

FRANCE: A POTENTIAL OF GROWTH

*French Economic Forecasts for 2005-2006**

For almost 10 years, the French economic performance has been above that of its European partners. Therefore, since 1997, the gap between growth in France and in the Euro zone has reached 0.4 percentage point per annum and more than one point with respect to Germany and Italy.

TABLE I: CONTRIBUTIONS TO GDP GROWTH

Annual percentage change	2003	2004	2005	2006
GDP	0.9	2.1	1.7	2.2
Household consumption and investment	1.1	1.4	1.4	1.5
Corporate investment and change in inventories	-0.1	1.0	0.8	0.5
Public consumption and investment	0.8	0.8	0.5	0.6
Total domestic demand	1.8	3.2	2.7	2.6
Net exports	-0.9	-1.1	-0.9	-0.4
Euro area GDP	0.7	1.8	1.3	1.9

Sources: INSEE, quarterly national accounts, OFCE forecasts, e-mod.fr model for 2005 and 2006.

Although above the Euro zone performance...

This comparative performance is due to a more vigorous domestic demand, especially household consumption. Between 1998 and 2002, French private consumption was fostered by a higher job creation than in its partners' economies. Since 2003, it is mainly the behaviour of savings that has accounted for differences between the three main countries of the Euro zone. Whereas the French savings rate decreased by 0.9 percentage point in 2003 and by 0.5 in 2004, it rose in Germany (by 0.4 point in 2003 and 0.5 point in 2004) and in Italy (by 0.2 point in 2003 and in 2004). According to an econometric analysis that we carried out, 50% of the decrease of the French savings rate since 2003 can be explained by the impact of the increase in house prices.

* 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° 95. The team, headed by Eric Heyer, consists of Guillaume Chevillon, Marion Cochard, Matthieu Lemoine, Hervé Péléraux and Mathieu Plane. The forecasts include information available up to 14 October 2005.

There are two types of impacts: firstly, the housing market is a strong transmission channel for monetary policy. Low interest rates make buying look cheap compared to renting and increases the number of households than can afford mortgage disbursements. By borrowing more, households inject more money in the economy and foster consumption. Secondly, according to an oft-mentioned wealth effect, home-owners feel richer and consume more.

These two reasons account for the whole difference in savings behaviour between France and Germany: as house prices have been practically stable in the latter, consumption has taken very little advantage of low interest rates and no potential "housing wealth effect" has been observed. Moreover, low income growth — due to a contraction in employment and wages and to the decrease in transfers — has also hampered the borrowing capacity of households and, hence, their consumption.

Whereas French growth has been more dynamic for the last 10 years than in Germany and Italy, output gaps are practically identical in 2004 in the three countries, because of higher potential growth in France.

The fact that growth has remained below its potential for five years helps explain the disappointing evolution of the labour market since 2001 and the slowing down of prices more recently. Indeed, instead of an expected inflationary shock, pressures are for the time being rather disinflationary: the consumption price index has of course increased because of oil prices, but these "first round" effects have not spread out to the rest of the economy. Thus, no wage-price spiral has been observed.

... the French economic growth has remained disappointing...

Although still above that of the Euro zone, French growth will remain disappointing in 2005 — with a yearly rate of 1.7% — close to the average of the last five years (1.6%). It will also be lower than rates seen over the last twenty years (2.1%) or over the last decade (2.2%).

TABLE 2: GROSS DOMESTIC PRODUCT AND COMPONENTS OF EXPENDITURE (IN VOLUME, 1995 PRICES)

	Volume (95 € bn)	Quarterly % change								Annual % change		
		2005				2006				2004	2005	2006
		2004	Q1	Q2	Q3	Q4	Q1	Q2	Q3			
GDP	1 535	0.4	0.1	0.7	0.6	0.6	0.6	0.6	0.6	2.1	1.7	2.2
Imports	445	0.7	1.3	1.5	1.4	1.5	1.6	1.7	1.7	6.1	5.6	6.3
Household consumption	854	0.8	-0.3	0.9	0.7	0.6	0.6	0.6	0.7	2.3	2.2	2.5
General government consumption	363	0.2	0.3	0.5	0.4	0.4	0.4	0.4	0.4	2.7	1.4	1.6
Gross fixed capital formation :	297	1.5	-0.4	0.9	0.7	0.9	1.0	1.0	1.0	2.1	2.9	3.3
of which : - Companies	171	1.9	-1.1	1.0	0.9	1.0	1.1	1.0	1.1	1.4	3.0	3.5
- Households	75	0.7	0.7	0.6	0.1	0.7	0.9	0.9	0.8	3.1	2.8	2.6
- General government	51	1.2	0.4	0.8	0.8	1.0	1.0	1.0	1.0	3.1	2.6	3.6
Exports	431	-0.2	1.0	1.2	1.4	1.4	1.4	1.4	1.5	2.0	2.5	5.5
Change in inventories (contribution)	13	-0.1	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.8	0.5	0.1
Total domestic demand, excluding inventories	1 536	0.8	-0.2	0.8	0.6	0.6	0.6	0.6	0.7	2.3	2.2	2.5

Sources: INSEE, quarterly national accounts, OFCE forecasts, e-mod.fr model from Q3 2005.

TABLE 3: MAIN RESULTS

	Quarterly change								Annual change					
	2005				2006				2004	2005	2006			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4						
Total employment (thousands)	29	-6	62	50	65	75	63	62	-13	92	235			
Number of unemployed ¹ (thousands)	36	-3	-67	-63	-5	-30	-20	-21	63	-10	-124			
Unemployment rate ¹ (in %)	10.1	10.2	9.9	9.8	9.6	9.5	9.3	9.2	10.0	10.0	9.4			
Consumer price index ² (in %)	0.1	0.9	0.4	0.3	0.4	0.4	0.1	0.1	2.1	1.8	1.7			
Average hourly wage in non-financial corporations (in %)	0.9	0.5	0.8	0.7	0.9	0.5	0.8	0.7	2.6	2.6	2.9			
Average wage in non financial corporations (in %)	0.9	0.5	0.7	0.8	0.8	0.8	0.7	0.7	2.5	2.6	3.0			
<i>Households</i>														
Purchasing power of disposable income (in %)	0.5	0.3	0.3	0.7	0.1	0.8	0.8	0.9	1.6	2.1	2.1			
Savings rate (in %)	15.3	15.8	15.3	15.2	14.8	15.0	15.1	15.3	15.4	15.4	15.0			
Financial savings rate (in %)	5.6	6.1	5.6	5.6	5.1	5.3	5.4	5.6	6.0	5.8	5.3			
<i>Companies</i>														
Mark-up (in %)	30.5	30.3	31.3	31.5	31.5	31.5	31.6	31.7	30.7	30.9	31.6			
Investment ratio ³ (in %)	17.5	17.3	17.3	17.3	17.3	17.4	17.4	17.4	17.1	17.3	17.4			
Internal financing ratio ⁴ (in %)	78.7	69.9	79.8	84.8	81.2	77.2	72.9	68.9	81.5	78.4	75.0			
<i>General Government</i>														
Net lending / GDP (in %)									-3.6	-3.2	-3.2			
Tax and social security contributions/GDP (in %)									43.4	43.7	43.7			
<i>Interest rates (level in %)</i>														
Long-term interest rates	3.6	3.4	3.3	3.4	3.4	3.5	3.5	3.6	4.1	3.8	3.4	3.4	3.5	3.6
Money-market rates	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.2	2.1	2.1	2.1	2.1

1. ILO definition.

2. CPI seasonally adjusted.

3. Current value, including stocks.

4. Gross Savings/Gross Fixed Capital Formation.

Sources: INSEE, quarterly national accounts, OFCE forecasts, e-mod.fr model from Q3 2005.

TABLE 4: INTERNATIONAL ENVIRONMENT AND FOREIGN TRADE FORECASTS

	Quarterly change								Annual average change		
	2005				2006				2004	2005	2006
	T1	T2	T3	T4	T1	T2	T3	T4			
Demand for French manufacturing products	-0.7	1.5	1.6	1.8	1.7	1.7	1.7	1.7	9.6	5.0	7.0
Competitor's prices in dollars	2.0	0.0	1.2	0.2	0.8	0.5	0.3	0.7	10.9	7.6	2.2
Oil price (Brent barrel, actual in \$)	47.5	51.6	61.5	60.0	60.0	60.0	60.0	60.0	38.2	55.2	60.0
Import prices in euros	0.0	0.5	0.2	0.4	0.6	0.4	0.4	0.2	1.2	2.3	1.7
Export prices in euros	-0.1	0.0	0.0	0.5	0.5	0.6	0.7	0.6	2.1	1.0	1.9
Balance of goods and services (euro bn)	-2.6	-3.6	-4.3	-4.3	-4.6	-4.8	-4.8	-4.8	4.5	-14.8	-19.0

Sources: INSEE, quarterly national accounts, OFCE forecasts, e-mod.fr model from Q3 2005.

... because of exogenous shocks...

Following three years of feeble growth, the recovery, which started in 2004, has been hardly vigorous, with a steady domestic demand and a negative impact of external trade on GDP growth. For the first time since 1991, the external balance has even become negative. More serious, over the last two years, France has been the euro zone country that benefited the least from world demand: in 2004, foreign trade had a negative effect of 1.1 GDP percentage point, whereas it had a neutral impact in the Euro zone as a whole.

What explains such a bad result is the negative effect of three exogenous shocks on French competitiveness and thus on activity.

First, the appreciation of the euro exchange rate between mid-2001 and the beginning of 2005 hampered French and European growth. The negative impact was maximal in 2004 (-0.7 percentage point of GDP growth) but it will still be important in 2005 (-0.6 point). The French business cycle was affected because it is highly dependent on foreign trade. And finally the additional increase in oil price cost France 0.2 percentage point of GDP growth in 2004 and 0.5 point in 2005. When adding up these two shocks, the impact on growth was practically 1 point in 2004 and 1.1 point in 2005, thus restraining the closure of the output gap, which had increased from 2001 to 2003.

To a large extent, the appreciation of the euro effective exchange rate and the increase in oil prices account for the bad results of the external trade since 2003. But what explains the bad performance of French external trade compared to the Euro zone is the misled specialization in terms of geographic and product markets and the aggressive cost reduction policy carried out in Germany. In doing so, Germany's unit labor costs have decreased relatively to those of its European partners, and in particular France. According to an econometric analysis that we carried out, this policy accounts for 30% of the loss of market shares that France experienced over the last two years. Moreover, because of the decrease in salaries and employment, and hence of the strong slow down of German domestic demand, the importations of our main partner have been sluggish.

... which are expected to blur in 2006

The depreciation of the euro exchange rate which occurred in the second quarter of 2005 is expected to continue, thus reaching 1.19 by the end of 2006. Therefore, it should stop hampering French growth by next year. We also expect the price of a barrel of crude oil to level off at 60 dollars. So, its negative impact on growth should be the same in 2006 as in 2005 (-0.5 point). Similarly, the German cost reduction policy should not affect French growth to a larger extent in 2006 than in 2005. All in all, these three effects are expected to hamper growth by 0.9 point in 2006, following 1.4 point in 2005 and 1.2 point in 2004.

What scenario until 2006?

The second semester of 2005 looks promising, with a more favourable exchange rate, a stabilization of firms' operational health and a recovering of their financial health and a new job-promotion policy. Moreover, the personal production

expectations in industry and services are recovering. Therefore, a GDP bounce should occur in the third quarter of 2005.

With the decrease in the household savings rate...

The decrease in the savings rate witnessed since 2003 has slowed down at the beginning of 2005. Indeed, a more dynamic income growth has allowed households to keep consuming without reducing much their savings. With the help of both a decrease in the unemployment rate and of low interest rates, the savings rate should decrease by 0.4 point in 2006, to reach 15% in annual average. Consumption is expected to grow by 2.5% in 2006, a modest pace compared to the last eight years, and in particular between 1998 and 2000, with peaks above 3.5%.

... and a new job promotion policy...

Finally, a new job promotion policy should allow more job creations in 2006 than in the previous years. Because of the delay in the setting-up of the "Contrats d'Avenir" and of the decrease in CES and "emplois jeunes", job policy, and in particular measures adopted in the June 2005 "Plan d'urgence pour l'emploi", should only contribute to a decline of unemployment in the second quarter of 2005. With the upturn in job creation in the private sector and the effects of pensions reform, the unemployment rate should decrease, from 10% at the end of 2004, to 9.8% by the end of 2005 and 9.2% at the end 2006.

... French growth should achieve its potential pace

On an annual average, the French economy should grow at its potential pace in 2006 (2.2%). A growth lower than 3%, following four years below potential, by no means constitutes an impressive achievement. The French recovery is hampered, in our forecast, by the international environment and fiscal policy. French growth will then be lower than it could have been after such a slowdown. A comparison with previous recoveries confirms this diagnosis: by 2006, the recovery should be disappointing compared to that of the late 80s or to that of 1997.

The public deficit should decrease from 3.6% of GDP in 2004 to 3.2% in 2005, when taking into account the exceptional sum received from electricity and gas companies. In 2006, the economic condition should improve and the tight fiscal stance should continue, thus compensating the lack of one-off measures and helping stabilize deficit, at 3.2% of GDP. Thus, the risk of a deficit higher than 3% for the fifth consecutive year is significant. Public debt should grow in 2005 and 2006 to 66.7% of GDP.

Remaining risks

Risks remain that could tear our scenario apart by 2006. They are essentially related to the international environment: a major oil crisis, a collapse of the dollar... These effects could hamper growth by 0.5 percentage point by 2006, should oil price reach USD 70 and the euro USD 1.4. A more pessimistic scenario is also possible (with a collapse of housing prices or an inflationary spiral...), but remains unlikely for the time being, given the short term surveys and statistics published by INSEE. ■