The euro zone's international environment

The euro zone's international environment should be buoyant in 2004. In the United States, activity is likely to benefit from a virtuous spiral initiated by the recent improvement in the job content of growth and, following a strong second quarter (almost 5%), GDP growth should be between 3% and 4% at annualised rate in the two final quarters of 2004. In the United Kingdom, GDP growth should be on an annual upward path of around 3% until end-2004, thanks notably to an acceleration in exports.

In the United States, the improvement in the job content of growth is set to trigger a virtuous spiral and stimulate growth until the end of 2004

Throughout 2004, consumption is likely to be increasingly stimulated by the recent improvement observed in the job content of growth. This tendency should trigger a virtuous spiral that would take up the running from the tax cuts from mid-2004 on. In fact, tax payments can be expected to fall again in Q2 2004 when households receive the benefit of the earlier adjustments. This fall would add roughly 0.4 of a point to quarterly consumption growth in Q2 *(see box 1)*. Starting in Q3, consumption would also be helped by increasingly job-rich growth. Job creation, which in March and April was at the firm rate of around 300,000 a month, seems set to continue, since these were not in the temporary employment agency sector but mainly in the business services sector. This rate of job creation will probably be maintained during 2004 and add roughly 0.4 of a point to quarterly growth in household income and 0.3 of a point to growth in consumption *(see box 2)*.

There are, however, two factors that are liable to curb consumption growth in the three final quarters of 2004, namely, the acceleration in prices following the surge in prices of oil and raw materials and the hardening of financial conditions, even though the latter remain favourable. The acceleration in prices is eroding household purchasing power. However, with a gradual easing of the oil price in Q3 2004 *(see section on "oil and raw materials" — available in the French version only)*, the negative impact on quarterly consumption growth would remain limited, amounting to less than 0.1 of a point *(see box 3)*. As for the financial conditions, these remain favourable even after a rise in long rates of roughly 90 basis points since the low reached in March and the change in the Fed's monetary stance. In particular, households are likely to have less recourse to mortgage refinancing.

All things considered, consumption growth is likely to remain strong in the three final quarters of 2004, being of the order of 3% to 4% at annualised rate, and slow down only to a small extent in Q3 with the ending of the impact of the reduction in tax rates *(see table 2)*. Household investment is likely to slow down from mid-2004 on as a result of the rise in long rates, but it seems to have remained vigorous in Q2, with households probably seeking to take advantage of the still relatively low level of interest rates.

In the corporate sector, the satisfactory outlook for both domestic and export demand can be expected to encourage investment growth. Moreover, financial conditions remain favourable despite the rise in long rates. In particular, the interest-rate spread between corporate and government bonds is still narrow and the banks say they are easing their lending conditions to firms. Finally, the expiry at the end of 2004 of the tax concession concerning accelerated depreciation of investment is likely to give an additional fillip to investment towards the end of the year. Meanwhile, the contribution from inventories will probably remain slightly positive in 2004. Stocks in industry are in fact still very low in relation to deliveries. The positive outlook and the accommodating financial conditions should lead firms to adopt inventory behaviour that is either neutral or positive.

World trade should benefit in 2004 from the acceleration in American domestic demand. In return, the acceleration in activity in the trading partners of the United States would then be transmitted into American exports. All in all, after slowing down in Q1 2004, activity in the principal partners of the United States should again accelerate, albeit with a certain lag in relation to American consumption. Growth in Japan, in particular, should be between 4% and 5% at annualised rate at the end of 2004 *(see box 4)*. The new impetus given to world trade should help to bring the annualised growth rate for American exports to between 2% and 3% in each quarter. The export outlook as reported in the ISM index has in fact recovered appreciably since March. Imports, meanwhile, can be expected to grow at a firm rate as a result of the domestic demand tendency and the ending of the depreciation of the dollar versus the

TABLE 1: UNITED STATES AND UNITED KINGDOM: RESOURCE-USE BALANCE IN VOLUME

	Quarterly % change								Annual % change		
	2003				2004						
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2002	2003	2004
UNITED STATES (37.2%) (1)											
GDP	0.5	0.8	2.0	1.0	1.1	1.2	0.8	0.9	2.2	3.1	4.6
Consumption	0.6	0.8	1.7	0.8	1.0	1.1	0.7	0.9	3.4	3.1	4.0
Private investment (2)	0.3	1.5	3.7	2.4	1.3	1.9	1.7	1.7	-3.7	4.5	8.1
Nonresidential investment	-0.1	1.7	3.0	2.6	1.4	2.0	2.5	2.8	-7.2	3.0	8.8
Residential investment	1.1	1.1	5.1	1.9	0.9	1.3	0.0	-0.6	4.9	7.5	6.0
Government expenditures (3)	-0.1	1.8	0.4	0.0	0.7	0.5	0.3	0.1	3.8	3.3	1.9
Exports	-0.5	-0.3	2.4	4.8	1.2	2.5	2.9	2.5	-2.4	2.0	9.9
Imports	-1.7	2.2	0.2	3.9	1.4	2.3	2.5	1.9	3.3	4.0	8.5
Contributions:											
Domestic demand excluding stocks	0.5	1.1	1.8	0.9	1.0	1.2	0.8	0.9	2.5	3.5	4.4
Change in private inventories	-0.2	-0.1	0.0	0.2	0.2	0.1	0.1	0.0	0.4	-0.1	0.4
Net exports	0.2	-0.3	0.2	-0.1	-0.1	-0.1	-0.1	0.0	-0.7	-0.4	-0.2
UNITED KINGDOM (5.6%) (1)											
GDP	0.3	0.6	0.8	0.9	0.6	0.7	0.8	0.8	1.6	2.2	3.0
Consumption	0.0	0.8	0.9	0.9	0.9	0.8	0.7	0.7	3.4	2.5	3.3
Total investment	-2.0	1.3	1.9	2.4	1.1	1.6	1.3	1.1	1.8	2.9	6.4
Enterprise investment	-3.3	0.9	1.3	1.9	0.3	1.0	1.0	1.0	-2.6	-0.5	4.1
Household investment (4)	-5.0	3.1	1.5	2.8	3.0	2.0	1.0	0.0	13.2	4.5	8.9
Public investment (4)	22.3	-1.1	8.7	4.1	1.0	4.0	4.0	4.0	12.0	27.3	18.2
Public consumption (5)	1.0	0.1	0.3	1.8	0.7	1.0	0.5	0.5	2.6	2.1	3.4
Exports	3.9	-1.9	0.1	1.3	-2.1	-0.5	1.0	1.0	-0.4	-0.1	-1.2
Imports	1.4	-2.8	1.3	2.7	-0.4	0.6	1.0	1.0	4.0	0.9	2.7
Contributions:											
Domestic demand excluding stocks	-0.1	0.7	1.0	1.4	0.9	1.0	0.8	0.8	3.0	2.6	4.0
Change in private inventories	-0.1	-0.5	0.3	0.0	0.1	0.0	0.1	0.1	-0.1	0.0	0.2
Net exports	0.6	0.4	-0.4	-0.5	-0.4	-0.3	-0.1	-0.1	-1.3	-0.3	-1.2

Forecast
(1) Country's share of OECD GDP (1995 PPP, 2003 volume)
(2) Investment of firms and households
(3) Government consumption and investment
(4) Consumption of unprofitable institutions included
(5) Data are not recorded in the provisional national accounts for the fourth quarter published on February, 25th.
Sources: BEA, ONS, Insee

currencies of the United States' trading partners. The import outlook in the ISM indicator is at a persistently high level.

According to the latest budget forecasts from the OMB, federal spending will slow down from Q2 2004 on, this slowdown being linked to that of defence spending.

All things considered, GDP should grow at a firm rate, close to 5% in Q1 and between 4% and 5% at annualised rate in the two following quarters. Production should in the short term track fluctuations in household consumption, slowing down only slightly in Q3 with the petering out of the fiscal stimulus. This scenario is based on the assumption of a gradual decline in the oil price until Q4 2004. Should this not materialise, consumption and imports would be less dynamic in 2004. On the other hand, production and investment would be affected after a longer time lag, of roughly one year *(see the March 2003 issue and the box in the overview).*

TABLE 2 : UNITED STATES : IMPACT OF CERTAIN SPECIFIC FACTORS ON CONSUMPTION GROWTH IN 2004

(Effect in point of growth)

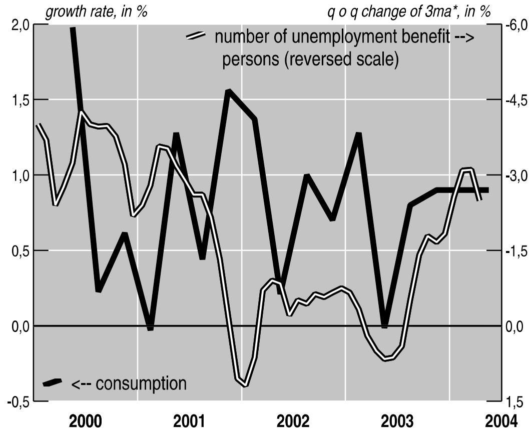
	Q1	Q2	Q3	Q4
Consumption growth	1.0	1.0	0.7	0.9
Of which:				
Increase in jobs content of growth	+0.1	+0.2	+0.3	+0.3
Increase in oil price	-0.0	-0.1	-0.1	-0.1
Tax cuts	+0.2	+0.4	-0.2	0.0

In the United Kingdom, despite a slight slowdown in domestic demand related to the monetary tightening, GDP is likely to show lively growth, boosted in particular by the acceleration in exports

GDP growth slowed down in Q1 2004 to 0.6% from 0.9% in the previous quarter. The decline in industrial activity (by 0.5% in Q1) contributed to this slowdown. In coming quarters, household consumption should remain brisk, although gradually

1

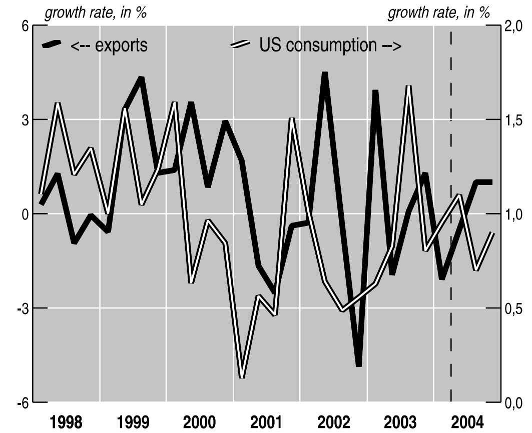
UNITED KINGDOM : HOUSEHOLD CONSUMPTION AND NUMBER OF UNEMPLOYMENT BENEFIT PERSONS



source : UK National Statistics
*3ma = 3 months moving average

2

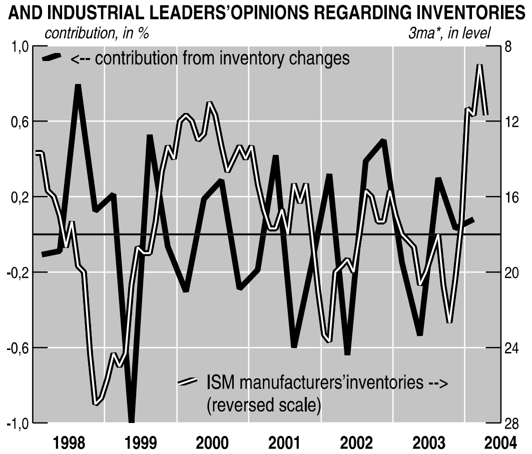
UNITED KINGDOM : BRITISH EXPORTS AND US CONSUMPTION



sources : UK National Statistics, BEA, Insee forecasts from Q2-2004
forecasts after the dotted line

3

UNITED KINGDOM : CONTRIBUTION FROM INVENTORY CHANGES AND INDUSTRIAL LEADERS'OPINIONS REGARDING INVENTORIES



sources : UK National Statistics, European Commission
*3ma = 3 months moving average

losing momentum. The GDP growth rate would nevertheless exceed its potential (0.7% in Q2, 0.8% in Q3 and Q4), with the contribution from foreign trade becoming less adverse in H2.

Household consumption should maintain a high growth rate in coming quarters. The wage growth and the strength of the labour market *(see graph 1)* can be expected to boost household income. The substantial appreciation of sterling versus the dollar has cushioned the impact of the rise in raw material prices on UK inflation, which remains relatively low (2.3% in May, excluding mortgage interest). However, the monetary tightening that began in November 2003 will probably continue after the increases in leading rates in February, April and June 2004 (by 0.25 percentage points on each occasion). The higher interest rates can be expected to influence households' consumption behaviour. On the one hand, their debt burden will be increased, since most loans have been taken out at variable rate, and, on the other, the cost of borrowing has been raised. Lastly, this rise in interest rates is likely to mean a gradual diminution in the impact of mortgage refinancing. Against this background, retail sales have in fact slowed down in the early part of Q2 and household confidence showed a slight deterioration in May. All things considered, consumption growth is likely to decline gradually to stand at 0.7% in Q4 2004. Household investment is also set to slow down in coming quarters. Growth in household investment appears to have been dynamic in the early part of the year, with the number of housing transactions rising significantly in Q1. However, the interest-rate rise, especially inasmuch it affects mortgage lending rates, can be expected to curb the growth in property purchases in coming quarters.

The strength of American imports should boost UK exports in H2. Exports declined by 2.1% in the early part of 2004, with the temporary slowdown in American imports and the substantial appreciation of sterling versus the dollar contributing to this fall. However, industrial leaders' views regarding the outlook for coming quarters are favourable and sterling has stopped rising against the dollar. As a result, exports should gradually return to a positive growth rate starting in H2 2004, responding after a certain time-lag to the firm growth in American consumption and the acceleration in American imports in coming quarters *(see graph 2)*.

Corporate investment, following the recent rise in the capacity utilisation rate, can be expected to increase in coming quarters, but its growth would nevertheless be curbed by the hardening of monetary conditions and by the weakness of industrial activity. In Q1, the 0.5% decline in industrial activity had an unfavourable impact on corporate investment (up just 0.3%). In coming quarters, however, investment should find additional support from the strong outlook for domestic and export demand. Even so, growth will be moderated by the fact that financial conditions will be less advantageous than in previous quarters. At the same time, the contribution to GDP growth from stocks should be fairly strong throughout 2004. Firms currently regard the level of stocks as very low *(see graph 3)* at a time when the demand outlook is good.

According to the 2003/2004 budget, public investment and public spending are to maintain a high growth rate in H1 2004. Social benefits as well as spending on goods and services should show a strong rise. However, a slowdown in public spending is foreseen in the latest budget report for the 2004/2005 tax year. ■

BOX 1: UNITED STATES: IMPACT OF TAX CUTS ON CONSUMPTION: AN UPDATING OF THE BOX IN THE MARCH 2004 ISSUE

In the March 2004 issue, there was a box setting out the expected impact of the tax cuts. These have in fact increased household income and consumption in Q1 in line with our expectations (see graph A). The tax cuts should again increase consumption growth in Q2, by 0.4 of a point, and then reduce it by 0.2 of a point in Q3.

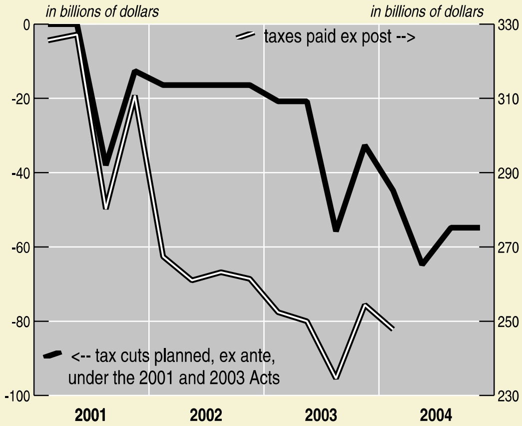
Calculated ex ante, the tax cuts voted in 2003 should again raise household income by 0.5 of a point in Q2 and Q3 2004...

In May 2003 a Law was voted extending and accelerating the programme of tax cuts already voted in May 2001 (for the detail of these measures see box 1 in the section on the euro zone's international environment in the March 2004 issue). Under this new law, taxes paid by households fell sharply in Q3 2003 and Q1 2004.

Again ex ante, taxes can be expected to fall further in Q2 and Q3 2004. In relation to the level seen in Q1 2004, they would be $20 billion lower in Q2 and $10 billion lower in Q3. These figures have been obtained from the latest evaluations of the Congressional Budget Office and the Joint Committee on Taxation (see the March 2004 issue). The tax stimulus in Q2 2004 is therefore likely to be substantial, of the order of 1 percentage point of disposable income, but negative in Q3 (by 0.5 of a point) because of the concentration of adjustments in Q2.

A

UNITED STATES : TAX CUTS



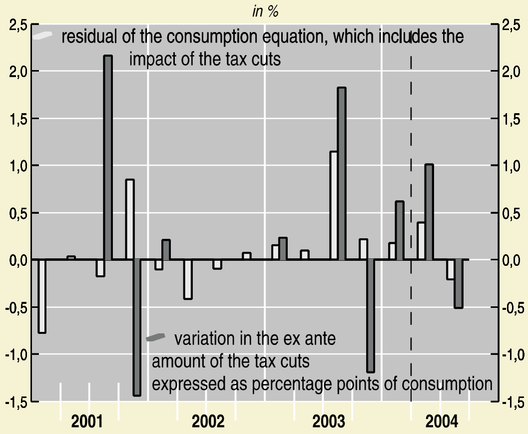
sources : BEA, CBO, JCT, Insee

Note:
the tax cuts forecast ex ante are calculated on the basis of evaluations by the CBO and on certain assumptions, namely that the new measures are applied starting in Q1 of the calendar year (retroactively for the measures voted for the current fiscal year, as in 2003) and that the new measures are applied uniformly as between the quarters.

B

UNITED STATES : TAX CUTS AND RESIDUAL OF AN EQUATION FOR CONSUMPTION

in %



sources : BEA, CBO, JCT, Insee

forecasts after the dotted line

Note:
A positive variation in the amount of tax cuts indicates that the amount of tax cuts granted to households has increased compared with the previous quarter. The residual of the consumption equation is obtained from a consumption-forecasting equation taking a level of gross disposable income from which the absolute value of the tax cuts has been deducted.

... and increase consumption by 0.2 of a point in Q2 and Q3 2004, with a substantial portion of the stimulus having already been consumed in anticipation around the end of 2003 and the beginning of 2004

The tax cuts are expected to have an impact on consumption growth in Q2 and Q3 2004, since they were not entirely consumed at the end of 2003 and the beginning of 2004. Taking the cumulative effects of the tax cuts already received since Q3 2003, the overall impact is equivalent to 1.8 of a percentage point of consumption, of which 1.2 of a point was already consumed in Q3 2003, 0.2 of a point in Q4 and 0.2 of a point in Q1 2004 (see graph B); this leaves a potential for consumption growth of 0.2 of a point (1.8 - 1.2 - 0.2 - 0.2).

With the tax cuts therefore increasing consumption by 0.2 of a point(1), the level of consumption is likely to be particularly high in Q2, inasmuch as that is the quarter in which the reimbursement cheques are received. The impact on consumption growth should be 0.4 of a point in Q2 and -0.2 of a point in Q3. ■

(1) The same exercise for Q3 and Q4 2001 shows that the tax cuts were entirely consumed.

BOX 2: IMPACT ON CONSUMPTION OF THE INCREASE IN THE JOB CONTENT OF GROWTH

Job creation set to remain brisk throughout 2004

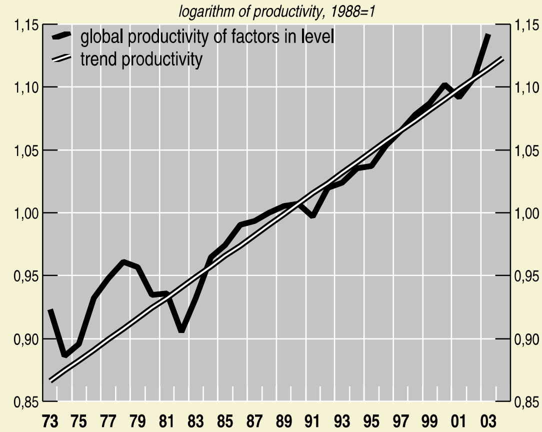
Growth has become distinctly more job-rich since March (353,000 creations in March, 346,000 in April and 248,000 in May). After reorganising between 2001 and 2003 to derive maximum benefit from their past investment, firms seem to have started to hire again in 2004 in order to keep up with demand. Productivity seems to have slowed down, with the drying up of specific sources of productivity gains, and cost reductions seem to have been completed (see box 2 in the section on the euro zone's international environment in the March 2004 issue).

The growth rates for employment seen in March, April and May (roughly 300,000 creations per month, a rise of roughly 0.7% per quarter) seem sustainable until the end of the year. Assuming a quarterly growth rate for GDP of the order of 1% as in our baseline scenario, labour productivity gains are likely to become very small, of the order of 0.3% (= 1% - 0.7%) per quarter, compared with quarterly growth in 2003 and early 2004 of the order of 1%. Labour productivity gains as small as these seem consistent with recent evolutions in its two long-term determinants, namely, capital per head and total factor productivity[1]. After slowing down sharply in 2002 and 2003 *(see box 2 in the March 2004 issue)*, capital per head is expected to stagnate in 2004 according to our investment scenario. As for total factor productivity, this has exceeded its trend values by several points (see graph A). Growth in both total factor productivity and in labour productivity (given the stagnation in capital per head) of 0.3% per quarter, i.e. 1.2% at annualised rate, would not even absorb this differential (given the potential growth rate in total factor productivity, which is around 0.8% per year[2]).

A

UNITED STATES : PRODUCTIVITY AND TREND PRODUCTIVITY IN THE PRIVATE SECTOR

logarithm of productivity, 1988=1



sources : BLS, Insee forecasts from 2002

Note:
Trend productivity is calculated for the 1987-2000 cycle (chosen by the peak-to-peak method).

Several labour market indicators are pointing to continuing strong growth in employment in coming quarters: applications for unemployment benefit are well below the 400,000 mark and the ISM confidence indices relating to employment are positively headed. This box sets out the expected effects on household consumption, assuming that job creations remain in 2004 at a level of roughly 300,000 per month.

With 300,000 job creations per month until the end of the year, household income would rise by 1.6 of a point in 2004, i.e. by roughly 0.4 of a point per quarter...

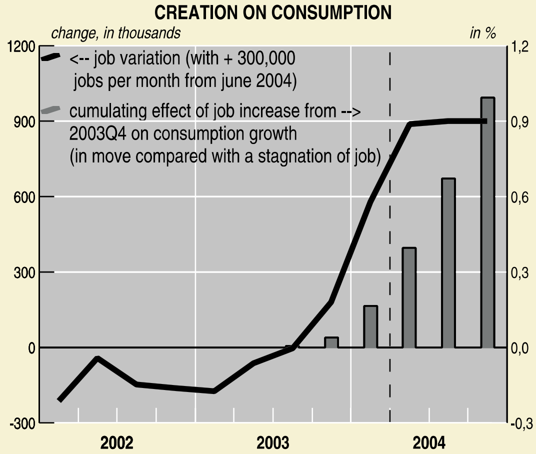
A statistical equation linking growth in gross household income to that of employment shows that a figure of 300,000 job creations per month until the end of the year, giving growth in employment of roughly 3% at annualised rate, increases household income by 1.6 of a point for 2004 as a whole compared with a situation in which employment continues to stagnate after Q3 2003.

... and consumption would rise in 2004 by 1.0 of a point, i.e. roughly 0.25 of a point per quarter

An equation explaining fluctuations in consumption mainly by fluctuations in household income shows, moreover, that this additional 1.6 of a point of income would be partly (1.0 of a point) consumed in 2004 *(see graph B).* ■

B

UNITED STATES : IMPACT OF JOBS CREATION ON CONSUMPTION



sources : BLS, Insee

forecasts after the dotted line

(1) Assuming a production function of the Cobb-Douglas type, labour productivity (Y/L) depends on capital intensity (K/L) and total factor productivity A: $\Delta \ln(Y/L) = (1-\alpha)\,\Delta \ln(K/L) + \Delta \ln A$ *where* α *is the remuneration of labour as a share of value-added.*
(2) This evaluation of the average since 1990 is close to that obtained by Oliner and Sichel (2002): "Information Technology and Productivity: where are we now and where are we going?", Fed working document.

BOX 3: UNITED STATES: A REVIVAL OF INFLATION LARGELY LINKED TO THE HIGHER OIL PRICE

Since the beginning of 2004, price growth has accelerated in the United States, with the quarterly rise in the price index 0.9% in Q1, up from 0.2% in Q4 2003. This increase in inflation is not confined to energy products, since the price index excluding energy and food rose from 0.3% in Q4 2003 to 0.7% in Q1 2004.

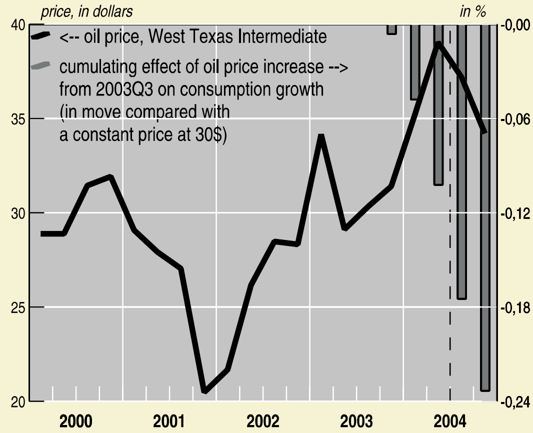
The impact on inflation of the rise in the price of crude between end-2003 and mid-2004 should be limited, on condition that this rise is of a temporary nature, as assumed in our scenario *(see note on "Oil and raw materials" (French version only))*. According to a model estimating the impact of the rise in prices of oil and raw materials on inflation, the latter would be increased by roughly 0.1 of a point per quarter, or 0.4 of a point in one year. An additional rise in the price of crude to 40 $/barrel would add a further 0.1 of a point to quarterly inflation.

Leaving aside the immediate impact of the rise in the oil price, inflation will probably remain limited, since the direct effects are unlikely to be followed by diffusion to other prices and to wages. The unemployment rate (5.5% in Q2 2004) is relatively high by comparison with the low point of around 4.0% seen at the end of 2000. Inflationary pressures on wages should therefore be moderate. Moreover, utilisation rates are much lower than their average level at the end of the 1990s (around 77%, compared with 83%) so that competition on the market for goods remain strong.

The additional inflation is likely to have only a small adverse impact on growth in household purchasing power and consumption. An equation explaining fluctuations in consumption on the basis of household income in particular makes it possible to estimate the negative impact on consumption over one year at 0.24 of a point, i.e. an average impact of 0.06 of a point per quarter *(see graph A)*. ■

A

UNITED STATES : IMPACT OF OIL PRICE INCREASE ON CONSUMPTION



sources : Dri-Wefa, Insee

forecasts after the dotted line

The economic situation in the euro zone

The upturn that began in the euro zone in mid-2003 gathered pace in the early part of 2004. In a still-buoyant international environment, the zone's GDP rose by 0.6% in Q1. Household consumption picked up distinctly, contributing half this growth.

Activity can be expected to grow throughout 2004, although slowing down slightly at the end of the year towards a growth rate not far off its potential. On an annual average basis, GDP growth would be 1.8%. Exports should remain underpinned by continuing strong world growth. The positive outlook for overall demand and the continuing accommodating financial conditions are likely to underpin the upturn in investment. The only major component of domestic demand that would be slow in reviving is household consumption, held back by a continuing adverse labour market.

Acceleration in activity in Q1 2004

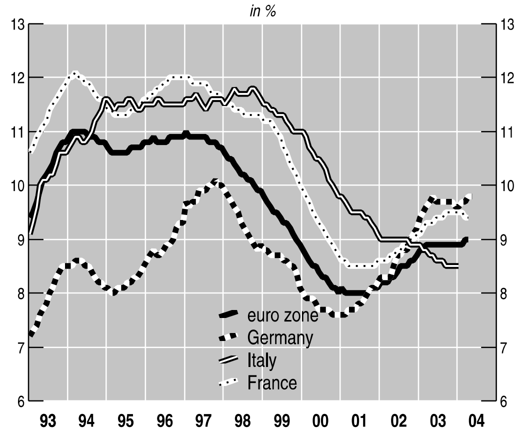
Euro-zone GDP rose by 0.6% in Q1 2004. Good performances by the zone's principal partners, in particular the United States and the United Kingdom, benefited exports, which constituted the main prop for growth. After stagnating for three quarters, household consumption picked up substantially (rising by 0.6%) and was particularly strong in France (a sign 1.1%). French households in fact drew on their savings and also financed their spending by recourse to borrowing *(see section on "household consumption" — available in the French version only)*. In most of the other countries, consumption remained moderate, despite the slowdown in inflation in Q1. The principal determinants of consumption remain fragile in the euro zone: the unemployment rate rose in March to 9.0% *(see graph 1)* and the stagnation of employment continues to have an adverse effect on household income. Investment, meanwhile, declined slightly (by 0.1%). The levelling off in the production outlook reflected in business surveys since February has led firms to postpone their investment projects, at a time when capacity utilisation rates are still regarded as low. Consumption by general government declined (by 0.2%), mainly because of the reform of the health-insurance system in Germany (many items of expenditure previously charged to general government through the healthcare system are now payable by German households).

The first quarter of the year saw strong growth in all countries of the zone *(see graph 2)*, but the driving-forces behind this growth differed from one country to another. Domestic demand is still positively headed in France and Spain, which are among the most dynamic countries in the zone. On the other hand, exports are the main prop for activity in Germany. Within the zone, it is Germany that has in fact derived most benefit from the liveliness of world trade, with exports rising by 4.6% whereas domestic demand in fact declined.

1

UNEMPLOYMENT RATE IN THE EURO ZONE

in %

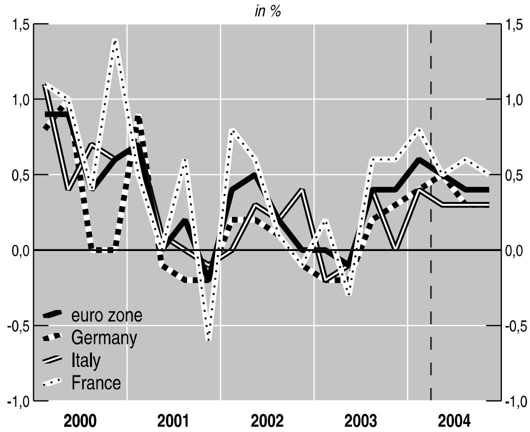


source : Eurostat

2

GDP GROWTH IN THE EURO ZONE COUNTRIES

in %



sources : Destatis, Eurostat, Insee, Istat

forecasts after the dotted line

EURO ZONE AND PRINCIPAL COUNTRIES : RESOURCE-USE BALANCE IN VOLUME

(% change)

	Quarterly changes								Annual changes		
	2003				2004				2002	2003	2004
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
GERMANY (31,5%)[1]											
GDP	**-0,2**	**-0,2**	**0,2**	**0,3**	**0,4**	**0,5**	**0,3**	**0,3**	**0,2**	**-0,1**	**1,3**
Household consumption	0,3	-0,4	-0,3	-0,2	0,0	0,6	0,3	0,3	-1,0	-0,1	0,3
Total GFCF	-0,8	-0,9	0,3	1,6	-1,8	0,7	0,7	0,7	-6,5	-2,0	0,3
Public consumption	0,1	0,7	0,7	-0,2	-1,2	0,1	0,1	0,1	1,7	0,9	-0,7
Exports	-0,8	-2,0	3,9	-0,1	4,6	2,2	1,3	1,3	3,4	1,5	8,8
Imports	2,2	-2,0	0,9	1,0	2,9	2,3	1,5	1,5	-1,6	3,4	6,6
Contributions:											
Domestic demand ex. stocks	*0,1*	*-0,3*	*0,0*	*0,2*	*-0,6*	*0,5*	*0,3*	*0,3*	*-1,7*	*-0,3*	*0,1*
Inventory change	*0,7*	*0,2*	*-0,9*	*0,5*	*0,2*	*-0,1*	*0,0*	*0,0*	*0,1*	*0,7*	*0,1*
Foreign trade	*-1,0*	*-0,1*	*1,1*	*-0,4*	*0,8*	*0,1*	*0,0*	*0,0*	*1,7*	*-0,5*	*1,1*
FRANCE (22,3%)[1]											
GDP	**0,2**	**-0,3**	**0,6**	**0,6**	**0,8**	**0,5**	**0,6**	**0,5**	**1,1**	**0,5**	**2,3**
Household consumption	0,7	-0,2	0,6	0,5	1,1	0,3	0,2	0,4	1,8	1,7	2,1
Total GFCF	0,3	0,5	0,0	0,8	1,2	0,6	0,9	0,9	-1,8	0,2	3,1
Public consumption	0,3	0,3	0,7	1,0	0,4	0,8	0,7	0,6	4,6	2,5	2,7
Export	-2,2	-1,4	0,9	1,5	0,3	1,3	1,6	1,2	1,7	-2,7	3,6
Imports	-0,6	-0,1	0,2	2,5	0,7	1,7	1,4	1,4	3,3	0,3	5,1
Contributions:											
Domestic demand ex. stocks	*0,5*	*0,1*	*0,5*	*0,6*	*0,9*	*0,5*	*0,5*	*0,5*	*1,7*	*1,6*	*2,5*
Inventory change	*0,1*	*0,0*	*-0,1*	*0,2*	*0,0*	*0,1*	*0,1*	*0,1*	*-0,2*	*-0,2*	*0,3*
Foreign trade	*-0,5*	*-0,4*	*0,2*	*-0,3*	*-0,1*	*-0,1*	*0,0*	*-0,1*	*-0,4*	*-0,8*	*-0,4*
ITALY (16,5 %)[1]											
GDP	**-0,2**	**-0,1**	**0,4**	**0,0**	**0,4**	**0,3**	**0,3**	**0,3**	**0,4**	**0,4**	**1,1**
Household consumption	-0,2	0,3	0,6	-0,2	0,8	0,3	0,3	0,3	0,4	1,2	1,5
Total GFCF	-5,7	-0,3	-0,9	-0,6	2,5	0,8	1,0	1,5	1,3	-2,1	3,0
Public consumption	1,0	0,6	0,5	0,2	-0,1	0,1	0,1	0,1	1,9	2,2	0,6
Exports	-5,9	0,2	6,4	-3,7	-2,1	1,0	1,2	1,0	-3,4	-3,9	-0,3
Imports	-5,5	1,6	2,4	-1,8	-1,5	0,6	1,0	1,2	-0,2	-0,6	0,0
Contributions:											
Domestic demand ex. stocks	*-1,2*	*0,2*	*0,3*	*-0,2*	*1,0*	*0,4*	*0,4*	*0,5*	*0,9*	*0,7*	*1,6*
Inventory change	*1,1*	*0,1*	*-0,9*	*0,7*	*-0,4*	*-0,1*	*-0,1*	*-0,1*	*0,5*	*0,6*	*-0,4*
Foreign trade	*-0,1*	*-0,4*	*1,1*	*-0,5*	*-0,2*	*0,1*	*0,1*	*-0,1*	*-0,9*	*-0,9*	*-0,1*
SPAIN (9,0%)[1]											
GDP	**0,5**	**0,7**	**0,6**	**0,7**	**0,6**	**0,6**	**0,6**	**0,6**	**2,0**	**2,4**	**2,6**
Household consumption	0,6	1,1	0,2	1,1	0,9	0,7	0,7	0,7	2,6	3,0	3,2
Total GFCF	0,4	-0,2	1,7	0,6	0,9	0,8	0,8	0,8	4,4	4,6	4,2
Public consumption	1,3	1,2	1,2	1,0	1,2	0,8	0,8	0,8	4,4	4,6	4,2
Exports	-1,7	4,0	-1,0	0,6	0,5	1,9	1,9	1,9	0,0	4,0	4,0
Imports	-2,8	2,1	1,2	2,2	1,0	2,0	2,0	2,0	1,8	6,7	6,9
Contributions:											
Domestic demand ex. stocks	*0,7*	*0,8*	*0,7*	*1,0*	*1,0*	*0,8*	*0,8*	*0,8*	*2,6*	*3,3*	*3,5*
Inventory change	*-0,6*	*-0,5*	*0,7*	*0,3*	*-0,2*	*0,0*	*0,0*	*0,0*	*0,0*	*0,1*	*0,2*
Foreign trade	*0,4*	*0,5*	*-0,7*	*-0,6*	*-0,2*	*-0,1*	*-0,1*	*-0,1*	*-0,6*	*-1,0*	*-0,9*
ZONE EURO (27,4%)[2]											
GDP	**0,0**	**-0,1**	**0,4**	**0,4**	**0,6**	**0,5**	**0,4**	**0,4**	**0,9**	**0,5**	**1,8**
Household consumption	0,4	-0,1	0,1	0,1	0,6	0,4	0,3	0,3	0,5	1,0	1,2
Total GFCF	-0,7	-0,3	0,0	0,6	-0,1	0,7	0,8	0,9	-2,8	-0,8	1,4
Public consumption	0,4	0,6	0,7	0,4	-0,2	0,4	0,4	0,3	3,0	2,0	1,1
Exports	-1,4	-0,9	2,3	0,1	1,7	1,6	1,2	1,1	1,5	0,1	4,8
Imports	-0,2	-0,5	1,3	1,1	0,8	1,5	1,3	1,3	0,3	1,9	4,3
Contributions:											
Domestic demand ex. stocks	*0,2*	*0,0*	*0,2*	*0,3*	*0,3*	*0,5*	*0,4*	*0,4*	*0,3*	*0,8*	*1,2*
Inventory change	*0,3*	*0,0*	*-0,2*	*0,5*	*-0,1*	*0,0*	*0,0*	*0,0*	*0,1*	*0,3*	*0,2*
Foreign trade	*-0,4*	*-0,1*	*0,4*	*-0,4*	*0,4*	*0,1*	*0,0*	*0,0*	*0,5*	*-0,7*	*0,3*

Forecast

Data available as of 10 June 2004.
(1) Country's share of euro-zone (2003 volume, 1995 base)
(2) Euro-zone share of OECD GDP (1995 PPP, 2003 volume)
Sources: Statistisches Bundesdamt, Insee, Istat, Ine, Eurostat

Exports still set to benefit throughout the year from the strength of world growth

Exports to outside the zone should continue to benefit from the strength of activity in its principal trading partners (notably the United States and the United Kingdom). The stabilisation of the euro exchange rate at a level close to $1.20, after coming close to $1.29 early in the year, is liable to improve the price-competitiveness of European products (see graph 3). Moreover, in most countries of the zone, business leaders regard their export order books as well-filled and are expecting a rise in foreign demand for their products *(see graph 4)*. The rise in exports to countries outside the zone was in fact already to be seen in the Italian customs data for April. Exports within the zone should also be underpinned by the upturn in the European economies. As a result, total exports inside and outside the zone should remain lively throughout the year, rising by 1.6% in Q2 before slowing down slightly to 1.1% in Q4 because of slower growth in world trade.

Despite the slight depreciation of the euro in the early part of the year (by 5.0% between January and April), imports are expected to remain strong as a result of the firm domestic demand and vigorous exports. The high oil price could nevertheless curb the growth in imports through a slowdown in energy consumption.

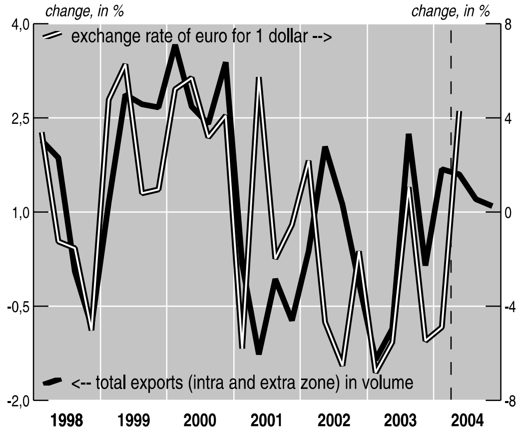
The accession of ten new countries to membership of the European Union since 1 May is likely to have only a limited impact on the zone's trade, as the commercial integration of these countries had already largely taken place through association agreements.

The positive outlook for export demand and the continuing accommodating financial conditions likely to underpin investment

The firming of demand expectations, principally for export, can be expected to launch a new upswing in investment. With financial conditions favourable throughout the zone in 2004, despite the recent rise in long rates, firms can be expected to invest again. However, the evolution of the business climate in industry, which was stable in May after improving sharply in April *(see graph 5)*, has highlighted the caution being shown by firms regarding the future evolution of domestic demand. Nevertheless, business surveys in construction have since February been recording an improvement in the business climate that could be heralding a lasting recovery in construction investment. In total, investment, after stagnating in Q1, is expected to rise at a rate of between 0.7% and 0.9% per quarter.

3

EXPORTS AND EXCHANGE RATE

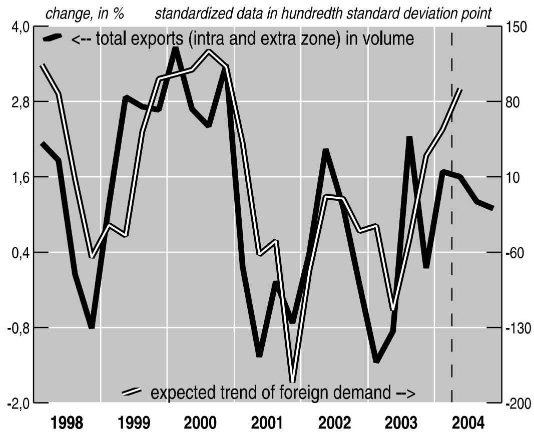


source : Eurostat

forecasts after the dotted line

4

EXPORTS AND EXPECTED TREND OF FOREIGN DEMAND IN MANUFACTURING INDUSTRY

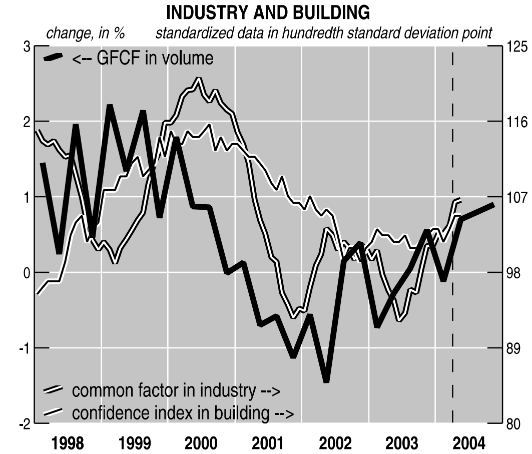


sources : European Commission, Eurostat, Ifo, Insee, Isae

forecasts after the dotted line

5

GFCF AND INDICATORS OF CONFIDENCE IN INDUSTRY AND BUILDING



sources : European Commission, Eurostat, Ifo, Insee, Isae

forecasts after the dotted line

In Italy, investment is likely to be more vigorous than in the other countries of the zone, accelerating up to Q4. It would in fact be stimulated towards the end of the year by the imminent expiry of the "Tecno Tremonti" tax incentives for investment in research and development. Firms are likely to bring projects forward in order to benefit from these measures while there is still time.

Household consumption set to remain modest in global terms during the year, with one-off boosts from tax cuts in Germany in Q2

Household consumption is thought to have remained vigorous in Q2 (up 0.4%), with one-off support from the decline in German tax rates that has been in force since January 2004. This tax measure is expected to lead in 2004 to an increase in German household income of more than €15 billion, equivalent to 0.2 percent of euro-zone GDP. Because taxes in Germany are deducted at source, the impact on incomes would be felt only in Q2 because of administrative delays in implementation. Retail sales in fact picked up in April (a rise of 2.5% following a fall of 1.5% in March). Household consumption in the euro zone will probably slow down in H2, with rises of 0.3% per quarter. Several determinants of consumption are in fact still unfavourable. The high level of unemployment and the stagnation of workforce numbers in the past several quarters can be expected to have an adverse effect on the evolution in incomes, which would then rise very little this year (see table with detailed forecasts for the euro zone). Furthermore, European households' pur-

DETAILED FORECASTS FOR THE EURO ZONE

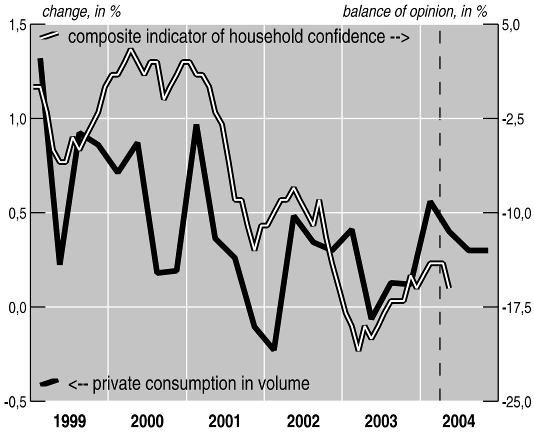
(% change)

	Quarterly changes								Annual changes	
	2003				2004				2003	2004
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4		
Volumes										
GDP	0.0	-0.1	0.4	0.4	0.6	0.5	0.4	0.4	0.5	1.8
Domestic demand	0.5	0.1	0.0	0.7	0.2	0.5	0.4	0.5	1.2	1.5
Household consumption	0.4	-0.1	0.1	0.1	0.6	0.4	0.3	0.3	1.0	1.2
Public consumption	0.4	0.6	0.7	0.4	-0.2	0.4	0.4	0.3	2.0	1.1
Investment	-0.7	-0.3	0.0	0.6	-0.1	0.7	0.8	0.9	-0.8	1.4
Foreign trade of goods ans services	-0.4	-0.1	0.4	-0.4	0.4	0.1	0.0	0.0	-0.7	0.3
Exports of goods	-0.7	-0.8	2.5	1.3	1.9	0.9	1.2	0.4	0.6	5.3
Imports of goods	2.0	1.4	-1.5	3.0	0.6	1.2	1.1	2.1	3.1	4.4
Prices										
Value added price	0.5	0.6	0.7	0.3	0.4	0.3	0.4	0.4	2.0	1.6
Consumption price	0.7	0.2	0.5	0.5	0.6	0.8	0.4	0.4	2.0	2.2
Investment price	0.5	0.2	0.2	0.2	0.7	0.5	0.3	0.3	1.4	1.6
Price of exports of goods	-1.0	-1.6	-0.4	-0.3	-0.5	0.0	0.0	0.0	-3.2	-1.3
Price of imports of goods	-0.3	-4.0	0.3	0.1	-0.8	3.0	-0.1	-1.1	-3.2	0.4
Wages	0.7	0.5	0.7	0.1	0.8	1.0	0.8	0.6	2.3	2.6
Employment and unemployment										
Unemployment rate (%)	8.8	8.9	8.9	8.9	8.9	9.0	9.1	9.1	8.9	9.0
Employment	0.1	0.1	0.0	0.1	0.0	0.0	0.1	0.1	0.2	0.2
Working population	0.3	0.2	0.0	0.1	0.1	0.1	0.2	0.1	0.7	0.3
Labour cost per unit	0.8	0.6	0.1	-0.1	0.3	0.4	0.4	0.3	1.9	1.0
Productivity of work	-0.1	-0.2	0.5	0.2	0.5	0.5	0.3	0.3	0.4	1.6
Others										
Global demand	1.7	0.8	1.9	2.6	2.2	2.0	1.9	1.8	5.4	8.1
Balance of trade (points of GDP)	1.9	2.1	2.6	2.3	2.5	2.0	2.1	2.0	9.4	9.1
3-month interest rate (%)	2.6 8.0	2.3 6.0	2.1 4.0	2.1 5.0	2.0 6.0	2.0 6.0	2.3 1.0	2.3 1.0	2.3 3.0	2.1 9.0
10-year interest rate (%)	4.1 5.0	3.9 6.0	4.1 6.0	4.3 7.0	4.1 5.0	4.1 5.0	4.4 0.0	4.4 0.0	4.1 6.0	4.2 8.0
Level of capacity utilization (%)	81.3	80.8	80.7	81.2	80.6	81.0	81.5	81.7	81.0	81.2
Gross disposable income (value)	0.5	0.6	1.0	0.7	1.0	0.9	0.8	0.8	2.1	3.4
Contribution of gross oeprating surplus	-0.1	0.0	0.5	0.3	0.3	0.2	0.2	0.2	0.4	1.1
Contribution of wages	0.6	0.4	0.5	0.1	0.6	0.7	0.6	0.5	1.9	2.1
Others contributions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	0.0

Forecasts obtained using the MZE model (see March 2003 issue)

6

PRIVATE CONSUMPTION AND HOUSEHOLD CONFIDENCE



sources : European Commission, Eurostat

forecasts after the dotted line

chasing power would no longer have the benefit of the appreciation of the euro versus the dollar and would at the same time be eroded by the rise in prices of petroleum products. Lastly, household confidence is being slow to recover, having in fact declined to a low level according to the May survey *(see graph 6)*. As a consequence, the saving ratio is likely to remain high for precautionary motives.

Only Spain, given the maintenance of its unemployment rate at a historically low level and the past slowdown in inflation, is likely to post a continuing firm growth rate for household consumption. ■

Consumer prices in the euro zone

After falling back to 1.6% in February 2004, inflation in the euro zone picked up appreciably in Q2, reaching 2.5% in May. While core inflation remained stable and food prices accelerated only moderately, the surge in the oil price and an unfavourable base effect caused a sharp increase in the year-on-year price change in the energy sector.

Inflation is thought to have remained high in Q1 2004, before declining in the summer and then remaining stable until the end of 2004. Core inflation [(1)] is expected to decline slightly as the result of the slowdown in prices of manufactures, while inflation in the services sector is expected to remain stable. In addition, inflation in the food sector is thought to have fallen steeply in June before gradually returning to more normal rates. On the other hand, the year-on-year rise in energy prices is likely in the first instance to continue to rise before ebbing in Q3 and then stabilising, thus largely explaining the pattern over time in overall inflation.

On the assumption that the Brent price eases back very gradually to $32/barrel in Q4 2004 and that the exchange rate stabilises at $1.20 to the euro, inflation should stand at 2.4% in June, before falling back and stabilising at close to 2.0% at the end of Q3. In December 2004 it would be 2.0%.

(1) Measured by the HICP excluding food, alcohol, tobacco and energy.

The surge in the oil price and an unfavourable base effect in the energy sector have produced an upturn in inflation in Q2 2004

Inflation in the euro zone declined markedly between the latter part of 2003 and the beginning of 2004, falling from 2.2% in November 2003 to 1.6% in February 2004. However, it then rebounded appreciably to reach 2.5% in May 2004. This tendency stems essentially from the sharp rise in inflation in the energy sector, where, in addition to a highly unfavourable base effect in the year-on-year calculation (prices had fallen by 2.9% in April 2003 and by 2.1% in May), prices were boosted by the surge in the oil price, from less than $30/barrel in December 2003 to more than $35 to /barrel since April 2004. This meant that inflation in the sector ceased to decline and in fact distinctly gathered pace in Q2 2004. After slowing down sharply from 7.6% in February 2003 to 1.6% in June 2003 and even -2.1% in February 2004, it came out at 6.7% in May 2004.

The rise in overall inflation was limited by the inertia shown by core inflation, which has been relatively stable, oscillating between 1.6% and 1.8% since May 2003. In May 2004 it was 1.8%. The rise in prices of services, the principal component of this indicator, has been stable since the beginning of 2004. On a year-on-year basis, it was 2.6% in May 2004, virtually unchanged on the January figure. On the other hand, inflation in the manufacturing sector, the second main component of core inflation,

TABLE 1: EURO ZONE INFLATION

(year on year % growth of HICP)*

Sectors (weight in the index)	April 2003	December 2003	May 2004	June 2004	December 2004
Total (100.0%)	**2.1**	**2.0**	**2.5**	**2.4**	**2.0**
Food (Beverage and Tobacco) (19.5%)	**2.4**	**3.6**	**3.1**	**2.7**	**2.5**
of which Food (15,6%)	*1.5*	*2.6*	*1.7*	*1.2*	*1.3*
Beverage and Tobacco (3,9%)	*5.6*	*7.7*	*8.4*	*8.5*	*7.5*
Energy (8.1%)	**2.2**	**1.8**	**6.7**	**7.5**	**3.7**
Core inflation (72.3%)	**2.0**	**1.6**	**1.8**	**1.8**	**1.7**
of which: Manufactured products (31.0%)	*0.8*	*0.7*	*0.8*	*0.8*	*0.6*
Services (41.3%)	*2.9*	*2.3*	*2.6*	*2.5*	*2.5*

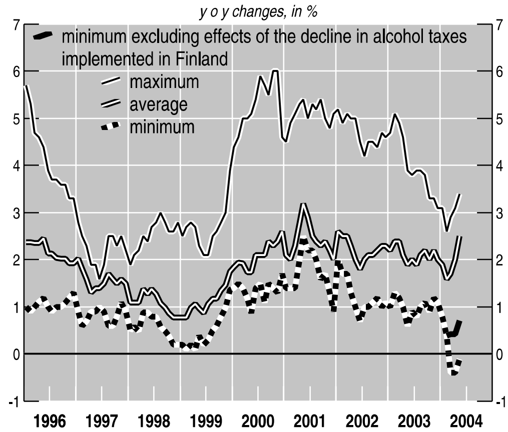
Forecast
* Harmonized Index of Consumer Prices
Source: Eurostat

Consumer prices in the euro zone

1

INFLATION IN THE EURO ZONE

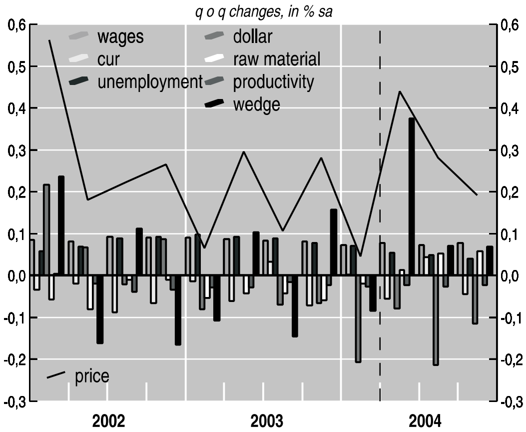
y o y changes, in %



2

ECONOMETRIC CONTRIBUTIONS TO THE EVOLUTION IN PRICES OF MANUFACTURED GOODS

q o q changes, in % sa

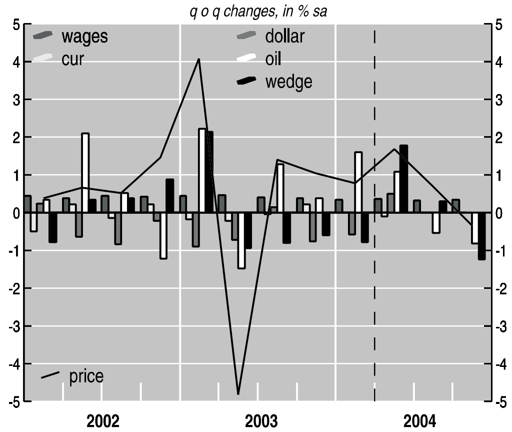


forecasts after the dotted line

3

ECONOMETRIC CONTRIBUTIONS TO THE EVOLUTION IN PRICE OF ENERGY PRODUCTS

q o q changes, in % sa



forecasts after the dotted line

showed a slight rise, from 0.6% in January to 0.8% in May, mainly as a result of the acceleration in prices of clothing.

The rise in prices under the “food” heading also had a moderating effect on overall inflation, reaching a low point in February 2004, mainly as a result of the fact that the rise in tobacco prices in Germany came later than in previous years. It thereafter returned to its levels of the beginning of the year, with the April price rise for tobacco in Germany being only partially offset by the slowdown in prices in the food sector. All things considered, food prices have slowed to down substantially compared with end-2003, standing at 3.1% in May 2004, compared with 3.6% in December 2003.

The narrowing of inflation differences within the euro zone was interrupted in the early part of 2004.

Between February 2003 and December 2003, inflation differentials within the euro zone narrowed rapidly, with the maximum spread falling from 3.8 points to 2.0 points. This tendency was interrupted in the early part of the year, with differentials starting to widen again, reaching 2.3 points in January 2004 and 3.5 points in May. However, a substantial portion — roughly 0.8 of a point — of this widening is attributable to one exceptional phenomenon, namely the decline in alcohol taxes implemented in Finland during March. If one excludes the effects of this reform, the maximum inflation differential in the euro zone comes out at 2.7 points in May 2004, which is nevertheless a significant rise compared with December 2003, linked to the relatively high level of inflation in Greece and in Luxembourg.

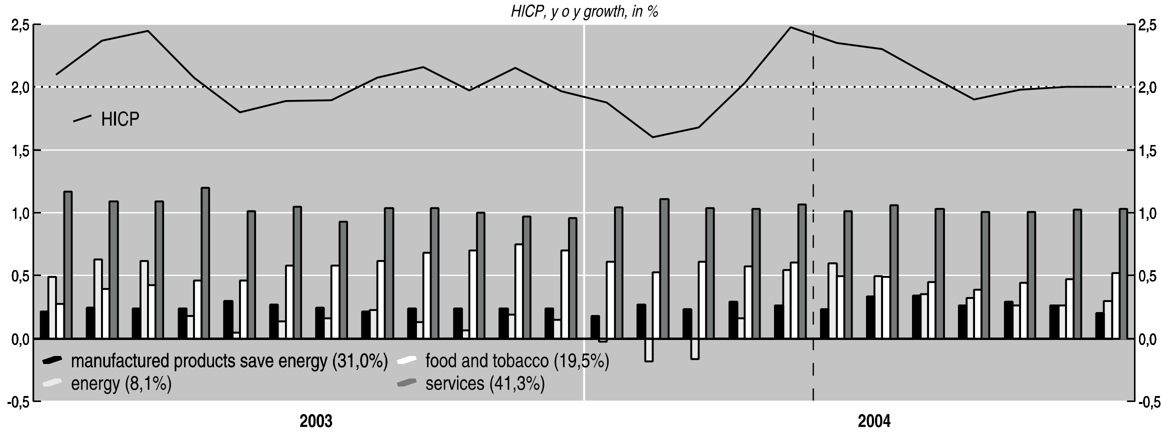
Core inflation in the euro zone expected to fall very slightly until the end of 2004.

Core inflation is expected to oscillate between 1.7% and 1.9% until the end of 2004, with a very slight downward tendency. This is because the evolution in the prices of services, in line with past wage increases, would be virtually stable while that of manufactures would remain moderate, accompanied by a slight tendency to slow down towards the end of the year. In these circumstances, core inflation would be 1.8% in June 2004 and 1.7% in December 2004.

The tendency for prices of manufactures to slow down in Q3 and especially Q4 *(see graph 2)* would mainly result from the past appreciation of the euro, via imported disinflation, and, to a small extent, from the initial impact on prices of the downward phase of the previous cycle. The year-on-year change in prices of manufactures, after standing at 0.8% in May 2004, is expected to be stable in June

4

EURO ZONE : BREAKDOWN OF INFLATION
contributions of the main items
HICP, y o y growth, in %



sources : Eurostat, Insee forecast

forecasts after the dotted line

2004 before falling back to 0.6% in December, despite the upward impact of the past increase in prices of raw materials. Inflation in the services sector is expected to be stable but still fairly high, amounting to 2.5% in both June and December 2004.

After a sharp rebound in Q2 2004, inflation is likely to stabilise at around 2% at the end of Q3.

On the assumption of a very gradual decline in the Brent price to $32/barrel in Q4 2004 and an exchange rate close to $1.20 to the euro until the end of the year, inflation should decline from the peak reached in May and then stabilise at around 2% from September 2004 on. This is because inflation in the food sector is likely to decline in June and pick up again only in Q4. The year-on-year change in energy prices should ease in Q3 and stabilise thereafter. Meanwhile, core inflation is likely to tend to decline very slightly. All in all, inflation in the euro zone would therefore stand at 2.4% in June 2004 and 2.0% in December 2004.

After accelerating sharply in Q2 in the wake of the oil price, prices of energy should slow down as the oil price itself gradually eases *(see graph 3)*. The year-on-year change in energy prices would increase in June 2004 to 7.5% from 6.7% in May and then ease back from the start of H2 before stabilising, finally standing at 3.7% in December 2004.

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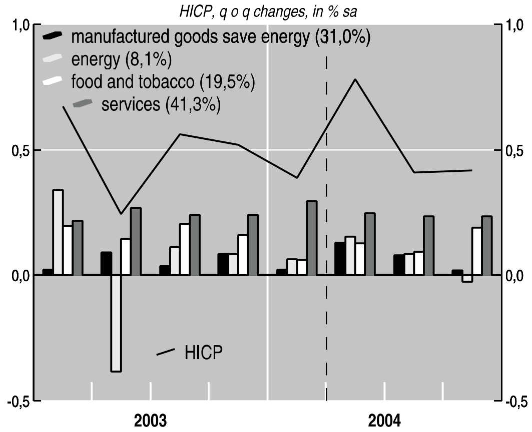
ZONE EURO INFLATION : QUARTERLY FIGURES AND CONTRIBUTIONS OF THE MAIN ITEMS
HICP, q o q changes, in % sa



sources : Eurostat, SA Insee

forecasts after the dotted line

The evolution in food prices should be relatively stable until Q3 and then accelerate in Q4, returning to more traditional levels for this sector. This is because prices had accelerated sharply in mid-2003 because of late frosts and an exceptionally dry summer and then slowed down substantially towards the end of the year. Assuming that there is no repetition of these exceptional phenomena in 2004, the price rise in this sector can be expected to come out below its long-period average for the first three quarters of 2004 and gradually return to that average by the end of the year. On a year-on-year basis, there would also be a decline in inflation before a pickup expected at the end of the year. ■