International overview

After a sharp loss of momentum in Q4 2007, GDP growth in the advanced economies —particularly the United States—should register a further slowdown in H1 2008.

Growth will likely be curbed by tighter financing conditions for households and enterprises despite a visible easing of tensions in the interbank markets since H2 2007. In addition, higher prices for energy and food commodities should erode household purchasing power in all regions.

World growth should nevertheless remain stronger overall, thanks to the vibrancy of the emerging economies.

Activity set to slow in H1 2008

GDP growth in the advanced economies is expected to weaken to just 0.3% in Q1 and Q2 2008 from an average 0.5% per quarter in 2007 *(Tables 1-2)*. In manufacturing, the general outlook admittedly stabilized at end-2007 at a level compatible with a year-on-year growth rate slightly below 2% in the advanced economies[1] *(Chart 1)*.

1. Same scope as IMF World Economic Outlook *(see "Measuring international macroeconomic developments" focus p. 28)*.

However, in January, the Purchasing Managers' Index (PMI) for the service sector tumbled to its lowest level since October 2001, indicating a steep slowdown.

On the upside, the main emerging economies are forecast to continue expanding at a very brisk pace. But South-East Asia should undergo a mild deceleration, with productive-investment growth having peaked at end-2007. On balance, year-on-year global GDP growth should dip to slightly under 5.0% by the end of H1 2008, compared with an average 5.4% in Q1-Q3 2007.

Financial markets are starting to return to normal

Financial markets have been battered since August 2007 by the fallout from the U.S. subprime mortgage-loan crisis. By early 2008, tensions in the interbank markets had eased somewhat. The spreads between three-month money-market rates and central-bank key rates have narrowed substantially, thanks to looser U.S. and U.K. monetary policies and repeated liquidity injections by the central banks. Yet the flight to quality is not over. Short-term yields on government securities are still well below money-market rates at the same maturities, and returns demanded on long-term

Table 1
Industrialized countries: consolidated supply and use table

in real terms

	Quarterly changes, %										Annual changes, %		
	2006				2007				2008		2006	2007	2008 ovhg*
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2			
GDP	**1.0**	**0.8**	**0.4**	**0.7**	**0.5**	**0.5**	**0.9**	**0.4**	**0.3**	**0.2**	**2.8**	**2.4**	**1.3**
Private consumption	0.8	0.6	0.4	0.8	0.6	0.4	0.6	0.2	0.2	0.2	2.4	2.2	0.9
Public consumption	0.9	0.2	0.4	0.5	0.4	0.5	0.7	0.5	0.4	0.3	1.6	1.8	1.4
Investment	1.2	1.0	-0.1	0.3	0.2	-0.1	0.3	-0.2	-0.7	-0.6	3.5	0.6	-1.1
Exports	3.2	1.4	0.4	2.7	0.9	1.3	3.3	1.0	1.3	0.9	8.5	6.4	4.8
Imports	2.3	0.9	0.4	0.8	1.0	-0.2	1.6	-0.4	0.3	0.2	6.5	2.5	0.9
Contributions to GDP growth													
Domestic demand excluding inventories	0.9	0.6	0.3	0.7	0.5	0.3	0.6	0.2	0.1	0.1	2.6	2.0	0.8
Inventories	-0.1	0.0	0.1	-0.3	0.1	-0.1	0.2	-0.2	0.0	0.0	0.1	-0.1	0.0
Net exports	0.1	0.1	-0.1	0.3	-0.1	0.3	0.1	0.3	0.1	0.1	0.2	0.5	0.5

Forecasts — *ovhg: overhang
Sources: national statistical institutes; IMF; INSEE estimates

corporate bonds were still running above their pre-crisis levels in early 2008. But tensions will probably ease by Q2, with a stabilization of long-term Treasury yields in the U.S. that may precede the same development in the euro zone. By and large, however, credit access for households and businesses is likely to remain tighter than in 2007, as indicated by bank surveys in all the advanced economies.

Because of the sharp economic slowdown in the U.S. and U.K., the Fed and the Bank of England will probably continue to trim rates despite inflationary pressures. The European Central Bank (ECB) has so far decided to hold key rates at 4%, arguing that growth is more resilient in the euro zone. In January, however, the ECB's more flexible pronouncements paved the way for possible rate cuts by year-end.

Monetary policy should thus remain accommodative in the advanced economies, with real short-term rates running well below economic growth *(Chart 2)*. From the borrowers' standpoint, however, the easing of riskless rates is, on the whole, more than offset by the rise in the risk premiums charged on their loans. As a result, their financing costs have not declined and, for some borrowers, have even increased.

Stock-market prices have been falling since October. This downtrend has been sharper in the emerging countries, as is usually the case when global risk aversion increases.

The real effective exchange rates of the dollar and pound sterling have tended to depreciate, while the euro has appreciated. In our forecast, we have stabilized the dollar exchange rate at its end-February level of 1.50 per euro.

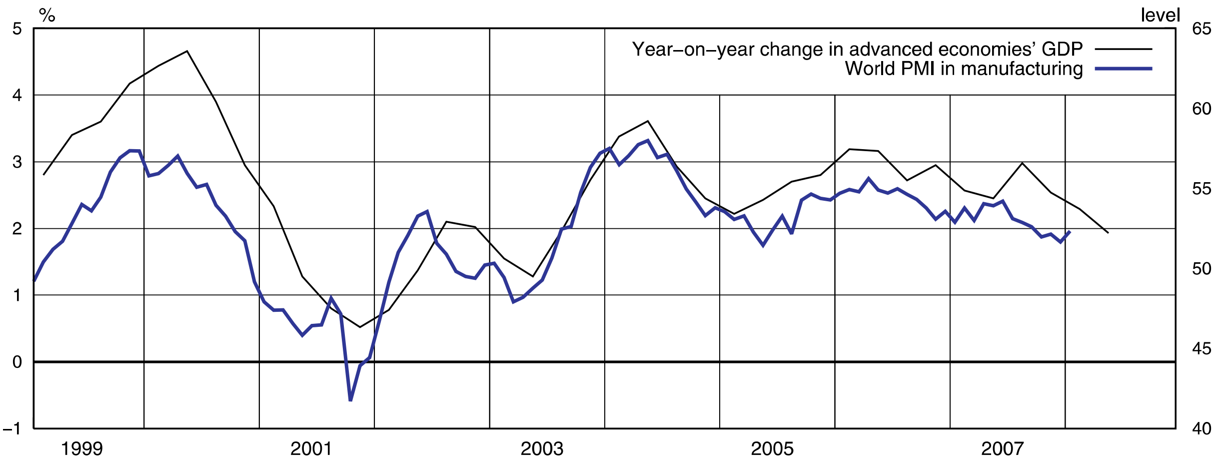
Table 2
Main industrialized countries: GDP

in real terms

	Quarterly changes, %										Annual changes, %		
	2006				2007				2008		2006	2007	2008 ovhg*
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2			
Total	**1.0**	**0.8**	**0.4**	**0.7**	**0.5**	**0.5**	**0.9**	**0.4**	**0.3**	**0.2**	**2.8**	**2.4**	**1.3**
United States	1.2	0.6	0.3	0.5	0.2	0.9	1.2	0.2	0.1	0.0	2.9	2.2	1.0
Japan	0.5	0.8	0.0	1.1	0.9	-0.4	0.3	0.9	0.5	0.4	2.4	2.0	1.5
United Kingdom	0.9	0.7	0.6	1.0	0.8	0.8	0.7	0.6	0.4	0.4	2.9	3.1	1.7
Euro zone, of which:	0.9	1.0	0.6	0.8	0.8	0.3	0.8	0.4	0.4	0.4	2.8	2.7	1.4
Germany	0.9	1.3	0.7	1.0	0.6	0.2	0.7	0.3	0.4	0.4	3.1	2.6	1.3
Italy	0.8	0.6	0.3	1.1	0.3	0.1	0.4	-0.1	0.3	0.3	1.9	1.7	0.6

Forecasts *ovhg: overhang
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

High inflationary tensions worldwide

Since summer 2007, inflation has been fueled by sharp rises in commodity prices, which have continued to climb since October. The barrel price of Brent crude oil has fluctuated around $95 since end-2007, but has posted a substantial increase from H1 2007. We have kept it at $95 for the entire forecasting period. In addition, food-commodity prices surged 46% between April 2007 and January 2008.

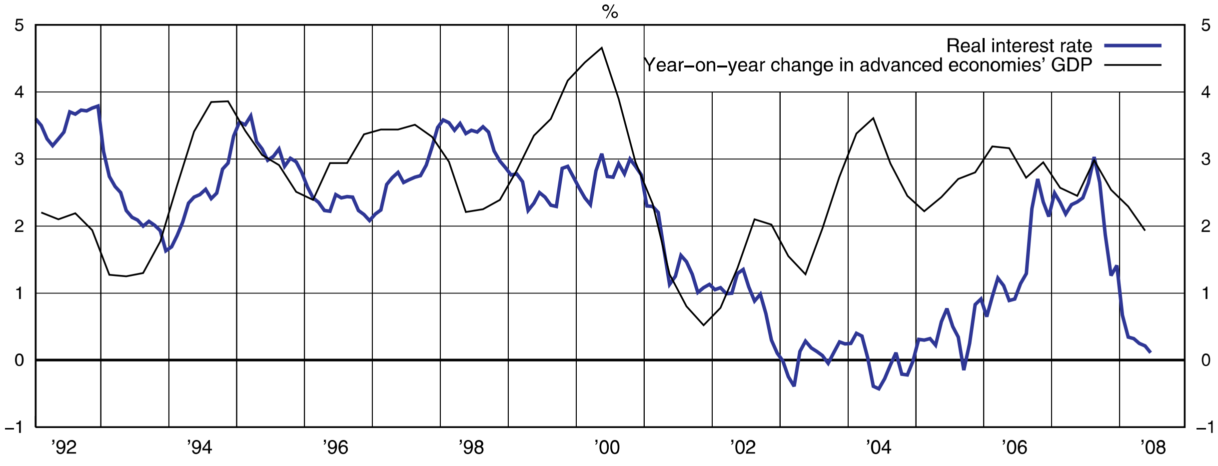
Our scenario thus calls for inflation to peak at the start of the year in all the advanced economies, before a mild easing in Q2 2008. We see a modest rise in core inflation, as the diffusion effects of commodity-price rises should offset the disinflationary impact of the activity slowdown. Liquidity should remain abundant, supporting growth in the short run but posing the threat of an inflation spiral in the medium term *(Chart 3)*.

Main uncertainty: the impact of tighter financing conditions

If prices of energy and food commodities rise more sharply than expected, world GDP growth will be weaker than in our scenario. However, the main uncertainty remains the impact of the financial crisis. Tighter financing conditions and greater risk aversion could hamper worldwide investment decisions more than forecast. Conversely, the resilience of the emerging economies may cushion the world growth slowdown more significantly than expected.

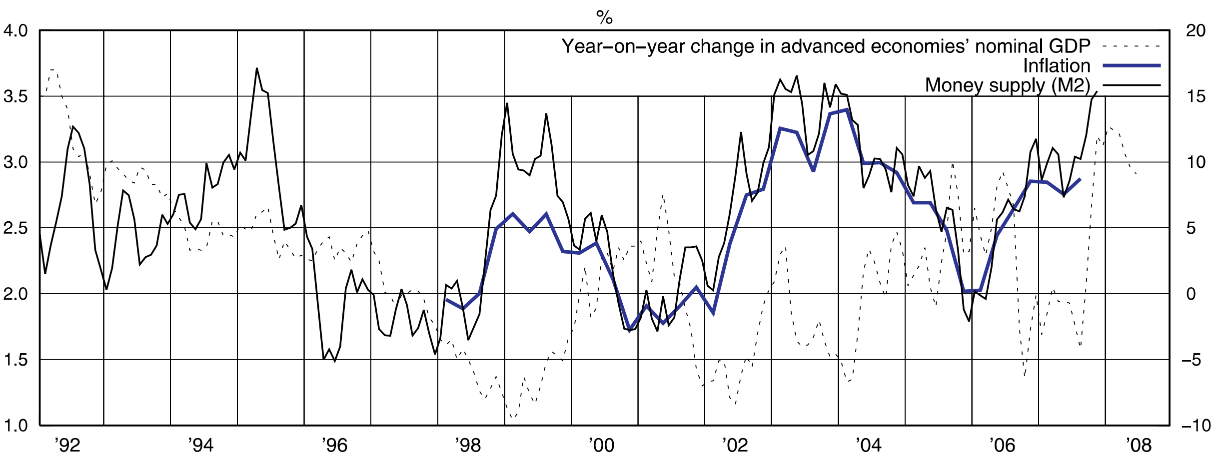
In this slacker international environment, we see world demand for French products rising at a moderate pace to mid-2008, particularly on account of the slowdown in U.S. imports. ■

2 – Monetary policy in advanced economies



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

3 – Inflationary tensions in advanced economies



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

Focus: Measuring international macroeconomic developments

The macroeconomic variables discussed in this chapter were constructed using the IMF World Economic Outlook methodology.

We examine two geographic groups:

- Advanced economies: Australia, Canada, Denmark, euro zone (15 member countries as of January 1, 2008), Hong Kong, Iceland, Israel, Japan, New Zealand, Norway, Singapore, South Korea, Sweden, Switzerland, Taiwan, United Kingdom, and United States.
- "World": advanced economies and BRIC (Brazil, Russia, India, China). This selection excludes countries for which statistical information is often incomplete. But it yields a good approximation of world growth, as it represents a combined 78% share of global GDP in purchasing power parity (PPP) terms, which has remained stable from 1992 to 2008 (source: IMF).

The gross domestic product (GDP) series are built from national data (we have constructed some series by linking data compiled on different base years). To obtain pre-1995 real-GDP series for Russia, India, and China, we converted annual IMF series to quarterly series.[1]

For GDP at constant prices (or: the consumer price index), we obtained the aggregation by weighting quarterly changes (or: the year-on-year change) by the country's share of PPP GDP.[2] We aggregated interest rates by applying the same method to three-month money-market rates (EURIBOR, LIBOR, SHIBOR). For GDP at current prices and the money supply (M2), the aggregation is equal to the sum after conversion of national currencies to dollars at market exchange rates.

From the aggregated GDP series for the advanced economies, we estimated a calibration on the Purchasing Managers' Indexes (PMIs), which are composite indicators of business activity *(see equation below)*. This tool points to a sharp slowdown in the advanced economies' GDP in early 2008 *(Chart)*. Our analysis by region leads us to a somewhat less pessimistic forecast, in particular because we expect a more moderate dip in U.S. growth than what business surveys suggest.

Calibration equation:

$$\Delta GDP = \underset{(-3.5)}{-2.02} + \underset{(4.6)}{0.048}\, PMI \ (\textit{first month of current quarter})$$

$$+ \underset{(2.6)}{0.08}\, \Delta PMI \ \left(\textit{third month of previous quarter}\right)$$

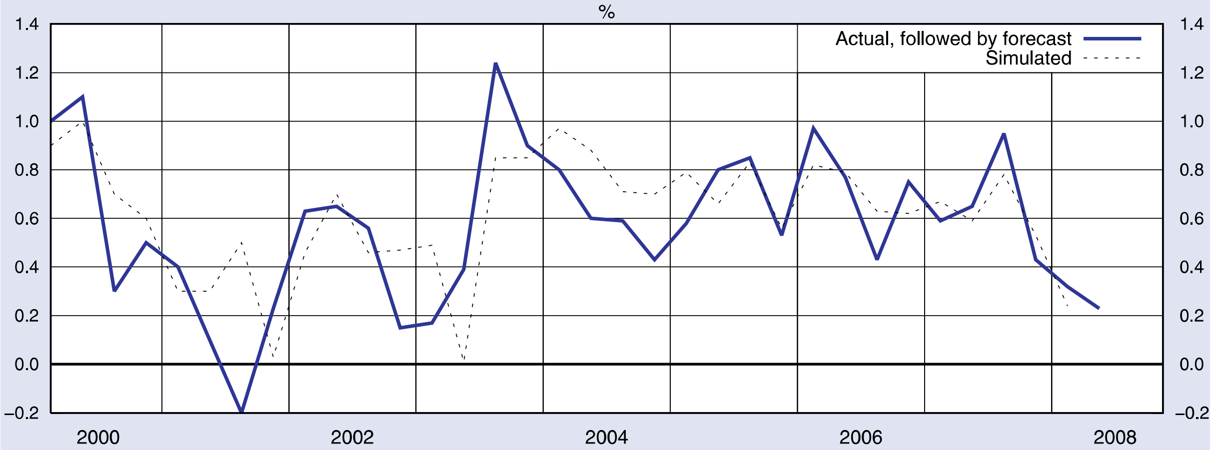
Adjusted R^2: 0.46

where GDP is the quarterly change in GDP of advanced economies.

PMI is the composite world PMI (source: JP Morgan). ■

1. Thanks to the Boot-Feibes-Lisman algorithm (1967), which makes it possible to obtain smooth series.
2. We used X12-ARIMA when seasonally adjusted data were not available.

Calibration of GDP of advanced economies from world PMIs



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

United States and United Kingdom

U.S. growth dipped to 0.2% in Q4 2007. We expect it to remain weak in H1 2008—at 0.1% in Q1 and 0.0% in Q2—for two reasons: first, the real-estate market should continue to adjust, which means that residential investment will continue to undermine GDP growth; second, tighter credit access portends a slowdown in business investment.

Our scenario calls for weaker growth in the United Kingdom as well, largely because of the gradual slackening of household demand.

Gradual slowdown expected in the U.S.

In H1 2008, U.S. growth will still be hampered by the contraction in residential investment. Real-estate activity does not appear to have bottomed out yet, if we compare quantitative business indicators to their levels in earlier real-estate crises. And in December, housing inventories, which are still rising, reached a level not seen since the 1978 crisis.

The U.S. economy is also likely to be undermined by the sharp slowdown in household consumption growth from 0.5% in Q4 2007 to 0.1% in Q1 2008 and 0.0% in Q2. Real gross disposable income is projected to move on a sluggish growth path of about 0.2% per quarter. There are two reasons for this. First, after more than four years of unbroken growth, employment declined in January and February, with 22,000 and 63,000 jobs lost respectively according to the Bureau of Labor Statistics (BLS).[1] This downturn should quicken in the coming quarters, particularly in the service sector, as suggested by the employment component of the Institute for Supply Management (ISM) index for services. The second factor is that year-on-year inflation is likely to stay above 3.0% in Q1 2008 before returning to 3.0% by mid-2008, assuming Brent oil stabilizes at $95/barrel. Personal consumption should also be dampened

1. These figures are, however, subject to major revision. For example, in the preliminary job figures for August 2007, the BLS also reported 4,000 net job losses. Later revisions have shown an estimated 74,000 net job creations in that month.

Table 1
United States: supply and use table

in real terms

	Quarterly changes, %										Annual changes, %		
	2006				2007				2008		2006	2007	2008 ovhg*
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2			
GDP	**1.2**	**0.6**	**0.3**	**0.5**	**0.2**	**0.9**	**1.2**	**0.2**	**0.1**	**0.0**	**2.9**	**2.2**	**1.0**
Household consumption (70%)	1.1	0.6	0.7	1.0	0.9	0.3	0.7	0.5	0.1	0.0	3.1	2.9	0.9
Investment (16%)	1.9	-0.5	-1.2	-1.8	-1.1	0.8	-0.2	-0.9	-1.9	-2.1	2.4	-2.9	-4.0
Non-residential (10%)	3.2	1.0	1.2	-0.3	0.5	2.6	2.3	1.7	0.8	0.0	6.6	4.8	3.9
Residential (6%)	-0.2	-3.1	-5.5	-4.6	-4.4	-3.1	-5.6	-7.0	-6.5	-5.5	-4.6	-17.0	-18.3
Exports (10%)	2.8	1.4	1.4	3.4	0.3	1.8	4.5	1.2	1.3	0.8	8.4	8.0	5.5
Imports (16%)	1.7	0.2	1.3	0.4	1.0	-0.7	1.1	-0.5	-0.5	-0.5	5.9	1.9	-0.9
Contributions to GDP growth													
Domestic demand excluding inventories	*1.3*	*0.4*	*0.3*	*0.5*	*0.4*	*0.6*	*0.6*	*0.3*	*-0.2*	*-0.2*	*2.9*	*1.9*	*0.4*
Inventories	*-0.1*	*0.1*	*0.0*	*-0.3*	*-0.2*	*0.1*	*0.2*	*-0.4*	*0.1*	*0.0*	*0.1*	*-0.3*	*-0.1*
Net exports	*0.0*	*0.1*	*-0.1*	*0.3*	*-0.1*	*0.3*	*0.3*	*0.2*	*0.2*	*0.2*	*-0.1*	*0.6*	*0.8*

Forecasts
*ovhg: overhang
(%): share of nominal GDP in 2005
Sources: BEA; INSEE estimates

by the mild dip in total wealth and tougher conditions for individual borrowers.

Business investment is also expected to continue braking U.S. growth. Bank surveys indicate a persistence of tighter access to credit, which already cramped corporate investment in Q4 2007. This portends a further decline in business-investment growth (*Chart 1*).

In our scenario, U.S. imports will stay on their downtrend begun in late 2007, losing 0.5% per quarter in H1 2008. They will be affected by slack domestic demand, particularly in its business-investment and consumption components. At the same time, exports are forecast to slow in H1 2008, assuming a stable exchange rate of $1.50 per euro and given the euro-zone import profile. Nevertheless, the U.S. economy should continue to benefit from rising foreign demand, particularly on the part of emerging countries, and from the dollar's accumulated depreciation. The external-trade contribution to GDP growth should stay positive through mid-2008 at around 0.2 points per quarter.

The main uncertainty concerns the financial crisis, which could lead to a further tightening of credit access for households and businesses. Conversely, consumption may prove resilient and the dollar's past slippage—which helps exports—could sustain U.S. growth beyond our expectations.

Slowdown forecast in the United Kingdom as well

As in the United States and broadly for the same reasons, consumption is losing momentum in the United Kingdom. Its growth rate fell from an average 0.8% in Q1-Q3 2007 to just 0.2% in Q4 2007 (*Chart 2*). Our forecast indicates further moderate growth of 0.4% in Q1 2008 and 0.3% in Q2 2008. In the coming quarters, the U.K. economic slowdown should also restrain employment growth. Food and energy price rises are expected to keep inflation above 2%. As a result, real household income should gain only 0.3% in Q4 2007 and Q1 2008. Moreover, the downswing in the real-estate market and the fall in financial-asset prices will likely dampen the positive wealth effect on consumption.[2] Household investment should remain limp, owing to earlier rises in mortgage-loan rates and the downturn in expectations about real-estate prices. Household demand—the main engine of the previous growth cycle—should therefore lose momentum over the forecasting horizon.

2. See "Asset wealth and consumption: weakly correlated in France, strongly in the United States," "*Conjoncture* in France," December 2007, pp. 11-25.

Table 2
United Kingdom: supply and use table

in real terms

	Quarterly changes, %										Annual changes, %		
	2006				**2007**				**2008**		**2006**	**2007**	**2008 ovhg***
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**			
GDP	**0.9**	**0.7**	**0.6**	**1.0**	**0.8**	**0.8**	**0.7**	**0.6**	**0.4**	**0.4**	**2.9**	**3.1**	**1.7**
Household consumption (70%)	0.0	1.3	0.2	1.0	0.9	0.7	0.9	0.2	0.4	0.3	1.9	3.1	1.4
Investment (16%)	1.8	1.9	2.7	3.3	0.8	-1.0	1.7	-0.5	0.4	0.3	7.9	5.0	0.9
Non-residential (10%)	1.8	2.8	3.1	4.5	-0.2	0.5	2.0	-0.5	0.7	0.5	-4.7	6.7	1.8
Residential (6%)	-1.2	3.7	2.1	-0.2	1.0	0.6	0.5	0.0	0.0	0.0	9.2	3.6	0.4
Exports (10%)	9.3	2.3	-11.8	0.1	-0.6	0.3	1.4	-0.5	0.6	0.6	11.0	-5.4	1.4
Imports (16%)	8.2	2.7	-10.0	-0.1	0.2	-0.5	3.9	-1.2	0.7	0.6	10.0	-3.2	2.1
Contributions to GDP growth													
Domestic demand excluding inventories	*0.6*	*1.0*	*0.7*	*1.3*	*0.9*	*0.3*	*1.0*	*0.2*	*0.4*	*0.4*	*3.1*	*3.3*	*3.3*
Inventories	*0.3*	*-0.1*	*0.0*	*-0.5*	*0.1*	*0.2*	*0.6*	*0.1*	*0.0*	*0.0*	*-0.1*	*0.3*	*0.3*
Net exports	*0.0*	*-0.2*	*-0.1*	*0.1*	*-0.3*	*0.3*	*-0.8*	*0.2*	*-0.1*	*0.0*	*0.0*	*-0.5*	*-0.5*

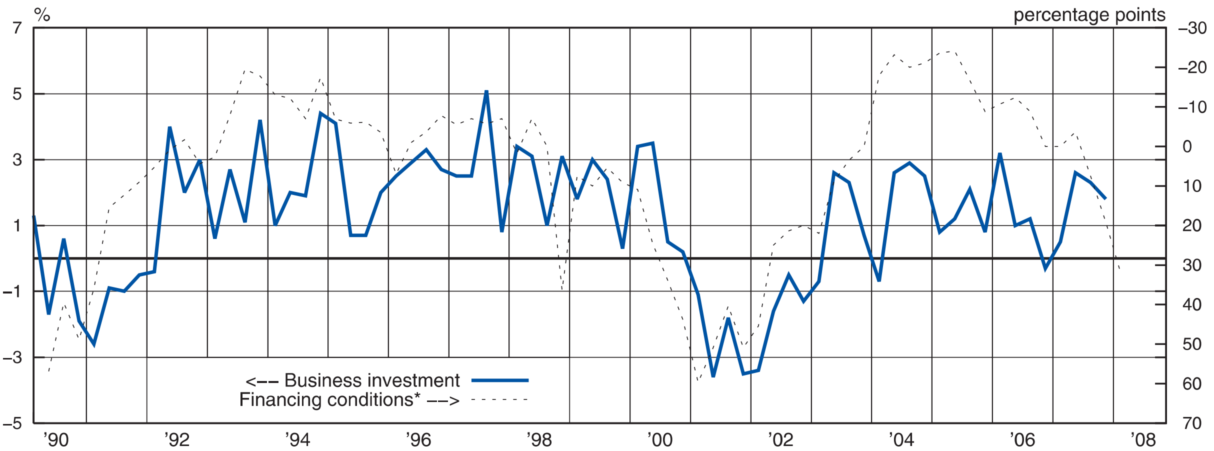
Forecasts
(%): share of nominal GDP in 2005
*ovhg: overhang
Sources: ONS; INSEE estimates

As regards British businesses, our scenario calls for a gradual easing of investment growth after an acceleration in Q1-Q3 2007. Business confidence surveys report greater pessimism in Q4 2007 and January 2008.

The pound's steep depreciation should trigger an export rebound of 0.6% per quarter in H1 2008, but the phenomenon will be restrained by the global demand slowdown. After declining in Q4 2007, imports are set to return to a growth path of about 0.7% per quarter. As a result, the U.K. trade deficit should continue to widen.

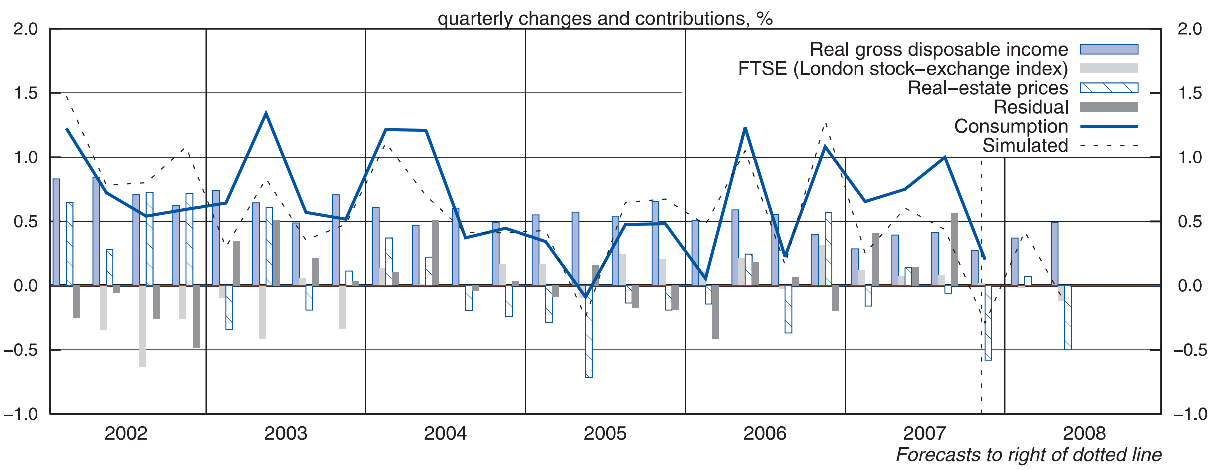
Our scenario sees British GDP growth slowing to 0.4% per quarter in H1 2008. The main uncertainty in the forecast is the scale of the consumption slowdown. ■

1 - Financing conditions and investment slowdown in the U.S.



*Net percentage of banks applying tighter lending conditions to medium-sized and large firms.
Sources: BEA; Federal Reserve Board

2 - U.K. consumption set to lose momentum



Sources: ONS; Financial Times

Japan and Asia

After its Q4 2007 rebound, the Japanese economy is set to weaken in H1 2008. Our scenario calls for stagnant business investment and a smaller external-trade contribution to GDP growth. The outlook for wage and salary growth remains very glum, further undermining household consumption.

The South-East Asian economies are expected to remain vibrant thanks to strong exports and firm domestic demand. China should continue to provide economic momentum to the region.

Moderate growth in Japan in H1 2008

In Japan, household consumption is likely to remain limp in H1 2008. One major reason is slower employment growth, after a sharp but temporary rebound in Q4 2007. Wages and salaries are also projected to stay on a downward path, owing to labor-market tensions and higher commodity prices, which weigh on Japanese firms' costs and prompt them to squeeze wages. Core inflation recovered at end-2007 and may finally turn positive by mid-2008. Absent wage growth, this uptrend in prices is expected to erode Japanese consumers' purchasing power in the quarters ahead.

Residential investment fell sharply in Q4 2007, as the tougher legislation on building permits passed in June 2007 delayed many construction starts. However, the year-end rebound in housing starts suggests a gradual return to normal in H1 2008. In a parallel development, non-residential investment is forecast to slow, as signaled by the contraction in business loans by Japanese banks *(Chart 1)*. The likely causes are slack domestic demand and sluggish exports.

Yet exports should continue to benefit from a fairly buoyant international environment, particularly thanks to Japan's main Asian partners. But weaker U.S. growth and the yen's appreciation against the dollar since July 2007 are forecast to weigh increasingly on Japanese exports. In our scenario,

Japan: supply and use table

in real terms

	Quarterly changes, %										Annual changes,%		
	2006				2007				2008		2006	2007	2008 ovhg*
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2			
GDP	**0.5**	**0.8**	**0.0**	**1.1**	**0.9**	**-0.4**	**0.3**	**0.9**	**0.5**	**0.4**	**2.4**	**2.0**	**1.5**
Household consumption (57%)	0.5	0.8	-0.8	1.0	0.6	0.2	0.1	0.2	0.1	0.1	2.0	1.5	0.4
Investment (23%)	-0.2	1.3	-0.4	2.0	0.4	-2.5	-1.0	0.0	0.8	1.1	1.3	-0.4	0.4
Non-residential (15%)	-0.5	5.0	0.6	1.8	-0.5	-1.6	0.9	2.0	0.5	0.8	4.3	2.1	2.6
Residential (4%)	0.6	-2.4	0.4	2.3	-1.3	-4.4	-8.3	-9.3	4.0	4.0	0.9	-9.3	-6.1
Public consumption (18%)	-0.4	0.5	0.4	-0.3	0.2	0.3	0.1	0.9	0.0	-0.2	-0.4	0.8	0.6
Exports (14%)	2.4	0.9	2.2	0.8	3.5	1.1	2.9	3.1	2.5	1.5	9.7	8.8	7.8
Imports (13%)	1.8	1.0	-0.2	0.1	1.0	0.5	-0.1	0.6	0.5	0.5	4.2	1.7	1.4
Contributions to GDP growth													
Domestic demand excluding inventories	*0.2*	*0.8*	*-0.5*	*1.0*	*0.5*	*-0.4*	*-0.1*	*0.3*	*0.2*	*0.2*	*1.4*	*0.9*	*0.4*
Inventories	*0.2*	*0.0*	*0.1*	*0.0*	*0.0*	*0.0*	*-0.1*	*0.1*	*0.0*	*0.0*	*0.2*	*0.0*	*0.0*
Net exports	*0.1*	*0.0*	*0.4*	*0.1*	*0.4*	*0.1*	*0.5*	*0.5*	*0.4*	*0.2*	*0.8*	*1.2*	*1.2*

Forecasts
*ovhg: overhang
(%): share of nominal GDP in 2005
Sources : BEA; INSEE estimates

slack domestic demand will restrain imports in the quarters ahead.

China's economic dynamism

The Chinese economy continued to perform vigorously in Q4 2007, with year-on-year GDP growth topping 11% for the fourth consecutive quarter. Buoyant productive investment and thriving exports are still the main drivers.

China's trade surplus rose nearly 45% to over USD260 billion in 2007. However, export growth registered a mild slowdown in H2 because of the sluggish U.S. economy and the yuan's appreciation against the dollar.

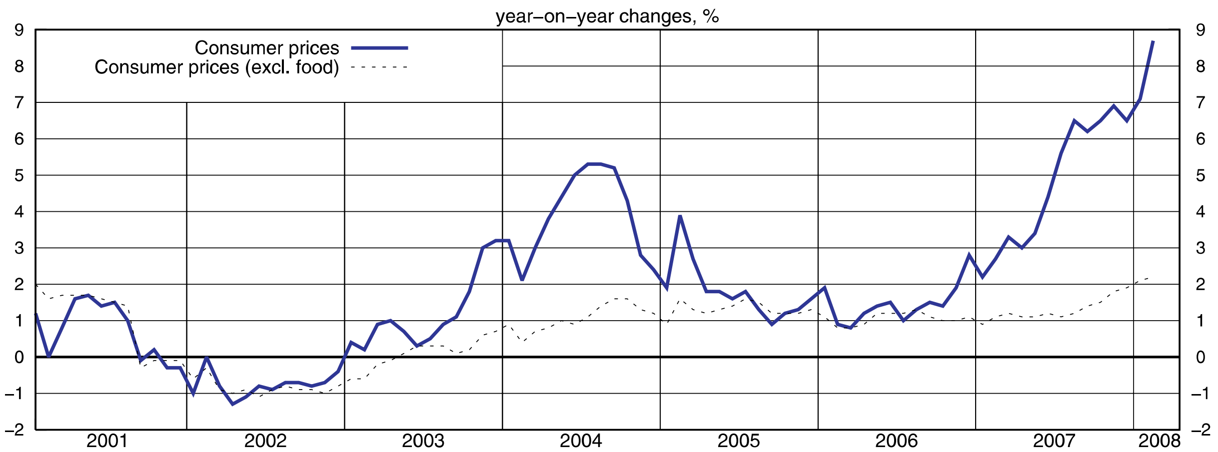
Business investment was still expanding briskly at end-2007. In Q4, expenditures on capital goods rose by an annualized 26%. This performance seems likely to last over the forecasting horizon, as suggested by the persistence of high business confidence. Chinese authorities did tighten monetary policy, lifting the key rate to 7.47% in December and raising banks' required reserves from 12.5% to 14.5% in Q4 2007. But these moves failed to curb credit growth and, in any event, they can hardly influence business investment as it is largely self-financed.

China's industrial activity should remain vibrant in the coming quarters, as implied by the production component of the PMI (Purchasing Managers' Index), which is still running high. We thus expect Chinese GDP growth to keep its present momentum in H1 2008.

1 - Contraction in bank loans to Japanese businesses

Source: Bank of Japan

2 - Rising inflation in China



How to read this chart:
As the Bank of China does not disclose the weight of the food component, we estimated it by means of a regression. The result is consistent with other available estimates. We computed the non-food index as a Tornqvist index.
Source: People's Bank of China

The main vulnerability of the Chinese economy is inflation. Year-on-year inflation rose to 8.7% in February—its highest level since December 1996—driven by higher commodity prices, particularly for foodstuffs *(Chart 2)*. Chinese monetary authorities may therefore take further tightening measures in the quarters ahead.

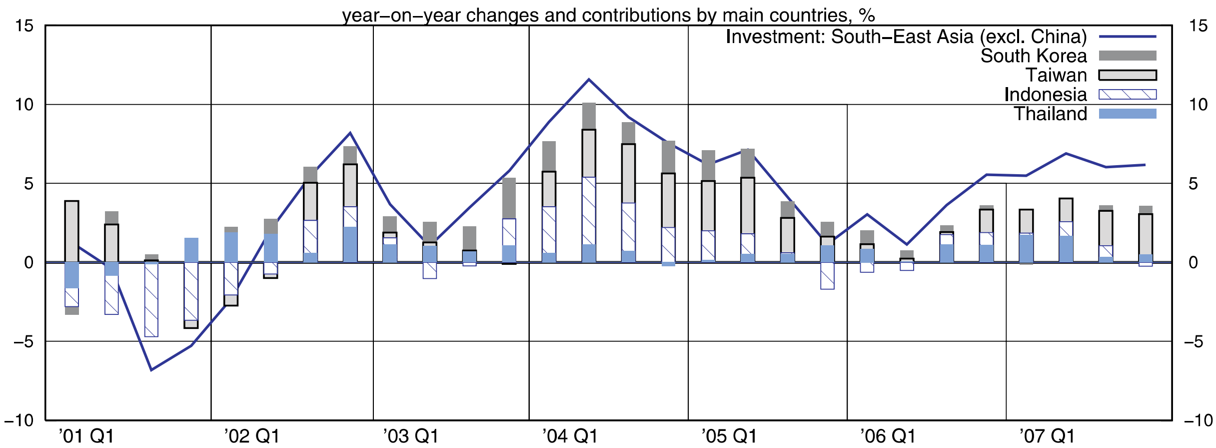
Activity still vigorous in South-East Asia

Elsewhere in Asia, growth remained solid in Q4 2007, with GDP gaining 6.2% year-on-year as in Q3. However, the investment boom that began in early 2006 seems to have leveled off since Q2 2007 *(Chart 3)*.

Inflation rose significantly in South-East Asia in H2 2007, mainly because of higher food and energy prices. But, for the moment, it is running only slightly above its long-term average. Only Taiwan's central bank tightened its policy in late 2007, and monetary conditions should therefore remain broadly favorable to the regional economy.

In conclusion, we expect further brisk growth in Asia in H1 2008, as suggested by the positive leading indicators in South Korea, Taiwan, and Thailand. ■

3 - Stability of Asian business-investment growth



Source: national statistical institutes

Euro zone

Euro-zone GDP growth slackened to 0.4% in Q4 2007. The three largest economies—Germany, France and Italy—felt the slowdown most strongly, registering an average 0.2% growth. By contrast, Spain, the Netherlands, and some smaller countries enjoyed robust growth.

In early 2008, the euro zone should continue to post moderate growth of 0.4% per quarter. The expected easing of inflation should prompt a consumption rebound, but equipment investment and construction investment are both set to lose further momentum. External trade is projected to make a negative contribution to GDP growth, as international demand will probably slacken and imports should move back up in line with domestic demand.

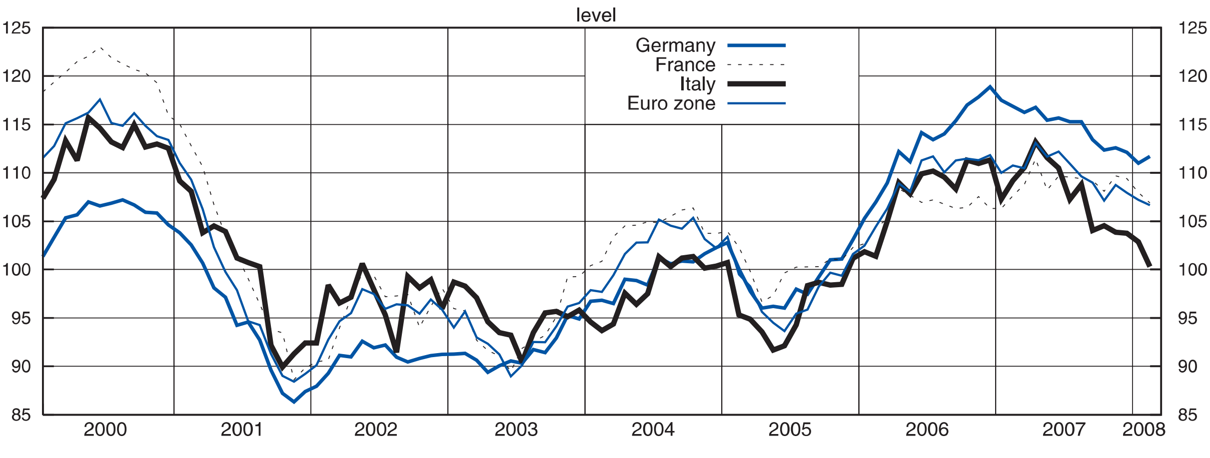
2007: a transition year

Euro-zone GDP growth rebalanced in 2007. Consumption and investment made comparable contributions, while external trade partly offset slacker domestic demand. However, differences in the growth mix between the region's main economies persisted and even widened. In France, Italy, and Spain, consumption remained the chief engine of growth, but this entailed a further sizable trade deficit for France and Spain. In Germany, by contrast, trade was a powerful growth driver while consumption fell sharply. Given these circumstances, investment is the only demand component with which to rate the major euro-zone countries' performance. Spain and Germany rank at or above the zone average, France and Italy rank below *(see "2007: a transition year" special analysis)*.

GDP growth expected to remain moderate in H1 2008

Business sentiment in the manufacturing industry nearly stabilized at end-2007 after a steady deterioration since the spring. Germany's economic climate had been far more positive than the euro-zone climate for two years previously; in 2007, it converged toward the rest of the zone, fueling a mild downtrend in the aggregate figure *(Chart 1)*. Industrial production should therefore continue to grow, but moderately, in early 2008. We forecast increases of 0.4% in Q1 and 0.1% in Q2, versus 0.1% in Q4 2007. The latter value reflects an exceptionally steep drop of 2.2% in Italy.

1 - Composite "synthetic" indicators from industry surveys



Sources: European Commission; Ifo; INSEE; INSEE estimates

In the service sector, business optimism started to decline later (in September), but the downtrend persists in early 2008. Activity was still vibrant in Q4 2007 but we expect a significant slowdown in Q1 2008.

In contrast, our forecast sees a rebound in construction activity after its end-2007 dip. Total GDP should grow 0.4% per quarter in early 2008, as in Q4 2007.

In all the main euro-zone countries, growth is set to stabilize after the year-long slowdown observed in 2007 *(Chart 2)*. The statistical overhang at the end of H1 2008 is projected at a modest 1.4%, compared with 2.2% in the same year-earlier period.

Table 1
Euro zone and main countries: GDP and its components

%

	Quarterly changes										Annual averages			
	2006				2007				2008		2005	2006	2007	2008 ovhg*
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2				
GERMANY (28%)[1]														
GDP	**0.9**	**1.3**	**0.7**	**1.0**	**0.6**	**0.2**	**0.7**	**0.3**	**0.4**	**0.4**	**1.0**	**3.1**	**2.6**	**1.3**
Household consumption	0.8	0.2	0.4	0.8	-1.8	0.8	0.3	-0.8	0.5	0.3	0.1	1.1	-0.5	0.5
Total GFCF**	-2.2	6.1	1.2	1.9	2.1	-1.4	0.6	1.1	0.5	1.0	1.3	7.0	5.1	2.1
Public consumption	0.5	-0.1	0.5	0.0	1.7	0.1	0.5	-0.5	0.2	0.2	0.5	0.9	2.1	0.2
Exports	4.9	1.8	3.3	5.3	-0.3	0.8	2.5	1.3	1.1	1.1	7.4	12.9	8.0	4.4
Imports	3.8	0.7	3.5	1.3	2.0	-2.0	3.2	-0.2	1.5	1.4	6.9	11.5	5.0	3.5
Contributions to GDP growth														
Domestic demand excluding inventories	*0.2*	*1.2*	*0.6*	*0.7*	*-0.4*	*0.2*	*0.4*	*-0.3*	*0.5*	*0.4*	*0.5*	*2.1*	*1.3*	*0.8*
Inventory changes	*0.0*	*-0.4*	*0.1*	*-1.6*	*2.0*	*-1.2*	*0.4*	*-0.1*	*0.1*	*0.0*	*0.0*	*-0.1*	*-0.1*	*0.0*
Net exports	*0.7*	*0.5*	*0.0*	*1.9*	*-1.0*	*1.2*	*-0.1*	*0.7*	*-0.1*	*0.0*	*0.5*	*1.1*	*1.4*	*0.6*
ITALY (19%)[1]														
GDP	**0.8**	**0.6**	**0.3**	**1.1**	**0.3**	**0.1**	**0.4**	**-0.1**	**0.3**	**0.3**	**0.2**	**1.9**	**1.7**	**0.6**
Household consumption	0.5	0.5	0.7	0.2	0.7	0.5	0.2	0.1	0.2	0.2	0.6	1.5	1.8	0.7
Total GFCF	1.8	0.9	-1.0	2.2	0.6	0.2	1.5	-1.0	0.6	0.6	-0.2	2.5	2.6	1.1
Public consumption	-0.3	-0.1	0.3	-0.1	0.0	-0.1	0.2	0.0	0.1	0.1	1.5	-0.3	0.1	0.3
Exports	2.2	1.5	-1.9	4.1	0.2	-1.4	0.9	-1.2	0.3	0.3	0.0	5.4	1.9	-0.3
Imports	1.2	0.4	2.0	1.8	-1.2	-0.2	2.4	-1.2	0.4	0.4	1.0	4.4	2.0	0.9
Contributions to GDP growth														
Domestic demand excluding inventories	*0.6*	*0.4*	*0.2*	*0.5*	*0.6*	*0.3*	*0.5*	*-0.1*	*0.3*	*0.3*	*0.6*	*1.3*	*1.6*	*0.7*
Inventory changes	*-0.1*	*-0.1*	*1.1*	*-0.1*	*-0.6*	*0.1*	*0.4*	*0.0*	*0.1*	*0.1*	*-0.1*	*0.4*	*0.1*	*0.3*
Net exports	*0.3*	*0.3*	*-1.0*	*0.6*	*0.4*	*-0.3*	*-0.4*	*0.0*	*0.0*	*0.0*	*-0.3*	*0.3*	*0.0*	*-0.3*
EURO ZONE (28%)[2]														
GDP	**0.9**	**1.0**	**0.6**	**0.8**	**0.8**	**0.3**	**0.7**	**0.4**	**0.4**	**0.4**	**1.7**	**2.8**	**2.6**	**1.4**
Household consumption	0.7	0.4	0.5	0.4	0.0	0.6	0.5	-0.1	0.4	0.4	1.6	1.8	1.4	1.1
Total GFCF	0.6	2.7	0.7	1.6	1.7	0.0	1.2	0.8	0.4	0.6	3.0	5.2	4.7	2.0
Public consumption	1.2	0.2	0.6	0.3	1.1	0.2	0.7	-0.1	0.3	0.2	1.5	2.0	2.1	0.8
Exports	3.2	1.5	0.9	3.1	0.9	0.8	2.1	0.5	1.0	0.8	4.9	7.9	5.9	3.2
Imports	2.4	1.3	1.5	1.7	1.4	0.3	2.5	-0.4	1.2	1.0	5.7	7.6	5.1	2.9
Contributions to GDP growth														
Domestic demand excluding inventories	*0.8*	*0.8*	*0.5*	*0.6*	*0.6*	*0.4*	*0.7*	*0.1*	*0.4*	*0.4*	*1.8*	*2.5*	*2.2*	*1.2*
Inventory changes	*-0.2*	*0.0*	*0.3*	*-0.5*	*0.4*	*-0.3*	*0.2*	*-0.1*	*0.0*	*0.0*	*0.0*	*0.1*	*0.0*	*0.0*
Net exports	*0.3*	*0.1*	*-0.2*	*0.6*	*-0.2*	*0.2*	*-0.1*	*0.4*	*0.0*	*-0.1*	*-0.2*	*0.2*	*0.4*	*0.2*

Forecast
*ovhg: overhang
** GFCF: gross fixed capital formation
1. Share of euro-zone GDP
2. Share of industrialized countries' GDP
Source: Eurostat

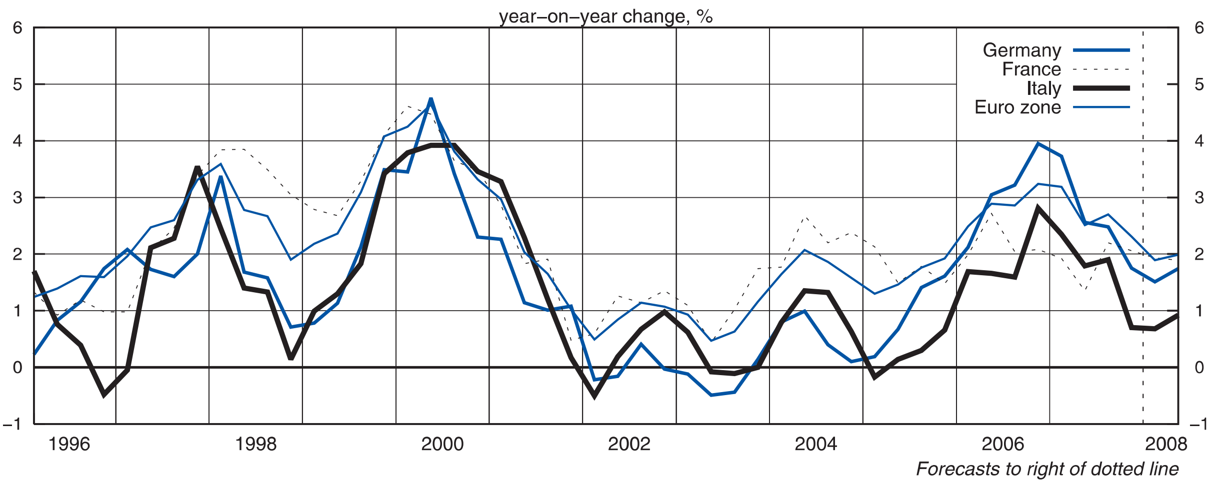
Consumption poised to rebound

The household-consumption rebound in Q2-Q3 2007 did not last. The Q4 data showed a 0.1% decline. In Germany, consumption fell again, as it did early in the year after the VAT increase. In France, consumption slowed sharply. In Italy, it appears to have practically stalled. Slower growth in household income in H2 and higher inflation weighed on household purchasing power. Nevertheless, in average annual terms, euro-zone consumption posted only a modest loss of momentum, gaining 1.4% in 2007 versus 1.8% in 2006. This performance was achieved despite the H2 price surge and the very negative impact of the VAT hike on German household consumption —which, in fact, has not yet returned to its level prior to the tax increase.

By and large, household-income growth should quicken in early 2008. Wages and salaries are expected to benefit from the settlements negotiated in 2007—particularly in German industry and the Italian civil service—while job creation should remain brisk. Net taxes and social contributions on household income should ease, after two years of fiscal austerity aimed at cutting public deficits. The mild downturn in inflation should also fuel purchasing-power gains.

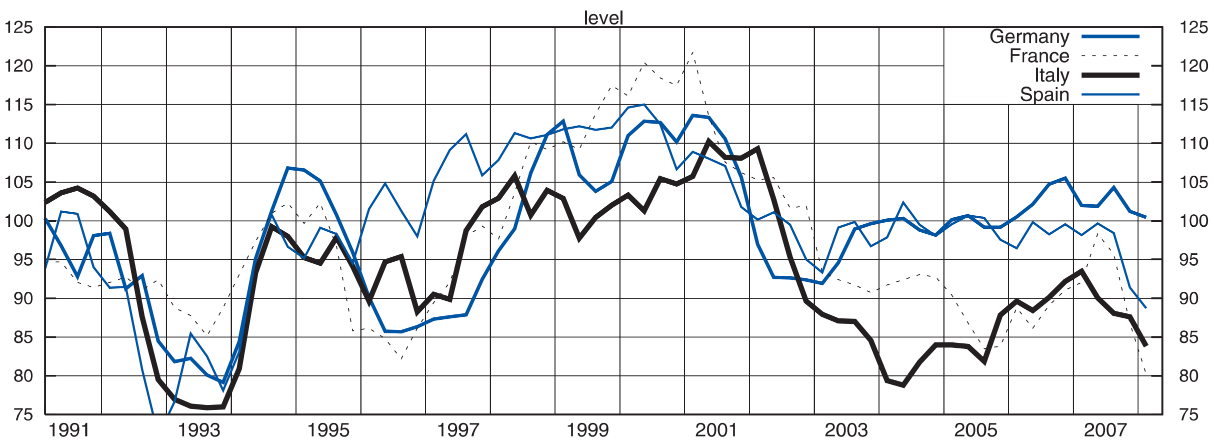
However, the decline in household confidence in most euro-zone countries may signal precautionary-saving behavior *(Chart 3)*. Consequently, we forecast that household-consumption growth will not exceed 0.4% per quarter in H1 2008, i.e., its average pace for 2007.

2 - Main euro-zone countries: GDP growth



Sources: Eurostat; Destatis; INSEE; Istat

3 - Main euro-zone countries: consumer confidence



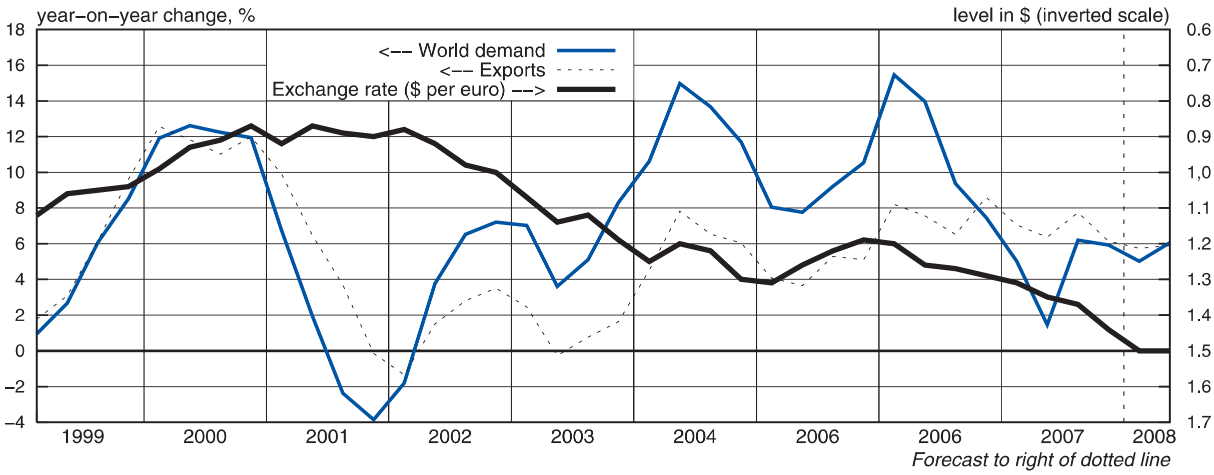
Sources: European Commission; INSEE

The investment slowdown begun in 2007 should continue

The slackening of investment growth, begun in 2007, should persist in early 2008. This is suggested by business surveys in the capital-goods sector, where respondents report that the growth cycle has clearly peaked. Investment determinants are less positive now. Demand is slowing and the productive capacity utilization rate in the manufacturing industry as a whole has stopped rising. The need to boost capacity thus seems less urgent. Moreover, the persistent financial turbulence, which spread to the stock markets in early 2008, means that credit-access conditions remain less conducive to investment. The heightened uncertainty may prompt industrialists to exercise caution and so delay some of their investment plans.

The underlying investment slowdown was, however, overshadowed at end-2007 by the temporary stimulus from investment spending by German firms wanting to take advantage of the extended write-off provisions before their expiry on December 31. These anticipated outlays should be offset by an even steeper slowdown in Q1 2008. We therefore expect equipment investment to post average growth of only 0.5% per quarter in H1 2008.

4 - Euro-zone: exports, world demand, and exchange rate



Sources: DGTPE; Eurostat; INSEE estimates

Table 2
Euro zone: Household accounts

%

	Quarterly changes										Annual averages			
	2006				2007				2008		2005	2006	2007	2008 ovhg*
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2				
Total wage bill	0.8	1.3	0.5	0.9	1.6	0.9	0.6	0.8	1.3	1.3	2.8	3.9	4.1	3.4
- Employment	0.3	0.6	0.3	0.4	0.7	0.6	0.3	0.5	0.5	0.3	1.0	1.6	2.0	1.4
- Unit wage	0.5	0.7	0.2	0.5	0.9	0.3	0.3	0.3	0.8	1.0	1.8	2.3	2.1	2.0
Gross disposable income (GDI)	0.6	1.1	1.0	0.9	1.1	0.8	0.5	0.9	1.3	1.3	3.2	3.7	3.7	3.4
Saving ratio (% of GDI)	13.3	13.4	13.4	13.6	14.3	13.9	13.5	13.4	13.4	13.7	13.7	13.4	13.8	13.6
Household consumption deflator	0.5	0.6	0.5	0.2	0.4	0.6	0.4	1.1	0.9	0.5	2.1	2.2	1.9	2.4
Real total wage bill	0.3	0.7	0.1	0.6	1.2	0.4	0.2	-0.3	0.4	0.8	0.7	1.7	2.2	1.0
- Real unit wage	0.0	0.1	-0.2	0.2	0.5	-0.2	-0.1	-0.8	-0.1	0.5	-0.3	0.1	0.2	-0.4
Purchasing power of GDI	0.1	0.5	0.5	0.7	0.8	0.2	0.1	-0.2	0.4	0.8	1.1	1.5	1.8	1.0

Forecast
*ovhg: overhang
Sources: Eurostat; INSEE estimates

Construction investment accelerated in 2007 thanks to the sharp rebound recorded in winter 2006/2007. The slowdown in building permits over the past year will probably erode construction-investment growth over the forecasting horizon. The sector is experiencing a business downturn in several euro-zone countries, particularly Spain—the driver of the euro-zone's construction industry since the late 1990s—but also Ireland and Finland.

Growth in euro-zone trade forecast to stabilize

External-trade flows were very weak in Q4 2007. Imports retreated 0.4% and export growth slipped from 2.1% in Q3 to 0.5%. However, the phenomenon reflects a downturn in intra-zone trade—partly due to sluggish domestic demand —rather than a steep decline in exports to countries outside the zone. In fact, external trade contributed a very positive 0.4 points to GDP growth in Q4.

We expect intra-zone trade to revive in early 2008. By contrast, growth in demand from the rest of the world should fall to a pace well below that observed since 2003: we forecast 0.8% per quarter versus an average 2.2% in the four previous years *(Chart 4)*. Euro-zone exports are thus likely to suffer from the weaker international environment and the euro's high exchange rate of around $1.50 per euro, well above the H2 2007 level of $1.43 per euro.

Conversely, imports should be fueled by euro-zone domestic demand and intermediate consumption of inputs used in the production of euro-zone exports. In 2007, imports grew far more slowly than what domestic demand would have led us to expect. This discrepancy should gradually narrow in H1 2008, with imports outpacing exports. As a result, the external-trade contribution to GDP growth is projected to become slightly negative again, at -0.1 points per quarter. ■

Consumer prices in the euro zone

Average annual euro-zone inflation eased slightly to 2.1% in 2007, in particular thanks to lower energy inflation.

We expect year-on-year core inflation—i.e., excluding food and energy, but including indirect taxes—to hold at around 1.7% in H1 2008. In our scenario, the January 2007 increase in German VAT will cease to have an impact, but the recent rise in oil and food-commodity prices will spread to other sectors, causing total inflation to peak at 3.2% in February. With energy inflation easing, total inflation should then decline very slightly to 3.1% by June.

Core inflation should hold steady at around 1.7%

Core inflation as measured by Eurostat[1] is forecast to hold steady at around 1.7% in H1 2008 *(Chart 1)*. The dissipation of the effects of the German VAT hike and softer demand should help to restrain price increases. These two factors, however, will likely be offset by the lagged impact of the surge in oil and food-commodity prices on other products.

Non-energy industrial-goods inflation eased to 0.7% in January, as merchants cut prices more heavily on winter clearance sales than in the previous year. The fading of the impact of the January 2007 German VAT increase is also helping to moderate inflation. However, we forecast that non-energy industrial-goods inflation will quicken to 0.9% by the end of H1 2008. The dampening effects should be more than offset by the acceleration in producer prices. The diffusion of the oil-price surge will likely outweigh the slowdown in unit labor costs.

Service-sector inflation held steady at 2.5% in January. Despite weaker demand, lower inflation in the education sector, and restraint in unit labor costs, the year-on-year change in service-sector prices should stay at its present level until June *(Table)*. The reason is that the steep climb in food-commodity prices will likely be passed on to restaurant, bar, and canteen prices.

1. Excluding food, alcohol, tobacco, and energy but including indirect taxes.

Table
Euro-zone inflation

%

	Year-on-year								Annual average	
	January 2007		June 2007		January 2008		June 2008		2006	2007
Sectors (weights in 2008 index)	yoy	cyoy	yoy	cyoy	yoy	cyoy	yoy	cyoy		
Total (100.0%)	**1.8**	**1.8**	**1.9**	**1.9**	**3.2**	**3.2**	**3.1**	**3.1**	**2.2**	**2.1**
Food (incl. alcohol and tobacco) (19.5%)	**2.8**	**0.5**	**2.4**	**0.5**	**4.8**	**0.9**	**6.2**	**1.2**	**2.4**	**2.8**
of which: Food (15.8%)	*2.5*	*0.4*	*2.1*	*0.3*	*5.4*	*0.8*	*7.1*	*1.1*	*2.3*	*2.7*
Alcohol and tobacco (3.7%)	*3.7*	*0.1*	*3.6*	*0.1*	*2.8*	*0.1*	*2.9*	*0.1*	*2.7*	*3.4*
Energy (9.8%)	**0.9**	**0.1**	**0.9**	**0.1**	**10.6**	**1.0**	**6.5**	**0.6**	**7.7**	**2.6**
Core inflation (70.7%)	**1.7**	**1.2**	**1.9**	**1.3**	**1.7**	**1.2**	**1.8**	**1.3**	**1.4**	**1.9**
of which: Non-energy industrial goods (29.7%)	*0.9*	*0.3*	*1.0*	*0.3*	*0.7*	*0.2*	*0.9*	*0.3*	*0.6*	*1.0*
Services (40.9%)	*2.3*	*0.9*	*2.6*	*1.0*	*2.5*	*1.0*	*2.5*	*1.0*	*2.0*	*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 spring

From November 2007 to January 2008, energy inflation continued to rise despite the decline in oil-product prices, as both France and Germany raised electricity tariffs in January. However, assuming stable oil prices over the forecasting horizon, year-on-year energy inflation should start to ease in February *(Chart 2)*.

The downtrend in energy inflation should more than compensate food inflation.

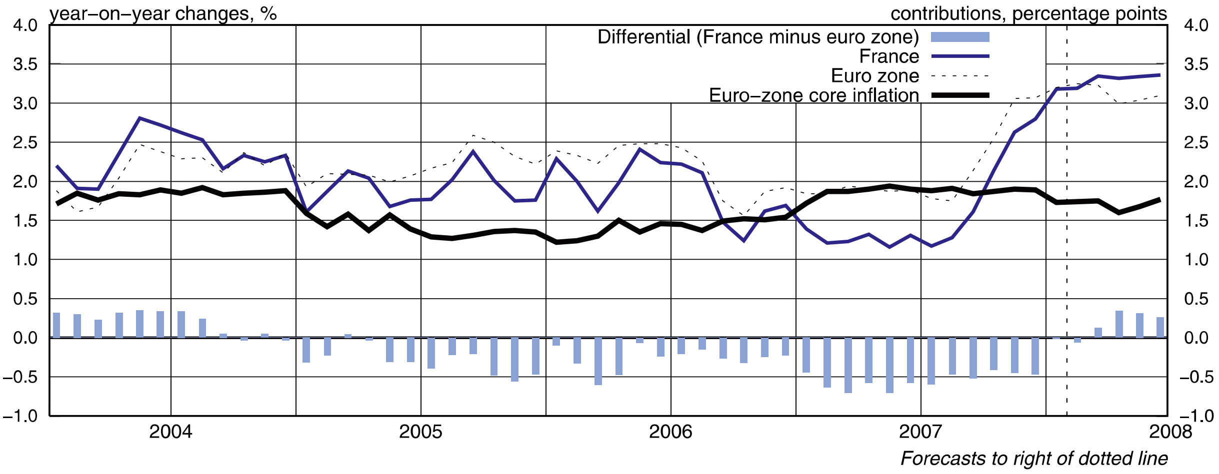
Since October 2007, food inflation has been driven up by the surge in food-commodity prices. Our forecast sees food inflation quickening from 4.8% in January to 6.2% in June *(Table)*. The persistent rise in processed-food prices should more than offset the easing of unprocessed-food inflation.[2]

Inflation differentials between euro-zone countries set to widen

The differential between the highest and lowest inflation in the euro zone widened with the upturn in Slovene inflation, moving from 4.1 points in December to 4.6 points in January *(Chart 3)*.

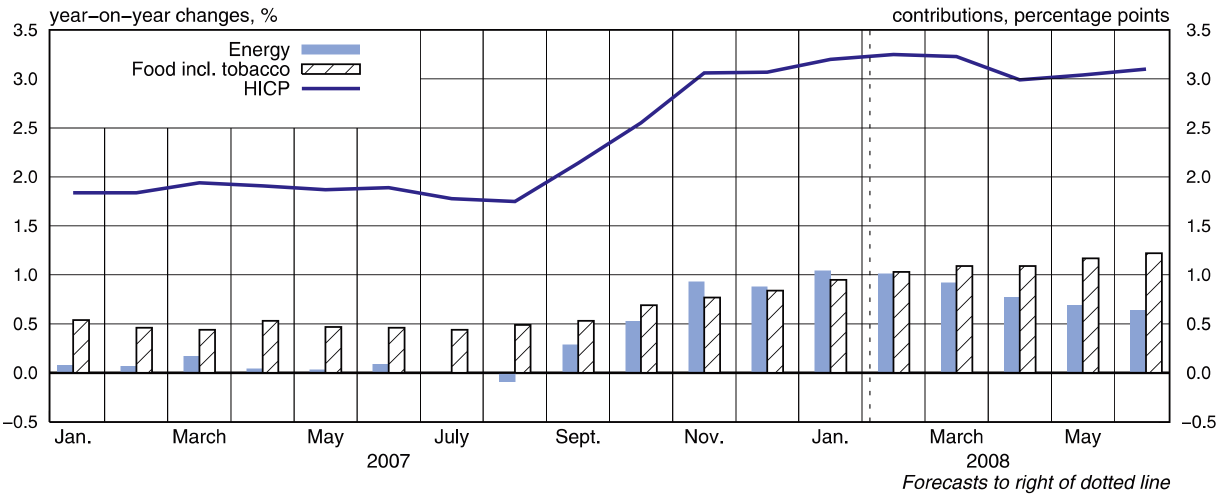
2. Adverse weather conditions had caused unprocessed-food prices to rise in spring 2007, whereas they usually start to decline in that season.

1 - Harmonised index of consumer prices (HICP): France and euro zone



Sources: Eurostat, INSEE forecasts

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



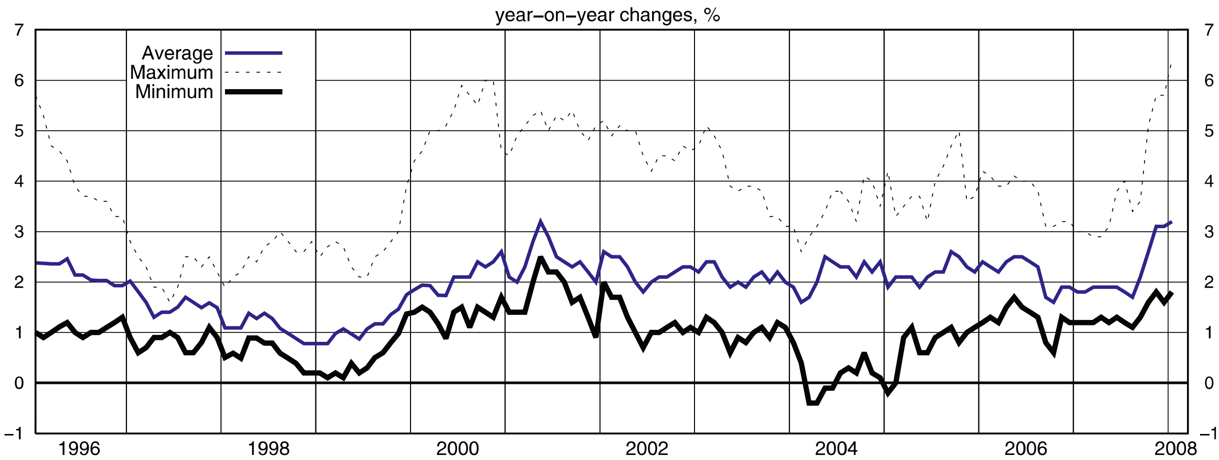
Sources: Eurostat, INSEE forecasts

Consumer prices in the euro zone

The entry of Cyprus and Malta into the euro zone in January 2008 has not impacted the harmonised index of consumer prices (HICP).

The inflation gap between France and the euro zone will likely be positive in H1 *(Chart 1)*, whereas it was negative before the German VAT increase. There are two reasons for this. First, healthcare prices rose faster in France than in the euro zone, owing to the introduction of an insurance deductible (*franchise médicale*) for patients on January 1, 2008. The HICP is affected by this measure because it takes into account the non-refunded portion of healthcare services and products. The second reason for the gap is that French inflation in non-energy industrial goods excluding healthcare products (i.e., chiefly in the automotive sector) is expected to outpace the euro zone average this year, after having risen more slowly in previous years. ■

3 - Euro-zone inflation rates



Source: Eurostat