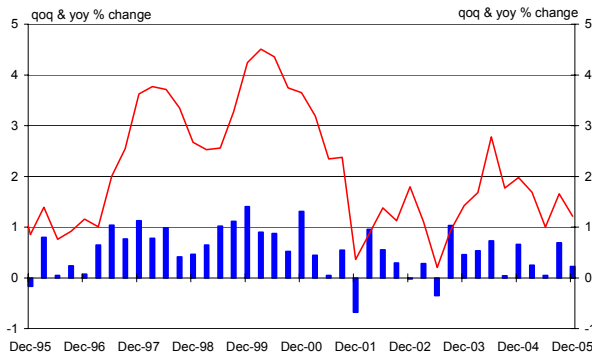




France – a mixed picture

French GDP rose by just 0.2% in December, following a 0.7% September rise, to be 1.2% higher over the year.

Chart 1: GDP



Real wages have risen strongly and combined with a declining savings ratio – driven in part by strong housing and equity price growth – this has enabled consumption to grow by 1.8% over the year to December. In turn, this has propelled investment and government spending, at 3.3 and 1.8% respectively.

Looking forward, this virtuous cycle looks likely to support the current domestic growth rates at around 2¼%, but the balance of risks is on the downside.

Weakness is found in the labour market: employment is only just rising and the unemployment rate is still very high.

Moreover, there is very little room for increases to government spending within the Stability and Growth Pact, and rising interest rates will likely rein in demand.

Exporters have been forced to shed labour, as strong wages and poor productivity has reduced their competitiveness, particularly compared to the Germans. Indeed, this has seen much of domestic demand fulfilled by imports (up 7.7%), rather than domestic supply.

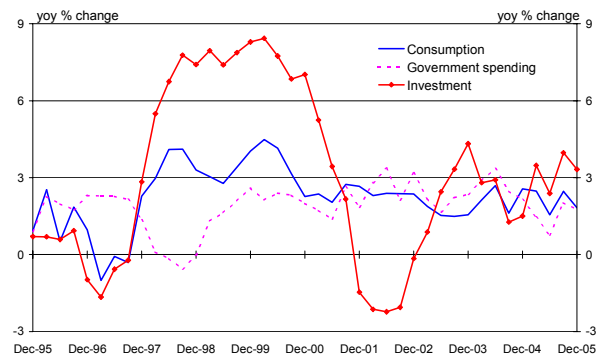
The recent depreciation of the Euro has given exports a welcome boost (up 4.6%), but export growth strong enough to fully offset import increases appears unlikely. Therefore, net exports will continue to lower growth.

Altogether, this suggests that annual GDP growth will be around or just below 2% during the next two years.

Domestic demand is resilient...

Domestic demand rose by 0.7% in December, to be 2.2% higher over the year. Within this reasonably solid performance, consumption and government spending have slowed slightly while investment has accelerated.

Chart 2: Components of domestic demand



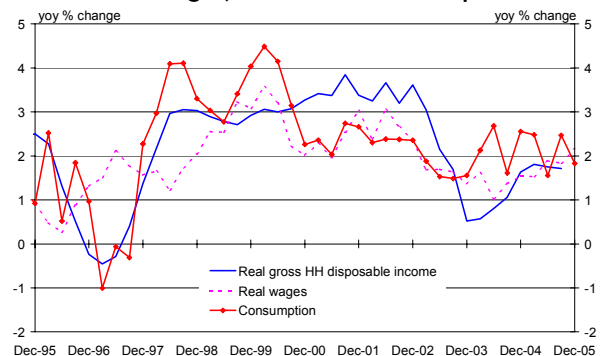
The French Services PMI suggests that domestic demand remained robust in January, at 57.1 – down from December, but inline with the December quarter.

...with solid real wages.

Solid domestic conditions have generated real wages growth, which has generated robust real income growth and underpinned consumption growth of 1.8% over the past year. Indeed, this has been the pattern for the past two and half years, with the savings ratio trending lower to further ensure steady growth.

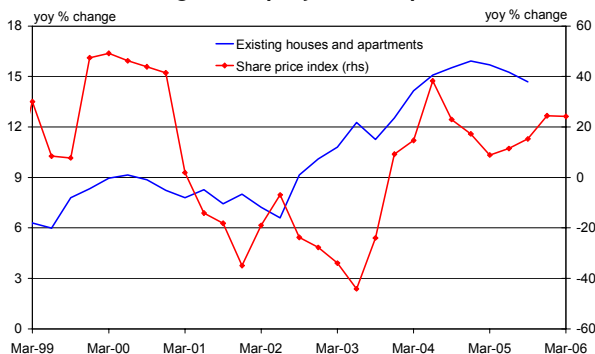
Looking ahead, real wages have been able to grow solidly due to the solid domestic market. Therefore, there is little reason to expect this to stop.

Chart 3: Real wages, income and consumption



The downward trend in the household saving rate is also expected to continue, with ongoing wealth effects from strong housing and equity markets.

Chart 4: Housing and Equity market prices



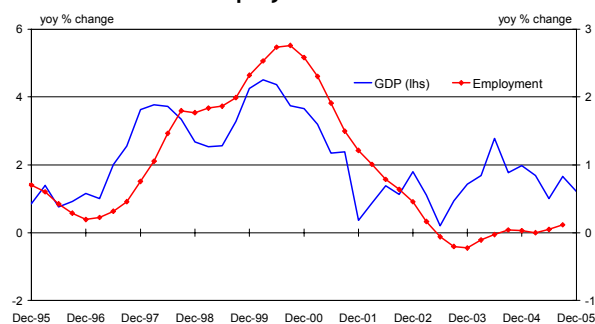
But this has come at the expense of a poor overall labour market...

Solid domestic demand is creating employment and encouraging strong wages growth – reinforcing each other.

However, these wage gains are making it difficult for the traded sectors to compete. As a result, French manufacturers, for example, are reducing labour in an attempt to maintain competitiveness – a task that has been made more difficult with the Euro at high levels.

The employment component of the Manufacturing PMI was just 47.2 in February, which is the eleventh consecutive month of contraction.

Chart 5: GDP and employment



Overall, therefore, employment growth is more or less stagnant. Employment rose by just 0.1% over the past year, compared with GDP growth of 1.2%.

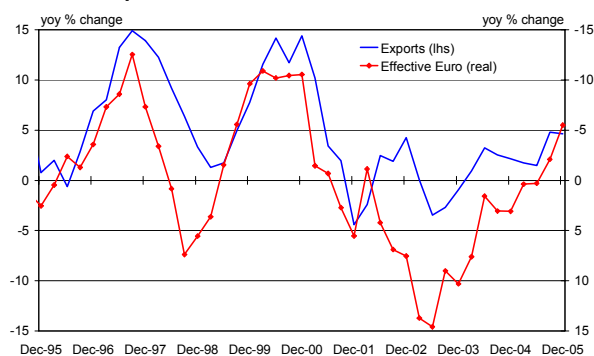
Job losses from the traded sectors reduce any positive flow-on effects for the overall economy. This makes the French economy more fragile.

...with a battle to maintain external competitiveness.

Exports rose by 4.6% over the year to the December quarter, which is the strongest exports performance from France since the year 2000. This was partly driven by a 5% decline in the real effective Euro over the past year, which enhanced the competitiveness of French exporters.

Looking forward, world growth is expected to remain solid and we expect the Euro to depreciate further, but at a slower rate. Therefore, exports will continue to grow.

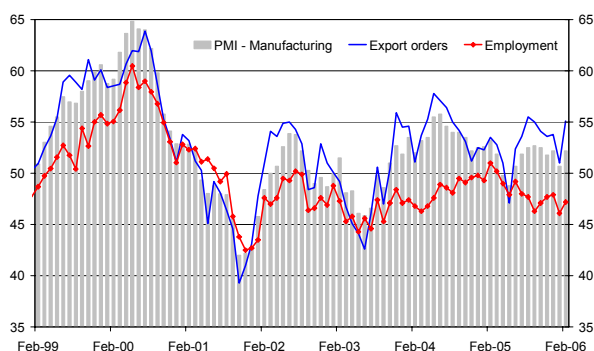
Chart 6: Exports and real effective Euro



The French Manufacturing PMI supports this outlook (at least for the short term). Following a very poor outcome of just 51 in January, export orders bounced back to 55.1 in February – almost at the levels recorded for August when actual exports performed so well (up by 3.2% in the September quarter alone).

That said, the volatility in export orders suggests that the volatile performance of exports will continue.

Chart 7: PMI Manufacturing



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