The euro zone's international environment

The first part of 2004 should find the euro zone's international environment still buoyant. Growth is likely to continue to be encouraged in the United States by the tax cuts voted in 2003 and by the gradual tendency for growth to become more job-rich. GDP is expected to continue to accelerate in Q1 in the United Kingdom before slowing down in response to the tightening of monetary policy. Average quarterly growth in the UK is expected to be 1% until mid-2004.

In the United States, activity is expected to accelerate slightly until the middle of the year, under the impetus of tax cuts and the gradual tendency for growth to become more job-rich

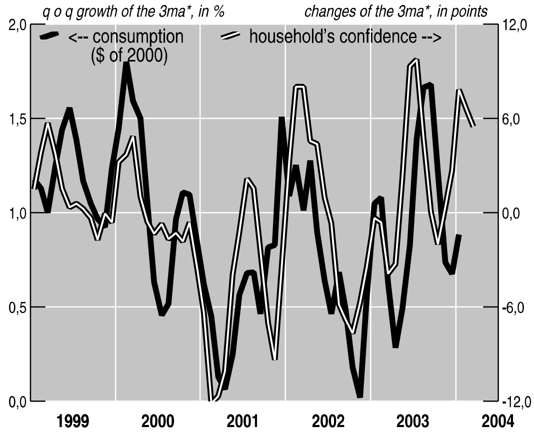
The tax cuts voted in 2003 should give another fillip to consumption in the early part of 2004. May 2003 saw the adoption of a law prolonging and accelerating the programme of tax cuts already voted in May 2001, the result being a sharp fall in the taxes paid by households already in Q3 2003, with a further fall due in 2004 *(see graph A in box 1)*. In total, the net fiscal stimulus since Q3 2003 would amount to 1.8 of a point of annual gross disposable income, with 1.2 of a point of this consumed in Q3 2003 and 0.2 of a point in Q4 (see graph B in box 1). In 2001, households consumed the totality of the net fiscal stimulus (roughly 1 percentage point of gross disposable income). There should therefore remain additional growth potential for consumption amounting to 0.4 of a point (=1.8 -1.2 - 0.2), mainly in Q2 2004 when households' tax positions will be regularised.

Consumption growth would also be encouraged by the increasingly job-rich nature of growth *(see box 2, notably graph D)* and by the positive wealth effects resulting from the rise in share prices since the beginning of 2003. One small cloud in this picture is the fact that households are turning less to mortgage refinancing, despite the fact that long rates remain very low. All things considered, consumption should show a further acceleration compared with Q4 2003, as is already visible in the figures for retail sales. Household confidence has also picked up appreciably in the past six months *(see graph 1)*. Household investment, on the other hand, seems set to slow down after the peak recorded in Q3 2003.

The acceleration in activity in the United States' trading partners and the past depreciation of the dollar are liable to encourage strong export growth during the first two quarters of 2004. At the end of 2003, industrial output was rising at quarterly rates of close to 4% in Japan and 2% in Canada, thus stimulating United States exports in Q4 *(see graph 2)*. These countries are likely to maintain these growth rates in 2004. In addition, activity seems to be accelerating

2

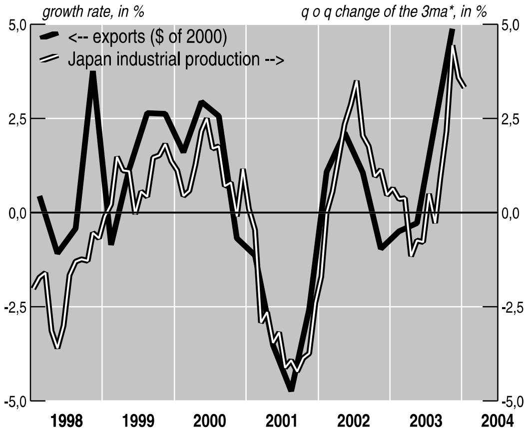
UNITED STATES : CONSUMPTION AND HOUSEHOLD'S CONFIDENCE



sources : BEA, University of Michigan
*3ma = 3 months moving average

2

UNITED STATES : UNITED STATES EXPORTS AND JAPAN INDUSTRIAL PRODUCTION



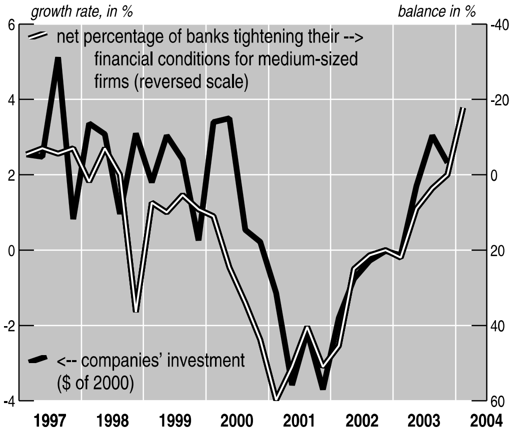
sources : BEA, Japan Ministry of Trade and Industry
*3ma = 3 months moving average

slightly in the euro zone [(1)] in the first part of 2004. Another positive factor is the depreciation of the dollar in 2003, exerting a lagged positive effect on exports. All things considered, exports can be expected to grow at rates of between 2% and 3% per quarter, not quite as fast as the high rate of 4% seen in Q4 2003. Imports, for their part, should grow at a firm rate matching that of external and domestic demand. In support of this view, the import outlook reported in the ISM survey remains at a high level.

The prospects for domestic and external demand should be favourable to strong growth in corporate investment and inventories. Moreover, financing conditions remain on the accommodating side *(see graph 3)*. In particular, the spreads between government and corporate bonds are still very small. Following a one-off slowdown in Q1 2004, already visible in orders for capital goods, investment is likely to grow at a rate of around 1.5% in Q2 2003. The expiry at the end of 2004 of the law relating to accelerated depreciation of capital investment is likely to generate a rise in growth occurring rather in H2. Meanwhile, the contribution from inventories is likely to be fairly substantial in the early part of 2004. Inventories are in fact still at very low levels in relation to deliveries by industry. The satisfactory outlook for

3

UNITED STATES : COMPANIES' INVESTMENT AND FINANCIAL CONDITIONS



sources : BEA, Fed

(1) The sanctions applied since 1 March 2004 by the European Union in order to force the American authorities to abolish subsidies to exporting firms are unlikely to have any appreciable effect in 2004. The additional customs duties for 2004 are in fact put by the European Commission at around $300 million, equivalent to 0.2% of the annual merchandise exports from the United States to the EU.

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

	Quarterly % change						Annual % change		
	2003				2004		2002	2003	2004 (c.o)
	Q1	Q2	Q3	Q4	Q1	Q2			
UNITED STATES (34.0%)									
GDP	**0.5**	**0.8**	**2.0**	**1.0**	**1.1**	**1.2**	**2.2**	**3.1**	**3.9**
Consumption	0.6	0.8	1.7	0.7	0.9	1.2	3.4	3.1	3.4
Private investment (1)	0.3	1.5	3.7	2.3	1.0	1.5	-3.7	4.4	6.1
Nonresidential investment	*-0.1*	*1.7*	*3.0*	*2.3*	*0.5*	*1.5*	*-7.2*	*2.9*	*5.3*
Residential investment	*1.1*	*1.1*	*5.1*	*2.1*	*1.9*	*1.5*	*4.9*	*7.5*	*7.4*
Government expenditures (2)	-0.1	1.8	0.4	0.2	1.0	0.5	3.8	3.4	2.2
Exports	-0.5	-0.3	2.4	4.9	2.0	2.9	-2.4	2.0	9.0
Imports	-1.7	2.2	0.2	3.9	2.0	2.9	3.3	4.0	7.7
Contributions:									
Domestic demand excluding stocks	*0.5*	*1.1*	*1.8*	*0.9*	*1.0*	*1.2*	*2.5*	*3.5*	*3.7*
Change in private inventories	*-0.2*	*-0.1*	*0.0*	*0.2*	*0.2*	*0.1*	*0.4*	*0.0*	*0.4*
Net exports	*0.2*	*-0.3*	*0.2*	*-0.1*	*-0.1*	*-0.1*	*-0.7*	*-0.4*	*-0.2*
UNITED KINGDOM (5.6%)									
GDP	**0.3**	**0.7**	**0.8**	**0.9**	**1.0**	**0.8**	**1.7**	**2.3**	**2.9**
Consumption	0.0	1.0	1.1	1.1	1.2	0.8	3.4	2.8	3.5
Total investment	-1.3	1.6	1.1	1.4	1.6	0.3	1.8	2.6	3.9
Enterprise investment	*-2.0*	*1.4*	*-0.1*	*1.3*	*1.5*	*0.5*	*-2.6*	*-1.1*	*3.2*
Household investment	*-4.0*	*3.0*	*1.6*	*1.0 (4)*	*0.5*	*0.0*	*13.2*	*5.5*	*2.8*
Public investment	*16.0*	*-2.0*	*7.2*	*5.0 (4)*	*5.0*	*0.0*	*11.8*	*25.4*	*12.1*
Public consumption (3)	1.2	0.2	0.2	1.9	0.5	0.5	2.7	2.4	2.5
Exports	4.0	-2.6	0.1	1.8	1.0	2.0	-0.4	-0.5	3.2
Imports	1.3	-2.5	1.1	2.2	2.0	1.0	4.0	0.8	4.3
Contributions:									
Domestic demand excluding stocks	*0.0*	*1.0*	*1.0*	*1.4*	*1.2*	*0.7*	*3.0*	*2.8*	*3.5*
Change in private inventories	*-0.2*	*-0.4*	*0.3*	*-0.3*	*0.2*	*-0.1*	*-0.1*	*0.0*	*0.0*
Net exports	*0.6*	*0.1*	*-0.3*	*-0.2*	*-0.3*	*0.2*	*-1.3*	*-0.4*	*-0.5*

Forecast
(1) Investment of firms and households
(2) Government consumption and investment
(3) Consumption of unprofitable institutions included
(4) Data are not recorded in the provisional national accounts for the fourth quarter published on February, 25th.
Sources: BEA, ONS, Insee

firms and the favourable financing conditions should lead them to adopt inventory behaviour as dynamic as at the end of 2003 *(see graph 4)*.

All things considered, GDP can be expected to accelerate slightly until mid-year, amounting to 1.1% in Q1 and 1.2% in Q2, compared with 1.0% in Q4 2003.

In the United Kingdom, the interest-rate hike is likely to hold back domestic demand from Q2 on

The upturn in United Kingdom activity seen in Q3 2003 (+0.8%) was confirmed in Q4, when GDP rose by 0.9%. This liveliness stems from the services sector, with industrial output falling by 0.1% in Q4 2003. GDP growth seems to have increased to 1.0% in Q1 2004 and should remain firm in Q2, albeit falling slightly to 0.8%. Household consumption is likely to remain brisk, although slowing down somewhat in Q2. The satisfactory economic outlook should underpin corporate investment, while the upturn in activity at world level should encourage export growth. Despite the strong appreciation of sterling, the contribution of foreign trade should be positive again in Q2 2004.

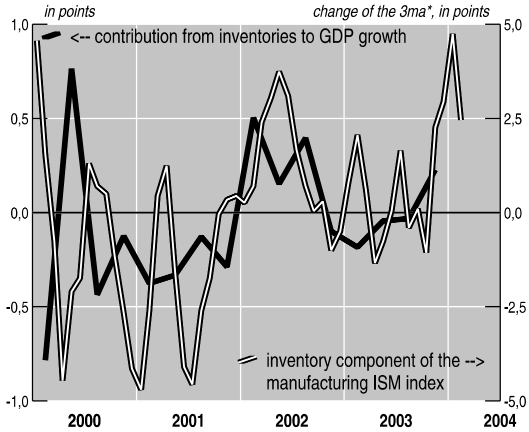
Household consumption, after rising strongly in H2 2003 (by 1.1% in both Q3 and Q4) is likely to remain firm, although showing a slight slowdown from Q2 2004 on. The rise in house prices (at a monthly rate of 3.1% in February, the highest since April 2002) should continue to encourage the granting of mortgage loans [(2)]. The Rightmove estate agency is reporting that there was still excess demand in the UK housing market in January for the ninth month running. The recovery on the stock market and the decline in unemployment are likely to increase household wealth and income. In these circumstances, household confidence is maintaining a steady improvement and the growth carryover for retail sales for Q1 2004 amounted to 1.8% at end-February. However, the tightening of monetary policy that was begun in November and taken a stage further in February (a rise of 0.25 percentage points in base rate on each occasion) can be expected to continue, to judge by statements coming out of the Monetary Policy Committee. Households' consumption behaviour is liable to be affected. For one thing, the moves will have increased their debt burden and, for another, the cost of borrowing will have been raised. All in all, growth in consumption can be expected to decline in Q2 2004 to 0.8% from 1.2% in Q1.

Household investment is likely to slow down in coming quarters, having been very strong [(3)] in Q4 2003, when starts rose by 3.5%. Even so, the number of housing transactions has stabilised at a low level and the rise in interest rates, notably on mortgages, will do nothing to encourage housing investment in 2004.

The buoyancy of the economy seen in recent quarters, combined with the satisfactory outlook for activity, should continue to stimulate corporate investment in the early part of 2004. Corporate investment was already dynamic (up 1.3%) in Q4 2003, despite the low capacity utilisation rates and the slowdown in industrial activity. Against a background of

4

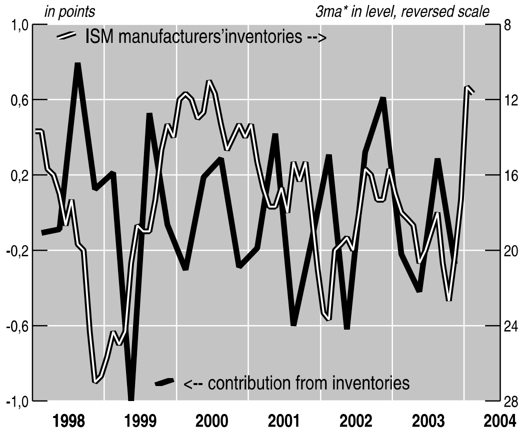
UNITED STATES : CONTRIBUTIONS FROM INVENTORIES AND OPINION REGARDING INVENTORIES IN PURCHASING MANAGERS'SURVEYS



sources : BEA, ISM
*3ma = 3 months moving average

5

UNITED KINGDOM : CONTRIBUTION FROM INVENTORIES AND INDUSTRIAL LEADERS' OPINIONS REGARDING INVENTORIES



sources : Central Statistical Office, European Commission
*3ma = 3 months moving average

(2) The UK financial system makes it easy for home-owners to use the security represented by the capital gains on their first homes for the purpose of obtaining consumer credit.
(3) Household investment and public investment are not recorded in the provisional national accounts for the fourth quarter published on 25 February.

tighter financial conditions, growth in corporate investment can be expected finally to slow down as of Q2 2004.

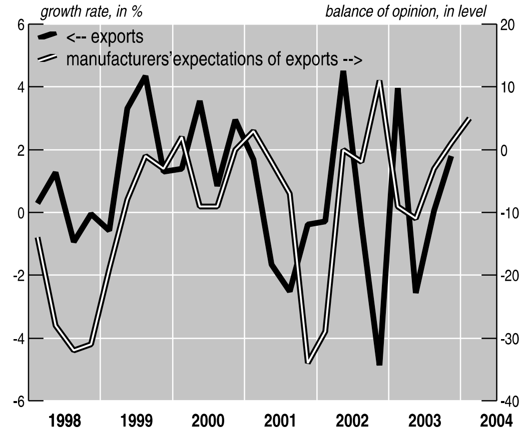
Firms are likely in coming months to adopt a less restrictive inventory behaviour than in the last part of 2003. In Q4 2003, industrial activity declined and firms ran down stocks substantially in order to meet strong domestic and foreign demand. However, expectations regarding inventory levels over the coming months show that this tendency can be expected to go into reverse *(see graph 5)*.

According to the draft budget for the 2003/2004 tax year, growth in public investment, as in other public spending, will be maintained at a firm rate.

The liveliness of American and European imports should continue to underpin United Kingdom exports. Export growth was in fact already firm in the last part of 2003 (up 1.8% in Q4) and the outlook reported by industrial business leaders for coming quarters is favourable *(see graph 6)*. However, the sharp rise in sterling versus the dollar could curb this growth. Imports, after rising by 2.2% in the last part of 2003, should continue to grow strongly in Q1. The purchase of the «Queen Mary 2" is equivalent to a one-off rise of 0.6 of a point in quarterly imports by value. In Q2, UK imports seem set to slow down in line with demand. All in all, foreign trade should again make a positive contribution to growth in Q2 2004. ■

6

UNITED KINGDOM : EXPORTS AND MANUFACTURERS' EXPECTATIONS OF EXPORTS



sources : UK Statistics, European Commission

BOX 1: THE IMPACT OF THE TAX CUTS ON CONSUMPTION IN THE UNITED STATES IN 2004: INDICATIONS COMPLEMENTING THOSE IN THE NOTE DATED DECEMBER 2003

The 2003 tax cuts are expected to result in a further increase in consumption of 0.4 of a point in 2004, much of this increase occurring in Q2. This is because the law voted in May 2003 provided for fresh tax cuts coming into force starting on 1 January 2004. This box provides a refinement of the assessment already contained in the Note dated December 2003.

The 2003 tax cuts are estimated to procure an additional 1 percentage point of income during the first three quarters of 2004

In May 2003 a law was voted prolonging and accelerating the programme of tax cuts already voted in May 2001. Its main provisions were as follows: an increase in the tax credits granted to parents; a decline in the rate of income tax; a decline in the rate of dividend tax; and a raising of the ceiling below which households are subjected to the minimum tax rate.

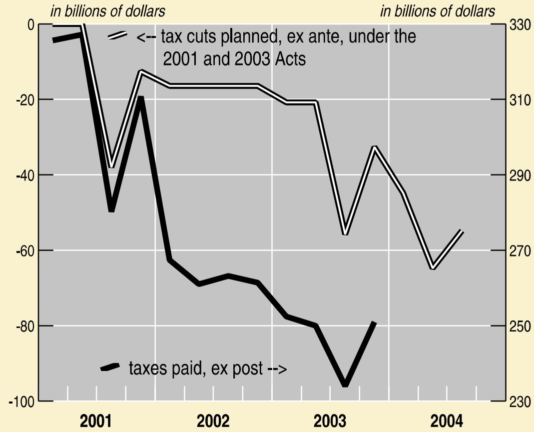
The taxes paid by households accordingly fell sharply in July and August 2003 before rising back virtually to their previous level in Q4 *(see graph A)*.

The fiscal stimulus in the early part of 2004 is likely to be substantial, amounting to 1.0 of a point of disposable income and concentrated on Q2.

The Congressional Budget Office (CBO, August 2003 and January 2004 (1)) and the Joint Committee on Taxation (JCT, May 2003 (2)) estimate the reduction in taxes paid by households during FY 2004 as the result of the

A

UNITED STATES : TAX CUTS RECEIVED BY HOUSEHOLD



sources : BEA, CBO, JCT, Insee

How to read the graph:
The tax cuts planned, ex ante, are calculated on the basis of the CBO figures and on certain assumptions: the new measures are applied starting in Q1 of the calendar year (retroactively for the measures voted for both the current fiscal year and in FY 2003).

(1) See «The budget and economic outlook: an update», CBO, 8 August 2003 and "The budget and economic outlook: fiscal years 2005 to 2014", CBO, 26 January 2004.
(2) See «Estimated Effects of the Conference Agreement for H.R. 2, The Jobs and Growth Tax Relief Reconciliation Act of 2003", JCX-55-03, 22 May 2003.

BOX 1: THE IMPACT OF THE TAX CUTS ON CONSUMPTION IN THE UNITED STATES IN 2004: INDICATIONS COMPLEMENTING THOSE IN THE NOTE DATED DECEMBER 2003

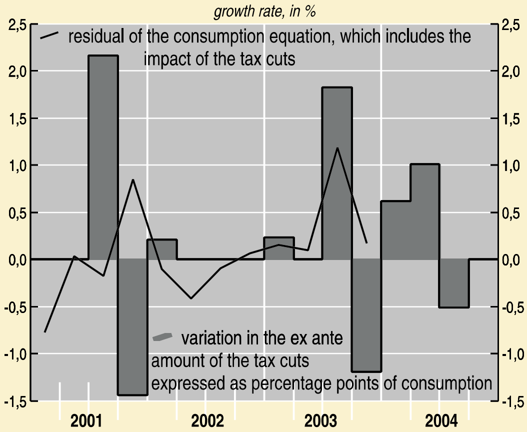
2003 legislation to be $107 billion, while the reductions resulting from the same law during FY 2003 would amount to 47 billion in a full year (3), so that the value of the new measures introduced during FY 2004 come to 60 billion. Moreover, the new measures are mostly applicable starting on 1 January of the calendar year, although they are in general not applied as early as this date. Households receive somewhat later the cheques consisting of the tax repayments enabling the situation to be regularised. This means that the tax cut would amount to 10 billion in Q1 and 30 billion in Q2, while in Q3 it would be 20 billion (*see graph A)*. This breakdown between Q1 and Q2 is consistent with a study carried out by the United States Treasury (4) according to which households are expected to receive roughly $40 billion in the spring in the form of tax repayment cheques.

However, given the improvement in the economic situation since 2002, the amount of taxes actually paid by households may not in fact decline in 2004.

B

UNITED STATES : TAX CUTS AND RESIDUALS OF A FORECASTING EQUATION FOR CONSUMPTION

growth rate, in %



How to read the graph:
A positive change in the amount of the tax cuts indicates that the amount of tax cuts granted to households has increased by comparison with the previous quarter. The residual of the consumption equation is obtained from a forecasting equation for consumption using gross disposable income to which the absolute value of the tax cuts has been added.

The resulting increase in consumption is likely to amount to 0.4 of a point in 2004, a substantial part of the stimulus having already been consumed in anticipation in 2003

The additional potential for growth in consumption as seen in the early part of 2004 is estimated to be only 0.4 of a point. When the effects of the tax cuts already received since Q3 2003 are cumulated, the overall impact amounts to 1.8 of a point of consumption, of which 1.2 of a point was already consumed in Q3 2003 and 0.2 of a point in Q4 *(see graph B)* (5).

This growth potential would be realised mainly in Q2, at the time of receipt of the spring tax repayment cheques. ■

(3) In practice, the measures in the law to be applied during FY 2003 involve only the first three quarters of 2003 and not Q4 2002. Their impact on the taxes paid by households, amounting to a reduction of 35 billion for the whole of FY 2003, therefore correspond to a net reduction of the order of 35/3 billion per quarter. Simply extrapolating these measures to the whole of FY 2004 would therefore reduce the taxes by (35/3)x4 = 47 billion for the whole of FY 2004.

(4) See «Treasury releases New Data on the Benefits of the Jobs and Growth Tax Relief Reconciliation Act», JS-1187, 19 February 2004.

(5) The use of a consumption equation makes it possible to calculate the share of the 1.8 of a point already consumed. The difference between planned and observed consumption is explained mainly by the impact of the tax cut on consumption.

BOX 2: PRODUCTIVITY AND JOBLESS GROWTH IN THE UNITED STATES

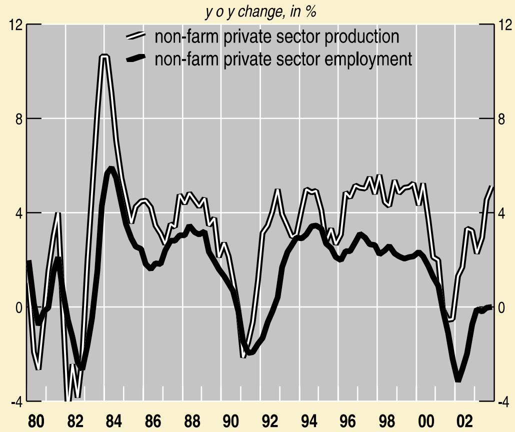
Following the 2001 recession, labour productivity in the United States has been growing at rates of above 4%, much higher than the rates seen at the end of the 1990s, which were already regarded as very substantial. The other side of the coin is that job creation has been particularly weak in view of the growth in production (see graph A).

This box takes a fresh look at the reasons that might possibly explain this upturn in productivity. It first reviews the measurement problems sometimes invoked that could explain why productivity has been growing at such artificially high rates. More fundamental explanations are then discussed, including the past acceleration in capital-intensity.

A

UNITED STATES : PRODUCTION AND EMPLOYMENT

y o y change, in %



source : BLS

In order to measure growth in employment, the payroll survey seems more reliable than that of households

In the United States, employment is measured from two different sources whose messages have diverged since 2002 [1]. The measurement of employment derived from the household survey indicates more dynamic job creation than that reported by the payroll (or establishment) survey (+0.7 million between February 2001 and February 2004, compared with a fall of 2.3 million reported for the same period in the payroll survey).

The fact that the payroll survey fails to take proper account of newly created firms would explain part of the difference compared with the household survey. It has to be remembered that these new firms are likely to be more numerous in an upswing phase, a fact that would explain why the payroll survey arrives at a less dynamic figure for employment growth in most upswing phases - that of 1983, for example. On the other hand, differences in the coverage of the two surveys are not sufficient to explain the divergence in results [2].

However, a study carried out by statisticians from the BLS and the Census Bureau [3] suggests that the payroll survey is the more reliable of the two. The study highlights the fact that the measurement of employment derived from the household survey is obtained by calibration on benchmark estimates of population in the census and these — and, to be more precise, the assumptions relating to immigration — are thought to be too high: having been set in 2000, they did not take into account the economic slowdown and the new security measures introduced following 11 September 2001. Alan Krueger makes a convincing analysis in an article in the New York Times, in which he explains the difference between the two surveys as being above all due to adjustments linked to population estimates and to the self-employed [4].

In addition, being based on a panel of 160,000 firms (and around 400,000 establishments) questioned each month, the payroll survey can be expected to provide a more precise picture of evolutions on the labour market than the household survey, which is based on a panel of 60,000 households contacted by telephone.

The recent acceleration in productivity, measured on the basis of the payroll survey, seems to be explained mainly by the past acceleration in capital per head

Productivity is pro-cyclical: in the early stages of an upswing, when production has just begun to recover in line with demand, growth in employment follows suit only after a time-lag, the result being that productivity accelerates. This phenomenon reflects the fact, among others, that at the beginning of an upswing firms prefer to ask greater efforts from their employees in order to meet demand rather than to resume hiring immediately. Furthermore, after a recession firms reduce the inefficiencies accumulated

(1) See "L'existence de trois sources statistiques différentes empêche d'avoir une vision claire de la santé du marché du travail", French Embassy to the United States, AF/04.011-BS, Bernard Salzmann.
(2) See «The Jobless Recovery», Remarks by Governor Ben S. Bernanke, 6 November 2003. The Fed has constructed a measure of employment based on the household survey but with coverage very close to that of the payroll survey. In particular, it takes into account the fact that people with two jobs are counted twice in the payroll survey and that self-employed workers are excluded, as are private household and agricultural workers. This new measure does not explain the difference between the two measures of employment, however. The decline in employment between March 2001 and November 2003 reported in the Fed's adjusted inquiry is 0.6 million, whereas it is 2.8 million in the payroll survey.
(3) See «Examining the Discrepancy in Employment Growth between the CPS and the CES», Nardone T., Bowler M., Kropf J. and Kirkland K., prepared for presentation to the Federal Economic Statistics Advisory Committee (FESAC), 17 October 2003.
(4) See "Slippery Data on the Job Market", New York Times, Alan Krueger, 18 September 2003.

BOX 2: PRODUCTIVITY AND JOBLESS GROWTH IN THE UNITED STATES

during the previous upswing. In a second stage, firms then recruit in order to respond to the acceleration in demand, so that productivity slows down. This is the productivity cycle as seen at the time of the 1974-1975 and 1982-1983 recessions. Currently, the United States economy is in the phase when employment grows much less rapidly than production *(see graph B)*.

However, this phase seems to be taking longer to complete than in past cycles. Whereas in the 1982 recession there was only one quarter during which the year-on-year change in production was positive and the change in employment negative, the corresponding number of quarters was 3 for the 1991 recession and already stands at 8 in the present case. Shown graphically, the productivity cycle has shifted upwards and to the left and growth is taking place «joblessly» *(see graph B)*.

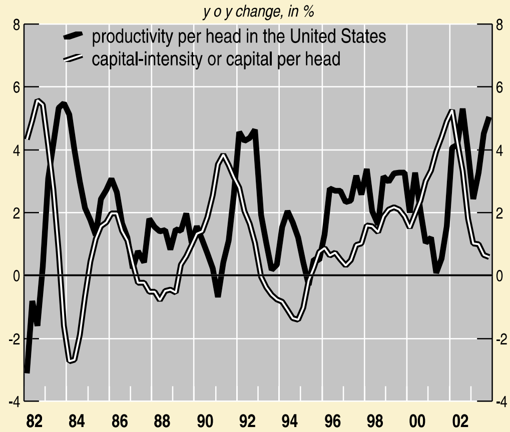
The very high productivity gains now being seen seem to stem from the rapid accumulation of capital, notably using the new technologies, that occurred towards the end of the 1990s. Firms would seem to need a certain time, amounting to one or two years, to reorganise and derive the full benefit from their past investments *(see graph C)*. More inefficiencies would have been built up because of the sheer length of the cycle (5). In order to meet demand, firms seem to be preferring to optimise the utilisation of their factors of production rather than to hire and to invest.

Two other more immediate factors could also be contributing to the weakness of job creation: the high degree of uncertainty in the macroeconomic environment associated with very different phenomena (11 September 2001, wars in Afghanistan and Iraq, accounting scandals, risk of deflation, uncertainties regarding the durability of the recovery, trade disputes between the United States and the European Union, etc.); and the sharp increase in labour costs via the rise in the cost of social benefits to the employers.

C

PRODUCTIVITY AND CAPITAL-INTENSITY

y o y change, in %



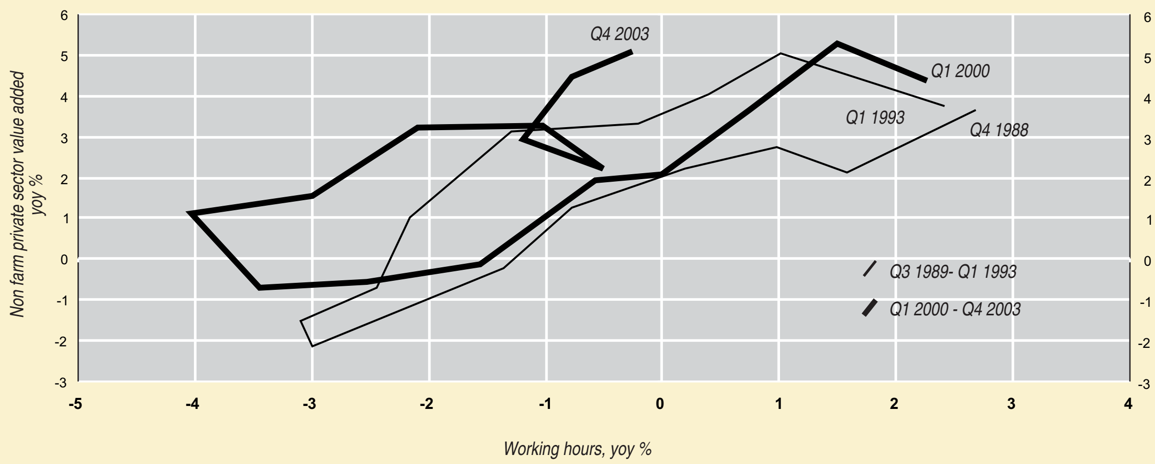
sources : BEA, Insee

Looking beyond these short-term factors, the structural changes that are now operating could also be helping to increase labour productivity and reduce the growth in employment needed to cope with demand. The structural changes seen in the United States would seem to result from, among other things, trade globalisation and the development of new technologies. Globalisation can be expected to lead firms to relocate their under-productive activities to low-wage countries. The development of new

(5) This is the thesis defended by Lawrence Katz. See «Why Jobs were So Late», Alan Krueger, New York Times, 13 November 2003.

B

PRODUCTIVITY CYCLE IN THE UNITED STATES IN THE 1990-1991 AND 2001-2002 RECESSIONS



Source: BLS

BOX 2: PRODUCTIVITY AND JOBLESS GROWTH IN THE UNITED STATES

technologies can be expected to make existing factors of production more efficient. These changes give rise to sectoral reallocations of labour that are more marked than previously (see Groshen and Potter[(6)]).

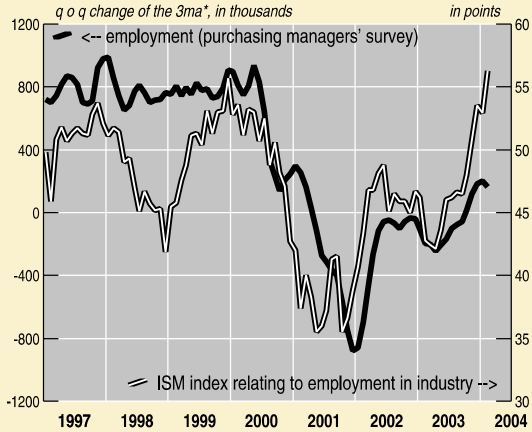
Growth likely to become more job-rich as result of the past slowdown in capital growth *(see graph C)*

Several indicators coming out of the labour market are pointing to a recovery in employment since the end of 2003: new weekly unemployment benefit claims are now well below 400,000; employment as measured by the payroll survey is increasing again, albeit slowly (by around 50,000 jobs a month); finally, the confidence indices relating to employment are satisfactorily headed, in both the payroll and household surveys *(see graph D)*. ■

(6) "Has Structural Change Contributed to a Jobless Recovery ?", Groshen and Potter, Federal Reserve Bank of New York, Current Issues in Economics and Finance, Volume 9 Number 8, August 2003.

D

EMPLOYMENT AND OPINION ON EMPLOYMENT IN THE PURCHASING MANAGERS' SURVEY



sources : BLS, ISM
*3ma = 3 months moving average

The economic situation in the euro zone

In 2003, the euro zone's GDP rose very slightly, by just 0.4%. Behind this low figure, however, a pattern of recovery is taking shape. Handicapped by the declines in foreign trade and investment in the early part of the year, activity levelled off in Q1 before contracting in Q2 (by 0.1%). Starting in Q3, growth picked up again, driven by the marked recovery in exports, with GDP rising by 0.4% in Q3 and 0.3% in Q4.

This recovery should be confirmed in the first half of 2004, with successive quarterly growth rates of 0.4% and 0.5%. Exports will probably continue to benefit from a buoyant international environment and then be backed up by a gradual rise in domestic demand. The improved prospects for overall demand and the maintenance of favourable financing conditions should bolster investment growth, while household consumption should be boosted by tax measures in France and especially in Germany.

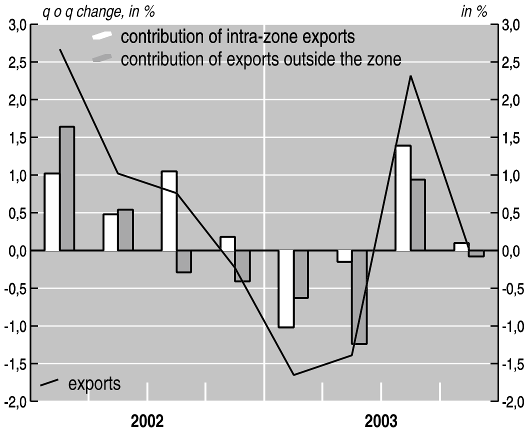
As of mid-2003, a recovery began to take shape, triggered by a revival in foreign trade

Euro-zone GDP fell back in H1 2003, handicapped by the weakness of domestic demand and by an unfavourable external environment. Only in Spain did growth remain dynamic, underpinned by strong demand from both households and firms. Exports from the zone declined, with trade within the zone suffering from the slackness of domestic demand and exports to other countries from the slowdown in world trade. Investment contracted, hit by the deterioration in the outlook for activity associated with uncertainties over the war in Iraq. The decline was further amplified by the ending of the «Tremonti» incentive measures in Italy.

In Q3 2003, the upturn in exports provided the main prop for activity. In Germany especially, exports were in fact the sole growth motor. The upturn that began in Q2 in the United States and the United Kingdom was confirmed, thus providing support for exports to outside the zone. The recovery in the zone's economies then stimulated trade among member countries *(see graph 1 and box 2)*. In order to cope with the upturn in external demand, business leaders ran down their stocks on a massive scale. In Q4 exports slowed down, partly as a result of the appreciation of the euro. Meanwhile, imports rallied in Q3 and Q4, in line with the upturn in demand.

1

CONTRIBUTIONS TO TOTAL MERCHANDISE EXPORTS FROM EXPORTS INSIDE AND OUTSIDE THE ZONE



source : Eurostat

Q4 saw domestic demand take up the running from external demand. Investment rallied strongly, having been in decline since the beginning of the year. The improved export demand expectations stimulated investment projects. In addition, financing conditions remained favourable, with interest rates remaining at low levels and share prices continuing to rise. On the other hand, household consumption remained weak in H2, notably because of a substantial decrease in Germany and stagnation in Italy *(see graph 11 of the overview)*. The stagnation of employment continued to hold back household incomes. Moreover, the stabilisation of the unemployment rate at a high level seems to have favoured precautionary savings behaviour.

Export growth is expected to intensify still further in the early part of 2004, despite the constraining effects of the exchange rate

The good performance posted by the euro zone's partners, especially the United States and the United Kingdom, is likely to be confirmed in the early part of 2004 and this would favour exports to outside the zone. In all member countries, business leaders are expecting an increase in foreign demand for their products *(see graph 2)*. There was confirmation of this tendency in Q4 of last year in the shape of sharp rises in foreign demand for manufactures in Germany (up 4.1%) and in Italy (5%). The negative im-

GDP FOR THE EURO ZONE AND FOR THE MAIN MEMBER COUNTRIES

(% change)

	Quarterly change								Annual changes		
	2002		2003				2004		2001	2002	2003
	Q1	Q2	Q1	Q2	Q3	Q4	Q1	Q2			
GERMANY											
GDP	**0.1**	**0.0**	**-0.2**	**-0.2**	**0.2**	**0.2**	**0.4**	**0.6**	**0.2**	**-0.1**	**1.1**
Household consumption	0.2	-0.1	0.4	-0.4	-0.3	-0.4	0.2	0.7	-1.0	-0.1	0.1
Total GFCF	0.1	-0.3	-1.5	-0.8	-0.5	1.7	0.8	0.8	-6.5	-2.9	2.2
Public consumption	0.5	-0.6	0.1	0.7	0.7	-0.2	-1.4	0.1	1.7	0.9	-1.0
Exports	2.1	0.1	-0.5	-2.6	3.8	0.3	1.5	2.0	3.4	1.1	4.5
Imports	1.0	0.9	1.5	-2.3	0.2	2.7	2.0	2.5	-1.6	2.5	5.4
Contributions:											
Domestic demand ex. stocks	*0.3*	*-0.2*	*-0.1*	*-0.2*	*-0.1*	*0.0*	*0.0*	*0.6*	*-1.6*	*-0.5*	*0.3*
Inventory change	*-0.5*	*0.4*	*0.5*	*0.3*	*-1.0*	*0.9*	*0.5*	*0.1*	*0.1*	*0.8*	*1.2*
Foreign trade	*0.4*	*-0.3*	*-0.7*	*-0.2*	*1.3*	*-0.7*	*-0.1*	*-0.1*	*1.7*	*-0.4*	*-0.1*
FRANCE											
GDP	**0.3**	**-0.3**	**0.0**	**-0.4**	**0.4**	**0.5**	**0.5**	**0.6**	**1.2**	**0.2**	**1.4**
Household consumption	0.5	0.3	0.7	0.0	0.5	0.3	0.5	0.3	1.4	1.6	1.2
Total GFCF	-0.7	-1.2	0.1	0.3	0.1	0.7	0.9	1.1	-1.4	-0.8	2.3
Public consumption	0.7	0.5	0.5	0.3	0.8	0.9	0.2	0.5	7.0	2.4	1.7
Export	0.1	-1.4	-1.6	-1.1	0.9	1.0	1.8	2.2	1.2	-2.1	4.4
Imports	0.7	-1.0	0.0	0.5	0.0	2.1	1.9	2.4	0.9	0.9	5.5
Contributions:											
Domestic demand ex. stocks	*0.3*	*0.0*	*0.5*	*0.1*	*0.5*	*0.5*	*0.4*	*0.5*	*1.4*	*1.3*	*1.4*
Inventory change	*0.1*	*-0.2*	*0.0*	*-0.1*	*-0.3*	*0.2*	*0.0*	*0.2*	*-0.3*	*-0.3*	*0.2*
Foreign trade	*-0.2*	*-0.2*	*-0.5*	*-0.4*	*0.2*	*-0.3*	*0.0*	*0.0*	*0.1*	*-0.9*	*-0.2*
ITALY											
GDP	**0.2**	**0.4**	**-0.2**	**-0.1**	**0.4**	**0.0**	**0.2**	**0.4**	**0.4**	**0.4**	**0.7**
Household consumption	0.4	0.7	0.2	0.1	0.4	-0.4	0.2	0.4	0.4	1.2	0.4
Total GFCF	2.8	4.3	-4.9	-1.0	-0.9	-1.2	0.4	1.0	1.3	-2.1	-0.4
Public consumption	0.2	0.4	1.0	0.5	0.5	0.0	0.4	0.4	1.9	2.2	1.1
Exports	1.3	-1.2	-5.3	-0.1	5.7	-3.8	0.5	1.3	-3.4	-3.9	2.3
Imports	-1.8	3.9	-4.8	0.1	5.2	-3.2	1.0	1.5	-0.2	-0.6	2.2
Contributions:											
Domestic demand ex. stocks	*0.8*	*1.4*	*-0.8*	*-0.1*	*0.1*	*-0.4*	*0.3*	*0.5*	*0.9*	*0.7*	*0.4*
Inventory change	*-1.4*	*0.4*	*0.7*	*0.0*	*0.2*	*0.6*	*0.0*	*0.0*	*0.5*	*0.6*	*0.3*
Foreign trade	*0.9*	*-1.4*	*-0.2*	*-0.1*	*0.2*	*-0.2*	*-0.1*	*0.0*	*-0.9*	*-0.9*	*0.0*
SPAIN											
GDP	**0.6**	**0.4**	**0.5**	**0.7**	**0.6**	**0.7**	**0.8**	**0.8**	**2.0**	**2.4**	**2.5**
Household consumption	-0.1	1.2	0.6	1.1	0.2	1.1	0.7	0.7	2.6	3.0	2.4
Total GFCF	2.1	1.0	0.4	-0.2	1.7	0.6	0.8	0.8	4.4	4.6	3.1
Public consumption	0.9	1.0	1.3	1.2	1.2	1.0	0.8	0.8	4.4	4.6	3.1
Exports	4.4	1.0	-1.7	4.0	-1.0	0.6	2.5	2.5	0.0	4.0	4.0
Imports	5.2	5.4	-2.8	2.1	1.2	2.2	2.1	2.1	1.8	6.7	6.6
Contributions:											
Domestic demand ex. stocks	*0.6*	*1.1*	*0.7*	*0.8*	*0.7*	*1.0*	*0.8*	*0.8*	*2.6*	*3.3*	*2.6*
Inventory change	*0.3*	*0.8*	*-0.6*	*-0.5*	*0.7*	*0.3*	*0.0*	*0.0*	*0.0*	*0.1*	*0.4*
Foreign trade	*-0.4*	*-1.5*	*0.4*	*0.5*	*-0.7*	*-0.6*	*0.0*	*0.0*	*-0.6*	*-1.0*	*-0.6*
ZONE EURO											
GDP	**0.2**	**0.0**	**0.0**	**-0.1**	**0.4**	**0.3**	**0.4**	**0.5**	**0.9**	**0.4**	**1.2**
Household consumption	0.3	0.3	0.4	0.0	0.2	0.1	0.3	0.5	0.1	1.0	0.8
Total GFCF	0.3	0.3	-0.9	-0.4	-0.2	0.6	0.7	0.9	-2.8	-1.2	1.7
Public consumption	0.6	0.1	0.5	0.6	0.6	0.6	-0.3	0.3	2.9	1.9	0.8
Exports	1.4	-0.4	-1.5	-0.9	2.3	0.2	1.3	1.7	1.5	0.0	3.8
Imports	1.5	0.3	-0.6	-0.4	0.8	2.1	1.6	1.9	-0.1	1.5	5.0
Contributions:											
Domestic demand ex. stocks	*0.3*	*0.2*	*0.1*	*0.0*	*0.2*	*0.3*	*0.3*	*0.5*	*0.0*	*0.7*	*1.0*
Inventory change	*-0.1*	*0.0*	*0.2*	*0.1*	*-0.4*	*0.7*	*0.2*	*0.0*	*0.2*	*0.3*	*0.5*
Foreign trade	*0.0*	*-0.2*	*-0.4*	*-0.2*	*0.6*	*-0.7*	*-0.1*	*0.0*	*0.6*	*-0.6*	*-0.3*

Forecast
Last update: March17th 2004.
Sources: Statistisches Bundesdamt, Insee, Istat, Ine, Eurostat

pact of the past appreciation of the exchange rate on the zone's export competitiveness would thus be compensated by a rise in foreign demand *(see graph 3)*.

In addition, the upturn in the European economies is likely to encourage intra-zone trade. In particular, intra-industry trade is likely to be brisk within the zone. Total exports, inside and outside the zone, are expected to rise by 1.3% in Q1 before accelerating to 1.7% in Q2. Imports are likely to remain strong because of the firmer domestic demand and the vigorous exports. The past appreciation of the euro would have a similar effect.

The accession of 10 new EU members on 1 May is not expected to have a major impact on the zone's trade in H1 2004. This is because the commercial integration of these countries into the EU zone has already taken place via association agreements.

The rise in investment expected to continue, on the back of the recovery in demand

The improved demand expectations, mainly on the export side, can be expected to provide business leaders with an incentive to invest. The scale of this investment is likely to be all the greater in that capacity utilisation rates have risen since the end of 2003 *(see graph 4)*.

Moreover, financing conditions are likely to remain very favourable throughout the zone in 2004. In particular, long rates began to decline again in the early part of the year and have now reached very low levels. At the same time, share prices are still generally headed upwards, with the Eurostoxx 50 having put on more than 30% in the space of a year.

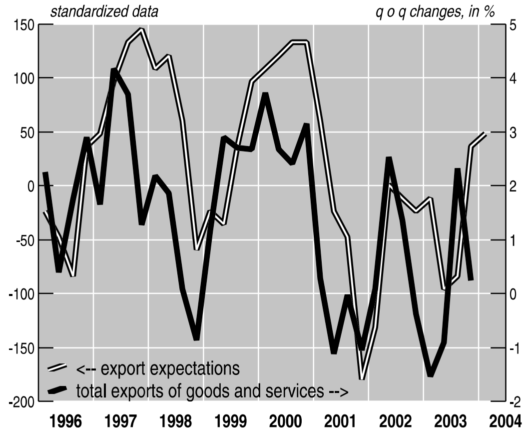
Even so, the business climate, after improving strongly, showed no further progress in February *(see graph 5)*. This underlines the fickleness of business leaders' opinions, which are conditioned by what they see as the durability of the rise in domestic demand. In these circumstances, stocks are liable to continue to make only a small contribution to growth in Q1 before becoming neutral in Q2.

Household consumption set to accelerate, boosted by tax cuts in Germany

The early part of 2004 is likely to see an acceleration in household consumption, with a rise of 0.3% in Q1 followed by 0.5% in Q2. Consumption is likely to be bolstered by tax cuts in Germany, a measure which should be reflected in 2004 in a rise of more than €15 billion in German households' incomes, equivalent to 0.2 of a point of euro-zone GDP. As taxes in Germany are deducted at source, the impact on incomes

2

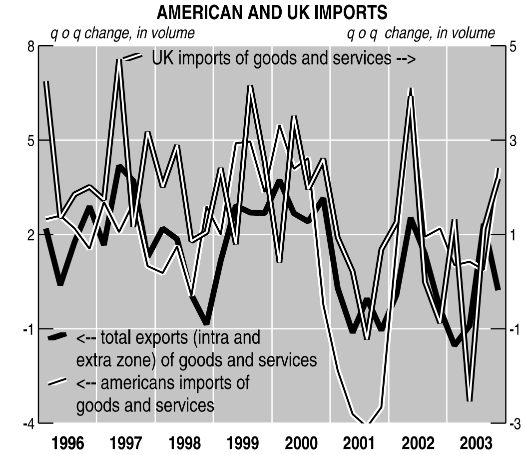
EXPORTS FROM THE EURO ZONE AND EXPORT EXPECTATIONS IN MANUFACTURING INDUSTRY



sources : European Commission, Eurostat, Ifo, Insee, Isae

3

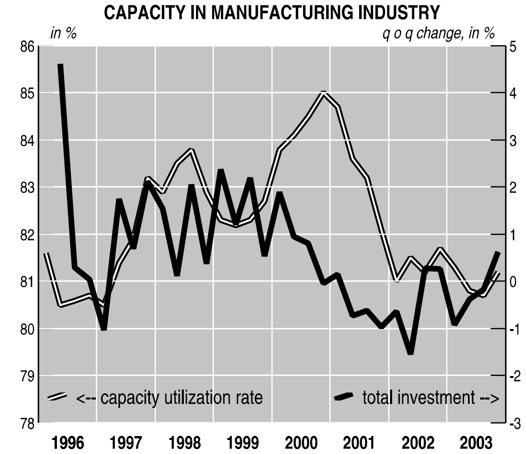
EXPORTS FROM THE EURO ZONE AND AMERICAN AND UK IMPORTS



sources : BEA, Eurostat, ONS

4

INVESTMENT AND OPINIONS REGARDING PRODUCTIVE CAPACITY IN MANUFACTURING INDUSTRY



sources : European Commission, Eurostat, Ifo, Insee, Isae will be felt already in the first half of the year (mainly in Q2 as a result of administrative delays) *(see box 1)*.

After declining during the winter, inflation in the euro zone is set to stabilise at below 2% *(see section on «consumer prices in the euro zone»)* and this would bolster household purchasing power. At the same time, the rise in share prices in the past year will have added to financial wealth.

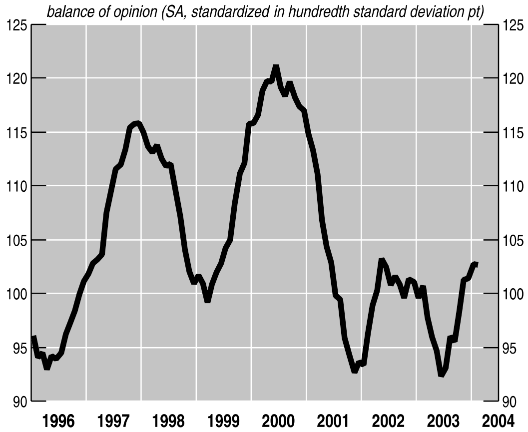
A factor operating in the other direction is the continuing slackness of the labour market. Unemployment has stabilised at a high level (8.8% in January) *(see graph 6)* and the past deterioration on the jobs market is liable to continue to exert a negative effect on incomes. All in all, in the absence of the exceptional measures taken in Germany, household consumption would probably not accelerate significantly in Q2 for the euro zone as a whole.

The evolution in consumption is likely to differ from one euro-zone country to another. In Italy, consumption is likely to be handicapped by the low level of household confidence, affected by the Parmalat scandal, since a substantial portion of the bonds issued by the firm are in the hands of private individu-

5

INDICATOR OF THE BUSINESS CLIMATE IN MANUFACTURING INDUSTRY

balance of opinion (SA, standardized in hundredth standard deviation pt)



sources : European Commission, Ifo, Isae, Insee calculation

EURO ZONE FORECASTS

(Quaterly % change, except specified)

	2003			2004	
	Q2	Q3	Q4	Q1	Q2
Volumes					
GDP	-0.1	0.4	0.3	0.4	0.5
Domestic demand	0.1	-0.2	1.0	0.5	0.5
Household consumption	0.0	0.2	0.1	0.3	0.5
Public consumption	0.6	0.6	0.6	-0.3	0.3
Investment	-0.4	-0.2	0.6	0.7	0.9
Foreign trade of goods ans services	-0.2	0.6	-0.7	-0.1	0.0
Exports of goods	-0.8	2.3	0.0	0.7	0.9
Imports of goods	1.5	-2.0	1.9	3.7	3.0
Prices					
Value added price	0.5	0.8	0.4	0.5	0.4
Consumption price	0.1	0.5	0.5	0.3	0.3
Investment price	0.4	0.3	0.3	0.2	0.3
Price of exports of goods	-1.7	-0.1	-0.5	-0.5	0.4
Price of imports of goods	-4.3	0.4	-1.4	-3.6	-1.3
Wages	0.8	0.8	0.9	0.9	0.8
Employment and unemployment					
Unemployment rate (%)	8.8	8.8	8.8	8.8	8.8
Employment	0.0	0.0	0.2	0.0	0.0
Working population	0.1	0.0	0.2	0.0	0.0
Labour cost per unit	0.9	0.4	0.9	0.5	0.3
Productivity of work	-0.1	0.5	0.1	0.4	0.5
Others					
Global demand	0.4	1.1	2.1	3.1	2.8
Balance of trade (points of GDP)	2.2	2.9	2.8	2.8	2.8
3-month interest rate (%)	2.4	2.1	2.2	2.1	2.1
10-year interest rate (%)	4.0	4.2	4.4	4.2	4.2
Level of capacity utilization (%)	80.8	80.7	80.7	81.1	81.4
Gross disposable income (value)	0.6	1.1	0.7	0.9	0.9
Contribution of gross oeprating surplus	0.0	0.5	0.0	0.2	0.3
Contribution of wages	0.6	0.6	0.9	0.7	0.6
Others contributions	0.0	0.0	-0.2	0.0	0.0

Forecast

BOX 1: THE IMPACT OF THE TAX CUTS IN GERMANY ON HOUSEHOLD CONSUMPTION IN H1 2004

In 2004, the income-tax schedules were revised downwards. This measure forms part of the major tax reform voted in 1999, to be implemented in three stages in the period to 2005. On 19 December 2003, the partial bringing forward of the third stage was voted. In total, the tax cuts can be expected to add 15.4 billion euros to household incomes in 2004.

As income tax in Germany is deducted at source, the tax cuts were due to take effect as early as end-January. However, because of implementation delays due to the need for adjustments in IT systems, most German households had not yet benefited from the cuts in February. The tax cuts will probably therefore have an impact on household incomes mainly from Q2 on.

A modelling of the impact of variations in household income on consumption suggests that these tax measures will increase German household consumption by 0.1 of a point in Q1 2004 and then by 0.5 of a point in Q2. ■

BOX 2: EURO-ZONE EXPORTS TO TYPES OF DESTINATION

In Q2 2003, «total [1]» merchandise exports from the euro zone rose sharply, with exports within the zone providing the bulk of the recovery. In fact, intra-zone trade was stimulated by the upturn seen in H2 in most countries of the zone. In addition, following the upturn in the economies of the United States and the United Kingdom, exports to these countries, which were handicapped by the tendency for the euro to appreciate in 2003, were no longer curbing growth in total exports *(see graph A)*.

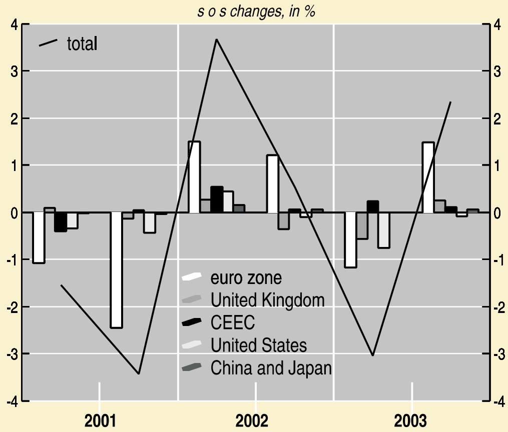
This pattern is found in varying degrees for all countries in the zone. For example, a similar tendency can be seen for Germany *(see graph B)*, whose exports rose strongly in H2, boosted in particular by very lively exports to Germany's European partners and a smaller negative contribution from exports to the United States. In Italy *(see graph C)*, the acceleration in total exports in H2 is explained by the recovery in exports to the euro zone and the United Kingdom. The same is true of France *(see section entitled «Échanges extérieurs» (French version only))*, with exports to United States accelerating more strongly. ■

(1) *In the statistics published by Eurostat, intra-zone trade, i.e. trade between member countries, is also included in total trade.*

A

ZONE EURO : EXPORTS AND CONTRIBUTIONS FROM CERTAIN FOREIGN MARKETS

s o s changes, in %

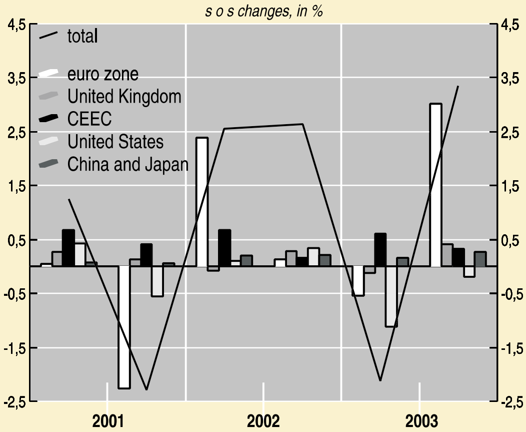


source : Eurostat

B

GERMANY : EXPORTS AND CONTRIBUTIONS FROM CERTAIN FOREIGN MARKETS

s o s changes, in %

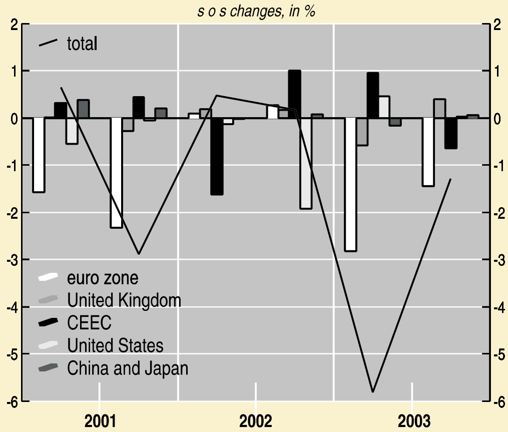


source : Statistisches Bundesamt

C

ITALY : EXPORTS AND CONTRIBUTIONS FROM CERTAIN FOREIGN MARKETS

s o s changes, in %



source : Istat

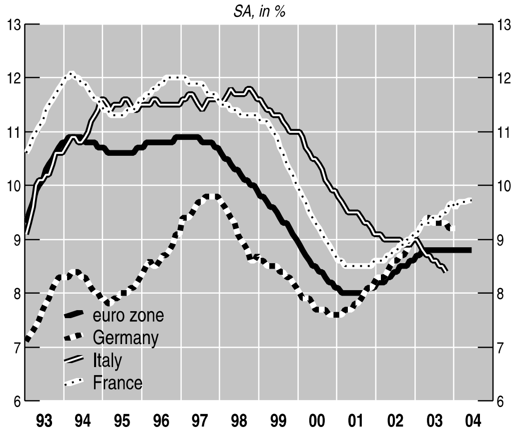
als. Even so, consumption in Italy is likely to pick up slightly in Q2, as the economic determinants remain positively headed: the unemployment rate reached a historically low level towards the end of 2003 (8.4% in October) and the wage increases agreed in branch-level bargaining can be expected to bolster purchasing power. In Spain, given the maintenance of the unemployment rate at a low level and the slow-down in inflation, household consumption should continue to rise at a firm rate, although this could be affected temporarily by the consequences of the Madrid terrorist attacks.

Consumption by general government is expected to decline in the early part of 2004, mainly because of the reform of the German health-insurance system, under which many items of expenditure that had previously been paid for by the system will now be borne by German households. ■

6

UNEMPLOYMENT RATE IN THE EURO ZONE

SA, in %



source : Eurostat

Consumer prices in the euro zone

After stabilising at slightly above 2%, year on year, in the summer of 2003, inflation in the euro zone declined during the winter. While core inflation and the growth in prices of foodstuffs remained stable, inflation in the energy sector followed a downward tendency thanks to an oil price that was admittedly high but not rising as fast as previously. Within the euro zone, inflation differentials continued to narrow.

Inflation is likely to remain virtually stable until the summer of 2004. Core inflation should ease slightly between now and June 2004, as the result of the slowdown in prices of manufactured goods, while inflation in prices of services should remain stable. However, this easing of core inflation, combined with the decline in inflation in the food sector, would be offset by an increase in the year-on-year price rise for energy.

Assuming a Brent price of $29/barrel in Q2 2004 and a euro/dollar exchange rate of around 1.25, inflation is expected to stabilise, standing at 1.7% in June.

The slowdown and the subsequent fall in energy prices have produced an easing of inflation in the winter of 2003

After levelling off slightly above 2% from the summer of 2003 on, inflation in the euro zone has been in decline since December 2003, falling from 2.2% in November to 1.6% in February 2004. This decline stems essentially from the marked easing of inflation in the energy sector. While the euro exchange rate, in effective terms, has appreciated less in the recent past than in the last part of 2003, the evolutions in the oil price have been much less unfavourable than a year ago, with the Brent price rising by only $1.8/barrel between November 2003 and February 2004, compared with a rise of $8.4 in the corresponding period a year earlier.

Core inflation [(1)] fluctuated between 1.6% and 1.8% in the period from May 2003 to January 2004, before standing at 1.9% in February 2004. The components of this index, namely prices of manufactured goods

(1) Measured as the HICP excluding food, alcohol, tobacco and energy.

TABLE 1: EURO ZONE INFLATION

(year on year % growth of HICP)*

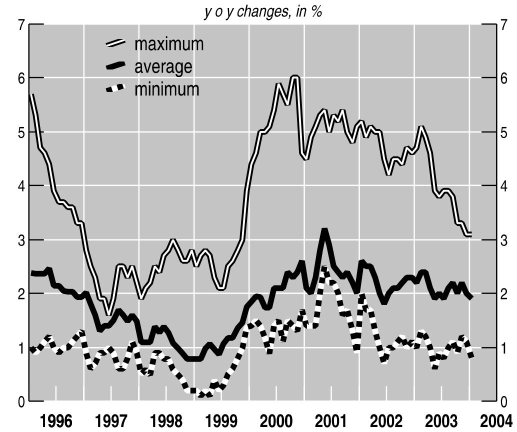
Sectors (weight in the index)	February 2003	June 2003	February 2004	June 2004
Food (15.6%)	1.2	2.3	2.0	1.7
Beverage and Tobacco (3.9%)	5.6	5.4	5.6	5.6
Clothing and footwear (7.5%)	0.5	1.1	0.6	-0.2
Housing. water. electricity and gas (14.9%)	2.8	2.5	1.4	1.8
Furnishings and household equipment (7.8%)	1.4	1.2	0.8	0.8
Health (4.0%)	2.6	2.5	7.2	7.1
Transports (15.1%)	4.4	1.5	0.4	0.9
Communications (2.9%)	-0.8	-0.6	-1.0	-1.2
Leisure and culture (9.6%)	0.5	0.1	-0.2	0.7
Education (0.9%)	3.5	3.7	3.5	3.5
Hotels-cafés-restaurants (9.6%)	3.4	3.1	2.8	2.7
Miscellaneous goods and services (8.2%)	2.9	2.8	2.3	1.7
Total (100.0%)	**2.4**	**1.9**	**1.6**	**1.7**
Food (Beverage and Tobacco) (19.5%)	**2.0**	**3.0**	**2.7**	**2.5**
Energy (8.1%)	**7.6**	**1.6**	**-2.3**	**-0.6**
Core inflation (72.3%)	**1.8**	**1.7**	**1.9**	**1.8**
of which: Manufactured products(31.0%)	*0.8*	*0.9*	*0.9*	*0.5*
Services (41.3%)	*2.7*	*2.6*	*2.7*	*2.7*

Forecast
* Harmonized Index of Consumer Prices
Source: Eurostat

1

INFLATION IN THE EURO ZONE

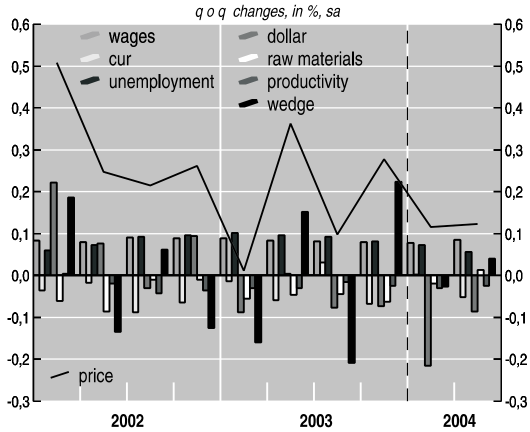
y o y changes, in %



2

ECONOMETRIC CONTRIBUTIONS TO THE EVOLUTION IN PRICES OF MANUFACTURED GOODS

q o q changes, in %, sa

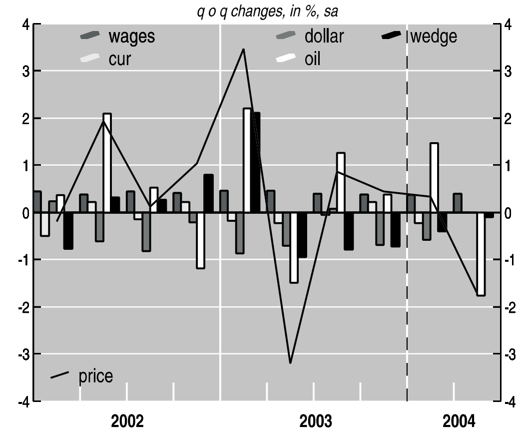


forecasts after the dotted line

3

ECONOMETRIC CONTRIBUTIONS TO THE EVOLUTION IN PRICES OF ENERGY PRODUCTS

q o q changes, in %, sa



forecasts after the dotted line

and services, showed fairly stable rises up to December 2003. In January 2004, the decline in prices of manufactured goods due to the sales was greater than usual, but part of this difference was made up in February, pushing inflation in the sector upwards. Prices of services accelerated in January following the reform of the German social welfare system(2), thus compensating for the decline in prices of manufactured products other than medicines. The respective year-on-year rises were 0.9% and 2.7% in February 2004, as against 0.9% and 2.6%, respectively, in June 2003.

Inflation in the energy sector continued its downward tendency, but with seesawing monthly changes. From a starting point of 7.6% in February 2003, it fell to 1.6% in June 2003 before -2.3% in February 2004. Evolutions in the oil price have therefore been much less unfavourable than they were a year earlier.

The rise in prices of foodstuffs continued at a high level in Q4 2003 before starting a downward tendency in the early part of 2004. This brought it to 2.7% in February 2004, compared with 3.6% in December 2003.

Inflation differentials within the euro zone continuing to narrow

Inflation differentials within the euro zone have been narrowing rapidly since February 2003, with the maximum spread falling from 3.8 points in that month to 2.2 points in February 2004. This convergence was towards the lower end of the range, with the gap between maximum and average inflation falling by 1.7 of a point and the gap between minimum and average inflation remaining relatively stable. In particular, inflation fell by more than 1 point in Spain, Greece, Ireland, the Netherlands and Portugal (countries where it had been above 3% in February 2003).

Core inflation in the euro zone should decline slightly between now and June

Core inflation is expected to fall slightly until mid-2004. This is because the evolution in the prices of services is likely to be virtually stable and that of

(2) In fact, following this reform, the share of health spending remaining to be met by the consumers rose steeply in January 2004. As the HICP records the prices paid by consumers net of social security reimbursements, this pushed consumer prices of health care steeply upwards in January 2004, by almost 16% in Germany and almost 4.7% for the euro zone. The impact on total inflation comes out at 0.6 of a point for Germany and 0.2 of a point for the euro zone.

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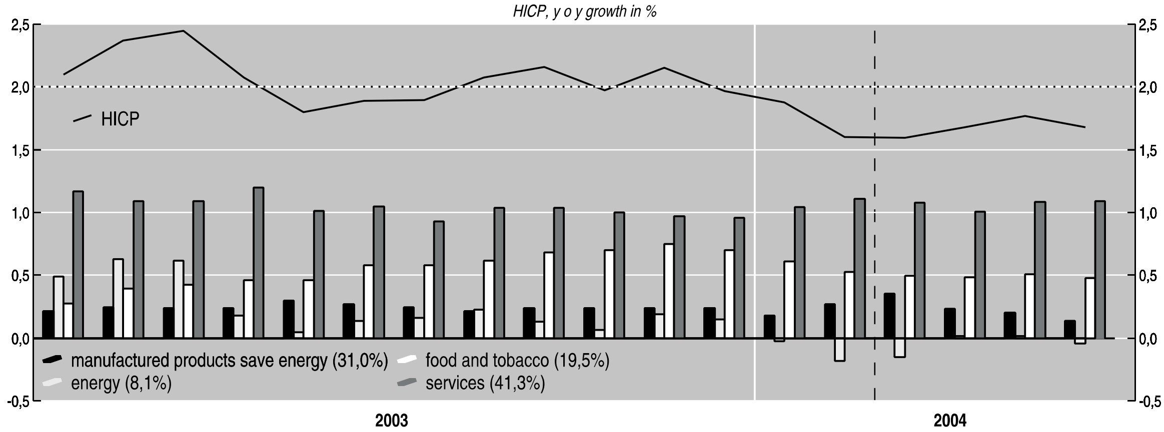
EURO ZONE : BREAKDOWN OF INFLATION
contributions of the main items
HICP, y o y growth in %



sources : Eurostat, Insee forecast

forecasts after the dotted line

manufactured goods to slow down. This would bring core inflation to 1.8% in June 2004, compared with 1.9% in February.

The slowdown in prices of manufactured goods would result mainly from the tendency for the euro to appreciate *(see graph 2)*. The euro has in fact put on almost 20% against the dollar in the past year. This has been helping to bring down the cost of imported goods. The year-on-year rise in prices of manufactured goods, which stood at 0.9% in February 2004, is expected to decline to 0.5% in June. Inflation in the services sector is expected to be stable at a relatively high rate, 2.7% in June 2004, as in February.

After easing in Q1 2004, inflation is expected to be stable and well entrenched below 2% in Q2.

On the assumption of a decline in the Brent price to $29/barrel in Q2 2004 and a dollar/euro exchange rate in the region of 1.25, inflation can be expected to stabilise at around 1.7%.

The time-pattern of changes in the price of energy will be fashioned by evolutions in the exchange rate and the price of crude oil *(see graph 3)*. The price per barrel of crude oil in fact rose until the beginning of 2004 before falling back to around $29/barrel. At the same time, in the past year the euro has tended to appreciate. All in all, energy prices can be expected to

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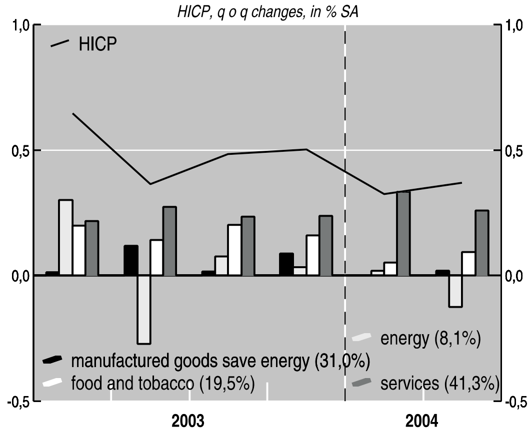
EURO ZONE INFLATION : QUARTERLY FIGURES
AND CONTRIBUTIONS OF THE MAIN ITEMS
HICP, q o q changes, in % SA



sources : Eurostat, CVS Insee

forecasts after the dotted line

rise slightly in Q1 2004 before declining in Q2. However, the rise in Q2 would be greater than a year earlier, meaning, as a consequence, a greater year-on-year price increase.

The evolutions in prices of foodstuffs are expected to be relatively stable from February 2004 on, but more moderate than in 2003, a year characterised by late spring frosts and a summer drought that sent prices of fresh produce rising steeply. This would mean a decline in the year-on-year rise. ■