The euro zone's international environment

The euro zone's international environment is liable to be less buoyant in 2005 than in 2004. The slackness of American, British and Japanese imports will probably restrict demand for euro-zone exports. In particular, the slowdown in euro-zone exports in Q1 is probably linked to the sharp dip in imports by the United Kingdom, the zone's leading trade partner.

In the United States, payroll growth is set to slow down in coming months and GDP growth for the year 2005 is expected to be 3.4% compared with 4.4% last year (see Table 1). United Kingdom growth, too, is likely to be more moderate this year, at around 2.1% following 3.1% in 2004, with the effects of the past monetary tightening restricting the liveliness of activity. In Japan, household consumption will probably be negatively affected by the slowdown in employment growth, with economic growth coming out at 1.7% in 2005 compared with 2.6% the previous year.

In the United States, payroll growth is set to slow down in coming months, bringing GDP growth in 2005 to 3.4%

Employment growth gathered pace in the early part of 2005, with job creations averaging 240,000 a month from February to April, a quarterly rate of 0.5%, as compared with 0.3% for the period from November to January. This acceleration enabled consumption to remain brisk in the first two quarters of the year, at annualised rates of close to 3.5%.

However, firms are now likely to be confronted with a less favourable economic environment as a result of the tightening of monetary policy and the weaker outlook for activity in the United States' principal trading partners *(see below in this section for Japan and the United Kingdom as well as the section «Economic situation in the euro zone»)*. With growth in labour productivity stable for several quarters at more sustainable levels *(see Graph 1)*, employment can be expected to slow down in coming months, bringing consumption with it. The latest business surveys in industry and services are in fact indicating that finding a job has become more difficult.

(1) According to the IMF model (see IMF working document «The Impact of Higher Oil Prices on the Global Economy», 2000), a permanent rise of 50% in the oil price, say from $30 to $45, would add 2.0 points to prices and reduce domestic demand (and GDP) by 0.7 of a point after one year.

Consumption will probably slow down because almost its only support in coming quarters will come from growth in wage incomes. Fiscal policy, for its part, is likely to be neutral having been expansionary in previous years: the budget for FY 2005 (already voted) maintains the tax cuts granted to households in 2001 and 2003. Monetary conditions, meanwhile, are expected to harden further. With the oil price still high, inflationary pressures cannot be ruled out in 2005 and the gradual raising of the Fed funds rate is likely to continue *(see the section «Financing of the economy», available in the French version only)*. What is more the higher oil price is continuing to eat into household purchasing power. With the price of Brent maintained at around $45/barrel until the end of 2005 *(see section «Oil and raw material prices", available in the French version only)*, the impact of the rise from $30 to $45 seen in 2004 would nevertheless remain limited. According to the IMF model, the result would be to raise prices by around 0.5 of a point per quarter and reduce consumption growth by around 0.2 of a point per quarter [(1)].

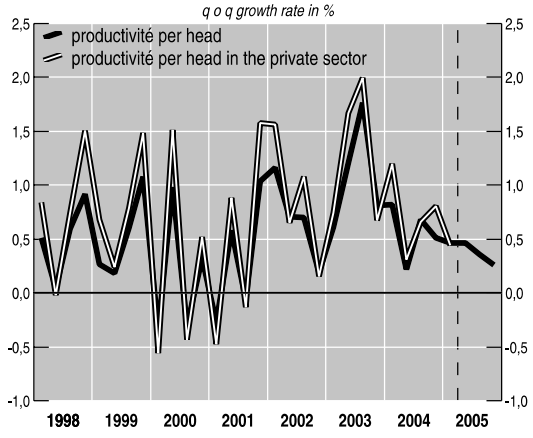
At the same time, owing to the tightening of monetary conditions and the rise in mortgage rates, growth in household investment is expected to stabilise in 2005 at less brisk rates than at the beginning of 2004.

Firms, meanwhile, are likely to cut back their investment in 2005. The expiry at the end of 2004 of the tax reduction relating to corporate depreciation has

1

PRODUCTIVITY IN THE UNITED STATES

q o q growth rate in %



sources: BEA, BLS, Insee

forecasts after the dotted line

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

	Quarterly % change								Annual % change		
	2004				2005				2003	2004	2005
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
UNITED STATES (37.2%)[1]											
GDP	**1.1**	**0.8**	**1.0**	**0.9**	**0.9**	**0.8**	**0.7**	**0.6**	**3.0**	**4.4**	**3.4**
Consumption	1.0	0.4	1.3	1.0	0.9	0.9	0.8	0.7	3.3	3.8	3.7
Private investment [2]	1.1	3.3	2.1	2.5	1.3	1.1	1.0	1.0	5.1	10.3	6.7
Nonresidential investment	*1.0*	*3.0*	*3.1*	*3.4*	*0.9*	*1.0*	*1.0*	*1.0*	*3.3*	*10.6*	*7.3*
Residential investment	*1.2*	*3.9*	*0.4*	*0.8*	*2.1*	*1.4*	*1.0*	*1.0*	*8.8*	*9.7*	*5.8*
Government expenditures [3]	0.6	0.6	0.2	0.2	0.0	0.0	0.0	0.0	2.8	1.9	0.3
Exports	1.8	1.8	1.5	0.8	1.7	1.5	1.0	1.0	1.9	8.6	5.4
Imports	2.6	3.0	1.1	2.7	2.2	1.0	1.0	1.0	4.4	9.9	7.0
Contributions:											
Domestic demand excluding stocks	*1.0*	*0.9*	*1.3*	*1.2*	*0.8*	*0.8*	*0.7*	*0.7*	*3.5*	*4.5*	*3.7*
Change in private inventories	*0.3*	*0.2*	*-0.2*	*0.1*	*0.2*	*0.0*	*0.0*	*0.0*	*-0.1*	*0.4*	*0.2*
Net exports	*-0.2*	*-0.3*	*0.0*	*-0.3*	*-0.2*	*0.0*	*-0.1*	*-0.1*	*-0.4*	*-0.6*	*-0.5*
UNITED KINGDOM (5.6%)[1]											
GDP	**0.7**	**1.0**	**0.6**	**0.7**	**0.5**	**0.3**	**0.4**	**0.5**	**2.2**	**3.1**	**2.1**
Consumption	1.2	0.8	0.7	0.2	0.3	0.3	0.6	0.6	2.3	3.3	1.7
Total investment	0.2	2.6	1.0	0.6	0.0	-0.4	0.1	0.4	2.3	5.6	1.4
Enterprise investment	*1.3*	*1.3*	*1.6*	*0.2*	*-0.1*	*-1.0*	*0.0*	*0.6*	*-1.2*	*5.5*	*0.5*
Household investment [4]	*-0.7*	*5.2*	*-0.1*	*0.7*	*-1.0*	*0.0*	*0.2*	*0.2*	*4.8*	*4.7*	*0.9*
Public investment [4]	*-4.2*	*4.8*	*0.9*	*1.9*	*4.0*	*2.0*	*0.0*	*0.0*	*22.9*	*8.9*	*8.7*
Public consumption [5]	0.8	0.7	1.1	1.0	0.7	0.5	0.5	0.5	3.1	4.4	3.0
Exports	0.6	2.2	-0.1	1.6	-1.0	0.8	0.8	0.8	0.9	2.5	2.0
Imports	-0.1	1.5	2.1	2.2	-1.9	0.6	1.0	1.0	1.9	5.2	2.3
Contributions:											
Domestic demand excluding stocks	*1.0*	*1.1*	*0.9*	*0.5*	*0.3*	*0.2*	*0.5*	*0.6*	*2.5*	*4.1*	*2.0*
Change in private inventories	*-0.6*	*-0.2*	*0.3*	*0.4*	*-0.1*	*0.0*	*0.0*	*0.0*	*0.0*	*-0.2*	*0.3*
Net exports	*0.2*	*0.1*	*-0.7*	*-0.2*	*0.3*	*0.0*	*-0.1*	*-0.1*	*-0.4*	*-0.8*	*-0.3*
JAPAN (14.8%)[1]											
GDP	**1.3**	**-0.2**	**-0.2**	**0.1**	**1.2**	**0.5**	**0.3**	**0.3**	**1.4**	**2.6**	**1.7**
Consumption	0.7	0.0	-0.1	-0.4	1.1	0.4	0.2	0.2	0.2	1.5	1.3
Total investment	0.2	-1.5	-0.2	0.0	1.2	0.7	0.3	0.3	1.0	1.5	1.5
Private investment	*-2.1*	*3.2*	*0.2*	*0.1*	*1.7*	*0.8*	*0.4*	*0.4*	*5.1*	*5.1*	*3.6*
Nonresidential investment	*-2.7*	*3.6*	*0.1*	*-0.1*	*2.4*	*1.0*	*0.5*	*0.5*	*6.6*	*5.8*	*4.4*
Residential investment	*0.6*	*1.3*	*0.6*	*0.6*	*-1.3*	*1.0*	*0.3*	*0.3*	*-1.1*	*2.2*	*0.8*
Public investment	*8.5*	*-16.9*	*-1.8*	*-0.3*	*-0.6*	*0.0*	*0.0*	*0.0*	*-10.6*	*-10.8*	*-6.6*
Public consumption	1.4	0.7	0.3	0.6	0.6	0.8	0.8	0.8	1.2	2.7	2.6
Exports	5.1	3.4	0.5	1.3	-0.4	0.5	0.5	0.5	9.1	14.5	2.5
Imports	3.7	1.9	2.3	2.1	0.5	0.5	0.5	0.5	3.8	8.9	4.5
Contributions:											
Domestic demand excluding stocks	*0.7*	*-0.2*	*-0.1*	*-0.1*	*1.0*	*0.5*	*0.3*	*0.3*	*0.6*	*1.6*	*1.5*
Change in private inventories	*0.4*	*-0.2*	*0.0*	*0.2*	*0.3*	*0.0*	*0.0*	*0.0*	*0.2*	*0.2*	*0.3*
Net exports	*0.3*	*0.2*	*-0.2*	*0.0*	*-0.1*	*0.0*	*0.0*	*0.0*	*0.6*	*0.8*	*-0.1*

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
(5) Consumption of unprofitable institutions included
Sources: BEA, ONS, Economic and Social Reasearch Institute, Insee

generated a slowdown in investment in the early part of 2005. In addition, the prospects for firms have not been very good for several months now. The confidence indicator for industrial firms has turned down since mid-2004. Finally, corporate investment would be curbed by the tightening of monetary conditions.

American exports are expected to slow down during 2005 after being underpinned by the depreciation of the dollar towards the end of 2004. In the early part of the year, they were still benefiting from the price-competitiveness gains obtained by the earlier depreciation, as shown by the prospects regarding foreign demand reported in the industrial confidence index since December. However, given the modest reversal of movements in the dollar versus partner countries' currencies and the slowdown in imports by these partners, exports can be expected to slow down during 2005. Imports, for their part, will probably slow down, too, in line with final demand.

TABLE 2 : HOUSEHOLDS' INCOME

(in %)

	Annual changes		
	2003	2004	2005 (carry over) (*)
United-States			
Non-farm dependent employment	-0.3	1.1	1.3
Average wage per head	3.3	3.9	4.6
Nominal gross disposable income	4.6	4.2	6.0
Private consumption deflator	1.9	2.2	2.0
Saving ratio	2.0	1.4	1.3
United Kingdom			
Dependent employment	0.4	0.7	0.9
Average wage per head	3.4	4.4	3.8
Nominal gross disposable income	4.6	3.8	0.7
Private consumption deflator	1.9	1.2	1.0
Saving ratio	5.9	5.6	5.8
Japan			
Total employment	-0.2	0.2	0.3
Average wage per head	-0.3	-0.7	1.3
Nominal gross disposable income (dependent household)	0.5	-	-
Private consumption deflator	-0.8	-0.5	-0.4
Saving ratio	6.3	-	-

(*) For the United States, end April.
For the United Kingdom, end-Q4 2004 for employment, income and saving, end-Q1 2005 for the rest.
For Japan, end March for average wage per head, end April for employment
Source : BEA, BLS, Central Statistical Office, Department of Employment, ONS, Economic and Social Research Institute, Ministry of Public Management, Ministry of La -

All things considered, GDP growth for 2005 as a whole is expected to be 3.4%, compared with 4.4% in 2004. This scenario is subject to three main uncertainties, however. The first, which would be positive, is an increase in hiring behaviour, leading to job creations of the order of 300,000 a month in coming quarters. This would add roughly 0.5 of a point to GDP growth in 2005. The second, which would also be positive for the United States, would be a depreciation of the dollar versus the renminbi in the event that the Chinese authorities allow the currency to fluctuate. The third and last, this time negative, would be an increase in inflation, linked either to a Brent price of around $55 or to a renewed period of depreciation of the dollar against the currencies of the United States' trading partners. Quite apart from its direct effect on household purchasing power, too great a surge in inflation could well oblige the Fed to raise its leading rates by larger amounts and bring about a substantial tightening of financial conditions. The impact on GDP would be appreciable. According to the Fed's model *(see «Aggregate Disturbances, Monetary Policy, and the Macroeconomy: The FRB/US Perspective», Federal Reserve Bulletin, January 1999)*, a permanent rise of 1 point in the leading rate would in fact reduce GDP growth by 0.1 of a point in 2005 and by 0.7 of a point in 2006.

This scenario of ours is close to the May consensus for GDP growth in 2005 as a whole (3.4%) and slightly below the IMF's April forecast (3.6%) and the OECD's May forecast (3.6%).

In the United Kingdom, GDP is set to slow down in 2005, handicapped by weak consumption

The poor retail sales posted in Q4 2004 and Q1 2005 seem to have been due principally to three phenomena. First, the rise in interest rates carried out by the Bank of England between end-2003 and mid-2004 substantially added to households' interest charges, given their high level of indebtedness (more than 135% of disposable income), mainly at variable rate. Second, the slowdown in the rise in house prices seems to have gradually cut back the mortgage refinancing used by households to finance their spending. Lastly, at the same time consumer prices have accelerated, eating into their purchasing power. Indeed, inflation stood at + 1.9% in March and April 2005, its highest level for seven years. In these circumstances, household consumption rose at only a slow rate around the end of 2004 and the beginning of 2005.

However, on the assumption of a stabilisation or a very gradual decline in house prices, consumption can be expected to pick up slightly during coming quarters. Household confidence remains satisfactory and consumer loans have been rising since the beginning of the year. Continued wage growth (+ 3.3% in March) and the firmness of the labour market, characterised by an extremely low unemployment rate (4.7% in April), are both liable to provide leverage for an upturn in consumption between now and the end of the year. The growth rate of household investment will probably be stable in 2005,

2

UNITED KINGDOM: CORPORATE INVESTMENT AND CONFIDENCE LEVELS IN MANUFACTURING

sources: UK National Statistics, CIPS/PMI, Reuters

having apparently slowed down in the early part of the year, before probably stabilising in mid-year. Following a sharp dip in January, the number of real estate transactions has risen slightly but remains well below the 2004 level. In addition, mortgage rates have more or less stabilised since the beginning of the year.

Despite the current inflationary pressures, the Bank of England is unlikely to raise rates this year. Its latest quarterly inflation report (dated May) in fact indicates a change of direction for monetary policy. Although inflation is close to the target of 2% set for 2005 and 2006 and may even temporarily exceed it, the Bank is more worried by the prospect of a slowdown in activity. A further rise in interest rates could trigger off an even sharper contraction of activity, so that the signs are that rates will be maintained at their current level. Given the numerous indications that the economy is weakening, the Bank could even introduce a cut in rates towards the end of the year.

Corporate investment is likely to rise very slightly in 2005. At the end of 2004, the weakness of household spending affected the outlook for industrial production and led to a deterioration in business confidence. Imports of finished manufactured goods accordingly fell sharply in the early part of 2005 and investment declined by 0.1% in Q1. According to the latest monthly surveys for industry, business leaders' expectations regarding future production have deteriorated. For example, the Purchasing Managers' Index has reached its lowest level for two years *(see Graph 2)*. The business climate is likely to be gloomy this year, with the slackness of both domestic and export demand curbing any desire on the part of industrial firms to invest in coming months.

Because of the weakness of domestic demand, United Kingdom imports fell sharply in Q1 (by 1.9%) after accelerating in the previous three quarters. This can be ascribed to the fact that both consumption and investment slowed down considerably around the end of 2004 and the beginning of 2005. In coming quarters, imports can be expected once more to rise in line with domestic demand, giving an annual growth rate of 2.3% in 2005, well below the 5.2% recorded in 2004.

Meanwhile, United Kingdom exports have declined substantially in Q1 following the sharp dip in imports by the euro zone, the United Kingdom's main trading partner. Moreover, because of the weakness of demand from the United States and the euro zone, they are likely to remain slack for the whole of 2005. In addition, the past appreciation of sterling versus the currencies of the main European partner countries can be expected to hold back exports between now and the end of the year. Sterling in fact appreciated by more than 4% on average in 2004 and by almost 0.8% in the first 4 months of 2005 compared with Q4 2004.

With a view to gradually restoring order to public finances, the government is likely to limit public investment following the May parliamentary elections. The budget for 2005-06 submitted in March had promised substantial investment in health, education and public services. However, the announcement of a future improvement in the current balance implies a tightening of fiscal policy next year. The Chancellor of the Exchequer in fact announced that the budget deficit would be reduced from 16.1 billion GBP in 2004-2005 to 6 billion in 2005-2006 (compatible with growth in the range 3-3.5%) before the re-emergence of a surplus of 1 billion GBP in the 2006-2007 tax year (with growth in the range 2.5-3%). This gradual restoration of order to public finances could induce the government to hold back on investment in the current year. Tax policy, meanwhile, would remain neutral in 2005, with no increases currently planned.

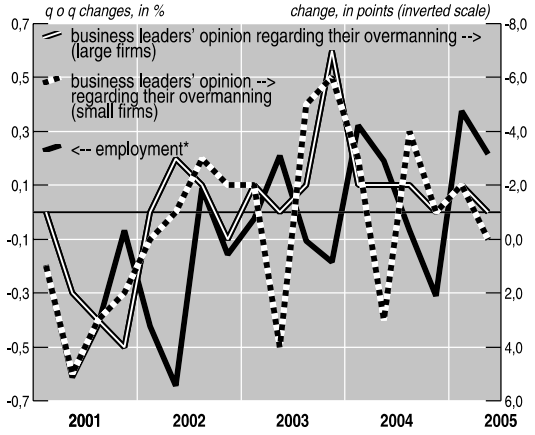
All things considered, GDP can be expected to grow by 2.1% this year, more slowly than in 2004.

Economic activity in Japan, after peaking in Q1 2005 under the impact of a temporary improvement on the labour market, is expected to slow down in coming quarters

Handicapped by the weakness of external demand and the slowdown in domestic demand, Japanese growth is likely to level off gradually during 2005, to stand at 1.7% for the year, marking a slowdown compared with the previous year's 2.6%. Even so, this levelling off in economic activity does not call into question the Japanese upturn.

3

JAPAN: EMPLOYMENT AND TANKAN SURVEY



sources: Ministry of Labor, Bank of Japan

Note:
**In the case of employment, the figure is the statistical carryover at end-April for Q2 2005*

Following a rise of 0.2% in 2004, the acceleration in job creation seen in Q1 2005 seems to have been only temporary. The statistical carryover for Q2 in fact shows a slowdown (a quarterly change of +0.2% compared with +0.4% the previous quarter. Furthermore, firms' predictions of their staff requirements as shown by the March Tankan survey are down on the previous quarter *(see Graph 3)*.

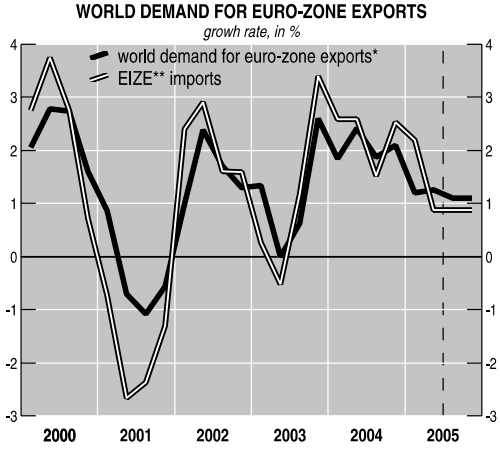
After peaking in Q1 2005, household consumption is set to slow down in coming quarters. The recovery in domestic demand is in fact vulnerable to the still-latent deflationary situation. The year-on-year change in consumer prices (the core index) was negative in April for the sixth consecutive month. Whether household consumption can continue to grow remains conditional on a lasting return of inflation to positive territory. As regards monetary policy, the main thrusts set out by the Bank of Japan remain unchanged (interest rates close to zero and massive supply of liquidity to the banking system) and are therefore unlikely to affect the tendency in household consumption.

The weakening of household consumption is likely to curb corporate investment in coming quarters. Private-sector orders for machinery are in fact pointing to a slowdown in investment following the upturn posted in Q1. Firms' expectations regarding their productive capacity and capital investment as revealed by the Tankan survey for March are delivering the same message of a levelling off in investment in coming quarters.

Exports, after declining in Q1 2005 because of the slowdown in Chinese import growth (from 30.3%, year on year, in Q4 2004 to 12.1% in Q1 2005) and the levelling off in growth in Asia in general (see box), are set to accelerate slightly during 2005 under the impact of the appreciation of the dollar versus the yen seen in the early part of 2005 (offsetting the appreciation of the yen that took place towards the end of 2004). Even so, they would not regain the growth rates seen towards the end of 2003 and at the beginning of 2004 .The result of the Tankan survey for Q1 2005 concerning firms' expectations of external demand also point to growth in Japanese exports in coming quarters. Meanwhile, the levelling off in American imports is liable to act as a restraining factor.

4

WORLD DEMAND FOR EURO-ZONE EXPORTS



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

Note :
**World demand for a country's exports is calculated as the sum of the imports of its partner countries, weighted by the exporting country's share of each partner country's imports (see "note de conjoncture*
***The aggregate imports in the case of the euro zone's international environment correspond to the sum of United States, United Kingdom and Japanese imports, weighted by the GDP of each of these countries.*

Overall, the slowdown in world demand for euro-zone exports that began in mid-2004 is likely to continue this year

World demand for euro-zone exports slowed down substantially in Q1 2005 *(see Graph 4)*, mainly under the impact of the sharp decline in United Kingdom imports. Because of the weakness of imports by the euro zone's principal trading partners in coming quarters, growth in world demand for euro-zone exports, as well as world trade in general, is likely to be weaker on average in 2005 than in 2004. ■

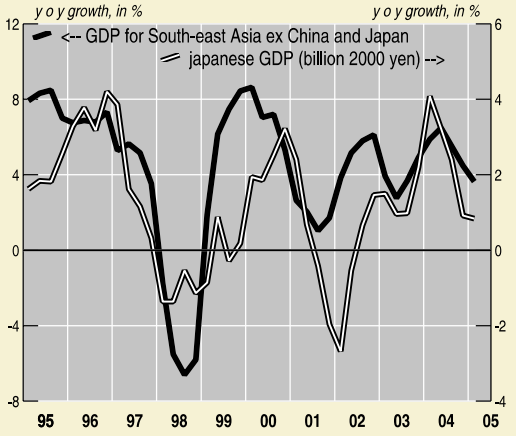
BOX: GROWTH IN THE COUNTRIES OF SOUTHEAST ASIA EX CHINA AND JAPAN

Economic activity is estimated to have slowed down in the leading countries of Southeast Asia other than China and Japan in Q1 2005 (see Graph A). In particular, GDP growth in Korea and Indonesia levelled off after the upturn seen in the previous quarter. This slowdown in economic activity in Southeast Asia ex China and Japan, combined with the slowdown in Chinese imports posted in Q1 2005, seems to be the principal explanation for the decline in Japanese exports in Q1 2005 (roughly half Japan's exports go to Southeast Asian countries).

The growth rate of GDP in the Southeast Asian zone ex China and Japan is the aggregate of the growth rates of individual countries, weighted as follows: Korea, 35.6%; Taiwan, 16.6%; Indonesia,14.0%; Hong Kong, 9.2%; Thailand, 8.4%; Malaysia, 6.1%; Singapore, 5.4%; Philippines, 4.6%. Official seasonally adjusted data exist only for Korea, Singapore and Hong Kong, with the result that seasonal adjustments have been carried out applying the X-11 Arima method to the GDP figures for the remaining countries included in the aggregate GDP. ■

A

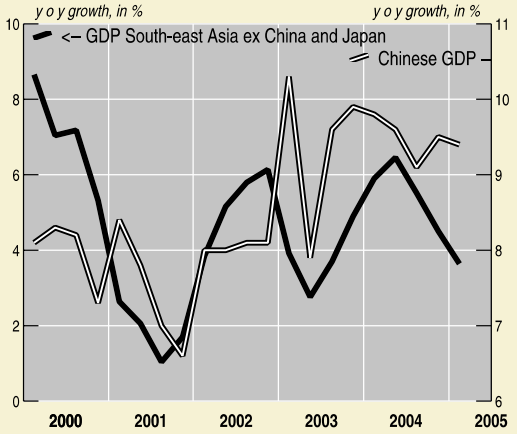
GDP FOR SOUTH-EAST ASIA EX CHINA AND JAPAN AND JAPANESE GDP



sources: Economic and social research institute, Insee

B

GDP FOR SOUTH-EAST ASIA EX CHINA AND JAPAN AND CHINESE GDP



sources: National bureau of statistics of China, Insee

The economic situation in the euro zone

Euro-zone GDP growth picked up in Q1 2005 to 0.5% from 0.2% in Q4 2004. This performance has to be put in perspective, however: only foreign trade — and then thanks to a decline in imports — provided support for growth, with domestic demand remaining distinctly flat. Moreover, the collapse of exports, combined with a slowdown in domestic demand, led to a further decline in European industrial production in Q1. Growth was highly uneven between individual countries: German GDP rallied strongly, whereas Italy entered recession (see Graph 1). The driving forces for activity were again very different between countries, as they had been at the end of last year: domestic demand in the case of France and Spain, exports in the case of Germany.

The persistent gloom shown by business leaders in Q2 seems to rule out any lasting upturn in industrial activity in the short term. As a result, GDP seems set to slow down again in Q2, with growth touching a low point of 0.2%. In the second half of the year, helped by the stabilisation of foreign demand and an incipient domestic improvement in Germany and Italy, growth can be expected to become firmer: 0.3% in Q3 followed by 0.4% in Q4. For 2005 as a whole, the rise in GDP would be 1.3%, compared with 1.7% in 2004.

Household consumption liable to be curbed by the slackness of employment and income purchasing power

In the early part of 2005, the fundamentals remained unfavourable for a pickup in private consumption. Household income was still handicapped by the past slackness of employment (which rose by only 0.6% in 2004) and the stagnation of wages at a time when the unemployment rate was no lower than at end-2000 *(see Graph 2)*. The income tax cuts implemented in Germany and Italy in Q1 failed to bring about any improvement in household spending. This was because these tax cuts, amounting to an overall gain of 0.3 of a point in the zone's household incomes, seem to have been saved in most countries, against a background of deteriorating public finances in Italy and a worsening labour market in Germany.

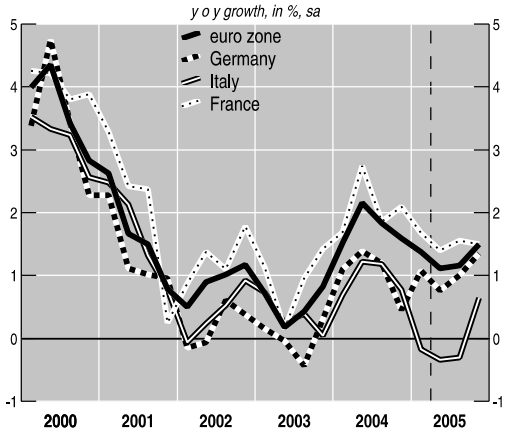
All in all, Q1 saw a weakening of growth in private spending from growth of 0.6% in the last part of 2004 to 0.3%.

Any significant resumption of growth in employment seems unlikely in coming quarters, with total employment rising by only around 0.2% per quarter *(see Graph 3)*. In addition, the high unemployment rate, the expectations of low inflation and firms' desire to preserve their margins at a time of slack demand, are liable to contribute to the maintenance of wage restraint (a rise of 1.9%, as in 2004 — *see the tables giving detailed forecasts for the euro zone and for the euro-zone household-sector account)*. European households' purchasing power is expected to rise by 1.3% in 2005 compared with 1.2% in 2004,

1

GDP GROWTH IN THE EURO-ZONE COUNTRIES

y o y growth, in %, sa



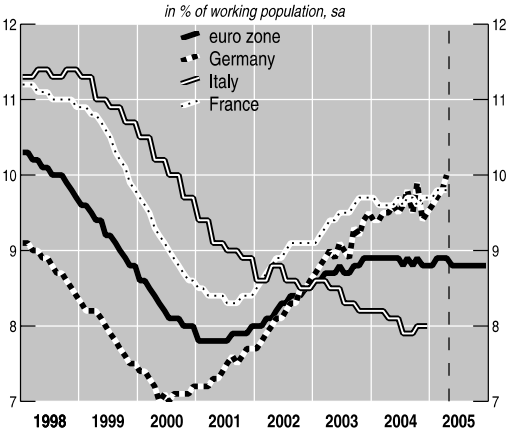
sources: Destatis, Eurostat, Istat, Insee

forecasts after the dotted line

2

HARMONISED UNEMPLOYMENT RATE IN THE EURO ZONE

in % of working population, sa



sources: Eurostat

forecasts after the dotted line

GDP IN THE EURO ZONE AND IN THE PRINCIPAL MEMBER COUNTRIES

(% change)

	Quarterly changes												Annual changes		
	2003				2004				2005				2003	2004	2005
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
GERMANY (29.4%)[1]															
GDP	**-0.4**	**-0.1**	**0.2**	**0.6**	**0.4**	**0.2**	**0.0**	**-0.1**	**1.0**	**-0.1**	**0.2**	**0.2**	**0.0**	**1.0**	**1.1**
Household consumption	0.0	0.3	-0.3	-0.3	-0.2	-0.3	0.3	0.3	-0.2	-0.1	0.0	0.1	0.3	-0.4	0.0
Total GFCF	-0.3	-0.7	-0.3	1.7	-3.1	0.1	0.5	0.3	-1.7	0.1	0.2	0.2	-1.7	-1.8	-1.0
Public consumption	-1.1	0.7	0.5	0.8	-2.0	0.0	0.7	0.1	-0.2	0.0	0.0	0.0	-0.4	-0.7	0.3
Exports	-1.3	-2.7	4.3	0.9	3.5	3.3	-1.0	1.1	2.9	1.0	1.0	1.0	1.7	8.0	5.6
Imports	2.2	-1.8	0.1	3.0	0.8	2.3	2.7	0.2	-1.4	0.7	0.9	0.9	4.2	5.8	1.9
Contributions :															
Domestic demand ex. stocks	*-0.3*	*0.2*	*-0.1*	*0.3*	*-1.1*	*-0.2*	*0.4*	*0.3*	*-0.5*	*-0.1*	*0.1*	*0.1*	*-0.1*	*-0.4*	*-0.4*
Inventory change	*1.1*	*0.1*	*-1.2*	*0.9*	*0.5*	*-0.1*	*0.8*	*-0.8*	*-0.1*	*-0.1*	*0.0*	*0.0*	*1.0*	*0.3*	*0.0*
Foreign trade	*-1.2*	*-0.4*	*1.5*	*-0.6*	*1.0*	*0.5*	*-1.3*	*0.4*	*1.6*	*0.1*	*0.1*	*0.1*	*-0.9*	*1.1*	*1.5*
FRANCE (21,3%)[1]															
GDP	**0.4**	**-0.4**	**1.1**	**0.4**	**0.6**	**0.6**	**0.2**	**0.7**	**0.2**	**0.3**	**0.4**	**0.6**	**0.9**	**2.1**	**1.5**
Household consumption	0.3	-0.1	1.1	0.3	1.0	0.5	-0.1	1.1	0.7	0.3	0.5	0.5	1.6	2.3	2.2
Total GFCF	1.0	0.8	1.3	1.2	-0.5	0.9	-0.3	1.3	1.3	0.5	0.5	0.6	2.7	2.2	3.2
Public consumption	0.1	0.5	0.9	0.9	0.6	0.5	0.5	0.6	-0.4	1.0	0.5	0.7	2.1	2.7	1.6
Exports	-1.9	-1.3	1.0	1.3	0.1	1.0	0.4	0.9	-0.1	0.5	0.6	1.0	-1.7	2.4	1.9
Imports	0.4	0.0	0.7	2.2	0.5	3.0	2.2	1.0	0.6	0.5	0.8	0.8	1.3	6.1	4.3
Contributions :															
Domestic demand ex. stocks	*0.4*	*0.2*	*1.1*	*0.6*	*0.6*	*0.6*	*0.0*	*1.0*	*0.5*	*0.5*	*0.5*	*0.6*	*1.9*	*2.4*	*2.2*
Inventory change	*0.6*	*-0.3*	*-0.1*	*0.1*	*0.1*	*0.6*	*0.7*	*-0.3*	*-0.1*	*-0.2*	*0.0*	*0.0*	*-0.2*	*0.8*	*0.0*
Foreign trade	*-0.7*	*-0.4*	*0.1*	*-0.2*	*-0.1*	*-0.6*	*-0.5*	*-0.1*	*-0.2*	*0.0*	*-0.1*	*-0.1*	*-0.9*	*-1.0*	*-0.7*
ITALY (17,9%)[1]															
GDP	**-0.2**	**-0.2**	**0.4**	**0.0**	**0.5**	**0.4**	**0.4**	**-0.4**	**-0.5**	**0.2**	**0.4**	**0.5**	**0.4**	**1.0**	**0.0**
Household consumption	0.0	0.3	0.7	-0.5	1.0	-0.3	0.0	0.4	0.2	0.3	0.3	0.3	1.4	1.0	0.9
Total GFCF	-5.0	-0.9	-0.6	-0.4	3.3	0.7	-1.5	-1.2	-0.6	0.4	0.6	0.6	-1.8	1.9	-1.4
Public consumption	0.8	0.5	1.0	0.0	-0.3	0.2	0.2	0.3	0.2	0.1	0.1	0.1	2.3	0.7	0.7
Exports	-2.1	-2.9	5.2	-1.2	-1.7	4.0	4.4	-4.5	-4.1	0.0	0.5	0.5	-1.9	3.2	-4.1
Imports	-2.1	-1.2	1.5	0.4	-0.5	2.3	1.1	0.0	-2.4	0.2	0.2	0.5	1.3	2.5	-0.9
Contributions :															
Domestic demand ex. stocks	*-0.9*	*0.1*	*0.5*	*-0.4*	*1.3*	*0.0*	*-0.3*	*0.0*	*0.0*	*0.3*	*0.3*	*0.3*	*0.9*	*1.1*	*0.4*
Inventory change	*0.8*	*0.2*	*-1.1*	*0.8*	*-0.4*	*-0.1*	*-0.3*	*0.8*	*0.0*	*0.1*	*0.0*	*0.2*	*0.4*	*-0.3*	*0.5*
Foreign trade	*0.0*	*-0.5*	*1.0*	*-0.5*	*-0.3*	*0.5*	*1.0*	*-1.3*	*-0.5*	*-0.1*	*0.1*	*0.0*	*-0.9*	*0.2*	*-0.9*
SPAIN (10,2%)[1]															
GDP	**-**	**0.7**	**0.6**	**0.9**	**0.7**	**0.8**	**0.7**	**0.9**	**0.9**	**0.8**	**0.7**	**0.7**	**-**	**3.1**	**3.2**
Household consumption	-	-0.4	1.5	1.6	0.6	1.0	1.4	1.7	0.6	0.7	0.7	0.7	-	4.4	4.0
Total GFCF	-	0.9	0.5	2.4	-0.5	0.7	2.2	3.4	0.9	0.6	0.6	0.6	-	4.4	5.7
Public consumption	-	1.5	0.2	0.4	3.3	2.4	0.9	0.0	2.6	1.0	1.0	1.0	-	6.4	5.2
Exports	-	0.1	0.9	0.7	1.7	-0.6	1.4	-0.8	-1.7	0.3	0.6	0.6	-	2.8	-1.0
Imports	-	0.7	2.3	2.0	1.1	2.3	3.5	1.6	-1.6	0.5	0.9	0.9	-	8.1	2.9
Contributions :															
Domestic demand ex. stocks	*-*	*0.3*	*1.0*	*1.6*	*0.8*	*1.2*	*1.6*	*1.9*	*1.1*	*0.8*	*0.8*	*0.7*	*-*	*4.9*	*4.9*
Inventory change	*-*	*0.6*	*0.1*	*-0.3*	*-0.2*	*0.5*	*-0.2*	*-0.4*	*-0.2*	*0.0*	*0.0*	*0.0*	*-*	*-0.2*	*-0.6*
Foreign trade	*-*	*-0.2*	*-0.4*	*-0.4*	*0.1*	*-0.8*	*-0.7*	*-0.7*	*0.0*	*0.0*	*-0.1*	*-0.1*	*-*	*-1.6*	*-1.1*
EURO ZONE (27,8%)[2]															
GDP	**0.0**	**-0.1**	**0.5**	**0.5**	**0.7**	**0.4**	**0.3**	**0.2**	**0.5**	**0.2**	**0.3**	**0.4**	**0.7**	**1.7**	**1.3**
Household consumption	0.1	0.1	0.4	0.1	0.5	0.1	0.3	0.6	0.3	0.2	0.3	0.3	1.1	1.2	1.3
Total GFCF	-0.5	-0.1	0.2	1.4	-0.5	0.4	0.5	0.8	-0.7	0.4	0.5	0.5	0.4	1.4	0.9
Public consumption	-0.1	0.6	0.7	1.1	0.3	0.7	0.9	0.2	-0.2	0.4	0.3	0.4	1.3	2.6	1.1
Exports	-1.1	-1.5	2.5	0.9	1.5	2.7	1.0	0.3	0.2	0.6	0.8	0.8	0.6	5.7	2.6
Imports	0.3	-0.8	1.0	2.2	0.3	2.7	2.4	0.9	-1.1	0.5	0.7	0.7	2.5	5.8	2.3
Contributions :															
Domestic demand ex. stocks	*0.0*	*0.2*	*0.4*	*0.6*	*0.3*	*0.3*	*0.5*	*0.6*	*0.0*	*0.3*	*0.3*	*0.4*	*1.0*	*1.5*	*1.2*
Inventory change	*0.6*	*0.0*	*-0.5*	*0.4*	*-0.1*	*0.1*	*0.3*	*-0.2*	*0.0*	*-0.1*	*0.0*	*0.0*	*0.4*	*0.1*	*-0.1*
Foreign trade	*-0.6*	*-0.3*	*0.6*	*-0.4*	*0.5*	*0.1*	*-0.5*	*-0.2*	*0.5*	*0.0*	*0.1*	*0.1*	*-0.7*	*0.1*	*0.2*

Forecast

1) Share of euro-zone GDP

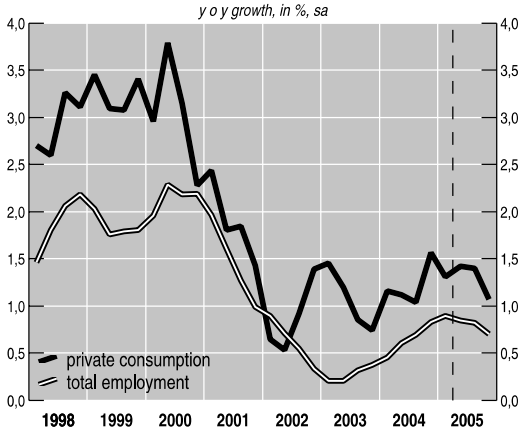
(2) Share of OECD GDP

Sources : Statistisches Bundesamt, Insee, Istat, Ine, Eurostat

3

GROWTH OF PRIVATE CONSUMPTION AND EMPLOYMENT IN THE EURO ZONE

y o y growth, in %, sa



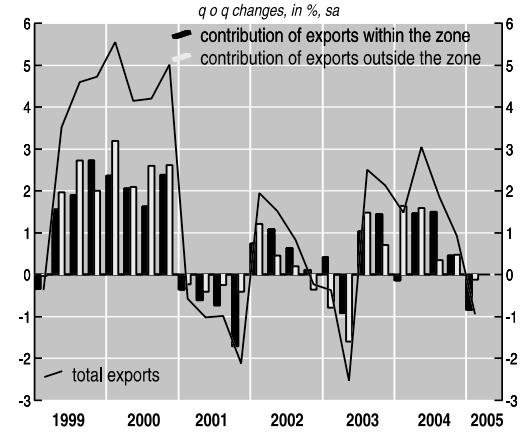
sources: Eurostat, Insee forecasts

forecasts after the dotted line

4

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

q o q changes, in %, sa



source: Eurostat

thanks to a slight easing of inflation. An increase in purchasing power of this size would be too small to trigger off a substantial rally in private consumption.

In these circumstances, household confidence has constantly declined in the period to May, according to European surveys. As a result, the saving ratio (13.8% in 2004) is likely to remain high as a result of precautionary behaviour in view of the employment situation and the outlook for public finances. As a consequence, household spending is unlikely to rise other than modestly, at a rate of 0.3% per quarter until the end of 2005.

In Germany in particular, against a background of persistent uncertainties regarding the labour market, households seem to be giving priority to savings, as noted by the Ifo and Gfk institutes. Real wages, after falling by 1.5% last year, will probably continue to stagnate. The expected effects on employment in mid-year of the Hartz IV labour-market reforms might give a slight fillip to consumption towards the end of the year, but still leave its annual growth close to zero.

Public consumption is unlikely to take up the running from private consumption. Public spending is not expected to grow by more than 1.1% in 2005, compared with 2.6% in 2004. Restrictions on public spending in the framework of the Growth and Stability Pact are expected to be strengthened in the zone, as the result, among other things, of the threat of the application of excessive deficit procedures against Italy and Portugal.

Exports unlikely to grow fast enough to provide genuine support for growth

Having slowed down markedly towards the end of last year, the export growth rate has stabilised at a low level in Q1 2005 (+ 0.2%), mainly as a result of an intensification of the slowdown in intra-zone trade. The weakness of domestic demand in certain of the zone's economies, notably Germany and Italy, was largely responsible for this. Customs figures for total merchandise exports showed a decline of 0.9% in Q1 (- 0.2% for exports to outside the zone and - 1.6% for exports inside the zone, *see Graph 4*). Exports to outside the zone were handicapped by the reduction in the strength of activity in the EMU's principal partners, combined with the past appreciation of the euro's effective exchange rate (+ 10% in nominal terms between the beginning of 2003 and March 2005). In addition, the sharp fall in United Kingdom exports in the early part of the year (- 1.9%) meant a severe cut in total foreign demand for the zone's exports.

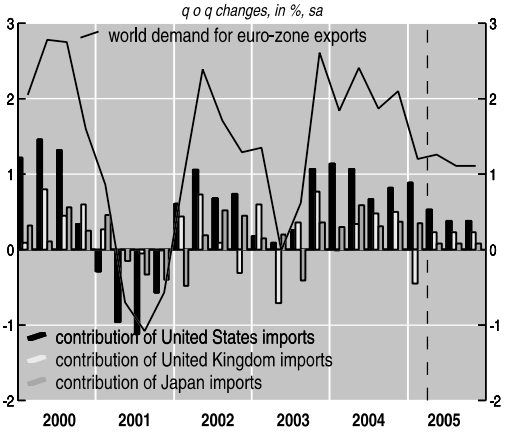
This slowdown in exports finds its reflection in the continued weakening of industrial production ex construction, which declined for the second consecutive quarter (- 0.1% following - 0.3% in Q4), having already been hit towards the end of the year by the running out of steam of foreign demand. The persistent gloom shown in business leaders' opinions in May leave no room for expecting any upturn in industrial production before Q3 2005 *(see box 3)*.

In the case of Italy, this phenomenon has shown even greater intensity and the industrial production index showed a further fall of 0.8% in Q1 2005. Crises affecting particular manufacturing sectors (textiles and cars, especially) helped to weaken the Italian economy even more, quite apart from structural competitiveness problems. By contrast, German in-

5

WORLD DEMAND FOR EURO-ZONE EXPORTS* AND CONTRIBUTIONS OF PRINCIPAL COUNTRIES

q o q changes, in %, sa



sources: DGTPE, Insee

forecasts after the dotted line

**World demand for a country's exports is calculated as the sum of the imports of its partner countries, weighted by the exporting country's share of each partner country's imports (see "note de conjoncture internationale de la DGTPE, décembre 2000, p.38: "La demande mondiale, outil d'analyse des échanges commerciaux").*

dustrial production rallied strongly, driven by foreign demand, notably as a result of exceptional Airbus deliveries (20 more aircraft than in Q1 2005).

Coming quarters are likely to see total exports from the euro zone favoured by incipient internal consolidation in Germany and Italy, despite the slowdown in activity in the zone's external environment (see Graph 5). One sign of this is that euro-zone business leaders were no longer reporting a deterioration in their export order books in May. Moreover, the decline in the euro versus the dollar since April (by 4.0% in the space of two months) followed by a stabilisation during the year at around $1.25 can be expected to benefit the price-competitiveness of European products. For these various reasons, exports can be expected to accelerate slightly rising by 0.6% in Q2 and by 0.8% in Q3 and Q4. However, this improvement is unlikely to be sufficient to breathe new life into economic activity in the zone and foreign trade in the second half of the year is liable to pro-

DETAILED FORECASTS FOR THE EURO ZONE

(% change)

	Quarterly changes						Annual changes	
	2004		2005				2004	2005
	Q3	Q4	Q1	Q2	Q3	Q4		
Volumes								
GDP	0.3	0.2	0.5	0.2	0.3	0.4	1.7	1.3
Domestic demand	0.8	0.4	0.0	0.1	0.3	0.3	1.7	1.1
Household consumption	0.3	0.6	0.3	0.2	0.3	0.3	1.2	1.3
Public consumption	0.9	0.2	-0.2	0.4	0.3	0.4	2.6	1.1
Investment	0.5	0.8	-0.7	0.4	0.5	0.5	1.4	0.9
Foreign trade of goods and services (contribution)	-0.5	-0.2	0.5	0.0	0.1	0.1	0.1	0.2
Exports of goods	-0.4	1.7	-3.8	-0.7	0.4	0.9	8.2	-2.3
Imports of goods	2.1	-0.2	-3.1	1.4	1.2	1.2	5.9	0.1
Prices								
Value added price	0.3	0.3	0.5	0.5	0.5	0.4	1.8	1.8
Consumption price	0.6	0.3	0.3	0.6	0.4	0.4	1.9	1.7
Investment price	0.8	0.4	0.5	0.4	0.4	0.4	2.8	2.0
Price of exports of goods	0.6	-0.6	-0.1	0.6	0.2	0.5	0.1	0.8
Price of imports of goods	2.7	0.6	-0.2	-0.6	-0.2	0.0	2.6	1.9
Wages	-0.2	0.4	0.5	0.7	0.7	0.7	1.9	1.9
Employment and unemployment								
Unemployment rate (percentage points)	8.8	8.8	8.8	8.8	8.8	8.8	8.8	8.8
Employment	0.2	0.2	0.2	0.2	0.2	0.1	0.6	0.8
Active population	0.2	0.1	0.3	0.1	0.1	0.1	0.8	0.8
Labour cost per unit	0.0	0.4	0.3	0.7	0.5	0.4	0.6	1.5
Productivity of work	-0.1	0.0	0.3	0.0	0.2	0.2	1.3	0.5
Others								
Global demand	2.3	2.5	1.9	1.3	1.2	1.3	9.9	7.6
Balance of trade (points of GDP)	2.0	1.8	1.7	1.6	1.6	1.6	9.9	7.1
3-month interest rate (%)	2.1	2.2	2.1	2.2	2.2	2.2	2.1	2.2
10-year interest rate (%)	4.2	3.8	3.7	3.6	3.7	3.7	4.1	3.6
Level of capacity utilization (%)	82.0	82.1	81.9	81.5	81.4	81.2	81.6	81.5
Gross disposable income (value)	0.5	0.6	0.9	0.7	0.8	0.8	3.1	3.0
Contribution of gross operating surplus	0.1	0.1	0.4	0.1	0.2	0.2	1.3	0.8
Contribution of wages	0.0	0.4	0.6	0.7	0.6	0.6	1.9	2.0
Others contributions	0.3	0.1	0.0	-0.1	0.0	0.0	-0.1	0.1

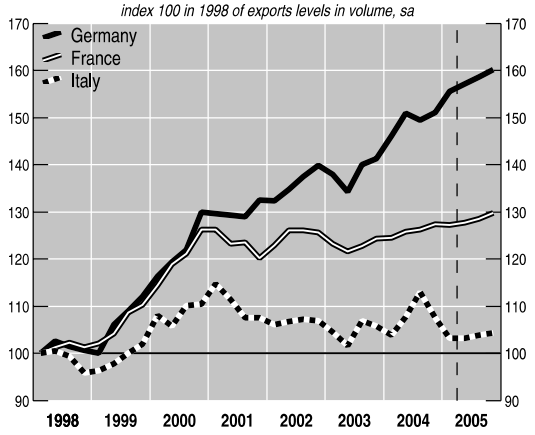
Forecast MZE

Sources : Eurostat, Insee

6

EXPORTS OF THE PRINCIPAL EURO-ZONE COUNTRIES

index 100 in 1998 of exports levels in volume, sa



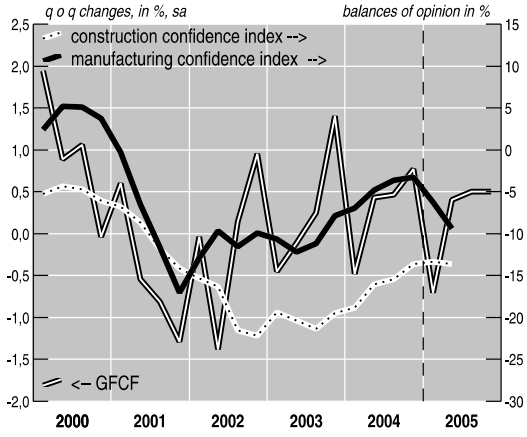
sources: Destatis, Insee, Istat

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

vide only moderate support for growth. Export growth for 2005 as a whole is expected to be 2.6%, only half the 2004 rate.

Italy's export performance is likely to remain disappointing, following steady losses of the country's market share since 1999. In addition, the lifting of quota restrictions on Chinese textile and clothing exports *(see fact sheet entitled «Foreign trade»*, available in the French version only) can be expected to have a negative but not precisely measurable impact on Italian exports by providing direct competition on a European market where Italy is currently the leader. By contrast, Germany is likely to continue to stand out for the strength of its exports *(see Graph 6)*. The improvement in firms' cost-competitiveness resulting from the decline in real wages, together with the continuing favourable sectoral specialisation, can be expected to provide further support for export growth in 2005.

Corporate investment likely to be handicapped by weak demand and continuing low capacity utilisation rates

As a consequence of the slowdown in world trade and in household demand, but also because of the poor performance from investment in construction, total investment contracted in the early part of the year (by 0.7% in Q1), after rising since mid-2004. The decline in investment was particularly marked in Germany and the Netherlands, whereas in France GFCF growth was firm. In the case of Germany, construction investment showed a particularly substantial one-off decline as a result of a cold spell in February and March that brought work on site to a halt.

In coming quarters, the continuing accommodating financial conditions and the accumulation of past earnings are unlikely to constitute sufficient motivation for European industrial firms to invest. Business leaders' morale has steadily worsened since February and the production outlook for coming months was still reported to be unfavourable in May. In addition, productive capacity utilisation rates de-

EURO-ZONE : HOUSEHOLDS ACCOUNTS

(annual changes %)

	2001	2002	2003	2004	2005
Total employment	1.4	0.5	0.2	0.6	0.8
Dependent employment	1.6	0.6	0.1	0.4	-
Average wage per head	2.8	2.6	2.3	1.9	1.9
Gross nominal disposable income	4.9	3.3	3.0	3.1	3.0
Private consumption deflator	2.3	2.3	2.0	1.9	-
Saving ratio absolute level	13.5	13.9	13.7	13.8	-

Forecasts Insee

Sources : Eurostat, Insee

clined in April and are now at low levels. The decided gloom shown by industrial business leaders since the beginning of Q2 will probably prevent any marked recovery in investment in the short term. The euro-zone common factor in the manufacturing survey is in fact at its lowest level since the end of 2003. All in all, growth in productive GFCF is likely to be limited this year.

The one positive point is that surveys in the construction industry remained favourable in May, with the morale of business leaders in the building industry stable at a high level *(see Graph 7)*. In Germany, as a reaction to the effect of the cold spell, construction investment seems to have bounced back in Q2 before stabilising. All in all, construction investment in the euro zone is expected to resume positive growth, continuing to rise in line with strong demand for housing, notably in France and Italy.

Growth in total investment is likely to be moderate until the end of 2005 (+ 0.4% in Q2, followed by + 0.5% in Q3 and Q4). Growth for the whole of 2005 is expected to be 0.9%, compared with 1.4% in 2004.

The slack growth in domestic demand and the weakness of foreign demand mean that import growth will probably be low in 2005. After declining sharply in Q1 2005 as a reflection of the domestic demand shock, imports should return during the year to positive growth rates of the order of 0.7% per quarter. ■

BOX 1: CHANGES IN NATIONAL ACCOUNTS METHODOLOGY IN 2005 (SEE THE INSEE SPECIAL REPORT ON THE MOVE TO THE 2000 BASE [1])

Introduction

In the vocabulary used by the French national accounting system («comptabilité nationale française» - CNF), the term 'base' describes a fixed set of concepts, nomenclatures and methods. There have been several changes of base since the creation of the CNF, each of the bases being traditionally identified by the respective base years for the constant price calculations. In the past 20 years, European construction and, more recently, the introduction of a single currency have increased the need for comparable national accounts data integrated within the new framework set up by the United Nations in 1993 (SNA 93). For this purpose, the European Union adopted the 1995 European System of Accounts (ESA 95), the European version of SNA 93, having the force of a European regulation binding on all members.

Principal changes in the 2000 base

In 2005, the EU countries are due to adopt the year 2000 as the base = 100 for price calculations. Simultaneously, the regulation on the allocation of financial intermediation services indirectly measured (FISIM) will come into force. At this time, most of the countries will be carrying out revisions and re-basings of all the values and calculations in their national accounts. In this connection, using the 2000 base has made it possible to make joint advances in four areas: measurement of the output of software and its allocation between investment and intermediate consumption; measurement of the volume of non-market activities, especially education services; measurement of forestry output; and the method of dealing with FISIM, part of whose consumption is now included in that of households.

The allocation of financial intermediation services indirectly measured (FISIM)

The breakdown of FISIM by use is the only major conceptual change introduced with the 2000 base. Financial intermediaries invoice part of the services provided to their customers in various forms: transfer charges, account-holding fees, custody fees, etc. However, a substantial part of their services are remunerated in the form of a spread between the interest paid on the deposits of their customers and that received on the loans they make. Financial Intermediation Services Indirectly Measured (FISIM) represent precisely that part of the financial services that is not invoiced. The output of financial institutions comprises two components:

- invoiced services, measured by fees that are explicitly charged,
- FISIM, in other words the interest-rate spread between loans and deposits.

Until the introduction of the 1995 base, the only recognised use of FISIM consisted of an intermediate consumption for the economy as a whole, being globally recorded as an intermediate consumption for a notional branch. The change being introduced in the 2000 base consists of allocating FISIM between the various actual uses: intermediate consumption, final consumption, exports. In the 2000 base, there are therefore final uses and external trade in FISIM, which correspondingly modify GDP. In the case of France, this new euro approach raises GDP in the year 2000 by 13.6 billion euros, or 0.95%. Generally speaking, the impact will vary from one country to another. According to Eurostat, this change of methodology is estimated to add of the order of 1-1.5% to annual EU GDP.

The consequences for comparisons between member states and for European aggregates

- As Member States will be applying different timetables in making the changes, comparability between those that have already introduced the new methodology and the remainder is reduced during the transition period. This is of particular importance for the comparison between absolute data, less in the case of comparisons of growth rates.
- Eurostat plans to publish European aggregates including FISIM at annual and quarterly level for Q3 2005. ■

(1) This box draws heavily on the special article concerning the 2000 base, available on the INSEE web site.

TIMETABLE FOR THE INCORPORATION OF THE NEW BREAKDOWN OF FISIM

	Initial publication	
	Annually	Quarterly
Austria	Prior to the move to the 2000 base	
Belgium	September 2005	December 2005
Finland	July 2005	
France	May 2005	
Germany	May 2005	
Greece	September 2005	June 2005
Ireland	June 2005	
Italy	September 2005	December 2005
Luxemburg	September 2005	
The Netherlands	July 2005	
Portugal	September 2005	December 2005
Spain	May 2005	

BOX 2: CHAINED PRICES: AN AID TO BETTER COMPREHENSION OF THE NEW BASE

Introduction

In 2005 and 2006, most EU Member States will introduce chained prices into their annual and quarterly national accounts in measuring the evolution in volume of their economic aggregates. A certain number have already introduced this method (see timetable), which is also used in the United States and Japan, among other countries. At the end of November 2005, Eurostat will be applying this change to the European aggregates.

Why this methodological change?

Variations in the value of an economic aggregate can be the result either of an increase in the prices of goods and services or an increase in volumes. In order to measure GDP growth, it is desirable to eliminate the price effect. In the past, this was down by selecting a reference year (the so-called base year) and then aggregating the variations in volume of the various components using as weightings the price structure of the base year. Volumes were then expressed «in constant [base year] prices». However, the more distant in time the year in question from the base year, the less relevant the base year price structure becomes. It is then necessary to make periodical changes in the base year. In practice, this was done every five years. However, a five-yearly basis year change is inadequate for describing an economic environment that is permanently evolving. This is particularly true in the field of information and communication technology. In addition, globalisation of markets and world competition are bringing about rapid changes in price structures.

What are chained prices?

The idea underlying chained prices is to update the base year more frequently in order to apprehend short-term evolutions. In this way, changes in volume from one period to another are calculated using the price structure of the preceding year, so that the price structure is effectively updated every year.

TIMETABLE FOR CHAINED PRICES

	Initial publication	
	Annually	Quaterly
Austria	Prior to the move to the 2000 base	
Belgium	September 2006	December 2006
Finland	December 2005	February 2006
France	Prior to 2005	May 2006
Germany	May 2005	
Greece	Prior to 2005	June 2007
Ireland	June 2005	
Italy	September 2005	December 2005
Luxemburg	Prior to 2005	April 2005
The Netherlands	Prior to the move to the 2000 base	
Portugal	Prior to the move to the 2000 base	
Spain	May 2005	

The changes described in this way between consecutive periods are then cumulated in order to produce a volume series.

Eurostat plans to publish the EU's annual and quarterly accounts using chained prices as of Q3 2005.

Precautionary note

Volume series cannot be added together. For example, GDP in volume in year t is not equal to the sum of its components in volume in year t. Similarly, euro-zone GDP in volume is not equal to the sum of the members' GDPs. On the other hand, it is possible to break volume growth for a given aggregate down into the growth of its components *(see section entitled «Formulae», part A)*.

Formulae

What are described here are the methodologies for the annual accounts of euro-zone countries using «chained prices» and «constant prices».

A) Chained prices

Take the example of the 2000 base. Let us suppose that the GDP is made up of *n* goods. In year *t*, good *i* is sold at price $p_{i,t}$ and in quantity $q_{i,t}$.

The series for the level of GDP in volume using chained prices is defined as follows:

$GDP^{Pch}_{2000} = GDP^{Va}_{2000}$

$GDP^{Pch}_{t+1} = Q_{t+1} GDP^{Pch}_{t}$ with the following Laspeyres volume index $Q_{t+1} = \dfrac{\sum_i p_{i,t} q_{i,t+1}}{\sum_i p_{i,t} q_{i,t}}$,

which corresponds to the ratio between the value for the current year at the preceding year's prices and the value for the preceding year.

and PIB^{Va}_{t}, GDP in value in year *t*, which can be written by definition as:

$$GDP^{Va}_{t} = \sum_i p_{i,t} q_{i,t}$$

The GDP deflator P_{t+1} is defined as follows:

$$P_{t+1} = \frac{GDP^{Va}_{t+1}}{GDP^{Pch}_{t+1}}$$

What we have here is an annually-chained Paasche index.

Individual contributions are simply obtained: GDP growth in volume for year *t+1* is equal to the weighted sum in value of the volume growths of the various components of GDP.

$$\frac{GDP^{Pch}_{t+1}}{GDP^{Pch}_{t}} - 1 = \sum_i \frac{C^{Va}_{i,t}}{GDP^{Va}_{t}} \left(\frac{C^{Pch}_{i,t+1}}{C^{Pch}_{i,t}} - 1 \right)$$ where GDP^{Pch}_{t} is GDP in volume for year *t* calculated using the prices of year *t-1*.

BOX 2: CHAINED PRICES: AN AID TO BETTER COMPREHENSION OF THE NEW BASE

B) Constant prices

Take the example of the 2000 base. Let us suppose that the GDP is made up of *n* goods. In year *t*, good *i* is sold at price $p_{i,t}$ and in quantity $q_{i,t}$.

As the base year is 2000, the fixed price structure is that of 2000. GDP in volume for year *t* is then:

$$GDP_t^{V0} = \sum_i p_{i,2000} q_{i,t}$$

The GDP deflator P can be written by definition as follows:

$$P_t = \frac{GDP_t^{Va}}{GDP_t^{V0}}$$

The GDP in value in year t is then equal to:

$$GDP_t^{Va} = \sum_i p_{i,t} q_{i,t}$$

The contributions to growths in year t of product i can be written by definition as follows:

$$\frac{GDP_t^{V0}}{GDP_{t-1}^{V0}} - 1 = \sum_i \frac{C_{i,t}^{V0} - C_{i,t-1}^{V0}}{GDP_{t-1}^{V0}}$$

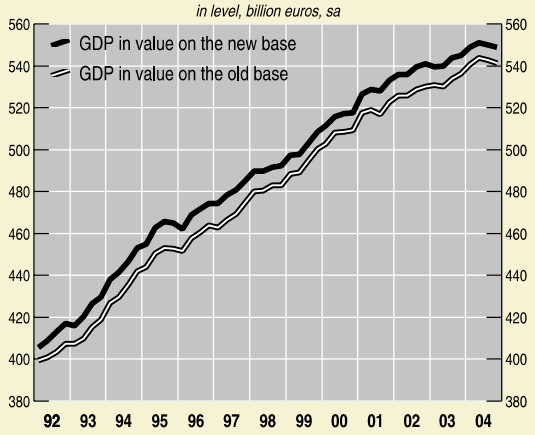
where GDP_t^{V0} stands for GDP in volume in year t at year 2000 prices. ■

EFFECTS OF THE BASE CHANGE IN FRANCE (INCORPORATION OF FISIM) AND GERMANY (INCORPORATION OF FISIM AND MOVE TO CHAINED PRICES) ON GDP IN ABSOLUTE VALUE AND THE SAVING RATIO

A

GERMANY: GDP

in level, billion euros, sa

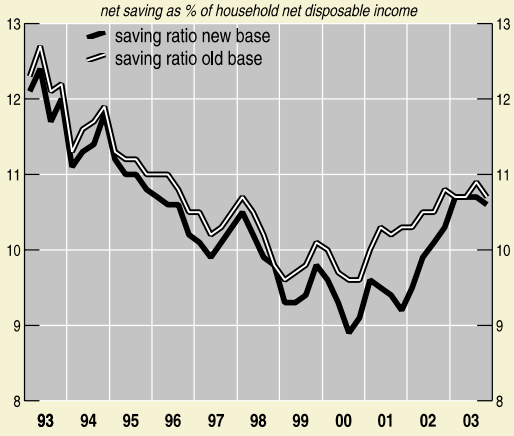


sources: Bundesbank, Destatis

C

GERMANY: SAVING RATIO

net saving as % of household net disposable income

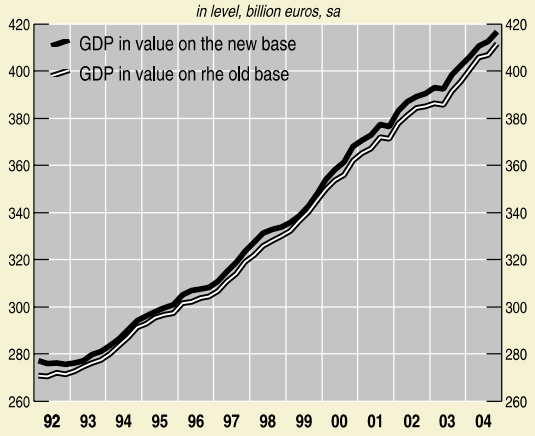


sources: Bundesbank, Destatis

B

FRANCE: GDP

in level, billion euros, sa

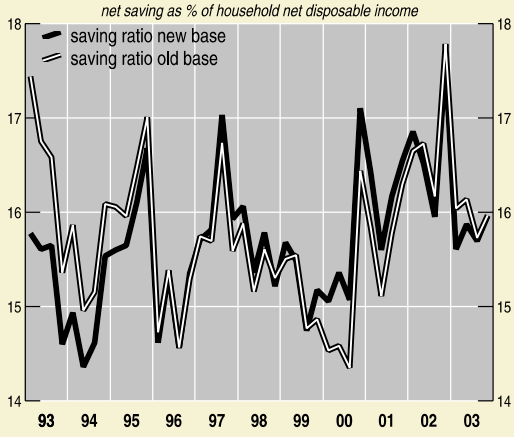


source: Insee

D

FRANCE: SAVING RATIO

net saving as % of household net disposable income



source: Insee

BOX 3: FORECASTS FOR THE INDUSTRIAL PRODUCTION INDEX (IPI) IN MANUFACTURING USING THE EUROPEAN COMMISSION'S INDUSTRY SURVEY

The aim of this box is to measure the predictive efficiency of various calibrations constructed using European business surveys. This efficiency is measured by the so-called «in-sample, out-of-sample» method, consisting of reproducing over time all the information available to the short-term economic analyst (in-sample), then making the forecast using the calibration in question and comparing it with the observed (out-of-sample) value.

It should be pointed out that this cannot be considered as a «real-time» approach as we are carrying out this exercise using revised data and not those actually available to the analyst at the moment in question. On the other hand, this approach takes into account the timetable of publication of the magnitudes used in the calibration. For example, as of the third month of the current quarter (June, in the case of this note) we can use the surveys for the first two months (April and May) while as of the second month (May), only the first month's survey (April) is available.

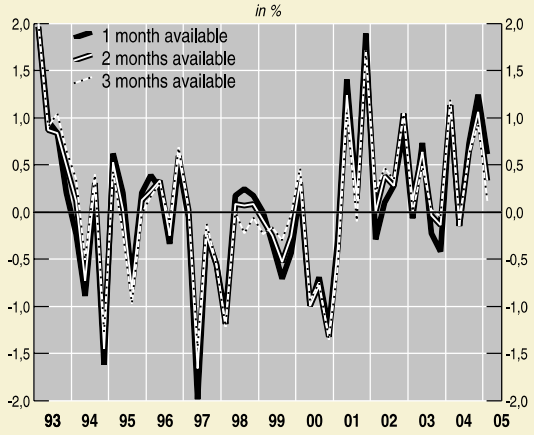
TABLE 1 : DESCRIPTION OF DATA

	Ipi	European Commission survey
Availability	M+45days	End of month
Frequency	Monthly	Monthly
Description	Industrial production index in the manufacturing sector in the euro zone	6 countries, 5 questions giving 30 balances of opinion

Ⓐ

OUT-OF-SAMPLE RESIDUALS

in %

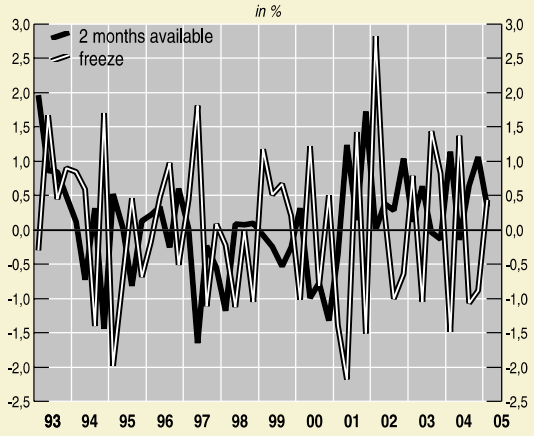


sources: European Commission, Insee calculation

Ⓑ

COMPARISON OF OUT-OF-SAMPLE RESIDUALS

in %



sources: European Commission, Insee calculation

The magnitude we are trying to predict is quarterly growth in euro-zone manufacturing ipi for the current quarter. For this purpose, we use the first source of information available, namely the European Commission's business surveys. The ipi and the business survey for manufacturing are published monthly but do not have the same availability.

We carry out a linear regression of the quarterly growth rate of the ipi on the first difference of the quarterly average of the business climate in industry constructed on the basis of the surveys (hereafter called the common factor). In making a forecast, the quarterly average of the common factor is not available for timetable reasons and is replaced by the average of the published common factors. In this way we obtain three sets of residuals (differences between predicted and observed values) one for each of the months for which we are making the forecast (May, June or July: one, two or three months' available surveys). We find that the residuals diminish with every addition of further information (see Graph A).

Estimation of the equation gives the following results (estimation period: Q2 1985 to Q1 2005)

$$gripi_t = \underset{(5,11)}{4{,}42.10^{-3}} + \underset{(7,90)}{1{,}85.10^{-3}} * fdceze_t + u_t$$

Adjusted R^2: 43%

RMSE: 0,93%

Notations used:

gripi: quarterly growth rate of ipi

fdceze: quarterly first difference of survey common factor

We compare this method to that consisting of forecasting the ipi growth rate on the basis of the last observed value ("freeze method") (see Graph B). The residuals are higher in this case, leading us to adopt the first method.

Conclusion

The forecast of ipi growth in Q2 using the method described here is -0.5 ■

Consumer prices in the euro zone

Inflation in the euro zone rose to 2.1% as of February 2005, pushed upwards by the further surge in the oil price, before returning to 1.9% in May. Within the zone, inflation differentials narrowed substantially in the early part of 2005, thanks in particular to the exit from the year-on-year calculation of the Finnish alcohol tax reform and the return to normal of the Greek clothing sector.

On the assumption that the Brent price gradually stabilises at around $45/barrel until the end of the year and that the euro exchange rate fluctuates around $1.25, inflation would then gradually decline, from 1.9% in June to 1.8% in December. Core inflation (1) is expected to be stable at well below 2%, while the year-on-year change in energy prices would drop back in line with the stabilisation of the oil price.

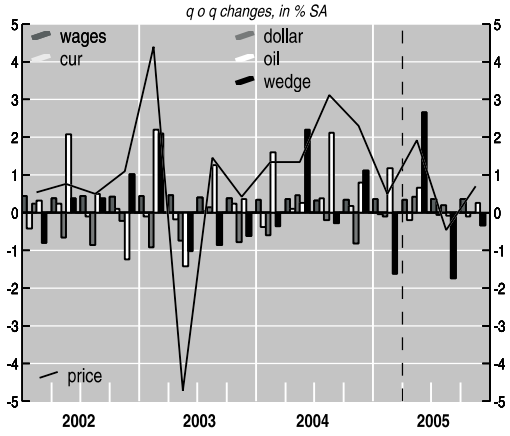
After a distinct decline in January 2005, inflation in the euro zone has been driven up by the rise in energy prices. There should from now on be a continuation of the easing begun in May, with the oil price stabilising at around $45/barrel.

Inflation in the euro zone fell back in January 2005 to 1.9%. This decline was due, in particular, to a base effect: at the beginning of 2004, the reform of the German health system, involving cuts in reimbursement rates, had pushed up prices as measured by the HICP. This tendency was then reinforced by favourable movements in food prices and by a slight easing of energy prices, despite the continuing high price of oil. The decline was then reversed, with inflation coming out at 2.1% in the three following months, driven up by energy prices, before falling back again to 1.9% in May.

On the assumption that the Brent price stabilises at around $45/barrel until the end of the year and that the euro exchange rate remains around $1.25 during the time-horizon of this forecast, inflation can be expected to fall back, reaching 1.8% in December.

1
CONTRIBUTIONS TO THE EVOLUTION OF PRICE OF ENERGY PRODUCTS

q o q changes, in % SA



forecasts after the dotted line

(1) Measured by 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 in 2005)	Year on year changes at end					Annual changes		
	June 2004	Dec. 2004	May 2005	June 2005	Dec. 2005	2003	2004	2005
Total (100.0%)	**2.4**	**2.4**	**1.9**	**1.9**	**1.8**	**2.1**	**2.1**	**1.9**
Food (Beverage and Tobacco) (19.6%)	**2.7**	**2.0**	**1.3**	**1.2**	**1.8**	**2.8**	**2.3**	**1.8**
of which Food (15.5%)	*1.4*	*0.3*	*0.6*	*0.4*	*1.4*	*2.1*	*1.0*	*0.9*
Beverage and Tobacco (4.2%)	*8.4*	*8.4*	*3.9*	*3.9*	*3.4*	*5.9*	*7.5*	*5.1*
Energy (8.5%)	**5.9**	**7.0**	**6.9**	**6.9**	**4.5**	**3.0**	**4.5**	**5.6**
Core inflation (71.8%)	**2.0**	**1.9**	**1.6**	**1.4**	**1.4**	**1.8**	**1.8**	**1.4**
of which: Manufactured products (30.8%)	*0.8*	*0.7*	*0.3*	*0.1*	*0.3*	*0.8*	*0.8*	*0.3*
Services (41.0%)	*2.6*	*2.7*	*2.5*	*2.4*	*2.3*	*2.5*	*2.6*	*2.3*

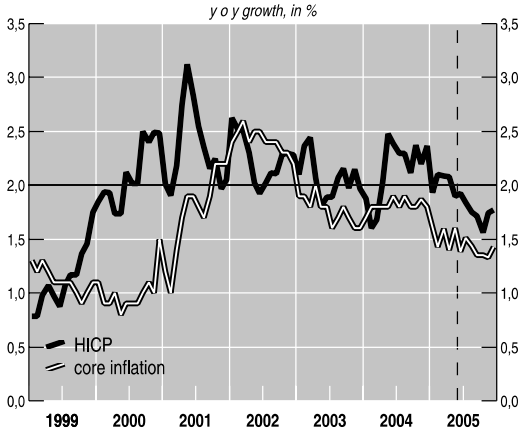
Forecast

Source: Eurostat

2

HICP AND CORE INFLATION

y o y growth, in %

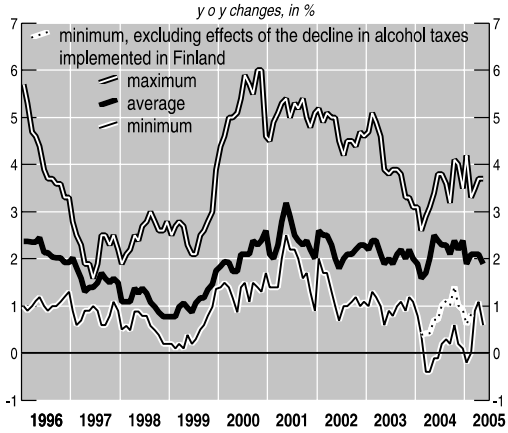


forecasts after the dotted line

3

INFLATION IN THE EURO ZONE

y o y changes, in %



After showing the first signs of easing towards the end of 2004, inflation in the energy sector began to move up again at the beginning of 2005, driven by the latest surge in the oil price, which rose from less than $40/barrel in December 2004 to more than $50/barrel in March and April 2005 [(2)]. It then stood at 10.2% in April, compared with 6.2% in January, before falling back to 6.9% in May. The forecast is that energy prices will slow down as the oil price returns to around $45. The year-on-year energy price change is expected to be 4.5% in December 2005.

After falling distinctly from the summer of 2004 on, because of the steep rises in 2003 due to exceptional weather conditions, food prices began to rise again in the early part of 2005. They are now expected to accelerate gradually and return to more customary inflation levels for this sector in H2 2005, i.e. around 1.4%.

Core inflation set to stabilise at around the low level of 1.4%

Core inflation was stable throughout 2004. However, its level of 1.8%-1.9% included the exceptional effects of the reform of the German health system at the beginning of 2004, which added around 0.3 of a point to core inflation. Excluding exceptional items, therefore, it would have been stable at around 1.5%.

With the German reform now out of the year-on-year calculation, core inflation has decline distinctly in the early part of 2005 and is now expected to fluctu-

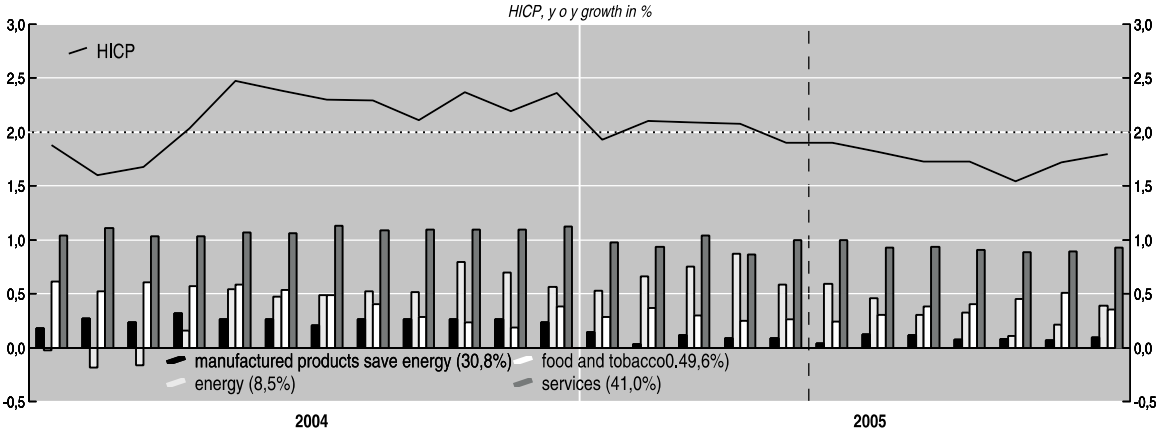
(2) See the fact sheet «Oil and raw material prices», available in the French version only.

4

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)

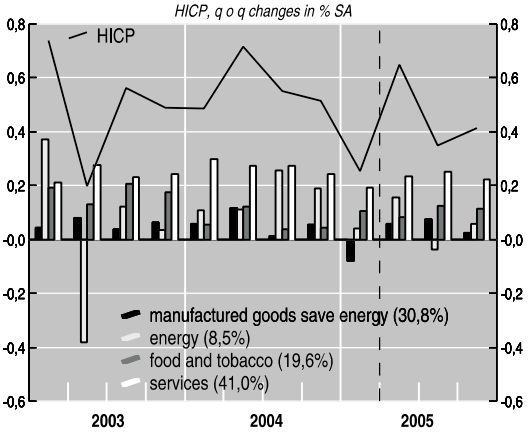
	HICP		Core inflation		Energy	
	May 2004	May 2005	May 2004	May 2005	May 2004	May 2005
Belgium	2.4	2.3	1.3	1.2	10.0	9.5
Germany	2.1	1.6	1.6	0.9	7.3	5.9
Greece	3.1	3.2	2.9	3.4	12.4	10.8
Spain	3.4	3.0	2.5	2.5	6.6	7.2
France	2.8	1.7	1.8	1.6	7.0	6.4
Ireland	2.1	2.2	1.8	2.1	6.9	11.7
Italy	2.3	2.3	2.0	2.2	1.9	8.1
Luxembourg	3.4	3.7	1.8	1.6	13.5	13.5
Netherlands	1.7	1.1	1.4	0.6	8.7	8.2
Austria	2.1	2.0	1.4	1.5	9.2	6.9
Portugal	2.4	1.8	2.5	1.8	3.9	6.7
Finland	-0.1	0.6	0.1	0.6	6.9	1.5
Euro zone	2.5	1.9	1.8	1.6	6.7	6.9

Source : Eurostat

5

EURO ZONE INFLATION: QUARTERLY FIGURES AND CONTRIBUTIONS OF THE MAIN ITEMS

HICP, q o q changes in % SA



sources: Eurostat, SA calculation Insee

forecasts after the dotted line

ate around 1.4% until the end of this year *(see Graph 2)*, posting this level in both June and December.

The rise in prices of services was stable in the final part of 2004, until the ending of the base effect at the beginning of 2005. This stability is likely to be maintained within the time-horizon of the forecast, with the year-on-year rise standing at 2.4% in June 2005 and 2.3% in December.

The price rise in the manufacturing sector has also remained on a stable tendency of the order of 0.8%, year on year, before declining appreciably at the beginning of 2005 under the impact of the exit from the year-on-year calculation of the impact of the reform of the German health system and seasonal declines in clothing prices that were greater than usual, before picking up slightly in April. During the rest of 2005, with the fading of the impact of the past appreciation in the euro and with commodity prices returning to more measured growth, the evolution in this sector should show a certain stability, with rises of the order of 0.2% per quarter. The year-on-year rise in prices of manufactures is expected to stand at 0.1% in June and 0.3% in December.

Inflation differentials within the euro zone have returned to levels similar to those of mid-2003

Inflation differentials within the euro zone narrowed distinctly in February and March 2005 under the successive impacts of the slowdown in Greek clothing prices following the sharp acceleration in January and the exit from the year-on-year calculation of the change in Finnish alcohol taxes that took place in March 2004. The maximum inflation differential nevertheless remains relatively high, it widened to 3.1 points in May because of the marked slowdown of the Finnish price rise.

The tendency towards narrowing of differentials in the case of core inflation (excluding energy and food) that had been seen in H2 2004 has now been halted, even if one leaves aside the exceptional figure for January. ■