7
Exports	394	0.7	1.1	1.7	1.7	1.7	1.7	1.8	1.9	-2.7	4.1	6.9
Change in inventories (contribution)		0.2	0.6	0.0	0.0	0.0	0.0	0.0	0.0	-0.2	0.8	0.1
Total domestic demand, excluding inventories	1 321	0.8	1.0	0.5	0.6	0.7	0.7	0.8	0.8	1.6	2.8	2.8

Sources: INSEE, quarterly accounts, OFCE forecast October 2004, e-mod.fr model from Q3 2004.

TABLE 3: SOME SIGNIFICANT RESULTS

	Quarterly change								2003 Average ⁴	2004 Average ⁴	2005 Average ⁴
	2004				2005						
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
Total employment (thousands)	7	27	23	47	52	57	80	109	0	40	215
Number of unemployed ¹ (thousands)	-22	-13	12	-10	-28	-32	-57	-85	211	24	-106
Unemployment rate ¹ (in %)	9.8	9.8	9.8	9.8	9.7	9.5	9.3	9.0	9.7	9.8	9.4
Consumer price index ² (in %)	0.6	0.5	0.6	0.5	0.5	0.5	0.5	0.5	2.1	2.2	2.0
Average hourly wage in non-financial corporations (in %)	0.7	0.5	0.8	0.7	0.8	0.8	0.9	1.0	1.9	2.5	3.1
Average wage in non financial corporations (in %)	0.7	0.5	0.8	0.7	0.7	0.7	0.9	1.0	1.9	2.5	3.1
<i>Households</i>											
Purchasing power of disposable income (in %)	0.2	0.5	0.9	0.7	0.0	0.6	0.7	0.8	0.5	1.7	2.1
Savings rate (in %)	15.2	15.0	15.3	15.3	14.8	14.7	14.8	14.9	15.8	15.2	14.8
Financial savings rate (in %)	5.7	5.3	6.2	6.2	5.2	5.2	5.2	5.3	6.6	5.9	5.2
<i>Companies</i>											
Mark-up (in %)	32.0	32.7	32.7	32.8	33.0	33.1	33.1	33.0	31.6	32.6	33.1
Investment ratio (in %)	16.9	17.0	17.2	17.3	17.5	17.7	17.9	18.1	16.9	17.1	17.8
Self-financing ratio ³ (in %)	86.9	89.9	88.1	88.1	88.2	86.3	84.1	81.6	85.0	88.3	85.0
<i>General Government</i>											
Net lending / GDP (in %)	-3.8	-3.7	-3.6	-3.5	-3.0	-2.9	-2.7	-2.6	-4.1	-3.7	-2.8
Tax and social security contributions/GDP (in %)	44.1	43.9	43.4	43.4	43.9	44.0	44.1	44.1	43.8	43.7	44.0
<i>Interest rates (level in %)</i>											
Long-term interest rates	4.1	4.3	4.3	4.4	4.4	4.5	4.5	4.5	4.1	4.3	4.5
Money-market rates	2.1	2.1	2.1	2.1	2.3	2.3	2.3	2.3	2.3	2.1	2.3

1. ILO definition.

2. ICP seasonally-adjusted.

3. Gross Saving / GFCF.

4. Average annual percentage change.

Sources: INSEE, quarterly accounts, OFCE forecasts, e-mod.fr model from Q3 2004.

TABLE 4: ASSUMPTIONS FOR THE INTERNATIONAL ENVIRONMENT AND THE FOREIGN BALANCE

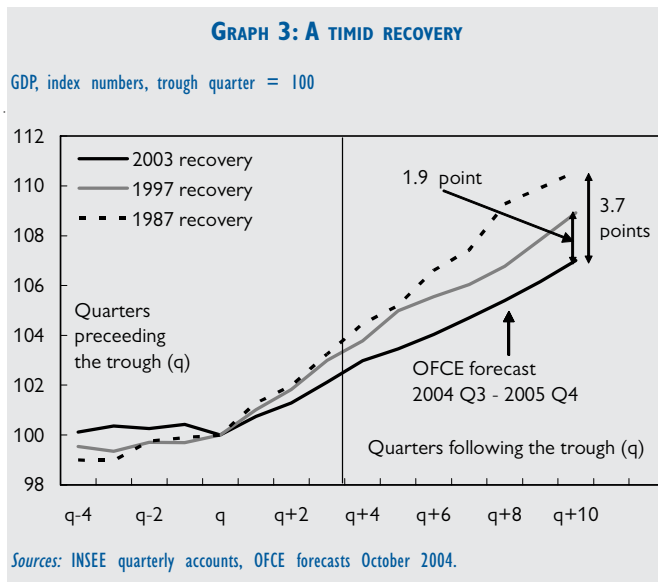
% change (except when stated)	Quarterly change								Annual average change		
	2004				2005				2003	2004	2005
	T1	T2	T3	T4	T1	T2	T3	T4			
Demand for manufacturing products addressed to France	1.9	1.9	2.1	2.0	1.8	1.8	1.8	1.9	3.5	7.5	7.8
Competitors' prices in own currencies	0.0	0.0	1.4	1.9	1.0	0.2	0.2	0.2	0.6	1.2	3.4
Oil price (brent, level in \$)	31.8	35.4	42.1	40.0	36.0	35.0	33.0	33.0	28.8	37.4	34.3
Import prices in euros	-0.7	0.3	0.4	0.3	0.2	0.1	0.1	0.1	-0.2	-1.0	0.9
Export prices in euros	0.0	0.6	0.7	0.5	0.0	0.0	0.0	0.0	0.2	1.3	1.0
Balance of goods and services (bn euros)	5.3	3.1	3.2	3.3	3.0	2.9	2.8	2.8	18.2	14.9	11.5

Sources: INSEE quarterly accounts, OFCE forecasts, e-mod.fr model from Q3 2004.

The reasons for a timid recovery...

On average, the French economy is set to grow by 2.5% in 2004 and 2.6% in 2005. A growth rate lower than 3% after three years of sluggish activity is somewhat disappointing.

It clearly falls short of what could be expected by looking at previous rebounds. The projected pace of upturn looking towards 2005 falls well short of the recoveries that occurred in the late-1980s and after 1997 (graph 3).



The first reason for the atypically slow recovery lies in the past rise in the European currency. This began in 2004 and we are assuming that the euro's effective exchange rate stabilises in the near future. Even so, because of the lagged response, the earlier rise in the euro is continuing to hamper European and French upturns this year. Its negative impact on French growth has increased in 2004, reducing activity by 0.6 GDP percentage points.

Consequently, the French growth cycle, which is usually strongly dependent on world trade, is being damped down, the more so as the oil-price hike has cut GDP growth by a further 0.2 percentage points in 2004. In 2005, exchange-rate variations will no longer affect the French economy. The price of oil is also expected to slip back towards 34 dollars a barrel by the end of 2005, and this will limit its dampening impact on activity (table 5).

On the other hand, monetary and fiscal policies will impose a burden on activity and in turn prevent the French economy from accelerating. The fiscal stance is assumed to reduce GDP growth by some 0.4 percentage points of GDP. The general government deficit is expected to decline from 3.7% of GDP in 2004 to 2.8% in 2005. Half this reduction comes from a one-off payment from EDF in exchange for the transfer to the social security system of responsibility for the payment of its employees' pensions. We assume that expenditure plans included in the Finance and Social Security Financing Acts will be respected, including those concerning health. The latter assumption requires a dramatic deceleration in public health spending, which is supposed to rise by 3.2% after growing by 5.2% in 2004. We think that the reform of the health insurance system adopted in summer 2004 will definitely curb spending in the short run, as did other plans in the past. The medium-to-long-term impact is much more questionable.

TABLE 5: THE REASONS FOR A LOW GEAR RECOVERY

Average annual impacts in % of GDP	2004	2005
Expected GDP growth in recovery	3.2	3.6
Impact of the exchange rate of the euro	-0.6	0.2
Impact of the fiscal policy	-0.1	-0.4
Impact of the monetary policy	0.1	-0.1
Impact of the oil price ¹	-0.2	-0.1
Carryover effect	—	-0.6
Predicted GDP growth	2.5	2.6

1. Impact of the price of oil by comparison with a scenario involving a stable oil price at 29 dollars, i.e. the average level of 2003.

Source: OFCE estimates, e-mod.fr model from Q4 2004.

... despite a reactivation of the employment policy

Up to 2004, the Raffarin government's policy towards people finding difficulties on the labour market has been targeted on the private sector, especially through cuts in social contributions. But the new "Revenu Minimum d'Activité" (RMA, minimum activity income), consisting of using income support to subsidise jobs in companies, failed to stem unemployment: only a few hundred RMAs have been signed up in 2004. The measures introduced have not permitted unemployment to be trimmed, whereas, in the meantime, the government cut low-paid short-term contracts in the public sector (the so-called "emplois jeunes" or "Contrats Emplois Solidarité", for instance).

In 2005, the Raffarin government's jobs policy is to change direction with the so-called "Borloo plan", named after the Labour Minister. New measures include the creation of "contrats d'avenir" (contracts for the future), to help people living on income support. These are short-term part-time subsidised contracts in the public sector or in non-profit associations. The effectiveness of this kind of job as a stepping-stone to a stable long-term private-sector job is widely questioned, but they are faster to take effect, and we expect this political shift to have a positive impact on the labour market in 2005.

TABLE 6: DETERMINANTS OF THE CHANGE IN UNEMPLOYMENT

Year-on-year change	2003		2004		2005	
	Thousands ¹	% ²	Thousands	%	Thousands	%
Unemployment³	200	0.7	- 33	-0.1	- 201	-0.8
- Employment policy in the non-market sector	56	0.2	45	0.2	- 66	-0.2
- Employment policy in the market sector	- 11	0.0	- 22	-0.1	- 28	-0.1
- Early retirement allowed by the pension reform	15	0.1	- 65	-0.2	- 40	-0.2
- Cyclical job creations	140	0.5	9	0.0	- 67	-0.3

1. Change in the number of unemployed people by the end of the year from the end of the previous year (in thousands);

2. Change in the unemployment rate by the end of the year from the end of the previous year (in percentage points of the active population);

3. ILO definition.

Sources: INSEE; Ministry of Labour; OFCE forecasts October 2004.

The measure giving the possibility for people who began working before 16 of retiring before 60, included in the 2003 pension reform, will also contribute to the reduction in the unemployment rate in 2005 since it will trim the working population by 70,000, following 100,000 in 2004.

These measures, supplemented by the employment recovery in the private sector, are consistent with a decline in the unemployment rate to 9.0% by the end of 2005, down 0.8 of a percentage point on a year earlier.

Risks

Of course, some risks should not be brushed aside and could well bring the ongoing recovery to a halt. Most of them relate to the international environment. A major oil crisis or a dramatic downturn in world growth would necessarily hamper the French rebound. For instance, if the price of oil were to remain stable at 50 dollars a barrel, economic growth would be cut by half a percentage point in 2005.

The potential for a domestic downturn would come from pessimistic expectations by businesses or households, or from tumbling house prices. In such a context, companies could well freeze investment plans and/or households could increase saving. But a bleak domestic scenario of this kind is rather unlikely considering the economic outlook suggested by surveys.

On the domestic stage, the risk is more likely to be skewed to the upside: as in the past, fiscal policy could end up being less restrictive than announced by the government. If so, the public deficit would come out higher, with a risk of exceeding the 3% of GDP threshold for the fourth year in a row. But GDP growth would be spurred by any public expenditure slippage. For instance, if health spending were to climb by 6.2% in 2005 – the average for the last three years – instead of the expected 3.2%, GDP growth would approach 3%. And the general government deficit would be just under 3% of GDP... ■