The euro zone's international environment

In H1 2001, the sharp slowdown in the American economy is likely to intensify the downturn already expected in the world economy — mainly in Canada and Mexico, emerging Asia and Japan. The other emerging zones (CEECs, Latin America other than Mexico) would initially be relatively sheltered from the direct impact on world trade of developments in the American economic situation.
More than the differences in exposure to international trade flows, the slowdown in world trade is likely to intensify the contrast prevailing between countries with strong and weak domestic demand. For example, the United Kingdom, the CEECs and Latin America would continue to grow at rates barely slower than those seen in Q3 2000. In the Asian countries, which are still suffering from the bursting of speculative bubbles in the 1990s (early 1990 in Japan, 1997-1998 in the rest of Asia), domestic demand has not been able to maintain the upturn begun in 1999-2000.
In the first half of the year, demand in euro-zone export markets in the rest of the world should grow at an annualised rate of 6%, down on the 8% recorded in H2 2000.

United States: stabilisation of expectations the key to recovery

United States growth slowed down sharply to an annualised rate of 1.6% in H2 2000 from 5.2% in H1. This sharp setback is not due to the slowdown in world trade, as the United States is a relatively closed economy, with exports no more than 13% of GDP. Rather, it reflects the running down of the internal motors for American growth, namely, investment and consumption.

The spectacular slowdown in the American economy is partly explained by previous tightenings of monetary policy, which tended to dry up the supply of credit through both the banks and the financial markets in the course of 2000. The rise of 175 basis points in the Fed Funds target rate between the early part of 1999 and May 2000 helped to slow the demand for loans by firms *(see graph 1)*. Simultaneously, the slump on the NASDAQ put an end to the financing facilities granted to new-tech firms. Moreover, these tensions spread to the bond market, meaning that large firms were affected just as much as small. Investment expenditure, which had accounted for a third of the growth in American GDP between 1995 and 1999 therefore ceased to act as a driving force at the end of 2000. The growth rate for investment in plant and machinery fell from an annualised 20% in Q1 to an actual decline of 3.5% in Q4.

Similarly, the tightening of monetary conditions helped to limit the financing opportunities as regards private consumption, the other driving force behind American growth. Moreover, the fading of the wealth effect and its later reversal following the stock-market correction last March, is now holding back consumption growth, especially as American households no longer have any appreciable savings they can draw on. These limitations have been combined with a slowdown in income growth. Job creations were equivalent to 0.5% of total employment in H2, as against 1.2% in H1, while at the same time the oil shock was eroding the purchasing power of American wage-earners. The combination of these tendencies led to a substantial slowdown in consumption growth, from roughly 5% a year in H1 2000 to 3.5% in H2.

The levelling off of domestic demand (investment and consumption) which is at the origin of the slowdown in American activity is likely to persist at least in the short term and to bring about virtual stagnation in H1 2001. As of January, the Fed reacted sharply by cutting its leading rates by 100 basis points in less than a month. It has since cut rates by a further 50 basis points on 20 March. The supply of credit should therefore soon ease, inasmuch as the banks' income accounts are relatively healthy at the moment. Already, the fall in long-term interest rates seen last autumn, brought about by the prospect of a slowdown, has permitted something of a rally in the building sector. Even though the recent expansion seems to have weakened the balance sheets (and hence the lending capacity) of lending establishments, these still have very few bad loans on their books. As a result, the deterioration in firms' financing conditions has not extended beyond the immediate impact of the tightening of monetary policy *(see graph 2)*, suggesting that the banks do not regard borrower risk as being greater than in 1995. At present, the default rate on industrial and commercial credits is stable at around 2%, as against 5.5% at the end of the 1980s. The share of loans in bank assets remains in line with its average for the 1990s as regards the domestic banks. It seems in fact that it is foreign banks that have most increased their exposure in the recent past *(see graph 3)*.

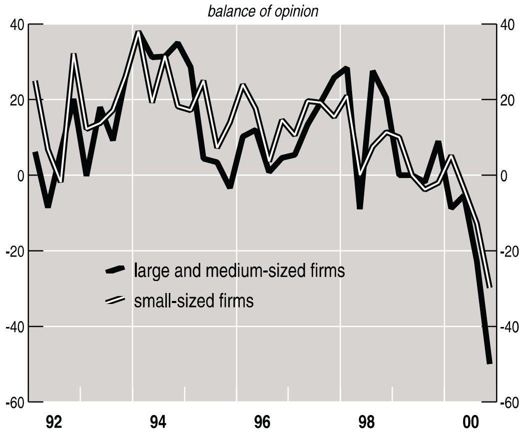
Even so, the liability side of American banks' balance sheets has tended to weaken somewhat throughout the decade. The risk of a mild credit crunch, a scenario in which the banks would allocate their own resources primarily to reconstituting more solid balance sheets, cannot therefore be totally ruled out. The share of deposits, which constitute the most reliable counterpart for bank lending, has steadily declined since 1992 *(see graph 4)*, being replaced by bond issues or borrowing from other lending establishments, in the United States or abroad. The increasing fragility of the banks is reflected in the significant downgrading of their credit ratings by agencies during the 1990s.

However, a financial crisis remains unlikely and the American financial system is probably not an obstacle to a recovery in American activity in the short term. The danger would be greater if the current stagnation, should it last too long, were to generate a rapid increase in loan payment defaults. A rapid acceleration in activity probably depends directly on economic agents' expectations. It will be recalled that in the early part of the 1990s the slowness of the recovery, which had led to extremely sluggish domestic demand for almost two years, was explained by the persistent pessimism of households and firms[1]. Conversely, in 1995 and 1998, the American economy had stood up well to the consequences

(1) See, for example, Olivier Blanchard ("What Caused the Last Recession?", American Economic Review, May 1993).

1

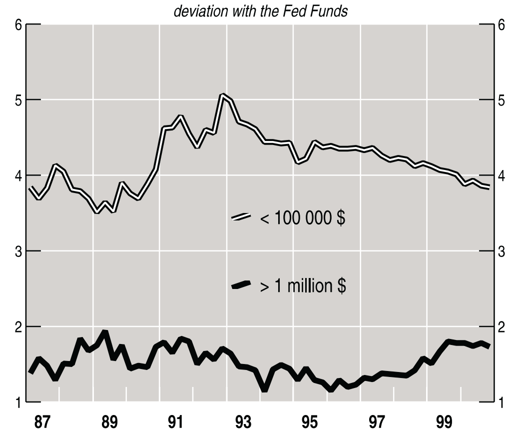
EVOLUTION IN THE DEMAND FOR LOANS
balance of opinion



source : Federal Reserve, survey of agency directors

2

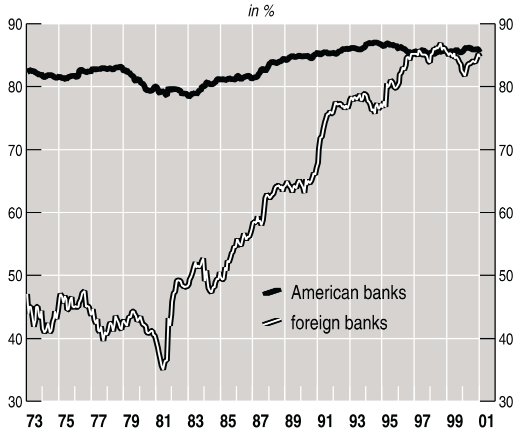
INTEREST RATES AGREED ON BANK LOANS
deviation with the Fed Funds



source : Federal Reserve

3

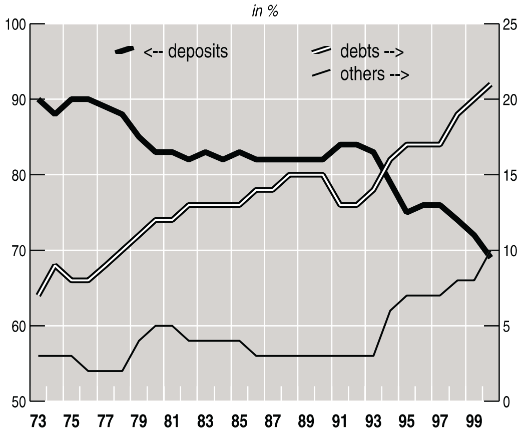
SHARE OF LOANS IN THE ASSET OF UNITED-STATES BANKS
in %



source : Federal Reserve

4

LIABILITIES OF AMERICAN BANKS
in %



source : Federal Reserve

of the Mexican and Asian crises, at a time when consumer confidence remained firm in the face of the temporary pessimism shown by business leaders *(see graph 5)*. Starting last autumn, consumer confidence slumped, with the size of the decline recorded in January larger than any seen since 1990. This steep drop is all the more worrying in that it was preceded by a collapse in business leaders' optimism. In contrast to consumer confidence, which remains relatively high, purchasing managers' confidence levels are now practically back to their low point of 1991, suggesting that the manufacturing sector — which accounts for roughly 11% of GDP but plays a much more important bellwether role in the economy — is now currently in recession. It is therefore in the first place the weakness of investment that could hamper an upturn in domestic demand. The technology, media and telecommunications (TMT) firms have not generated profits on the expected scale, while the new technologies they are responsible for do not at present seem to be generating significant productivity gains outside the manufacturing sector[2].

(2) See, on this subject, the critical study by Robert Gordon (Journal of Economic Perspectives, autumn 2000).

GDP IN OTHER REGIONS OF THE WORLD

(Annual % changes)

	Annual averages		
	1999	2000	2001
Countries in transition	3.1	6.2	5.6
Russia	3.2	7.4	6.0
Central Europe	3.0	4.1	3.9
Emerging Asia[1]	5.2	6.7	3.5
Latin America[2]	0.9	4.3	3.5

Forecast

(1) Korea, Hong Kong, Indonesia, Malaya, Philippines, Singapore, Taiwan, Thailand.

(2) Argentina, Brazil, Chile, Mexico, Venezuela.

Source: Direction de la Prévision

GDP IN LEADING INDUSTRIALISED COUNTRIES OUTSIDE THE EURO ZONE (SHARE OF COUNTRIES IN OECD TOTAL)

(Annual and half-yearly % change)

Annual average				Half-yearly % change		
				2000		2001
1999	2000	2001		H1	H2	H1
			UNITED STATES (34.0%)			
4.2	5.0	1.7	GDP	2.6	0.8	0.4
10.7	13.7	4.4	Imports (16%)	7.2	4.1	0.5
5.3	5.3	2.2	Private consumption (68%)	2.6	1.8	0.8
3.3	2.8	2.7	Public consumption (17%)	0.9	0.4	1.6
9.2	9.2	1.3	Total private GFCF (17%)	6.6	0.4	0.2
2.9	9.2	4.8	Exports (13%)	4.9	2.2	2.2
5.7	*5.7*	*2.2*	*Contributions[2]: Domestic demand excluding stocks*	*3.1*	*1.3*	*0.9*
-0.4	*0.2*	*-0.4*	*Stock change*	*0.0*	*-0.2*	*-0.5*
-1.2	*-1.0*	*-0.1*	*Foreign trade*	*-0.6*	*-0.5*	*0.1*
			JAPAN (17.2%)			
0.8	1.7	1.5	GDP	2.6	0.2	1.1
2.9	8.8	5.4	Imports (11%)	4.3	5.8	2.1
1.2	0.7	1.1	Private consumption (59%)	2.1	-0.6	0.6
4.0	3.4	1.5	Public consumption (9%)	2.2	1.4	0.6
-0.8	1.7	2.9	Total private GFCF (29%)	1.5	2.6	2.5
1.3	12.0	3.9	Exports (14%)	8.4	0.8	1.0
1.1	*1.4*	*1.6*	*Contributions[2]: Domestic demand excluding stocks*	*1.9*	*0.6*	*1.1*
-0.2	*0.0*	*-0.1*	*Stock change*	*0.3*	*0.0*	*0.0*
-0.1	*0.5*	*0.0*	*Foreign trade*	*0.5*	*-0.4*	*0.0*
			UNITED KINGDOM (5.6%)			
2.2	3.1	2.5	PIB	1.4	1.2	1.2
7.6	9.1	6.8	Importations (34%)	4.5	3.5	3.0
4.4	3.9	3.1	Private consumption (63%)	1.7	1.7	1.4
3.3	3.4	4.1	Public consumption (19%)	2.5	1.7	1.7
6.1	1.6	2.2	Total private GFCF (18%)	-0.1	-0.1	1.6
3.3	7.6	5.5	Exports (31%)	4.3	2.7	2.5
4.6	*3.5*	*3.3*	*Contributions[2]: Domestic demand excluding stocks*	*1.5*	*1.5*	*1.6*
-0.7	*0.6*	*0.0*	*Stock change*	*0.3*	*0.1*	*0.0*
-1.6	*-0.9*	*-0.8*	*Foreign trade*	*-0.3*	*-0.4*	*-0.3*

Forecast

(1) Variation between the last quarter of the current half-year and the last quarter of the previous half-year.

(2) It might happen, for statical reasons, that the sum of the contributions does not exactly match the GDP variation at a given date.

Source: Direction de la prévision

Lastly, consumption can be expected to experience difficulties in playing the driving-force role it did until mid-2000, given that no appreciable improvement in growth in household consumption is expected in 2001. Job creation is likely to continue to slow down, while real wages are unlikely to pick up. In fact, despite the slowdown in activity, inflation is likely to ease only slowly. The fall in oil prices would be largely offset by an acceleration in the underlying index, fuelled by unit wage costs.

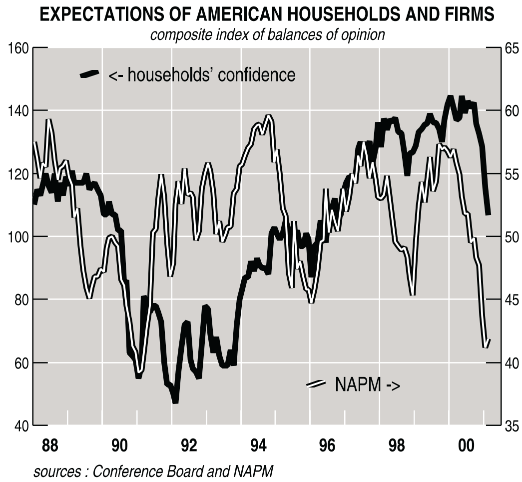
In all, as the result of the weakness of domestic demand, the economy will be close to stagnation in H1 2001. Because of weaker imports and a slight fall in the dollar, the external contribution to growth would be slightly positive.

Japan: an abortive recovery

The second half of 2000 saw the Japanese economy rising at a very slow annual rate (0.5%), with domestic demand unable to latch on to the upturn in exports. The domestic economy continues to suffer from the bursting of the financial and real-estate bubbles at the end of the 1980s, even though almost ten years have now passed. In these circumstances, it is the ups-and-downs in the world economy that set the tone for the Japanese economic situation.

In H1 2001, the Japanese economy is liable to suffer, above all, from the severe levelling off in exports. In fact, since the mid-1990s, as the result of the weakness of domestic demand, exports have been making the major contribution to Japanese growth, even though Japan's exports account for little more than 10% of its GDP *(see graph 6)*. Unfortunately, the main overseas outlets for Japanese industry are the two regions of the world where the economy is likely to slow down most in 2001: the United States and Asia. 45% of Japanese exports go to other Asian countries and 30% to the United States. Another factor that is potentially harmful for exports is that, at international level, Japan specialises in high-tech goods, especially hardware (computers, printed circuits, components) for which world demand is slowing down sharply. On top of this demand shock there could be one from the supply side: the substantial slowdown in the decline in computer prices in the United States indicates that technical progress in the sector is also slowing down.

Domestic demand remains slack. Japan seems incapable at present of escaping from the liquidity trap where it has been entombed for the past ten years. The return to a zero-interest-rate policy, as the result of the rate cuts on 28 February (10 basis points) and 19 March (9 basis points), has used up the very small room for manoeuvre still left to monetary policy. Deflation persists, despite the recent fall



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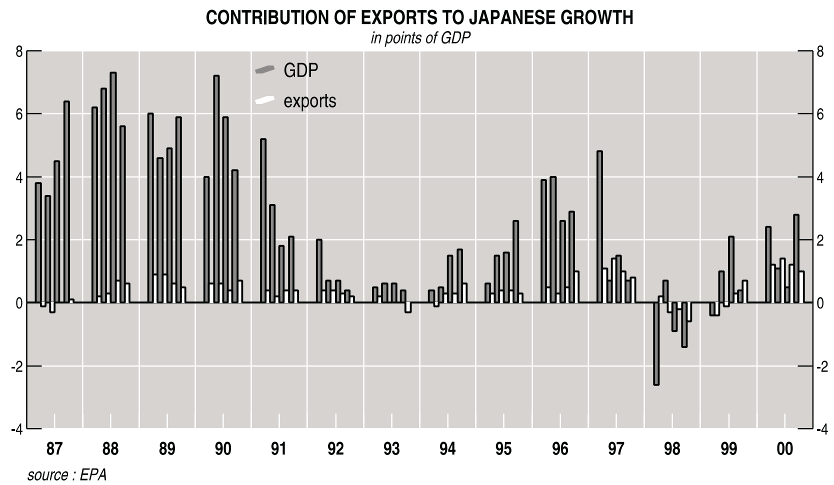
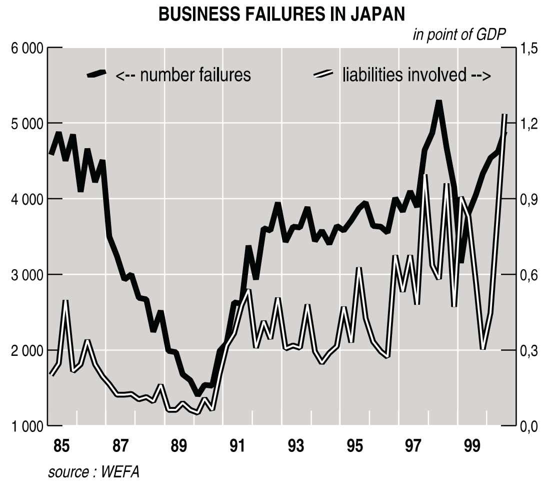


6

in the yen against the dollar and the euro. Consumption remains very weak, although consumer confidence and retail sales picked up slightly in January. Admittedly, there are numerous uncertainties clouding the outlook for households. Unemployment has continued to rise, reaching a new record of 4.9% in December. Following the eighth re-stimulus package, public debt is getting close to 150% of GDP without public spending having managed to kick-start domestic demand. Lastly, the country now seems to have entered a period of political instability.

7



Japan has still not got over the financial and real-estate bubbles of the 1980s. The persistence of their effects is based on a mechanism similar to that seen before the 1929 crisis in United States: by reducing borrowers' assets, the bursting of the speculative bubble has indefinitely impaired their capacity for financing investment, and hence the reinvigoration of the Japanese economy[(3)]. Firms, having become less rich but remaining as indebted as ever, are no longer able to borrow and now have to concentrate on mopping up their excess capacity. The efforts needed to invest in the new technologies, which have recently underpinned investment demand, could mark time this year, as in the rest of the world. The construction sector, still feeling the effects of past real-estate speculation, remains depressed and is kept afloat only by the boosts from the various public re-stimulus packages.

Above all, however, the Japanese banks' balance sheets are still uneasily seated on numerous bad debts, as indicated by the revival in business failures (both in number and in terms of the liabilities involved) in H2 2000 *(see graph 7)*. This means that it is not only demand, but also an inadequate supply of lending, that is holding back the upturn in investment.

In the absence of autonomous domestic demand, and in association with the marked downturn in international trade, economic activity is likely to be close to stagnation in H1.

Emerging zones

The slowdown in activity in the United States and Japan has already had a major depressing effect on Asian exports, since these two countries together account for roughly 60% of the zone's total exports. Asia ex Japan will continue to experience a major contraction in demand for its goods. Domestic demand is unlikely to be sufficient to sustain the upturn that began in 1999, since in many respects the situation in Asia is similar to that of Japan. The 1997 financial crisis continues to exert a depressive effect on the economy, having durably weakened economic agents' financing capacity. The productive sector finds itself obliged to give priority to reducing its excess capacity and this leaves little leeway for an upturn in investment. The banking sector, whose bad loans remain very substantial in countries like Thailand or Korea, is fragile. The ongoing consolidation of assets is therefore preventing any revival of lending to the private sector, which has in fact been steadily declining since 1997. Furthermore, in this region the coming deterioration in current-account balances is liable to intensify the process by increasing the burden of domestic economic agents' dollar-denominated debt.

The situation is slightly better in the other emerging zones. Being relatively unexposed to the American slowdown, the Latin American countries — Mexico apart — should continue to be able to rely on the momentum of their domestic demand and the re-burgeoning intra-zone trade. Growth in Brazil and Chile should remain at annual rates of 4 to 5%. The return to a more accommodating monetary stance in the United States, as well as an IMF rescue package, might give Argentina some breathing space. But Mexico, 80% of whose exports go to the United States, can be expected to see a much more marked weakening in activity.

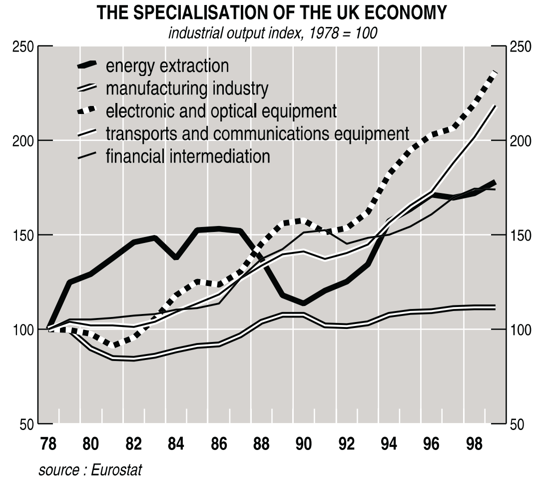
In the CEECs, domestic demand should remain brisk and the economies remain under tight surveillance by the monetary authorities. The 2001 slowdown is likely to be moderate, given the zone's lower exposure to the American situation. In all, growth can be expected

(3) See the article by Ben Bernanke and S.Gertier, "Agency Costs, Net Worth, and Business Fluctuations", (1989) American Economic Review.

to ease from 7% in 2000 to 6% in 2001. In Russia, however, there are substantial doubts hanging over the economy's capacity to prolong the upturn that had been generated by the rise in the oil price in 1999 and 2000 and by the devaluation of the rouble.

United Kingdom: a relatively unfavourable form of specialisation in international trade but robust domestic demand

8



The United Kingdom economy posted a marked slowdown in Q4 2000 (to an annualised rate of 1.2%). But this figure needs to be put in perspective, since a drop in energy production, traditionally a volatile sector, explains most of the downturn. Although declining slightly, domestic demand remains robust, founded on a substantial rise in income.

The robustness of domestic demand should enable the United Kingdom to keep growth going within the time-horizon of the forecast. Moreover, any risk of inflation now seems ruled out. All the same, given the form of its specialisation in international trade, the United Kingdom could suffer more than its partners from the present tendency in the world economic situation.

Domestic demand can be expected to remain firm in H1 2001. Private consumption would be underpinned by brisk income growth, based on substantial wage increases (4 to 5%) and a price rise whose moderation is remarkable in view of the past oil shock (inflation remains at a rate of roughly 2% and should even fall). The low level of unemployment is underpinning household confidence and limiting precautionary saving. Even so, the saving ratio could pick up again, as the result of the fading of the wealth effects due to the rise in house prices, which had increased households' net wealth in 1999 and the early part of 2000 but which now seems to be coming to an end. Testifying to the continued strength of consumption, retail sales rose by 1.3% in Q4 and the PMI-Reuters services index remained high in February. With parliamentary elections approaching, fiscal policy has taken an expansive turn. Although the impact is unlikely to be felt within the time-horizon of this forecast, it could nevertheless limit to a certain extent the possibilities for an easing of monetary policy on the part of the Bank of England.

At the same time, investment, which declined steadily throughout the year 2000, should pick up again this year. British firms would have the benefit of an easing of monetary conditions, especially via the exchange rate — sterling depreciated by some 10% against the euro between October 2000 and February 2001. In addition, the monetary stance has become slightly more expansionary, with the Bank of England lopping 25 basis points off its leading rates on 8 February. The results of the latest CIPS survey show optimism in British industry — which trades as much with the euro zone as with the United States — holding up well, despite the recession in American industry. Meanwhile, the supply of credit should pose no barrier to the upturn in investment. British banks have not been overexposed to bad debts in recent years and the share of loans to the private sector in UK banks' assets has remained stable in 1999 and 2000.

Until mid-2000, world demand for products in which the United Kingdom specialises was especially strong, but is liable to level off appreciably in coming months. By comparison with its trading partners, especially in the euro zone, the United Kingdom is in fact specialised in the production of financial services, oil, and to a smaller extent, TMT products. The cumulative rise in energy production over the period 1978-2000 comes out at 80%, a figure comparable to that for the production of financial services as the result of the importance of London as a financial centre[(4)]. These activities have established themselves at the expense of the manufacturing sector, which barely progressed between 1978 and 2000 (12%), largely because of the penalising effect on merchandise exports exerted by the strength of the pound.

The demand shock created by the present downturn in world activity is therefore likely to be particularly

(4) In 1999, exports of financial services constituted 5% of UK exports, as against less than 0.5% in France and Japan and 1.5% in United States.

unfavourable in the case of United Kingdom. The trebling of the oil price between the end of 1998 and Q2 2000 had enabled it to rake in additional income equivalent to roughly 0.7 of a point of GDP. The return of the price to around USD 25/barrel within the time-horizon of the forecast is liable to cause a loss of revenue of the order of 0.3 of a point.

World demand for financial services is also likely to ease somewhat this year. The correction that began in March 2000 on the world markets is likely to reduce the demand for assets quoted in London. Moreover, this correction could have a negative impact on the momentum of M&A deals, now that financing through take-over by share exchange or bond issues has become more difficult. The rate of M&A growth has already decreased strongly around the turn of the year, following a record year 2000. This tendency will also tend to reduce foreign demand for UK financial services.

Finally, by comparison with its continental European partners, the United Kingdom is relatively specialised in the TMT sectors. This means that the economy could suffer more than the euro zone from a slowdown in world spending on the new technologies.

All things considered, the UK economy should continue to grow at an annualised rate of the order of 2.5%. This growth would be underpinned by the strength of domestic demand, offsetting the slowdown in exports. ■

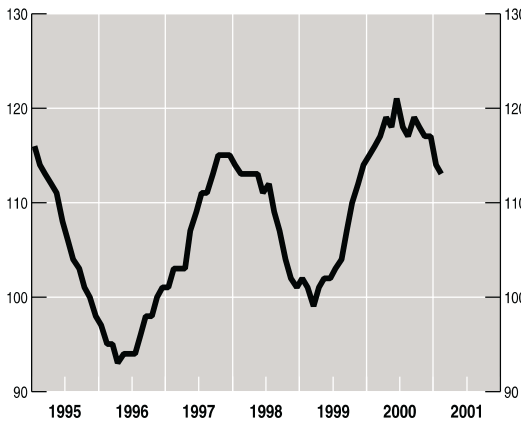
The economic situation in the euro zone

Growth in the euro zone reached 3.4% on an annual average basis in 2000. However, following a lively first half of the year, activity slowed down in the second. The impact of the higher oil price combined with the maturing of the industrial upswing to bring the rate down to 2.5% a year. Households seem to have taken the brunt of the oil shock, with consumption slowing down markedly from Q3 on. Investment also weakened and this helped to erode domestic demand.

The first half of 2001 finds growth still at an annual rate of close to 2.5%. A distinct slowdown in the zone's exports is to be expected, partly as a result of the deterioration in the international environment but also of the gradual disappearance of the competitiveness gains linked to the past weakness of the euro. However, the slowdown is likely to be compensated by an upturn in domestic demand. The tax cuts introduced in several major European countries can be expected to combine with the continuing job creation to generate rises in household income. The easing of inflation, due to the marked deceleration in oil prices, would further boost purchasing power.

Cyclical disparities between countries, which had narrowed in H1 2000, have since widened again. A renewed tendency towards homogenisation is likely to emerge in H1 2001, but this convergence could be held back by the slowdown in the world economy. Germany and Italy, which had already suffered more than the other countries during the winter of 1998-99 from the consequences of the emerging-country crisis, could again feel somewhat more strongly the knock-on effects of the slowdown in world demand.

COMPOSITE INDICATOR FOR MANUFACTURING INDUSTRY IN THE EURO ZONE



Industrial activity in the euro zone set to continue its slight slowdown in H1 2001

Following the strong growth posted between mid-1999 and mid-2000, activity in the euro zone has slowed down under the impact of the higher oil price and the maturing of the industrial upswing. In Q4 2000, activity in manufacturing was at an annual rate of close to 5.5%, but this was less than the rates of more than 7% seen until the middle of the year. At the same time, INSEE's composite indicator, summarising the tone of business surveys in manufacturing in the euro zone, has weakened, although staying for the moment at a high level that is compatible with continuing firm activity. The deterioration in the production outlook in the early part of 2001 partly reflects uncertainties linked to recent tendencies in the international environment. However, the high level of orders towards the end of 2000, in Germany in particular, should continue to prop up output in the early part of 2001. All things considered, activity is likely to slow down slightly in H1, the annualised rate being of the order of 4%.

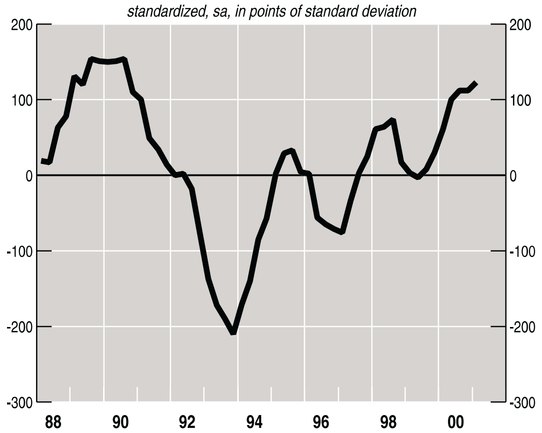
Domestic demand headed for an upturn in H1 2001

Investment set to remain brisk

Investment weakened in H2 2000, rising at an annualised growth rate of 3%, as against 5% in H1. The pattern of investment showed contrasts both between countries and within the half-year. It was very dynamic in France throughout H2 2000, but remained weak in Germany. However, this weakness stems mainly from substantial and persistent postponements of construction investment (which posted an annualised decline of 4% throughout the year). On top of this, German productive investment failed to derive the expected benefit from the imminent impact of the tightening of depreciation regulations that came into force on 1 January 2001. In Spain, following a very lively third quarter (a quarterly rise of 2.5%), the last part of the year saw a decline of 2%, led by productive investment. Construction was dynamic in both Spain and Italy.

CAPACITY UTILISATION RATES IN THE EURO ZONE

standardized, sa, in points of standard deviation



sources : IFO, INSEE, ISAE, European Commission (ECFIN)

In H1 2001, investment in the euro zone is expected to accelerate somewhat, bringing its annualised growth rate close to 5%. Despite the backdrop of easing industrial activity, business surveys report that firms still regard capacity as highly insufficient. Moreover, monetary conditions still favour investment. Lastly, domestic orders for capital goods are very high in both Germany and Italy, foreshadowing a sharp rise in investment in the early part of 2001.

An appreciable rise in consumption

In the space of two years, the unemployment rate in the euro zone has plummeted by 1 1/2 points, from 10.3% to 8.8%. Solidly based industrial momentum and especially expansion in job-rich sectors such as services and construction have permitted massive job creation. This was also helped on by measures aimed at reducing the

FORECASTS FOR THE EURO ZONE

(annual and quarterly % change)

	Annual changes			Quarterly changes									
				1999				**2000**				**2001**	
	1998	**1999**	**2000**	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
GDP													
Growth rate	2.8	2.5	3.4	0.8	0.5	1.0	1.0	0.9	0.8	0.5	0.7	0.6	0.6
year on year growth	-	-	-	2.0	2.1	2.6	3.3	3.5	3.7	3.2	3.0	2.7	2.5
IMPORTS													
Growth rate	9.5	6.7	10.4	1.0	2.6	2.6	2.7	2.2	2.3	2.6	3.2	2.0	2.0
year on year growth	-	-	-	4.5	5.6	7.4	9.1	10.5	10.1	10.2	10.7	10.5	10.1
HOUSEHOLD CONSUMPTION													
Growth rate	3.1	2.9	2.5	0.9	0.3	0.8	0.7	0.8	0.7	0.1	0.3	0.8	0.7
Contribution	*1.7*	*1.6*	*1.4*	*0.5*	*0.1*	*0.5*	*0.4*	*0.4*	*0.4*	*0.1*	*0.2*	*0.4*	*0.4*
year on year growth	-	-	-	3.2	2.8	2.7	2.7	2.6	3.1	2.3	2.0	2.0	2.0
GFCF													
Growth rate	4.8	5.3	4.6	1.5	1.4	1.9	0.6	1.8	0.6	1.1	0.4	1.4	1.0
Contribution	*1.0*	*1.1*	*1.0*	*0.3*	*0.3*	*0.4*	*0.1*	*0.4*	*0.1*	*0.2*	*0.1*	*0.3*	*0.2*
year on year growth	-	-	-	4.2	5.7	5.7	5.5	5.7	4.9	4.0	3.9	3.5	3.9
EXPORTS													
Growth rate	7.0	4.7	11.7	0.4	3.2	3.0	3.0	3.0	2.0	2.8	3.3	1.7	1.5
year on year growth	-	-	-	0.6	2.6	5.8	10.0	12.8	11.4	11.2	11.6	10.1	9.6
DOMESTIC DEMAND EXCL. STOCKS													
Growth rate	3.0	3.1	2.8	1.0	0.5	1.0	0.6	1.0	0.6	0.3	0.4	0.9	0.7
Contribution	*2.9*	*3.0*	*2.8*	*0.9*	*0.5*	*1.0*	*0.6*	*1.0*	*0.6*	*0.3*	*0.4*	*0.8*	*0.7*
year on year growth	-	-	-	3.0	3.2	3.2	3.1	3.1	3.2	2.6	2.4	2.3	2.4
FOREIGN TRADE													
Contribution	*-0.5*	*-0.5*	*0.6*	*-0.2*	*0.2*	*0.2*	*0.1*	*0.3*	*-0.1*	*0.1*	*0.1*	*-0.1*	*-0.1*
STOCKS													
Contribution	*0.4*	*0.0*	*0.0*	*0.0*	*-0.2*	*-0.1*	*0.2*	*-0.3*	*0.2*	*0.1*	*0.2*	*-0.1*	*0.0*

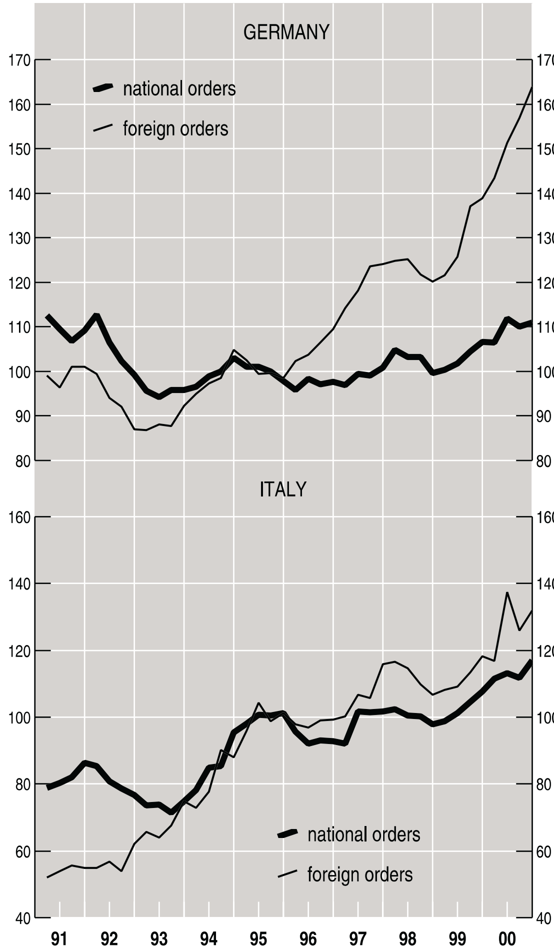
Forecast

burden on employers and increasing labour-market flexibility in a certain number of countries (Italy and Spain, in particular). The second half of the year, however, saw a weakening in the annualised rate of dependent job creation in the private sector in Germany and Spain, the growth rates falling, respectively, from 2% to 1% and from 4% to 2%. In France, on the other hand, employment remained brisk, with the growth rate virtually stable at over 3% in the private sector. In the first half of 2001, the rate of job creation could well remain comparable to that of the previous half-year.

Despite the upturn in inflation recorded in H2 2000, wages have continued to grow at a moderate rate, of the order of 2% in most countries in the zone. In 2001, with agreements expiring in several sectors, a large number of wage renegotiations are in progress or imminent. These are likely to result, in Italy and Spain in particular, in compensation for purchasing power losses due to the price rises recorded since Q2 2000. Even so, wage growth in the euro zone, although accelerating, is expected to remain moderate.

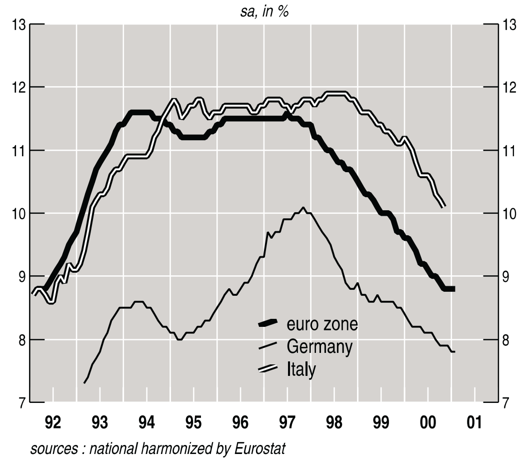
Inflation in the euro zone rose steadily in 2000, by reason of the higher energy prices. However, after peaking at 2.9% in November 2000, the year-on-year rise in the HICP was down to 2.6% in February 2001 and, on the assumption of stabilisation in the EUR/USD rate at 0.95 and in the oil price at USD 25/barrel, inflation should ease back to 2.1% in mid-2001. The impact of decisions regarding indirect taxes is liable to curb this tendency (rise in the “eco-tax” in Germany and in VAT in the Netherlands at the beginning of 2001; disappearance next April of the impact of the April 2000 VAT cut in France). This easing of inflation would provide additional purchasing power for households.

ORDERS
in point index, base 100 in 1995



sources : national

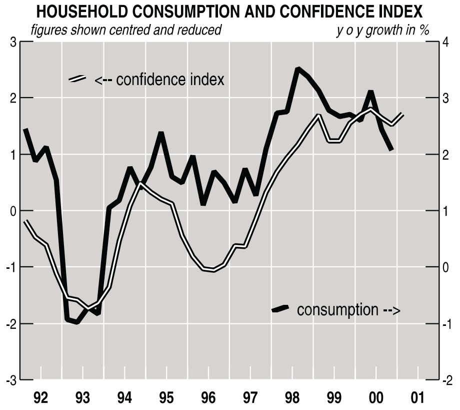
UNEMPLOYMENT RATE
sa, in %



sources : national harmonized by Eurostat

Consumption, which was very brisk in the first half of 2000, slowed down sharply in the second (from an annualised rate of 3% to less than 1%). The higher oil price was the main reason for this decline, as the continuing job creation, albeit at a slower rate, continued to underpin the rise in household purchasing power. In the early part of 2001, household disposable income should benefit from the decline in inflation, but also from tax cuts in the zone's principal countries. These policies were introduced as early as Q4 2000 in certain countries (France, Italy) and at the beginning of 2001 in others (Germany). The resulting faster growth in real income should permit an upturn in private consumption to a growth rate of 3% in H1 2001, especially as household confidence at the beginning of the year was back to levels comparable to those of H1 2000. This renewed strength of private consumption is likely to be general throughout the zone, and possibly accentuated in France and Germany.

In all, following a distinct slowdown in H2 2000, growth in domestic demand excluding stocks can be expected to rebound to a rate of 3 1/4% in H1 2001 from 1 1/2%.



sources : national and Eurostat

The pattern during the half-year mainly reflects catch-up effects involving private consumption and investment in Q1. At the time when business surveys are indicating that stocks are seen as close to their average level, the renewed strength of domestic demand could also lead to a slight de-stocking tendency.

The external contribution set to turn slightly negative

Imports, which had already been very lively in H1 2000, accelerated further in H2 (an annualised rate of 12%, compared with 9%), this being mainly connected with the acceleration in exports, which, despite the slowdown in world demand, benefited from the price-competitiveness effects linked to the past weakness of the euro. Taking the average for H2 2000, external trade boosted growth by around 0.1 of a point of GDP per quarter.

In H1 2001, the contribution from foreign trade is likely to turn slightly negative. Exports can be expected to slow down sharply under the impact of the erosion of world activity. For their part, imports, boosted by strong domestic demand, are likely to remain at an annual growth rate of the order of 8%. ■

Consumer prices in the euro zone

After rising steadily during 2000, inflation in the euro zone reached a peak of 2.9% in November, a reflection of the twists and turns in the oil price. Since then, the year-on-year price rise has fallen back to around 2.5%. After rising slightly in Q4 2000, underlying inflation (ex food and energy) has since stabilised at around 1.6%.

The recent easing of inflation in the euro zone is mainly the result of the rapid fall in the oil price, which has been accompanied by an appreciation of the euro. This movement has tended to mask the rise in food prices.

Assuming a stabilisation of the euro at USD 0.95 and of the oil price at USD 25/barrel between now and the end of June, the effects of the oil shock can be expected to fade gradually. However, food prices are likely to continue to rise because of the crises affecting European agriculture (BSE and food-and-mouth disease). All things considered, inflation in the euro zone should continue to ease, reaching 2.1% in June 2001.

The latest turns in the oil price saga

The year-on-year price rise was 2.6% in February 2001,compared with 2.0% a year earlier. At the time of the final spurt in the oil price in November 2000, inflation in the euro zone peaked at 2.9%. The appreciable fall in the oil price since then enabled inflation to fall back rapidly around the end of the year.

Since December 2000, the ebbing of energy prices has been a principal factor in the easing of inflation in the euro zone, contributing 0.3 of a point to the overall year-on-year fall recorded in February. The year-on-year change in the price of fuels, which had remained above 20.0% during the first three quarters of 2000, dropped sharply to 6.3% in February 2001.

Over the same period, food prices have posted a sharp acceleration (with 3 points added to the year-on-year change), mainly due to higher prices for fresh produce and meat. The BSE crisis has since December 2000 resulted in a sharp increase in prices of this category (a year-on-year rise of 4.7% in January 2001, up from 3.1% in November 2000). In total, food prices accounted for 0.5 of a point of the addition to the price rise in the year to February 2001.

Underlying inflation(1) has stabilised since Q4 2000 at around 1.6%, compared with roughly 1.0% at the beginning of 2000. The slight spurt seen in prices of manufactures in H2 2000 (adding 0.5 of a point to the year-on-year change) followed by those of services since the beginning of 2001 (+0.4 of a point) contributed 0.4 of a point to the increase in the overall price change in the year to February 2001. The delayed effects of the depreciation of the euro and the diffusion to other sectors of the rise in the oil price remain limited. The rises in the prices of manufactures and services are at an annual rate comparable to that seen in 1998. No marked second-round effects are likely, therefore.

Varying rates of absorption of the oil shock in different countries

The early part of 2001 has seen inflation falling back in most euro-zone countries, reaching the same level as in Q1 2000 and remaining above 2.0% everywhere except in France (1.4%).

Over the past year, the addition to inflation has remained below 1 point in all countries except Portugal (3.3 points) and the Netherlands (3.4 points), countries where specific tax factors have been operating. In the Netherlands, the standard VAT rate was raised from 17.5% to 19% in January 2001; in Portugal, the last country in the zone where energy prices are entirely set by the authorities, the recent falls in the oil price are taking time to be passed on into energy consumer prices, which have therefore continued to show a year-on-year rise of 10.0% in Q1 2001.

With Ireland posting a marked decline in its inflation rate at the beginning of 2001 (a fall of 2.1 points in the year-on-year rise between

(1) Measured as the year-on-year price change in the index ex food and energy.

October 2000 and February 2001), it is now the Netherlands that has the highest rate (4.9%) as a result of the rise in VAT rates mentioned earlier. The maximum inflation differential between countries in the euro zone has been stable over the past year (3.5 points in February 2001).

Greece, which joined the euro zone in January 2001, now has an inflation rate that, while still above the euro-zone average, is similar to that of countries like Spain, Belgium or Luxembourg.

Decline in the inflationary risk

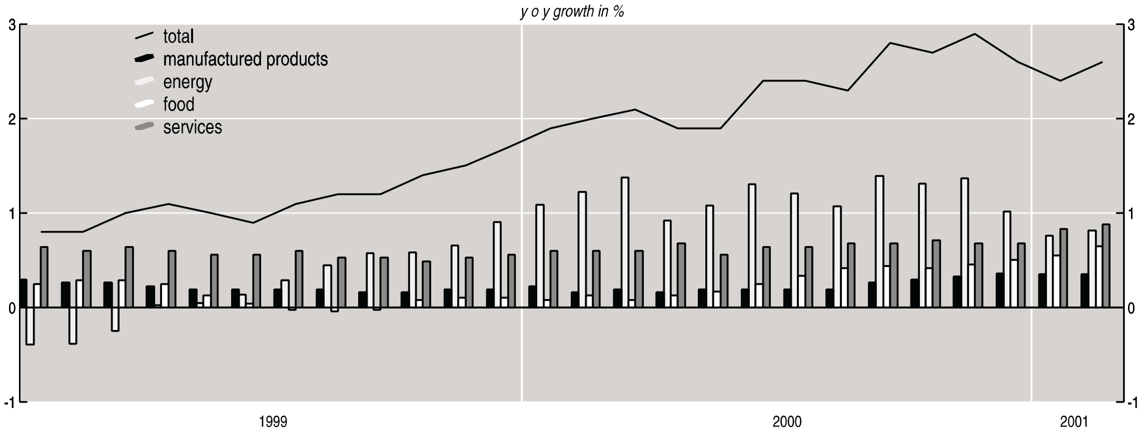
Nominal wages and salaries continued to rise at a moderate rate in 2000 and are not expected to accelerate appreciably in H1 2001. This means that the rise in energy prices in 2000 is unlikely to trigger off a price-wage spiral.

Reflecting the upturn in industry in the past two years, capacity utilisation rates attained high levels in 2000. However, this tendency seems to be running out of steam under the impact of the industrial slowdown seen since H2 2000, combined with the high level of investment. This can be expected to take much of the sting out of the inflationary risk in H1 2001, as testified by the decline in the outlook for prices reported by euro-zone industrial leaders in Q1 2001.

The decline in inflation in H1 2001 being held back by food prices

On the assumption of stability for the euro at USD 0.95 and for the oil price (Brent) at USD 25/barrel, inflation in the euro zone can be expected to ease in H1, to reach 2.1% in June, compared with 2.6% in February.

EURO ZONE INFLATION BREAKDOWN
contribution of the main items
y o y growth in %



EURO ZONE INFLATION

(year on year % growth of HCPI)*

Sectors (weigh in the index)	February 2000	February 2001	March 2001	June 2001
Total (100,0%)	**2.0**	**2.6**	**2.3**	**2.1**
Food (16.4%)	0.2	3.2	3.4	3.6
Beverage and Tobacco (4.0%)	2.5	2.3	2.4	2.5
Clothing and footwear (7.8%)	0.5	0.8	0.1	0.6
Housing, water, electricity and gas (15.5%)	3.6	4.8	4.6	3.9
Furnishings and household equipment (7.9%)	0.7	1.5	1.3	1.6
Health (3.9%)	1.7	1.1	0.8	0.7
Transports (15.6%)	5.7	2.8	1.6	-0.5
Communications (2.3%)	-3.0	-4.3	-3.8	-2.6
Leisure and culture (9.4%)	0.1	1.8	1.9	1.9
Education (0.9%)	2.4	3.0	3.1	3.1
Hotels-cafés-restaurants (8.8%)	2.5	2.8	2.5	2.5
Miscellaneous goods and services (7.4%)	2.2	2.5	1.9	1.9
Core inflation (70.1%)	**1.1**	**1.7**	**1.5**	**1.6**

Forecast
* Harmonized Consumer Price Index
Source: Eurostat

EURO ZONE INFLATION BY COUNTRIES

(year on year % growth of HCPI)*

	February 2000	February 2001
France	1.5	1.4
Germany	2.1	2.5
Italy	2.4	2.7
Spain	3.0	4.0
Netherlands	1.5	4.9
Belgium	2.1	2.5
Austria	2.0	1.8
Finland	2.7	2.7
Portugal	1.6	4.9
Ireland	4.6	3.9
Luxembourg	2.6	2.9
Greece	2.6	3.5
Euro Zone	**2.0**	**2.6**
United Kingdom	1.0	-
Sweden	1.4	1.5
Denmark	2.8	2.3
E.U.	**1.9**	**2.3**

* Harmonized Consumer Price Index.
Source: Eurostat

INFLATION DIFFERENTIALS IN THE EURO ZONE

Within the euro zone, the year-on-year price rise put on 0.5 of a point during 2000 (see table). The end of 2000 and the beginning of 2001 saw a significant slowdown in euro-zone inflation, reflecting the gradual disappearance of the effects of the oil shock. This return to more moderate inflation nevertheless masks contrasting national situations, as shown by the maintenance of the maximum spread at over 3 points.

In the major countries (France, Germany, Italy) underlying inflation has accelerated only slightly and the risks of second-round effects are low because of the current wage restraint. Overall inflation is therefore declining in step with the easing of the impact of the oil shock on energy prices.

This factor aside, the rate of decline has differed slightly because of the various national tax measures aimed at cushioning the oil shock (the “floating” rate of tax on petroleum products in the case of France, for example). These differences, too, should disappear during 2001.

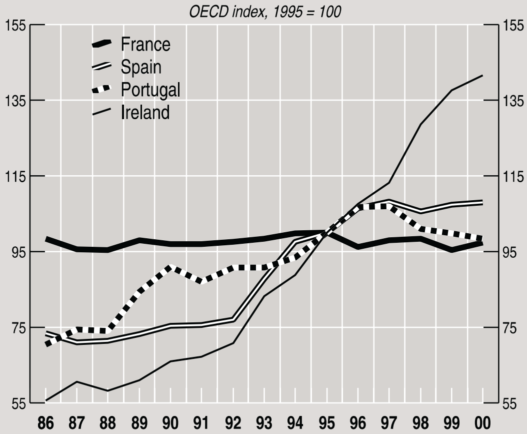
On the other hand, in five countries (Spain, Portugal, Ireland, Netherlands, Greece) inflation remains significantly above the euro-zone average. However, this faster price rise is not generating a fundamental inflationary risk, being explained by national “catch-up” phenomena and temporary problems of synchronisation or convergence in certain economies.

Economic catch-up phenomena (Balassa-Samuelson effect) in Ireland, Spain and Portugal

The persistence of high levels of inflation is the reflection of the price catch-up process now taking place in the countries where activity has been most dynamic in the past two years. In these countries, the tradable goods (manufacturing) sectors generate rapid productivity gains permitting wage increases that are higher than the average for the zone. These wage rises are then passed on to the rest of the economy. In the sector sheltered from international competition (services), firms then adjust their prices to the rise in their production costs, since competitiveness gains in this sector are limited.

This phenomenon, known as the Balassa-Samuelson effect, should not, a priori, constitute a difficulty for monetary policy. The addition to inflation seen in the sheltered sector is not the result of overheating but reflects the adjustment of the general price level to the competitiveness gains in the sector exposed to international competition. Ireland, Spain and Portugal are experiencing, or have recently experienced, this type of competitiveness gain (see graph) leading to an above-average rise in wage costs and a persistently large contribution to inflation from the services sector.

EXPORTS' COMPETITIVENESS OF MANUFACTURED PRODUCTS WITHIN EURO ZONE
OECD index, 1995 = 100



	Inflation		Core inflation		Manufactured goods(2)		Services[2]		Unit wage costs[3]		
	January 2000	January 2001	January 2000	January 2001	January 2000	January 2001	January 2000	January 2001	1998	1999	2000
Euro zone	**1.9**	**2.4**	**1.1**	**1.6**	**0.2**	**0.4**	**0.6**	**0.8**	**0.5**	**1.7**	**1.1**
Germany	**1.9**	**2.2**	0.8	1.2	0.1	0.2	0.5	0.7	-0.1	0.8	0.0
France	**1.7**	**1.4**	0.7	0.7	0.2	0.1	0.3	0.4	0.6	0.9	1.0
Italy	**2.2**	**2.7**	1.9	2.2	0.5	0.7	0.9	0.9	-2.7	2.2	1.0
Spain	**2.9**	**3.8**	2.3	3.5	0.5	0.8	1.1	1.6	2.7	3.1	2.9
Belgium	**2.1**	**2.8**	0.2	0.5	0.2	0.3	0.7	0.5	1.4	0.8	0.8
Netherlands	**1.6**	**4.5**	1.1	3.3	0.3	0.9	0.5	1.4	2.4	2.6	2.4
Portugal	**1.9**	**4.4**	2.6	3.4	0.5	0.6	1.3	1.6	7.5	5.3	4.2
Finland	**2.3**	**2.9**	1.6	2.7	0.0	0.4	1.1	1.4	1.9	0.5	0.8
Austria	**1.4**	**2.2**	0.8	1.9[1]	0.0	0.3	0.6	1.1	1.4	2.0	0.0
Ireland	**4.4**	**3.9**	3.0	3.7	-0.1	0.4	2.0	2.0	3.2	1.9	2.2
Greece	**2.4**	**3.2**	1.5	3.1	0.0	0.8	1.0	1.2	9.0	2.6	3.7

(1) : The core inflation rebound in Austria reflects a base effect (sharp drop in January 2000) which wanes as soon as the month of February (+1.3% in core inflation, +1.8% in total).
(2) : Contribution to total inflation.
(3) : Annual growth rate.
Sources: Eurostat, OECD.

While Ireland continued to post substantial competitiveness gains in 2000, the phenomenon has lost momentum in Spain and Portugal since 1998. Now that these countries are coming to the end of the catch-up process, the residual addition to inflation is prompting a slowdown in activity which in turn is easing inflationary pressures.

Cyclical lead and tax measures in the Netherlands

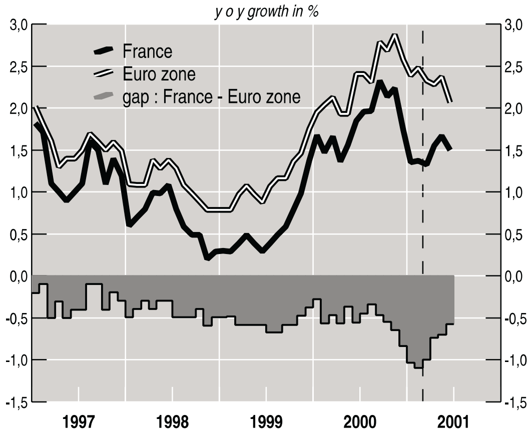
Firmer activity in the Netherlands than in the rest of the zone is temporarily generating an inflation differential, which in return is helping to reduce the cyclical gap. In 2000, activity slowed down to fall in line with the European cycle and this slowdown should now help to bring about a decline in inflation.

Moreover, half of the marked acceleration seen in Dutch inflation in Q1 2001 is explained by the rise in the standard VAT rate from 17.5% to 19% in January, on top of which there was in February a rise in tobacco duties. These measures produced an addition to inflation estimated to amount to 1 point, masking the slowdown in prices in the services and energy sectors that began at the end of 2000.

Convergence efforts in Greece

Greece has in the past three years recorded the largest productivity gains in the euro zone apart from Ireland and this explains the dynamic growth in wages and salaries. However, the risk of inflation in Greece is small because of the continuation of the convergence efforts launched in 1998-1999. Underlying inflation in fact slowed down from 5.5% in 1998 to 1.6% in 2000, while unit wage costs, which had risen at annual rates of more than 10% until 1997, have eased sharply *(see table)*. ■

HARMONIZED CONSUMER PRICE INDEX
France and euro zone
y o y growth in %



sources : Eurostat, Insee

forecasts beyond the dotted line

Temporary widening of the inflation differential between France and the euro zone

The inflation (HICP) differential between France and the euro zone steadily widened during 2000, from 0.5 of a point in February 2000 to 1.2 of a point in February 2001. This widening is mainly explained by tax measures at national level affecting energy items in particular.

The stabilisation of oil prices should lead in coming months to a distinct decline in the year-on-year rise in energy prices, which would then contribute 0.5 of a point to the slowdown in the overall inflation rate between February and June 2001.

Food prices, on the other hand, look set to remain strong for some time to come, with the price rise moving up from 3.1% in February to 3.5% in June in reaction to the crises sweeping European agriculture (BSE and foot-and-mouth disease). As a result, inflation in the food sector would hamper the downward tendency in the overall year-on-year price rise, pushing it up by 0.1 of a point.

Against a background of moderating supply-side pressures and a levelling off of activity in the euro zone, underlying inflation is unlikely to change much, probably coming out at 1.6% in June 2001. Its contribution to the decline in overall inflation in H1 2001 would therefore be of the order of 0.1 of a point.

To be more precise, two tax measures specific to France helped to widen this inflation differential. These were the cuts in the standard VAT rate in April 2000 and in the tax on petroleum products in October, the latter being intended to cushion the oil shock. The gradual disappearance of the effects of these measures from the year-on-year price comparisons should bring the inflation differential between France and the euro zone down to the previously-observed average of 0.5 of a point by next autumn. ■