The euro zone's international environment

The euro zone's international environment is likely to be less supportive during H1 2005 than at the end of 2004. In the case of the United States, growth is expected to remain at annual rates close to 3.5% (see Table 1), thanks to a fresh acceleration in employment, but imports would be less lively as a result of the slowdown in domestic demand that began at the end of 2004. In the United Kingdom, economic activity is likely to show a slight slowdown, as a result of weaker domestic demand than in the past. In Japan, activity is likely to remain slack in H1 2005, handicapped by a depressed labour market and less dynamic exports.

Overall, demand in the euro zone's export markets is likely in the early part of 2005 to continue the tendency to weaken that was first seen in mid-2004.

In the United States, GDP growth is likely to be maintained during H1 2005 at annual rates close to 3.5%, but imports are expected to be less dynamic

Employment has apparently accelerated in the early part of 2005, with job creations approaching 300,000 per month, equivalent to quarterly growth of 0.7%. Unemployment benefit claims, which are a coincident indicator of employment, have in fact fallen markedly since February. The Conference Board's surveys of households are also showing that it is now less difficult to find a job *(see graph 1)*. This further acceleration in employment should enable consumption to remain brisk during the first two quarters of the year, with creations then returning in Q2 to around 150,000 per month.

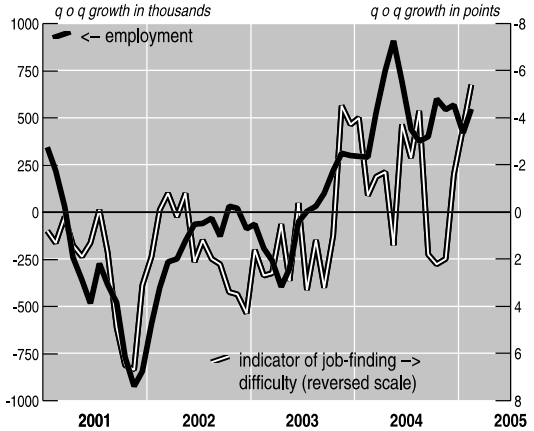
The main support for consumption is likely to come from wage growth in the first two quarters of 2005. Fiscal policy will probably be neutral, with the budget for FY 2005 (already voted) providing for the maintenance of the tax cuts granted to households in 2001 and 2003 and with the fiscal stimulus now a thing of the past. As for monetary conditions, these are likely to continue to tighten, in line with the gradual raising of the Fed Funds rate *(see note on «Financement de l'économie», available in the French version only)*. Inflationary pressures cannot in fact be ruled out in 2005 because of the continuing high oil price and an expected slowdown in productivity *(see box)*.

Households are unlikely in 2005 to benefit from dividends as large as those paid out in Q4 2004, which were inflated by the Microsoft payout of $3 per share. Exceptional dividends of this kind (amounting to 32 $ billion, or roughly 3 percentage points of quarterly disposable income) are likely to have given a one-off boost to consumption at the end of 2004, relaxing the liquidity constraints felt by certain households. However, a large proportion is likely to have been saved, so that the impact on consumption in 2005 could well be small. Meanwhile, the oil price is continuing to make inroads into household purchasing power. However, with the Brent price expected to be maintained at around $40/barrel in mid-2005, the impact of the rise from $30 to $40 seen during 2004 should remain limited. According to the IMF model, the result would be to raise prices by around 0.2 of a point per quarter and reduce consumption growth by around 0.1 of a point per quarter [(1)].

At the same time, household investment is expected to stagnate in Q2 2005, thanks partly to the tightening of monetary conditions. Its growth in Q1 2005 would be only temporary and result from the slight decline in mortgage rates seen at the end of 2004.

1

UNITED STATES: EMPLOYMENT AND INDICATOR OF JOB-FINDING DIFFICULTY



sources : BLS, Conference Board

(1) According to the IMF model, an immediate and lasting rise of 30% in the oil price, for example from $30 to $40/barrel, would mean an increase in prices of 1.2 of a point and a reduction in domestic demand (and GDP) of 0.5 of a point after one year.

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

	Quarterly % change								Annual % change		
	2003		2004				2005		2003	2004	2005 (c.o)
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2			
UNITED STATES (37.2%)[1]											
GDP	**1.8**	**1.0**	**1.1**	**0.8**	**1.0**	**0.9**	**0.8**	**0.9**	**3.0**	**4.4**	**2.9**
Consumption	1.2	0.9	1.0	0.4	1.3	1.0	0.7	1.0	3.3	3.8	3.0
Private investment [2]	4.3	2.6	1.2	3.5	2.3	2.6	1.8	1.1	5.1	10.7	6.6
Nonresidential investment	*3.7*	*2.6*	*1.0*	*3.0*	*3.1*	*3.3*	*2.0*	*1.5*	*3.3*	*10.6*	*7.9*
Residential investment	*5.2*	*2.3*	*1.2*	*3.9*	*0.4*	*0.5*	*1.0*	*0.0*	*8.8*	*9.6*	*2.5*
Government expenditures [3]	0.0	0.4	0.6	0.6	0.2	0.3	0.6	0.5	2.8	2.0	1.5
Exports	2.7	4.1	1.8	1.8	1.5	0.6	2.5	1.0	1.9	8.5	4.8
Imports	0.7	4.0	2.6	3.0	1.1	2.7	1.5	1.0	4.4	9.9	5.6
Contributions:											
Domestic demand excluding stocks	*1.5*	*1.1*	*1.0*	*0.9*	*1.3*	*1.1*	*0.9*	*1.0*	*3.5*	*4.5*	*3.3*
Change in private inventories	*0.1*	*0.1*	*0.3*	*0.2*	*-0.2*	*0.1*	*-0.1*	*0.0*	*-0.1*	*0.4*	*-0.1*
Net exports	*0.2*	*-0.2*	*-0.2*	*-0.3*	*0.0*	*-0.4*	*0.0*	*-0.1*	*-0.4*	*-0.6*	*-0.4*
UNITED KINGDOM (5.6%)[1]											
GDP	**0.9**	**1.0**	**0.6**	**1.0**	**0.5**	**0.7**	**0.4**	**0.5**	**2.2**	**3.1**	**1.8**
Consumption	1.0	0.5	1.1	0.7	0.6	0.4	0.4	0.6	2.3	3.1	1.6
Total investment	0.5	1.7	1.8	1.8	0.9	1.4	0.9	0.7	2.2	5.9	3.3
Enterprise investment	*0.0*	*1.5*	*1.8*	*1.1*	*1.3*	*0.7*	*1.0*	*0.7*	*-1.2*	*5.4*	*3.0*
Household investment [4]	*-0.7*	*1.6*	*2.6*	*3.6*	*0.4*	*-1.0*	*-1.0*	*0.0*	*4.0*	*6.1*	*-0.6*
Public investment [4]	*7.6*	*3.1*	*0.1*	*1.7*	*-0.2*	*9.7*	*4.0*	*2.0*	*24.1*	*8.9*	*13.1*
Public consumption [5]	1.4	1.9	0.8	0.7	1.2	0.8	0.5	0.5	3.4	4.5	2.3
Exports	-0.1	3.0	-1.6	2.1	1.2	1.9	1.0	0.5	0.9	3.7	3.9
Imports	1.6	3.0	0.2	1.4	1.9	2.0	1.0	0.8	1.8	5.1	4.4
Contributions:											
Domestic demand excluding stocks[4]	*1.0*	*1.1*	*1.2*	*0.9*	*0.8*	*0.7*	*0.5*	*0.6*	*2.6*	*4.0*	*2.1*
Change in private inventories	*0.4*	*0.1*	*-0.2*	*0.0*	*0.0*	*0.1*	*-0.1*	*0.0*	*0.0*	*-0.2*	*0.0*
Net exports	*-0.5*	*-0.1*	*-0.5*	*0.1*	*-0.3*	*-0.1*	*0.0*	*-0.1*	*-0.3*	*-0.9*	*-0.3*
JAPAN (14.8%)[1]											
GDP	**0.4**	**1.4**	**1.5**	**-0.3**	**-0.3**	**0.1**	**0.3**	**0.2**	**1.4**	**2.6**	**0.4**
Consumption	0.1	1.1	0.7	0.1	-0.2	-0.3	0.2	0.0	0.2	1.5	-0.1
Total investment	-0.4	2.6	0.4	-1.4	-0.3	0.1	0.1	0.2	1.1	1.5	-0.2
Private investment	*0.3*	*4.4*	*-1.8*	*3.2*	*0.1*	*0.2*	*0.1*	*0.2*	*5.1*	*5.0*	*1.2*
Nonresidential investment	*-0.1*	*5.7*	*-2.3*	*3.7*	*-0.1*	*0.1*	*0.0*	*0.2*	*6.6*	*5.7*	*1.0*
Residential investment	*2.2*	*-1.0*	*0.4*	*1.1*	*0.8*	*0.9*	*0.5*	*0.5*	*-1.1*	*2.2*	*2.2*
Public investment	*-3.0*	*-3.6*	*8.7*	*-16.9*	*-1.9*	*-0.4*	*0.0*	*0.0*	*-10.6*	*-10.8*	*-6.1*
Public consumption	0.9	0.2	1.2	0.8	0.3	0.8	0.8	0.8	1.2	2.7	2.8
Exports	3.4	5.2	4.7	3.5	0.6	1.2	1.3	1.0	9.1	14.4	4.6
Imports	2.2	2.1	3.3	2.0	2.2	2.4	1.5	1.0	3.8	8.9	6.0
Contributions:											
Domestic demand excluding stocks	*0.1*	*1.3*	*0.7*	*-0.2*	*-0.1*	*0.0*	*0.3*	*0.2*	*0.6*	*1.7*	*0.3*
Change in private inventories	*0.2*	*-0.3*	*0.6*	*-0.4*	*-0.1*	*0.2*	*0.0*	*0.0*	*0.2*	*0.2*	*0.0*
Net exports	*0.2*	*0.4*	*0.3*	*0.2*	*-0.1*	*-0.1*	*0.0*	*0.0*	*0.6*	*0.8*	*0.0*

Forecast
(1) Country's share of OECD GDP (1995 PPP. 2003 volume)
(2) Investment of firms and households
(3) Government consumption and investment
(4) Items on which there is no information in the provisional accounts

Firms, meanwhile, are likely to reduce the pace of their investment in 2005. The expiry at the end of 2004 of the tax relief on depreciation of corporate capital will probably lead to a slowdown in investment in Q1 2005. Also, the prospects seen by firms have been less favourable for several months now, with the ISM industrial confidence index showing a significant decline since mid-2004. Finally, with monetary policy becoming less accommodating, borrowing conditions are set to harden progressively.

American exports are likely to be dynamic at the beginning of 2005 because of the depreciation of the dollar towards the end of 2004. The United States is tending to benefit from the price-competitiveness gains generated by the depreciation of the dollar in the past six months, as shown by the export outlook reported in the ISM index for December, January and February. Imports, meanwhile, are expected to post a slowdown in H1, in line with that of domestic demand, especially consumption, that began at the end of 2004.

All in all, GDP growth in the first two quarters of 2005 is likely to be close to 3.5% at annualised rate. There are two main unknown factors in this scenario. The first, positive in nature, is the possibility that job creation may remain at 300,000 a month in the second quarter, as happened on several occasions in the late 1990s. The second, this time negative, is the possibility of higher inflation, as a result either of a lasting Brent price of around $50/barrel or of a further slide in the dollar versus the currencies of the United States' trading partners. Quite apart from the direct impact on household purchasing power, too great a surge in inflation could also oblige the Fed to make larger hikes in its leading rates and hence generate a substantial tightening of the financial conditions.

In the United Kingdom, economic activity is unlikely to accelerate in coming quarters, with private consumption no longer underpinned by a dynamic housing market

The rise in interest rates and the loss of confidence in the housing market mean that household consumption is likely to be less firm in 2005 than in 2004. With most existing mortgages at floating rates and given their substantial recourse to mortgage refinancing, UK households would be doubly affected by the rise in interest rates and the slowdown in house prices. The tightening of the Bank of England's monetary stance between November 2003 and August 2004, amounting to more than 100 basis points, can be expected to have provoked a substantial increase in the household debt burden and to have been at the origin of the gradual downturn in the housing market. It has to be remembered that UK households tend to secure much of their consumer credit on the value of their property. The decline in house prices that began in October 2004 could therefore have a negative impact on their spending. In fact, consumption growth in Q4 2004 came out at 0.4%, compared with 0.6% in Q3. However, since December according to the Halifax index and since January according to the Nationwide index, house prices have temporarily ceased to fall. Moreover, the labour market remains very tight and wage growth is continuing. The unemployment rate in January stood at its lowest level since June 1975 (2.6%). The saving ratio and nominal disposable income both rose throughout 2004. On the assumption that house prices stabilise or fall gradually, household consumption would pick up slightly in the next few quarters, while maintaining growth rates smaller than in 2004 — of the order of 0.4% in Q1 2005, followed by 0.6% in Q2.

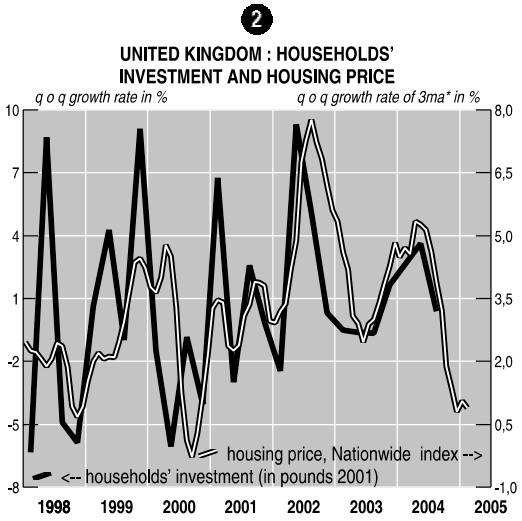
Household investment, meanwhile, is likely to have weakened further around the turn of the year, before stabilising in mid-2005. The number of housing transactions has slowed down considerably since mid-2004, following the rise in interest rates, notably mortgage rates. Household investment would be hit by the slowdown in house prices since Q2 2004

TABLE 2 : HOUSEHOLDS' INCOME

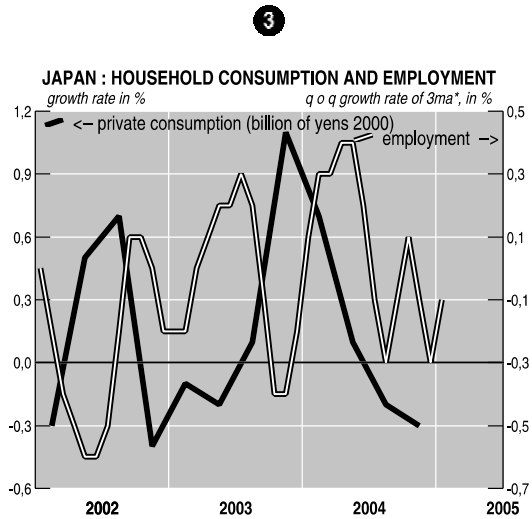
(in %)

	Annual changes		
	2002	2003	2004 (carry over) (*)
United-States			
Non-farm dependent employment	-1.1	-0.3	1.1
Average wage per head	2.7	3.3	3.9
Nominal gross disposable income	4.1	4.6	4.2
Private consumption deflator	1.4	1.9	2.2
Saving ratio	1.8	2.0	1.4
United Kingdom			
Dependent employment	0.4	0.4	0.4
Average wage per head	3.6	3.4	4.4
Nominal gross disposable income	3.0	4.4	4.2
Private consumption deflator	1.5	1.9	1.4
Saving ratio	5.3	5.7	5.5
Japan			
Total employment	-1.2	-0.2	0.2
Average wage per head	-2.8	-0.3	-0.7
Nominal gross disposable income (dependent household)	1.4	0.5	-
Private consumption deflator	-2.8	-0.3	-0.7
Saving ratio	6.1	6.3	-

(*) For the United States and Japan, this is not a carryover, as the data are available to end-2004.
For the United Kingdom, end-Q3 for employment, income and saving, end-Q4 for the rest.
Source : BEA, BLS, Central Statistical Office, Department of Employment, ONS, Direction de la prévision, Economic and Social Research Institute, Ministry of Public Management, Ministry of Labour



sources : National Statistics, National Building Society
*3ma = 3 months moving average



sources : Economic and social research institute, Ministry of Labor
*3ma = 3 months moving average

(see graph 2). In this climate of uncertainty regarding the evolution in the housing market and, as a result, in household consumption, the Bank of England is unlikely to raise interest rates in the short term. Moreover, in its latest Inflation Report, the Monetary Policy Committee predicts that inflation will not reach its target level of 2% before 2006. In January, it stabilised at 1.6%, year on year, its highest level in seven months.

The favourable outlook for production reported by industrial business leaders is likely to mean a slight acceleration in corporate investment in the first part of 2005. However, export order books are still not showing a satisfactory tendency, with UK industry having difficulty in remaining competitive because of movements in exchange rates. In addition, the upward drift in labour costs linked to wage inflation, combined with the relative slackness of household consumption, is likely to hold back corporate investment as of Q2. As regards fiscal policy, the government is likely to maintain a robust level of growth in public investment and keep tax policy neutral — at least until the general election expected in May.

United Kingdom exports, following strong growth of almost 2% in the last part of 2004, are expected to start to weaken in 2005, in line with overseas demand. Doubly handicapped by the appreciation of sterling against the dollar and by a slowdown in foreign demand — especially by the weaker growth in American imports — United Kingdom exports are likely to slow down in 2005. Given the levelling off in growth in domestic demand starting in 2005, UK imports are also expected to be less lively than in previous quarters.

All things considered, United Kingdom GDP growth is likely to slow down in 2005, being of the order of 0.4% in Q1 and 0.5% in Q2, compared with 0.6% in Q4 2004.

In Japan, economic activity is likely to be relatively slack in H1 2005 despite a small upturn in the first quarter

With a slowdown in domestic demand and a zero contribution from foreign trade, Japanese GDP growth is likely to be slow in H1 2005, reaching a quarterly rate of 0.2% in Q2 and having been only slightly faster in Q1 (0.3%, quarter on quarter) under the impact of a temporary upturn in household consumption and continuing restrained growth in exports.

Household consumption will probably remain lacklustre in H1 2005 because of the unsatisfactory outlook for growth in household incomes, which declined by 3% in Q4 2004 and by 0.4% the previous quarter. Tax policy is expected to remain neutral until the end of 2005 and would therefore have no effect on consumption. Tax rises are admittedly contained in the 2005 Finance Bill, but would only take effect in January 2006. Household consumption can be expected to pick up slightly in Q1 2005, under the impact of an increase in the average wage (by 2.2% in Q4 2004). It would then slow down in Q2 as a result of the deterioration in employment *(see graph 3)*. There would be a downward tendency in household investment starting in Q1 2005 as a result of the decline in household purchasing power seen towards the end of 2004.

Growth in corporate investment is likely to remain depressed in H1 2005, as a result of the slowdown in American imports as of Q1 2005 and the slackness of household consumption. However, this tendency would be moderated by an accommodating monetary stance and by the rise in Japanese companies' profits. According to the Tankan survey for Q4

2004, Japanese firms were expecting their profits to show a rise of 15.3% in 2004 (compared with 14.4% in 2003).

The contribution to Japanese growth from foreign trade remained substantially positive until Q2 2004. In the second half of the year, the appreciation of the yen versus the dollar and the weaker growth of American imports had a negative impact on Japanese export growth, although this remained fairly dynamic in Q1 2005 under the impact of the slight upturn in American imports recorded in Q4 2004. Even so, the expected slowdown in American imports as of Q1 2005, combined with the maintenance of a high JPY/USD exchange rate in the early part of 2005, can be expected to hold back exports in Q2.

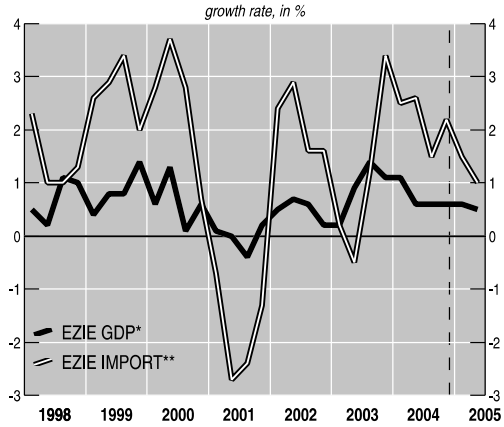
Demand in the euro zone's export markets is set to slow down during H1 2005

In the course of H1 2005, demand in the euro zone's export markets is likely to show a considerable slowdown compared with the latter part of 2004. Imports into the United States, the United Kingdom and Japan are likely to slow down because of less brisk domestic demand in each of the countries concerned *(see graph 4)*. It is mainly the slowdown in United States imports that would be at the origin of the decline in demand for euro-zone goods. ■

4

WORLD DEMAND FOR EURO-ZONE EXPORTS

growth rate, in %



sources : UK National Statistics, Bureau of economic analysis, Economic and social research institute *forecasts after the dotted line*

* GDP of the euro-zone's international environment: sum of GDP growth rates for the United States, the UK and Japan, weighted by the respective shares of OECD GDP.

** aggregate imports by the euro-zone's international environment: sum of import growth rates for the United States, the UK and Japan, weighted by the respective shares of OECD GDP.

IS THERE A RISK OF INFLATION IN THE UNITED STATES IN 2005?

In 2004, the rise in the oil price and the depreciation of the dollar versus the currencies of the United States' main trading partners raised fears of the emergence of excessive inflation. The year-on-year change in the consumption deflator rose from 1.6% at end-2003 to 2.4% at end-2004. Does this mean that we should expect inflation to be as strong, or even stronger, in 2005? Does the close link that exists between prices and wages, generally known as the wage-price loop, mean that the impact of past inflationary factors is likely to persist in 2005? Economic theory suggests that this is not the case. The acceleration in prices in 2004 seems in fact to have resulted from more rapid import price growth and, to a smaller extent, from higher capital productivity. Wages, on the other hand, do not seem to have contributed to the acceleration in inflation. This means that the disappearance of the factors contributing to the acceleration in import price growth in 2004 - in other words, on the assumption of stabilisation in the oil price and the dollar exchange rate - means that inflation in 2005 would not be fuelled by a wage-price loop. This box sets out the determinants of the acceleration in prices in 2004.

The determinants of inflation according to economic theory

Consumer prices depend on producer prices and import prices, since the goods consumed are either locally produced or imported. These prices are measured here, respectively, by the consumption deflator denoted by p_c, by the import deflator denoted by p_m and by the GDP deflator denoted by p. *All the magnitudes are expressed in logarithmic form. The relationship can then be written as:*

$$p_c = f(p, p_m) \qquad (1)$$

Producer prices, for their part, are determined by the various factors of production, in this case labour and capital, and by total factor productivity. The greater the increases in the cost of factors of production, the larger the amount by which firms raise their prices. Moreover, when total factor productivity increases, firms produce more with smaller quantities of the factors of production, leading them to reduce their prices. With the cost of labour denoted by w and that of capital by ρ and total factor productivity by a, this second relationship, commonly known as the «factor-price frontier» can be written as follows:

$$p = g(w, \rho, a)$$

The «factor-price frontier» is generally difficult to estimate directly because of inaccurate measurement of the cost of capital. One solution to this problem consists of making use of the fact that firms bring capital productivity (y-k) into equality with its real cost. It is then possible to estimate a relationship of the following type:

$$p = h(w, y - k, a) \qquad (2)$$

Finally, by combining equations (1) and (2), a relationship is obtained between consumer prices, the cost of labour, capital productivity, total factor productivity and import prices:

$$p_c = i(w, y - k, a, p_m) \qquad (3)$$

Wage movements do not explain the acceleration in prices in 2004

Equations (1) and (2) were estimated for the United States for the periods 1980-2002 and 1985-2002. Relationship (3) was then deduced. *Graph A* shows the observed evolution in the consumption deflator, the evolution simulated by the model and the econometric contributions of the different variables. The acceleration in prices between 2003 and 2004 is mainly the result of the evolution in import prices and, to a smaller extent, that of capital productivity. The acceleration in import prices is, as might be expected, closely related to the depreciation of the dollar and the rise in the oil price. As for capital productivity, this reflects a rise in the capital utilisation ratio and the emergence of pressures on the productive system — the fact that more output is being produced from the same amount of capital means that the capital is being used more intensively. On the other hand, the contribution of the cost of labour is seen to be relatively stable between 2003 and 2004.

Wage pressures do not seem to have been particularly strong in 2004

Economic theory generally links the evolution in the cost of labour to that of consumer prices and the level of unemployment, denoted here by *u*. This relationship can then be interpreted as follows: in the course of wage bargaining, workers have a minimum objective of maintaining their purchasing power; at the same time, their negotiating power depends on the level of unemployment:

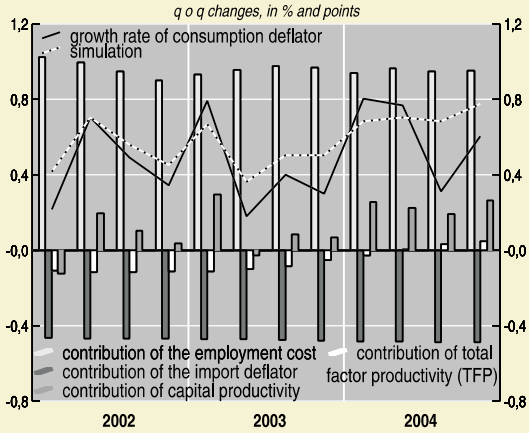
$$\Delta w = j(\Delta p_c, u) \qquad (4)$$

This relationship was estimated for the United States over the period 1990-2002. *Graph B* shows that the contribution of prices to the evolution in the cost of labour admittedly increased in 2004, but the result was nevertheless a modest increase in wages, of the order of 4% at annual rate. With inflation at this level, the growth in the real cost of labour is around 2% (4% - 2%), roughly equivalent to the potential growth rate in labour productivity. ■

A

UNITED STATES: THE CONSUMPTION DEFLATOR AND ITS DETERMINANTS

q o q changes, in % and points

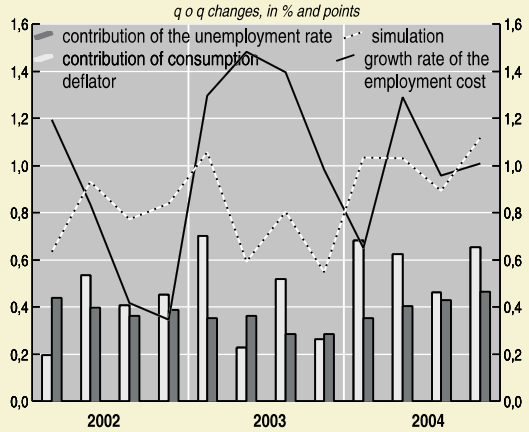


sources : BEA, BLS, Insee

B

UNITED STATES: THE COST OF LABOUR AND ITS DETERMINANTS

q o q changes, in % and points



sources : BEA, BLS, Insee

The economic situation in the euro zone

In 2004, euro-zone GDP rose at an average rate of 1.8%, following two years of virtual stagnation. After a first half-year of vigorous activity, driven by the external sector, the European economy ran out of steam in the second half and the slowdown in exports held back activity in industry, with slack domestic demand failing to take up the running from external trade. As a consequence, growth in the zone has remained highly dependent on that of partner countries. The growth motors have differed substantially from country to country: domestic demand in France and Spain and exports in Germany, with Italy in an intermediate situation. Q4 2004 saw growth in the zone's GDP reach a new low (+ 0.2%) as the result of the contraction in activity in Germany and Italy (see graph 1).

In the early part of 2005, with the help of tax policies bolstering household income and at a time when productive investment is showing signs of picking up, growth is expected to move up again to 0.4% in Q1 and 0.3% in Q2. Foreign trade should no longer be holding back growth, but domestic demand is likely to remain too fragile to breathe new life into the recovery.

Foreign trade no longer holding back growth in 2005

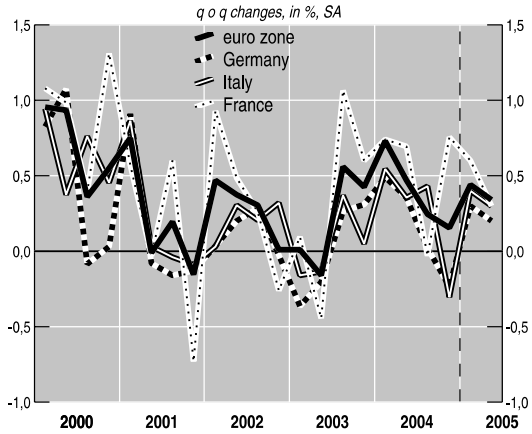
In H2 2004, exports to countries outside the zone slowed down, under the dual handicap of the slowdown in world trade and the steep appreciation of the euro, which rose by 10% versus the dollar during 2004. In addition, in Q4 the slackness of activity in the euro zone limited trade among European partners *(see graph 2)*. This tendency can be seen in the weakness of industrial output excluding construction (+0.9%, year on year, in Q4 compared with +2.6% in Q3 - *see graph 3*). Production in Italy even showed a decline of 2.1% in Q4. Export growth was in fact halved towards the end of last year, with the rise in Q4 compared with six months earlier only 1.8%, as against 4.2% in Q2.

Export growth should be firm in the early part of 2005. Business leaders are still reporting well-filled export order books *(see graph 4)*. In the case of Germany and Italy, export orders for manufacturing industry have risen sharply (quarterly rises of 5.2% for Germany in January and 22.9% for Italy in December), pointing to strong exports in Q1. In Q2, on the assumption of a stable exchange rate of $1.30 to the euro, exports should remain dynamic, albeit slowing down slightly because of the expected reduction in the momentum of activity in the zone's trading partners (notably the United States and the United Kingdom).

1

GDP GROWTH IN THE EURO-ZONE COUNTRIES

q o q changes, in %, SA



sources : Destatis, Eurostat, Istat, Insee

forecasts after the dotted line

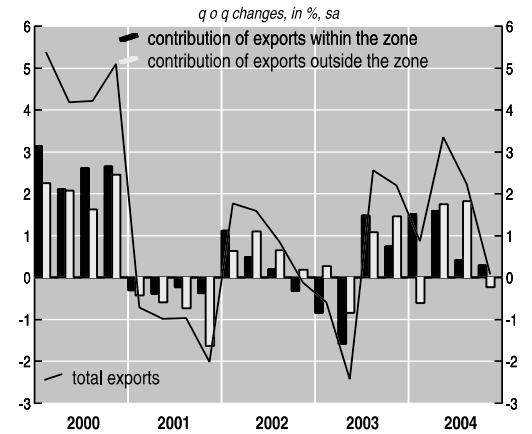
This means that after slowing down considerably to 0.5% in Q4 2004 export growth in 2005 should be around 1.0% per quarter and foreign trade would no longer hold back growth.

Germany is likely to continue to stand out by reason of the strength of exports. This is because it is better placed to take advantage of the vitality of world

2

CONTRIBUTIONS OF EXPORTS TO OUTSIDE THE ZONE AND WITHIN THE ZONE TO GROWTH IN TOTAL EURO-ZONE MERCHANDISE EXPORTS

q o q changes, in %, sa



source : Eurostat

GDP IN THE EURO ZONE AND IN THE PRINCIPAL MEMBER COUNTRIES

(% change)

	Quarterly changes										Annual changes		
	2003				2004				2005		2003	2004	2005 c.o
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2			
GERMANY (29.4%)[1]													
GDP	**-0.4**	**-0.2**	**0.3**	**0.3**	**0.5**	**0.4**	**0.0**	**-0.2**	**0.3**	**0.2**	**-0.1**	**1.0**	**0.3**
Household consumption	0.1	-0.1	-0.3	-0.6	0.1	-0.4	0.1	0.2	0.2	0.2	0.0	-0.8	0.5
Total GFCF	-0.6	-0.6	-0.2	1.2	-3.1	-0.1	0.7	0.2	0.9	0.5	-2.2	-2.2	1.7
Public consumption	-1.5	0.7	0.1	0.0	0.0	0.1	0.6	-0.7	0.0	0.0	0.1	0.4	-0.2
Exports	-0.9	-2.8	3.8	0.7	3.6	3.4	-1.5	1.1	1.5	1.2	1.8	7.5	3.3
Imports	2.0	-2.5	1.0	2.6	0.5	2.1	2.9	-0.2	1.5	1.2	3.9	5.4	4.3
Contributions :													
Domestic demand ex. stocks	*-0.3*	*-0.1*	*-0.2*	*-0.1*	*-0.6*	*-0.3*	*0.3*	*0.0*	*0.3*	*0.2*	*-0.4*	*-0.8*	*-0.6*
Inventory change	*0.9*	*0.1*	*-0.6*	*1.0*	*-0.2*	*0.0*	*1.3*	*-0.8*	*-0.1*	*-0.1*	*0.9*	*0.8*	*0.0*
Foreign trade	*-1.0*	*-0.2*	*1.1*	*-0.6*	*1.2*	*0.6*	*-1.6*	*0.5*	*0.1*	*0.1*	*-0.6*	*1.0*	*0.2*
FRANCE (21.3%)[1]													
GDP	**0.1**	**-0.4**	**1.1**	**0.6**	**0.7**	**0.7**	**0.0**	**0.8**	**0.6**	**0.3**	**0.5**	**2.3**	**1.6**
Household consumption	0.6	-0.3	1.0	0.3	1.1	0.4	-0.2	1.2	0.8	0.3	1.6	2.2	2.0
Total GFCF	0.0	0.2	1.2	1.5	0.5	1.5	-0.5	0.9	1.0	0.6	0.2	3.3	2.3
Public consumption	0.2	0.3	0.9	0.9	0.5	0.8	0.2	0.6	0.7	0.6	2.5	2.6	1.9
Exports	-2.2	-1.4	0.9	1.4	0.6	1.0	0.5	1.3	1.0	1.0	-2.5	3.2	3.3
Imports	-0.2	-0.5	-0.2	2.8	1.1	3.7	2.3	1.1	1.3	1.2	0.2	7.4	5.1
Contributions :													
Domestic demand ex. stocks	*0.4*	*0.0*	*1.0*	*0.7*	*0.8*	*0.7*	*-0.2*	*1.0*	*0.8*	*0.5*	*1.5*	*2.5*	*2.0*
Inventory change	*0.3*	*-0.2*	*-0.2*	*0.3*	*0.1*	*0.7*	*0.7*	*-0.3*	*-0.1*	*-0.1*	*-0.2*	*0.9*	*0.2*
Foreign trade	*-0.6*	*-0.3*	*0.3*	*-0.4*	*-0.1*	*-0.7*	*-0.5*	*0.0*	*-0.1*	*0.0*	*-0.8*	*-1.2*	*-0.6*
ITALY (17.9%)[1]													
GDP	**-0.2**	**-0.1**	**0.4**	**0.0**	**0.5**	**0.4**	**0.4**	**-0.3**	**0.4**	**0.3**	**0.4**	**1.1**	**0.7**
Household consumption	-0.2	0.3	0.6	-0.3	1.2	-0.5	0.2	0.0	0.5	0.3	1.2	1.1	0.7
Total GFCF	-6.0	-0.5	-0.2	-0.3	2.4	1.0	-0.8	-0.2	0.6	0.6	-2.1	2.3	0.8
Public consumption	0.7	0.3	1.0	0.5	-0.7	0.5	-0.5	0.5	0.1	0.1	2.2	0.5	0.4
Exports	-6.3	0.4	6.8	-4.0	-1.3	3.8	4.8	-0.5	0.5	0.5	-3.9	4.2	3.8
Imports	-5.4	1.2	2.7	-1.8	0.2	1.9	1.2	0.5	1.0	0.5	-0.6	2.7	2.9
Contributions :													
Domestic demand ex. stocks	*-1.3*	*0.2*	*0.5*	*-0.1*	*1.1*	*0.0*	*-0.1*	*0.1*	*0.4*	*0.3*	*0.7*	*1.2*	*0.7*
Inventory change	*1.4*	*-0.1*	*-1.2*	*0.8*	*-0.1*	*-0.2*	*-0.5*	*-0.1*	*0.1*	*0.0*	*0.6*	*-0.5*	*-0.3*
Foreign trade	*-0.3*	*-0.2*	*1.1*	*-0.7*	*-0.4*	*0.5*	*1.0*	*-0.3*	*-0.1*	*0.0*	*-0.9*	*0.4*	*0.3*
SPAIN (10.2%)[1]													
GDP	**0.9**	**0.6**	**0.6**	**0.7**	**0.8**	**0.5**	**0.6**	**0.8**	**0.6**	**0.6**	**2.5**	**2.7**	**2.1**
Household consumption	0.5	0.8	0.5	1.0	1.0	0.9	0.5	1.0	1.0	1.0	2.9	3.5	3.0
Total GFCF	0.0	-0.4	1.1	1.9	0.1	0.9	2.9	2.0	1.0	1.0	3.9	4.9	5.0
Public consumption	1.1	0.7	1.0	1.4	1.5	0.8	1.1	2.0	0.8	0.8	3.9	4.9	3.7
Exports	-4.5	5.4	2.8	-1.9	-0.9	3.2	3.6	-0.8	1.0	1.0	2.6	4.5	3.7
Imports	-2.7	2.3	3.8	0.4	1.2	2.5	5.1	1.0	1.9	1.9	4.8	9.0	7.4
Contributions :													
Domestic demand ex. stocks	*0.5*	*0.5*	*0.8*	*1.3*	*0.9*	*0.9*	*1.2*	*1.5*	*1.0*	*1.0*	*3.2*	*4.1*	*3.7*
Inventory change	*0.8*	*-0.8*	*0.3*	*0.2*	*0.6*	*-0.6*	*0.1*	*0.0*	*0.0*	*0.0*	*0.1*	*0.2*	*-0.2*
Foreign trade	*-0.5*	*0.8*	*-0.4*	*-0.7*	*-0.7*	*0.1*	*-0.7*	*-0.6*	*-0.4*	*-0.4*	*-0.8*	*-1.7*	*-1.5*
EURO ZONE (27.8%)[2]													
GDP	**0.0**	**-0.2**	**0.6**	**0.4**	**0.7**	**0.5**	**0.2**	**0.2**	**0.4**	**0.3**	**0.5**	**1.8**	**1.1**
Household consumption	0.2	0.1	0.4	0.0	0.8	0.0	0.1	0.5	0.5	0.3	1.0	1.1	1.1
Total GFCF	-1.0	-0.3	0.4	1.1	-0.1	0.5	0.6	0.6	0.9	0.6	-0.6	1.7	2.2
Public consumption	-0.3	0.5	0.7	0.5	0.2	0.4	0.4	0.2	0.2	0.3	1.6	1.6	0.8
Exports	-1.9	-0.7	2.7	0.1	1.4	2.7	1.3	0.5	1.2	1.0	0.2	5.6	3.7
Imports	-0.4	-0.6	1.3	1.7	0.4	2.4	3.1	1.0	1.3	1.1	2.0	5.9	5.1
Contributions :													
Domestic demand ex. stocks	*-0.2*	*0.1*	*0.4*	*0.3*	*0.5*	*0.2*	*0.3*	*0.4*	*0.5*	*0.4*	*0.8*	*1.3*	*1.3*
Inventory change	*0.8*	*-0.2*	*-0.4*	*0.7*	*-0.1*	*0.1*	*0.7*	*-0.1*	*0.0*	*0.0*	*0.4*	*0.5*	*0.2*
Foreign trade	*-0.6*	*-0.1*	*0.6*	*-0.6*	*0.4*	*0.2*	*-0.7*	*-0.2*	*0.0*	*0.0*	*-0.6*	*0.0*	*-0.4*

Prévision

(1) Share of euro-zone GDP

(2) Share of OECD GDP

DETAILED FORECASTS FOR THE EURO ZONE

(% change)

	Quarterly changes						Annual changes	
	2004				2005		2004	2005
	Q1	Q2	Q3	Q4	Q1	Q2		c.o.
Volumes								
GDP	0.7	0.5	0.2	0.2	0.4	0.3	1.8	1.1
Domestic demand	0.3	0.3	0.9	0.3	0.5	0.4	1.8	1.5
Household consumption	0.8	0.0	0.1	0.5	0.5	0.3	1.1	1.1
Public consumption	0.2	0.4	0.4	0.2	0.2	0.3	1.6	0.8
Investment	-0.1	0.5	0.6	0.6	0.9	0.6	1.7	2.2
Foreign trade of goods ans services	0.4	0.2	-0.7	-0.2	0.0	0.0	6.4	-17.8
Exports of goods	3.6	2.4	-0.4	1.4	2.1	1.3	8.0	4.5
Imports of goods	0.5	2.0	2.0	0.7	0.6	0.7	5.8	3.1
Prices								
Value added price	0.5	0.5	0.2	0.7	0.6	0.6	1.9	1.8
Consumption price	0.4	0.5	0.6	0.5	0.4	0.4	1.8	1.6
Investment price	0.9	0.9	0.7	0.5	0.4	0.4	2.5	1.6
Price of exports of goods	-0.4	1.5	0.7	-0.6	0.1	0.3	0.1	0.5
Price of imports of goods	-0.7	3.5	2.8	-1.9	-2.3	-1.8	1.9	-2.8
Wages	0.8	0.4	-0.1	0.8	0.7	0.7	1.8	1.9
Employment and unemployment								
Unemployment rate (percentage points)	9.0	8.8	8.9	8.8	8.8	8.8	8.9	8.8
Employment	0.1	0.2	0.2	0.2	0.2	0.1	0.5	0.5
Labour cost per unit	0.2	-0.1	0.0	0.8	0.4	0.5	0.4	1.4
Productivity of work	0.6	0.5	-0.1	0.0	0.3	0.2	1.3	0.5
Others								
Global demand	2.5	2.7	1.5	2.0	1.7	1.1	9.3	5.4
Balance of trade (points of GDP)	2.7	2.6	2.0	2.3	2.9	3.3	2.4	3.1
3-month interest rate (%)	2.1	2.1	2.1	2.2	2.2	2.2	2.1	2.2
10-year interest rate (%)	4.2	4.4	4.2	3.8	3.7	3.9	4.1	3.8
Level of capacity utilization (%)	80.6	80.8	81.6	82.0	81.7	81.4	81.3	81.6
Gross disposable income (value)	1.2	1.0	0.4	0.9	1.2	0.9	3.0	3.3
Contribution of wages	0.7	0.5	0.1	0.7	0.7	0.6	1.8	1.8
Others contributions	0.5	0.5	0.4	0.2	0.4	0.3	1.2	1.4

Forecast MZE
Source : Eurostat,

trade thanks to its industrial specialisation, notably in the capital goods badly needed by the high-growth emerging economies (China, CEEC). Italy is expected to lag behind, handicapped by an adverse sectoral specialisation that puts it in direct competition with the emerging countries.

The turn of the year 2004 – 2005 finds household spending likely to be temporarily boosted as the result of tax measures and despite the weakness of employment

In the euro zone, the fundamentals remained unfavourable to a revival of private consumption in 2004 and are likely to improve only moderately in the first part of 2005. Household incomes will probably remain handicapped by the past sluggishness of employment growth and by the decline in the purchasing power of wages (+ 0.5% and - 0.1%, respectively, in 2004), with firms giving priority to consolidating profits and competitiveness. The unemployment rate has in fact remained at 8.8% in January *(see graph 5)*. All in all, the total wage bill rose very little in real terms in 2004 (by 0.4%), leading in turn to a very small real-terms rise in households' gross disposable income (GDI). In coming quarters, it is unlikely that there will be any significant upturn on the labour market. Total employment is expected to rise by only around 0.2% per quarter *(see graph 6 and the table «Detailed forecasts for the euro zone»)* and the wage restraint seen in 2004 is likely to persist.

(1) I.e., growth for the year as a whole, assuming zero growth in the remaining period.

EURO-ZONE : HOUSEHOLDS ACCOUNTS

(annual changes %)

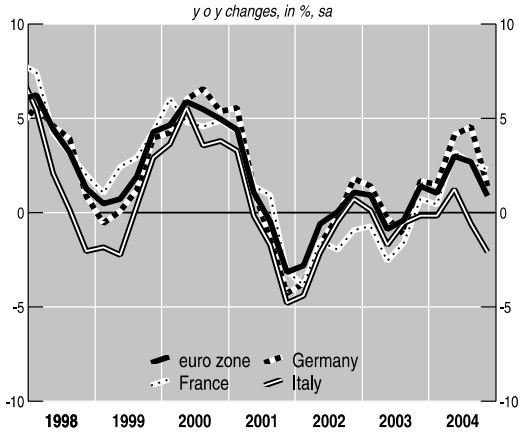
	2001	2002	2003	2004
Total employment	1.4	0.5	0.2	0.5
Dependent employment	1.6	0.6	0.2	0.2*
Average wage per head	2.8	2.5	2.3	1.8
Gross nominal disposable income	4.8	3.4	2.9	3.0
Private consumption deflator	2.3	2.2	2.0	1.8*
Saving ratio absolute level	13.5	13.9	13.9	14.0

Forecast MZE
(*) Statistical carryover at end of Q3
Sources : Eurostat, INSEE calculations (MZE model, cf. Note de conjoncture for March 2003)

3

INDUSTRIAL PRODUCTION INDEX, EX CONSTRUCTION, FOR THE PRINCIPAL EURO ZONE COUNTRIES

y o y changes, in %, sa

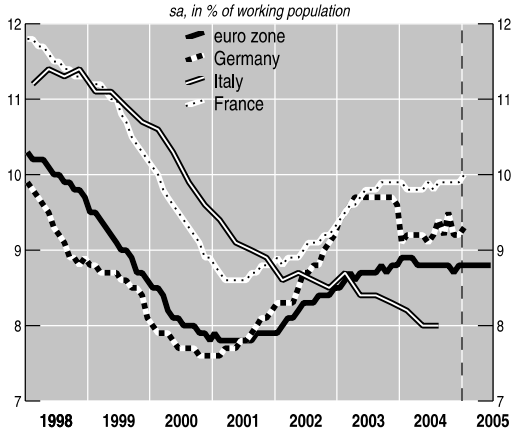


source : Eurostat

5

UNEMPLOYMENT RATE IN THE EURO ZONE

sa, in % of working population



sources : Destatis, Eurostat, Insee, Istat

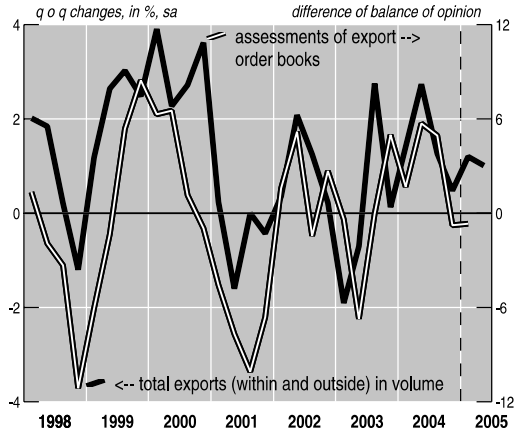
forecasts after the dotted line

In order to breathe fresh life into private consumption, the governments of the zone's three leading countries have introduced tax measures to boost household incomes. For example, in Q4 2004, European households' spending posted a good performance thanks to French households' benefiting from the «Sarkozy» stimulus measures (see note on «consommation et investissement des ménages», available in the French version only). In Germany and Italy, the corresponding tax measures have taken the form of cuts in income tax amounting in 2005 to 7 billion euros in Germany and 6 billion euros in Italy, giving a total of 13 billion, equivalent to an overall gain of 0.3 of a point for household incomes in the zone. The early part of 2005 should therefore see firm growth in private consumption (0.5%), thanks to these one-off tax cuts.

4

EXPORTS AND ASSESSMENTS OF EXPORT ORDER BOOKS FOR MANUFACTURING INDUSTRY IN THE EURO ZONE

q o q changes, in %, sa *difference of balance of opinion*



sources : European Commission, Eurostat

forecasts after the dotted line

Private spending is likely to slow down to 0.3% in Q2 once the impact of the tax stimulus has faded, despite the additional support for household purchasing power due to the easing of inflation. This is because a lasting upturn in household spending is likely to be conditional on more rapid wage growth and a more marked recovery in employment. In addition, household confidence is having difficulty in reviving at a time of structural reform and budget constraints. As a result, the household saving ratio is likely to remain high for precautionary motives, given the employment situation and the outlook for public finances.

In Germany, the high level of unemployment and the reduction in benefits following the introduction of the Hartz IV reform can be expected to lead the trade unions to give preference to maintaining employ-

ment over wage increases *(see box 1)*. As a result, wage restraint is likely to be maintained in 2005, with most of the growth in household income resulting from the tax cuts. On average, private consumption is likely to grow only moderately (a year-on-year rise of 0.7% in Q2).

Investment set to increase in coming quarters

There was an acceleration in investment in 2004, to a quarterly growth rate of 0.6% by the end of the year. After two years of contraction, it was mainly investment in plant and machinery that was concerned by this upturn, with a growth carryover of 2.4% for 2004 in Q3 [(1)]. Investment in buildings was less dynamic (growth carryover of 0.4% for 2004 in Q3), mainly supported by French and Spanish households.

In Q1 2005, the demand situation is likely to be favourable to a continuation of the rise in productive investment. In industry, the balance of opinion regarding total orders was positive by 18 points in February 2005, compared with an average of -10 points since January 2003.

More generally, accommodative financial conditions in H1 2005 and the need to replace run-down equipment should be beneficial to firms' investment plans *(see box 2)*. Long-term interest rates are at historically low levels. Moreover, the past acceleration in activity and the continued improvement in mark-up ratios have enabled firms to increase their profits, which are now likely to be partly allocated to investment.

In Q2 2005, on the other hand, growth in productive investment is likely to be held back by the fragility of household demand and the expected slowdown in export demand. In February, business leaders were already signalling the fragility of the upturn *(see graph 7)*. This is likely to mean more hesitant investment behaviour in Q2.

In Germany, following three years of declining investment during which firms were setting their financial situations in order, the rise in new orders for industry (by 2.0% in January on a quarterly average basis) could mean a return to positive growth in productive investment.

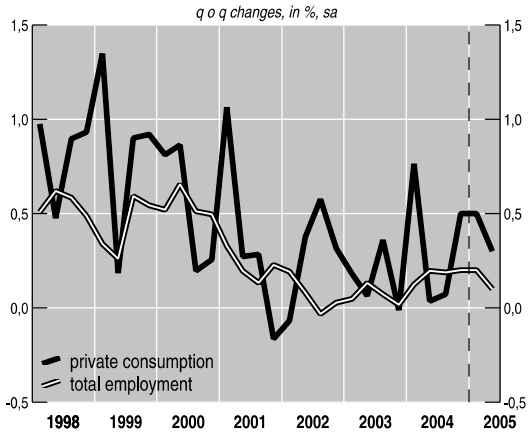
Investment in buildings, which has been positive since mid-2004, should continue to rise, given the continuing low levels of interest rates and the strong demand for housing in France, Italy and Spain. January saw the construction confidence index holding at a high level *(see graph 7)*. All things considered, investment is expected to rise by 0.9% in Q1 before slowing down to 0.6% in Q2.

The massive stocking movement seen in Q3 2004 led firms to draw on their stocks towards the end of the year in order to meet demand, thus holding back industrial production (the industrial production index fell by 0.4% in Q4). Inventory behaviour is expected to return to neutrality in 2005 and no longer hold back growth. ■

6

GROWTH OF PRIVATE CONSUMPTION AND EMPLOYMENT IN THE EURO ZONE

q o q changes, in %, sa



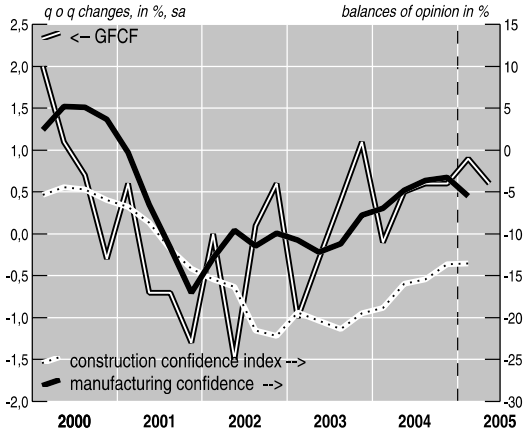
sources : Eurostat, Insee forecasts

forecasts after the dotted line

7

EURO ZONE: GFCF AND BUSINESS CLIMATE IN CONSTRUCTION AND MANUFACTURING

q o q changes, in %, sa *balances of opinion in %*



sources : European Commission, Eurostat

forecasts after the dotted line

BOX 1: THE HARTZ IV REFORM HAS ARTIFICIALLY INCREASED THE NUMBER OF JOBSEEKERS IN GERMANY

At the beginning of 2005, the implementation of unemployment benefit reform in Germany, under the so-called «Hartz IV» legislation, led to a spectacular rise in the number of registered jobseekers (by 388,000, sa, in January and February) *(see graph A)*. The national unemployment rate accordingly rose from 10.8% to 11.7% in the space of two months, an increase that is, however, not the reflection of a dramatic deterioration in the situation on the labour market.

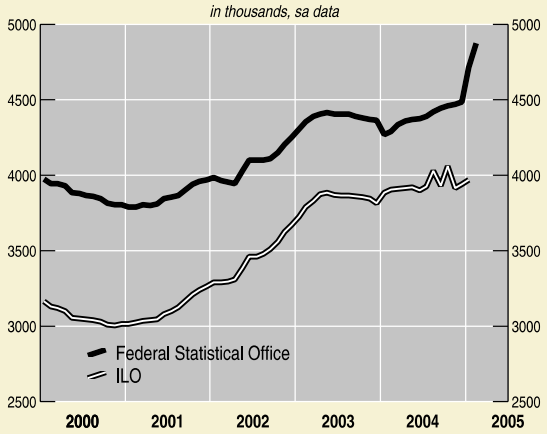
In practice, this reform, whose ultimate aim is to reduce the number of jobseekers, consists in particular of merging benefits for the long-term unemployed with social income support in one and the same allowance. People benefiting from income support are now required to register as unemployed in order to receive an allowance, the result being an artificial increase in the unemployment figures.

In these circumstances, the number of unemployed persons as defined by the ILO, with a rise of «only» 31,000 in January, bringing the unemployment rate to 9.3%, constitutes a more realistic measure of the situation on the labour market. ■

A

GERMANY: UNEMPLOYMENT AS DEFINED BY THE FEDERAL STATISTICAL OFFICE AND AS DEFINED BY THE ILO

in thousands, sa data



sources : Bundesbank, Office fédéral du travail

BOX 2: IS INVESTMENT IN PLANT AND MACHINERY SET TO ACCELERATE IN THE EURO ZONE?

Since the beginning of the 1990s, the gap between Gross Fixed Capital Formation (GFCF) in plant and machinery separating the euro zone and the United States has continually widened *(see graph A)*. American firms, which have invested massively in the new information and communication technologies, more than doubled the level of their investment in the space of 10 years. After narrowing slightly in 2001 and 2002, the gap has widened again since 2003.

Within the euro zone, the overall weakness of investment masks disparities between countries *(see graph B)*. In the case of France, even more than in the rest of the zone, firms were able to take advantage of the upswing in activity in 1997 and 2003 in order to step up their investment. In Italy, investment behaviour was similar to the zone average, except at the end of 2002, when there was a spectacular increase due to the imminent expiry of the «Tremonti» tax incentives.

In Germany, by contrast, not only has investment failed to increase, it has in fact declined continuously since the end of 2000 (by 17% between end-2000 and end-2003). This fall cannot be totally attributed to the weaker level of German activity, as can be seen from the uncoupling of investment from GDP growth in 2001 *(see graph C)*. In 1990, the shock of German unification on labour costs had a lasting impact on corporate profits. In addition, the distinct decline in investment in 2001 seems to have reflected a concern on the part of firms to restore their financial situations at the expense of investment.

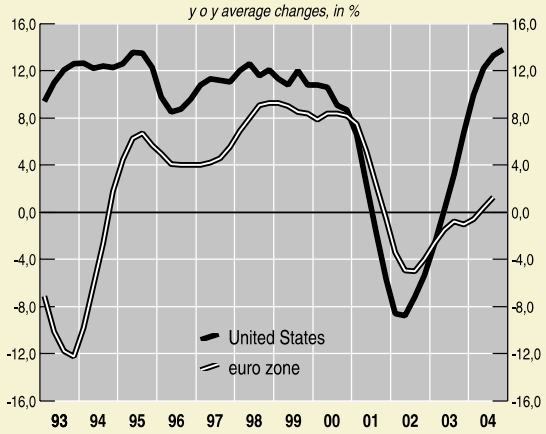
However, the wage restraint has enabled German firms to reconstitute and even increase their mark-up ratios, which have been improving since 1994 *(see graph D)*. Not only that, German firms now need to replace run-down capital and to make up their investment lag vis-à-vis their European and American competitors. The stabilisation at a high level of demand expectations and the continued positive tendency in export orders should permit a prolongation of the positive investment rates seen since mid-2004.

The upturn in German investment in plant and equipment means that it is no longer likely to hold back GFCF growth in the euro zone as a whole. ■

A

INVESTMENT AND PLANT AND MACHINERY IN THE EURO ZONE AND IN THE UNITED STATES

y o y average changes, in %

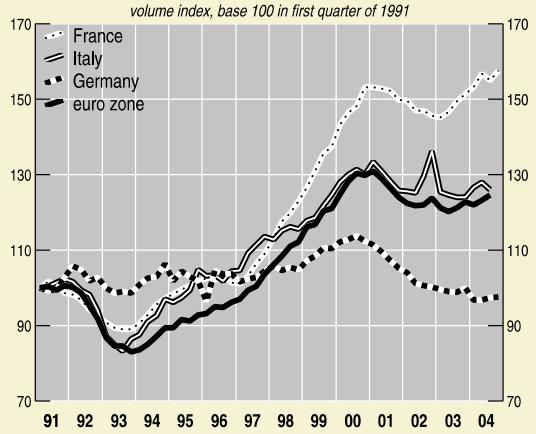


sources : Bureau of economic analysis, Eurostat

B

INVESTMENT IN PLANT AND MACHINERY IN THE EURO ZONE AND IN THE PRINCIPAL MEMBERS COUNTRIES

volume index, base 100 in first quarter of 1991

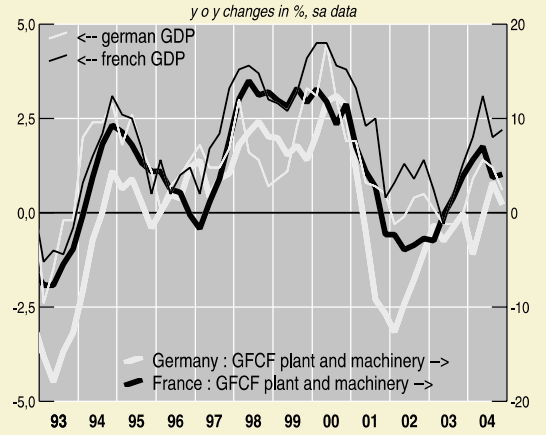


sources : Bundesbank, Destatis, Eurostat, Insee, Istat

C

GDP GROWTH AND GROWTH IN INVESTMENT IN PLANT AND MACHINERY IN FRANCE AND GERMANY

y o y changes in %, sa data

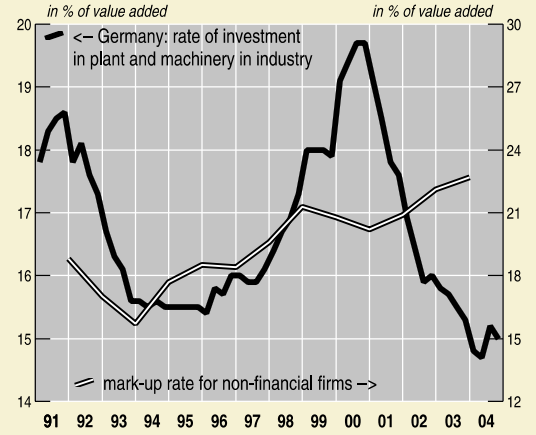


sources : Bundesbank, Destatis, Insee

D

GERMANY: RATE OF INVESTMENT IN PLANT AND MACHINERY AND MARK-UP RATE FOR NON-FINANCIAL FIRMS

in % of value added *in % of value added*



sources : Bundesbank, Destatis

Consumer prices in the euro zone

After remaining at over 2.0% during the last three quarters of 2004, pushed up by the surge in the oil price, inflation in the euro zone fell back appreciably in January 2005, notably because of the exit from the year-on-year calculation of the impact of the reform of the German healthcare system. Inflation differentials among euro-zone countries widened in January, after having returned at the end of 2004 to the configurations seen at the beginning of the year. This was especially due to the upturn in Greek inflation.

On the assumptions that the Brent price eases back gradually to $40/barrel in mid-2005 and that the USD/EUR rate stabilises at 1.30, inflation can be expected to decline gradually to 1.6% by mid-2005. Core inflation[1] would be stable, while the year-on-year rise in energy prices would fall in line with the oil price, following a slight increase.

Inflation has declined distinctly in the euro zone in the early part of 2005. This decline can be expected to continue but in more gradual fashion between now and mid-2005 in the wake of energy prices

After stabilising at around 2.3% in the final part of 2004, euro-zone inflation eased distinctly in January 2005 to 1.9%. This was largely due to a base effect: at the beginning of 2004, the reform of the German healthcare system, involving cuts in reimbursement rates, had pushed up prices as measured by the HICP, adding roughly 0.2 of a point to euro-zone inflation. The downward tendency in January 2005 was strengthened by favourable movements in food prices and a slight easing of energy prices, despite the continuing high price of oil. February saw only a modest upturn in inflation to 2.1%.

On the assumptions that the Brent price eases gradually to $40/barrel in Q2 2005 and of a USD/EUR rate of 1.30 within the time-horizon of this forecast, inflation can be expected to fall back gradually to a rate of 1.6% in June 2005 *(see Table 1)*.

Inflation in the energy sector began to ebb at the end of 2004, in the wake of the crude oil price, which fell from $49.7 in October to $39.8 in December, with the year-on-year rise in January 2005 standing at 6.2% compared with 9.8% in October. Energy prices are forecast to post a slight upturn in Q1, in line with the flurry in the oil price seen in the early part of the year, before slowing down along with the subsequent easing of the latter *(see graph 1)*. The year-on-year rise in energy prices is forecast to be 2.9% in June 2005.

Food prices have slowed down distinctly since the summer of 2004, with weather conditions more favourable than they had been in 2003. Moreover, in contrast to 2003, there was no rise in the price of tobacco in France in 2004. Food price inflation as a result stood at 1.4% in January 2005, down from 2.7% in June 2004. Subsequently, the rise in food prices is

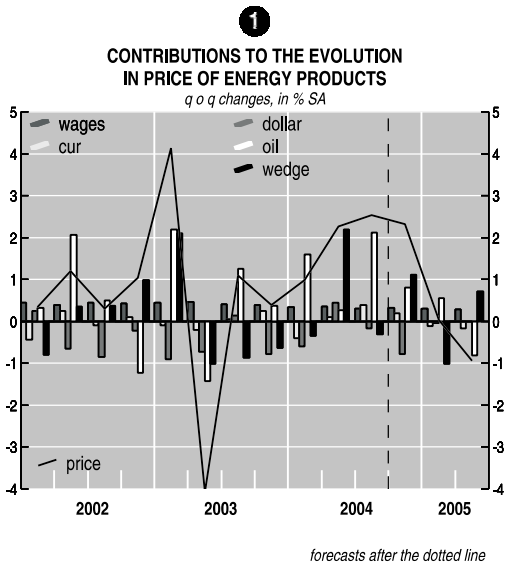
(1) Measured as the Harmonised Index of Consumer Prices (HICP) ex food, alcohol, tobacco and energy.

TABLE 1: EURO ZONE INFLATION

(year on year % growth of HICP)*

Sectors (weight in the index)	January 2004	June 2004	December 2004	January 2005	June 2005
Total (100.0%)	**1.9**	**2.4**	2,4	**1.9**	**1.6**
Food (Beverage and Tobacco) (19.5%)	**3.1**	**2.7**	**2.0**	**1.4**	**0.9**
of which Food (15.6%)	*2.5*	*1.4*	*0.3*	*-0.1*	*-0.2*
Beverage and Tobacco (3.9%)	*6.0*	*8.4*	*8.4*	*7.5*	*4.7*
Energy (8.1%)	**-0.3**	**5.9**	**7.0**	**6.2**	**2.9**
Core inflation (72.3%)	**1.7**	**2.0**	**1.9**	**1.6**	**1.6**
of which: Manufactured products (31.0%)	*0.6*	*0.8*	*0.7*	*0.5*	*0.5*
Services (41.3%)	*2.5*	*2.6*	*2.7*	*2.4*	*2.5*

Forecast
Source: Eurostat



expected to recover gradually to levels more traditional for this type of product. Prices had in fact accelerated sharply in 2003 as the result of late frosts and an abnormally dry summer. As these exceptional phenomena were not repeated in 2004, the price rise for these products came out below its long-period average.

Core inflation set to remain established below 2%

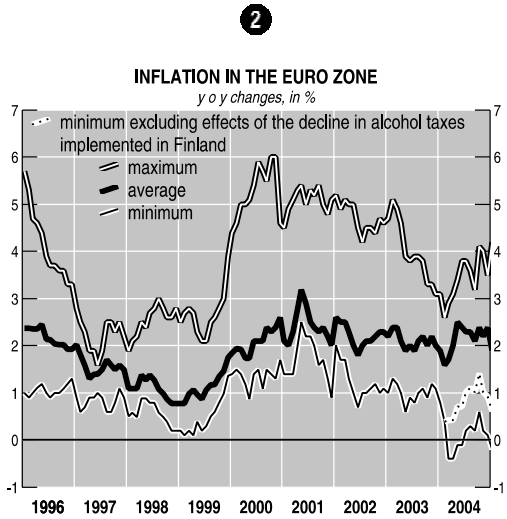
Core inflation has remained fairly stable, fluctuating between 1.7% and 1.9% throughout 2004. It then fell back markedly in January 2005 to 1.6%. This tendency is explained mainly by the exit from the year-on-year calculation of the effects of the reform of the German healthcare system in January 2004, which had resulted in a rise of 0.9 of a point in German core inflation and 0.3 of a point in that of the euro zone as a whole. With this exceptional phenomenon out of the way, core inflation is set to remain on a stable tendency until mid-2005, standing at 1.6% in June.

The rise in prices of services, the principal component of the core-inflation indicator, also remained stable in the last part of 2004 prior to the exceptional base effect seen in January 2005. This stability is expected to be maintained within the time-horizon of the forecast, with the year-on-year rise standing at 2.5% in June 2005.

Inflation in the case of manufactured goods, the second component of core inflation, also remained on a stable tendency of the order of 0.8%, year on year, in 2004, before falling back to 0.5% in January 2005. Over the first half of 2005, with the disappearance of the effects of the past appreciation in the euro and with commodity prices returning to more reasonable tendencies, the evolution in prices in this sector is likely to be one of relative stability. The year-on-year rise in prices of manufactures is expected to be 0.5% in June 2005.

Inflation differentials among euro-zone countries are at their widest since 2000, thanks in large part to a change in Finnish alcohol taxes and the surge in Greek inflation

After widening in the final part of 2004, inflation differentials in the euro zone narrowed in December,



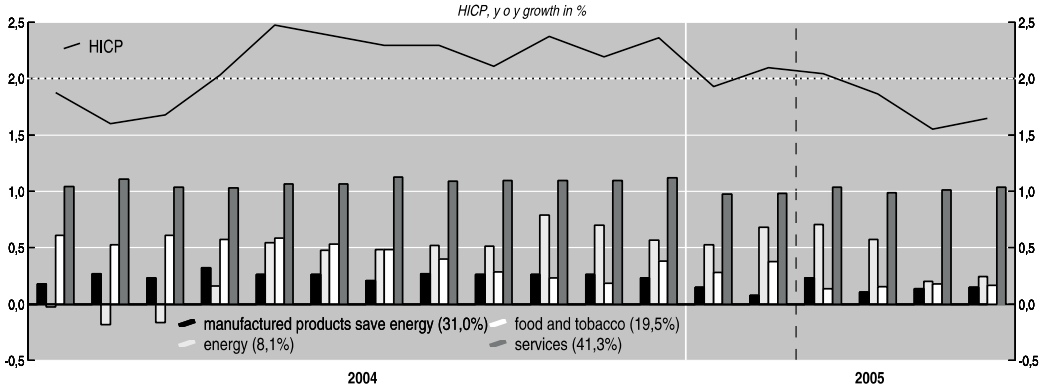
returning to their April level. However, this tendency was blocked in January by the surge in Greek inflation, which rose to 4.2%. The result was to bring the maximum differential to 4.4 percentage points, its highest level since 2000. However, this figure falls to 3.6 if adjustment is made for the change in taxation of alcohol that has taken place in Finland *(see graph 2)*.

The tendency for core inflation differentials to narrow that had been seen since the beginning of 2003 was interrupted in Q2 2004. It later resumed, bringing the maximum to 2.3 points in December 2004, the same level as at the beginning of the year. It then rose steeply to 4.3 points in January 2005, as the result of the surge in core inflation in Greece *(see Table 2)*. This was largely due to the fact that clothing prices, and to a smaller extent those of furnishings, were stable in Greece in January 2005, but had shown a sharp fall a year earlier.

Cyclical gaps among countries in the zone do not seem capable of explaining the core inflation differentials. Admittedly, the price rises are more rapid in Spain and Greece, countries enjoying robust growth, and slower in Germany, where the economic climate

3

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



sources : Eurostat, Insee forecasts

forecasts after the dotted line

TABLE 2 : EURO ZONE INFLATION BY COUNTRIES

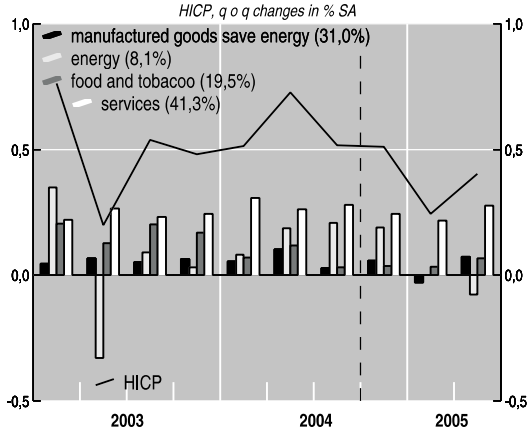
(year on year % growth of HICP)

	HICP		Core inflation		Energy	
	January 2004	January 2005	January 2004	January 2005	January 2004	January 2005
Belgium	1.4	2.0	1.5	1.2	-1.5	8.9
Germany	1.2	1.6	1.4	0.8	-0.1	5.3
Greece	3.1	4.2	3.0	5.0	-1.4	7.9
Spain	2.3	3.1	2.3	2.4	-1.6	5.7
France	2.2	1.6	1.8	1.7	-1.1	6.7
Ireland	2.3	2.1	2.2	1.9	3.9	9.8
Italy	2.2	2.0	1.8	2.0	-0.1	5.0
Luxembourg	2.3	2.8	2.0	1.5	1.5	9.0
Netherlands	1.5	1.3	1.7	0.7	2.7	9.6
Austria	1.2	2.4	1.2	1.9	0.0	8.4
Portugal	2.2	2.0	2.4	2.1	1.5	7.6
Finland	0.8	-0.2	0.6	0.7	-1.1	3.0
Euro zone	1.9	1.9	1.7	1.6	-0.4	6.2

Source : Eurostat

4

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



sources : Eurostat, CVS Insee

forecasts after the dotted line

is morose. However, it is also very slow in Finland, which is posting faster growth. It is also slower in Italy than in France.

At the same time, a cause of the widening of inflation differentials in the euro zone is the diversity of ways in which energy prices in the different countries have reacted to the recent surge in the oil price *(see Table 2)*. This in turn is largely due to substantial differences in the taxation of petroleum products, since a tax applied pro rata on quantities automatically dilutes the evolution in pre-tax prices. This has meant, for example, that taxes on domestic fuel oil ranged in 2002 from 5.21 euros per 1000 litres in Luxembourg to 403.21 euros per 1000 litres in Italy. ■