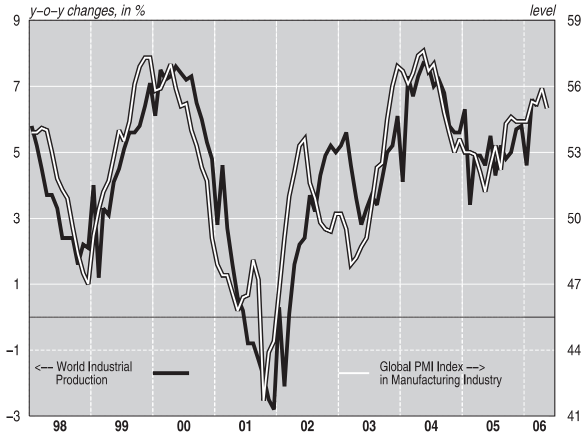
The international economic situation

The year 2006 looks like being exceptional from the point of view of international commercial trade flows, which seem to have reached new peaks in the past winter and can be expected to maintain a relatively firm growth rate, thanks to the continued expansion of the world economy. Seen in this light, the circumscribed nature of the impact of the oil shock is again being confirmed. The latest tendencies in inflation and wages provide further evidence of the absence of second-round effects. In this favourable context, growth rates are likely in general to be fairly brisk in all the industrialised countries, with even a convergence between zones as the result of the expected acceleration in the European countries. Even so, the disequilibria at world level are likely to be maintained between now and the end of the year.

1

EXPECTATIONS IN MANUFACTURING INDUSTRY



sources: national institutes, JP Morgan/NTC, Insee calculations

While the outlook for activity at world level has been positive in the early part of the year, currency and stock markets have begun to react to the American economic situation.

After stabilising towards the end of last year, the prospects for manufacturing activity have taken a turn for the better in the early part of 2006. This suggests that world industrial output can be expected to remain dynamic in coming months, with the year-on-year growth rates close to 6% (*see Graph 1*). Moreover, the global purchasing managers' index in the services sector has also remained positively headed.

This optimism on the part of business leaders, encapsulated in the global composite PMI, is compatible with the maintenance of GDP growth in the major industrialised zones at an annual rate of around 3% (*see Table 1*). Admittedly, the uncoupling - seen in certain euro-zone countries in particular - between business surveys and quantitative data indicate a need for caution. However, given the globally highly favourable context, demand in French export markets is expected to be particularly strong in 2006, growing by almost 10% on an annual average basis.

TABLE 1 : INDUSTRIAL COUNTRIES : RESOURCE-USE BALANCE

In volume

	Quarterly change								Annual change		
	2005				2006				2004	2005	2006
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
GDP	0.7	0.7	0.7	0.5	0.9	0.8	0.6	0.5	3.1	2.6	2.9
Private consumption	0.6	0.6	0.7	0.3	0.9	0.6	0.6	0.5	2.7	2.5	2.6
Public consumption	0.5	0.6	0.7	0.0	0.7	0.5	0.4	0.2	1.8	1.7	1.8
Investment	1.1	1.7	1.6	0.5	1.5	1.1	0.8	0.7	5.4	5.2	4.8
Export	0.7	2.4	1.7	1.5	3.3	1.7	1.5	1.6	8.2	5.9	8.9
Imports	0.4	1.2	1.9	1.7	2.9	1.7	1.5	1.5	8.6	5.8	8.5
Contributions to growth											
Domestic demand excluding stocks	0.7	0.8	0.9	0.3	0.9	0.7	0.6	0.5	3.0	2.9	2.8
Stocks	0.0	-0.2	-0.1	0.3	-0.1	0.0	0.0	0.0	0.3	-0.1	0.1
Net foreign trade	0.1	0.1	0.0	-0.1	0.0	-0.1	-0.1	0.0	-0.2	-0.2	-0.2

Forecast
Sources : National Data,World Bank, Insee calculations

At the present stage, therefore, the world economy seems only moderately affected by the tightening of borrowing conditions that took place around the end of the year *(see the fact sheet «Financement de l'économie», available in the French version only)*. Short-term interest rates have nevertheless continued to rise in the United States and, to a smaller extent, in the euro zone, but they have remained stable in the United Kingdom and Japan. Meanwhile, long rates, because of the maintained outlook for growth and inflation, have risen in all the industrialised zones in the early part of 2006. The markets expect that the European Central Bank will continue its monetary tightening cycle until the end of the year and that the Bank of England will also raise rates, most probably in August. In these circumstances, loan conditions are likely to harden further during the forecast time-horizon.

Meanwhile, the currency markets, which had shown considerable stability in the first quarter of the year, began at the end of April and the beginning of May to react to the economic situation in the United States, with the dollar depreciating against both the euro and the Asian currencies. Stock markets also declined. In these circumstances, the dollar/euro exchange rate adopted for forecasting purposes is 1.27, i.e. its average during the first three weeks of May.

The impact of the energy shock expected to remain confined to diffusion to input prices

On the commodity markets, the tendencies that had begun to take shape around the turn of the year have been maintained. The Brent price has continued to rise, in the end fluctuating around $70/barrel and bringing in its wake rises in the prices of petroleum derivatives. In fact, prices of all industrial raw materials have remained on an upward tendency in the early part of the year, notably metals *(see fact sheet «Pétrole et matières premières», available in the French version only).*

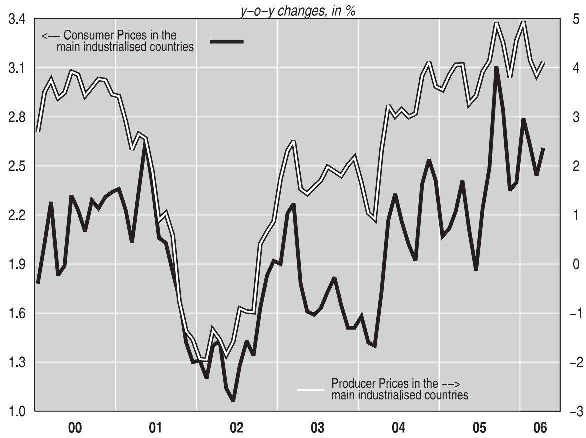
In these circumstances, producer prices have continued to rise at annual rates of between 4% and 5% in all the industrialised countries. The pattern has mainly been dictated by energy, the same being true of consumer prices *(see Graph 2)*. The latter eased slightly during Q1 2006 before picking up again in April as a result of the renewed surge in oil prices. Japan, now in the process of emerging from deflation, has followed suit, although to a more moderate extent. In the other Asian countries, inflationary pressures have in general remained relatively well in hand. For example, April saw the year-on-year consumer price rise standing at 2.0% in South Korea, 1.2% in Taiwan and 1.1% in Singapore. Only Indonesia and, to a smaller extent, Thailand are currently experiencing inflationary pressures. In these circumstances, the monetary tightening cycles have been interrupted in most emerging Asian countries.

These factors provide added confirmation that the impact of the oil shock remains well cushioned.

2

PRICES IN THE MAIN INDUSTRIALISED COUNTRIES

y–o–y changes, in %



sources : national institutes, Insee calculations

This situation is expected to last until the end of the year. Movements in inflation, dictated essentially by energy components, should remain generally well controlled, on the assumption that the Brent price stabilises at around $70/barrel *(see fact sheets «The euro zone's principal partner countries» and «Consumer prices in the euro zone»)*. As a result, unlike what happened in the two episodes in the 1970s, the price-wage loop is not expected to be engaged. Even in the United States, where the labour market remains tight, the productivity gains and the moderate level of core inflation should keep wage costs well in hand in coming quarters. In the United Kingdom wages are expected to maintain their present momentum, while in Japan they could show a distinct acceleration following the exit from deflation. Finally, wages in the euro zone are likely to be relatively inert in real terms. Generally speaking, the pressure of competition from the emerging countries is likely to be such as to limit growth in wage costs in all the industrialised countries. Nevertheless, even in emerging Asia, firms seem to have already started to trim margins in order to cushion the rise in the costs of inputs and this may be taking place at the expense of investment decisions.

Imminent convergence of growth rates in different zones, but maintenance or even further aggravation of disequilibria at world level

The year 2006 is likely to be exceptional not only in terms of world trade but also because it can be expected to mark the start of a phase of convergence between growth rates in different industrialised zones *(see Table 2)*. For example, while United States growth is likely to start to level off (3.5% in 2006, as in 2005), European countries should see an acceleration, with euro-zone growth exceeding 2% (compared with 1.4% in 2005) and the United Kingdom should post growth of 2.4% (compared with 1.8% in 2005). In parallel, the upturn in the Japanese economy should be confirmed, with GDP growth expected to be 3.2% (compared with 2.6% in 2005).

TABLE 2 : MAIN INDUSTRIAL COUNTRIES - GDP

In volume

	Quarterly change								Annual change		
	2005				2006				2004	2005	2006
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
Total	0.7	0.7	0.7	0.5	0.9	0.8	0.6	0.5	3.1	2.6	2.9
United States	0.9	0.8	1.0	0.4	1.3	0.8	0.7	0.6	4.2	3.5	3.5
Japan	1.3	1.3	0.3	1.1	0.8	0.9	0.6	0.6	2.3	2.6	3.2
United Kingdom	0.2	0.5	0.4	0.6	0.6	0.8	0.6	0.6	3.1	1.8	2.4
Euro zone, of which :	0.4	0.4	0.7	0.3	0.6	0.6	0.5	0.5	1.8	1.4	2.1
Germany	0.6	0.4	0.6	0.0	0.4	0.8	0.5	0.5	1.1	1.2	1.8
Italy	-0.4	0.6	0.3	0.0	0.6	0.3	0.2	0.2	0.9	0.1	1.3
Spain	0.8	0.8	0.9	0.9	0.8	0.6	0.6	0.6	3.1	3.4	3.1

Forecast

Sources : National Data, World Bank, Insee calculations

The rest of Asia should also maintain its strong momentum.

Growth rates for domestic demand in the main industrialised zones are nevertheless likely to continue to show substantial divergences. A point to note, however, is that consumption by households in the euro zone is expected to show signs of acceleration *(see fact sheet «Economic situation in the euro zone»)*. Admittedly, this upturn would be partly due to certain temporary phenomena (notably in Germany, with the hosting of the Football World Cup and the bringing forward of purchases in anticipation of the rise in VAT rates announced for 2007), but at a more fundamental level it would nevertheless be due to more rapid growth in employment than in the recent past and to the continuing decline in the saving ratio. In terms of corporate investment, there is likely to remain a relatively clear-cut divide between European countries, on the one hand, and the United States and Japan, on the other, with Europe showing greater caution.

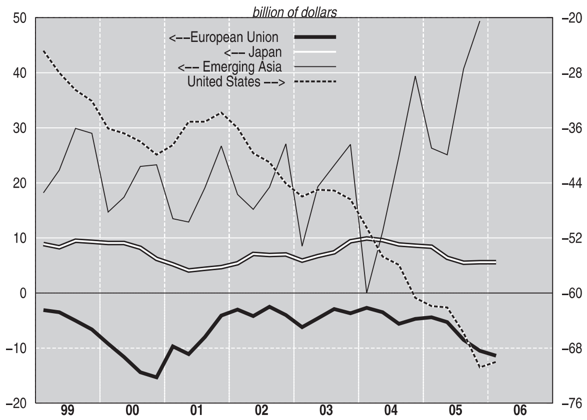
In Southeast Asia, activity remained firm in Q1 2006. Year-on-year growth in industrial output (excluding China) remained above 7% in March, a rate similar to that recorded on average in the past six months. In this region, growth is expected to remain brisk between now and the end of the year. Generally speaking, firms seem able to cope with increases in their production costs by compressing their margins. In most countries, the persistence of high oil prices is unlikely to have more than a marginal impact on manufacturing activity. This phenomenon is, moreover, corroborated by the recent evolution in leading economic indicators for the principal countries of the zone. However, the slowdown in productive investment seen since Q2 2004 (again, excluding China), probably related both to the rise in oil prices and past interest-rate hikes, could well continue.

Finally, the oil-exporting countries are likely again this year to benefit to the full from the surge in crude oil prices. On the basis of the behaviour seen in 2005, they can be expected nevertheless to remain prudent regarding the use of this windfall *(see box)*, having shown much lower propensities to spend the additional revenue on imports than at the time of the 1970s oil shocks (50%, compared with 75% on the previous occasion, according to the IMF). Even the recycling of the petrodollars into financial investments seems to have evolved by comparison with previous episodes. Taking the OPEC countries, for example, a much smaller proportion has gone into portfolio investments and overseas bank deposits and more has been held in the form of foreign-exchange reserves or even invested on local markets (stocks and real estate) and in hedge funds.

With the re-balancing of growth between zones still only timid, the disequilibria at world level seem set to last at least until the end of the year. This tendency has in fact been seen in the industrialised countries in the early part of 2006 *(see Graph 3)*. In emerging Asia, trade surpluses have widened since mid-2004 — driven mainly by China — and this situation is expected to persist in the next few quarters, although on the assumption that there is no sharp adjustment in Asian currencies, notably vis-à-vis the dollar. ■

3

CHANGE IN TRADE BALANCE (GOODS)



sources: national institutes, Insee calculations

BOX: THE RECYCLING OF THE PETRODOLLARS

The oil revenues of exporting countries rose from around 260 billion dollars in 2002 to more than 600 billion in 2005 [(1)], according to the IMF. These additional earnings of around 350 billion dollars are equivalent to almost 40% of these countries' ex ante GDP, a level that stands midway between those attained during the two previous shocks (48% in 1973-76 and 31% in 1978-81).

The recycling of these petrodollars seems to have evolved compared with the previous episodes. The propensity to spend the additional revenue appears to be smaller (50%, compared with 75%) and the funds saved, although difficult to evaluate, seem to have been invested in a more diversified range of financial products than previously. This oil windfall seems in the end to have had little impact on the disequilibria at world level. The rise in oil prices has simply further widened the current-account deficits in regions where they already existed (typically the United States). In the case of France, the bilateral trade surplus with the oil-suppliers deteriorated sharply between 2003 and 2005, again suggesting that the recycling of petrodollars in the form of purchases of French products has been relatively limited, of the order of 20%.

A lower propensity to spend the additional oil revenues than in the 1970s

Since 2002, the oil-exporting countries have been spending a smaller share of their additional revenues than at the time of the previous oil shocks. Their imports as a proportion of GDP have remained globally stable in recent years. Even in absolute terms, the rise in imports corresponds to less than half the additional income (compared with three-quarters in the 1970s).

Significant divergences have nevertheless opened up between different countries. The lowest proportions of spending are to be seen in the Gulf countries. Iran, by contrast, has spent a substantial proportion of its earnings. On average, budget surpluses have risen by 11 GDP points over the period 2002-2005, for the oil-exporters as a whole.

Investment of revenues in much more diversified financial products than in the past

The international institutions (notably the IMF and the Bank for International Settlements) admit that it is relatively difficult to obtain a precise idea of how the savings of the oil-exporting countries are allocated. Only one third of the funds liable to be invested can be identified (compared with one half during previous episodes). Use can be made of two particular sources of information: the central banks' foreign-exchange situations and the recycling of the petrodollars in the form of bank deposits. The central banks' reserves have indeed risen by 90 billion dollars in 2005, but this represents less than one third of the current-account surpluses. Furthermore, in contrast to the experience in the 1970s, little of the additional revenue has been accumulated in the form of bank deposits (equivalent to less than one third of the cumulative current-account surpluses in the case of the banks reporting to the BIS). What has in fact happened is that in certain countries, such as Russia, Saudi Arabia and the UAE, governments have entrusted their surpluses to investment companies or to oil-price stabilisation funds, investments that are difficult to identify.

Generally speaking, the oil-exporting countries now have access to a wider range of investment opportunities than they did in the 1970s. Local stock markets have been built up and there is a roaring real estate boom in certain regions, particularly the Middle East. However, as is suggested by the smallness of the rise in official reserves in relation to the current-account surpluses, most of the oil revenue is being invested abroad. With reference to this latter point, however, the holding by OPEC countries of US Treasury bonds declined in 2005, although the possibility that such purchases were made via London, Geneva or Hong Kong cannot be ruled out.

The recycling of the petrodollars has principally taken place in the United States, where it has eased pressures on financing costs

The recycling of the oil windfall, even if it corresponds to only a fairly small proportion of world GDP (1.0%, compared with roughly 1.5% at the time of the previous episodes), is capable of influencing the disequilibria at world level.

In the short term, the rise in oil prices produces a deterioration in the current-account balances of the oil-importing countries and, conversely, creates surpluses in the exporting regions. Subsequently, whether they spend or save their oil revenue (whatever the recycling mechanism), the behaviour of the oil-exporting countries affects the current-account disequilibria through two channels:

- If the oil-exporting countries spend their revenue (the absorption channel), part of the inflow of petrodollars flows out again to pay for imports of goods and services, most of which come from oil-importing countries. This mechanism correspondingly limits the impact on the trade deficits of the oil-importing countries vis-à-vis the oil-exporting countries.
- If the oil-exporting countries save this income (the current-account channel), this may initially divert financial resources from investment or consumption in the importing countries. Their imports are automatically reduced and this helps to limit their current-account deficits. This mechanism is nevertheless cushioned by the fact that the oil-exporting countries invest part of their petrodollars in foreign assets, thus limiting the rise in interest rates in the importing countries, with the result that the latter's domestic demand is less affected by monetary tightening on the part of their central banks in response to the rise in inflation.

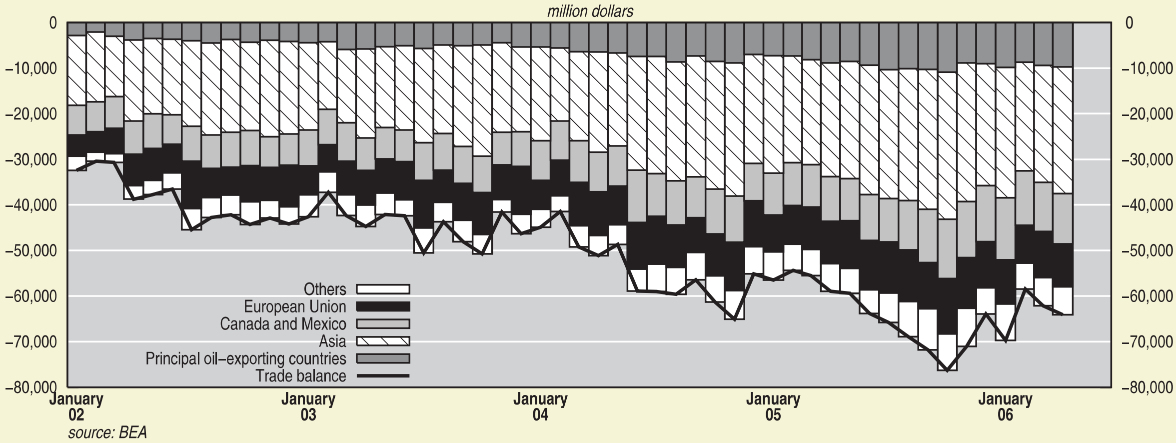
In reality, in the recent past the rise in oil prices has simply helped to widen current-account deficits in regions where

1) All the estimates shown here, except those for France, are taken from the IMF.

A

UNITED STATES MERCHANDISE TRADE BALANCE

million dollars



source: BEA

they already existed, typically the United States. In that country, the recycling of the petrodollars has mainly helped to ease pressures on the cost of financing, these pressures having been induced by the capital outflow generated by the high level of oil prices. On the other hand, the oil revenues spent by the exporting countries have not played a major direct role in reducing the American current-account deficit. One reason is that the oil-exporting countries import less and less from the United States (a 5-point fall between 1981 and 2004 in the United States' share of their total merchandise imports). Even if one assumes that the oil-exporting countries spend all their additional revenue, the US current-account deficit would still be set to widen by 25 billion additional dollars (0.2 of a GDP point). This means that the oil-exporting countries have not been the principal source of the widening of the US current-account deficit *(see the illustration relating to the trade deficit, Graph A)*. Even so, the current-account surpluses of the oil-exporting countries were equivalent to roughly 40% of the US current-account deficit in 2005, twice the 2004 figure.

A fairly limited impact of the recycling of petrodollars on the French trade balance

The diagnosis is identical in the case of France, i.e. a limited impact of the recycling of petrodollars on the trade balance.

Since January 2005, the French Customs statistics have shown the geographic breakdown of imports of hydrocarbons by country, no longer by country of origin but by "the last country of transit". There is therefore a bias in favour of transit countries like Germany and Belgium, especially concerning flows of crude oil originating respectively in Russia (and the CIS in general) and in Norway.

The OPEC countries' share of French imports has remained relatively constant, however. In order to correct for this technical bias, it has been assumed that the shares of the various other suppliers have also remained relatively constant. To be more precise, starting in January 2005 a fixed percentage has been deducted from the flows recorded as coming from a transit country and added to the imports from the original supplier country. This means that each country's average share for the four quarters of 2005 is assumed to be equal to its average for 2003-2004. The flows by country of origin, adjusted in this way, are shown in Graph B.

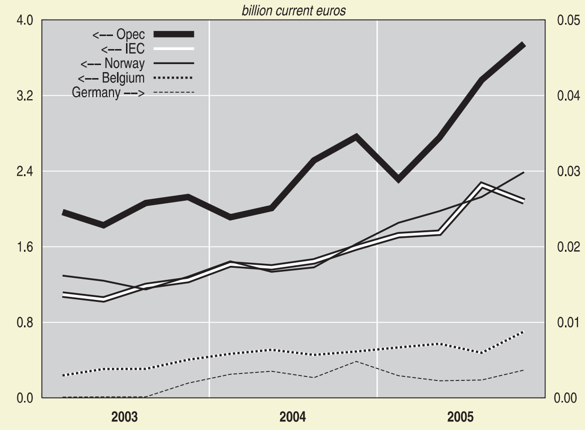
These adjusted series show a new picture of the bilateral structure of the widening of the French trade deficit. After taking into account this potential break in series, 80% of French crude oil imports in 2005 are indeed shown to have come from the country's three main suppliers, OPEC, the CIS and Norway. These flows rose sharply between 2003 and 2005 (by 10.8 billion euros), accounting for 80% of the rise in total French crude oil imports as recorded in the quarterly national accounts. **Moreover, they account for 70% of the widening of the trade deficit in energy, with flows of refined products remaining relatively balanced.**

This statistical adjustment also makes it possible to refute the assumption of a recycling of petrodollars into French products. While imports of crude oil from these three sources on their own rose by 10.8 billion euros, French exports to these countries rose by only 2.2 billion euros, **giving a recycling ratio of only 20%**. As a consequence, the French bilateral trade balance with its oil suppliers deteriorated substantially between 2003 and 2005. ■

B

FRENCH IMPORTS OF CRUDE OIL BY COUNTRY OF ORIGIN

billion current euros



sources: Customs, Insee calculations

References:

"Oil prices and global imbalances", World Economic Outlook, IMF, April 2006

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The euro zone's principal partner countries

Despite being affected by the surge in prices of oil and other commodities, the United States, the United Kingdom and Japan are likely to post firm growth rates in 2006. In all three countries, household consumption is expected to be lively, underpinned by the strength of real incomes. Labour markets should be buoyant, while in the United Kingdom and the United States the price rise should be fuelled mainly by the diffusion effects of the energy shock and in Japan the exit from the deflation should be confirmed.

Another feature shared by the euro zone's leading partner countries is that all of them are likely to have seen their commercial trade flows reach new highs in the early part of the year. However, only Japan is liable to derive any real advantage from this improvement, with the contribution from foreign trade to the country's growth expected to be markedly positive.

As regards investment, there seems to be no common pattern, with individual national specificities fully revealed this year. For example, whereas housing investment in the United Kingdom and Japan should benefit from the improvement on the housing market, it is liable to level off in the United States, following record growth in recent years. Productive investment is expected to accelerate in the United Kingdom, remain firm in the United States and ease in Japan. Industrial business surveys and the evolution in orders are evidence of these contrasting evolutions.

All things considered, GDP growth is expected to stabilise between 2005 and 2006 in the United States (+ 3.5%), and those of Japan and the United Kingdom to accelerate compared with 2005, from 2.6% to 3.2% and from 1.8% to 2.4%, respectively.

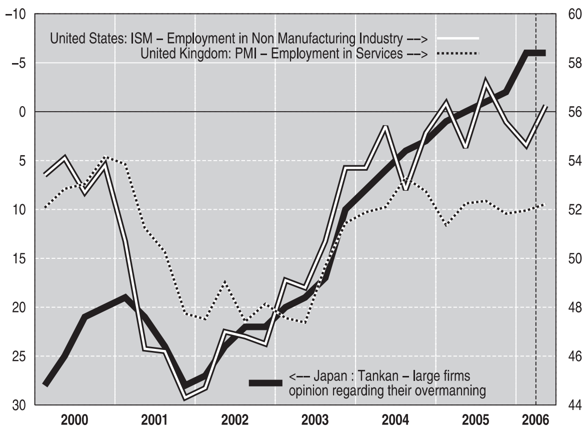
Brisk growth in purchasing power should mean firm growth in household consumption in the United Kingdom, Japan and the United States

In 2006, the labour market should be relatively buoyant in the euro zone's three principal partner countries. In all three, job creations should benefit from the past strength of activity. An upturn is in fact already discernible in the United Kingdom and Japan, where, after declining by 0.2% in Q4 2005, employment has risen again in the early part of 2006 (by 0.4% in United Kingdom and by 0.2% in Japan). Judging by the latest survey figures *(see Graph 1)*, this improvement seems set to last in coming quarters: opinion survey results regarding employment tendencies in the United Kingdom have recently improved for both manufacturing and services; in a similar manner, the results of the Q1 Tankan confirm that Japanese firms are no longer overmanned. In addition, the number of job vacancies in Japan has exceeded that of jobseekers since December 2005. The employment situation in the United States is also expected to be relatively favourable in coming months. Job creations, after remaining at around 175,000 per month in Q1, are nevertheless likely to decline somewhat between now and the end of the year because of the expected weakening of activity; admittedly, there was a certain levelling-off in April and May, but business leaders' opinions remain firm regarding the evolution of employment in the non-manufacturing sector.

At the same time, wages are expected to grow at firm rates in both the United Kingdom and the United States and even accelerate clearly in Japan. In the United Kingdom and the United States, the monthly indicators have already been showing a positive tendency in the early part of the year (year-on-year growth in the average hourly wage of 4.2% in Q1 in the first case, 3.7% in May in the second). In both

1

BUSINESS LEADERS' OPINION REGARDING CHANGES IN EMPLOYMENT



sources : BoJ, ISM, CIPS *forecasts after the dotted line**

How to read the graph:
Forecast for Japan, April-May average for the others.

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

	Quarterly % change								Annual % change		
	2005				2006				2004	2005	2006
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
UNITED STATES (37.2%)(1)											
GDP	**0.9**	**0.8**	**1.0**	**0.4**	**1.3**	**0.8**	**0.7**	**0.6**	**4.2**	**3.5**	**3.5**
Consumption	0.9	0.8	1.0	0.2	1.3	0.7	0.8	0.7	3.9	3.5	3.3
Private investment (2)	1.7	2.3	2.0	1.0	2.3	1.3	0.7	0.7	9.7	8.1	6.2
Non-residential investment	*1.4*	*2.1*	*2.0*	*1.1*	*3.1*	*2.0*	*1.7*	*1.7*	*9.4*	*8.6*	*8.6*
Residential investment	*2.3*	*2.6*	*1.8*	*0.7*	*0.7*	*0.0*	*-1.0*	*-1.0*	*10.3*	*7.1*	*2.1*
Government expenditures (3)	0.5	0.6	0.7	-0.2	1.1	0.6	0.5	0.2	2.2	1.8	2.2
Exports	1.8	2.6	0.6	1.2	3.5	2.0	1.8	1.8	8.4	6.9	8.5
Imports	1.8	-0.1	0.6	2.9	3.1	1.8	1.7	1.7	10.7	6.3	8.4
Contributions:											
Domestic demand excluding stocks	*1.0*	*1.1*	*1.2*	*0.3*	*1.5*	*0.9*	*0.8*	*0.6*	*4.6*	*4.1*	*3.7*
Change in private inventories	*0.1*	*-0.5*	*-0.1*	*0.5*	*0.0*	*0.0*	*0.0*	*0.0*	*0.3*	*-0.3*	*0.2*
Net exports	*-0.1*	*0.3*	*0.0*	*-0.3*	*-0.1*	*-0.1*	*-0.1*	*-0.1*	*-0.7*	*-0.3*	*-0.5*
UNITED KINGDOM (5.6%)(1)											
GDP	**0.2**	**0.5**	**0.4**	**0.6**	**0.6**	**0.8**	**0.6**	**0.6**	**3.1**	**1.8**	**2.4**
Consumption	0.0	0.3	0.5	0.7	0.2	0.8	0.6	0.6	3.6	1.7	2.2
Total investment	0.8	0.2	2.7	-0.5	1.5	1.1	0.8	0.8	5.1	3.2	3.9
Enterprise investment	*-0.3*	*1.0*	*1.2*	*-0.9*	*1.7*	*1.2*	*1.0*	*1.0*	*3.3*	*2.0*	*3.5*
Household investment (4)	*-3.9*	*4.4*	*0.6*	*-1.3*	*1.0*	*1.0*	*0.5*	*0.5*	*6.2*	*1.5*	*2.1*
Public investment (4)	*19.3*	*-12.6*	*15.4*	*3.4*	*1.5*	*0.5*	*0.5*	*0.5*	*13.1*	*14.4*	*9.5*
Public consumption (5)	0.3	0.7	1.4	1.2	0.7	0.5	0.5	0.5	2.9	2.7	3.4
Exports	0.4	3.4	0.9	2.2	4.7	2.0	1.5	1.5	4.6	5.6	10.7
Imports	-1.3	2.5	2.3	1.0	5.5	1.7	1.4	1.4	6.7	5.3	10.8
Contributions:											
Domestic demand excluding stocks(4)	*0.2*	*0.3*	*1.1*	*0.7*	*0.6*	*0.8*	*0.6*	*0.6*	*3.8*	*2.3*	*2.8*
Change in private inventories	*-0.5*	*-0.1*	*0.0*	*-0.5*	*0.5*	*0.0*	*0.0*	*0.0*	*0.1*	*-0.3*	*0.1*
Net exports	*0.5*	*0.1*	*-0.4*	*0.3*	*-0.4*	*0.0*	*0.0*	*0.0*	*-0.8*	*-0.1*	*-0.4*
JAPAN (14.8%)(1)											
GDP	**1.3**	**1.3**	**0.3**	**1.1**	**0.8**	**0.9**	**0.6**	**0.6**	**2.3**	**2.6**	**3.2**
Consumption	1.4	0.8	0.5	0.6	0.5	0.6	0.5	0.5	1.9	2.1	2.3
Total investment	1.1	1.5	1.3	0.0	2.0	1.8	1.0	1.0	1.0	3.4	5.2
Private investment	*1.4*	*1.8*	*1.5*	*0.6*	*2.8*	*1.5*	*0.9*	*0.9*	*4.1*	*6.1*	*6.2*
Non-residential investment	*2.5*	*2.4*	*1.5*	*0.2*	*3.1*	*2.0*	*1.0*	*1.0*	*4.7*	*7.8*	*7.0*
Residential investment	*-1.3*	*-1.9*	*1.6*	*2.1*	*1.1*	*1.5*	*1.5*	*1.5*	*2.0*	*-0.7*	*5.4*
Public investment	*-1.0*	*1.1*	*0.6*	*-2.5*	*-0.6*	*1.5*	*0.5*	*0.5*	*-8.8*	*-5.9*	*-0.5*
Public consumption	0.9	0.1	0.5	0.1	0.2	0.1	0.1	0.1	2.0	1.7	0.6
Exports	-0.2	3.5	3.1	3.8	2.7	2.5	2.0	2.0	13.9	7.0	11.8
Imports	-0.1	2.2	3.1	-0.6	3.5	2.2	1.8	1.8	8.5	6.3	8.5
Contributions:											
Domestic demand excluding stocks	*1.4*	*0.7*	*0.6*	*0.3*	*0.4*	*0.8*	*0.5*	*0.5*	*1.7*	*2.3*	*2.1*
Change in private inventories	*0.1*	*0.3*	*-0.5*	*0.1*	*0.0*	*0.0*	*0.0*	*0.0*	*-0.2*	*0.1*	*0.0*
Net exports	*0.0*	*0.2*	*0.0*	*0.6*	*-0.1*	*0.1*	*0.1*	*0.1*	*0.8*	*0.2*	*0.6*

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 Research Institute, Insee

cases, the low unemployment rates (5.3% in April and 4.6% in May, respectively) are liable to influence future wage claims. On top of this, in the case of the United States there has very recently been a rise in inflationary expectations, generated by the surge in the oil price. However, inasmuch as the rise in the core elements of inflation is expected to be limited, wage increases are not expected to sustain inflationary pressures. Finally, wages in Japan, after declining in Q1 2006 (by 1.8%), should rapidly accelerate again. The spring wage negotiations (shunto) that were completed at the end of April in fact enabled the trade unions to obtain increases in compensation for the first time in five years, although the amounts vary widely from sector to sector.

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

(in %)

	Annual changes			
	2003	2004	2005	2006
United States				
Non-farm dependent employment	-0.3	1.1	1.5	1.5
Average wage per head	2.9	4.3	4.4	4.5
Nominal gross disposable income	4.3	6.1	4.2	5.8
Private consumption deflator	1.9	2.6	2.8	2.7
Saving ratio	2.1	1.8	-0.5	-0.7
United Kingdom				
Dependent employment	1.0	1.0	1.0	0.9
Average wage per head	3.5	3.6	3.8	4.0
Nominal gross disposable income	4.7	3.4	4.1	4.3
Private consumption deflator	1.9	1.2	1.9	2.2
Saving ratio	5.4	4.3	5.0	5.0
Japan				
Total employment	-0.3	0.2	0.4	0.6
Average wage per head	-1.2	-1.5	0.8	1.9
Nominal gross disposable income	-1.2	0.4	0.5	1.7
Private consumption deflator	-0.9	-0.6	-0.8	-0.2
Saving ratio	4.0	3.1	2.4	2.4

Forecast

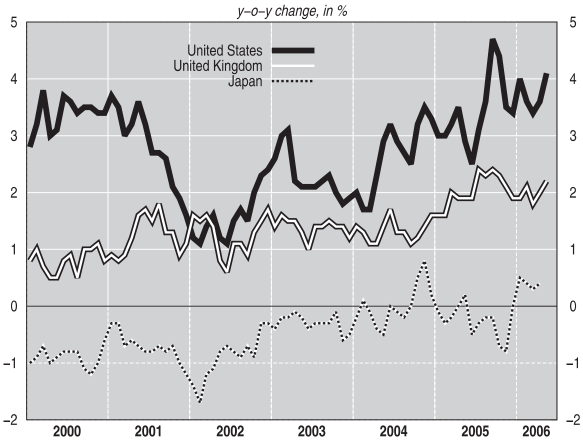
Source : BEA, BLS, Central Statistical Office, Department of Employment, ONS, Economic and Social Research Institute, Ministry of Public Management, Ministry of La - bour, Insee

In all three countries, the combination of these tendencies in employment and wages can be expected to fuel income growth in coming quarters. At the same time, inflationary pressures should continue to be kept under control in the United Kingdom and the United States *(see Graph 2)*. The interventions of the central banks should help in this respect. Given the strength of activity and the slight overshoot of the inflation target in the United Kingdom (2.2% in May), the markets are expecting the Bank of England to raise key rates in the near future. Any rise would probably take place in August, following a year of «no change», at that month's meeting of the Monetary Policy Committee, which is usually the occasion for an update of the scenario regarding growth and inflation. The US Federal Reserve, meanwhile, has been steadily raising its key rates since June 2004. The pattern of inflation in the United States is likely to be mainly dictated by the energy component, which is not expected to show any real decline before Q3 of this year. Finally, in Japan the evolutions in both the consumer price index and the consumption deflator are already indicating a gradual exit from the deflationary situation that had plagued the economy for several years *(see box)*.

2

CONSUMER PRICES

y–o–y change, in %



sources : BLS, ONS, Ministry of Public Management–Home Affairs–Posts and Telecom

Taking the year as a whole, the resulting purchasing power gains are likely to boost consumption. Spending by Japanese households should maintain its momentum, especially as the confidence level in Q1 2006 was the highest since June 1991. In the United Kingdom, an additional factor can be expected to contribute to the marked upturn in consumption, in that the palpable recovery on the housing market, by raising housing asset values, should be reflected in increased use by households of mortgage refinancing for the purpose of expenditure. Retail sales were in fact already showing a very substantial statistical carryover at the end of May (1.7%). Finally, American households' consumption is not expected to be quite as dynamic as last year. Following an exceptionally strong first quarter, expenditure is likely to ease, in line with growth in real incomes. Moreover, May saw only a timid rise in retail sales, while household confidence has declined in recent months. In these circumstances, the saving ratio, after declining appreciably in 2005 (to -0.5% from 1.8% in 2004), is expected to remain almost stable in 2006 (- 0.7%).

Evolutions in investment are likely to be dominated by national specificities: the housing component should pick up strongly in the United Kingdom and Japan but level off in the United States, while in the case of productive investment, an upturn in the United Kingdom is likely to contrast with the maintenance — or slight moderation — of the upward tendency in the other two countries.

Housing investment is expected to recover in the United Kingdom and Japan, but level off in the United States. In the United Kingdom, it should pick up, benefiting both from the positive tendency in purchasing power and from low mortgage rates, as shown by the recent upturn in house prices. It is likely to regain strength to some extent in the United States, under the impact of the return of house prices to positive territory after 15 years' stagnation: this is in fact being suggested by the upturn in starts posted in Q1. Conversely, the slowdown in housing investment seen in the United States this winter is likely to intensify, given that starts have again been falling since February and that house sales have continued the decline that began in mid-2005. Other factors have recently provided confirmation of the recent levelling-off in the American real estate market *(see the special article « Is the American housing market posing a threat?»)*. Mortgage applications have been showing signs of weakness, having probably peaked in H2 2005. At the same time, housing affordability has deteriorated since mid-2004, under the impact of the surge in prices and the rise in interest rates. In these circumstances, housing market confidence has deteriorated distinctly since the end of last year.

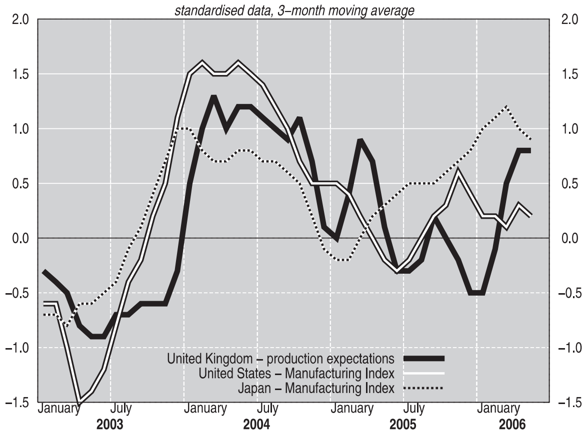
Disparities between the three countries in terms of growth in non-housing investment are also expected to be marked this year. Corporate investment is expected to accelerate in the United Kingdom, maintain its momentum in the United States and slow down in Japan. Business surveys are providing an initial indication of these divergences between the respective evolutions *(see Graph 3)*. In the United Kingdom, the survey by the Confederation of British Industry shows UK business leaders' expectations to have improved appreciably since February, on the back of the upturn in manufacturing activity (a rise of 0.7% in Q1, following declines in the previous four quarters). In the United States, looking beyond the short-term fluctuations, the ISM leading indicator for manufacturing remained at its average 2005 level in the first five months of this year. Meanwhile, balances of opinion regarding orders have improved again in the past two months in the non-manufacturing sector. By contrast, the results of the Q1 Tankan survey show Japanese firms intending to ease back their investment in capital goods in coming quarters, in line with a downward tendency in profit expectations. On similar lines, the manufacturing PMI is highlighting an erosion of industrial leaders' expectations.

Japanese firms' investment expenditure can therefore be expected to slow down progressively during 2006, following the upturn posted at the beginning of the year. In this connection, machinery orders, which constitute a leading indicator of investment with an advance of three to six months, declined in Q1 2006 and the Cabinet Office is expecting a further decline in Q2 (by 2.5%, quarter on quarter). Furthermore, the productive capacity utilisation rate dropped in the early part of the year. By contrast, productive investment in the United Kingdom, helped by the renewed vigour of manufacturing, is likely to gain strength this year, given that, in addition, financing conditions remain extremely favourable. Despite the surge in prices of energy and other commodities, the prospect of dynamic consumption, on the one hand, and satisfactory export markets, on the other, should encourage firms to invest in coming quarters. However, investment is likely to be moderated by the recent easing of pressures on productive capacity. Finally, in the United States the levelling-off of international trade at historic peaks and the initial signs of a weakening of household demand are likely to prompt firms to show greater caution in coming months. Nevertheless, industrial output was posting a positive carryover of 1.2% at the end of May and the productive capacity utilisation rate is standing at a level close to that seen in 2000. In addition, financing conditions have hardened only slightly, despite the hikes in key rates. Firms' self-financing capacity has been restored and profit margins and mark-ups are standing at levels not seen for 30 years (above 10% and 25%, respectively). How-

3

INDUSTRIAL SECTOR – BUSINESS LEADERS' OPINION

standardised data, 3-month moving average



sources : CBI, ISM, PMI

ever, capital goods orders have been slipping gradually, so that after a particularly dynamic opening to the year investment expenditure is expected to ease.

While commercial trade flows seem to have reached new highs in all three countries in the early part of 2006, the contribution of foreign trade to growth is again this year likely to be positive only in Japan.

The first quarter of 2006 saw trade flows extremely firm, notably in the United Kingdom, whose trade was particularly intense with the euro zone. Taking the year as a whole, however, only Japan is likely to benefit to any substantial extent from the strength of world trade. Japanese exports should in fact continue to benefit from a supportive international environment, especially as economic activity in its principal Asian partner countries is set to remain dynamic. In these circumstances, the contribution of Japanese foreign trade to growth should be distinctly positive in 2006. The opposite pattern is taking shape in the United States and the United Kingdom. In both countries, import growth, fuelled by the strength of domestic demand, is likely to dominate the lively export growth.

Growth in international trade naturally depends on the rates of activity growth to be expected in the euro zone's three principal partner countries. It could in fact be compromised if unforeseen factors having a negative effect on growth in these economies were to materialise. In the United States, for example, the fairly rapid deterioration in the housing climate could be heralding a more abrupt decline in housing investment than is currently expected. The evolution in household consumption, for its part, is largely conditioned by what happens to inflation. If the easing of prices now expected for the end of the year were to be deferred, household expenditure would be directly curbed, in the absence of a further decline in the saving ratio. In the case of Japan, the main factor that could interrupt the spending momentum would be expectations of monetary tightening. Conversely, however, a more rapid recovery than expected in productive investment in the three countries would provide greater-than-expected support for world trade this year.

At more fundamental level, the scenarios shown here are based on a stabilisation of exchange rates at levels close to the latest rates recorded *(see fact sheet «Financement de l'économie», available in the French version only)*. If, instead, the decline in the dollar were to persist, the international environment could be somewhat less dynamic than expected. By way of illustration, the OECD's INTERLINK model estimates that an appreciation of 10% in the dollar would reduce OECD countries' growth by around 0.1 of a point over a one-year time-horizon. ■

BOX: THE END OF DEFLATION IN JAPAN?

The change in the orientation of Japanese monetary policy seen in March was signalling the end of deflation in Japan

The Bank of Japan on 9 March officially ended its policy of massive injection of liquidity into the banking sector, in order to return progressively to a more traditional monetary policy of management through changes in key interest rates. Since then, pressures on long rates have in fact gradually increased. For example, the rates on 10-year government bonds rose by 30 basis points between March and May 2006.

By this change in policy the Bank was signalling that it regarded Japan as being on the point of exiting from the situation of deflation that had plagued the economy since 1998. In so doing, it was basing itself on the favourable evolution in the core price index seen since end-2005 *(see below)* but also on the prospect of firm growth, itself mainly the result of the strengthening of domestic demand. The Bank has not set a precise inflation target but has mentioned a range of between 0% and 2% for the year-on-year change in core inflation.

A return of the price rise to positive territory that could be partially called into question by the revision in the consumer price index

The year-on-year change in the consumer price index excluding fresh produce has been rising steadily since June 2005. It turned positive in November 2005 and stood at +0.5% in April 2006. This tendency is explained by the combined evolution in the prices of several products: the persistence of high oil prices, which helped maintain the year-on-year rise in prices of petroleum products at around 10%; the gradual weakening of the impact of the downward tendency in the price of rice; and, above all, an upward tendency in the year-on-year price rise for manufactures *(see Graph A)*. This latter factor was the most decisive, highlighting as it does the fact that Japanese firms are starting to pass on the rise in their producer prices — linked in particular to the rise in energy prices — into their selling prices instead of squeezing profit margins. What has in fact happened is that the simultaneous rises in employment and in wages have boosted consumer spending and therefore provided Japanese firms with greater leeway for increasing their prices.

Housing prices, meanwhile, have been rising in the large Japanese towns since September 2005 (a year-on-year rise of 1.3% in March 2006, compared with 0.1% in September 2005), following 15 years' uninterrupted decline *(see Graph B)*.

However, various factors could tend to moderate the consumer price rise in Japan in coming quarters. First of all, this could result from the revision of the price index planned for August 2006. This will involve an overhaul of the weighting coefficients but also, above all, the introduction of new products into the reference basket, notably IT goods, whose prices are declining rapidly. All things considered, the downward impact on the year-on-year rise in the core price index is estimated to amount to 0.3 of a point [(1)]. At the same time, the healthcare reform and further price reductions for mobile telephones and electricity are likely to drag the core price index down, although this is not necessarily catastrophic: a price decline that stems from technical progress cannot be interpreted in the same way as a price decline resulting from a recessionary spiral.

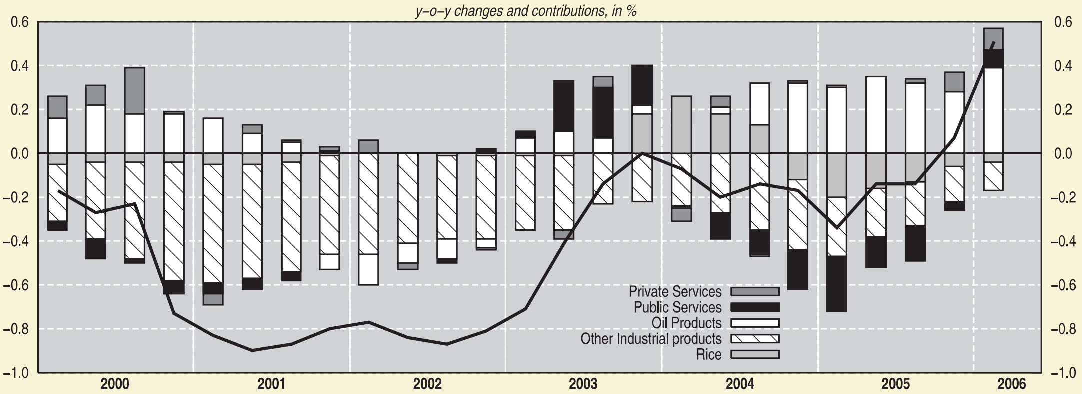
Furthermore, taking alternative measures of the evolution in prices, namely the price deflator for household consumption or, at a more general level, the GDP deflator, the ending of the decline in prices emerges less distinctly. The consumption deflator showed a year-on-year fall of 0.2% in Q1 2006 (compared with one of 0.8% the previous quarter). The GDP deflator, for its part, was still showing a decline of 1.2%, compared with 1.6% in Q4 2005.

(1) Cf. "Methodological developments in the 2005 revision of the CPI in Japan" (Statistics Bureau of Japan) , prepared for the Joint UNECE/ILO Meeting on Consumer Price Indices, May 2006.

A

CORE INFLATION AND CONTRIBUTIONS

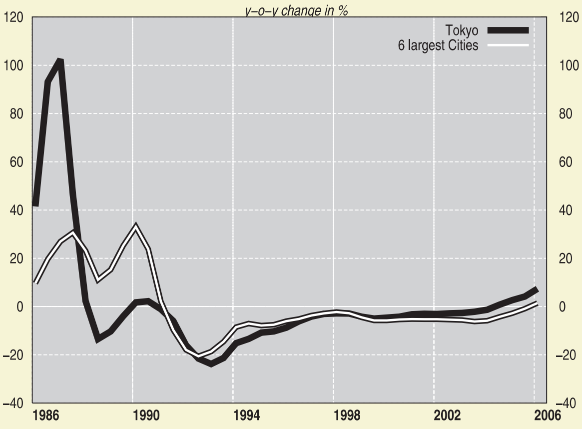
y–o–y changes and contributions, in %



source: Statistics Bureau

B

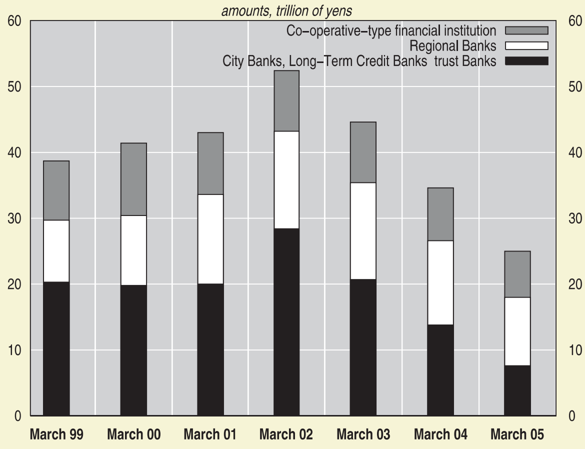
HOUSE PRICES



source: Japan Real Estate Institute

D

NON PERFORMING LOANS ON THE BOOKS OF DEPOSIT BANKS



source: Financial Services Agency

The recent upturn in lending, made possible by the shakeout in the banking sector, gives a clearer signal of the exit from deflation

Following the bursting of the housing bubble at the beginning of the 1990s, Japanese banks have had to cope with very large amounts of non performing loans. The resulting cleaning-up process led to a tightening of bank lending, notably to firms. This initially took the form of a stagnation and then, starting in 1995, a steep fall in the outstanding loans by the principal financial institutions *(see Graph C)*.

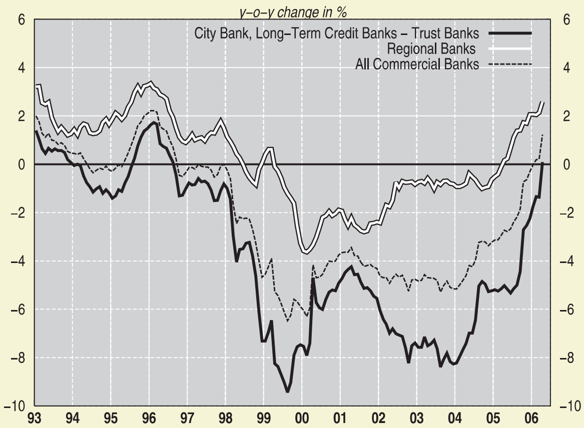
However, significant progress has been made in the direction of reducing the amount of non performing loans since 2002 *(see Graph D)*. The results of the survey carried out by the Financial Services Agency in March 2005 showed a halving of the amount since March 2002, with the volume of bad debts brought down from 5% of GDP in March 2005 from 11% three years earlier.

In this more favourable climate, the rise in outstanding loans accelerated towards the end of 2005 and the outlook for the granting of new loans has been positively headed since the beginning of 2006. The results of the Bank of Japan's April survey of the large banking institutions [(2)] has in fact confirmed the increase in loan applications from firms and households that began in the mid-2005 *(see Graph E)*. ■

(2) Senior Loan Officer Opinion Survey on Bank Lending Practices at Large Japanese Banks

C

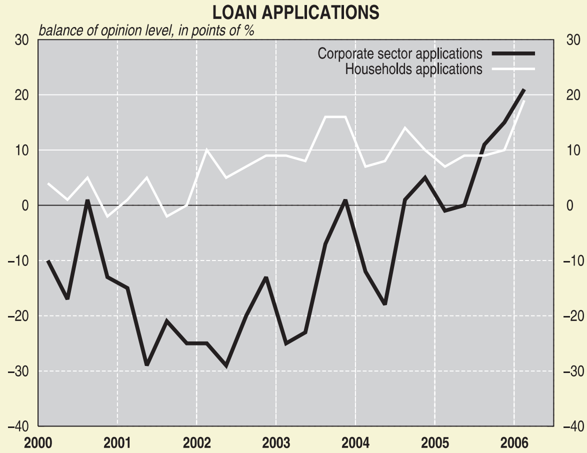
CHANGE IN OUTSTANDING LOAN BALANCES OF THE PRINCIPAL BANKING INSTITUTIONS



source: Bank of Japan

E

MAJOR JAPANESE BANKS'OPINION REGARDING LOAN APPLICATIONS



source: Bank of Japan

The economic situation in the euro zone

The euro zone posted strong growth in Q1 2006: 0.6%, compared with 0.3% in Q4 2005. The upturns in household consumption and in exports boosted European industrial output at the beginning of the year. Growth was very uneven as between countries, however. French and German GDP growth remained below the average for the zone, while that of Spain very strong.

During 2006, the improvement on the labour market and the continued decline in the household saving ratio can be expected to stimulate private consumption, while the firmness of world demand should help to underpin the zone's exports. As a result, foreign trade should no longer hold back growth in activity. On the other hand, the improvement in the economic climate is not expected to result in any distinct acceleration in investment. All things considered, euro-zone GDP growth is expected to be 2.1%, compared with 1.4% in 2005.

The growth carryovers for the three major countries (France, Germany, Italy) showed a differential of 0.3 of a point vis-à-vis the zone average in Q1. In H2, growth in Germany and France is expected to catch up with the zone average, while Italy is set to continue to lag behind.

Improvement, but no dramatic recovery, in euro-zone activity in 2006

The figures for Q1 have confirmed the temporary character of the levelling-off in activity seen towards the end of 2005. They demonstrate the renewed vigour of foreign trade, as well as a timid consolidation of the domestic determinants of growth, especially household consumption.

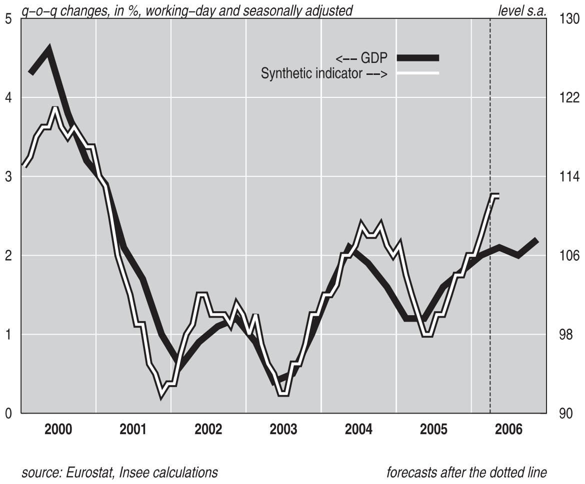
Driven by both domestic and external demand, industrial output accelerated in the early part of the year, with a statistical carryover for 2006 of 1.8% in April. German industrial output remained among the most dynamic of the zone (carryover of 3.5% in April), substantially outstripping Italy (+ 0.8%) and France (- 0.1%).

Despite the rises in oil prices and the euro, industrial business surveys for May still showed a satisfactory business climate, confirming the optimism seen since mid-2005 *(see Graph 1)*.

GDP growth is therefore expected to remain strong in the euro zone throughout the year. During the year, growth rates for France and Germany are expected to converge and catch up that of the zone as a whole *(see Graph 2)* and outdistance that of Italy. However, the annual figures for the major countries are unlikely to show any dramatic recovery, mainly because of the small statistical carryover for growth at the end of the first quarter.

1

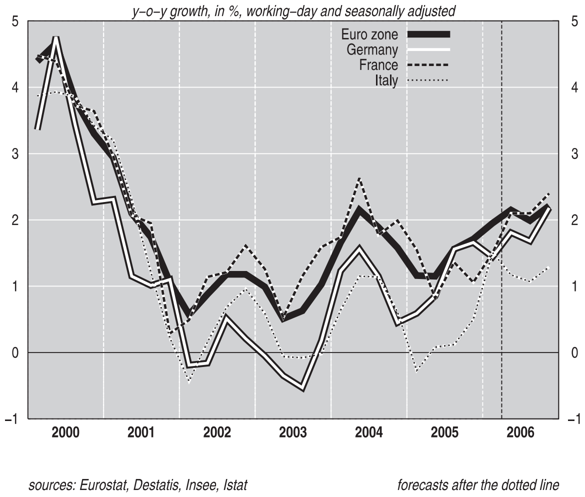
EURO ZONE : GDP AND SYNTHETIC INDICATOR



source: Eurostat, Insee calculations *forecasts after the dotted line*

2

GDP GROWTH IN THE EURO–ZONE COUNTRIES



sources: Eurostat, Destatis, Insee, Istat *forecasts after the dotted line*

GDP IN THE EURO ZONE AND IN THE PRINCIPAL MEMBER COUNTRIES

(q-o-q % change)

	2004				2005				2006				2003	2004	2005	2006
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4				
GERMANY (29.4%)[(1)]																
GDP	**0.5**	**0.2**	**-0.1**	**-0.1**	**0.6**	**0.4**	**0.6**	**0.0**	**0.4**	**0.8**	**0.5**	**0.5**	**-0.2**	**1.1**	**1.2**	**1.8**
Household consumption	0.5	-0.2	0.0	0.8	-0.2	0.0	0.3	-0.5	0.6	0.7	0.4	0.4	0.1	0.2	0.4	1.2
Total GFCF	-1.9	-0.3	0.9	-0.4	-1.0	0.3	1.5	0.6	-0.6	0.7	1.0	0.9	-0.7	-1.5	0.2	1.9
Public consumption	-1.0	-0.5	0.4	-1.9	0.5	1.5	0.4	-1.6	0.6	0.3	0.0	0.0	0.1	-1.6	0.1	0.2
Exports	3.3	3.2	-0.5	0.5	2.1	1.1	4.9	0.5	4.6	2.3	1.9	1.7	2.3	8.3	6.6	11.1
Imports	1.6	2.0	2.4	0.5	-1.1	2.1	5.2	1.1	4.5	2.0	1.7	1.5	5.0	6.1	5.5	11.6
Contributions :																
Domestic demand ex. stocks	*-0.2*	*-0.2*	*0.2*	*0.0*	*-0.2*	*0.3*	*0.5*	*-0.5*	*0.4*	*0.6*	*0.4*	*0.4*	*0.1*	*-0.2*	*0.1*	*1.2*
Inventory change	*0.0*	*-0.1*	*0.6*	*-0.1*	*-0.4*	*0.4*	*0.0*	*0.7*	*-0.2*	*0.0*	*0.0*	*0.0*	*0.6*	*0.5*	*0.2*	*0.4*
Foreign trade	*0.7*	*0.6*	*-1.0*	*0.0*	*1.2*	*-0.3*	*0.2*	*-0.2*	*0.2*	*0.2*	*0.2*	*0.2*	*-0.9*	*0.8*	*0.9*	*0.2*
ITALY (17,9%)[(1)]																
GDP	**0.4**	**0.3**	**0.2**	**-0.4**	**-0.4**	**0.6**	**0.3**	**0.0**	**0.6**	**0.3**	**0.2**	**0.2**	**0.1**	**0.9**	**0.1**	**1.3**
Household consumption	0.6	-0.2	-0.2	0.3	-0.7	0.6	0.5	-0.1	0.8	0.2	0.2	0.2	1.0	0.5	0.1	1.4
Total GFCF	1.5	1.0	-0.8	-0.5	-1.3	1.9	1.0	-1.6	1.7	1.0	0.7	0.7	-1.5	1.9	-0.4	2.7
Public consumption	0.3	-0.2	-0.1	0.4	0.9	0.0	0.1	0.1	0.1	0.1	0.1	0.1	2.1	0.6	1.2	0.4
Exports	-1.1	2.7	0.3	-0.7	-1.6	2.5	-0.4	1.2	2.5	1.0	1.0	1.0	-2.2	2.5	0.7	5.5
Imports	-0.7	0.7	0.4	1.8	-1.7	2.0	0.2	1.0	1.6	1.2	1.2	1.2	1.0	1.9	1.8	4.8
Contributions :																
Domestic demand ex. stocks	*0.7*	*0.0*	*-0.3*	*0.2*	*-0.5*	*0.7*	*0.5*	*-0.4*	*0.8*	*0.3*	*0.3*	*0.3*	*0.6*	*0.8*	*0.2*	*1.5*
Inventory change	*-0.2*	*-0.2*	*0.6*	*0.0*	*0.1*	*-0.3*	*-0.1*	*0.3*	*-0.5*	*0.0*	*0.0*	*0.0*	*0.3*	*-0.1*	*0.2*	*-0.4*
Foreign trade	*-0.1*	*0.5*	*0.0*	*-0.6*	*0.0*	*0.2*	*-0.1*	*0.1*	*0.2*	*-0.1*	*-0.1*	*-0.1*	*-0.8*	*0.2*	*-0.3*	*0.2*
SPAIN (10,2%)[(1)]																
GDP	**0.8**	**0.7**	**0.8**	**0.9**	**0.8**	**0.8**	**0.9**	**0.9**	**0.8**	**0.6**	**0.6**	**0.6**	**2.9**	**3.1**	**3.4**	**2.6**
Household consumption	0.7	1.0	1.4	1.5	0.7	1.0	1.1	1.2	0.6	0.5	0.5	0.5	2.6	4.4	4.4	2.7
Total GFCF	0.3	1.1	1.4	2.6	1.8	1.6	1.1	2.1	1.3	1.2	1.1	1.0	5.6	4.9	7.2	4.8
Public consumption	2.3	2.3	1.7	1.2	-0.2	1.1	1.9	1.7	-0.1	1.0	1.0	1.0	4.8	6.0	4.5	3.1
Exports	1.9	0.0	1.4	-1.0	-1.8	2.7	2.2	-1.2	5.1	1.0	1.4	1.4	3.6	3.3	1.0	6.8
Imports	2.8	1.7	3.4	2.0	-1.0	3.3	3.3	0.9	4.4	1.5	1.9	1.9	6.0	9.3	7.1	8.8
Contributions :																
Domestic demand ex. stocks	*0.9*	*1.3*	*1.5*	*1.8*	*0.9*	*1.2*	*1.3*	*1.6*	*0.7*	*0.8*	*0.8*	*0.8*	*4.2*	*5.0*	*5.3*	*3.5*
Inventory change	*0.2*	*0.0*	*0.0*	*0.0*	*0.1*	*-0.1*	*0.0*	*-0.1*	*0.2*	*0.0*	*0.0*	*0.0*	*0.2*	*-0.1*	*0.0*	*0.1*
Foreign trade	*-0.3*	*-0.5*	*-0.7*	*-0.9*	*-0.2*	*-0.3*	*-0.5*	*-0.6*	*-0.1*	*-0.2*	*-0.2*	*-0.2*	*-1.5*	*-1.8*	*-1.9*	*-0.9*
EURO ZONE (27,8%)[(2)]																
GDP	**0.8**	**0.4**	**0.3**	**0.1**	**0.4**	**0.4**	**0.7**	**0.3**	**0.6**	**0.6**	**0.5**	**0.5**	**0.8**	**1.8**	**1.4**	**2.1**
Household consumption	0.6	0.1	0.2	0.9	0.1	0.3	0.5	0.1	0.7	0.6	0.4	0.4	1.2	1.4	1.4	1.9
Total GFCF	0.5	0.5	0.3	0.6	0.2	1.4	1.0	0.2	0.3	1.0	1.0	0.9	0.8	1.8	2.6	2.8
Public consumption	0.0	0.2	0.4	-0.2	0.3	0.6	0.7	0.0	0.5	0.4	0.3	0.3	1.7	1.0	1.3	1.5
Exports	1.9	2.3	0.6	0.8	-0.2	1.5	2.8	0.7	3.1	1.6	1.5	1.5	1.3	6.1	4.0	7.9
Imports	1.3	2.1	1.9	1.5	-1.0	2.0	2.9	1.3	2.5	1.9	1.7	1.5	3.1	6.2	4.9	8.3
Contributions :																
Domestic demand ex. stocks	*0.5*	*0.2*	*0.3*	*0.6*	*0.1*	*0.6*	*0.7*	*0.1*	*0.5*	*0.6*	*0.5*	*0.5*	*1.2*	*1.4*	*1.6*	*2.0*
Inventory change	*0.1*	*0.1*	*0.4*	*-0.2*	*-0.1*	*0.0*	*0.0*	*0.4*	*-0.2*	*0.0*	*0.0*	*0.0*	*0.2*	*0.4*	*0.1*	*0.2*
Foreign trade	*0.2*	*0.1*	*-0.4*	*-0.2*	*0.3*	*-0.2*	*0.0*	*-0.2*	*0.3*	*-0.1*	*-0.1*	*0.0*	*-0.6*	*0.0*	*-0.3*	*-0.1*

Forecast
(1) Share of euro-zone GDP
(2) Share of OECD GDP
Sources : Eurostat

Private consumption set to accelerate slightly thanks to the improved employment situation and the decline in the household saving ratio

In 2006, the fundamentals are heralding an upturn in private consumption in the euro zone *(see Graph 3)*. While the expected acceleration in wages is unlikely to compensate for the predicted rise in inflation, the gradual improvement on the labour market, with employment rising by 1.1%, is expected to benefit growth in household income, which would accelerate to 1.5% in purchasing power terms, compared with 0.7% in 2005. The decline in unemployment in the zone seems set to continue, with the unemployment rate reaching 7.8% by the end of the year *(see Graph 4)*. Within the zone, the acceleration in employment would nevertheless show disparities between countries. In the case of Germany, 2006 is likely to be the year when job losses come to an end; by contrast, the dynamism of the Spanish economy should continue to create a substantial number of jobs.

In addition, after five slack years, consumption by German households should enter a recovery phase, boosted in Q2 by the Football World Cup (adding 0.3 of a point to consumption, *see the special article "Zoom sur l'économie allemande: l'Allemagne se qualifie pour la reprise", available in the French version only*) and in H2 by additional consumption of durable goods, notably cars, in anticipation of the rise in VAT rates. The acceleration in household consumption in the zone would therefore be greater than indicated by its traditional determinants and would be reflected in a decline in the saving ratio (11.8% in 2006, compared with 12.2% in 2005).

All things considered, despite the fall in statistically-recorded private consumption in the Netherlands following the reform of the healthcare system (*see "Conjoncture in France", December 2005 p. 37*), private consumption growth in the euro zone is expected to accelerate in 2006 (to 1.9% from 1.4% in 2005).

The acceleration expected in recorded public consumption in 2006 is explained by a symmetrical accounting effect. The reform of the healthcare system in the Netherlands will involve a transfer of expenditure of 9 billion euros from the household sector to the general government sector, and so tend to increase public consumption (growth of 1.5%, compared with 1.3% in 2005). Elsewhere, government spending is expected to remain well in hand. In Germany and Italy, under the impetus of newly-elected governments, control over public spending is expected even to be strengthened in order to meet the demands of the Stability and Growth Pact.

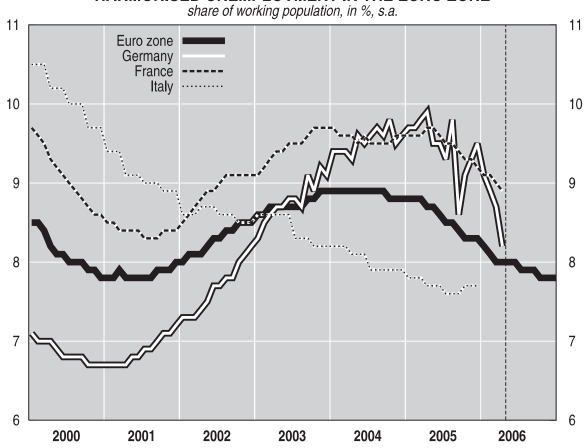
Productive investment unlikely to accelerate

The steady improvement in the business climate in the euro zone is likely to be reflected in sustained growth of corporate investment. The continuing firm prospects for both the domestic economy and foreign trade, together with the pressures on productive capacity seen since the end of 2005, are likely to encourage the consolidation of productive investment. At the same time, despite the prospect of higher

4

HARMONISED UNEMPLOYMENT IN THE EURO ZONE

share of working population, in %, s.a.



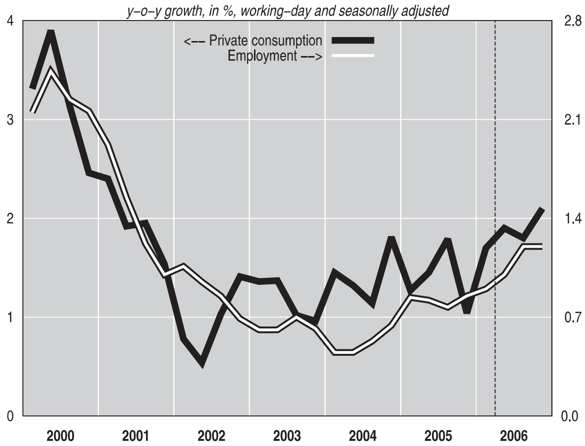
source: Eurostat *forecasts after the dotted line*

The Harmonised Unemployment Rate is the ILO Unemployment Rate issued by Eurostat. It differs from rates issued by National Statistical Institutes.

3

EURO ZONE: PRIVATE CONSUMPTION AND EMPLOYMENT

y–o–y growth, in %, working–day and seasonally adjusted

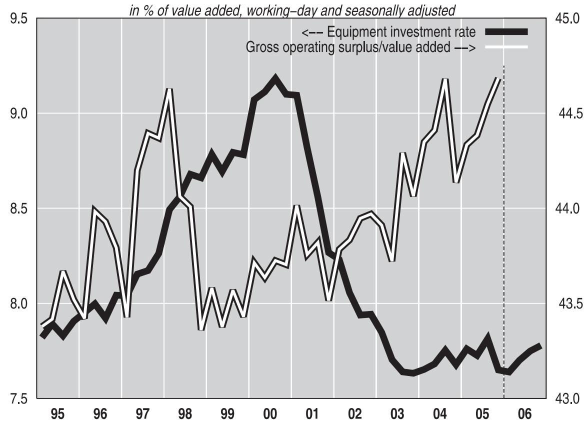


source: Eurostat *forecasts after the dotted line*

5

EURO ZONE: MARGIN RATE (GOS/VA) AND EQUIPMENT INVESTMENT RATE

in % of value added, working–day and seasonally adjusted



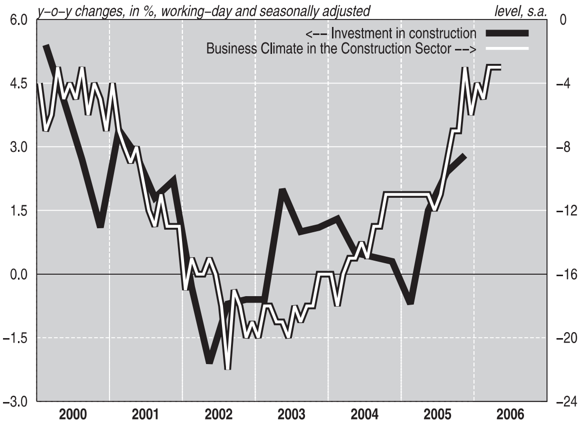
source: Eurostat, Insee calculations *forecasts after the dotted line* interest rates, financing conditions remain accommodating and the build-up of past profits should continue to facilitate investment projects *(see Graph 5)*.

Even so, the vigour of corporate investment remains fragile. For one thing, difficulties persist in the industrial sector in certain countries of the zone (notably Italy and France). For another, the upturn in domestic demand, especially in private consumption, is not necessarily set to last beyond the end of 2006. Finally, the figures for Q4 2005 have demonstrated the fragile nature of the recovery, still at the mercy of unforeseen external events.

All in all, in view of the slowdown seen in the early part of the year, growth in productive investment in 2006 is unlikely to exceed the rate achieved in 2005. Inter-country disparities remain marked: in Italy and, to a smaller extent, in Germany firms are expected to accelerate their investment, whereas in France the 2005 growth rate is likely to be maintained.

6

EURO ZONE: INVESTMENT IN CONSTRUCTION AND BUSINESS CLIMATE



sources: Eurostat, European Commission

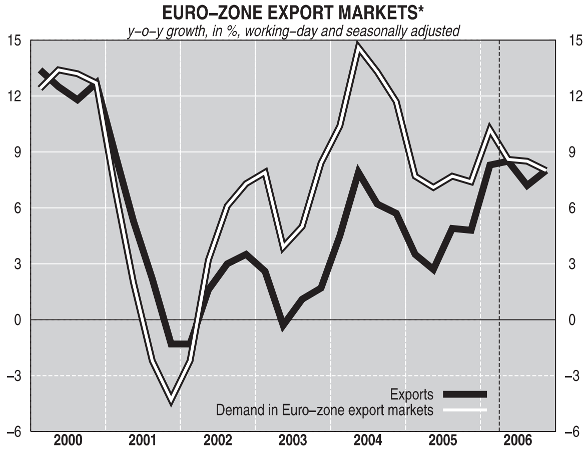
As regards investment in construction, despite the decline in Q1 due to the long winter, business leaders' optimism, especially in Germany and France, make it possible to envisage a slight acceleration in 2006 *(see Graph 6)*. All things considered, investment is expected to rise by 2.8% in 2006, compared with 2.6% in 2005.

Growth less handicapped by foreign trade

Starting in Q2 2006, export growth is likely to return to the rate suggested by the evolution in its determinants. Competitiveness will probably deteriorate in H2 because of the appreciation in the euro's exchange rate seen since March (4.0% in nominal terms in the space of three months). However, strong

7

EXPORTS AND DEMAND IN THE EURO–ZONE EXPORT MARKETS*



sources: Eurostat, 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: "la demande mondiale, outil d'analyse des échanges commerciaux", available in French only).

ZONE EURO : HOUSEHOLDS ACCOUNTS

(Annual and quarterly % changes)

	2003	2004	2005	2006	2004				2005				2006			
					Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Total wage bill	2.4	2.7	2.7	3.2	1.1	0.6	0.1	0.8	1.0	0.6	0.5	0.5	0.9	1.1	0.9	0.9
- Employment	0.6	0.5	0.8	1.1	0.1	0.2	0.2	0.2	0.3	0.1	0.2	0.3	0.3	0.3	0.3	0.3
- Unit wage	1.8	2.1	1.9	2.1	1.0	0.5	-0.1	0.7	0.8	0.4	0.3	0.3	0.6	0.8	0.6	0.6
GDI	2.8	3.5	2.8	3.9	1.3	0.9	0.5	0.2	1.0	0.7	0.8	0.8	1.0	1.2	0.9	1.0
Saving ratio (% of GDI)	12.8	12.9	12.2	11.8	13.1	13.2	13.0	12.1	12.5	12.4	11.9	12.1	11.9	11.7	11.8	11.9
Households Consumption deflator	2.1	2.0	2.1	2.4	0.5	0.6	0.5	0.4	0.4	0.5	0.8	0.6	0.5	0.8	0.4	0.5
Real total wage bill	0.3	0.7	0.6	0.8	0.6	0.0	-0.4	0.5	0.6	0.0	-0.3	0.0	0.4	0.3	0.5	0.4
- Real unit wage	-0.3	0.1	-0.2	-0.3	0.6	-0.2	-0.6	0.3	0.3	-0.1	-0.4	-0.3	0.1	0.0	0.2	0.1
Purchasing power of GDI	0.7	1.5	0.7	1.5	0.8	0.3	-0.1	-0.2	0.6	0.2	0.0	0.3	0.5	0.4	0.5	0.5

Forecast (MZE model)
Sources : Eurostat, Insee calculations

demand in the zone's export markets (a rise of 1.6% per quarter) can be expected to boost exports to non-euro-zone countries throughout the year *(see Graph 7)*. In this connection, leader's opinions regarding export order books remain positive in the manufacturing sector. All in all, allowing for the substantial statistical carryover at the end of Q1 (5.4%), the annual average export growth rate in 2006 should be twice that attained in 2005.

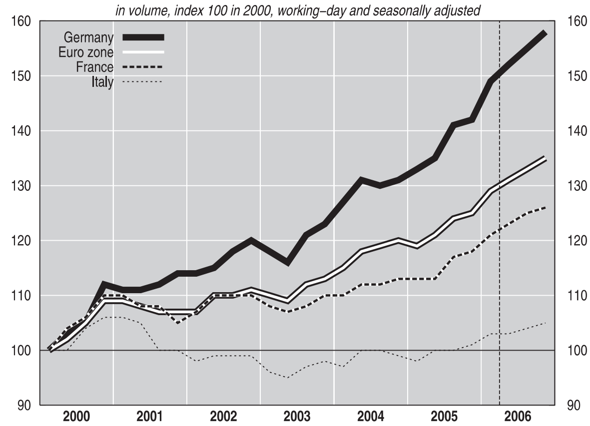
Italy's export performance is expected to remain disappointing, however, with the economy having steadily lost market share since 1999 *(see Graph 8)*. The acceleration in world trade in the first part of the year has given a partial stimulus to Italian exports, but their growth nevertheless remains below that of world demand. Germany, by contrast, seems likely to continue to stand out for the strength of its exports. The improvement in firms' cost competitiveness due to the decline in real wages and Germany's continuing favourable sectoral specialisation should underpin the strength of exports in 2006, with growth expected to be 11.1% for the year.

Thanks to the strength of foreign demand, but also to the acceleration in domestic consumption, imports are also likely to remain lively. All things considered, foreign trade should make barely any negative contribution to growth in 2006 (- 0.1 of a point, compared with - 0.3 of a point in 2005). ■

8

EXPORTS OF THE PRINCIPAL EURO-ZONE COUNTRIES

in volume, index 100 in 2000, working-day and seasonally adjusted



sources: Destatis, Eurostat, Istat, Insee *forecasts after the dotted line*

Consumer prices in the euro zone

The early part of 2006 was marked by a further acceleration in energy prices, following the rise in the Brent price above $70/barrel. Having fallen back to 2.2% towards the end of 2005, inflation in the euro zone therefore picked up again to 2.5% in May 2006. Meanwhile, core inflation[(1)] has remained practically stable, standing at 1.3% in May. However, this figure masks disparities in price movements among different countries in the zone.

On the assumptions that the crude oil price stabilises at $70/barrel and that the euro/dollar exchange rate remains at 1.27, inflation in the euro zone is expected to fall slightly to 2.4% in June 2006 and subsequently decline to 2.2% by the end of the year, having passed temporarily below the 2.0% level because of the base effect resulting from the oil shock in the latter part of 2005. Core inflation is expected to be 1.5% in December, reflecting the very limited diffusion of the energy shock and the absence of second-round wage effects.

On the assumptions of stabilisation of the oil price at a high level and a strong euro, inflation in the euro zone should remain above 2% at the end of 2006.

With the oil price breaking through the $70/barrel level, inflation in the euro zone picked up to 2.5% in May 2006, after falling to 2.2% in December 2005.

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

This shows that in the early part of 2006 the strength of energy prices has continued to dictate the pattern for overall inflation in the zone.

On the assumption of a Brent price close to $70/barrel and a euro/dollar exchange rate of 1.27, inflation in the euro zone can be expected to ease slightly and stand at 2.2% in December, following 2.4% in June *(see Table 1 and Graph 1)*. This evolution would not be smooth, however, particularly as the result of the exit from the year-on-year comparison in the latter part of 2006 of the record inflation rates posted in September and October 2005 following the energy shock. The final result would be to bring inflation down slightly below the 2% level.

After showing initial signs of a decline towards the end of 2005 following the exit from the oil shock posted last autumn, energy prices accelerated again in the early part of 2006. The expected drop in the energy component of inflation therefore failed to materialise and, with the Brent price now standing above $70/barrel, the year-on-year rise in energy prices amounted to 12.9% in May. Looking to the future, on the assumptions of stabilisation of the oil price and a euro/dollar rate of 1.27, energy inflation would fall back to 10.3% in December, following a trough in the autumn. The persistence of a high year-on-year figure is partly explained by the expected alignment of prices of gas and electricity on that of oil in various countries in the zone.

The year-on-year rise in food prices picked up in the early part of the year to 2.0% in May from 1.7% in December 2005. It is forecast to stand at 1.7% in December, following 1.6% in June. The diffusion of

TABLE 1: EURO-ZONE INFLATION

(year on year % growth of HICP)

	Year on year changes at end					Annual change		
Sectors (weight in the 2006 index)	June 2005	Dec. 2005	May 2006	June 2006	Dec. 2006	2004	2005	2006
Total (100.0%)	**2.1**	**2.2**	**2.5**	**2.4**	**2.2**	**2.1**	**2.2**	**2.2**
Food (Beverage and Tobacco included) (19.3%)	**1.1**	**1.7**	**2.0**	**1.6**	**1.7**	**2.3**	**1.6**	**1.8**
of which Food (15.3%)	*0.4*	*1.4*	*1.8*	*1.2*	*1.4*	*1.0*	*0.7*	*1.5*
Beverage and Tobacco (4.0%)	*3.9*	*2.7*	*2.8*	*2.8*	*2.5*	*7.5*	*4.9*	*2.6*
Energy (9.2%)	**9.4**	**11.2**	**12.9**	**14.3**	**10.3**	**4.5**	**10.1**	**10.2**
Core inflation (71.5%)	**1.4**	**1.4**	**1.3**	**1.3**	**1.5**	**1.8**	**1.4**	**1.4**
of which: Manufactured products (30.7%)	*0.2*	*0.4*	*0.7*	*0.4*	*0.7*	*0.8*	*0.3*	*0.7*
Services (40.8%)	*2.2*	*2.1*	*1.8*	*2.2*	*2.3*	*2.6*	*2.3*	*2.2*

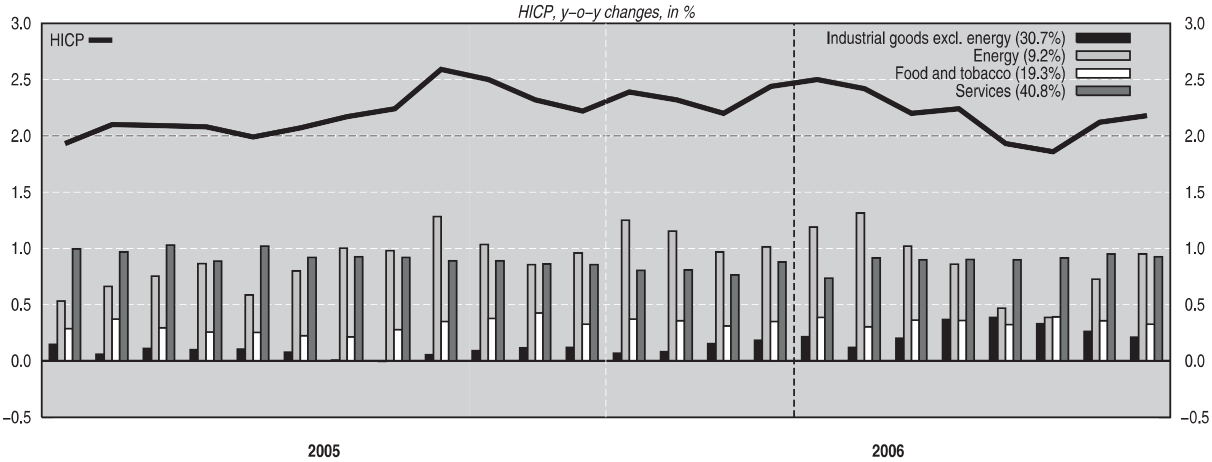
Forecast

Source: Eurostat

Consumer prices in the euro zone

1

BREAKDOWN OF INFLATION IN THE EURO ZONE
contributions of the main items
HICP, y–o–y changes, in %



sources : Eurostat, Insee forecasts

forecasts after the dotted line

past rises in the oil price and in commodity prices would be partly compensated by continued aggressive mark-up behaviour in this sector.

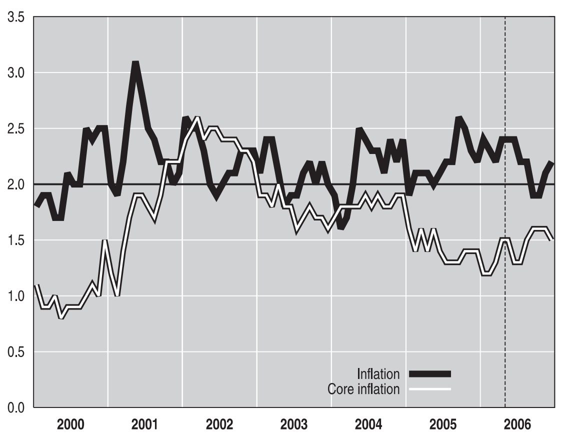
Core inflation set to stand at 1.5% in December 2006, with no risk of an inflationary spiral

Core inflation has remained practically stable in the early part of this year (1.3% in May, compared with 1.4% in December 2005). It is expected to rise slightly between now and the end of the year, reaching 1.5% in December. Against a background of firmer growth in the euro zone, past rises in oil and commodity prices are likely to be passed on to a greater extent to the other sectors. However, the recent appreciation of the euro should tend to limit these diffusion effects. Looking further ahead, the materialisation of second-round effects on wages seems highly improbable *(see Graph 2)*.

The year-on-year rise in prices of services, the principal component of core inflation, has been fluctuating around 2% since the beginning of the year, falling from 2.1% in December 2005 to 1.8% in May 2006.

2

HICP AND CORE INFLATION IN THE EURO–ZONE



forecasts after the dotted line

Prices of services are forecast to accelerate slightly (2.2% in June, 2.3% in December), but this acceleration would be limited by the continued wage restraint in the euro zone. Certain sectors, such as transport, could nevertheless pass on to a greater extent the successive leaps in the oil price and this represents a potential upward pressure factor for this forecast.

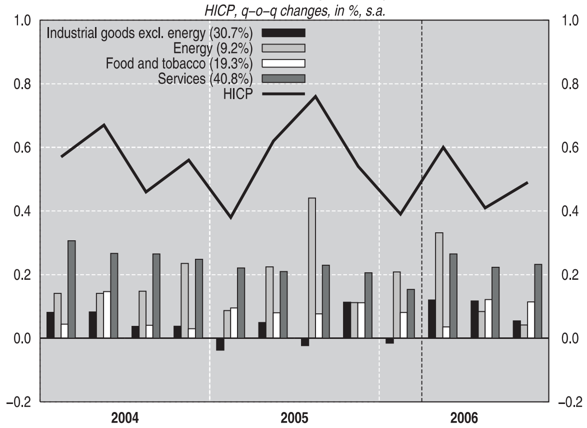
The slight rise in prices of manufactures, the second largest component of core inflation, has meant an increase in the year-on-year figure from 0.4% in December 2005 to 0.7% in May 2006. The year-on-year figure is forecast to be still 0.7% in December 2006. Past rises in commodity prices are expected to have only a limited impact on the time-pattern of inflation in this sector in H2 2006, thanks to the combined effect of a strong euro and substantial efforts to keep prices down.

Substantial divergences between core inflation rates within the euro zone

Inflation differentials within the euro zone have narrowed slightly, partly as a result of the persistence of high levels of energy inflation. The contributions of

3

EURO ZONE: BREAKDOWN OF INFLATION
contributions of the main items
HICP, q–o–q changes, in %, s.a.



forecasts after the dotted line

the energy component to inflation in May in the various countries remain extremely close. As a result, the maximum differential was 2.4 points[(2)] in May 2006, compared with 2.6 points in December 2005.

On the other hand, core inflation differentials have widened. The maximum differential in May, between Spain and Finland, was 2.3 points Meanwhile, Greece, Ireland and Luxembourg are posting core inflation rates of more than 2%, while the rates for the Netherlands and Germany are below 1%. These figures point to very different reactions to the diffusion effects of the oil shock on the part of the European economies.

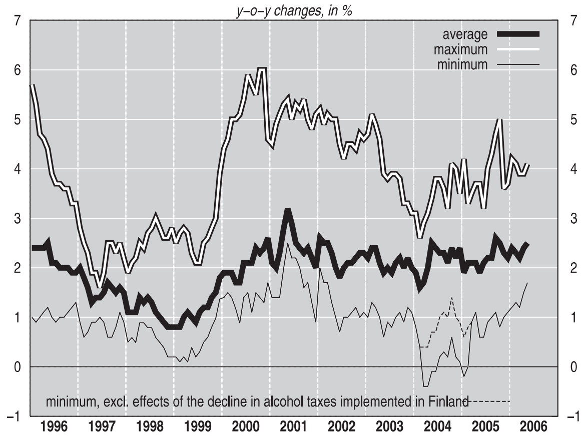
Finally, the inflation differential between France and the rest of the zone on the basis of the HICP (harmonised index of consumer prices) stood at -0.1 of a point in May 2006. It is forecast to remain small *(see Graph 5)*. The forecast time-patterns for the HICP in France and in the euro zone are very similar. ■

(2) This is the figure for the inflation differential between Spain and Finland. Figures for May 2006 in the case of Portugal are not yet available.

4

INFLATION IN THE EURO ZONE

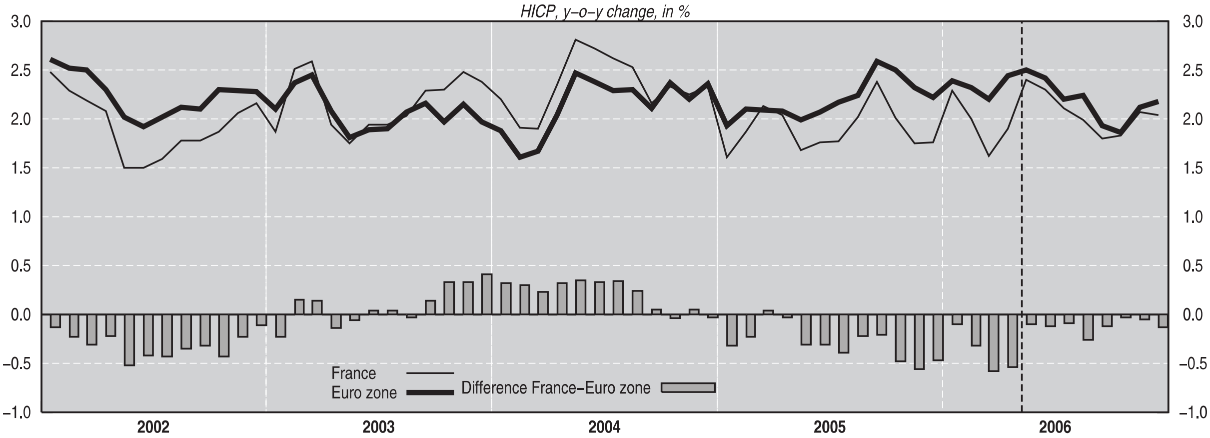
y-o-y changes, in %



5

HARMONISED INDEX OF CONSUMER PRICES IN FRANCE AND EURO ZONE

HICP, y-o-y change, in %



forecasts after the dotted line

TABLE 2 : EURO-ZONE INFLATION BY COUNTRIES

(year on year % growth of HICP)

	HICP		Core inflation		Energy	
	May 2005	May 2006	May 2005	May 2006	May 2005	May 2006
Austria	2.0	2.1	1.5	1.4	6.9	10.5 (0.9)
Belgium	2.3	2.8	1.2	1.6	9.5	13.2 (1.3)
Finland	0.6	1.7	0.6	0.6	1.5	13.1 (0.9)
France	1.7	2.4	1.6	1.4	6.4	12.6 (1.1)
Germany	1.6	2.1	0.9	0.4	6.0	13.6 (1.5)
Greece	3.2	3.3	3.4	2.3	10.8	14.3 (1.1)
Ireland	2.1	3.0	2.0	2.1	11.6	13.1 (1.1)
Italy	2.3	2.3	2.2	1.7	8.1	10.5 (0.7)
Luxembourg	3.7	3.6	1.5	2.2	13.5	15.8 (1.8)
Netherlands	1.0	1.8	0.6	0.9	8.2	11.0 (1.1)
Portugal	1.8	-	1.8	-	6.8	-
Spain	3.0	4.1	2.5	2.9	6.8	14.3 (1.3)
Euro zone	**2.0**	**2.5**	**1.6**	**1.3**	**6.8**	**12.9 (1.2)**

In the final column, the contribution of the energy component to overall inflation is shown in brackets.
NB : data relative to Finland are not available for February 2006. Year-on-year changes for Euro zone are based on Eurostat estimations.
Source : Eurostat, Insee calculations