The euro zone's international environment

Activity in the United States and the United Kingdom seems headed for below-potential growth in the early part of 2003 because of a slowdown in household consumption. The negative wealth effects on consumption can no longer be expected to be offset by the beneficial impact of economic policies as in 2002. In particular, households are likely gradually to reduce their mortgage borrowing and their refinancing of earlier mortgages, as the impact of past cuts in money-market rates will gradually disappear. Moreover, the expected slowdown in house prices is likely to have an unfavourable effect on recourse to borrowing of this kind. Consumption would also be affected in the early part of the year by the rise in the oil price and the worsening of household confidence, especially because of uncertainties surrounding the Iraq crisis.

Investment, on the other hand, should continue to strengthen, in view of the ongoing easing of borrowing terms for firms in the United States and the United Kingdom. Capital goods would be more particularly targeted, with the aim of improving the productivity of productive capacity already installed.

The final months of 2002 saw corporate demand partly taking up the running from household consumption in the United States

For the whole of the year 2002, American growth amounted to 2.4%, slightly below potential *(see table)*. Whereas household consumption was brisk, firms continued to keep a tight rein on spending. Meanwhile, the external environment provided little support.

Household consumption was boosted in 2002 by three factors: the tax cuts introduced in 2001 and 2002, the refinancing of mortgage loans that became particularly advantageous because of the steep decline in interest rates in 2001 and 2002 and the exceptional incentives offered by the carmakers. These factors partly compensated households [(1)] for the negative wealth effects linked to the slump in stock-market prices in 2002.

GDP IN LEADING INDUSTRIALISED COUNTRIES OUTSIDE THE EURO ZONE
(share of countries in oecd total)

(Annual and half-yearly % change)

	Half-yearly % change						Annual average		
	2002				2003		2001	2002	2003 (c.o)
	H1	H2	H3	H4	H1	H2			
UNITED STATES (34.0%)									
GDP	1.2	0.3	1.0	0.4	0.6	0.7	0.2	2.4	2.0
Imports	2.1	5.0	0.8	1.7	1.6	1.1	-3.0	3.5	5.4
Private consumption	0.8	0.4	1.0	0.4	0.4	0.6	2.5	3.1	1.8
Public expenditure (1)	1.4	0.4	0.7	1.2	0.8	0.8	3.6	4.4	2.8
Total private GFCF (2)	-0.1	-0.2	-0.1	1.1	1.0	1.5	-3.9	-3.1	2.9
Exports	0.9	3.3	1.1	-1.1	1.2	1.2	-5.5	-1.7	2.7
Contributions : Domestic demand excluding stocks	0.8	0.3	0.8	0.7	0.6	0.8	1.7	2.4	2.2
Stock change	0.8	0.4	0.1	0.1	0.1	0.0	-1.4	0.7	0.3
Foreign trade	-0.2	-0.3	0.0	-0.4	-0.1	0.0	-0.2	-0.6	-0.5
UNITED KINGDOM (5.6%)									
GDP	0.1	0.6	0.9	0.4	0.4	0.5	2.0	1.6	1.9
Imports	1.6	1.3	-0.3	-0.3	-0.3	0.5	2.8	1.2	0.3
Private consumption	0.6	1.1	0.8	1.0	0.3	0.5	4.1	3.9	2.3
Public consumption	1.1	-0.9	1.3	0.8	1.0	1.0	3.1	4.2	3.3
Total GFCF (3)	-2.7	1.4	-1.3	-0.6	0.0	0.5	0.3	-4.5	-0.2
Exports	0.4	3.8	-0.9	-3.4	-0.3	0.2	1.2	-1.4	-2.1
Contributions : Domestic demand excluding stocks	0.1	0.8	0.6	0.7	0.4	0.6	3.3	2.7	2.7
Stock change	0.4	-0.9	0.4	0.7	0.0	0.0	0.0	-0.1	0.1
Foreign trade	-0.5	0.8	-0.2	-1.0	0.0	-0.1	-0.7	-1.0	-0.8

Forecast
(1) Public consumption and investment
(2) Investments of firms and households
(3) Investments of firms and households and public investment

In addition, households also took advantage of the decline in mortgage rates to make very substantial investments in real estate. Housing investment rose at a rate close to 4% for the year as a whole.

For firms, on the other hand, 2002 was a year of consolidation: private investment excluding housing fell by almost 6% during the year. As in 2001, companies reabsorbed the excess accumulation of previous years and accordingly cleaned up their balance sheets.

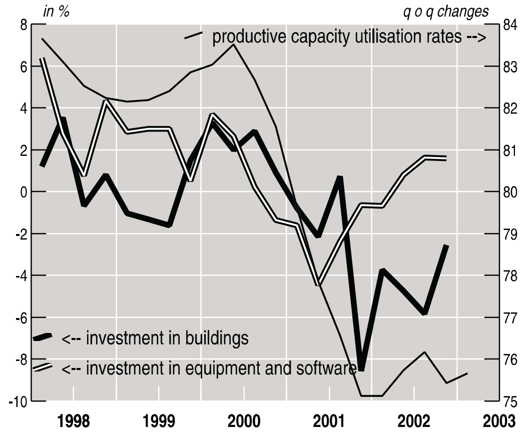
However, corporate behaviour became gradually less restrictive in the course of 2002, even though expectations regarding demand and the deterioration in financial conditions towards the end of the year prevented firms from re-launching capacity investment. The fall in investment slowed down during 2002 and towards the end of the year the investment growth rate even turned positive again. This was due to the recovery in investment in machinery and software as of Q2 2002, with firms attempting to cut costs and improve productivity. On the other hand, investment in buildings continued to decline throughout the year, reflecting business leaders' policies of not increasing their productive capacity *(see graph 1)*.

Inventory behaviour also became more positive starting in 2002. After drawing down stocks throughout 2001, firms began to rebuild them again starting in Q1 2002. This reversal in inventory behaviour explains the substantial contribution of inventory changes to growth in 2002 (+0.7 of a point of GDP).

(1) These generally positive factors from the households' point of view are necessarily unfavourable from the point of view of the lending agents: everything else remaining equal, the government's finances deteriorate, while the financial situation of the banks or other creditors supplying the refinancing is adversely affected, as is that of the carmakers adopting the exceptional incentives.

1

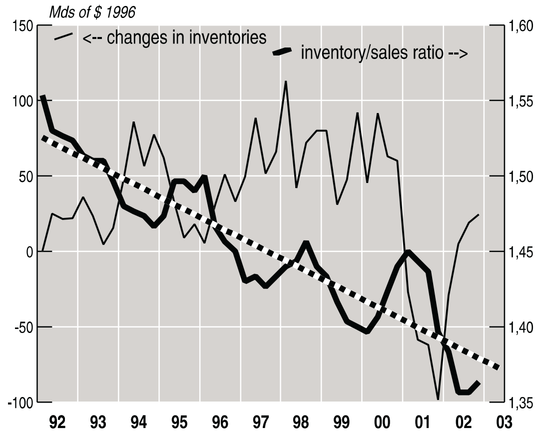
INVESTMENT IN EQUIPMENT AND SOFTWARE AND BUILDINGS AND PRODUCTIVE CAPACITY UTILISATION RATES



sources : BEA et FRB

2

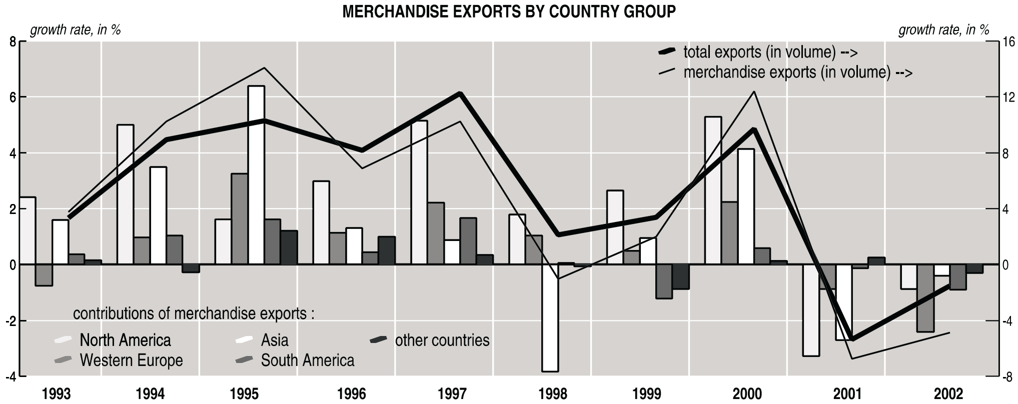
CHANGES IN INVENTORIES AND INVENTORY/SALES RATIO



sources : BEA et Census

3

TOTAL EXPORTS, MERCHANDISE EXPORTS AND CONTRIBUTIONS OF MERCHANDISE EXPORTS BY COUNTRY GROUP



sources : BEA, Census

Even so, the rate of re-stocking has remained moderate, and this was particularly true of H2 2002. Following a distinct increase in the early part of the year, stocks have since been maintained at a level that remains low in relation to sales *(see graph 2)*. The more cautious inventory behaviour of firms in the second half of the year probably reflects the tightening of financial conditions linked to the fall in stock-market prices and rising uncertainty regarding the demand outlook.

Meanwhile, the external environment was of little support in 2002, with exports down by 1.7% on 2001. This fall results mainly from the reduction in exports to the euro zone, where growth was particularly weak in 2002 *(see graph 3)*.

However, the rate of export decline slowed substantially compared with 2001. After reaching a low in Q4 2001, exports picked up again in 2002. This recovery was mainly the result of the rise in exports to Asia and North America *(see graph 4)*.

The liveliness of imports in 2002 is due to the firm growth in consumption and to the reversal of inventory behaviour. All in all, foreign trade made a fairly substantial negative contribution to growth in 2002.

The delayed impact of past stock-market declines can be expected to hold back American growth in 2003

The American economy is likely to continue to grow in 2003 at a rate slightly below its potential in view of the persistence of negative wealth effects, the slowdown in mortgage refinancing and the smaller fiscal stimulus compared with 2002.

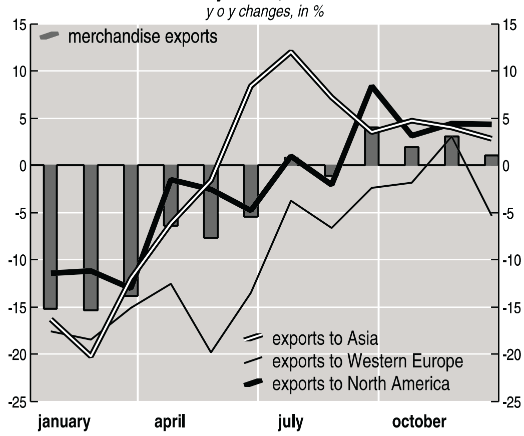
Following a marked slowdown towards the end of last year, consumption growth seems set to continue in Q1 2003 at a relatively low rate. This is the picture painted by retail sales figures for January and February, which bring the statistical growth carry-over for Q1 to 0.5% in value terms. There would then be an acceleration in Q2.

In relation to its potential, consumption growth is likely to be relatively slow, averaging 0.5% a quarter. The negative wealth effects associated with past falls in equity prices can be expected to hold back consumption in 2003 (*see graph 5)*. The further cuts in taxes proposed by the government for 2003 are unlikely to be brought in before the summer. In the first two quarters of 2003, therefore, they would not be present to offset the negative wealth effects, as was the case in 2002. Moreover, the conditions for mortgage refinancing are probably about to stabilise. After passing on the steep declines in long rates in 2001 and 2002, the rates for this type of borrowing can be expected to cease falling *(see graph 6)*. The Fed no longer has much leeway for rate cuts, meaning that long rates and mortgage rates can be expected to stabilise in 2003. The growth in resources derived from mortgage refinancing could therefore gradually slow down and make a smaller contribution to consumption growth in 2003 *(see graph 7)*. Finally, international political tensions will probably affect consumption growth via the impact on the oil price. The rise in the oil price that began in November 2002 has added to inflation and is eating into household purchasing power *(see box)*. The international political tensions are also affecting consumption by impairing consumer confidence *(see box in the overview)*.

Total investment (firms and households) is also likely to be affected by the rise in the oil price, but with a longer time lag than in the case of consumption, meaning that the effects would not be felt before the end of 2003 *(see box)*.

4

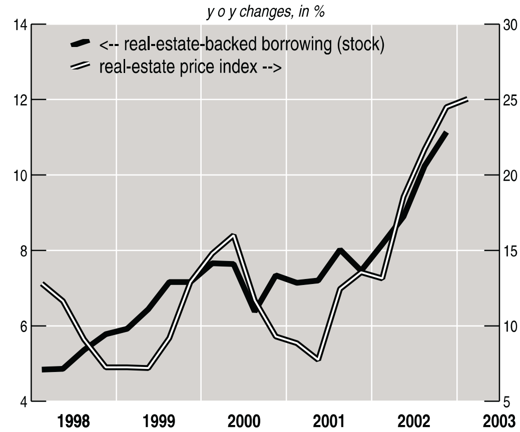
MERCHANDISE EXPORTS BY COUNTRY GROUP
by month, 2002
y o y changes, in %



source : Census

5

REAL-ESTATE-BACKED BORROWING AND REAL-ESTATE PRICE INDEX
y o y changes, in %



sources : ONS et Nationwide Building Society

IMPACT OF THE RISE IN THE OIL PRICE ON AMERICAN GROWTH

The rise in the oil price from November 2002 to the present is the result of the build-up of international political tensions between the international community and Iraq and of the domestic crisis that halted oil production in Venezuela for almost two months (December 2002 and January 2003). With a conflict in Iraq in prospect, the markets anticipated a substantial negative shock to oil supplies corresponding to a stoppage of production in both Iraq and Venezuela. A shock of this kind can largely explain the rise in the price of oil seen between November 2002 and the present (see box in the section dealing with oil – available only in the French version).

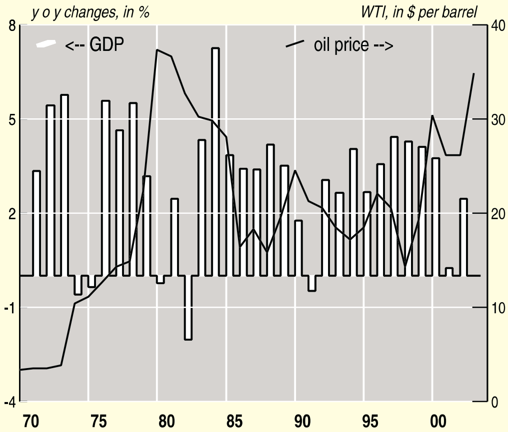
In the past, sharp rises in the oil price have had a major recessionary impact, with a time lag of roughly one year *(see graph)*. The aim of this box is to evaluate the impact of the recent rise in the oil price on American economic activity.

The rise in the oil price is liable to affect the behaviour of all economic agents. It eats into household purchasing power and as a result depresses consumption. It also reduces the demand for firms' products and hence acts as a curb on investment.

In order to measure the amplitude of this impact, an equation can be estimated linking the variable of interest (for example, GDP) to variations in the oil price. A key problem in estimations of this kind stems from the possible endogeneity of the oil price [(1)]. In order to deal with this, the method worked out by Hamilton (What is an Oil Shock? 2000, NBER WP N° 7755) was used [(2)]. Simply expressed, this method consists of taking only those rises in the oil price that result from exogenous international political tensions and to evaluate their impact on GDP [(3)]. The exogenous international political tensions examined by Hamilton are the crises taking place in the Middle East and which are recapitulated in the box in the section dealing with oil – available only in the French version.

The estimates (reproduced below) show that rises in the oil price have a major effect on GDP, but with a time lag of 4 quarters (this result is very close to those obtained by Hamilton). In the shorter term, they seem to have a negative effect on consumption and imports, so that the impact on GDP turns out to be non-significant. Four quarters after the shock, investment and GDP are also affected. The present rise in the oil price can therefore be expected to have a negative impact on consumption and imports during H1 2003 but would not influence GDP and investment before the end of 2003. ■

UNITED STATES GDP AND OIL PRICE



sources : BEA et Global Insight

1) The following example explains the notion of endogeneity and shows why it should pose a problem for our estimate. Let us assume the occurrence of a negative shock having a direct effect on GDP (i.e., through a different channel from that of the oil price); the reduction in activity depresses the demand for oil and, in so doing, brings down the oil price; the relationship between GDP and the oil price in this example can therefore be seen to introduce a bias into the estimation of the impact of a variation in the oil price on activity.
(2) The Hamilton method also makes it possible to take account of the fact that rises and falls in the oil price do not have symmetrical effects.
(3) Hamilton proposes to use the variable Q as an instrument for the variations in the oil prices (defined more precisely in the box in the section dealing with oil – available only in the French version). This variable measures the ex ante variations in the supply of oil resulting from exogenous international political tensions.

Equations:

$$TxPIB = \underset{(6.4)}{0.007} + \underset{(2.8)}{0.23} * TxPIB(-1) - \underset{(-3.2)}{0.07} * TxPPET(-4)$$

$$TxCONSO = \underset{(8.0)}{0.009} + \underset{(4.7)}{0.36} * TxCONSO(-2) - \underset{(-3.5)}{0.29} * TxCONSO(-4) - \underset{(-2.4)}{0.04} * TxPPET(-1) - \underset{(-2.1)}{0.04} * TxPPET(-4)$$

$$TxINVT = \underset{(3.8)}{0.02} - \underset{(-3.3)}{0.28} * TxINVT(-4) - \underset{(-2.3)}{0.30} * TxPPET(-4) - \underset{(-3.0)}{0.38} * TxPPET(-5)$$

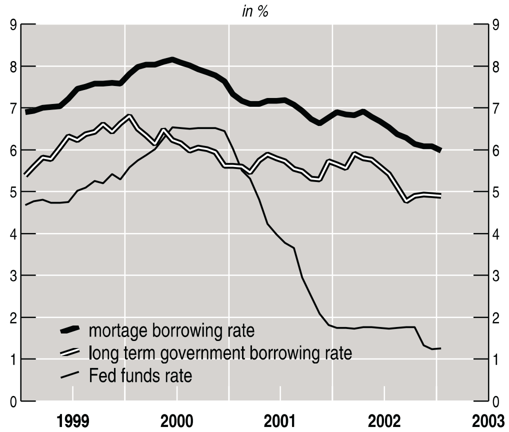
Estimation period: 1949:Q2 2002 :Q4

where: TxPIB = GDP growth rate
TxCONSO = Consumption growth rate
TxINVT = Investment growth rate
TxPPET = Crude oil growth rate

6

FED FUNDS, LONG TERM BORROWING AND MORTAGE BORROWING RATES

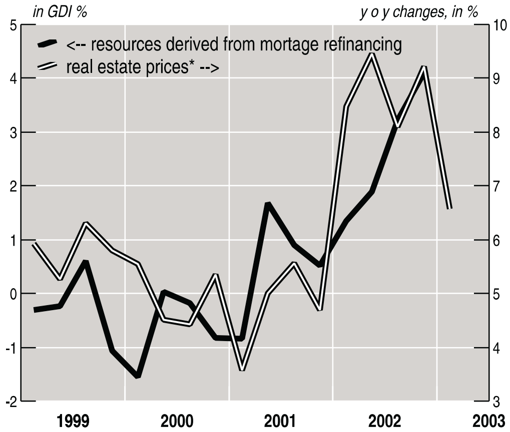
in %



source : FRB, Department of Treasury, Moody's investors

7

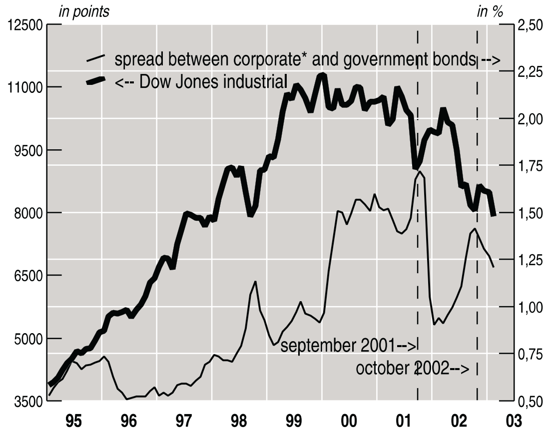
RESOURCES DERIVED FROM MORTAGE REFINANCING AND REAL-ESTATE PRICES



sources : FRB, NAR et BEA
**average selling prices of existing houses*

8

STOCK-MARKET INDEX AND SPREAD BETWEEN CORPORATE BONDS AND GOVERNMENT BONDS



source : WEFA, FRB
**for firms rated AAA*

Since the end of 2002, companies' financing conditions have been gradually easing. The risk premium paid by firms for obtaining finance on the bond market is in fact starting to decline from the high level reached at the time of the 2002 stock-market shock *(see graph 8)*. In 2003, investment is nevertheless likely to pick up only modestly (by 1.2% and 1.4% in Q1 and Q2 2003, compared with 0.6% in Q4 2002) and stocking behaviour is not likely to be more than slightly positive, given that capacity utilisation rates remain low *(see graph 1)*. Firms are likely to continue to invest in the new technologies in order to raise productivity, but not to raise other than very slowly their investment aimed at increasing productive capacity.

Turning to the household sector, housing investment is likely to remain fairly brisk in 2003 (+0.7% and +1.5% in Q1 and Q2 2003, compared with +2.2% in Q4 2002). This growth is nevertheless likely to slow down, given that mortgage rates would no longer be falling. Furthermore, the poor weather conditions experienced in February will probably have affected housing investment in Q1.

Following the rise in the oil price, imports are likely to increase less rapidly. This rise has been having a direct negative impact on imports of energy and an indirect impact on other imports because of the decline in consumption. The slower growth in imports would in the short term compensate for the negative impact on GDP of the slowdown in household demand *(see box)*. This means that the weakness of GDP growth compared to its potential would result, in the first place, from persistent negative wealth effects and the smaller fiscal stimulus in the early part of the year.

The external environment can be expected gradually to become more favourable to growth. American exports, affected in Q1 2003 by the slackness of demand in the euro zone and its slowdown in the United Kingdom, should benefit from the revival in trade with North America and Asia and from the depreciation of the dollar.

As for public spending, this should continue to rise fairly strongly because of the military spending committed for the war in Iraq.

Private and public consumption the main growth motors for the United Kingdom in 2002

The United Kingdom economy grew by 1.6% in 2002, the lowest annual figure since 1992. This weakness is due to an unsupportive international environment, especially in the case of the euro zone. As a result, exports dropped by 1.4% in 2002 whereas imports rose by 1.2%, boosted mainly by the strength of private consumption. All in all, external trade made a negative contribution of 1 point to United Kingdom GDP growth.

The weakness of economic activity is also explained by the drop in investment (down 4.5%). Corporate investment fell by 10% as a result of the weakness of industrial activity, which was particularly depressed throughout the year, but it was also affected by the deterioration in financing conditions in the second half of the year. Meanwhile, public investment rose by 18%.

Despite the global slowdown, economic activity in the United Kingdom remained relatively firm in relation to that of the euro zone in 2001 and 2002 *(see graph 9)*.

United Kingdom growth was to a large extent stimulated by household consumption, which remained very brisk in 2002 (rising by 3.9%). For one thing, the steep rise in house prices encouraged borrowing, since property is regularly used by UK households as loan security *(see graph 10)*. For another, the low level of monetary interest rates — 4.0% throughout 2002, down from 6.0% at the beginning of 2001 — consolidated UK households' financial situations. Households in fact carry a very high debt ratio and most of this is at variable rate. This means that any lasting decline in interest rates reduces the debt burden. The low level of interest rates and the rise in house prices enabled consumption to remain dynamic in H2 2002, despite the negative wealth effects linked to the slump on the stock market.

Public consumption was also a substantial support factor for growth. Public spending rose by 4.2% in 2002, faster than at any time since 1975.

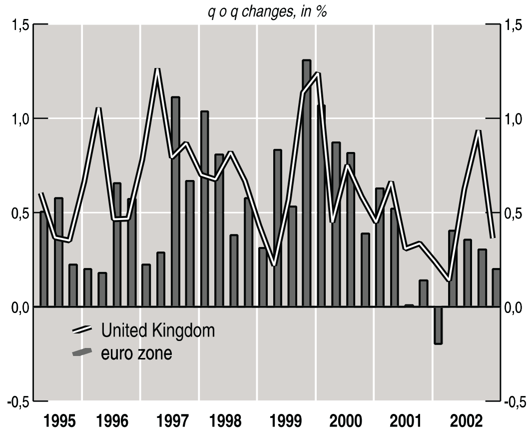
In 2003, the slowdown in private consumption should be gradually offset by a slight upturn in exports and investment

Household consumption can be expected to ease back in H1 2003, mainly because of the slowdown in household income. There has already been a noticeably steep reduction in the growth in real earnings *(see graph 11)*. Earnings have in fact been affected by a slowdown in nominal wages. The labour market underwent a restructuring in the last part of 2002, with part-time working in the general government sector tending to replace full-time jobs in industry and finance. As a result, average earnings per head have been declining because of the fall in the number of hours worked but also because the jobs created in the general government sector pay less well than those in the financial sector. Real earnings also suffered from the rise in inflation. The rise in energy prices can be expected to have an adverse effect on inflation in H1 2003, thus reducing household pur-

9

UNITED KINGDOM AND EURO ZONE GDP

q o q changes, in %

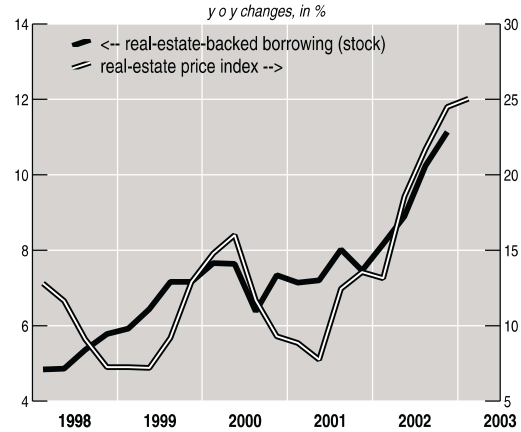


sources : ONS et Eurostat

10

REAL-ESTATE-BACKED BORROWING AND REAL-ESTATE PRICE INDEX

y o y changes, in %

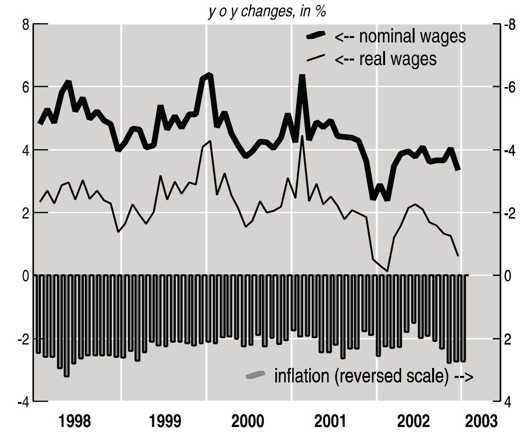


sources : ONS et Nationwide Building Society

11

INFLATION AND REAL WAGES

y o y changes, in %



source : ONS

chasing power. This reduction would be all the greater in that healthcare contributions are due to rise in April.

In these circumstances, household consumption will in all likelihood slow down. Retail sales in January were already 1% down in volume terms on the previous month. House purchases can be expected to follow the same tendency, with the result that the growth in house prices should ease back to 10% in 2003 from 26% in 2002, according to the forecasts from the Nationwide Building Society. The growth in the resources derived by households from mortgage financing would then also be less dynamic and this mechanism would accentuate the slowdown in consumption.

Meanwhile, public consumption will probably maintain a dynamic growth rate, in line with the objectives announced by the government, notably concerning the restructuring of the health service and the education system.

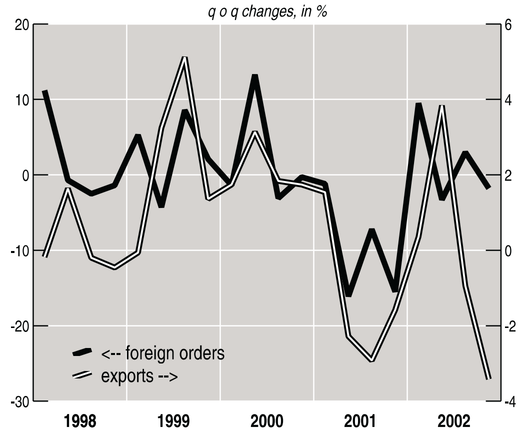
The slowdown in domestic demand would be partly cushioned by the ending of the decline in investment as of Q2 2003. With the deterioration in lending conditions coming to a halt, investment growth would turn positive again (+0.5%) as of Q2, marking the beginning of a new investment upswing. However, this upturn would still be precarious: for one thing, the capacity utilisation rate remains low; for another, the expected slowdown in domestic demand and the political uncertainties are having a negative impact on firms' expectations and optimism, and this is bound to discourage massive investment.

Given the slackness of growth in the euro zone, export growth seems set to remain slightly negative in Q1 2003. This tendency seems to find confirmation in the business surveys, showing that export prospects and overseas order books have deteriorated slightly *(see graph 12)*. The revival in American activity in the early part of 2003 should, after a certain time lag, have an impact on the foreign trade of United Kingdom and the euro zone. As a result, export growth should turn positive again as of Q2, although remaining at relatively low levels because of the moderate scale of the recovery in the European economy.

12

FOREIGN ORDERS AND EXPORTS

q o q changes, in %

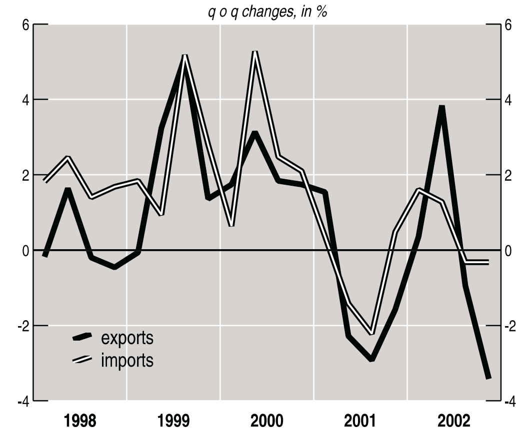


source : ONS

13

EXPORTS AND IMPORTS OF GOODS AND SERVICES

q o q changes, in %



source : ONS

Growth in imports, largely dependent on the level of total demand, and especially of exports *(see graph 13)*, is likely to be negative in Q1 2003 before turning positive again in Q2.

All in all, the contribution from foreign trade, which was strongly negative in 2002, should be less of a millstone for growth in H1 2003. ■

The economic situation in the euro zone

Euro-zone GDP rose at only a very moderate pace in 2002, i.e. by 0.8%. The main cause of this weak growth lay in the slackness of domestic demand, which contributed no more than 0.2%.

In Q1 2003, domestic demand in the euro zone is expected to remain lifeless and GDP to stagnate. At the end of Q2, activity could pick up again slightly, this upturn being perceptible in the main economies of the zone.

An upturn in activity in the early part of 2002, thanks to a more supportive external environment

In manufacturing industry, there was an appreciable improvement in the business climate as of the end of 2001. The production outlook revived markedly in the main economies of the euro zone in January 2002 *(see graph 1)*. The improvement in the zone's international environment, starting in Q1, probably in part explains the recovery in business leaders' expectations. In Germany and Italy especially, export orders received by manufacturing industry rose sharply in H1 2002, the growth rates being 6.3% for Germany and 6.5% for Italy.

This renewal of confidence on the part of European industrial leaders had positive repercussions on activity. The industrial production index rose in H1 2002 at an annualised rate close to 2.5% *(see graph 2)*. As of Q2, the improvement in the zone's international environment boosted exports, so that after being nil in Q1 export growth was at annualised rates of close to 8% in Q2 and Q3 2002 (see table).

The improved business climate also prompted firms to adopt a less restrictive attitude to stocks. The contribution of inventory changes to GDP growth was therefore positive in H1 2002.

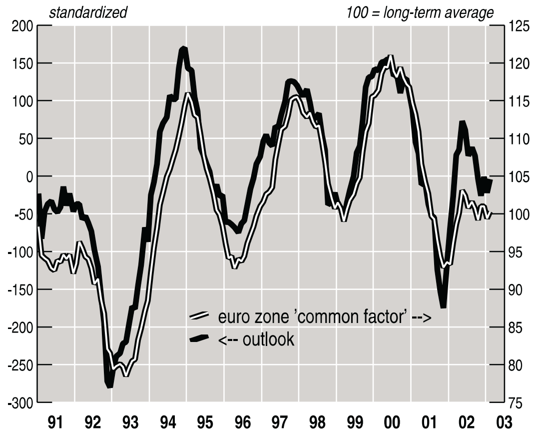
The upturn in expectations helped to reduce the decline in investment in equipment in Q2 and to stabilise it in Q3. Investment in Spain and Italy, in particular, recovered strongly in Q3 (up 2.6% and 3.9%, respectively), preventing a fall in total euro-zone investment. In Italy, the imminent expiry of incentive tax measures may also explain the tendency to invest seen in H2 2002.

However, household demand remained slack during 2002, restricting corporate demand

Private consumption rose by only 0.6% in 2002, showing a marked slowdown compared with 2001. The persistent deterioration of the labour markets explains the weakness of household demand. Employment, after slowing down in the first two quarters of 2002, actually contracted in Q3 and this had an adverse effect on earned income. At the same time, the gradual rise in the unemployment rate, from 8.1% in December 2001 to 8.5% in December 2002 *(see graph 3)*, continued to depress household

1

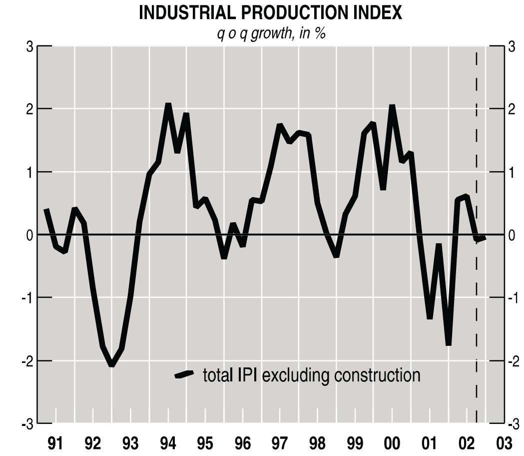
BUSINESS LEADERS' EXPECTATIONS IN THE EURO ZONE MANUFACTURING INDUSTRY



sources : european commission, Insee

2

INDUSTRIAL PRODUCTION INDEX



source : Eurostat

prévision au-delà du pointillé

GDP FOR THE EURO ZONE AND FOR THE MAIN MEMBER COUNTRIES

(annuals and quarterly % change)

	Quarterly changes								Annual changes		
	2001		2002				2003		2001	2002	2003 (c.o)
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2			
GERMANY											
GDP	**-0.2**	**-0.3**	**0.3**	**0.2**	**0.3**	**0.0**	**-0.1**	**0.1**	**0.7**	**0.2**	**0.1**
Imports	-2.2	-0.1	-3.6	1.7	2.1	1.9	0.1	0.1	1.3	-2.1	3.1
Household consumption	-0.2	-0.5	-0.7	0.2	0.4	0.1	-0.1	0.0	1.6	-0.6	0.2
Public consumption	-0.2	0.8	0.7	0.6	0.2	-0.5	0.1	0.1	0.8	1.5	0.1
Total GFCF	-1.7	-1.3	-1.9	-3.5	-0.2	0.8	-0.7	0.1	-4.9	-6.5	-1.0
Exports	0.9	-1.0	0.6	1.2	2.9	0.3	0.3	0.5	5.4	2.7	2.6
Contributions:											
Domestic demand ex. stocks	*-0.5*	*-0.4*	*-0.7*	*-0.5*	*0.2*	*0.1*	*-0.2*	*0.0*	*0.0*	*-1.4*	*-0.1*
Inventory change	*-0.7*	*0.4*	*-0.4*	*0.7*	*-0.3*	*0.3*	*0.0*	*-0.1*	*-0.6*	*0.1*	*0.2*
Foreign trade	*1.0*	*-0.3*	*1.4*	*-0.1*	*0.4*	*-0.5*	*0.1*	*0.2*	*1.4*	*1.6*	*0.0*
FRANCE											
GDP	**0.3**	**-0.3**	**0.7**	**0.4**	**0.3**	**0.2**	**0.3**	**0.3**	**1.8**	**1.2**	**0.9**
Imports	-0.7	-2.9	3.0	1.6	0.6	-0.4	0.9	1.0	0.9	1.2	2.1
Household consumption	0.9	0.2	0.3	0.4	0.6	0.4	0.7	0.3	2.7	1.8	1.7
Public consumption	1.2	0.4	1.2	1.0	0.5	1.1	0.7	0.7	2.5	3.6	2.6
Total GFCF	0.4	-0.5	0.3	-0.1	-0.7	-0.7	-0.4	-0.1	2.6	-0.6	-1.4
Exports	-0.6	-1.8	1.9	1.8	1.6	-0.3	0.5	0.5	1.5	1.5	1.8
Contributions:											
Domestic demand ex. stocks	*0.8*	*0.1*	*0.5*	*0.5*	*0.3*	*0.3*	*0.5*	*0.3*	*2.6*	*1.7*	*1.2*
Inventory change	*-0.5*	*-0.7*	*0.4*	*-0.1*	*-0.3*	*-0.1*	*0.0*	*0.1*	*-1.0*	*-0.6*	*-0.3*
Foreign trade	*0.0*	*0.3*	*-0.2*	*0.1*	*0.3*	*0.0*	*-0.1*	*-0.1*	*0.2*	*0.1*	*0.0*
ITALY											
GDP	**0.1**	**-0.1**	**0.0**	**0.2**	**0.3**	**0.4**	**0.1**	**0.2**	**1.8**	**0.4**	**0.7**
Imports	-4.0	-0.4	-0.6	3.7	2.4	2.1	0.1	0.5	1.0	1.5	4.2
Household consumption	-0.4	0.1	-0.3	0.2	0.8	1.0	0.2	0.2	1.0	0.4	1.4
Public consumption	0.6	0.8	0.6	0.2	0.1	-0.6	0.3	0.3	3.5	1.7	0.1
Total GFCF	-0.2	-0.5	-1.5	0.5	2.8	2.1	-0.7	0.2	2.6	0.5	1.7
Exports	-3.2	-0.2	-3.9	5.2	3.3	-0.1	0.3	0.5	1.1	-1.0	4.3
Contributions:											
Domestic demand ex. stocks	*-0.1*	*0.1*	*-0.4*	*0.3*	*1.1*	*0.9*	*0.0*	*0.2*	*1.8*	*0.7*	*1.2*
Inventory change	*0.0*	*-0.3*	*1.3*	*-0.5*	*-1.0*	*0.1*	*0.0*	*-0.1*	*0.0*	*0.4*	*-0.6*
Foreign trade	*0.2*	*0.1*	*-1.0*	*0.4*	*0.3*	*-0.6*	*0.1*	*0.0*	*0.1*	*-0.7*	*0.1*
SPAIN											
GDP	**1.0**	**0.1**	**0.5**	**0.5**	**0.8**	**0.3**	**0.2**	**0.4**	**2.7**	**2.0**	**1.3**
Imports	-1.7	0.9	-0.8	-0.1	4.2	4.0	0.2	0.5	3.5	2.2	5.6
Household consumption	0.4	0.7	0.3	0.3	0.2	1.0	0.1	0.3	2.5	1.9	1.2
Public consumption	0.9	0.9	1.1	0.8	0.8	1.2	0.8	0.8	3.1	3.8	2.9
Total GFCF	0.8	-1.5	0.8	1.0	1.4	-0.6	0.3	0.3	3.2	1.4	0.9
Exports	0.0	-0.6	-2.3	1.4	5.9	1.1	0.8	0.6	3.4	1.4	5.3
Contributions:											
Domestic demand ex. stocks	*0.6*	*0.2*	*0.6*	*0.6*	*0.6*	*0.6*	*0.2*	*0.4*	*2.8*	*2.1*	*1.4*
Inventory change	*-0.2*	*0.3*	*0.4*	*-0.5*	*-0.2*	*0.7*	*-0.2*	*0.0*	*0.0*	*0.1*	*0.1*
Foreign trade	*0.6*	*-0.5*	*-0.4*	*0.4*	*0.4*	*-1.0*	*0.2*	*0.0*	*-0.1*	*-0.3*	*-0.2*
ZONE EURO											
GDP	**0.1**	**-0.2**	**0.4**	**0.3**	**0.4**	**0.2**	**0.0**	**0.2**	**1.4**	**0.8**	**0.6**
Imports	-1.2	-0.8	-1.0	1.5	1.8	0.6	0.3	0.5	1.5	-0.3	2.4
Household consumption	0.2	0.0	-0.2	0.4	0.4	0.4	0.2	0.1	1.8	0.6	0.7
Public consumption	0.2	0.6	0.7	0.9	0.3	0.5	0.4	0.4	2.1	2.5	1.5
Total GFCF	-0.7	-0.9	-0.2	-1.3	-0.2	-0.1	-0.5	0.2	-0.6	-2.5	-0.8
Exports	-0.1	-1.2	0.2	1.7	2.1	0.0	0.2	0.6	2.8	1.2	2.1
Contributions:											
Domestic demand ex. stocks	*0.0*	*-0.1*	*0.0*	*0.1*	*0.3*	*0.3*	*0.0*	*0.2*	*1.3*	*0.3*	*0.6*
Inventory change	*-0.3*	*0.0*	*0.0*	*0.1*	*0.0*	*0.1*	*0.0*	*0.0*	*-0.4*	*-0.1*	*0.0*
Foreign trade	*0.4*	*-0.2*	*0.4*	*0.1*	*0.2*	*-0.2*	*0.0*	*0.1*	*0.5*	*0.6*	*0.0*

Forecast
Last update : March 10th 2003

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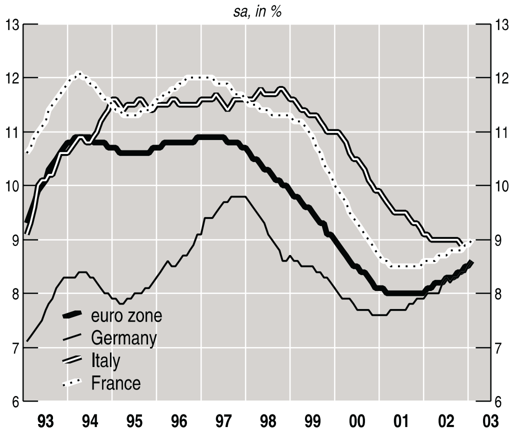
UNEMPLOYMENT RATE

sa, in %



source : Eurostat

confidence, which showed a distinct decline starting in June. All the countries in the zone have been confronted with the same situation, apart from Italy. However, Germany seems to have suffered more than the rest, with employment falling by 0.9% in the course of the year. The deterioration on the German labour market has had repercussions for household consumption expenditure, which made a negative contribution to GDP growth in 2002 (0.4 of a point).

The lacklustre growth in private consumption for the year as a whole nevertheless tends to mask a pattern of recovery as the year went on. Private consumption picked up appreciably as of Q2, when it posted a growth rate of 0.4%. In this, it was helped by, among other things, the slowdown in inflation, from 2.7% in January to 1.8% in June.

In Q3, exceptional measures aimed at boosting household income added to this phenomenon: cuts in income tax in France, substantial payment of family benefits in Germany.

In Q4 2002, private consumption in the euro zone was maintained at the rates already recorded in Q2 and Q3 (+0.4%). However, had it not been for the one-off support for household consumer spending in Italy there would probably have been a slight slowdown. The wage restraint seen in Q4 and the weakening of household confidence linked to the persistent rise in unemployment in all the countries had in fact heralded a slowdown in household spending in the euro zone. In Italy, the acceleration in private consumption can be explained by the very brisk sales of cars in Q4 (up 11.2%), following the introduction of measures to help the car sector that were introduced by the government in July: tax exemptions, abolition of annual licences for three years for the purchase of small cars before the end of 2002. Anticipation of the expiry of these aids prompted Italians to make very substantial purchases of cars.

The economic situation deteriorated in Q3 2002, with the emergence of uncertainties regarding the external environment and financial conditions

Starting in the summer, the euro zone's external environment deteriorated, as shown by the marked slowdown in imports to the United States. Within the zone, the opinions regarding export orders recorded in the business surveys weakened. In Germany and Italy, export orders received by manufacturing industry fell in Q3.

At the same time, financial conditions hardened following the accounting scandals in the United States. Stock markets posted sharp falls in Q3, with the Eurostoxx 50 index falling by 20%.

The emergence of these uncertainties led in most countries in the zone to a distinct deterioration in the production outlook for manufacturing industry starting in June. While industrial production stabilised in Q3 2002, the deterioration in the economic climate affected GDP growth mainly in Q4 (a rise of just 0.2%). During this quarter, European export stagnated after rising sharply in Q2 and Q3. Investment again fell back slightly, still handicapped by the weakness of household demand.

The slowdown in growth in Q4 was to be seen in the leading economies of the euro zone. In Germany, activity showed no increase at all. In Italy, however, the imminent expiry at the end of the year of exceptional measures in favour of productive investment (the "Tremonti-bis" law) and the strong car sales had the effect of once more boosting domestic demand and hence sustaining GDP growth in Q4 (+0.4%).

GDP likely to stagnate in Q1 2003 because of weak domestic demand and the rise in the euro

In Q1 2003, consumption is likely to remain handicapped by the low growth in disposable income against a background of a depressed labour market, with total employment growth fading to nothing. Moreover, household purchasing power is likely to be eroded by the acceleration in inflation linked to the sharp rise in oil prices seen since November. In Spain and Italy, this phenomenon would come on top of the very sharp price rises already seen since the beginning of 2002 (year-on-year rates of 3.7% and 2.9%, respectively, in January 2003). Taken on its own, however, the rise in the oil price should have only a small effect on GDP growth in the euro zone in the short term. This is because the negative impact on private consumption would be offset by a negative effect on imports of much the same size (see special article "The contribution of a macroeconomic model to short-term analysis of the economic situation in the euro zone").

Consumption is likely also to be affected by the deterioration in household confidence in Q1 2003 *(see graph 4)*. Rising unemployment and uncertainties connected with war in Iraq have had a damaging impact on household morale in recent months.

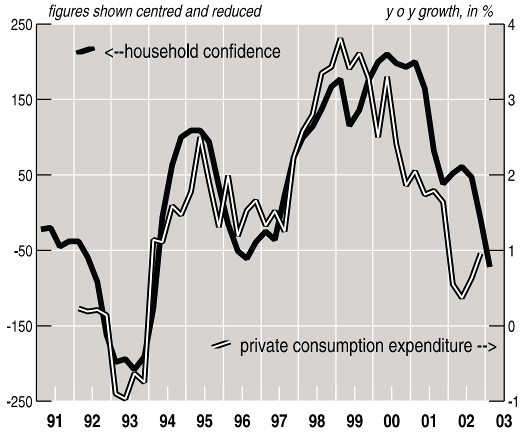
All in all, private consumption can be expected to slow down in Q1 2003, rising by 0.2%, compared with 0.4% in Q4 2002. In Germany, increased social insurance contributions, higher taxes on energy and the job losses seen at the end of 2002 will probably depress private consumer spending more than in the other euro-zone countries, with private consumption likely to fall by 0.1% in Q1. In Italy, the rapid inflation and the tax hikes expected following the government's announcement of a reduction in the budget deficit would outweigh the positive impact of the tax cuts planned for 2003.

The persistent weakness of domestic demand, intensified by the slowdown in private consumption, is likely to continue to curb corporate demand and investment in Q1 2003. Business surveys in manufacturing for February have reported a further deterioration in the outlook for activity, with a growing proportion of business leaders regarding their productive capacity as adequate in relation to demand. Moreover, despite the low level of real interest rates, investment is likely to continue to suffer from the past tightening of financial conditions following the sharp falls in stock-market prices in 2002. As a result, total investment is expected to fall by 0.5% in Q1, after falling by 0.1% in Q4. In Italy, investment would in addition feel the backlash of the ending of the beneficial effects of the "Tremonti-bis" law.

Finally, exports seem set to remain depressed. The euro zone's external environment has in fact been less supportive since Q3 2002, with imports slowing down in both the United States and United Kingdom. Moreover, the steady appreciation in the euro's exchange rate since Q2 2002 can be expected to have a negative impact on the price-competitiveness of European exports. As a result, exports are expected to rise by only 0.2% in Q1, after showing no rise at all in Q4 2002.

4

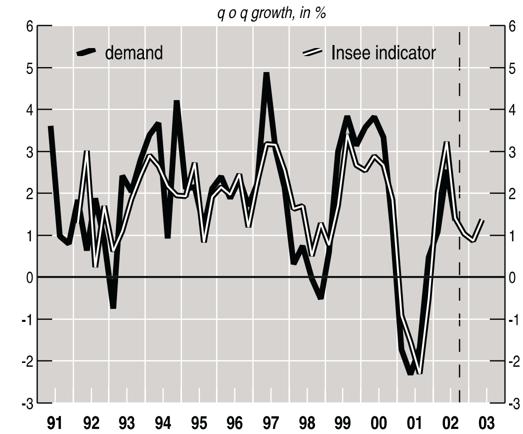
EURO ZONE : HOUSEHOLD CONFIDENCE AND PRIVATE CONSUMPTION EXPENDITURE



source : european commission, Eurostat

5

DEMAND IN EURO ZONE OVERSEAS MARKETS



source : Direction de la prévision, Insee

forecasts after the dotted line

The second quarter is likely to see a recovery, thanks to a more supportive external environment and an easing of borrowing conditions

GDP is expected to rise by 0.2% in the euro zone in Q2 2003. After being sluggish in Q1, the zone's international environment is likely gradually to become more supportive, starting in Q2 *(see graph 5)*. Even so, the appreciation in the euro can be expected to have an adverse effect on European exports, which are not likely to pick up more than slightly.

The gradual easing of borrowing conditions should help to bring about a moderate recovery in productive investment. However, investment will probably remain handicapped by the slackness of household demand and the past weakness of export demand. In Italy, investment would in addition be helped by tax measures, notably a two-point cut in corporation tax starting on 1 January 2003. In addition, public investment would be boosted by the implementation of electoral promises concerning the modernisation of state infrastructure.

Finally, private consumption is likely to remain handicapped by the persistent slackness of employment and by the negative impact on household purchasing power of the rise in the oil price. Private consumer spending is expected to rise in Q2 at the same slower rate posted in Q1 (0.1%).

The upturn in activity in Q2 2003 is likely to differ from one euro-zone country to another. In Germany, activity will probably remain depressed during the period, with GDP stagnating after falling by 0.1% in Q1. In Italy, activity should pick up again slowly in Q2 because of a gradual improvement in domestic demand. In Spain, the improvement in European growth and the easing of financial constraints should enable GDP growth to pick up more appreciably, by 0.4% in Q2 2003. ■

Consumer prices in the euro zone

The rise in oil prices during the winter has led to a continuation of the upturn in inflation in the euro zone, amounting to +2.4% in February 2003, up from a low of +1.8% in June 2002.

However, these figures mask an ebbing of core inflation, which during the same period fell from 2.4% to 1.9%. Given the acceleration in prices of manufacture products, core inflation is expected to level out in H1 2003 (standing at 1.9% in June).

Assuming a Brent price of close to USD 30/barrel and a stable exchange rate for the euro of 1.08 USD, inflation in the euro zone is likely to continue to rise slowly because of the strength of energy prices and the slight acceleration in food prices. The year-on-year figure for June 2003 is expected to be 2.5%.

In the last part of 2002, the fall in core inflation was masked by the rise in energy prices

Inflation in the euro zone has risen by 0.6 of a point since mid-2002, rising from a year-on-year growth rate of 1.8% in June to 2.4% in February 2003. This upturn was largely brought about by the rise in the oil price from 24 to 32 USD per barrel during this period. This meant a further increase in the year-on-year rise in energy prices during the winter, making a larger-than-expected contribution [1] to the rise in the overall inflation (adding 0.9 of point between June 2002 and February 2003).

This phenomenon masked the decline in core inflation [2], which fell from 2.4% in June 2002 to 1.9% in February 2003. This was because the past slowdown in industrial producer prices continued to generate a slowdown in consumer prices of manufactured products during the winter. Prices for this product grouping account for the bulk of the decline in core inflation over this period, contributing -0.25 of a point to the variation in overall inflation. Prices of services made only a marginal contribution (-0.1 of a point), because of the continuing impact of the past strong rise in wages in the euro zone.

Food prices again slowed down slightly this winter, thanks to a favourable base effect. The bad weather conditions at the end of 2001 had led to sharp rises in

(1) The forecasting exercise carried out in December 2002 assumed that the Brent price would remain stable at USD 25/barrel, while it exceeded 30 USD from the beginning of 2003 onwards.
(2) Measured as the year-on-year change in the HICP excluding energy, food, alcohol and tobacco.

EURO ZONE INFLATION

(year on year % growth of HICP)*

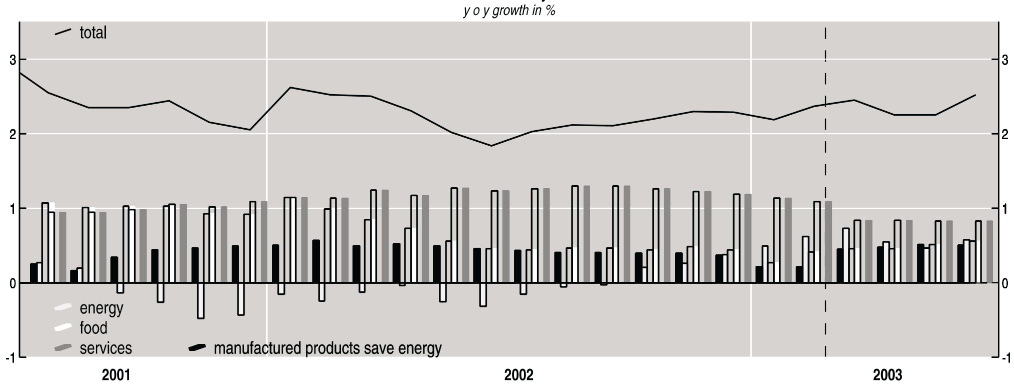
Sectors (weight in the index)	February 2002	June 2002	February 2003	June 2003
Food (15.5%)	5.1	1.9	1.3	1.9
Beverage and Tobacco (3.8%)	3.7	4.1	5.6	6.3
Clothing and footwear (7.6%)	2.7	2.3	0.5	0.1
Housing. water. electricity and gas (14.9%)	1.3	0.7	2.8	3.3
Furnishings and household equipment (7.9%)	1.9	1.7	1.3	1.1
Health (3.9%)	2.1	2.3	2.6	2.3
Transports (15.3%)	0.5	0.5	4.4	3.8
Communications (2.9%)	-0.6	0.0	-1.1	-1.7
Leisure and culture (9.7%)	1.6	1.5	0.5	0.9
Education (0.9%)	3.7	3.8	3.7	3.8
Hotels-cafés-restaurants (9.5%)	4.4	4.7	3.5	3.6
Miscellaneous goods and services (8.1%)	3.0	2.9	3.0	2.9
Total (100.0%)	**2.5**	**1.8**	**2.4**	**2.5**
Food (Beverage and Tobacco) (19.3%)	**4.8**	**2.3**	**2.1**	**2.9**
Energy (8.2%)	**-2.9**	**-3.5**	**7.6**	**7.0**
Core inflation (72.5%)	**2.5**	**2.4**	**1.9**	**1.9**
of which: Manufactured products(31.6%)	*1.8*	*1.4*	*0.7*	*1.6*
Services (40.9%)	*3.1*	*3.2*	*2.7*	*2.0*

Forecast
* Harmonized Index of Consumer Prices
Source: Eurostat

Consumer prices in the euro zone

1

BREAKDOWN OF INFLATION IN THE EURO ZONE
contribution of major items
y o y growth in %



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BOX : PRICE TENDENCIES IN THE EURO ZONE BECOMING MORE HETEROGENEOUS

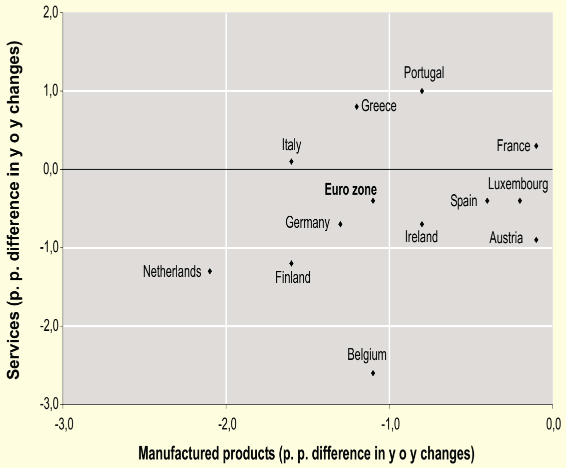
Over the past year, core inflation in the euro zone has been declining, standing at 1.9% in February 2003 compared with 2.5% in February 2002. However, this decline was not universally recorded in all the euro-zone countries. In Portugal, for example, there was no decline in core inflation over this period [(1)]. The maximum inflation differential widened from 3.2 to 3.8 points.

This wider dispersion is to be seen in the light of the evolution in core inflation and in its two principal components: services and manufactured products. Prices of services have been accelerating in the past year in the «Latin» countries (Italy, Portugal, Greece and France — *see graph*), offsetting disinflation in the manufacturing sector. This dynamism in prices of services has fuelled the continuing firmness of core inflation. In contrast, Germany, Austria, Finland and Belgium saw the slowdown in the price of services amplify the decline in core inflation, which now stands below 1.5% in these four countries.

The case of the «small dynamic economies» (Ireland and the Netherlands) has to be looked at separately: for these two countries, the year 2002 was essentially a period of absorption of the impact on inflation of the oil-price shock in 2000. ■

(1) This is also true of France, but the situation here is exceptional, with the effects disappearing in March. The price index posted a larger rise than usual in February, because this year the sales were concentrated on January and had no downward impact on the index in February.

INFLATION IN THE EURO-ZONE COUNTRIES
Variation between February 2002 and February 2003



source : Eurostat

Euro zone inflation by countries

(year on year % growth of HICP)*

	Inflation		Core inflation	
	Feb. 2002	Feb. 2003	Feb. 2002	Feb. 2003
France	2.3	2.5	1.9	2.0
Germany	1.7	1.3	1.6	0.6
Italy	2.7	2.6	3.0	2.4
Spain	3.2	3.8	3.5	3.2
Netherlands	4.5	3.2	4.5	2.9
Belgium	2.5	1.6	3.0	1.1
Austria	1.7	1.8	2.1	1.5
Finland	2.5	2.1	2.8	1.5
Portugal	3.3	4.1	4.2	4.2
Ireland	4.9	5.1	5.5	4.7
Luxembourg	2.2	3.2	2.4	2.1
Greece	3.9	4.2	3.5	3.3
Euro Zone	**2.5**	**2.4**	**2.5**	**1.9**
United Kingdom	1.5	n.d.	1.6	n.d.
Sweden	2.7	3.3	2.3	1.7
Denmark	2.4	2.9	2.7	2.8
E.U.	**2.3**	**2.3**	**2.3**	**1.8**

* Harmonized Index of Consumer Prices.
source: Eurostat

prices of seasonal food in the early part of 2002 and these have now dropped out of the year-on-year growth rate calculation. This tendency has been offset by the acceleration in prices of tobacco (higher taxes in France and Germany). All in all, food prices including alcohol and tobacco made a neutral contribution to the acceleration in the overall index between June 2002 and February 2003.

The acceleration in prices of manufactured products means that core inflation can no longer be expected to decline

Consumer prices of manufactured products [3] can be expected, following the usual time lags, to reflect the upward tendency in producer prices seen since November 2002. This means that they would start to accelerate slowly in Q2 2003. In the case of prices of services, wage movements constitute a leading indicator for consumer prices, with an advance of around of 4 to 5 quarters. Since wage growth in the euro zone eased back slightly in Q2 and Q3 2002, prices of services can be expected to follow suit in H1 2003. This decline would then be amplified by the exit from the year-on-year growth rate calculation of the unaccustomed rises recorded in Q1 2002, notably at the time of the euro changeover.

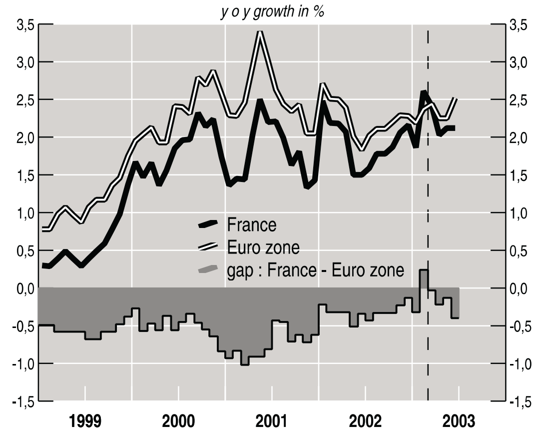
The fact that prices of manufactured products will again be rising more rapidly in Q2 is liable to be compensated by the slowdown in prices of services. The overall result would be that core inflation would remain stable at around its February 2003 level, standing at 1.9% in June 2003.

Inflation set to remain above 2.0% in H1 2003

Assuming a Brent price of close to USD 30/barrel and a stable exchange rate for the euro of 1.08 USD, inflation in the euro zone is likely to continue to rise slowly in Q2 because of the strength of energy prices and the slight acceleration in food prices. The year-on-year figure for June is expected to be 2.5%.

2

HARMONIZED INDEX OF CONSUMER PRICES
France and the Euro zone
y o y growth in %



sources : Eurostat, Insee

forecasts after the dotted line

Taking individual sectors, this increase in inflation of 0.1 of a point between February and June 2003 would be due to a slight acceleration in food prices. The second quarter of 2002 was characterised by moderation in food prices, but the latter should in Q2 2003 resume their usual seasonal tendencies, assuming normal weather conditions. A base effect of the same type but acting in the other direction would operate in the case of energy prices, which in Q2 2002 posted sharp rises linked to the isolated upturn in oil prices in May 2002. The assumption of stability for the oil price at its present level until June 2003 implies in terms of the forecast that these rises will not be repeated at the end of the half-year, the result being a slight downturn in the year-on-year price rise for energy and a neutral contribution to inflation between now and June 2003. ■

(3) The erratic movements recorded in January and February 2003 for this grouping are due to the statistical impact of the change in the timing of the sales in France, which were concentrated on the month of January, unlike the previous year.