The international economic situation

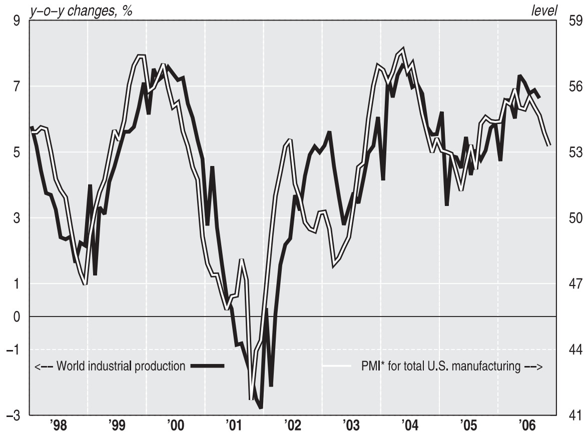
In the wake of the U.S. slowdown and under the effect of the monetary-tightening measures enacted around the world for over a year, the world economy should gradually lose momentum in early 2007. However, the shift should be subdued, especially as the U.S. is unlikely to register an abrupt downturn. The U.S. real-estate market should slowly normalize and, most important, consumption ought to remain fairly resilient.

The softer U.S. economy should affect world trade growth, which should gradually decline. Emerging Asian countries should continue to restrain investment, in the knowledge that China-in a deliberate effort to curb growth-would experience a manufacturing slowdown.

In this somewhat slacker global environment, demand in the commodity markets should weaken, allowing oil prices to stabilize at around $60/barrel. This would promote further easing of inflation in most regions, which-all other things being equal-would stimulate household spending. In the euro zone, however, the start of 2007 will be marked by the German VAT increase: this will automatically impact consumer prices, but especially household expenditures and, more generally, euro-zone dynamics.

1

MANUFACTURING–INDUSTRY OUTLOOK



Sources: national statistical institutes, JP Morgan, NTC, INSEE computations
**PMI: Purchasing Managers´ Index*

The weaker economic outlook, combined with the effects of past monetary tightening, suggests further moderate growth in the industrialized countries between now and mid-2007

After trending down since spring 2006, the global Purchasing Managers' Index (PMI) for the service sector began heading up again this fall. At the same

TABLE 1: INDUSTRIALIZED COUNTRIES - CONSOLIDATED SUPPLY AND USE

In real terms

	Quarterly change, %								Annual change, %		
	2005		2006				2007		2005	2006	2007 ovhg*
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2			
GDP	0.8	0.5	1.1	0.7	0.5	0.5	0.4	0.5	2.5	3.0	1.6
Private consumption	0.8	0.3	0.8	0.5	0.4	0.7	0.3	0.5	2.5	2.4	1.5
Public consumption	0.7	0.0	0.9	0.2	0.6	0.2	0.4	0.4	1.3	1.9	1.2
Investment	1.5	0.5	1.7	0.7	0.4	0.3	0.3	0.6	4.9	4.1	1.4
Exports	1.8	2.1	3.7	1.5	0.9	1.6	1.5	1.5	6.1	9.0	4.7
Imports	1.9	2.0	2.9	0.9	0.7	1.4	1.2	1.4	6.0	7.2	3.9
Contributions to growth											
Domestic demand excl. inventories	0.9	0.3	1.0	0.5	0.5	0.5	0.4	0.5	2.7	2.7	1.5
Inventories	-0.1	0.4	-0.1	0.1	0.1	0.0	0.0	0.0	-0.1	0.2	0.1
Net foreign trade	0.0	-0.1	0.1	0.1	0.0	0.0	0.0	0.0	-0.2	0.1	0.0

Forecast

* ovhg: statistical overhang, i.e. annual change if variable in question was to remain at its level in the last known quarter. The overhang measures the impact of past changes; it is not a forecast

Sources: national data, World Bank, INSEE computations time, however, the business outlook manufacturing has been on a steady downtrend since summer 2006: this growing pessimism in the surveys suggests that world industrial production may slow in the quarters ahead, moving below 6% annual growth (*Chart 1*).

In this less upbeat climate, growth in the main industrialized countries is projected to slow to an annual 2% by mid-2007 after nearly 3% in 2006 (*Table 1*). The downturn will probably occur in all regions, albeit in a mild form in the United Kingdom. While most Asian countries should continue to enjoy broad economic momentum, manufacturing activity could gradually weaken in China, as has already been the case in recent months. World GDP growth would therefore slow as well.

With the U.S. economy running out of steam, global trade should gradually contract. Another factor of relevance to France is the partly temporary slowdown forecast in Germany. In consequence, foreign demand for French exports is likely to decelerate (*see "Échanges extérieurs" [External trade] chapter, available in French version only*). At the end of the forecasting period, the growth rate in foreign demand should return to slightly below its long-term average.

This less buoyant environment is partly due to past monetary tightening. After the rise in central-bank rates in the industrialized countries, short-term interest rates have moved up steadily in 2006. However, the U.S. Federal Reserve's August 2006 pause has restrained the uptrend in recent months. Meanwhile, given the less favorable growth expectations and the rather reassuring inflation outlook, particularly in the United States, long-term interest rates have been heading downward since late summer. But financing terms are generally tightening in all regions, except the United States.

Markets expect a further hike in European Central Bank rates by mid-2007 (*see "Financement de l'économie" [Financing the economy] chapter, available in French version only*). The Bank of England may also continue to lift rates, especially if real-estate prices remain strong. In Japan, a weak consumer price index, the lending slowdown, and the recent consumption downturn may lead the central bank to act cautiously in the months ahead. In the United States, the darker economic outlook and the recent easing of inflation may prompt the Federal Reserve to trim its key rates by spring 2007. In most Asian emerging countries, the lessening of inflationary pressures led monetary authorities to halt their key-rate hikes by fall 2006.

Even though growth expectations have somewhat worsened, share prices have generally stayed firm. On the currency front, the euro and the dollar have remained fairly stable in real effective terms. Sterling appreciated while the yen continued to weaken, albeit more slowly than in 2005. By convention, our study assumes exchange rate stability with the euro at $1.30.

Commodity-price stabilization is expected to produce an easing of inflation by next spring

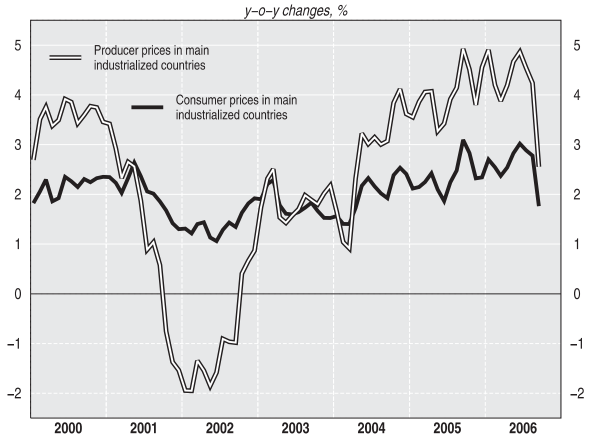
Prices of non-energy industrial commodities have leveled off since spring 2006. The price of Brent crude has been falling sharply since September, reaching slightly over $60/barrel in early December. Despite the onset of winter, it should return to about $60 owing to the probable slackening of world demand-a direct consequence of the economic slowdown in most countries (*see "Pétrole et matières premières" [Oil and commodities] chapter, available in French version only*).

Amid this easing of tension, producer prices and consumer prices have continued to soften, thanks to positive base effects on the energy components (*Chart 2*). While losing intensity, this phenomenon-common to all regions-is set to last until mid-2007. Core inflation, by contrast, should display greater differences from country to country. For instance, it should stop rising in the United States with the end to the catch-up in imputed rents, whereas it is expected to stay low in Japan. In the euro zone, its profile will largely be shaped by the impact of Germany's VAT increase in Q1 2007 (*see "Consumer prices in the euro zone" chapter*). In emerging Asia, the price growth triggered by the past oil-price surge is fading, especially absent any visible second-round effect.

2

PRICES IN MAIN INDUSTRIALIZED COUNTRIES

y–o–y changes, %



Sources: national statistical institutes, INSEE computations

Toward a moderate but general slowdown of activity by mid-2007

After converging in Q3 2006, economic activity in the main industrialized regions should slow at a uniform pace (*Table 2*). The narrowing of growth gaps will likely occur via household demand, given that non-residential investment (or construction investment) should play a fairly important role as well.

Specifically, the most significant dampening of growth should occur in the United States, because of the real-estate market downswing there (*see "Main partner countries of the euro zone" chapter*). Yet U.S. household consumption should prove rather resilient, thanks to the persistence of comfortable wage and salary earnings. After a particularly vibrant performance in early 2006, Japan, as well, should experience a fairly sharp slowdown. Besides the world-trade deceleration, the Japanese economy will probably see an adjustment in corporate investment, which-in view of weaker lending in recent months-will last for some time. In the euro zone, fundamentals-particularly employment and real wages-are on a positive albeit still modest uptrend (*see "Economic situation in the euro zone" chapter*). But the German VAT increase will probably generate a somewhat jagged profile for economic activity, with an end-2006 rebound driven by German households' advance purchases, followed by an automatic downward correction in early 2007. Among the industrialized economies, the most resilient promises to be the United Kingdom, since recent monetary-tightening measures appear to have had only a very marginal impact on it.

Meanwhile, the Chinese economy is showing signs of a slowdown. By September 2006, the year-on-year growth in industrial production stood at less than 15%, down from an average of more than 16% in Q3 2006. At the same time, fixed capital investment by Chinese firms has gradually declined. This pattern suggests that the government's cooling-off measures-particularly aimed at corporate investment-are finally producing results. Moreover, China's trade will likely suffer from the U.S. economic slowdown.

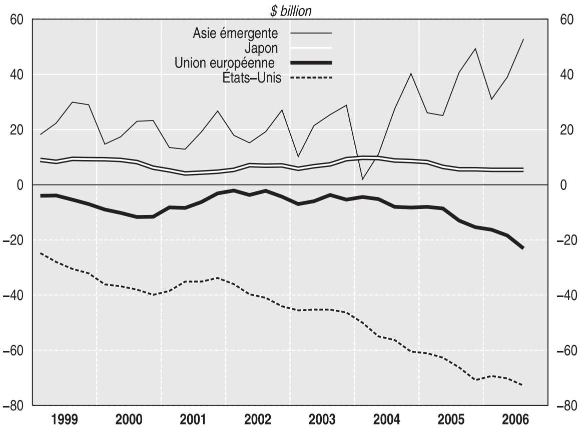
In the rest of Asia, year-on-year GDP growth, after a mild deceleration in the spring, is estimated to have stabilized at about 5.0% in Q3 2006. Manufacturing activity should remain brisk until year-end, as suggested by the gains in South Korean and Taiwanese leading indicators in recent months. However, manufacturing should be impacted in early 2007 by the combined slowdown of the Chinese and U.S. economies.

Given the gradualness of the U.S. downturn, global imbalances should remain conspicuous in mid-2007, but emerging Asia may post somewhat less spectacular trade surpluses than in the recent past (*Chart 3*).

3

MERCHANDISE TRADE BALANCE

$ billion



Sources: national statistical institutes, INSEE computations

TABLE 2: MAIN INDUSTRIALIZED COUNTRIES - GDP

In real terms

	Quarterly change, %								Annual change, %		
	2005		2006				2007		2005	2006	2007 ovhg*
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2			
Total	0.8	0.5	1.1	0.7	0.5	0.5	0.4	0.5	2.5	3.0	1.6
United States	1.0	0.4	1.4	0.6	0.5	0.5	0.5	0.6	3.2	3.3	1.6
Japan	0.5	1.0	0.8	0.4	0.5	0.4	0.5	0.5	2.7	2.8	1.5
United Kingdom	0.4	0.7	0.7	0.7	0.7	0.6	0.6	0.5	1.9	2.6	2.0
Euro zone, of which:	0.6	0.4	0.8	1.0	0.5	0.7	0.2	0.4	1.4	2.7	1.5
Germany	0.5	0.3	0.8	1.1	0.6	0.7	0.0	0.4	1.1	2.7	1.4
Italy	0.3	0.0	0.8	0.6	0.3	0.3	0.2	0.2	0.1	1.8	0.9

Forecast
** ovhg: statistical overhang*
Sources : national data, World Bank, INSEE computations

The main negative uncertainty in this scenario is a harsher slowdown of the U.S. economy and a stronger contagion effect on the rest of the world

The future of oil prices remains, as usual, uncertain. OPEC's new output cut-which may occur before end-2006-and the onset of winter could send prices rising again. Conversely, slacker world growth could send prices below the projected $60/barrel.

But the main uncertainty in this forecasting scenario is the U.S. slowdown and its impact on the rest of the world. U.S. households could react to the fall in the real-estate market more strongly than expected by raising their saving rate. In addition, the contagion effects on countries that export massively to the U.S.-especially the Asian countries-may prove faster and larger than expected. On the other hand, the fallback in oil prices and the resulting decline in long-term interest rates could exert a stronger-than-expected stabilizing effect, enabling world growth to take off again by next spring.

A final, significant uncertainty in the forecast is whether the depreciation of the dollar recorded in late November and early December will persist. While intrinsically neutral with respect to global growth, it would promote U.S. expansion and hamper the rebalancing of growth to the benefit of the rest of the world, notably Europe. ■

The euro zone's main partner countries

Economic activity in the United States, Japan, and the United Kingdom is expected to slow by mid-2007 from its winter 2005-2006 levels. In the U.S., the process-already under way-was triggered by the abrupt downswing in the real-estate market. In the U.K., the forecast decline reflects the initial impact of the Bank of England's monetary tightening since August 2006. In Japan, the main dampening factor should be the return of corporate investment to a path more consistent with demand growth.

Hampered by a less buoyant international climate than in early 2006, the three countries should post a weaker trade performance in the quarters ahead. The dip in their GDP growth, however, will likely be cushioned by resilient household consumption, sustained by reasonably positive labor-market dynamics.

Under this scenario, the statistical overhang for GDP growth at the end of Q2 2007 will reach 1.6% in the United States (as against an annual average 3.3% for 2006), 2.0% in the United Kingdom (versus 2.6% annual growth in 2006) and 1.5% in Japan (down from 2.8% in 2006).

As usual, these projections are surrounded by uncertainties. The greatest, no doubt, involves the U.S. economy. The crisis-exit scenario developed for its real-estate market, although based on recent indicators, may prove too optimistic. Such an outcome would be especially harmful as it could inhibit household-consumption growth. Conversely, the expected slowdown in U.S. business investment may prove milder than forecast, particularly if the external-demand outlook turns out to be brighter than expected.

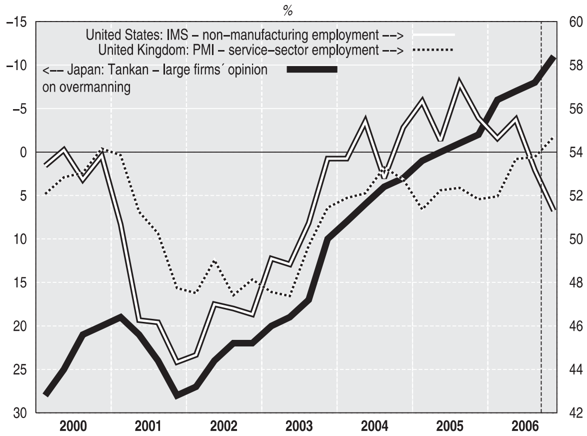
The persistence of relatively favorable labor-market conditions should allow household consumption to stay firm in the United States and United Kingdom, and even to rebound in Japan

The mild easing of growth expected at end-2006 in the U.S. and U.K. should weigh on hirings in early 2007, whereas Japan can look forward to an employment recovery. In the U.S., the pace of job creations lost further momentum in October 2006 (reaching 92 000, versus an average 150,000 per month in Q1-Q3 2006), largely on account of job losses in manufacturing. The manufacturing-output slowdown in recent months and the halt in construction output thus seem to be exerting initial negative effects on hirings. Meanwhile, business sentiment on non-manufacturing employment has turned substantially more pessimistic in recent months *(Chart 1)*. Given these developments, our scenario calls for only moderate gains in employment by next spring. In the U.K. as well, employment is set to lose momentum in H1 2007, reflecting the economic slowdown since mid-2006. By contrast, we expect a gradual increase in the number of hirings in Japan in early 2007. The ratio of job offers to job applications continued to rise, moving from 1.06 in Q2 to 1.08 in Q3. The results of the Q3 Tankan survey, like the Q4 forecasts, indicate that a growing number of enterprises report undermanning.

In all three countries, nominal wages seem to be moving on a still relatively favorable path. In the U.S., the year-on-year growth in hourly wages is currently fluctuating around 4%, despite the slowdown in productivity gains. With inflation expectations now firmly rooted, the trend is likely to continue in the quarters ahead. This should entail steady growth in per-capita wages, especially with the persistence of a low unemployment rate, close to its October 2006 level of 4.6%. In the U.K., wage growth should move on a more subdued growth path, owing to (1) a steady rise in the unemployment rate (5.6% in July-September), which would dampen pay demands, and (2) price deceleration starting in 2007. The wave of immigration from countries newly admitted to the European Union appears to play a mod-

1

BUSINESS SENTIMENT ON EMPLOYMENT SITUATION



Sources: Tankan, ISM, CIPS

Japan: forecasts to right of dotted line
U.S., U.K.: average of first two months

TABLE 1 : UNITED STATES, UNITED KINGDOM, AND JAPAN - SUPPLY AND USE

in volume terms

	Quarterly change, %								Annual change,%		
	2005		2006				2007		2005	2006	2007 ovhg*
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2			
UNITED STATES (37.2%)[1]											
GDP	**1.0**	**0.4**	**1.4**	**0.6**	**0.5**	**0.5**	**0.5**	**0.6**	**3.2**	**3.3**	**1.6**
Consumption	1.0	0.2	1.2	0.6	0.7	0.7	0.5	0.6	3.5	3.1	2.0
Private investment[2]	1.5	0.7	2.0	-0.4	-0.2	-1.0	-0.4	0.2	7.5	3.3	-1.1
Non-residential investment	*1.4*	*1.3*	*3.3*	*1.1*	*2.4*	*1.5*	*1.5*	*1.5*	*6.8*	*7.9*	*5.4*
Residential investment	*1.7*	*-0.2*	*-0.1*	*-2.9*	*-4.8*	*-5.0*	*-3.5*	*-2.0*	*8.6*	*-4.1*	*-11.5*
Government expenditures[3]	0.8	-0.3	1.2	0.2	0.5	0.2	0.6	0.6	0.9	2.0	1.6
Exports	0.8	2.3	3.3	1.5	1.5	1.5	1.5	1.5	6.8	8.6	5.1
Imports	0.6	3.1	2.2	0.4	1.3	0.8	1.3	1.3	6.1	6.2	3.6
Contributions:											
Domestic demand excluding inventories	*1.1*	*0.2*	*1.4*	*0.4*	*0.6*	*0.4*	*0.4*	*0.6*	*3.8*	*3.1*	*1.5*
Change in private inventories	*0.0*	*0.5*	*0.0*	*0.1*	*0.0*	*0.0*	*0.0*	*0.0*	*-0.3*	*0.3*	*0.2*
Net exports	*0.0*	*-0.3*	*0.0*	*0.1*	*-0.1*	*0.0*	*0.0*	*0.0*	*-0.3*	*-0.1*	*0.0*
UNITED KINGDOM (5.6%)[1]											
GDP	**0.4**	**0.7**	**0.7**	**0.7**	**0.7**	**0.6**	**0.6**	**0.5**	**1.9**	**2.6**	**2.0**
Consumption	0.4	0.7	0.3	0.9	0.4	0.5	0.6	0.5	1.4	2.1	1.8
Total investment	2.5	0.8	2.0	0.6	2.3	1.4	1.3	0.9	2.7	5.7	4.4
Enterprise investment	*1.0*	*0.1*	*2.0*	*1.6*	*3.1*	*1.5*	*1.5*	*1.2*	*3.2*	*6.0*	*5.4*
Household investment[4]	*3.0*	*-0.2*	*-4.0*	*5.1*	*1.5*	*1.0*	*0.5*	*0.5*	*-1.6*	*3.7*	*3.7*
Public investment[4]	*10.6*	*4.5*	*0.3*	*-4.2*	*1.0*	*2.0*	*3.0*	*1.0*	*-2.6*	*3.4*	*4.7*
Public consumption[5]	0.6	0.4	0.5	0.7	0.9	0.5	0.5	0.5	2.8	2.5	1.9
Exports	1.7	3.3	8.5	4.5	-10.9	0.0	1.0	1.0	7.1	10.8	-3.0
Imports	3.4	2.4	8.9	3.4	-9.2	0.0	1.0	1.0	6.5	10.7	-2.3
Contributions:											
Domestic demand excluding inventories[4]	*0.8*	*0.6*	*0.6*	*0.8*	*0.9*	*0.7*	*0.7*	*0.6*	*1.9*	*2.8*	*2.3*
Change in private inventories	*0.4*	*-0.2*	*0.4*	*-0.5*	*0.1*	*0.0*	*0.0*	*0.0*	*-0.1*	*0.0*	*-0.2*
Net exports	-0.5	0.2	-0.4	0.2	0.0	0.0	0.0	0.0	0.0	-0.3	-0.1
JAPAN (14.8%)[1]											
GDP	**0.5**	**1.0**	**0.8**	**0.4**	**0.5**	**0.4**	**0.5**	**0.5**	**2.7**	**2.8**	**1.5**
Consumption	0.9	0.7	-0.1	0.5	-0.7	0.2	0.5	0.5	2.2	1.2	0.7
Total investment	1.2	-0.4	2.4	0.6	0.7	0.7	0.8	0.8	3.3	4.1	2.4
Private investment	*1.2*	*0.4*	*3.2*	*2.4*	*2.4*	*0.7*	*0.8*	*0.8*	*6.0*	*7.9*	*3.7*
Non-residential investment	*1.1*	*0.2*	*3.7*	*3.5*	*2.9*	*1.0*	*1.0*	*1.0*	*7.6*	*9.6*	*4.9*
Residential investment	*1.5*	*1.6*	*1.2*	*-2.5*	*0.1*	*0.0*	*0.5*	*0.5*	*-0.7*	*0.9*	*0.3*
Public investment	*1.5*	*-3.6*	*-0.8*	*-6.5*	*-6.7*	*0.0*	*0.0*	*0.0*	*-5.8*	*-10.3*	*-5.2*
Public consumption	0.3	0.1	0.0	0.2	0.1	0.1	0.1	0.1	1.7	0.6	0.3
Exports	2.9	3.7	2.5	0.9	2.7	2.0	1.8	1.8	6.9	10.5	6.4
Imports	3.9	-0.8	2.4	1.4	-0.1	2.0	1.4	1.4	6.3	5.7	4.3
Contributions:											
Domestic demand excluding inventories	*0.8*	*0.3*	*0.5*	*0.5*	*-0.2*	*0.3*	*0.5*	*0.5*	*2.3*	*1.7*	*1.1*
Change in private inventories	*-0.3*	*0.1*	*0.2*	*0.0*	*0.3*	*0.0*	*0.0*	*0.0*	*0.1*	*0.3*	*0.1*
Net exports	*-0.1*	*0.6*	*0.0*	*-0.1*	*0.4*	*0.0*	*0.1*	*0.1*	*0.2*	*0.8*	*0.4*

Forecast

* ovhg: statistical overhang, i.e. annual change if variable in question was to remain at its level in the last known quarter.
1. Country's share of OECD GDP (1995 PPP. 2003 volume)
2. Investment by enterprises and households
3. Government consumption and investment
4. Items on which there is no information in the provisional accounts
5. Includes consumption by non-profit institutions
Sources: BEA, ONS, Economic and Social Research Institute (ESRI), INSEE

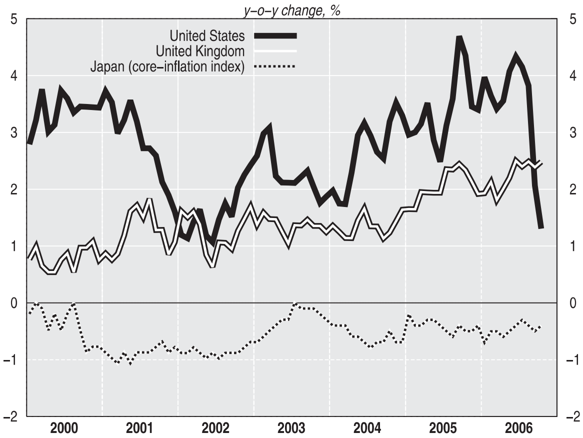
erating role. In Japan, after the dip in wages observed in Q3 2006, bonus distributions in December are expected to spur a temporary increase at year-end.

Real household incomes should also be lifted by weaker oil prices at end-2006, particularly in the United States and Japan. U.S. inflation already ebbed sharply in October *(Chart 2)*. In the United Kingdom, however, the downswing in energy prices should be partly offset by the rise in core inflation due to increases in such items as university tuition and gas and electricity. In early 2007, absent a sharp swing in oil prices, inflation should keep growing by slightly over 0.6% per quarter in the U.S. and 0.3% in the U.K., generating real income gains of about 0.6% per quarter in both countries. The year-on-year change in Japanese consumer prices will likely be near zero, with the country's economy making a slower than expected exit from deflation. As a result, the gains in real household income will remain weakly positive.

In sum, household expenditures should remain reasonably firm in all three countries during the forecasting period. In Japan, they should be stimulated

2

CONSUMER PRICES



Sources: BLS (U.S.); ONS (U.K.); Ministries of Public Management, Home Affairs, Posts and Telecom (Japan)

by a brighter job market and a temporary rise in wages and salaries. Indeed, Japanese banks expect a small rebound in credit demand from households by the end of this year. In the United States, the consumption slowdown is likely to be moderate, thanks to a still relatively buoyant labor market and declining inflation. The impact of the expected fall in real-estate prices within this time frame should be offset by the past effects of bullish financial markets. In the United Kingdom, household demand should weaken slightly, owing to higher key interest rates (up 25 basis points in August and again in November 2006), which will raise their interest payments. Nevertheless, consumer demand will probably be stimulated by further intensification of real-estate wealth effects.

Household investment should continue to recover in Japan, but should suffer from higher interest rates in the United Kingdom and undergo a slow adjustment in the United States

After an unexpected rebound in September 2006, U.S. housing starts fell again in October. Most important, housing stocks remain worryingly high, suggesting a fairly long adjustment in the real-estate market. The downswing in residential investment will therefore weaken very gradually in the months ahead. A further slippage at the current pace is admittedly possible, as the softening of prices that is starting to occur in some regions could generate wait-and-see behavior. But three developments raise hopes that the situation will eventually return to normal: the halt in the decline of the real-estate market confidence indicator, the somewhat more positive pattern in sales of existing homes, and the recent stabilization of mortgage-loan applications due to the easing of long-term rates.

In the U.K., household investment recovered in 2006 thanks to the real-estate market upswing, but will probably cool in early 2007, particularly because of

TABLE 2 : UNITED-STATES, UNITED KINGDOM, AND JAPAN : HOUSEHOLD ACCOUNTS

(%)

	Average annual changes			
	2004	2005	2006	2007[1]
United States				
Non-farm payroll employment	1.1	1.5	1.4	0.7
Average wage per head	4.3	3.5	5.0	2.9
Nominal gross disposable income	6.4	4.1	5.5	4.1
Private consumption deflator	2.6	2.9	2.9	1.8
Saving ratio	2.0	-0.4	-1.0	-0.7
United Kingdom				
Dependent employment	1.0	0.9	0.8	0.6
Average wage per head	3.3	3.8	3.6	3.0
Nominal gross disposable income	3.4	4.8	4.1	3.0
Private consumption deflator	1.5	2.4	2.2	1.6
Saving ratio	3.7	4.9	5.7	5.5
Japan				
Total employment	0.2	0.4	0.3	0.3
Average wage per head	-1.5	0.8	1.5	1.5
Nominal gross disposable income	0.4	0.5	0.9	0.8
Private consumption deflator	-0.7	-1.0	-0.4	0.2
Saving ratio (net)	3.1	2.4	2.6	2.6

Forecast
1. Statistical overhang in Q2
Sources : BEA, BLS, Economic and Social Research Institute (ESRI); Central Statistical Office, Department of Employment, ONS; Ministry of Public Management, Minis - try of Labour; INSEE

monetary tightening. In Japan, residential investment should continue to be stimulated by the rise in housing prices that began in Q1 2006.

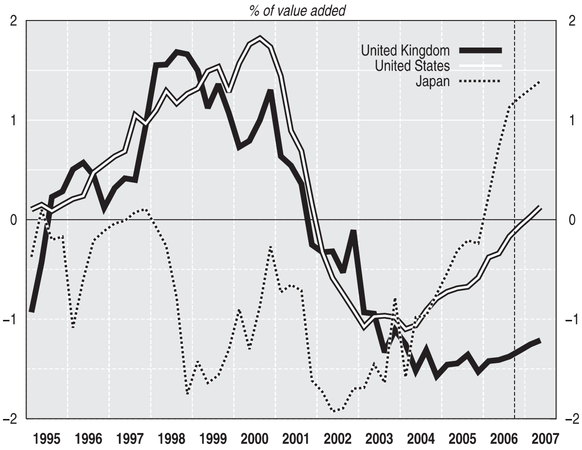
The moderation of economic activity in the three countries as well as the world trade slowdown should lead U.S., British, and Japanese businesses to trim their investments

In the U.S., softer external demand and weaker personal consumption should gradually weigh on corporate investment decisions. The slippage in the ISM (Institute for Supply Management) index for the manufacturing sector since August effectively portends cautious behavior by firms. The concurrent fall in the productive capacity utilization rate is a further sign that expenditure growth will not remain as vigorous as in early 2006. The same is true for capital-goods orders, which have been declining since the end of Q3. Moreover, banks surveyed quarterly by the Federal Reserve recently indicated that they were tightening lending standards for medium-sized and large corporate borrowers. In the U.K., confidence among industrial firms should gradually weaken because of the contraction in export order books, especially given the pound's continuous appreciation since May. These gloomier prospects in the international market, combined with the effects of rising interest rates, will likely lead to a very gradual slowdown in British business investment by mid-2007.

3

BUSINESS INVESTMENT RATE

% of value added



Sources: ESRI, BEA, ONS *Forecasts to right of dotted line*

The investment rate is the ratio of nominal business investment to nominal GDP. To make the chart easier to read, we have shown the difference between the investment rate and its 1991-2005 averages of 15.1% for Japan, 10.8% for the United States, and 10.9% for the United Kingdom. For example, in Q1 2000, the U.K. investment rate was 11.6%, shown on the chart as a 0.7% positive difference with the long-term average.

After three consecutive steep quarterly rises, Japanese non-residential investment will slow by year-end, stabilizing at an annualized growth rate of about 4.0%. Among other factors, the expected economic downturn in the country's main partners will incite Japanese firms to reduce their investments. As evidence of this, machinery orders excluding ships fell sharply in Q3 2006. The results of the September Tankan survey indicate a downbeat profit outlook and plans by Japanese business leaders to trim productive investment in the quarters ahead. However, the high capacity utilization rate, along with the rebound in non-residential building starts in Q3 2006, should soften the cutback in Japanese corporate investment by next spring. Likewise, in the United Kingdom, the persistence of growing pressures on productive capacity does not lead us to forecast a very significant investment slowdown.

Business investment expenditures are therefore expected to contract in all three countries in early winter, but without preventing an increase in the investment rate *(Chart 3)*.

Undermined by a less buoyant international environment than in early 2006, the external-trade performance of all three countries is projected to weaken in the quarters ahead

Export growth in the United States and United Kingdom is likely to remain moderate in the next few quarters. It will be impacted by the expected softening of demand from both countries' main trading partners and, as a result, will not match the rates recorded in H1 2006. By comparison with that period, imports will decrease in early 2007, largely because of the forecast business slowdown in both countries. The external-trade contribution to U.S. and British growth should thus gradually return to zero. In contrast, Japanese exports should continue to benefit from vibrant manufacturing activity in the rest of Asia and a favorable exchange rate. Consequently, despite the adverse effect of the expected economic slowdown in the U.S. and China, Japan's external trade is likely to keep making a positive contribution to growth in the coming quarters.

While the main uncertainty in the United States concerns the behavior of the real-estate market, the chief uncertainties in Japan and the United Kingdom focus on the direction of monetary policies

In the United States, while some indicators suggest the beginnings of an upturn in the real-estate market, our crisis-exit scenario may prove somewhat over-optimistic. If so, household consumption might also be jeopardized, leading to a steeper-than-expected rise in the saving rate. Alternatively, the slowdown in business investment could turn out to be milder than expected, especially if the international market outlook is brighter than forecast.

In Japan and the United Kingdom, the uncertainties that could impair economic activity largely center on monetary policy. For example, an overly precipitous rise in Japan's key rates could compromise the domestic-demand rebound and so delay a clear exit from deflation. In the U.K., the adjustment lag between interest-rate hikes and their moderating effects on the rise in real-estate prices is very uncertain. If it is long, the Bank of England-even without explicitly targeting real-estate prices-will probably continue its monetary tightening, which could inhibit economic activity more forcefully than expected. Conversely, if the lag is very short and inflation shows clear signs of easing in early 2007, one cannot rule out a rate cut by spring, aimed at stimulating growth. ■

Economic situation in the euro zone

Euro-zone GDP grew 0.5% in Q3 2006. Of the region's four largest economies, France and Italy posted below-average performances; Spain and, to a lesser extent, Germany exceeded the average.

After the brisk recovery in H1, economic growth returned to a more average pace in Q3. Domestic demand excluding inventories held steady, while external trade had a mildly negative effect on the zone's GDP. A rebound is expected in Q4, but mostly because of non-recurring factors in France and Germany. Average annual GDP growth for 2006 is thus poised to reach 2.7%, the best figure since 2000.

However, GDP is likely to lose momentum in early 2007. Amid a more sluggish international environment, the euro-zone economy should also experience the negative effect on German demand of the VAT increase scheduled for January 1.

The euro zone is on track to a temporary recovery in 2006

The recovery in the euro zone, which began in late 2005, has persisted. GDP is set to gain 2.7% in 2006 after 1.4% in 2005. All countries in the zone-particularly Germany and Italy-will have contributed to this pickup. Investment appears to have made a consistent contribution in the leading economies, but external trade and consumption have had different effects on their growth *(Chart 1)*. The data suggest consumption-driven growth in France and Italy, but a more balanced mix in Germany thanks to its export performance.

However, euro-zone growth seems to have peaked in H1 2006. Business surveys in industry show that confidence stopped increasing in June, after a year's rise *(Chart 2)*, and industrial production expanded by only 0.9% in Q3 after averaging 1.2% in Q1-Q2 2006. German industry continues to show signs of good health: its production gained 1.9% in Q3, significantly outpacing the euro-zone average. After an exceptional H1, euro-zone growth has returned to a moderate 0.5%.

GDP growth in the next few quarters will probably be disrupted by the German VAT increase on January 1, 2007. A rebound is forecast in Q4 2006, notably on account of German household purchases ahead of the tax rise. Under this scenario, growth will then slow in all euro-zone countries in early 2007 *(Chart 3)*, owing to less favorable international conditions and the expected shock on German domestic demand at the start of the year.

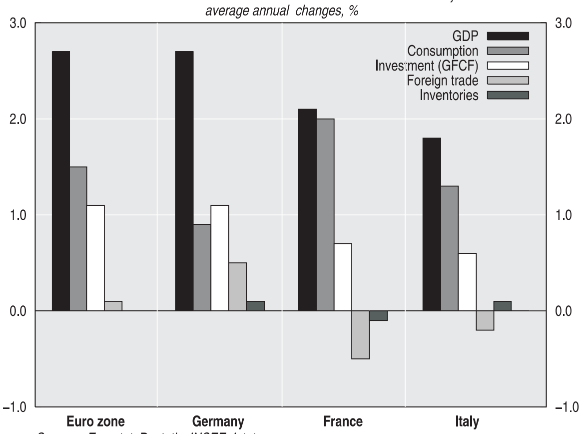
Household consumption growth should stay on a moderate growth path, with a negative impact from Germany's VAT increase

The available data suggest that the pace of job creations in the euro zone quickened from 0.9% in 2005 to 13% in 2006, while the unemployment rate continued to fall *(Chart 4)*. By contrast, real wages do

1

CONTRIBUTIONS TO EURO-ZONE GDP GROWTH, 2006

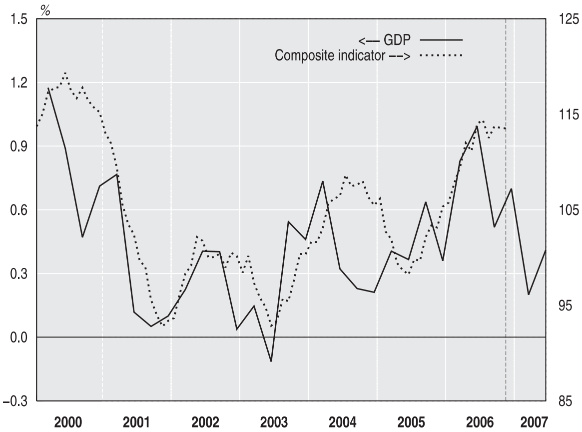
average annual changes, %



Sources: Eurostat, Destatis, INSEE, Istat

2

EURO ZONE: GDP (real quarterly growth) AND COMPOSITE INDICATOR FROM INDUSTRY SURVEYS



Sources: Eurostat, DgEcFin, INSEE computations *Forecasts to right of dotted line*

GDP IN THE EURO ZONE AND IN THE PRINCIPAL MEMBER COUNTRIES

(annual and quarterly change, %)

	2005				2006				2007		2004	2005	2006	2007 ovhg*
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2				
GERMANY (29.4%)[1]														
GDP	**0.6**	**0.3**	**0.5**	**0.3**	**0.8**	**1.1**	**0.6**	**0.7**	**0.0**	**0.4**	**0.8**	**1.1**	**2.7**	**1.4**
Household consumption	-0.4	0.0	0.6	-0.8	1.0	-0.2	0.7	1.0	-1.1	0.2	-0.3	0.3	1.2	0.1
Total GFCF	-0.2	-0.1	2.2	1.1	0.0	4.4	0.8	2.1	1.3	1.3	-1.4	1.0	6.3	5.4
Public consumption	0.8	1.2	-0.1	-0.6	1.6	-1.0	0.9	0.0	0.0	0.0	-1.3	0.6	1.1	0.2
Exports	1.4	1.9	4.1	1.2	4.9	0.8	4.2	2.2	2.0	2.0	8.8	7.1	12.0	7.6
Imports	-1.1	3.6	3.5	1.7	4.6	0.8	3.6	3.0	1.3	1.9	6.2	6.7	12.2	7.1
Contributions :														
Domestic demand ex. stocks	*-0.1*	*0.2*	*0.7*	*-0.4*	*0.9*	*0.5*	*0.7*	*1.0*	*-0.4*	*0.3*	*-0.7*	*0.5*	*2.0*	*1.0*
Inventory change	*-0.1*	*0.5*	*-0.6*	*0.7*	*-0.5*	*0.6*	*-0.5*	*-0.1*	*0.0*	*0.0*	*0.3*	*0.2*	*0.1*	*-0.1*
Foreign trade	*0.9*	*-0.5*	*0.4*	*-0.1*	*0.4*	*0.0*	*0.4*	*-0.2*	*0.4*	*0.1*	*1.2*	*0.5*	*0.5*	*0.5*
ITALY (17.9%)[1]														
GDP	**-0.4**	**0.6**	**0.4**	**0.0**	**0.8**	**0.6**	**0.3**	**0.3**	**0.2**	**0.2**	**0.9**	**0.1**	**1.8**	**0.9**
Household consumption	-0.8	0.7	0.5	-0.1	1.0	0.3	0.6	0.3	0.2	0.2	0.5	0.1	2.0	1.0
Total GFCF	-1.7	2.1	1.4	-1.6	2.3	1.1	-1.3	1.0	0.5	0.5	1.9	-0.4	2.7	1.2
Public consumption	0.8	0.1	0.2	0.0	0.2	0.2	-0.2	0.1	0.1	0.1	0.6	1.2	0.3	0.2
Exports	-1.7	2.4	-0.2	1.5	2.5	1.0	-1.7	1.0	0.8	0.6	2.5	0.7	4.3	1.4
Imports	-2.0	2.4	-0.1	1.0	1.9	0.2	2.1	1.2	0.9	0.7	1.9	1.8	4.9	3.5
Contributions :														
Domestic demand ex. stocks	*-0.6*	*0.9*	*0.6*	*-0.4*	*1.1*	*0.4*	*0.0*	*0.4*	*0.2*	*0.2*	*0.8*	*0.2*	*1.8*	*0.9*
Inventory change	*0.2*	*-0.3*	*-0.2*	*0.3*	*-0.5*	*0.0*	*1.3*	*0.0*	*0.0*	*0.0*	*-0.1*	*0.2*	*0.1*	*0.6*
Foreign trade	*0.0*	*0.0*	*0.0*	*0.1*	*0.2*	*0.2*	*-1.0*	*-0.1*	*0.0*	*0.0*	*0.2*	*-0.3*	*-0.2*	*-0.6*
EURO ZONE (27.8%)[2]														
GDP	**0.4**	**0.4**	**0.6**	**0.4**	**0.8**	**1.0**	**0.5**	**0.7**	**0.2**	**0.4**	**1.7**	**1.4**	**2.7**	**1.5**
Household consumption	0.0	0.4	0.7	0.1	0.7	0.3	0.6	0.7	-0.2	0.4	1.3	1.4	1.9	1.0
Total GFCF	0.3	1.0	1.4	0.6	1.0	2.3	0.8	1.6	0.9	0.9	1.8	2.7	5.0	3.8
Public consumption	0.1	0.5	0.6	0.4	0.9	0.1	0.8	0.3	0.1	0.1	1.1	1.3	2.1	0.8
Exports	-0.4	1.8	2.6	0.7	3.8	1.1	1.7	1.8	1.4	1.5	6.3	4.5	8.5	5.1
Imports	-1.0	2.5	2.5	1.6	2.8	1.1	2.1	2.2	1.2	1.5	6.2	5.5	8.5	5.4
Contributions :														
Domestic demand ex. stocks	*0.1*	*0.5*	*0.8*	*0.2*	*0.8*	*0.7*	*0.7*	*0.8*	*0.1*	*0.4*	*1.4*	*1.6*	*2.6*	*1.6*
Inventory change	*0.1*	*0.0*	*-0.3*	*0.4*	*-0.4*	*0.3*	*0.0*	*0.0*	*0.0*	*0.0*	*0.2*	*0.1*	*0.0*	*0.0*
Foreign trade	*0.2*	*-0.2*	*0.1*	*-0.3*	*0.4*	*0.0*	*-0.1*	*-0.1*	*0.1*	*0.0*	*0.2*	*-0.3*	*0.1*	*0.0*

Forecast

* ovhg: statistical overhang, i.e. annual change if variable in question was to remain at its level in the last known quarter.
1. Share of euro zone GDP
2. Share of OECD GDP
Sources : Eurostat, Destatis, Istat

not seem to be rising, as their decline in Germany continues to depress the regional average. Aggregate income growth for euro-zone households will probably remain slack; their consumption will probably have continued to outpace their income in 2006, gaining 1.9% and 1.0% respectively.

From Q4 2006 on, euro-zone household consumption is likely to exhibit a jagged profile due to the behavior of German consumers in response to the VAT increase scheduled for January 1, 2007. In France, household consumption should remain the chief growth driver, staying on its recent years' trend in early 2007. In Italy, by contrast, its contribution to GDP growth should become marginal. For the euro zone as a whole, we thus expect household consumption to gain 0.7% in Q4 2006, followed by a 0.2% dip in Q1 2007 before a 0.4% rebound in Q2 once the immediate effects of the German consumption shock have worn off.

The fiscal plans announced by the German and Italian governments, with the aim of cutting their public deficits, should also curb the rise in public spending and restrain the growth of household income via higher taxes. These corrective measures are estimated at about 1 point of GDP for Germany and Italy.[1] In H1 2007, public consumption growth should fall to 0.1% per quarter.

1. In Italy, the improvement in public finances should be nominally greater, for the 2006 deficit public is expected to include a 1.2-point surcharge consisting of a one-time refund of VAT on automobile purchases by businesses-the consequence of a ruling by the European Court of Justice.

3

EURO ZONE: GDP GROWTH IN MAIN COUNTRIES

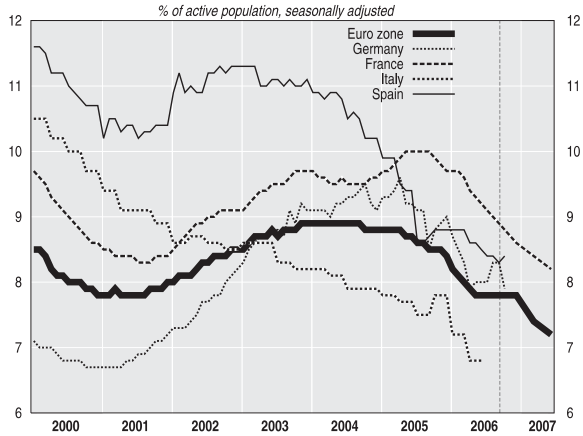
Average annual changes, %, working–day and seasonally adjusted

Sources: Eurostat, Destatis, INSEE, Istat *Forecasts to right of dotted line*

4

EURO ZONE: HARMONIZED UNEMPLOYMENT RATE

% of active population, seasonally adjusted



Source: Eurostat *Forecasts to right of dotted line*

Productive investment will probably stop accelerating

Since the end of Q2 2006, business leaders have been expecting a demand slowdown in the euro zone. This will probably occur in early 2007, both for domestic demand and external demand *(Chart 5)*. In addition, financial conditions are becoming less accommodative far earlier in the current investment cycle than in previous expansion phases. The rise in interest rates thus might be amplifying the equipment-investment slowdown in the euro zone, triggered by worsening demand expectations.

Business investment should nevertheless continue to be sustained by the financial maneuvering room that firms have obtained by rebuilding their margins *(Chart 6)*. Their equipment-investment expenditures are likely to keep growing, but at a more moderate pace of slightly under 1.0% per quarter in H1 2007. This uptrend should remain persistently stronger in Germany than in France and Italy, in particular thanks to brisk demand for manufactured products.

Further growth is expected in construction investment, although at a more subdued pace than in 2006 *(Chart 7)*. Being heavily dependent on specific national conditions, it should continue to be stimulated by the end of the crisis in Germany's construction industry and grow by about 1.0% per quarter until the end of H2 2006.

The worsening international environment is likely to weigh on euro-zone exports

Since end-2005, the euro zone's trade balance with the rest of the world has become negative, owing to the surge in oil prices and the stronger euro. These effects faded in Q3 2006, although the trade deficit with countries outside the zone further widened (*Chart 8*).

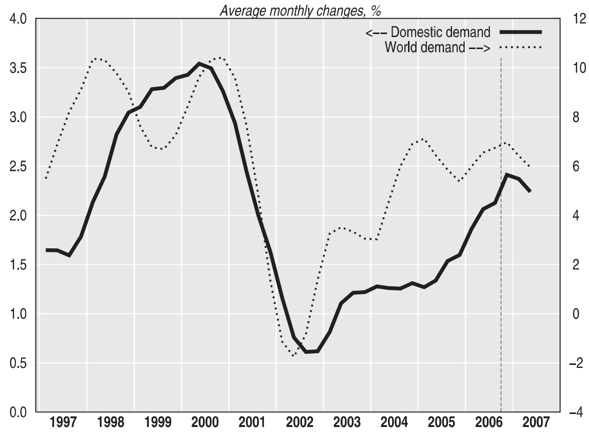
Demand from the rest of the world is expected to weaken significantly within our forecast horizon, dragged down by the U.S. economic slowdown in H2 2006. Over one year, the quarterly growth rate of world demand for euro-zone exports is set to decline from 2.0% to 1.2%. Exports should thus rise by only 1.5% or so per quarter in H1 2007; imports are projected to experience a temporary slowdown at the start of the year due to slacker German domestic demand, followed by a return to the same growth rate as exports.

Unlike the other leading euro-zone countries, Germany should benefit from still-vigorous world demand, because its external trade is better focused on high-growth markets. As a result, German exports will likely remain robust *(Chart 9)*. By contrast, Italy

5

EURO ZONE: DOMESTIC DEMAND AND WORLD DEMAND

Average monthly changes, %

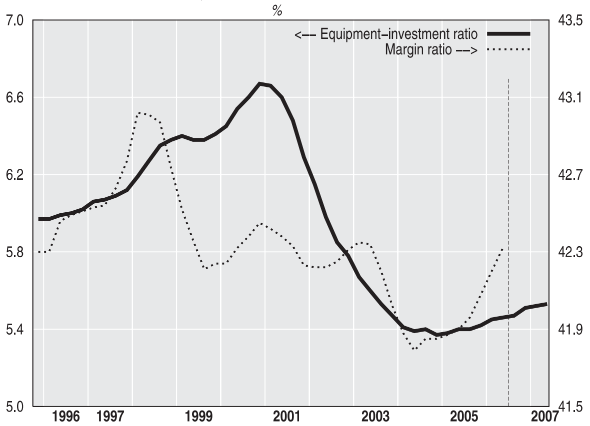


Sources: Eurostat, INSEE computations *Forecasts to right of dotted line* will continue to be handicapped by its economy's structural competitiveness problems. After an outstanding H1 2006, in which it benefited from the brisk growth of world trade, the external-trade contribution to euro-zone growth is expected to be negative for full-year 2006. ■

6

EURO ZONE: TOTAL MARGIN RATIO AND EQUIPMENT–INVESTMENT RATIO

%

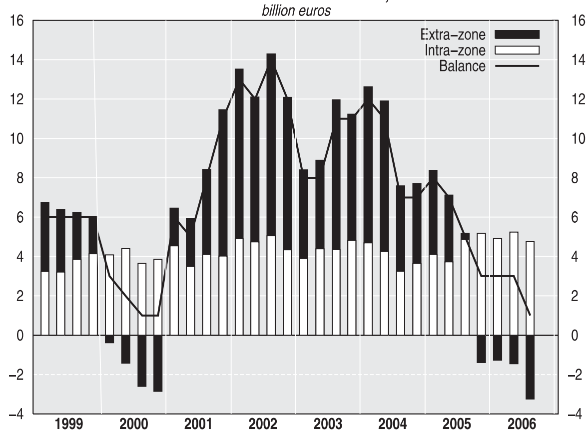


Sources: Eurostat, INSEE computations *Forecasts to right of dotted line*

8

MERCHANDISE TRADE BALANCE, INTRA– AND EXTRA–EURO ZONE, NOMINAL

billion euros

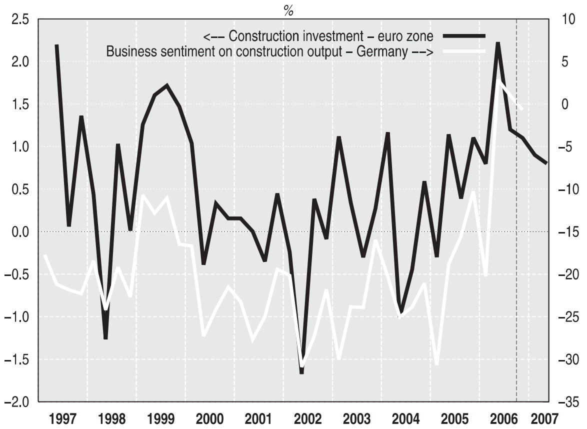


Source: Eurostat

7

CONSTRUCTION INVESTMENT (QUARTERLY GROWTH) AND GERMAN CONSTRUCTION OUTPUT

%

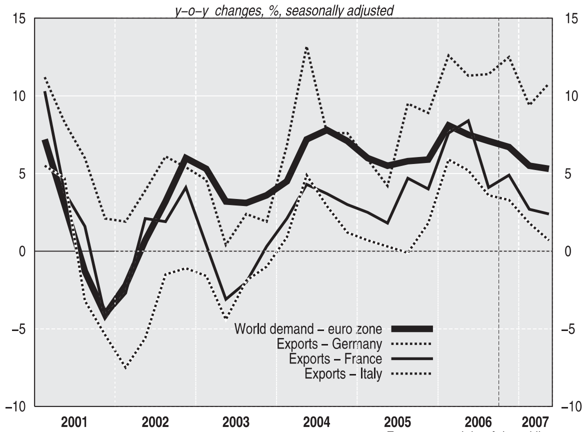


Sources: Eurostat, European Commission *Forecasts to right of dotted line*

9

EURO–ZONE EXPORTS

y–o–y changes, %, seasonally adjusted



Sources: Eurostat, INSEE computations *Forecasts to right of dotted line*

EURO ZONE: HOUSEHOLDS ACCOUNTS

(Annual and quarterly % changes)

	2005				2006				2007		2004	2005	2006	2007 ovhg*
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2				
Total wage bill	0.7	0.6	0.5	1.1	0.8	1.0	1.0	0.8	1.0	0.5	2.8	2.5	3.4	2.7
- Employment	0.1	0.1	0.2	0.3	0.3	0.4	0.3	0.3	0.3	0.3	0.7	0.8	1.3	1.0
- Unit wage	0.6	0.4	0.3	0.8	0.4	0.6	0.7	0.5	0.7	0.2	2.1	1.8	2.2	1.7
GDI	-0.1	1.0	0.4	1.1	0.2	0.9	2.4	-0.5	1.0	0.9	3.4	2.2	3.2	2.1
Saving ratio (% of GDI)	13.9	14.0	13.5	13.7	13.1	13.2	13.9	12.9	13.3	13.3	14.5	13.8	13.3	13.3
Households Consumption deflator	0.4	0.6	0.7	0.5	0.6	0.5	0.5	0.5	0.5	0.6	2.1	2.0	2.2	1.8
Real total wage bill	0.3	0.0	-0.1	0.6	0.2	0.5	0.5	0.3	0.5	-0.1	0.7	0.5	1.2	0.9
- Real unit wage	0.2	-0.2	-0.3	0.3	-0.1	0.1	0.2	0.0	0.2	-0.4	0.0	-0.3	0.0	-0.1
Purchasing power of GDI	-0.5	0.5	-0.3	0.6	-0.4	0.4	1.9	-1.0	0.5	0.3	1.3	0.2	1.0	0.3

Forecast (MZE model)
* ovhg: statistical overhang
Sources : Eurostat, INSEE computations

BOX: COMPARISON OF CURRENT RECOVERIES IN FRANCE AND GERMANY: WHICH SECTORS ARE LEADING THE WAY?

France and Germany have been moving into a recovery phase since end-2003, but not at the same pace. The economic upswing was initially sharper in France than in Germany, with total value added gaining an average 0.6% per quarter in France versus 0.3% in Germany between mid-2003 and end-2004 *(Charts A and B)*. Since early 2005, Germany's average growth has slightly exceeded that of France, at 0.6% versus 0.4% per quarter respectively. However, the drivers of the recent expansion are not identical in both countries. In Germany, growth is largely fueled by manufacturing. But, since mid-2005, construction has ceased to make a negative contribution. Services-whose performance in Germany had been slack for many years-seem to have rebounded for the past several quarters and are now also contributing to growth. In France, financial, real-estate, and business services have provided most of the momentum since 2003, although an accelerating trend in the other major sectors is currently rebalancing the growth mix.

Industry

The industrial (i.e., manufacturing) sector is contributing twice as much to value-added growth in Germany as in France. The sector's share of total value added is larger in Germany than in France, at 25% versus 18% in 2002. Moreover, German industry has grown more vigorously than its French counterpart in 2002-2006, notably thanks to buoyant exports. The competitiveness strategy based on labor-cost restraint[1] seems to have yielded results *(Chart C)*. Since end-2005, the mild recovery in wages and salaries has not undermined the robust growth of value added in German industry. Between 2002 and 2005, industry's share of total value added in Germany has remained broadly stable at 25%. In France, by contrast, industry's share of total value added has dwindled to 15%.

Construction

For the past decade, Germany's construction sector has experienced a structural crisis that has weighed on value-added growth; even more significantly, by comparison with France, the crisis has had a negative impact on employment. Since mid-2005, however, the construction industry has been recovering. On average, it is making a positive-albeit modest-contribution to growth and is creating jobs again. By contrast, the French construction sector has benefited from a vibrant real-estate market throughout the 2002-2006 period.

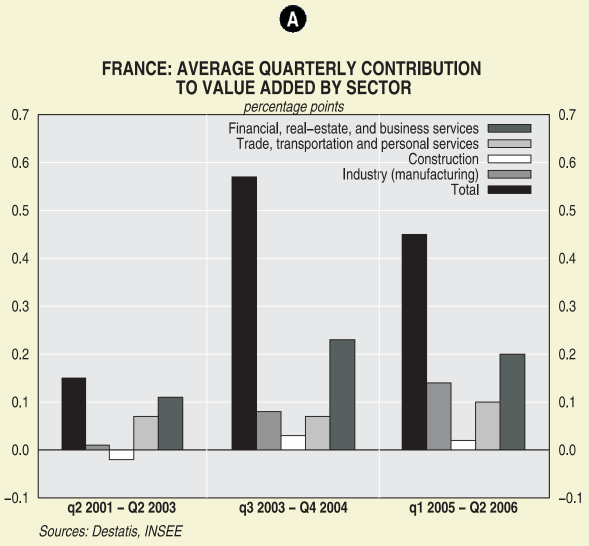
Wholesale/retail trade, transportation, and personal services

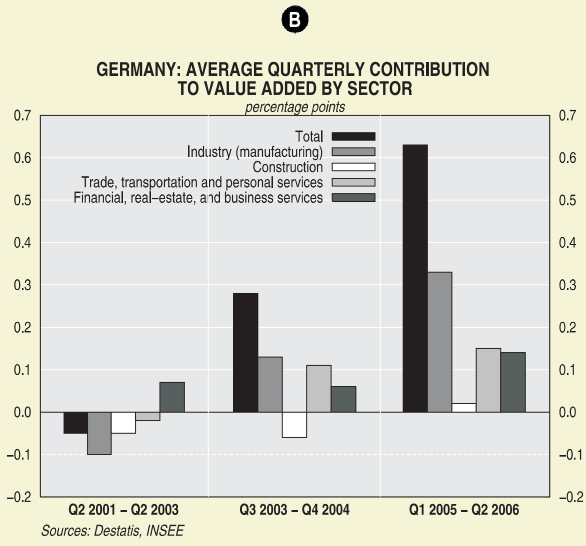
After diverging in the early 2000s, wholesale/retail trade, transportation, and personal services have displayed similar growth patterns in France and Germany in the recent period. Indeed, these sectors account for most of the difference between French and German employment dynamics in the years 2001-2003.

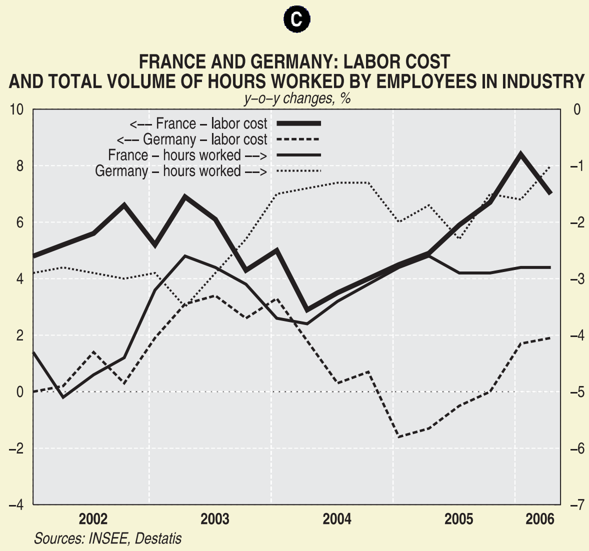
Financial, real-estate, and business services

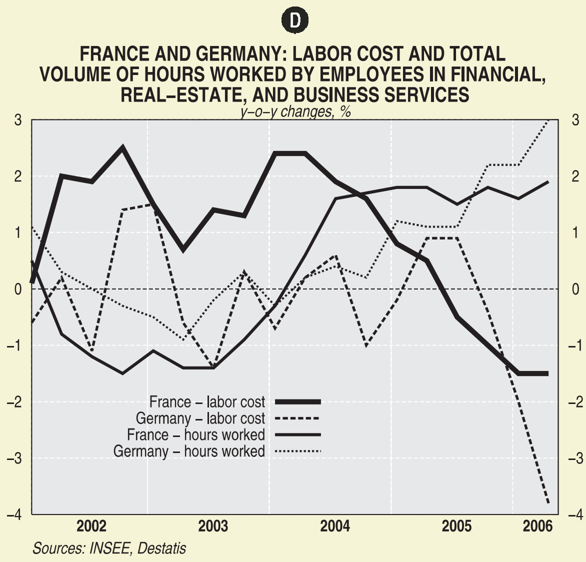
The contribution of financial, real-estate, and business services to value-added growth in France exhibits a distinctive feature: it has remained relatively constant and high in the past four years, insensitive to economic slowdowns. In Germany, by contrast, their contribution has been modest, for two reasons. First, their share of total value added is smaller, at 29% versus 35% in France. Second, their growth is less robust and far more cyclical than in France. Over the entire period studied, financial, real-estate, and business services have performed far less vigorously in Germany than in France. As in the industrial sector, German wage restraint has generated a sizable labor-cost differential since 2001 *(Chart D)*. However, the gains in value added or employment have not yet enabled the German sector to catch up, in growth terms, with its French counterpart, which has also been squeezing labor costs for the past two years in order to stay competitive. But the German banks' structural adjustment requirements-a factor sometimes emphasized by analysts-may help to explain the sector's limp growth. ■

1. Labor costs studied here are unit wage costs deflated by the change in value-added prices.


A
FRANCE: AVERAGE QUARTERLY CONTRIBUTION
TO VALUE ADDED BY SECTOR
percentage points
Financial, real–estate, and business services
Trade, transportation and personal services
Construction
Industry (manufacturing)
Total
q2 2001 – Q2 2003
q3 2003 – Q4 2004
q1 2005 – Q2 2006
Sources: Destatis, INSEE


B
GERMANY: AVERAGE QUARTERLY CONTRIBUTION
TO VALUE ADDED BY SECTOR
percentage points
Total
Industry (manufacturing)
Construction
Trade, transportation and personal services
Financial, real–estate, and business services
Q2 2001 – Q2 2003
Q3 2003 – Q4 2004
Q1 2005 – Q2 2006
Sources: Destatis, INSEE


C
FRANCE AND GERMANY: LABOR COST
AND TOTAL VOLUME OF HOURS WORKED BY EMPLOYEES IN INDUSTRY
y–o–y changes, %
<— France – labor cost
<— Germany – labor cost
France – hours worked —>
Germany – hours worked —>
2002
2003
2004
2005
2006
Sources: INSEE, Destatis


D
FRANCE AND GERMANY: LABOR COST AND TOTAL
VOLUME OF HOURS WORKED BY EMPLOYEES IN FINANCIAL,
REAL–ESTATE, AND BUSINESS SERVICES
y–o–y changes, %
France – labor cost
Germany – labor cost
France – hours worked
Germany – hours worked
2002
2003
2004
2005
2006
Sources: INSEE, Destatis

Consumer prices in the euro zone

After rising to 2.5% in June 2006, mainly owing to higher oil prices, overall euro-zone inflation declined to 1.8% in November with the easing of energy prices. In the euro zone, overall-inflation differentials remained fairly stable throughout 2006, but energy indices in the zone's countries responded differently to oil-price rises. Other inflation components remained broadly stable, except for a mid-year spike in food prices.

In Q1 2007, the impact of the German VAT increase (3 points for the standard rate) is projected to add 0.3 points to the rise in the overall euro-zone index and 0.4 points to the rise in the zone's core-inflation index, which, unlike the French index, is not tax-adjusted. "Core" inflation[1] should thus reach 2.0% in June 2007, up from 1.5% in October 2006. Assuming a stabilized price for Brent crude of $60/barrel and an exchange rate of $1.30 per euro, the year-on-year change in energy prices should decrease, then turn negative, in H1 2007. This would drive down overall inflation and offset the German VAT effect. Under this scenario, euro-zone inflation would ease to 1.6% by the end of H1 2007.

Overall euro-zone inflation forecast to ease from 2.0% to 1.6% in H1 2007, assuming Brent oil at $60 a barrel

With a year-on-year change slipping from 11.0% in June 2006 to a negative 0.5% in October, energy prices drove down the overall euro-zone index from 2.5% to 1.6% in the same period *(Chart 1)*. Oil prices climbed to historically high levels in the summer, with Brent topping $75/barrel *(see "Pétrole et matières premières" [Oil and commodities] chapter, available in French version only)* before easing to about $60 in recent months. This major contribution to the inflation drop was only mildly offset by a rise in food prices in late summer: year-on-year changes in industrial-product prices excluding energy and service prices remained relatively stable.

In early 2007, the German VAT increase is expected to push overall inflation to 2.1%. The effect should be more visible in core inflation, which—unlike the French index—is not tax-adjusted *(see below and Chart 2)*. The gradual decline in year-on-year growth of energy prices, assuming an oil price of $60/barrel and an exchange rate of $1.30 per euro, should send the overall index to 1.6% by the end of H1. Under this scenario, energy prices will gradually return to levels below those of 2006, with a year-on-year change of 1.5% in March weakening to a negative 2.4% by June 2007 *(Table 1)*. Food prices are unlikely to contribute significantly to the variation in the overall index. In the wake of their sharp rise this year, they should register a mild fall in their year-on-year change at end-2006 and in H1 2007. Their year-on-year change should thus ease from 3.0% in October 2006 to 2.2% in June 2007. This slowdown, however, would have been steeper without the effect of the German VAT increase, as producers can pass on in their selling prices the fall in energy prices that they have factored into their costs.

1. Measured as the EU Harmonised Index of Consumer Prices (HICP) excluding food, alcohol, tobacco, and energy.

TABLE 1: EURO-ZONE INFLATION

(% changes)

Sectors (weight in the 2006 index)	Year on year changes at end							Annual average		
	June 2005	Dec. 2005	June 2006	Oct. 2006	Dec. 2006	March 2007	June 2007	2004	2005	2006
Total (100.0%)	**2.1**	**2.2**	**2.5**	**1.6**	**2.0**	**2.1**	**1.6**	**2.1**	**2.2**	**2.2**
Food (incl. beverage and tobacco) (19.3%)	**1.1**	**1.7**	**2.2**	**3.0**	**2.5**	**2.3**	**2.2**	**2.3**	**1.6**	**2.3**
of which Food (15.3%)	*0.4*	*1.4*	*2.0*	*3.0*	*2.3*	*2.0*	*1.8*	*1.0*	*0.7*	*2.2*
Alcoholic beverages and tobacco (4.0%)	*3.9*	*2.7*	*2.8*	*2.9*	*3.2*	*3.5*	*3.6*	*7.5*	*4.9*	*2.7*
Energy (9.2%)	**9.4**	**11.2**	**11.0**	**-0.5**	**4.1**	**1.5**	**-2.4**	**4.5**	**10.1**	**7.9**
Core inflation (71.5%)	**1.4**	**1.4**	**1.5**	**1.5**	**1.5**	**2.1**	**2.0**	**1.8**	**1.4**	**1.4**
of which: Manufactured products (30.7%)	*0.2*	*0.4*	*0.7*	*0.8*	*0.2*	*1.0*	*0.6*	*0.8*	*0.3*	*0.6*
Services (40.8%)	*2.2*	*2.1*	*2.0*	*2.1*	*2.5*	*3.0*	*3.1*	*2.6*	*2.3*	*2.1*

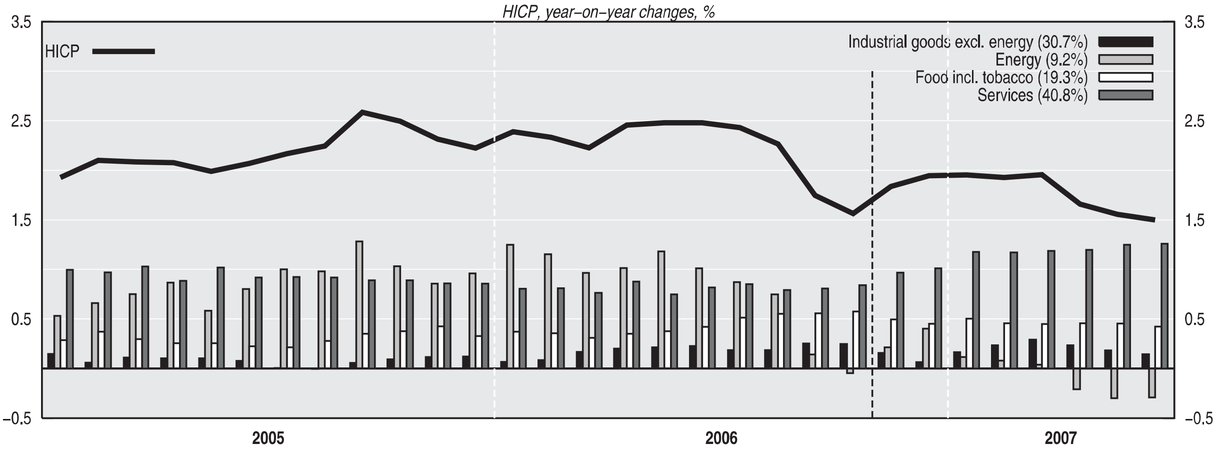
Forecast (shaded: Dec. 2006, March 2007, June 2007, 2006)
Source: Eurostat

Consumer prices in the euro zone

1

BREAKDOWN OF EURO-ZONE INFLATION: CONTRIBUTIONS OF MAIN ITEMS

HICP, year-on-year changes, %



Forecasts to right of dotted line

The Germany VAT increase should trigger a jump in core inflation, which is forecast to reach 2% in June 2007

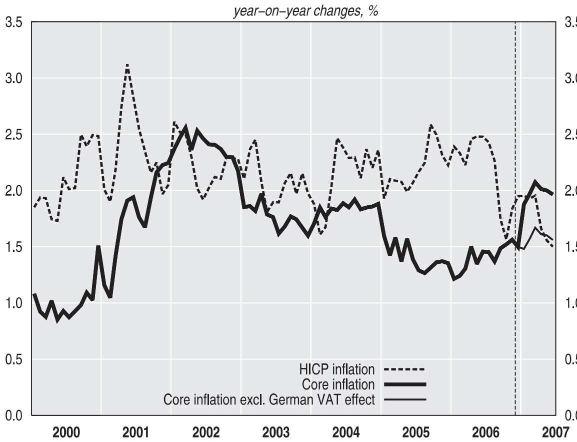
On January 1, 2007, Germany will be raising its standard VAT rate from 16% to 19%. The reduced rate will stay unchanged at 7%. Assuming that two-thirds of the increase will be passed on in selling prices—the final third being absorbed in profit margins—and bearing in mind that goods taxed at the standard rate account for just over one-half of the German HICP, the impact on Germany's overall index is estimated at about one percentage point. Most of the rise should occur in January. The German VAT increase should therefore entail an increase of about 0.3 points in the euro-zone HICP and 0.4 points in the core index *(Chart 2)*. With regard to the core-index components, the impact on prices of manufactured products and services should be comparable.

Excluding this effect, manufactured-product prices should gradually ease during the forecasting period. The spread of softer energy prices and the impact of the euro's recent gains against the dollar ought to lower the costs of imported products and firms' intermediate consumption. By contrast, inflation in service prices appears to be on a mild uptrend, driven by the effects of past increases in euro-zone GDP growth and by the falling unemployment rate.

2

EURO-ZONE HICP INFLATION AND CORE INFLATION

year-on-year changes, %



Forecasts to right of dotted line

TABLE 2: EURO-ZONE INFLATION BY COUNTRIES

(HICP, year on year changes, %)

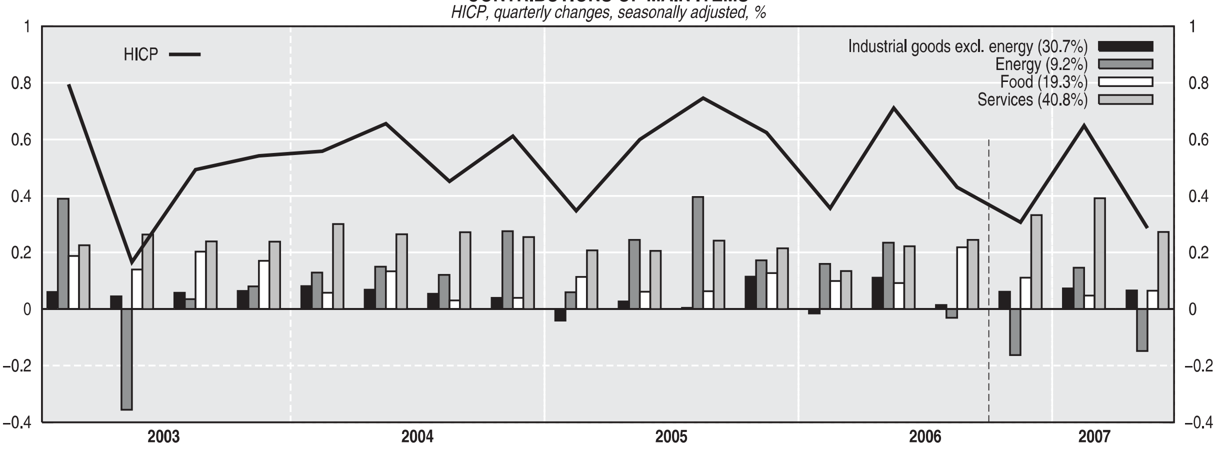
	HICP		Core inflation		Energy	
	October 2005	October 2006	October 2005	October 2006	October 2005	October 2006*
Austria	2.0	1.2	1.0	1.4	12.0	-1.9 (-0.2)
Belgium	2.2	1.7	1.5	1.4	12.1	-0.2 (0.0)
Finland	0.8	0.9	0.1	1.2	8.9	-4.5 (-0.4)
France	2.0	1.2	1.3	1.5	11.6	-1.7 (-0.1)
Germany	2.3	1.1	0.7	0.8	12.6	-0.2 (0.0)
Greece	3.7	3.1	2.9	2.7	13.6	-0.6 (-0.1)
Ireland	2.6	2.2	1.7	2.9	20.0	-2.1 (-0.2)
Italy	2.6	1.9	1.8	1.8	12.3	1.5 (0.1)
Luxembourg	5.0	0.6	1.7	2.0	23.9	-9.6 (-0.8)
Netherlands	1.8	1.3	0.6	1.1	12.5	2.2 (0.1)
Portugal	2.6	2.6	2.0	2.5	13.2	-0.9 (-0.1)
Spain	3.5	2.6	2.6	2.7	11.3	-1.9 (-0.2)
Euro zone	**2.4**	**1.6**	**1.4**	**1.2**	**8.9**	**-0.5** (0.0)

* In last column, energy-component contribution to overall inflation shown in parentheses.
Sources: Eurostat, INSEE computations

3

BREAKDOWN OF EURO-ZONE INFLATION: CONTRIBUTIONS OF MAIN ITEMS

HICP, quarterly changes, seasonally adjusted, %



Forecasts to right of dotted line

Differentials in overall inflation between euro-zone countries remain stable but energy-price patterns vary from one country to another

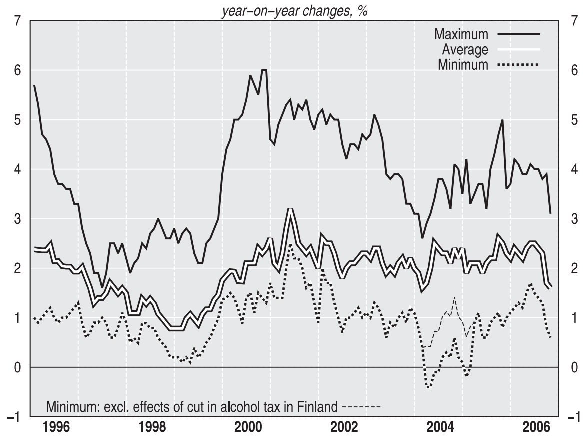
Between June and October 2006, the differential between the highest and lowest inflation rates in the euro zone remained stable at around 2.5 points *(Chart 4)*. It had been higher a year earlier when oil prices were rising. This reflects the fact that the reaction of individual countries' energy components to Brent-price fluctuations can be either sharp, as in Ireland and Luxembourg, or relatively mild, as in the Netherlands and Italy *(Table 2)*. Moreover, core-inflation differentials have narrowed from 2.8 points in October 2005 to 2.3 points in June 2006 and 1.9 points in October 2006. At present, core inflation is weakest in Germany, but is running high in the Mediterranean countries.

The inflation differential between the French and euro-zone Harmonised Indices of Consumer Prices (HICPs) widened to 0.3 points in France's favor in October. The gap will inevitably grow when Germany raises VAT, and will then stabilize. ■

4

EURO-ZONE INFLATION

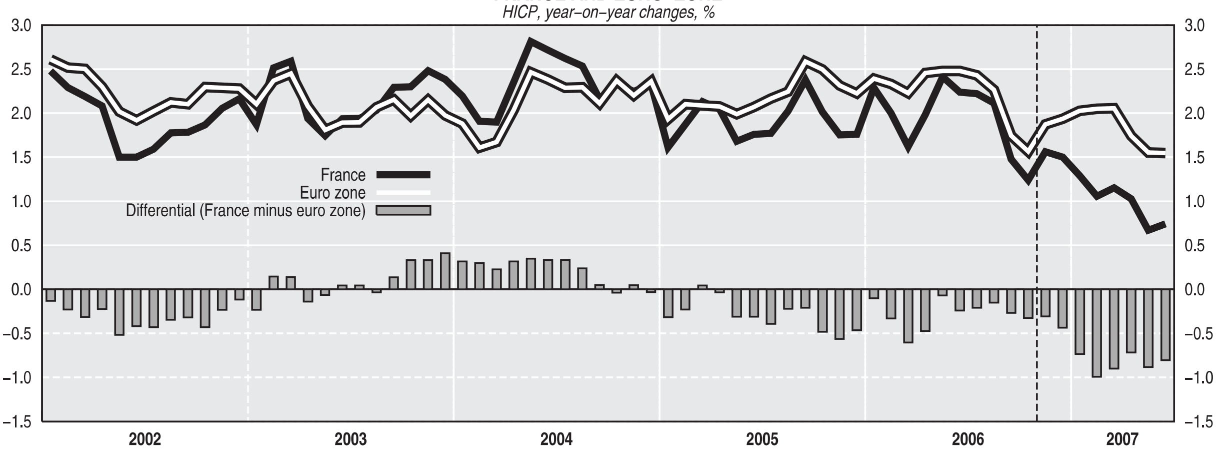
year-on-year changes, %



5

HARMONISED INDEX OF CONSUMER PRICES FRANCE AND EURO-ZONE

HICP, year-on-year changes, %



Forecasts to right of dotted line