International overview

GDP growth in the advanced economies rebounded slightly from 0.3% in Q4 2007 to 0.5% in Q1 2008, thanks to the unexpected vigor of the German and Japanese economies. These performances were largely due to non-recurrent factors, whose absence in Q2 is thus likely to quicken the slowdown under way in the advanced economies.

Annual average GDP growth in the advanced economies is forecast to weaken from 2.4% in 2007 to 1.5% this year, under the combined effects of tighter credit access, rising inflation, and the slump in real-estate markets. The emerging economies show signs of losing momentum as well—another factor contributing to the global economic slowdown.

Sharp downturn by year-end

GDP growth in the advanced economies[1] is expected to slow by year-end, as suggested by the gloomier overall outlook in the manufacturing industry tracked by the Purchasing Managers' Index (PMI) survey. These hint at a year-on-year GDP growth for the advanced economies of around 1.5% in Q2 (*Chart 1*). The PMI activity indicator for the service sector posted a similar decline in April, heralding a further slowdown. Growth is actually forecast to be somewhat weaker in Q2 than in H2. This is due to the expected negative rebound from the exceptional Q1 growth in Germany and Japan, which was fueled largely by one-time factors (*Tables 1 and 2*).

Annual average GDP growth in the advanced economies is thus projected to weaken from 2.4% in 2007 to 1.5% in 2008. Similarly, short-term indicators announce a slowdown in the main emerging countries: Brazil, Russia, India, and China. The emerging countries as a whole may suffer from the inflation surge triggered by the steep rise in food prices and the monetary-policy tightening that could ensue. On the other hand, the purely internal drivers of their robust growth in recent years persist, such as productivity catch-up

1. Our scope of coverage is identical to that of the IMF's *World Economic Outlook*. For a description of our aggregation methodology and econometric tools, see "Focus: Measuring international macroeconomic developments," in the March 2008 issue of "*Conjoncture* in France."

Table 1

Industrialized countries: consolidated supply and use table

in real terms

	Quarterly changes, %								Annual changes, %		
	2007				2008				2006	2007	2008
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
GDP	0.5	0.5	0.8	0.3	0.5	0.0	0.3	0.1	2.8	2.4	1.5
Private consumption	0.6	0.4	0.5	0.3	0.4	0.3	0.5	0.1	2.4	2.3	1.5
Public consumption	0.3	0.6	0.7	0.3	0.4	0.4	0.4	0.4	1.6	1.9	1.7
Investment	0.1	-0.2	0.3	0.0	-0.3	-1.5	-1.2	-1.1	3.6	0.5	-2.2
Exports	0.8	1.4	3.3	1.1	1.5	0.3	0.8	0.8	8.6	6.5	5.2
Imports	1.1	-0.2	1.6	-0.2	0.5	-0.1	0.0	-0.3	6.5	2.7	0.9
Contributions to GDP growth											
Domestic demand excluding inventories	0.5	0.3	0.5	0.3	0.3	0.0	0.2	0.0	2.6	2.0	1.0
Inventories	0.1	-0.1	0.2	-0.2	0.0	-0.1	0.0	0.0	0.1	-0.1	-0.1
Net exports	-0.1	0.3	0.1	0.2	0.2	0.0	0.1	0.1	0.2	0.5	0.6

Forecasts

Sources: national statistical institutes; IMF; INSEE estimates and rural-urban migration. We see global GDP growth slipping from an average 5.5% in 2007 to 4.0% year-on-year at end-2008.

In this lackluster international environment, world demand for French products is likely to post moderate growth between now and December 2008, notably on account of weaker EU imports and sagging U.S. demand. By the end of the forecasting period, it should be rising more slowly than its long-term average.

Worldwide inflationary pressures

Agricultural and energy commodity prices have climbed steeply since summer 2007, driving up inflation in the advanced countries (*Chart 2*) and even more so in the developing countries. The barrel price of Brent crude oil has been rising since the start of 2007, approaching $140 in early June 2008. Agricultural prices seem to be slowing, but past increases continue to impact consumer prices.

By year-end, core inflation should have risen slightly in most countries, as the diffusion effects of higher commodity prices will likely exceed the disinflationary impact of the economic slowdown. In our scenario, total inflation will peak in mid-year then gradually recede in H2 2008, assuming oil prices stabilize at around $130 per barrel.

A likely easing of financial-market tensions

Tensions persist on the interbank markets. The spread between the three-month money-market rate and the U.S. Fed Funds rate remains well above its long-term average. Nevertheless, the narrowing of the gap between three-month money-market rates and yields on three-month

Table 2

Main industrialized countries: GDP

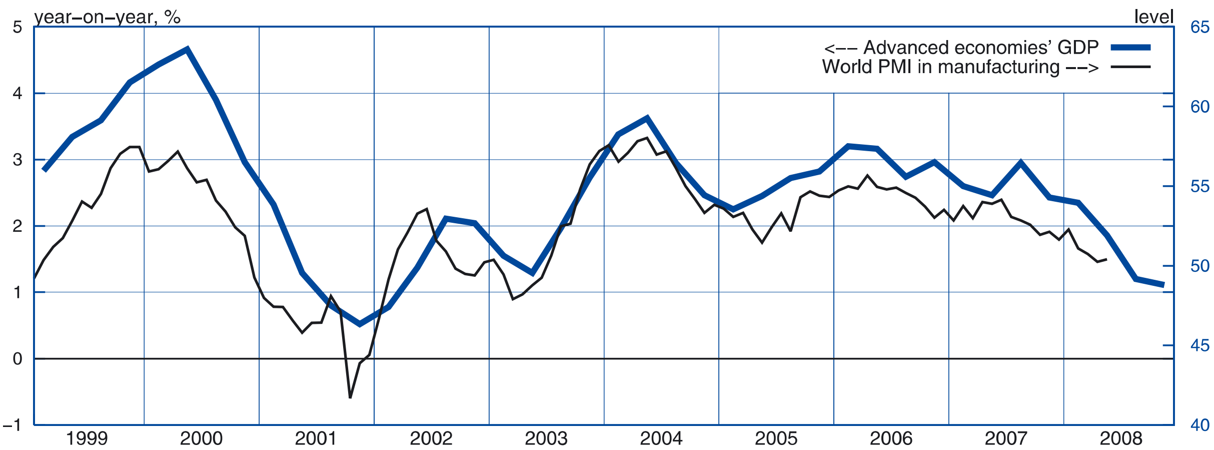
in real terms

	Quarterly changes, %								Annual changes, %		
	2007				2008				2006	2007	2008
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
Total	**0.5**	**0.5**	**0.8**	**0.3**	**0.5**	**0.0**	**0.3**	**0.1**	**2.8**	**2.4**	**1.5**
United States	0.2	0.9	1.2	0.1	0.2	-0.1	0.4	0.0	2.9	2.2	1.3
Japan	1.1	-0.6	0.2	0.7	1.0	0.2	0.4	0.4	2.4	2.0	1.9
United Kingdom	0.7	0.8	0.6	0.6	0.4	0.2	0.2	0.2	2.9	3.0	1.7
Euro zone, of which:	0.8	0.4	0.7	0.3	0.8	0.0	0.2	0.2	2.9	2.6	1.6
Germany	0.6	0.2	0.7	0.3	1.5	-0.3	0.3	0.3	3.1	2.6	2.1
Italy	0.3	0.0	0.2	-0.4	0.4	0.1	0.1	0.2	1.9	1.4	0.3

Forecasts

Sources: national statistical institutes; IMF; INSEE estimates

1 – GDP growth and PMI (Purchasing Managers' Index) in manufacturing



Sources: JP Morgan; national statistical institutes; IMF; INSEE estimates government securities apparently indicates a less intense flight to quality. At the same time, yield spreads between corporate and government bonds have stabilized in most advanced economies, although they are still running high. In H2 2008, money-markets tensions should abate without vanishing altogether, as uncertainties over bank balance-sheets cannot be totally resolved by year-end.

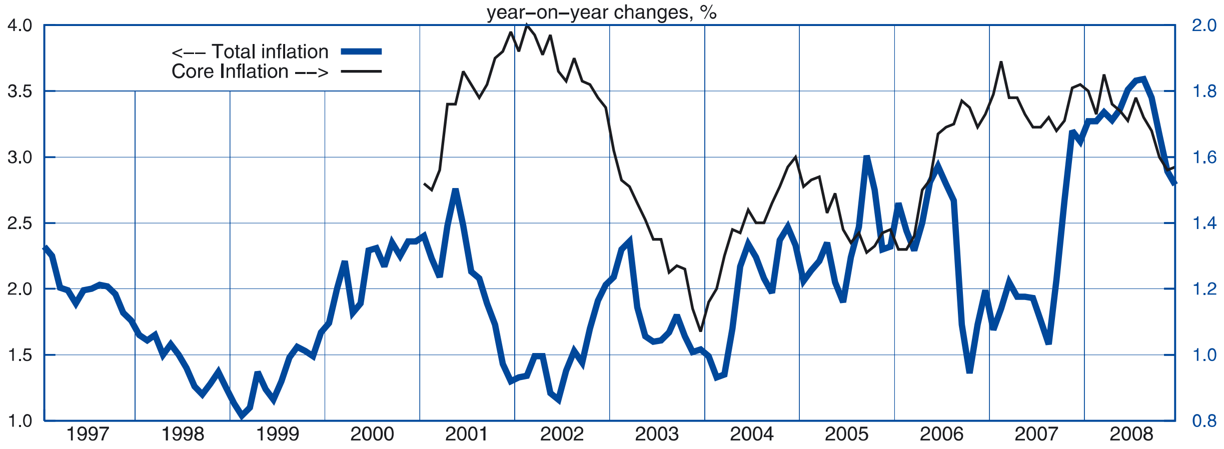
Between now and December, limp growth and persistently high inflation are expected to make the U.S. Federal Reserve opt for the status quo on key rates. The European Central Bank (ECB) has held its main refinancing rate stable at 4% since summer 2007, out of concern for growing inflationary pressures, the persistence of money-market tensions, and worsening economic conditions in the euro zone. Today, the ECB seems ready to lift its key rate.

By and large, monetary policies remain accommodative and could still fuel inflationary risks in the medium term. Short-term interest rates continue to run slightly below nominal GDP growth in the advanced countries (*Chart 3*) and liquidity remains plentiful.

Main uncertainty: the impact of the financial crisis

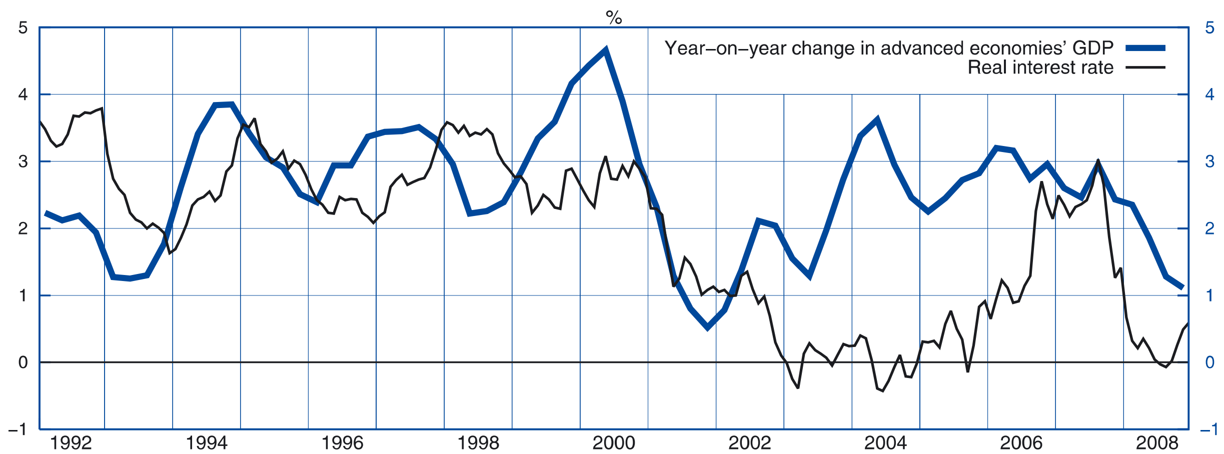
The main downward uncertainty is the impact of the financial crisis: tighter credit access and greater risk aversion could have a worldwide dampening effect on both household and business investment decisions. Moreover, inflation is again burdening the global economy, and fresh rises in energy and food commodity prices constitute a downward risk in our scenario. On the positive side, a greater resilience of the emerging economies or an easing of monetary tensions may cushion the world growth slowdown, at the risk of stoking inflationary tensions. ■

2 – Inflationary tensions in advanced economies



Sources: national statistical institutes; IMF; Data Insight; INSEE estimates

3 – Monetary policy in advanced economies



Sources: national statistical institutes; IMF; Data Insight; INSEE estimates

United States and United Kingdom

The near-stagnation phase that the U.S. economy entered in Q4 2007 is forecast to continue in 2008. The tax rebate should, however, give household consumption a temporary boost in H2.

British GDP growth is expected to slow, largely owing to slacker household demand. In particular, households are likely to cut back their investment because of the downswing in real-estate prices and tighter credit access.

Weak U.S. growth despite the tax rebate

Between now and end-2008, our scenario sees the U.S. economy still undermined by the effects of the real-estate downturn and the financial crisis. The first negative factor is residential investment, which is set to decline further. A comparison of quantitative economic indicators with their levels in earlier real-estate crises[1] shows that, in all likelihood, the cycle has not yet bottomed out (*Chart 1*). The second negative factor is consumption, which is expected to weaken because of wealth losses (particularly on real-estate assets), sagging employment (which registered its fifth consecutive monthly decline in May), and slower wage growth in the quarters ahead. The tax rebate should, however, provide an income supplement that will temporarily sustain consumption in H2 ("*Focus: The U.S. Economic Stimulus Act (ESA)*"). The third negative factor is business investment, which is projected to lose 1.0% per quarter until year-end, after a 0.1% loss in Q1 (*Table 1*), notably on account of tighter credit access.

The U.S. economy should nevertheless continue to benefit from the dollar's past depreciation, which will dampen the effects of the expected slowdown in international demand. As a result, exports are set to keep growing 0.8% per quarter. In our scenario, the dollar's depreciation to date will also amplify the downturn in imports, caused by weak domestic demand. The contribution of external trade to GDP growth should therefore stay positive between now and end-2008.

1. In particular, this comparison reveals similarities between the present crisis and that of 1978.

Table 1

United States: supply and use table

%

	Quarterly changes, %								Annual changes, %		
	2007				2008				2006	2007	2008
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
GDP	**0.2**	**0.9**	**1.2**	**0.1**	**0.2**	**-0.1**	**0.4**	**0.0**	**2.9**	**2.2**	**1.3**
Household consumption (70%)	0.9	0.3	0.7	0.6	0.2	0.5	0.8	0.0	3.1	2.9	1.9
Investment (16%)	-1.1	0.8	-0.2	-1.0	-2.0	-3.3	-3.1	-2.9	2.4	-2.9	-7.1
Non-residential (10%)	0.5	2.6	2.3	1.5	-0.1	-1.0	-1.0	-1.0	6.6	4.7	1.3
Residential (6%)	-4.4	-3.1	-5.6	-7.0	-7.1	-7.0	-6.5	-6.0	-4.6	-17.0	-23.4
Exports (10%)	0.3	1.8	4.5	1.6	-0.7	0.8	0.8	0.8	8.4	8.1	5.8
Imports (16%)	1.0	-0.7	1.1	-0.4	-0.7	-0.5	-1.0	-1.5	5.9	1.9	-1.8
Contributions to GDP growth											
Domestic demand excl. inventories	*0.4*	*0.6*	*0.6*	*0.3*	*0.0*	*-0.1*	*0.2*	*-0.4*	*2.9*	*1.9*	*0.6*
Inventories	*-0.2*	*0.1*	*0.2*	*-0.4*	*0.1*	*-0.1*	*0.0*	*0.0*	*0.1*	*-0.3*	*-0.3*
Net exports	*-0.1*	*0.3*	*0.3*	*0.3*	*0.2*	*0.2*	*0.2*	*0.3*	*-0.1*	*0.6*	*1.0*

Forecasts

(%): share of nominal GDP in 2005

Sources: BEA, INSEE estimates

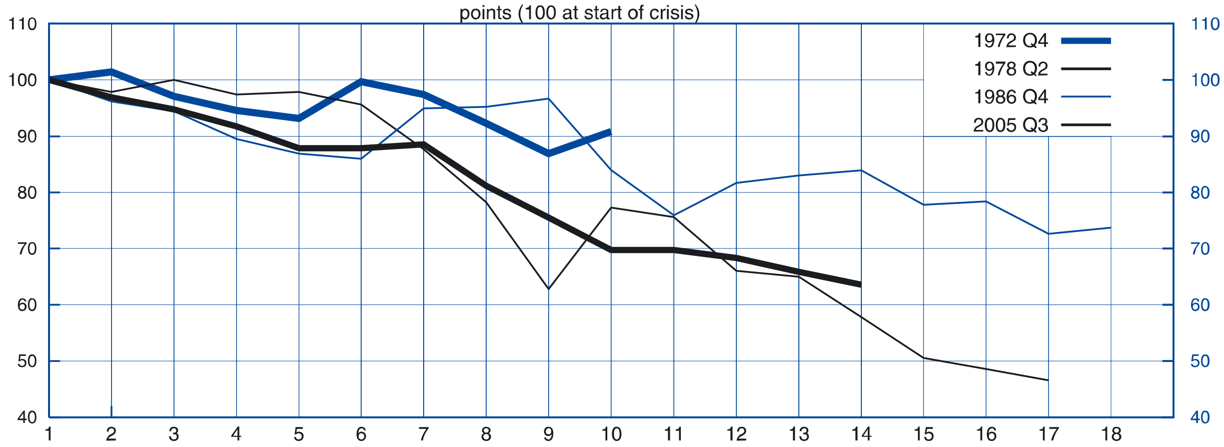
On an annual-average basis, U.S. GDP growth is forecast to slow sharply from 2.2% in 2007 to 1.3% in 2008. The main uncertainty concerns consumption by households, who might either behave more prudently than expected or, on the contrary, decide to spend nearly all the extra income handed out by the U.S. government. Meanwhile, the financial crisis could weigh more heavily on corporate investment decisions, whereas external trade may sustain GDP growth more than forecast.

The U.K. economy is headed for a sharp slowdown in 2008 owing to the downturn in real-estate prices

The U.K. real-estate market was initially hit by the Bank of England's interest-rate hikes in H1 2007. Since summer 2007, it has also been battered by the financial crisis, which has driven banks to tighten credit access.

Real-estate prices have thus fallen since October 2007 (*Chart 2*). Household investment began to weaken in H2 2007, losing 1.0% in Q3 and 0.6% in Q4. We expect it to keep declining in 2008, by 2% in Q2, 2% in Q3, and 1% in Q4 (*Table 2*).

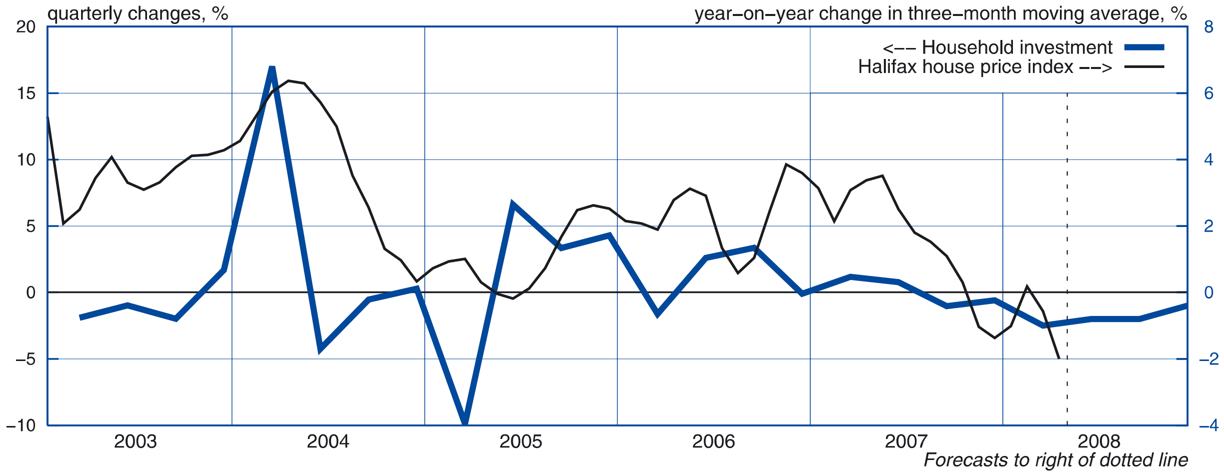
1 - Sales of existing homes in U.S. during four real-estate crises



How to read this chart: the curve plots quarterly sales of existing homes in four U.S. real-estate crises, standardized to 100 at the start of each crisis.

Sources: National Association of Realtors; INSEE forecasts (last three points in Q3 2005 in forecast)

2 - Downturn in U.K. real-estate prices



Sources: UK National statistics; INSEE forecasts (to right of dotted line)

The real-estate downswing is also likely to affect U.K. consumption. Despite an unexpected rebound of 1.3% in Q1, our scenario puts consumption growth at 0.0% in Q2, edging up to 0.1% per quarter in H2. In particular, the real-estate wealth effect that drove consumption should be reversed, given the further decline in real-estate prices. Employment should adjust gradually, until year-end, to the current economic slowdown. Lastly, the steep rise in energy and food-commodity prices will likely persist, fueling inflation. In our scenario, U.K. inflation will stay above 3% between now and end-2008. We therefore see only modest gains in British households' purchasing power in 2008.

All in all, household demand should provide a very weak stimulus to growth in 2008.

Business investment fell in Q1 2008 because of tighter credit access. We project that it will stall in the coming quarters, as suggested by the stabilization of business leaders' opinions on the production outlook in manufacturing.

In our scenario, external trade will offer mild support to the U.K. economy in the last three quarters of 2008. Unlike those of other EU countries, British exports did not increase in Q1. They should recover by a modest 1.1% in Q2, thanks to the pound's depreciation. They are expected to grow more slowly thereafter, notably on account of weaker foreign demand. Import growth should be even weaker—at 0.5% in Q2 and 0.0% per quarter in H2—because of the pound's depreciation and limp domestic demand. External trade should thus contribute a positive 0.1 points per quarter to GDP growth.

To sum up, we expect U.K. annual average GDP growth to slow sharply from 3.0% in 2007 to 1.7% in 2008. The main uncertainties surrounding this forecast are the scale of the consumption slowdown and the impact of tighter lending on investment. ■

Table 2

United Kingdom: supply and use table

%

	Quarterly changes, %								Annual changes, %		
	2007				2008				2006	2007	2008
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
GDP	**0.7**	**0.8**	**0.6**	**0.6**	**0.4**	**0.2**	**0.2**	**0.2**	**2.9**	**3.0**	**1.7**
Household consumption (62%)	0.8	0.7	0.8	0.1	1.3	0.0	0.1	0.1	1.9	3.0	2.1
Investment[1] (17%)	1.4	-1.2	2.1	1.8	-1.6	-0.6	-0.6	-0.3	7.9	6.2	-0.3
Non-residential (11%)	0.1	0.5	2.7	1.8	-1.4	0.0	0.0	0.0	-4.7	7.9	1.5
Residential (5%)	1.2	0.8	-1.0	-0.6	-2.5	-2.0	-2.0	-1.0	9.2	3.3	-5.9
Exports (26%)	-1.0	0.7	1.4	-0.5	0.0	1.1	0.5	0.5	11.0	-5.3	1.7
Imports (30%)	0.6	-0.7	4.3	-1.0	-0.6	0.5	0.0	0.0	10.0	-2.9	0.9
Contributions to GDP growth											
Domestic demand excl. inventories	0.9	0.3	1.0	0.3	0.8	0.0	0.1	0.1	3.1	3.5	1.7
Inventories	0.3	0.1	0.6	0.1	-0.6	0.0	0.0	0.0	-0.1	0.1	-0.2
Net exports	-0.5	0.4	-0.9	0.2	0.2	0.1	0.1	0.1	0.0	-0.5	0.2

Forecasts

(%): share of nominal GDP in 2005

1. Total also includes public-sector investment, not separated here

Sources: BEA; INSEE estimates

Focus: The U.S. Economic Stimulus Act (ESA)

The United States Congress passed the Economic Stimulus Act (ESA) in February 2008. Similar plans have already been implemented in the past. According to Congressional assessments and the results of a household survey, the 2008 tax stimulus should boost GDP growth by 0.1 points in Q2 2008 and 0.4 points in Q3. Through a negative rebound effect, however, growth is likely to lose 0.2 points in Q4.

The package should stimulate income growth by May

In reaction to the worsening U.S. economic outlook, and in particular to offset the slowdown in household consumption, U.S. lawmakers have passed a tax stimulus package. Its main provision is a $116-billion tax rebate,[1] targeted at the lowest-income households. For households below the taxable-income threshold, the stimulus comes in the form of a negative tax. In practice, a single person with "gross adjusted" income (a concept that includes all types of income, allowances, benefits, and subsidies) between $3,000 and $75,000 (the ceiling is doubled for a married couple) will receive between $300 and $600 (twice the amount for a married couple). For each child living at home, the household will receive an extra $300. In response to the tightening of credit access for businesses and households, the package includes two other measures designed to sustain growth in the short term: a $50-billion investment incentive for businesses based on an increase in the maximum deduction for investment and in the depreciation rate; and a rise in the ceiling on mortgage loans guaranteed by the Federal Housing Administration, which would allow some households to refinance loans or spread repayments.

After Presidential approval, the tax-rebate bill was passed into law on February 13, 2008, under the name of Economic Stimulus Act (ESA) of 2008. The Internal Revenue Service (IRS) has announced the timetable for distribution of the extra income to U.S. households. According to the Congressional Joint Committee on Taxation, nearly all payments should be made in Q2 and Q3 2008 (*Table 1*).[2]

Similar measures have been enacted in the past

The United States has already resorted to this type of tax-rebate stimulus package: the 1975 Tax Reduction Act (TRA), the 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRA), and the 2003 Jobs and Growth Act (JGA). The analysis of these precedents may enable us to predict the impact of the latest Act (*Table 2 for main points of comparison*).

As a rule, households have consumed about two-thirds of the extra income over a period of three quarters, of which one-half by the first quarter. However, the comparison between the present package and the 2001 and 2003 plans is probably biased by the long-term character of this year's reforms, whose impact will last until 2011. By contrast, the comparison with the 1975 package—which was temporary as well—seems more justified, and the estimated effects become weaker. Blinder (1981) estimated that consumption rose by 16% of the value of the tax rebate in the following quarter, and the effects persisted in later quarters, for a cumulative impact of 21% in a year. Using monthly data, Poterba (1988) found an effect of the same magnitude, i.e., a total ranging from 12% to 24% for temporary stimulus packages. Modigliani and Steindel (1977) found even weaker effects.

What household surveys tell us

The University of Michigan household confidence survey routinely includes a question on the expected use of tax rebates: "What will you mostly do with your tax rebate?" (*Table 3*). Other, similar surveys give fairly convergent results. Nearly one-half of respondents state that they want to reduce their debt burden, one-third say that they mainly want to spend the rebate, and the rest intend to save it. Retrospective analysis of the 2001 and 2003 packages found a higher level of income consumption (Agarwal *et al*. 2008; Coronado *et al.*, 2005), notably because some households that listed debt reduction as their priority eventually spent part of the rebate on consumption. But U.S. households are more indebted today than in 2001, and the 1975 precedent suggests that households are less likely to consume the extra income than in 2001 or 2003. We may plausibly estimate,

Table 1
Tax-rebate distribution timetable

Mailing dates	Households concerned (million)	Rebate amount ($ bn)
Total	**130**	**116**
DIRECT (Internet)	**34**	**30**
May 2	7	6
May 9	19	17
May 16	8	7
CHECK (mail)	**96**	**86**
May 16	9.5	9
May 23	8.5	8
May 30	7.0	5
June 6	12.5	11
June 13	12.5	11
June 20	11.5	10
June 27	11.5	10
July 4	11.5	10
July 11	11.5	10

1. $106 billion appropriated from the 2008 budget and $10 billion from the 2009 budget.
2. In its timetable, the IRS does not rule out the possibility of mailing some checks in Q4. But the Act forbids it from sending out checks after December 31, 2008.

therefore, that about one-third of the total amount will be consumed.

The tax stimulus is expected to boost quarterly GDP growth by one-tenth of a point in Q2, by two- to three-tenths in H2 , and by four-tenths in Q4

Preliminary data for May do not indicate a rise in sales. This suggests moderate consumption growth in Q2. One-third of the extra income distributed should be consumed by end-2008, mostly in Q3 (*Table 4*). The impact in terms of extra GDP growth should be slightly weaker, since part of the extra consumption will be spent on imports.

The increase in tax deductibility of business investments—a mechanism already implemented in the U.S. in 2002 and 2003—is projected to have a moderate impact. Various survey-based analyses (Knittel 2007; Cohen and Cummins 2006) estimate that although over half of U.S. businesses benefited from the measure, only 10% of their investments were influenced by it in terms of timing and level. Nevertheless, this represents a growth factor and leads us to a somewhat more upbeat investment forecast than what standard determinants—in particular the tightening of credit access—would indicate.

All told, the tax stimulus should provide extra growth of about 0.1 points in Q2 and 0.4 points in Q3. As a result of a negative rebound effect, GDP growth is expected to shed 0.2 points in Q4. ■

Table 2

U.S. tax stimulus plans

	TRA	EGTRA	JGA	ESA
Year	1975	2001	2003	2008
Month	May	July-September	July-August	May-July
Recession**	November 1973	March 2001	-	(fears early 2008)
Rebate per person	$100-200	$300*		$300-600*
Supplement per child			$400	$300
Total rebate ($ billion)		38	15	116
Comments		Permanent reduction in marginal tax rates		

* Amounts doubled for a couple
** Month of start of recession according to official NBER dating
Sources: Joint Committee on Taxation, IRS

Table 3

Uses of previous income supplements

%

Tax packages	Spending	Saving	Loan repayment
EGTRA 2001	32	23	45
JGA 2003	24	27	49
ESA 2008	28	26	46

How to read this table: When the 2001 tax stimulus package was enacted, 32% of households surveyed stated their intention of spending most of the extra income.

Source: University of Michigan household survey

Table 4

Estimated impact of 2008 tax rebate

	2008 Q2	2008 Q3	2008 Q4	TOTAL
On gross disposable income (nominal)				
$ billion	96	20	0	116
On quarterly growth rate	+3.6	-2.7	-0.8	+1.2*
On consumption (real)				
Billions of 2000 $	4	16	10	30
On level (percentage points)	+0.2	+0.8	+0.5	+1.5
On quarterly growth rate	+0.2	+0.6	-0.2	+0.4*
On GDP (real)				
On level (percentage points)	+0.1	+0.5	+0.2	+0.8
On quarterly growth rate	+0.1	+0.4	-0.2	+0.2*

*Impact on 2008 annual average growth.
Source: INSEE estimates

Japan, China, and emerging Asia

Japanese GDP growth continued to accelerate, quickening from 0.7% in Q4 2007 to 1.0% in Q1 2008. This upturn, partly due to one-time factors, should be temporary. Soft domestic demand and weaker external trade are forecast to put a brake on the economy by end-2008.

In South-East Asian countries and China, growth should ease somewhat by year-end because of the expected slowdown among their main partners and monetary-policy tightening.

Japanese economy headed for a slowdown in 2008

Japan's household consumption accelerated sharply in Q1 2008. This performance may be partly due to a working-day effect (February having an extra leap-year day in 2008), which some analysts regard as inadequately adjusted for in Japanese national accounts. In any event, the consumption determinants are generally pointing downward. In particular, wage growth will remain slack in the quarters ahead. Labor-market tensions continued to ease in Q1, as indicated by the decline in the job supply/demand ratio, and firms are squeezing wages to dampen the impact of higher commodity prices on their margins. Amid this weak wage growth and stagnant employment, coupled with the inflation surge, Japanese consumers' purchasing power is forecast to decline in the coming quarters. At the same time, Japanese households' confidence is on a sharp downtrend, notably as regards their plans to purchase durable goods (*Chart 1*). In our scenario, household consumption will therefore post weak growth between now and year-end, gaining 0.2% per quarter in H2 2008. We even expect it to stagnate in Q2, as a counter-reaction to its steep rise in Q1.

Household investment rebounded in Q1 2008 after a four-quarter decline, thanks to a return to normal in building-permit issuance since

Japan: supply and use table

in real terms

	Quarterly changes, %								Annual changes,%		
	2007				2008				2006	2007	2008
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
GDP	**1.1**	**-0.6**	**0.2**	**0.7**	**1.0**	**0.2**	**0.4**	**0.4**	**2.4**	**2.0**	**1.9**
Household consumption (57%)	0.6	0.2	0.0	0.4	0.8	0.0	0.2	0.2	2.0	1.5	1.3
Investment (23%)	0.7	-3.0	-0.9	-0.4	1.0	1.3	0.8	0.7	1.3	-0.6	0.9
Non-residential (15%)	0.8	-2.5	0.8	1.2	0.2	1.5	0.8	0.8	4.3	1.9	2.6
Residential (4%)	-1.6	-4.5	-8.0	-9.2	4.6	2.5	1.5	1.0	0.9	-9.3	-5.4
Public consumption (18%)	0.3	0.2	0.1	0.8	-0.4	0.0	0.0	0.0	-0.4	0.7	0.3
Exports (14%)	3.3	1.2	2.8	2.6	4.0	-2.0	1.0	1.0	9.7	8.6	7.0
Imports (13%)	0.8	0.7	-0.1	0.9	1.4	-1.5	0.5	0.5	4.2	1.8	1.5
Contributions to GDP growth											
Domestic demand excluding inventories	*0.5*	*-0.6*	*-0.2*	*0.3*	*0.6*	*0.3*	*0.3*	*0.3*	*1.4*	*0.8*	*1.0*
Inventories	*0.1*	*-0.2*	*-0.1*	*0.1*	*-0.1*	*0.0*	*0.0*	*0.0*	*0.2*	*0.1*	*-0.1*
Net exports	*0.4*	*0.1*	*0.5*	*0.3*	*0.5*	*-0.1*	*0.1*	*0.1*	*0.8*	*1.1*	*1.0*

Forecasts
(%): share of nominal GDP in 2005
Sources: Cabinet Office; INSEE estimates

end-2007.[1] This normalization is set to continue into mid-2008. Household investment ought to record further gains in the quarters ahead, but at a milder pace than at the start of the year (*Chart 2*). Business investment, after its Q1 slowdown, should rebound in Q2, as suggested by the high volume of machinery orders in Q1. In H2, weak domestic demand and softer external trade are expected to cause businesses to curb their investment spending.

After their exceptional 4.0% rise in Q1, exports are projected to fall sharply in Q2, losing 2.0%. However, they should be somewhat reinvigorated in H2 thanks to firm demand from Japan's Asian partners—although they will not repeat their 2007 performance. Imports are poised to decline in Q2 because of slacker economic activity, before recovering in H2.

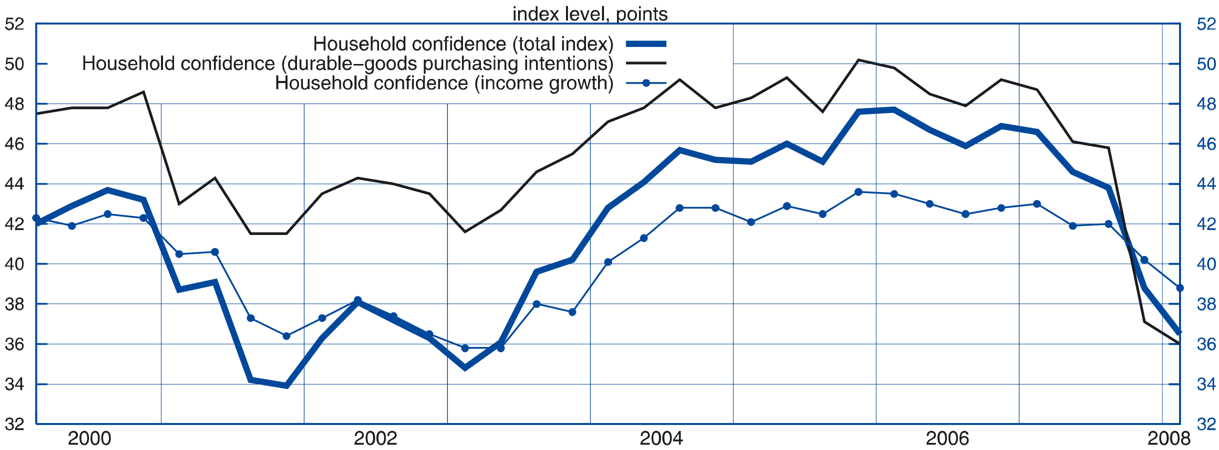
In annual-average terms, the Japanese economy is forecast to grow 1.9% in 2008, nearly the same pace as last year's 2.0%.

1. In June 2007, legislation was toughened to ensure greater compliance with anti-earthquake standards. This resulted in a sharp drop in new building permits for a few months, followed by a catch-up since late 2007.

China heading toward a moderate slowdown in late 2008

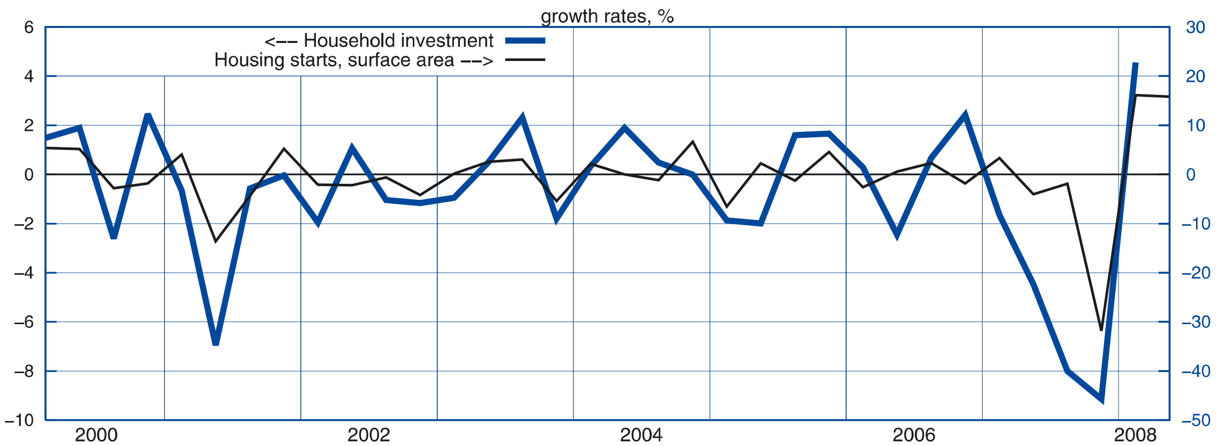
China posted further two-digit growth in Q1 2008, with GDP up 10.6% year-on-year. The latest performance, however, does not quite match the

1 - Japanese household confidence



Source: Economic and Social Research Institute

2 - Housing starts in Japan



How to read this chart:Housing-start data are lagged 3 months

Sources: ESRI; Ministry of Land, Infrastructure and Transport

11%-12% year-on-year increase registered in 2007. This mild dip is mostly due to weaker exports, whose year-on-year growth slipped from over 26% in 2007 to about 23% in January-May 2008 (*Chart 3*). In the same period, imports outpaced exports, trimming China's trade surplus by more than 8% from its 2007 level. This downtrend may gain momentum between now and end-2008 because of the expected economic slowdown in the U.S. and the euro zone.

Chinese business investment remained buoyant in Q1. However, the dimmer export outlook may induce firms to curb investment spending in Q2-Q4. The effects of repeated monetary tightening may also start to work through the system. Lending could be restricted even further if inflationary tensions persist in the coming quarters—despite the price controls enacted by Chinese authorities.

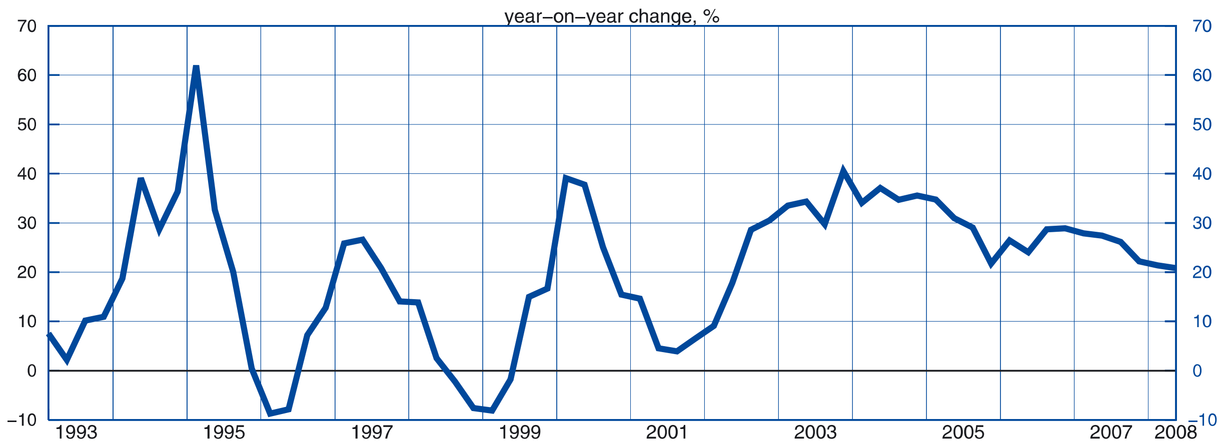
All in all, we expect a slight dip in Chinese growth by end-2008, essentially due to a somewhat less buoyant external-trade performance.

Investment growth leveling off in emerging Asia

Inflation posted further gains in South-East Asia in Q1 2008 owing to the rise in commodity prices, particularly for food. For the region as a whole, year-on-year price growth quickened from 4.1% in December 2007 to 5.9% in April 2008. This inflation revival may incite the region's central banks to tighten their monetary policies in the quarters ahead.

At the same time, the region continued to enjoy robust growth in Q1 2008, with GDP up 6.0% year-on-year, the same pace as in the two previous quarters. In our scenario, the economy will continue to expand thanks to flourishing external trade and vigorous domestic demand. However, business investment growth is set to decline because of the worsening export outlook and the probable monetary-policy tightening. Industrial activity is thus likely to lose some momentum, as suggested by the downturn in leading short-term indicators in South Korea and Taiwan. ■

3 - Chinese exports



Source: customs data

Euro zone

Euro-zone GDP rebounded vigorously from 0.3% in Q4 2007 to 0.8% in Q1 2008. The zone's three largest economies—Germany, France, and Italy—contributed to the upswing, while most other countries posted a significant slowdown.

However, we expect euro-zone growth to weaken in the quarters ahead. Domestic demand should continue to slow, as a result of rising food and energy commodity prices, as well as the real-estate market downswing. In addition, exports will likely suffer from sagging world demand and the euro's strong appreciation. Our scenario sees the euro zone's annual average GDP growth slowing from 2.6% in 2007 to 1.6% in 2008.

The Q1 2008 rebound will likely be short-lived

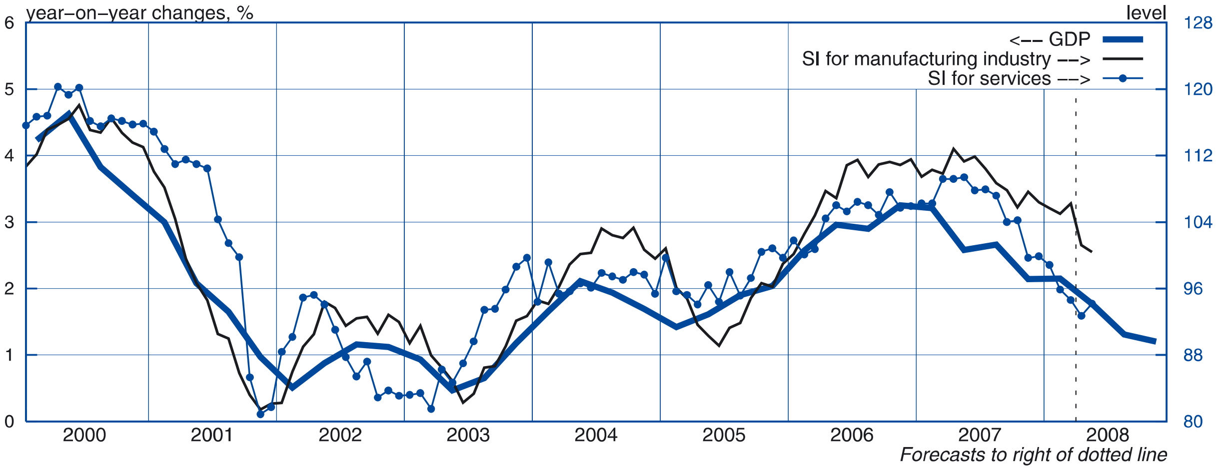
The business outlook tracked by euro-zone surveys of industry and services deteriorated between Q3 2007 and Q1 2008 (*Chart 1*). They thus failed to predict such a vigorous rebound in Q1 2008 (0.8%).

Indeed, this acceleration seems mainly due to non-recurring factors. In Germany, the mild winter stimulated construction activity, usually low in that season. Moreover, the timing shift in the Easter holidays, which fell in Q2 last year and in Q1 in 2008, may have weakened the statistical adjustment for working days. As a result, German GDP rose at an exceptional quarterly pace of 1.5%. In Italy, a truckers' strike paralyzed the economy in November-December 2007. This caused a 0.4% drop in GDP in Q4 2007, fully offset in Q1 2008. This specific profile of Italian GDP also contributed to the economic acceleration in the euro zone.

The downtrend in confidence surveys persisted in the first months of Q2 2008, the May rebound in services barely making up for the April fall. Although they mirror the region-wide deterioration, German surveys are showing greater optimism—particularly in the industrial sector—than those of the euro-zone's other main countries.

Between now and end-2008, we expect very moderate growth in the euro zone, consistent with the slowdown announced by all business surveys. GDP should rise 0.2% per quarter in H2 (*Table 1*). Our scenario even sees zero change in Q2, as the

1 - Euro zone: GDP and "synthetic" indicators (SIs) from surveys



Sources: European Commission; Eurostat; INSEE estimates adjustment for the exceptional construction activity in Germany in January-February will likely reduce euro-zone GDP growth by 0.2 points.

We thus forecast that the euro-zone's annual average GDP growth will slow sharply to 1.6% in 2008 from 2.6% in 2007 and 2.9% in 2006.

Household consumption to stay on a moderate growth path in 2008, after a late-2007 dip

Euro-zone employment has not yet been affected by decelerating GDP growth, because of the typical lags in labor-market adjustment to

Table 1

Euro zone and main countries: GDP and its components

%

	Quarterly changes								Annual averages		
	2007				**2008**						
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**2006**	**2007**	**2008**
GERMANY (28%)[1]											
GDP	**0.6**	**0.2**	**0.7**	**0.3**	**1.5**	**-0.3**	**0.3**	**0.3**	**3.1**	**2.6**	**2.1**
Household consumption	-1.8	0.8	0.3	-0.8	0.3	0.3	0.3	0.3	1.1	-0.5	0.5
Total GFCF[2]	1.7	-1.4	0.7	1.5	3.7	-1.5	0.4	0.4	7.0	5.1	3.9
Public consumption	1.8	0.1	0.4	-0.6	1.3	0.2	0.2	0.2	0.9	2.1	1.3
Exports	-0.3	0.8	2.5	1.3	2.4	-0.5	1.0	1.0	12.9	8.0	5.3
Imports	1.6	-1.7	2.9	0.2	3.5	-0.5	1.2	1.2	11.5	5.0	5.3
Contributions to GDP growth											
Domestic demand excluding inventories	*-0.5*	*0.1*	*0.4*	*-0.2*	*1.0*	*-0.1*	*0.3*	*0.3*	*2.1*	*1.1*	*1.3*
Inventories	*1.9*	*-1.0*	*0.3*	*0.0*	*0.7*	*-0.2*	*0.0*	*0.0*	*-0.1*	*-0.1*	*0.6*
Net exports	*-0.8*	*1.1*	*0.0*	*0.5*	*-0.2*	*0.0*	*0.0*	*0.0*	*1.1*	*1.6*	*0.3*
ITALY (19%)[1]											
GDP	**0.3**	**0.0**	**0.2**	**-0.4**	**0.5**	**0.1**	**0.1**	**0.2**	**1.9**	**1.4**	**0.5**
Household consumption	1.0	0.1	0.2	-0.4	0.1	0.1	0.1	0.2	1.1	1.5	0.2
Total GFCF	-0.1	-0.5	-0.1	0.5	-0.2	0.1	0.3	0.3	2.7	0.8	0.3
Public consumption	0.4	0.0	0.3	0.1	0.4	0.1	0.1	0.1	0.9	1.3	0.8
Exports	1.6	-1.8	2.3	-1.2	1.4	0.3	0.3	0.3	6.4	4.5	1.7
Imports	1.3	-0.7	1.2	-1.0	-0.5	0.4	0.4	0.4	6.0	4.0	-0.3
Contributions to GDP growth											
Domestic demand excluding inventories	*0.6*	*-0.1*	*0.2*	*-0.1*	*0.1*	*0.1*	*0.1*	*0.2*	*1.4*	*1.3*	*0.3*
Inventories	*-0.4*	*0.4*	*-0.3*	*-0.2*	*-0.2*	*0.0*	*0.0*	*0.0*	*0.4*	*-0.1*	*-0.4*
Net exports	*0.1*	*-0.3*	*0.3*	*-0.1*	*0.6*	*0.0*	*0.0*	*0.0*	*0.1*	*0.1*	*0.6*
EURO ZONE (28%)[3]											
GDP	**0.8**	**0.4**	**0.7**	**0.3**	**0.8**	**0.0**	**0.2**	**0.2**	**2.9**	**2.6**	**1.6**
Household consumption	0.2	0.6	0.4	-0.1	0.2	0.2	0.3	0.3	1.9	1.6	0.9
Total GFCF	1.2	0.0	0.9	1.0	1.6	-0.5	0.3	0.3	5.4	4.3	2.7
Public consumption	0.9	0.3	0.8	0.0	0.4	0.4	0.4	0.4	2.0	2.3	1.4
Exports	0.9	0.9	2.2	0.3	1.9	0.5	0.8	0.8	7.8	5.9	4.4
Imports	1.6	0.2	2.4	-0.3	1.9	0.8	1.0	1.0	7.5	5.3	4.3
Contributions to GDP growth											
Domestic demand excluding inventories	*0.5*	*0.4*	*0.6*	*0.2*	*0.5*	*0.1*	*0.3*	*0.3*	*2.6*	*2.3*	*1.4*
Inventories	*0.5*	*-0.3*	*0.1*	*-0.1*	*0.2*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.1*
Net exports	*-0.3*	*0.3*	*0.0*	*0.2*	*0.0*	*-0.1*	*-0.1*	*-0.1*	*0.2*	*0.3*	*0.1*

Forecast

1. Share of euro-zone GDP
2. Gross fixed capital formation
3. Share of industrialized countries' GDP

Source: Eurostat

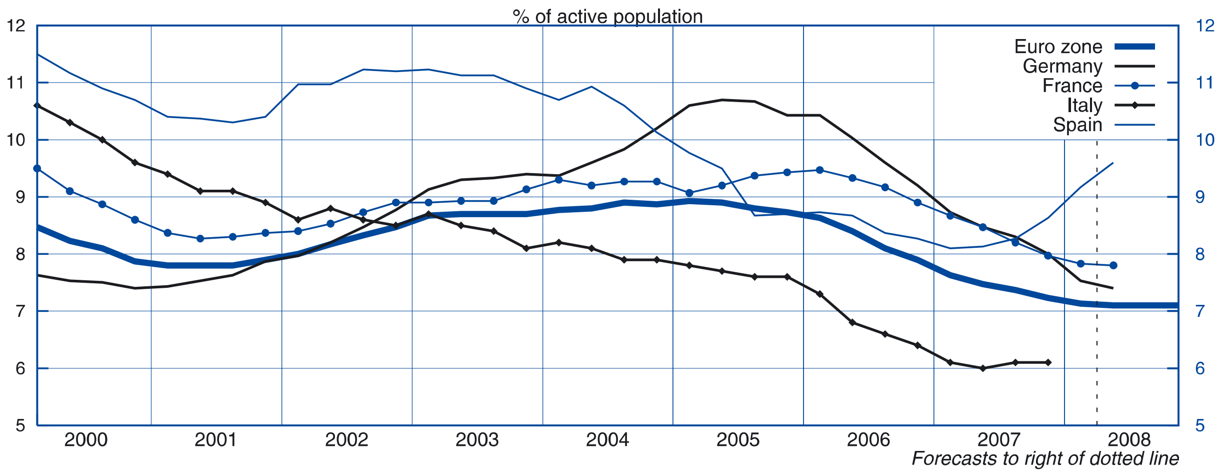
economic slowdowns. However, after a joint improvement in 2006-2007, job markets in the euro-zone countries display contrasting profiles (*Chart 2*). In Spain—whose construction sector has powerfully contributed to job creation across the zone for the past ten years—the real-estate market downturn has driven up the unemployment rate 1.5 points in a year. By contrast, German unemployment has been trending down since early 2008 at a robust pace of 0.4 points per quarter, as in 2006-2007.

In full-year 2008, however, euro-zone job creation is expected to ease. Our scenario sees employment gaining 1.6%, as against 1.9% in 2007, and unemployment stabilizing at 7.1% of the active population from Q2 onward.

Labor-market pressures and rising inflation—projected to stay above 3% for all of 2008—should quicken wage growth. But the gains are likely to be modest, for wages will undergo only a partial adjustment to consumer-price increases, as has been the case in recent years. Household purchasing power has been eroded by surging food and energy commodity prices since Q3 2007. It should gradually return to a more robust growth path starting in Q2 2008. Nevertheless, we expect that the annual average growth in household purchasing power will lose significant momentum, slowing from 1.7% in 2007 to 0.9% in 2008 (*Table 2*).

Household consumption stalled at end-2007, losing 0.1% despite brisk growth in automobile purchases ahead of tax changes in France and Italy. Instead of the expected downswing after this

2 - Harmonized unemployment rates in euro zone



Source: Eurostat

Table 2

Euro zone: Household accounts

%

	Quarterly changes								Annual averages		
	2007				**2008**				**2006**	**2007**	**2008**
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**			
Total wage bill	1.3	1.0	1.0	1.2	1.2	1.2	1.0	1.0	4.0	4.3	4.4
- Employment	0.6	0.5	0.4	0.4	0.6	0.4	0.2	0.2	1.7	1.9	1.6
- Wage per capita	0.6	0.5	0.6	0.8	0.6	0.8	0.8	0.8	2.2	2.3	2.9
Gross disposable income (GDI)	1.2	0.7	0.8	1.0	1.0	1.2	1.0	1.1	3.7	3.8	4.1
Saving ratio (% of GDI)	13.5	13.0	12.9	12.9	12.9	13.1	13.1	13.3	12.9	13.1	13.1
Household consumption deflator	0.5	0.6	0.5	1.1	0.8	0.8	0.8	0.5	2.2	2.1	3.2
Real total wage bill	0.8	0.3	0.5	0.1	0.3	0.4	0.2	0.5	1.7	2.1	1.3
- Real wage per capita	0.2	-0.2	0.1	-0.3	-0.2	0.0	0.0	0.3	0.0	0.2	-0.3
Purchasing power of GDI	0.7	0.1	0.3	-0.1	0.2	0.4	0.2	0.6	1.5	1.7	0.9

Forecast

Sources: Eurostat; INSEE estimates

one-time jump in automobile purchases, household consumption rebounded 0.2% in Q1 2008, thanks to Germany and, to a lesser extent, Italy—the two euro-zone countries where consumption fell most steeply at end-2007. In our scenario, household consumption will continue to rise 0.2%-0.3% per quarter until December 2008. This forecast reflects the projected weakness of purchasing-power gains and the growing worries over future economic conditions—a concern shared by households in the main euro-zone countries.

Meanwhile, residential construction investment is likely to stagnate in 2008. This prospect is suggested by the slowdown in building-permit issuance over the past year—a consequence of the real-estate market downturn, most notably in Spain, Ireland, and Finland. The non-residential construction sector is expected to perform slightly better, keeping annual average growth in construction investment at a still-positive 1.5% in 2008. The Q1 peak was chiefly due to projects begun ahead of schedule in Germany thanks to the mild winter. It should be partly corrected by Q2.

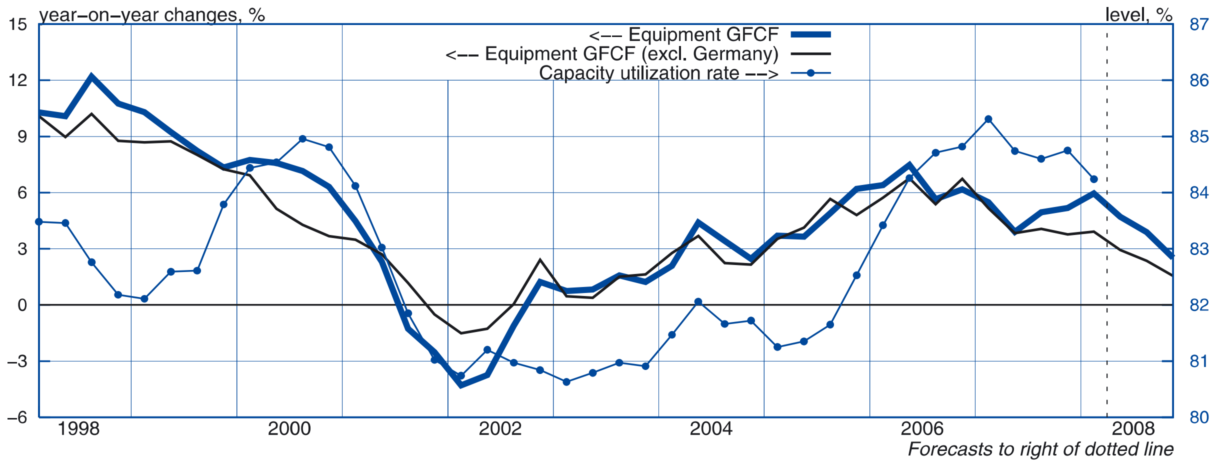
Reprieve for investment in Q1

The cyclical downswing in equipment investment, begun in H2 2006, was temporarily suspended by a recovery at year-end 2007 lasting into Q1 2008. Euro-zone investment was stimulated in late 2007 by German businesses, which anticipated outlays ahead of a corporate tax reform. The expected negative rebound in Q1 2008 did not occur. Instead, equipment investment has continued to grow at a brisk pace. But investment is diverging from the behavior predicted by its standard determinants: the demand outlook is dimmer, pressures on productive capacity are easing (*Chart 3*), and credit-access conditions—which deteriorated as a result of the financial crisis—are slow in returning to normal. We therefore do not expect the good Q1 performance to last, and our scenario sees equipment-investment growth slowing in Q2-Q4 2008 to a year-on-year pace of 2.5% in December, down from 6.0% in Q1.

Sluggish trade

The euro zone made little progress in external trade at end-2007, as world demand for its products retreated in Q4. The 1.9% export rebound in Q1 2008 thus came as a surprise. This strong performance exceeds what the 0.6% rise in foreign demand can explain. Moreover, the euro's appreciation has been eroding the export price competitiveness of euro-zone firms: in real effective exchange-rate terms, the euro has risen 6.8% since January 2006. The euro zone is thus unlikely to hold on to its market-share gains of early 2008 in the quarters ahead. Exports will probably suffer from the euro zone's gloomier international environment, as well as from the negative effect of the domestic-demand slowdown on intra-zone trade. Annual average export growth is projected to ease to 4.4%. Imports should display a similar profile, but with slightly higher growth rates. Our scenario puts the contribution of trade to euro-zone GDP growth at a negative 0.1 points per quarter until end-2008. ■

3 - Euro zone: equipment investment and capacity utilization rate



GFCF: gross fixed capital formation

Sources: European Commission; Eurostat

Consumer prices in the euro zone

By year-end 2008, euro-zone "core inflation"—i.e., excluding food and energy, but including indirect taxes—is projected to reach 1.8% year-on-year. This reflects our forecast that the surge in commodity prices will continue to spread to certain categories of manufactured goods and services. Headline inflation should peak at nearly 4.0% this summer. We expect it to ease to 3.0% by year-end, assuming oil prices hold steady at $130 per barrel in H2. On an annual-average basis, headline inflation is projected to quicken from 2.1% in 2007 to 3.5% in 2008.

Core inflation moving toward 1.8%

"Core inflation" as measured by Eurostat[1] should reach 1.8% at year-end, up from 1.6% in April (*Table and Chart 1*). In our scenario, the surge in commodity prices will continue to spread to prices of certain non-energy industrial goods, the restaurant sector, and transportation services. However, this faster price growth will be curtailed by weaker demand and the euro's appreciation.

Non-energy industrial-goods inflation is expected to rise slightly between early and late 2008, moving from 0.8% in April to 0.9% in December (*Table*). The recent acceleration in prices of intermediate industrial goods, which reflects soaring commodity prices, will probably drive up retail prices. However, this increase should be dampened by softer demand and the stronger euro.

Service-sector inflation eased from 2.5% in December 2007 to 2.3% in April 2008 (*Table*). The decline is due to the absence of two non-recurring factors in Germany: the increase in the standard rate of value added tax (VAT) and in university tuition fees, which had driven up inflation in early 2007.

In our forecast, year-on-year service-sector price growth will quicken slightly to 2.4% at end-2008. As noted earlier, the surge in commodity prices should continue to spread to the restaurant and transportation sectors. Moreover, wage bargaining in the euro zone has led to higher pay raises than in 2007. But the expected weakening of demand may lead businesses to trim their margins, which would restrain the price acceleration.

1. Excluding food, alcohol, tobacco, and energy, but including indirect taxes. By comparison, INSEE's "core" index excludes only 68% of food products (unprocessed foods, meat, dairy products, and so on) but is adjusted for indirect-tax effects. On the other hand, the INSEE measure excludes healthcare products and services whose prices are regulated.

Euro-zone inflation

changes, %; contributions, percentage points

	June 2007		Dec. 2007		April 2008		June 2008		Dec. 2008		Annual average		
Sectors (weights in 2008 index)	yoy	cyoy	yoy	cyoy	yoy	cyoy	yoy	cyoy	yoy	cyoy	**2006**	**2007**	**2008**
Total (100.0%)	**1.9**	**1.9**	**3.1**	**3.1**	**3.3**	**3.3**	**3.9**	**3.9**	**3.0**	**3.0**	**2.2**	**2.1**	**3.5**
Food (incl. alcohol and tobacco) (19.5%)	**2.4**	**0.5**	**4.3**	**0.8**	**5.4**	**1.1**	**5.8**	**1.1**	**3.6**	**0.7**	**2.4**	**2.8**	**5.0**
of which: Food (15.8%)	2.1	0.3	4.8	0.7	6.0	0.9	6.4	1.0	3.6	0.6	2.3	2.7	5.5
Alcohol and tobacco (3.7%)	3.6	0.1	2.5	0.1	3.2	0.1	3.5	0.1	3.7	0.1	2.7	3.4	3.4
Energy (9.8%)	**0.9**	**0.1**	**9.2**	**0.9**	**10.8**	**1.1**	**15.5**	**1.5**	**11.2**	**1.1**	**7.7**	**2.6**	**12.9**
Core inflation (70.7%)	**1.9**	**1.3**	**1.9**	**1.3**	**1.6**	**1.2**	**1.8**	**1.2**	**1.8**	**1.3**	**1.4**	**1.9**	**1.8**
of which: Non-energy industrial goods (29.7%)	1.0	0.3	1.0	0.3	0.8	0.2	0.8	0.2	0.9	0.3	0.6	1.0	0.9
Services (40.9%)	2.6	1.0	2.5	1.0	2.3	0.9	2.5	1.0	2.4	1.0	2.0	2.5	2.5

Forecast
yoy: year-on-year change
cyoy: contribution to year-on-year change
Sources: Eurostat; INSEE forecasts

Volatile inflation expected to weaken in the fall

After easing in February, energy inflation rebounded with the Brent price flare-up. The steep rise in oil prices in early May and early June should drive year-on-year growth in energy prices to around 15.5% in June. Energy inflation should then subside to 11.2% by year-end (*Table and Chart 2*). This reflects our forecast's assumption of a stable price for Brent crude, in contrast to its sharp rise in late 2007.

Food inflation is expected to keep rising until the summer. Meat prices, which were still posting moderate growth in early 2008, should then take over from processed-food prices as the main driver, owing to higher animal-feed prices. In our scenario, food inflation will ease to around 3.6% by year-end, as the H2 2007 price rises will start to disappear from the year-on-year calculation base (*Table*).

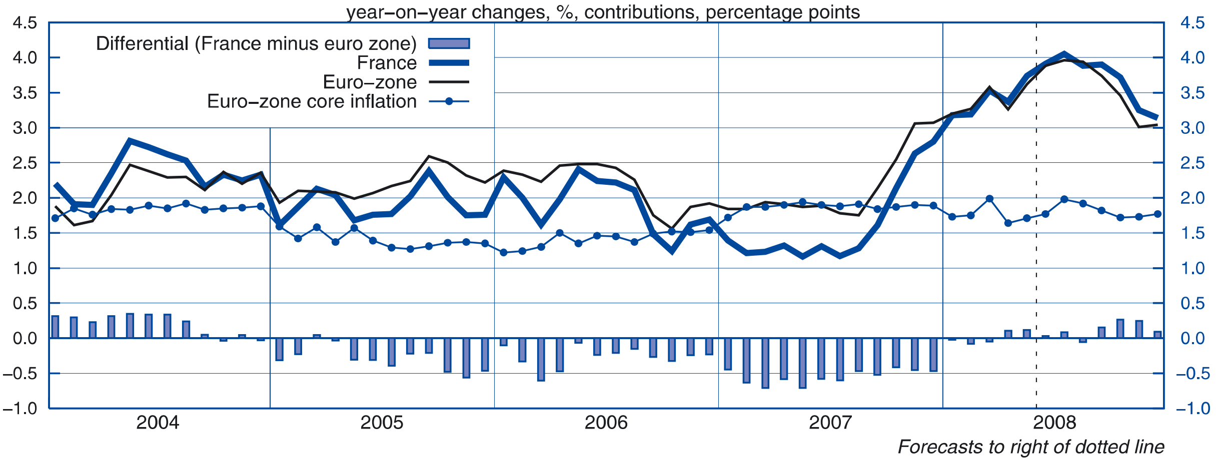
In 2008, annual average price growth, forecast at 3.5% (*Table*), should exceed the European Central Bank (ECB) inflation threshold. In fact, it is likely to be the highest annual average increase since 1996, the first year of data for the euro-zone harmonized price index. The surge in commodity prices has driven up volatile inflation—i. e., energy and food prices—since summer 2007 and, to a lesser extent, core inflation. This upward pressure on core inflation should be offset[2] in 2008 by the fading of the impact of Germany's 2007 VAT hike.

French inflation expected to mildly outpace euro-zone inflation

French inflation, which used to run below the euro-zone average, is now outpacing it. The two main reasons are France's implementation of a flat

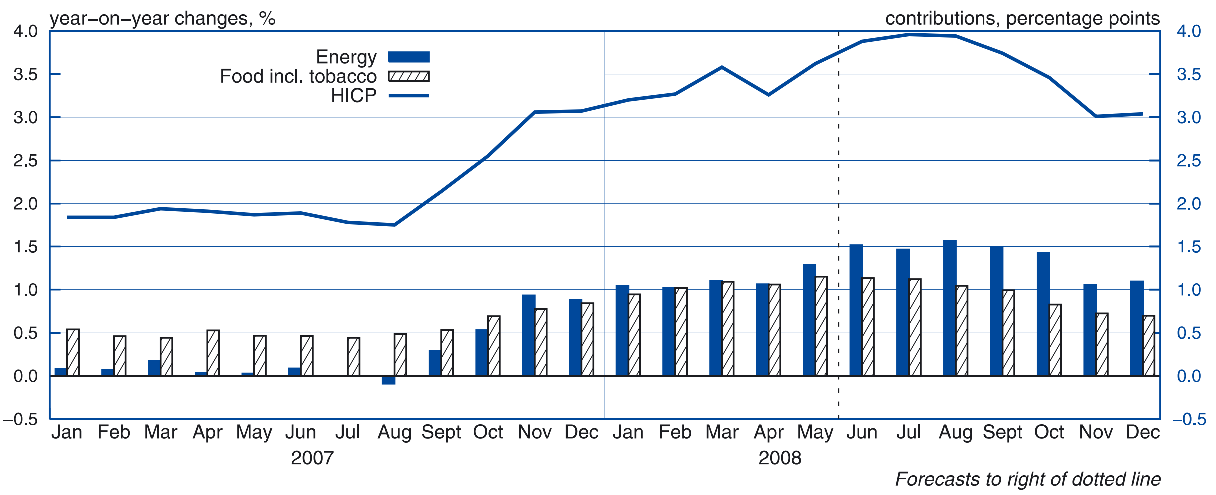
2. Artificially, as it makes little sense to incorporate one-time tax hikes into a "core inflation" indicator.

1 - Harmonised Index of Consumer Prices (HICP): France and euro zone



Sources: Eurostat, INSEE forecasts

2 - Euro-zone inflation: contribution of most volatile items



Sources: Eurostat, INSEE forecasts

non-refundable fee per medical procedure in early 2008, and the disappearance of the effects of the German VAT increase from the year-on-year computation base for euro-zone prices. Furthermore, the successive reforms of the Loi Galland (regulating the retail trade) had hitherto curbed food inflation in France (*"Special Analysis: The 'Loi Galland' and French consumer prices" in this issue*). The recent pause in this disinflationary effect has narrowed the inflation gap between France and the euro zone. Our forecast sees French inflation outpacing euro-zone inflation until end-2008. ■