The euro zone's international environment

The euro zone's international environment is likely to be less supportive in the early part of 2005. In the United States, GDP growth seems set to weaken following a peak of almost 4% annualised growth at the end of 2004, meaning that the rise in job creations seen in the latter part of 2004 was in fact temporary. In the United Kingdom, following the marked slowdown seen in Q3, growth in activity is likely to settle down around the turn of the year at an annualised rate of about 2.5%, following the tightening of monetary conditions. In Japan, following two quarters of marked slowdown, activity is likely to pick up again only slightly around the turn of the year. Handicapped by a depressed labour market, growth is likely to remain distinctly weaker than at the end of 2003 and the beginning of 2004 (1.5% at annualised rate).

In the United States, GDP is likely to slow down at the beginning of 2005 with annualised growth of close to 4% in the final part of 2004

Consumption seems likely to be mainly underpinned by the rise in wage income in coming quarters. Fiscal policy is likely to be neutral, with the new Bush Administration maintaining the tax cuts granted to households in 2001 and 2003, and the impact of the fiscal stimulus would be a thing of the past. Monetary conditions, for their part, are likely to continue to tighten gradually, with the Fed gradually raising the Fed funds target rate.

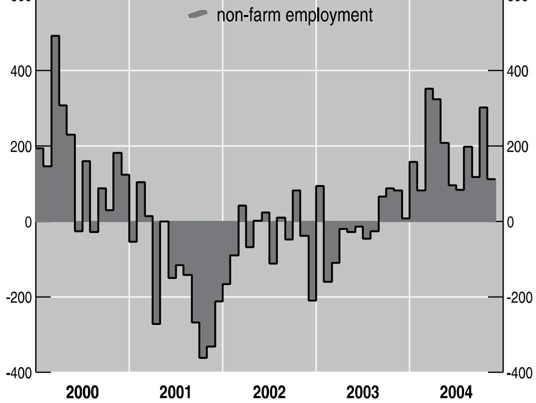
The acceleration in employment seen at the beginning of Q4, with job creations of more than 300,000 a month *(cf. graph 1)*, can be expected to stimulate household income and consumption in the final part of 2004. Following an average quarterly growth rate of 0.8% in Q2 and Q3 2004, growth in consumption is expected to be 1% in Q4 *(cf. table 1)*. Even so, job creations are unlikely to remain as brisk in the early part of 2005 *(cf. box)*, falling back to around 150,000 a month. Growth in employment on this scale (a quarterly rate of 0.35%) is hardly compatible with consumption growth as high as in the final part of 2004. This growth is in fact likely to slow down and to be of the order of 0.7% per quarter until mid-2005 - especially as the rise in the oil price is likely to eat into household purchasing power. With an oil price in mid-2005 around $40 per barrel for Brent, the impact should nevertheless remain limited. According to the IMF model, an immediate rise of 30% in the oil price would add 1.2 of a point to prices and reduce domestic demand (and GDP) by 0.5 of a point after one year. The rise from $30 to $40 between the beginning of 2004 and mid-2005 would therefore increase prices by around 0.2 of a point per quarter and would hold back consumption by 0.1 of a point per quarter. At the same time, household investment is likely to slow down progressively in response to the tightening of monetary conditions.

Firms are expected to curb the growth in their investment around the end of the year in view of the less good economic outlook, the slightly less favourable monetary conditions and the expiry at the end of 2004 of the possibility of accelerated depreciation of new investment. Firms have in fact become less optimistic about the future in recent months, with the ISM industrial leaders' confidence index falling significantly since July. Moreover, given the less favourable stance adopted by the Fed, monetary conditions, which are still currently very favourable, are set to tighten gradually. Finally, the ending of the tax measures relating to accelerated depreciation has prompted firms to bring forward their investment projects. As regards the contribution of stocks to growth, this is expected to be neutral in coming quarters. Stocks are in fact still at very low levels in rela-

1

UNITED STATES : JOB CREATION

change, in thousands



source : BLS

TABLE 1 : UNITED STATES, UNITED KINGDOM AND JAPAN : RESOURCE-USE BALANCE IN VOLUME

	Quarterly % change								Annual % change		
	2003		2004				2005		2003	2004	2005 (c.o)
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2			
UNITED STATES (37.2%)[1]											
GDP	**1.8**	**1.0**	**1.1**	**0.8**	**1.0**	**0.9**	**0.7**	**0.6**	**3.0**	**4.4**	**2.5**
Consumption	1.2	0.9	1.0	0.4	1.2	1.0	0.7	0.7	3.3	3.7	2.7
Private investment [2]	4.3	2.6	1.2	3.5	2.3	2.2	1.5	0.9	5.1	10.6	5.9
Nonresidential investment	*3.7*	*2.6*	*1.0*	*3.0*	*3.1*	*2.5*	*2.0*	*1.0*	*3.3*	*10.3*	*6.9*
Residential investment	*5.2*	*2.3*	*1.2*	*3.9*	*0.4*	*1.5*	*0.4*	*0.7*	*8.8*	*9.9*	*3.2*
Government expenditures [3]	0.0	0.4	0.6	0.6	0.3	0.5	0.1	0.1	2.8	2.1	0.9
Exports	2.7	4.1	1.8	1.8	1.6	2.5	2.5	1.0	1.9	9.1	6.4
Imports	0.7	4.0	2.6	3.0	1.5	3.0	2.0	1.0	4.4	10.2	6.6
Contributions:											
Domestic demand excluding stocks	*1.5*	*1.1*	*1.0*	*0.9*	*1.3*	*1.1*	*0.7*	*0.7*	*3.5*	*4.5*	*2.9*
Change in private inventories	*0.1*	*0.1*	*0.3*	*0.2*	*-0.2*	*0.0*	*0.0*	*0.0*	*-0.1*	*0.4*	*-0.1*
Net exports	*0.2*	*-0.2*	*-0.2*	*-0.3*	*-0.1*	*-0.2*	*-0.1*	*-0.1*	*-0.4*	*-0.5*	*-0.3*
UNITED KINGDOM (5.6%)[1]											
GDP	**0.9**	**1.0**	**0.7**	**0.9**	**0.4**	**0.7**	**0.6**	**0.6**	**2.2**	**3.2**	**2.0**
Consumption	0.8	0.6	1.2	0.6	0.5	0.7	0.6	0.6	2.3	3.0	3.3
Total investment	1.1	1.9	1.6	2.4	-0.1	1.0	0.8	0.8	2.2	5.9	2.0
Enterprise investment	*0.2*	*2.0*	*0.9*	*2.6*	*0.1*	*0.8*	*0.5*	*0.5*	*-0.9*	*5.3*	*2.0*
Household investment [4]	*0.6*	*2.5*	*4.8*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*3.1*	*6.4*	*2.0*
Public investment [4]	*9.0*	*-0.3*	*-2.3*	*8.1*	*-1.5*	*4.0*	*4.0*	*4.0*	*24.4*	*8.0*	*11.3*
Public consumption [5]	1.4	1.9	0.8	0.4	1.3	0.5	0.5	0.5	3.4	4.2	2.0
Exports	0.2	1.6	-1.0	1.5	1.9	2.0	1.0	1.0	0.1	2.7	4.6
Imports	1.4	3.1	0.3	1.1	1.6	1.0	0.9	0.8	1.3	4.3	3.3
Contributions:											
Domestic demand excluding stocks	*1.0*	*1.2*	*1.2*	*0.9*	*0.6*	*0.7*	*0.6*	*0.6*	*2.6*	*4.0*	*2.2*
Change in private inventories	*0.3*	*0.4*	*-0.2*	*0.0*	*-0.2*	*-0.2*	*0.0*	*-0.1*	*0.0*	*0.0*	*-0.3*
Net exports	*-0.4*	*-0.5*	*-0.4*	*0.0*	*0.0*	*0.2*	*0.0*	*0.0*	*-0.4*	*-0.7*	*0.2*
JAPAN (14.8%)[1]											
GDP	0.6	0.9	1.7	-0.1	0.1	0.3	0.4	0.4	2.2	3.0	0.9
Consumption	0.3	0.6	0.9	0.3	0.2	0.2	0.4	0.4	0.5	1.9	1.0
Total investment[6]	-0.3	2.0	0.5	-1.1	0.4	0.6	0.5	0.5	2.9	2.0	1.3
Public consumption [5]	0.9	0.1	1.2	0.8	0.4	0.4	0.4	0.4	1.2	2.6	1.4
Exports	3.3	5.3	4.6	3.4	0.6	2.5	1.0	1.0	9.8	14.6	4.8
Imports	2.1	2.7	3.3	1.7	1.8	2.0	1.5	1.5	4.8	9.1	5.5
Contributions:											
Domestic demand excluding stocks	*0.2*	*0.9*	*0.8*	*0.0*	*0.3*	*0.3*	*0.4*	*0.4*	*1.2*	*2.0*	*1.1*
Change in private inventories	*0.2*	*-0.3*	*0.6*	*-0.4*	*-0.1*	*-0.1*	*0.0*	*0.0*	*0.4*	*0.1*	*-0.3*
Net exports	*0.2*	*0.4*	*0.3*	*0.3*	*-0.1*	*0.1*	*0.0*	*0.0*	*0.7*	*1.0*	*0.1*

Forecast

(1) Country's share of OECD GDP (1995 PPP. 2003 volume)
(2) Investment of firms and households
(3) Government consumption and investment
(4) Items on which there is no information in the provisional accounts
(5) Consumption of unprofitable institutions included

tion to deliveries by industry, so that firms are likely to maintain a positive rate of stocking close to that seen in Q3 2004.

American exports are expected to be lively around the turn of the year, in view of a slight acceleration in world trade towards the end of 2004 and the recent depreciation in the dollar (by 9% against the euro, 7% against sterling and 5% against the yen). Customs data have in fact shown an upturn starting in September and the export outlook reported by the ISM index has improved since October. As far as imports are concerned, these are likely to remain vigorous until the end of the year before later slowing down in line with GDP.

All things considered, GDP growth is expected to have remained strong in Q4 2004 (0.9%), before weakening in Q1 and Q2 2005 to 0.7% and 0.6%, respectively. There are three major unknowns in this scenario, one that is negative for growth in the United States and two that are positive. The first of these is that the oil price could settle down on a lasting basis at above $50/barrel for Brent, given the tense situation on the oil market and the numerous geo-political uncertainties. This would bring it to around 20% above the regained price of $40 in our baseline scenario and mean a GDP loss of 0.2 of a point after one year, or 0.05 of a point per quarter, according to the IMF model. Conversely, job creations could remain at 300,000 a month in the early part of 2005, twice the amount in our baseline scenario,

TABLE 2 : HOUSEHOLDS' INCOME

(in %)

	Annual changes		
	2002	2003	2004 (carry over) (*)
United-States			
Non-farm dependent employment	-1.1	-0.3	1.0
Average wage per head	2.7	3.3	3.9
Nominal gross disposable income	4.1	4.6	4.2
Private consumption deflator	1.4	1.9	2.1
Saving ratio	1.8	2.0	1.4
United Kingdom			
Dependent employment	0.3	0.2	0.3
Average wage per head	3.6	3.4	4.1
Nominal gross disposable income	3.0	4.1	4.4
Private consumption deflator	1.5	1.8	1.2
Saving ratio	5.3	5.5	6.2
Japan			
Total employment	-1.2	-0.2	0.3
Average wage per head	-2.8	-0.3	-1.7
Nominal gross disposable income (dependent household)	-2.3	-2.5	2.2
Private consumption deflator	-1.3	-1.4	-1.5
Saving ratio	6.1	5.9	-

meaning that GDP would add 0.4 of a point after one year, or roughly 0.1 of a point per quarter, according to our model explaining consumption on the basis of household income, short-term interest rates, consumer prices and the unemployment rate. The final uncertainty concerns the dollar, which could continue to depreciate against all partner currencies. After a period of relative stability since the beginning of 2004, it has lost more than 5% since September in nominal terms. An additional depreciation of 10% in real terms would increase GDP by 0.4 of a point after one year, or roughly 0.1 of a point per quarter, according to the Fed's model.

In the United Kingdom, the effects of the monetary tightening applied by the Bank of England are likely to start to make themselves felt, with GDP growth slowing down in line with that of consumption in coming quarters.

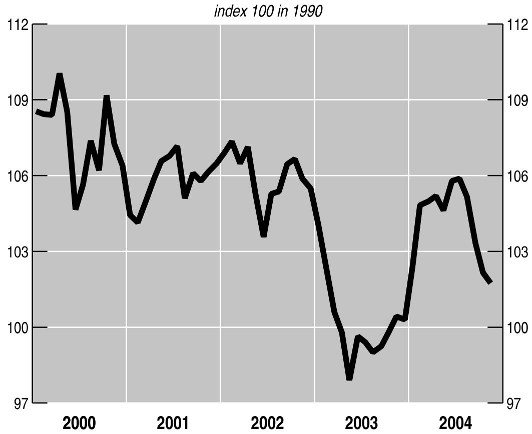
After accelerating in mid-2004, United Kingdom GDP growth fell back substantially in Q3, from 0.9% to 0.4%. This setback, although temporary, seems to be signalling the start of a slowdown in activity in the United Kingdom, under the impact of slowdowns in both household consumption and corporate investment, the result being a weakening of industrial activity. The origin of the slowdown would seem to lie in the tightening of monetary policy, bringing UK growth gradually closer to its potential (of the order of 0.6% per quarter) in the early part of 2005.

Household consumption, the main driving force for growth, is likely to be less brisk in coming quarters. Since November 2003, the Bank of England has raised its interest rates by more than 100 basis points, a move that can be expected to affect consumption in two ways. First, it increases the burden on households of servicing existing debt (most of which is at variable interest rates) and contributes to a slowdown in new lending because of the increased cost. Second, it is liable to curb the growth in house prices and hence the impact of the mortgage refinancing mechanisms. Today, all the indicators are converging in announcing a downturn on the housing market. House prices in fact posted their first monthly fall since 2001 in October (0.4% according to Nationwide). This decline should not be taken as meaning the beginning of a market collapse of the kind seen at the end of the 1980s. In fact, the UK economy is likely to continue to grow fairly fast and the labour market to remain under pressure. The unemployment rate is currently at a historically low level. Already, the prospect of a levelling off in household consumption seems to have been reflected in the slowdown in retail sales in October. In these circumstances, household investment can be expected to stagnate in coming quarters.

The slowdown in household demand, the higher energy costs and the tightening of monetary policy can be expected to hold back corporate investment, which, following several quarters of strong increases, slowed down substantially in Q3 2004, the growth rate falling from 2.6% to 0.1%. Meanwhile, manufacturing output was as much as 1% down on Q2. At a time when domestic demand is expected to

2

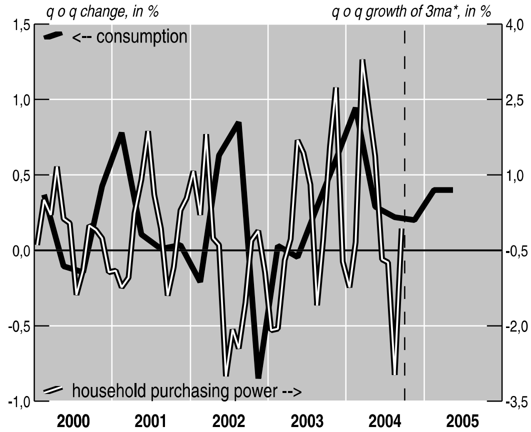
UNITED KINGDOM:
REAL EFFECTIVE STERLING EXCHANGE RATE
index 100 in 1990



source : Bank of England

3

JAPAN: HOUSEHOLD PURCHASING POWER



sources : Eco. and soc. research institute, min. of public management
**3ma = 3 months moving average* *forecasts after the dotted line*

slow down gradually, the fall in industrial activity seen in Q3 would therefore go towards curbing growth in investment. Moreover, according to the CBI study for November, industrial leaders' views regarding future production are gloomy for the end of the year. Finally, the rise in the oil price is likely to contribute to an increase in production costs and affect industrial leaders' confidence. If the price per barrel of Brent were to remain at its present high levels, this would also have an impact on the United Kingdom economy that would be all the greater in that the country seems to be again becoming a net oil importer.

Foreign trade is expected to accelerate in the final part of the year before running out of steam next year. United Kingdom exports seem in fact to be driven by strong growth in American exports in the final part of 2004 and by the depreciation of sterling versus the country's trading partners'currencies *(cf. graph 2)*. They are then likely to return to lower quarterly growth rates, of the order of 1%, because of the less supportive external environment, with imports by both euro-zone countries and the United States likely to be less dynamic than at the end of 2004. As for United Kingdom imports, these are expected to slow down in coming quarters in response to the expected slower growth in domestic demand than at the beginning of the year.

United Kingdom GDP growth is therefore likely to be bell-shaped. Following a steep fall in Q3, it is likely to rise to 0.7% in Q4, before falling back to a rate of the order of 0.6% until mid-2005.

In Japan, activity is likely to pick up gradually but without regaining its dynamism of the end of 2003 and the beginning of 2004, because of the deterioration seen on the labour market

Japanese GDP slowed down considerably in the second and third quarters of 2004, falling from 1.7% in Q1 to 0.1% in Q3. The slowdown in corporate investment and in exports contributed to this weakening. In coming quarters, economic activity is expected to accelerate gradually, underpinned by a temporary improvement in foreign trade at the end of 2004. As a result, growth will probably rise to 0.3% in Q4 before returning in the early part of 2005 to growth rates of the order of 0.4% per quarter.

The deterioration of conditions on the labour market can be expected to handicap household consumption at the end of 2004 and the beginning of 2005. Employment failed to increase in Q3 2004. Moreover, Japanese firms are persisting with their policy of cutting wage costs by putting pressure on wage rates. The average wage of workers with a full-time contract fell by 0.2% in Q3 2004. All things considered, the purchasing power of wage-earning households fell by 0.1% in Q3 2004 *(cf. graph 3)*. Finally, the development of temporary agency and part-time working could affect household consumption by increasing the general level of job precariousness. This means that, at a time of weak wage growth and a depressed labour market, growth in household consumption is likely to remain moderate until mid-2005.

As regards Japanese exports, these are likely to be temporarily boosted by American imports at the end of the year. Export growth fell from 3.4% in Q2 to 0.6% in Q3, mainly under the impact of a weakening of American imports. But the acceleration in these imports expected towards the end of 2004 is likely to give a temporary fillip to Japanese exports, which would then rise by 2.5% in Q4 2004. However, the slowdown in world activity expected in H1 2005 and the appreciation of the yen versus the dollar can be expected to hold back Japanese exports, causing them to slow down again at the beginning of 2005.

Following the high level reached recently by the productive capacity utilisation rate in Japan, corporate investment is expected to accelerate slightly in coming quarters. Investment went through a trough in Q3 2004 because of particularly unfavourable weather conditions and a slowdown in foreign demand. However, the Tankan survey for Q3 shows Japanese firms expecting to increase their investment spending by 3.5% (compared with the 1.5% expected in June) in the tax year ending March 2005. In addition, the rise in Japanese companies' profits (6.7% for Q3 2004, compared with 10.7% the previous quarter) and the maintenance of an accommodating monetary stance should encourage an upturn in corporate investment. ■

BOX: UNITED STATES: EMPLOYMENT, AFTER ACCELERATING FROM OCTOBER ON, IS SET TO SLOW DOWN IN THE EARLY PART OF 2005

Employment picked up substantially in the United States as of October 2004, with job creations in excess of 300,000 a month (0.7% quarterly growth). This increase in job creations is nevertheless likely to be temporary, being linked to the reconstruction work following an exceptional series of hurricanes at the end of the summer. This means that job creations can be expected to slow down in the early part of 2005, returning to around 150,000 a month (0.35% quarterly growth). This would mean that employment growth would again be in line with its usual economic determinants, having been below what these were suggesting between the beginning of 2001 and the beginning of 2004. A diagnosis based on the usual economic model of corporate demand for labour is set out in this box.

According to economic theory, corporate demand for labour depends on production and on the real cost of labour

Corporate demand for labour has been estimated for the private sector in the United States. It depends on GDP and on the cost of labour and is expressed as the number of hours. Employment is then determined by the number of hours required, GDP and a trend factor resulting from the long-term tendency for the number of hours worked per job to decline. The two corresponding equations have been estimated using the ordinary least squares method on the basis of quarterly data for the period 1960-2002 for the first equation and 1980-2002 for the second. The explained portion of the variance is 71% in the first case and 91% in the second. All the coefficients are significantly different from 0 at a 5% threshold.

DLH = 0.04+0.23*DLH(-1)+0.10*DLH(-3) +0.54*DLY
+0.13*DLY(-1) -0.45*DLW+0.14*DLW(-1)
-0.05*(LH-LY+LW)(-1)

DLE = -0.27+0.13*DLE(-1) +0.56*DLH +0.06*DLY(-2)
-0.15*(LE-LH-0.6%*time)(-1)

with the following notations:

DLH = growth rate of hours worked in the private sector

DLY = GDP growth rate

DLW = growth rate of the real cost of labour in the private sector

DLE = growth rate of employment in the private sector

LH = logarithm of hours worked in the private sector

LY = logarithm of GDP

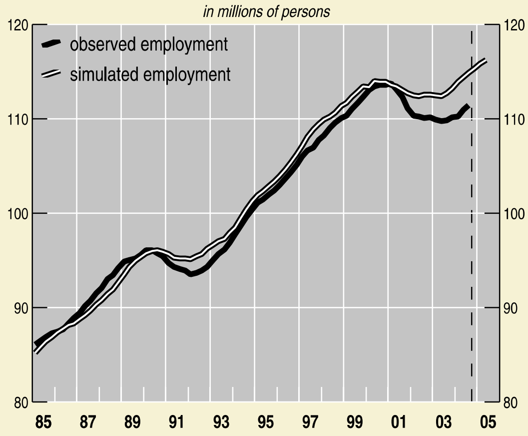
LW = logarithm of the real cost of labour in the private sector

LE = logarithm of employment in the private sector

A

UNITED STATES: PRIVATE-SECTOR EMPLOYMENT SINCE 1985

in millions of persons



sources : BLS, Insee

forecasts after the dotted line

As in 1991, employment since 2001 has been lower than its determinants would suggest

Observed employment in the private sector is distinctly lower than the estimate obtained from its determinants *(cf. graph A)*. Labour productivity has in fact accelerated sharply since 2001, growing at average annual rates of 3.5%, well above the rates seen in the 1980s and 1990s (which were of the order of 2.0%). This strong growth in labour productivity made it possible to produce more without increasing the workforce. Just as in 1991, recovery was described as «jobless».

In our baseline scenario, employment is expected to reach the level calculated on the basis of its determinants only very slowly, as in 1991.

Following the 1991 recovery, employment was in fact slow in returning to the level calculated on the basis of its determinants. In similar fashion, it is now expected to grow at rates close to those suggested by its determinants. For the forecast, the figure used for GDP growth is that of our baseline scenario *(cf. table 1)* and that of the real cost of labour is its average since 2001, in other words 0.4% per quarter.

This would then mean employment growth of the order of 0.35% per quarter, or roughly 150,000 job creations per month, until Q2 2005 *(cf. graph B)*. It would nevertheless post a temporary increase towards the end of 2004 - already partly observed - linked to the reconstruction work following the hurricanes. Job creations in the construction sector were very high in October (around 70,000, compared with 10,000 in September) and were particularly brisk in regions affected by the hurricanes. This also means that labour productivity would slowdown around the end of 2004 and the beginning of 2005 and grow at rates of around 2.0%. ■

B

UNITED STATES: GROWTH IN PRIVATE-SECTOR EMPLOYMENT AND CONTRIBUTIONS OF ITS DETERMINANTS

sources : BLS, Insee

forecasts after the dotted line

The economic situation in the euro zone

The recovery that began in the euro zone in mid-2003 marked a pause in Q3 2004, with GDP for the zone rising by only 0.3%, compared with 0.7% in Q1 and 0.5% in Q2. In a less supportive international environment, exports suddenly lost their vigour, imposing a handicap on growth. And yet, on the side of domestic demand, strong corporate demand cushioned the negative impact on activity of the weakness of household consumption.

In coming quarters, activity should accelerate slightly to a rate close to its potential (0.4% per quarter). Despite the appreciation of the euro, foreign trade seems no longer likely to hold back growth. Meanwhile, investment is expected to grow slowly but the improvement in employment is likely to hang fire and this would weaken the domestic underpinnings of European growth in the early part of 2005.

The abrupt levelling off in world trade led to a pause in GDP growth in Q3

Following several quarters of firm activity, European growth weakened in the summer, reaching 0.3% in Q3. The slowdown in foreign trade had a substantial adverse effect on industrial activity in all countries of the zone, a tendency reflected in the very small growth in the industrial production index in Q3 (0.2%, following 1.0% in the previous quarter). The decline in the vigour shown by the zone's partner economies, notably the United States, held back exports to outside the zone, so that growth in foreign trade, which had hitherto been the driving force behind the recovery, imposed a severe handicap on growth by coming to an abrupt halt *(cf. graph 1)*.

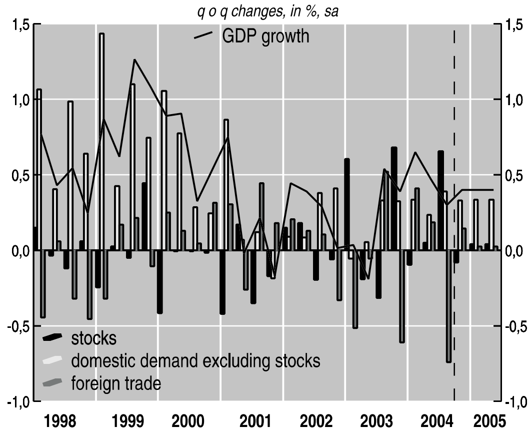
The third quarter saw private consumption rising only slowly (by 0.2%). The wage restraint and the lack of job creation continued to have an adverse effect on incomes and on the confidence shown by households, whose expenditure was slack in most countries. In the case of France, consumption, which had previously been the mainstay of growth, marked time, while in Germany the tax cuts decided in December 2003 — but probably partly saved for retirement purposes — failed to kick-start consumption.

Corporate demand, on the other hand, was strong, with firms investing in response to the past rise in demand for their products since mid-2003. The rise in

1

GDP GROWTH AND CONTRIBUTIONS FROM DEMAND ITEMS

q o q changes, in %, sa



sources : Eurostat, Insee forecasts

forecasts after the dotted line

the productive capacity utilisation rates and the maintenance of interest rates at a low level also contributed to the acceleration in investment. Moreover, the abrupt slowdown in external demand seen in Q3 had not been expected, the immediate result being substantial additions to stocks, which in fact contributed 0.7 of a point to GDP growth in Q3.

Imports rose strongly in Q3, especially from outside the zone, a tendency seen in virtually all countries.

The appreciable differences between the leading countries that had emerged in H1 2004 faded in Q3 *(cf. box 1)*. In France and Germany, the driving forces behind growth ran out of steam and GDP virtually stagnated. Exports, which had previously been very lively, declined sharply in Germany and domestic demand stagnated in France *(cf. graph 2)*.

In view of the upturn in exports, activity is expected to rise at a modest rate starting in Q4 2004

The fourth quarter of 2004 is likely to see exports to outside the zone accelerating temporarily despite the unfavourable exchange rate. This is because they would have the benefit of the revival of world trade due to the strength of American demand. In most countries in the zone, business leaders regard order books as being fairly full and expect stabilisation at a high level in foreign demand for their products *(cf. graph 3)*. Italian business leaders are expecting a

The economic situation in the euro zone

GDP IN THE EURO ZONE AND IN THE PRINCIPAL MEMBER COUNTRIES

(% change)

	Quarterly changes										Annual changes			
	2003				2004				2005		2002	2003	2004	2005 c.o
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2				
GERMANY (29.4%)[1]														
GDP	**-0.4**	**-0.2**	**0.3**	**0.3**	**0.4**	**0.4**	**0.1**	**0.3**	**0.3**	**0.3**	**0.1**	**-0.1**	**1.2**	**0.9**
Household consumption	0.1	-0.1	-0.3	-0.6	0.0	-0.2	0.0	0.2	0.3	0.3	-0.7	0.0	-0.7	0.6
Total GFCF	-0.7	-0.5	-0.3	1.3	-2.9	-0.4	1.3	0.2	0.2	0.2	-6.3	-2.2	-1.7	1.0
Public consumption	-1.3	0.6	0.3	-0.3	-0.1	0.0	0.6	0.1	0.1	0.1	1.9	0.1	0.3	0.6
Exports	-0.7	-2.7	3.6	0.6	4.1	3.4	-1.1	2.0	1.5	1.5	4.1	1.8	8.3	4.4
Imports	1.9	-2.6	1.1	2.7	1.0	2.2	4.3	1.9	1.5	1.5	-1.6	3.9	7.4	6.8
Contributions :														
Domestic demand ex. stocks	*-0.3*	*-0.1*	*-0.2*	*-0.1*	*-0.6*	*-0.2*	*0.4*	*0.2*	*0.2*	*0.2*	*-1.4*	*-0.4*	*-0.7*	*-0.7*
Inventory change	*0.8*	*0.0*	*-0.5*	*1.1*	*-0.2*	*0.0*	*1.6*	*0.0*	*0.0*	*0.0*	*-0.4*	*0.9*	*1.2*	*-0.8*
Foreign trade	*-0.9*	*-0.2*	*1.0*	*-0.7*	*1.2*	*0.6*	*-1.9*	*0.1*	*0.1*	*0.1*	*1.9*	*-0.6*	*0.7*	*0.6*
FRANCE (21.3%)[1]														
GDP	**0.2**	**-0.5**	**1.0**	**0.6**	**0.7**	**0.6**	**0.1**	**0.6**	**0.5**	**0.4**	**1.1**	**0.6**	**2.1**	**1.4**
Household consumption	0.7	-0.3	0.9	0.4	1.0	0.5	-0.1	0.6	0.4	0.4	1.8	1.7	2.1	1.2
Total GFCF	0.0	0.2	1.0	1.5	0.1	1.3	-0.5	0.9	0.9	0.7	-1.8	0.2	2.7	2.2
Public consumption	0.3	0.2	0.9	0.8	0.4	0.9	0.3	0.7	0.4	0.5	4.6	2.5	2.5	1.7
Exports	-2.2	-1.3	0.8	1.5	0.5	0.9	0.8	1.2	1.0	0.9	1.7	-2.6	3.2	3.3
Imports	-0.3	-0.5	-0.2	3.0	1.1	3.9	2.5	0.8	1.0	1.1	3.3	0.2	7.7	4.7
Contributions :														
Domestic demand ex. stocks	*0.4*	*-0.1*	*0.9*	*0.7*	*0.6*	*0.7*	*-0.1*	*0.7*	*0.5*	*0.5*	*1.7*	*1.6*	*2.3*	*1.5*
Inventory change	*0.3*	*-0.2*	*-0.2*	*0.3*	*0.2*	*0.7*	*0.7*	*-0.2*	*0.0*	*0.0*	*-0.2*	*-0.2*	*1.1*	*0.3*
Foreign trade	*-0.6*	*-0.2*	*0.3*	*-0.4*	*-0.2*	*-0.8*	*-0.5*	*0.1*	*0.0*	*-0.1*	*-0.4*	*-0.8*	*-1.2*	*-0.4*
ITALY (17.9%)[1]														
GDP	**-0.2**	**-0.1**	**0.4**	**0.0**	**0.5**	**0.4**	**0.4**	**0.3**	**0.3**	**0.3**	**0.4**	**0.4**	**1.3**	**1.1**
Household consumption	-0.2	0.4	0.6	-0.3	1.1	-0.3	0.1	0.3	0.3	0.3	0.4	1.2	1.1	0.7
Total GFCF	-5.6	-0.5	-0.5	-0.4	2.6	1.4	0.3	0.6	0.6	0.6	1.3	-2.1	3.3	2.0
Public consumption	0.7	0.4	0.6	0.7	-0.6	0.7	0.2	0.2	0.1	0.1	1.9	2.2	1.0	0.6
Exports	-6.3	0.2	6.8	-3.8	-1.1	4.7	2.2	0.8	0.6	0.6	-3.4	-3.9	4.2	3.9
Imports	-5.2	1.1	2.4	-1.6	0.4	2.7	1.6	0.9	0.6	0.6	-0.2	-0.6	3.8	3.2
Contributions :														
Domestic demand ex. stocks	*-1.2*	*0.2*	*0.3*	*-0.1*	*1.1*	*0.2*	*0.2*	*0.3*	*0.3*	*0.3*	*0.9*	*0.7*	*1.6*	*1.0*
Inventory change	*1.3*	*-0.1*	*-1.1*	*0.8*	*-0.2*	*-0.4*	*0.1*	*0.0*	*0.0*	*0.0*	*0.5*	*0.6*	*-0.4*	*0.0*
Foreign trade	*-0.3*	*-0.2*	*1.2*	*-0.6*	*-0.4*	*0.5*	*0.2*	*0.0*	*0.0*	*0.0*	*-0.9*	*-0.9*	*0.1*	*0.2*
SPAIN (10.2%)[1]														
GDP	**0.9**	**0.6**	**0.6**	**0.7**	**0.7**	**0.5**	**0.6**	**0.6**	**0.6**	**0.6**	**2.4**	**2.5**	**2.6**	**1.9**
Household consumption	0.5	0.8	0.5	1.0	1.0	0.9	0.5	0.6	0.6	0.6	2.9	2.9	3.3	2.0
Total GFCF	0.0	-0.4	1.1	1.9	0.2	0.9	2.8	0.6	0.6	0.6	4.5	3.9	4.2	2.8
Public consumption	1.1	0.7	1.0	1.4	1.1	0.7	1.1	0.8	0.8	0.8	4.5	3.9	4.2	2.8
Exports	-4.5	5.4	2.8	-1.9	-0.8	3.4	3.5	2.0	2.0	2.0	1.3	2.6	5.4	7.7
Imports	-2.7	2.3	3.8	0.4	1.1	2.5	5.3	2.0	2.0	2.0	3.0	4.8	9.2	8.4
Contributions :														
Domestic demand ex. stocks	*0.5*	*0.5*	*0.8*	*1.3*	*0.8*	*0.9*	*1.2*	*0.7*	*0.7*	*0.7*	*2.9*	*3.2*	*3.8*	*2.5*
Inventory change	*0.8*	*-0.8*	*0.3*	*0.2*	*0.5*	*-0.6*	*0.1*	*0.0*	*0.0*	*0.0*	*0.1*	*0.1*	*0.2*	*0.0*
Foreign trade	*-0.5*	*0.8*	*-0.4*	*-0.7*	*-0.6*	*0.2*	*-0.8*	*-0.1*	*-0.1*	*-0.1*	*-0.6*	*-0.8*	*-1.5*	*-0.6*
EURO ZONE (27.8%)[2]														
GDP	**0.0**	**-0.2**	**0.5**	**0.4**	**0.7**	**0.5**	**0.3**	**0.4**	**0.4**	**0.4**	**0.9**	**0.5**	**1.8**	**1.3**
Household consumption	0.2	0.0	0.3	0.0	0.6	0.2	0.2	0.3	0.3	0.3	0.6	1.0	1.1	1.0
Total GFCF	-0.8	-0.2	0.3	1.0	-0.3	0.3	0.6	0.4	0.4	0.4	-2.7	-0.5	1.2	1.3
Public consumption	-0.1	0.4	0.6	0.5	0.1	0.4	0.8	0.4	0.3	0.3	3.1	1.6	1.8	1.4
Exports	-1.7	-0.8	2.6	0.3	1.5	3.1	1.2	1.6	1.1	1.1	1.9	0.2	6.2	4.5
Imports	-0.4	-0.7	1.3	2.0	0.5	2.8	3.2	1.3	1.1	1.1	0.5	1.9	6.6	5.2
Contributions :														
Domestic demand ex. stocks	*-0.1*	*0.1*	*0.3*	*0.3*	*0.3*	*0.2*	*0.4*	*0.3*	*0.3*	*0.3*	*0.4*	*0.8*	*1.2*	*1.1*
Inventory change	*0.6*	*-0.2*	*-0.3*	*0.7*	*-0.1*	*0.1*	*0.7*	*-0.1*	*0.0*	*0.0*	*-0.1*	*0.4*	*0.6*	*0.3*
Foreign trade	*-0.5*	*-0.1*	*0.5*	*-0.6*	*0.4*	*0.2*	*-0.7*	*0.1*	*0.0*	*0.0*	*0.6*	*-0.6*	*0.0*	*-0.2*

Prévision

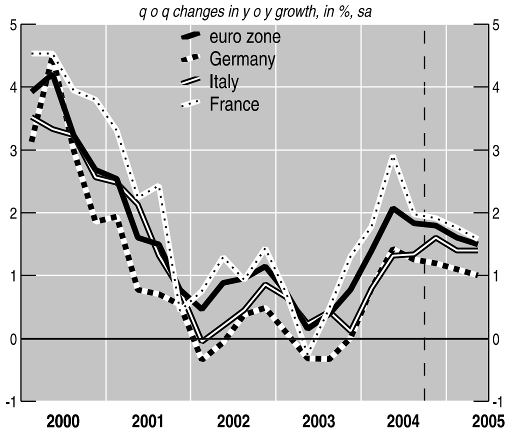
(1) Share of euro-zone GDP (2) Share of OECD GDP

Sources : Statistisches Bundesamt, Insee, Istat, Ine, Eurostat

2

GDP GROWTH IN THE EURO ZONE COUNTRIES

q o q changes in y o y growth, in %, sa



sources : Destatis, Eurostat, Istat, Insee

forecasts after the dotted line

distinct deterioration in foreign demand. It is true that Italian products are vulnerable to increased competition from emerging countries at a time of reduced competitiveness due to the rise in the effective exchange rate.

The early part of 2005 is likely to see exports to outside the zone held back by the expected decline in the liveliness of activity in the zone's principal partner countries. notably the United States. In addition, the present level of the euro/dollar exchange rate, which reached an unprecedented high of 1.32 in November, can be expected to handicap the price competitiveness of European goods. Our model (see the special article on the euro zone model in the December 2003 Note in this series) shows that growth in merchandise exports to outside the zone would be reduced by roughly 0.5 of a point per quarter in 2005.

Exports within the zone are expected to be maintained over the next three quarters, in line with the stabilisation of domestic demand. This means that, following the external demand shock recorded in Q3, total exports can expected to rise by 1.6% in Q4 2004 before slowing down to 1.1% in Q1 and Q2 2005.

Imports are expected to slow down starting in Q4 2004, although still remaining brisk, given the strength of exports and the stability of domestic demand.

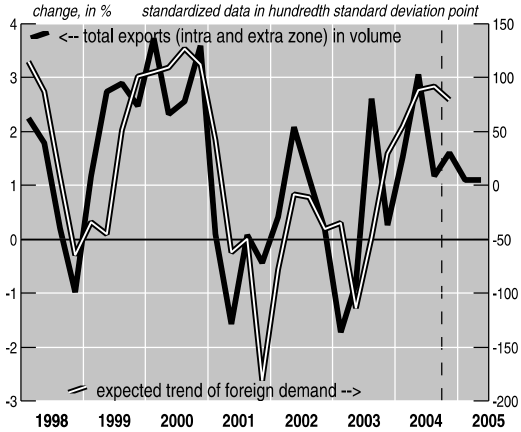
Consumption likely to gather pace, although still limited by the very weak upturn in employment

Household consumption is likely to grow at the moderate pace of 0.3% per quarter until mid-2005. The fundamentals are still unfavourable to an upturn in household expenditure. The labour market in the euro zone remains depressed and is likely to improve only very modestly *(see table containing detailed forecasts for the euro zone)*. Employment is expected to increase only very slightly in coming quarters (by 0.1% per quarter). This small increase would be insufficient to permit an improvement in the unemployment rate, which is expected to stand at 9.0% at the beginning of 2005 *(cf. graph 4)*. Moreover, the wage restraint seen since the beginning of 2004 would still be present. In Germany, in particular, several firms have signed agreements providing for an increase in the number of hours worked without any wage compensation. In addition, the rise in the oil price can be expected to erode household purchasing power. This seems to have been particularly true of Q4 2004 *(cf. fact sheet « Consumer prices in the euro zone»)*. As a result, the purchasing power of household incomes will probably rise only slowly. after two years of virtual stagnation (rises of 0.2% in 2002 and 0.3% in 2003). Moreover, household confidence is struggling to recover at a time of major structural reforms of healthcare systems and the labour market, combined with fiscal discipline — probably increased by revelations regarding the win-

3

EXPORTS AND EXPECTED TREND OF FOREIGN DEMAND IN MANUFACTURING INDUSTRY

change, in % *standardized data in hundredth standard deviation point*



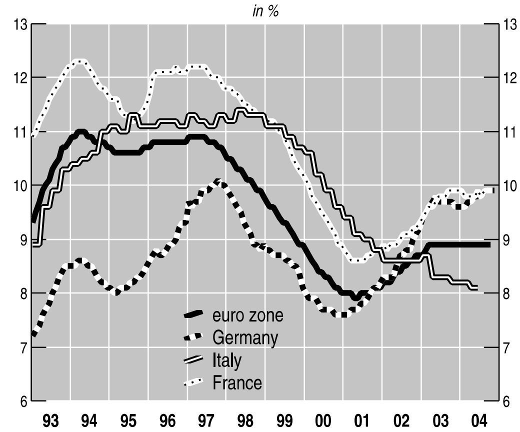
sources : European Commission, Eurostat, Ifo, Isae, Insee

forecasts after the dotted line

4

UNEMPLOYMENT RATE IN THE EURO ZONE

in %



source : Eurostat

dow-dressing of the Greek public accounts. One of the consequences is that the income tax cuts introduced in many countries of the zone will be partly or even totally offset by increases in social contributions. These factors in combination mean that the saving ratio is likely to remain high for precautionary motives linked to the employment situation and the outlook for public finances.

There are likely to be wide contrasts from one country to another in the evolution of household consumption. Consumption in Spain is expected to remain brisk in view of the maintenance of unemployment at a historically low level. In Italy, private consumption is expected to rise modestly despite the introduction of measures to bolster purchasing power. It is in fact likely that possible tax cuts and other measures taken by the government (freeze on the prices of financial services. for example) will have little impact on private expenditure. In Germany, at a time of rising unemployment and persistent uncertainty regarding the financing of retirement pensions. the tax cuts are not expected to stimulate household consumption this year. In 2005, the so-called Hartz IV reform, which would reduce the income received by the long-term job-seekers, would offset the new tax cut measures *(cf. box 2).* In this continuing gloomy climate, therefore, private consumption is expected to grow very little.

Corporate investment set to rise. although limited by the weakness of domestic demand

The business climate has stopped improving in the euro zone since August. The decline in business leaders' confidence has been aggravated since the beginning of Q4 by the weakness of the dollar, which is starting to have an impact on the zone's competitiveness. In addition, the lagged effects of the rise in the oil price can be expected to have a negative impact on production costs. Indeed, in November German and Italian industrial leaders reported a deterioration in the outlook for activity.

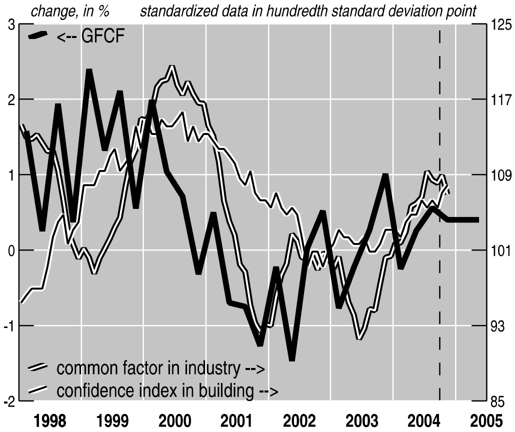
The high level of stocks reached in Q3 can be expected to reduce firms' production and at the same time hold back imports. Firms are likely to have resorted first to de-stocking in Q4 in order to meet demand.

In coming quarters, growth in productive investment is likely to be curbed by the continuing low capacity utilisation rates *(cf. graph 5)* and the fact that domestic demand is having trouble in picking up again. However, financial conditions should remain favourable to investment projects in all countries, notably through the maintenance of interest rates at a low level and the stability of stock-market prices. All things considered. business leaders can be expected to adopt a prudent investment policy in coming quarters.

The improvement in the business climate in the case of the construction industry seems to be pointing to an upturn in investment *(cf. graph 6)* except in Germany, where the sector has still not recovered from the structural crisis it has been in ever since unification. The low level of interest rates can be expected to continue to stimulate investment in housing, so that total investment is likely to grow at a modest pace of 0.4% per quarter until mid-2005. ■

5

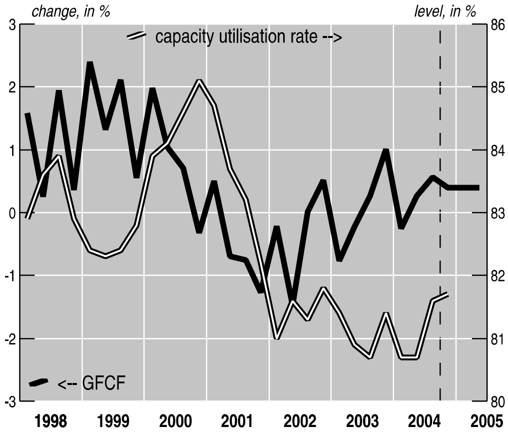
GFCF AND INDICATORS OF CONFIDENCE IN INDUSTRY AND BUILDING



sources : European Commission, Eurostat, Ifo, Isae, Insee
forecasts after the dotted line

6

GFCF AND CAPACITY UTILISATION RATE OF PRODUCTION IN MANUFACTIRING INDUSTRY



sources : European Commission, Eurostat, Insee
forecasts after the dotted line

DETAILED FORECASTS FOR THE EURO ZONE

(% change)

	Quarterly changes						Annual changes	
	2004				2005		2004	2005
	Q1	Q2	Q3	Q4	Q1	Q2		c.o.
Volumes								
GDP	0.7	0.5	0.3	0.4	0.4	0.4	1.8	1.3
Domestic demand	0.3	0.3	1.1	0.3	0.4	0.4	1.8	1.5
Household consumption	0.7	0.3	0.2	0.3	0.3	0.3	1.2	1.0
Public consumption	0.1	0.5	0.8	0.4	0.3	0.3	1.8	1.4
Investment	-0.1	0.1	0.6	0.4	0.4	0.4	1.0	1.3
Foreign trade of goods ans services	0.4	0.2	-0.7	0.1	0.0	0.0	0.0	-0.2
Exports of goods	4.1	2.2	-0.4	4.1	1.8	1.7	9.0	6.4
Imports of goods	1.7	1.3	4.0	-0.5	0.1	0.7	6.6	2.6
Prices								
Value added price	0.5	0.6	0.5	0.5	0.5	0.5	1.9	1.7
Consumption price	0.4	0.5	0.5	0.6	0.4	0.4	1.9	1.5
Investment price	0.8	1.1	0.5	0.4	0.4	0.4	2.5	1.5
Price of exports of goods	-0.7	1.5	0.1	-0.7	0.4	0.3	-0.5	0.5
Price of imports of goods	-1.1	3.8	0.6	-1.3	-2.3	-1.1	0.9	-2.8
Wages	0.8	0.5	0.7	0.8	0.7	0.7	2.2	2.2
Employment and unemployment								
Unemployment rate (%)	8.9	8.9	8.9	8.9	9.0	9.0	8.9	9.0
Employment	0.0	0.1	0.1	0.1	0.1	0.1	0.2	0.3
Working population	0.0	0.1	0.1	0.1	0.1	0.1	0.2	0.4
Labour cost per unit	0.1	-0.1	0.5	0.5	0.3	0.3	0.5	1.1
Productivity of work	0.7	0.6	0.2	0.3	0.3	0.3	1.7	1.1
Others								
Global demand	1.9	2.1	1.5	1.9	1.4	1.5	8.0	5.2
Balance of trade (points of GDP)	2.7	2.6	1.9	2.7	3.4	3.8	10.0	9.9
3-month interest rate (%)	2.06	2.08	2.00	2.00	2.00	2.00	2.0	2.0
10-year interest rate (%)	4.15	4.36	4.21	4.21	4.21	4.21	4.2	4.2
Level of capacity utilization (%)	80.7	80.7	81.6	81.9	81.8	81.7	81.2	81.5
Gross disposable income (value)	1.1	1.1	0.8	0.9	0.9	0.8	3.7	2.9
Contribution of gross oeprating surplus	0.5	0.6	0.2	0.3	0.3	0.3	1.6	1.0
Contribution of wages	0.6	0.5	0.6	0.6	0.6	0.5	1.8	1.9
Others contributions	0.0	0.1	0.0	0.0	0.0	0.0	0.3	0.1

Forecasts obtained using the MZE model (see March 2003 issue)

EURO-ZONE HOUSEHOLDS ACCOUNTS

(% change)

	2002	2003	2004
Germany			
Total employment	-1.0	-0.5	0.2
Dependent employment	-0.7	-1.3	-
Average wage per head	0.8	0.4	-
Gross nominal disposable income	1.4	0.3	1.9
Private consumption deflator	1.1	1.1	1.5
Saving ratio absolute level	10.8	10.7	11.1
France			
Dependent employment	0.8	-0.1	-0.1
Average wage per head	2.7	2.2	2.8
Gross nominal disposable income	4.3	2.3	3.2
Private consumption deflator	1.7	1.8	1.6
Saving ratio absolute level	16.7	15.8	15.4
Italy			
Dependent employment	2.5	1.4	**-**
Total employment	1.8	1.2	**0.7**
Average wage per head	1.8	2.9	**-**
Gross nominal disposable income	3.5	-	**-**
Private consumption deflator	3.1	2.5	**1.6**
Saving ratio absolute level	15.8	-	**-**
Spain			
Dependent employment	2.1	2.4	-
Average wage per head	3.9	3.8	-
Gross nominal disposable income	7.0	-	-
Private consumption deflator	3.4	3.1	2.5
Saving ratio absolute level	10.6	-	-
Euro-zone			
Total employment	0.5	0.2	0.2
Dependent employment	0.8	0.2	**0.0**
Average wage per head	2.7	2.4	2.2
Gross nominal disposable income	2.5	2.3	3.7
Private consumption deflator	2.3	2.0	1.7
Saving ratio absolute level	13.2	12.7	**13.1**

Forecast Insee

Carry over (In bold : carry over in Q3. Normal : carry over in Q2)

Sources : Bundesbank, Destatis, Eurostat, Ine, Insee, Istat

BOX 1: THE CONTRAST BETWEEN THE RESPECTIVE GROWTH MOTORS IN FRANCE AND IN GERMANY WAS ELIMINATED IN Q3

The upturns in growth posted simultaneously in France and in Germany between H2 2003 and H1 2004 were based on different growth motors : strong domestic demand in the case of France and lively foreign trade in the case of Germany *(cf. graphs A and B)*.

On the side of domestic demand. consumption by French households (showing a rise of 2.8%, year on year, in Q2 2004) benefited from wage increases and an improvement in confidence. Faced with this improved demand, firms began investing again (a year-on-year rise of 4.5% in Q2 2004). In Germany, by contrast, the weak increases in household spending at a time of severe wage restraint held back growth. In addition, the persistence of unemployment and uncertainties regarding the future financing of retirement pensions probably incited German households to save (*cf. tables showing the household accounts)*.

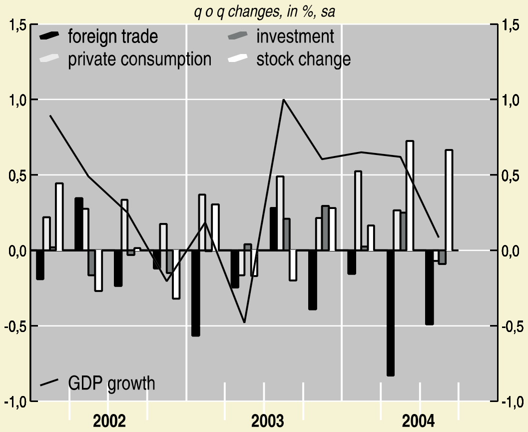
In the external sector, German exports were particularly dynamic, in contrast to those of France. Germany in fact profited more from demand from euro-zone partner countries. Consumer goods and capital goods, especially, benefited from the improvement in foreign trade *(cf. graphs C and D)*. As a result, Germany was probably able to take advantage of the strength of French domestic demand (investment and consumption), whereas French exports were handicapped by the weakness of German demand.

These differences faded away in Q3 and both growth motors marked a pause. GDP growth slowed down abruptly in both Germany and in France. In the two countries, stocks have been making a major contribution to growth, underlining the fact that the downturn had probably been only partially expected. ■

A

FRANCE: GDP GROWTH AND CONTRIBUTIONS FROM DEMAND ITEMS

q o q changes, in %, sa

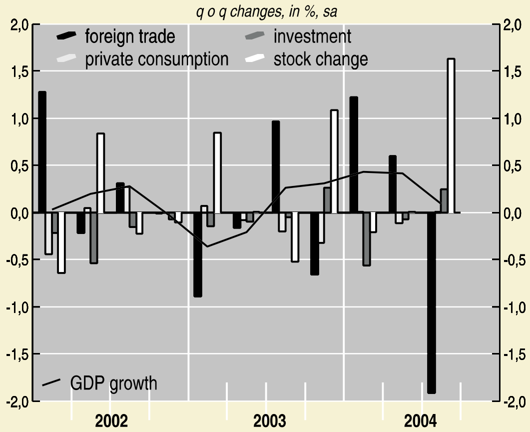


sources : Douanes, Insee

B

GERMANY: GDP GROWTH AND CONTRIBUTIONS FROM DEMAND ITEMS

q o q changes, in %, sa

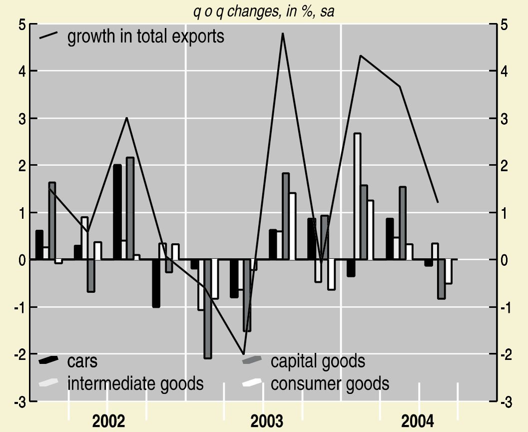


sources : Destatis, Bundesbank

C

GERMANY: EXPORTS AND CONTRIBUTIONS BY PRODUCT

q o q changes, in %, sa

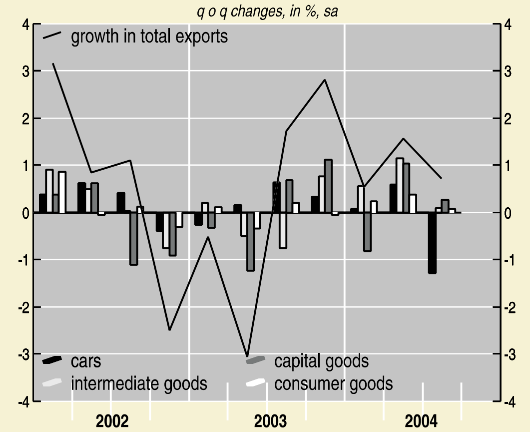


sources : Destatis, Bundesbank

D

FRANCE: EXPORTS AND CONTRIBUTIONS BY PRODUCT

q o q changes, in %, sa



sources : Douanes, Insee

BOX 2: THE REFORM OF THE GERMAN UNEMPLOYMENT BENEFIT SYSTEM IN 2005 (THE SO-CALLED HARTZ IV LEGISLATION)

The agreement reached on 30 June 2004 between the government and the opposition finalised the so-called Hartz reform of the labour market. For 1 January 2005, the final section of the reform provides for :

* the merger of the temporary allowances accorded to long-term job-seekers (Arbeitslosenhilfe) with social assistance (Sozialhilfe). The new allocation granted to long-term job-seekers (Arbeitslosengeld II) is thought to mean 2 million people seeing their allocation gradually reduced. A supplementary arrangement would make it possible to limit the immediate decline in income for the people concerned.

* On the other hand, the means-test conditions for this new allocation have been tightened. They now take into account the personal assets of the beneficiary and the income of the spouse. This tightening is estimated to have an immediate impact on the income received by 500.000 people, who would no longer receive any allowance.

Consumer prices in the euro zone

Consumer prices in the euro zone accelerated in Q4, driven by the rise in the oil price. While core inflation has remained stable and prices of foodstuffs have slowed down, the year-on-year price rise in the energy sector increased substantially. Within the euro zone, inflation differentials are stabilising, after widening in spring 2004, at a time when the responses of energy prices to the rise in the crude oil price have turned out to differ widely from one country to another.

On the assumption that the Brent price is around $40/barrel in mid-2005 and that the dollar/euro exchange rate is 1.30, inflation can be expected to stabilise at close to 2.3% in December before falling back to below 2.0% by end-June 2005. Core inflation[(1)] should remain stable before ebbing in H1 2005, while the year-on-year rise in energy prices would ease in line with prices of crude. On the other hand, inflation in the foodstuffs sector is likely to rise gradually and return to more normal levels.

Inflation has started to move up again in the euro zone, linked to the rise in the oil price. It is now forecast to stabilise before easing in H1 2005.

Following a brisk acceleration in spring, inflation in the euro zone eased during the summer, notably because of the slowdown in prices of foodstuffs. The actual fall was from 2.5% in May 2004 to 2.1% in September. This easing was rapidly countered, however, by the surge in energy prices linked to the 42% rise in the price of crude oil between June and October. Inflation in the zone peaked at 2.4% in October 2004.

(1) Measured by the Harmonised Index of Consumer Prices (HICP) excluding food, alcohol, tobacco and energy.

On the assumption that the price of Brent stabilises at around $40/barrel in Q2 2005 and that the dollar-euro exchange rate is 1.30 over the time-horizon of this forecast, inflation can be expected to stabilise at nearly 2.3% before starting to ease back towards 2.0% during the first half of 2005.

Inflation in the energy sector picked up strongly in October, reaching 9.8%. While the crude oil price remained fairly stable between March and June following the previous months' rises, it then recorded a sharp increase (to $49.7 in October from $35.1 in June). The forecast is that energy prices will slow down distinctly, in line with the easing of the crude oil price *(cf. graph 1)*. The year-on-year price rise for energy is thought to have slowed down in November 2004 and is expected to reach 4.4% in June 2005.

Food prices have slowed down since the summer, thanks to much more favourable conditions than in the previous year. In addition, on this occasion there was no rise in tobacco prices in France. Inflation in the food sector therefore came to 1.2% in October 2004, compared with 2.7% in June and 3.6% in December 2003. Thereafter, food prices seem to have accelerated steadily to return to inflation levels that are more traditional for this sector. What happened in 2003 was that prices had accelerated strongly be-

TABLE 1: EURO ZONE INFLATION

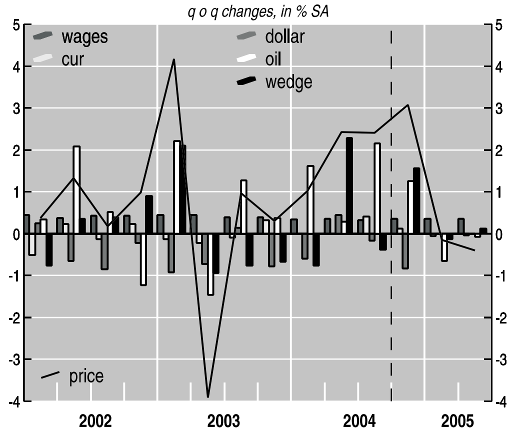
(year on year % growth of HICP)*

Sectors (weight in the index)	December 2003	June 2004	October 2004	December 2004	June 2005
Total (100.0%)	2.0	2.4	2.4	2.3	1.8
Food (Beverage and Tobacco) (19.5%)	3.6	2.7	1.2	1.5	1.7
of which *Food (15.6%)*	2.6	1.4	-0.2	0.4	0.8
Beverage and Tobacco (3.9%)	7.7	8.4	7.1	6.0	4.8
Energy (8.1%)	1.8	5.9	9.8	9.1	4.4
Core inflation (72.3%)	1.6	2.0	1.9	1.8	1.5
of which: *Manufactured products (31.0%)*	0.8	0.8	0.8	0.6	0.4
Services (41.3%)	2.3	2.6	2.6	2.6	2.4

Forecast (December 2004 and June 2005 columns)
* Harmonized Index of Consumer Prices
Source: Eurostat

1

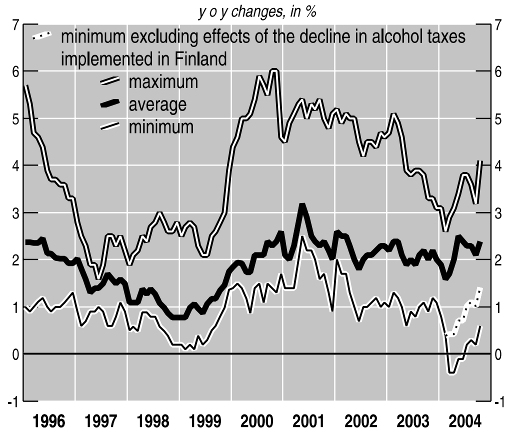
CONTRIBUTIONS TO THE EVOLUTION
IN PRICE OF ENERGY PRODUCTS
q o q changes, in % SA



forecasts after the dotted line

2

INFLATION IN THE EURO ZONE
y o y changes, in %



cause of late frosts and a particularly dry summer. As these exceptional phenomena were not repeated in 2004, the price rise in the sector came out below its long-term average throughout the first three quarters of 2004.

Inflation differentials within the euro zone have stabilised but are still wider than those seen in H2 2003

The period from February 2003 to December 2003 saw a rapid narrowing of inflation differentials among euro-zone countries, with the maximum declining from 3.8 points to 2.0 points. This tendency was interrupted at the beginning of 2004, with differentials widening again to 2.3 points in January and 3.5 points in April and again in October. Roughly half the widening of the inflation differentials is due to one exceptional phenomenon, namely the reduction in the Finnish alcohol tax in March.

At the same time, a major source of widening of inflation differentials within the euro zone has been the contrasting reactions of energy prices in the different countries to the past rise in the oil price *(cf. table 2)*. While the year-on-year energy price rise came out at 9.8% in October 2004 for the euro zone as a whole, movements in individual countries ranged from 5.8% in Italy to 22.2% in Luxembourg. This tendency for energy prices to react more strongly in Luxembourg has been seen in the past(2) at other periods of wide swings in the oil price. The same is true of the smaller reaction in Italy.

(2) This is mainly the result of the lower level of taxation of energy products in Luxembourg than in the other European countries. For example, in August 2002 taxes in Luxembourg expressed in euros per 1000 litres amounted to 372.09 for top-quality lead-free petrol (the EU average is 504.89), 252.85 for diesel fuel (351.61) 13.43 for domestic heating oil (126.35) and 6.20 for heavy fuel oil (62.64).

(3) The differential even reached 3.5 points in June 2004, but this was largely the result of a particular phenomenon, namely the fact that prices for hotels and catering rose by 6.7% in June in Portugal before stepping back of 4.0% in July. Excluding this exceptional phenomenon, the maximum differential in core inflation would have been 2.8 points in June.

TABLE 2 : EURO ZONE INFLATION BY COUNTRIES

(year on year % growth of HICP)

	HICP		Core inflation		Energy	
	October 2003	October 2004	October 2003	October 2004	October 2003	October 2004
Belgium	1.4	2.7	1.7	1.2	-2.4	16.0
Germany	1.1	2.2	0.8	1.5	2.2	9.4
Greece	3.2	3.3	2.9	3.3	1.4	13.3
Spain	2.7	3.6	2.7	2.6	-1.8	11.6
France	2.3	2.3	1.9	1.6	-0.4	10.1
Ireland	3.3	2.5	3.3	2.0	1.5	12.5
Italy	2.8	2.1	2.4	2.2	1.1	5.8
Luxembourg	1.8	4.1	2.2	1.5	-7.0	22.2
Netherlands	1.9	1.5	1.7	1.5	3.2	8.1
Austria	1.1	2.3	1.2	1.8	-1.5	12.1
Portugal	2.8	2.4	2.6	2.3	3.7	9.2
Finland	0.9	0.6	0.7	0.9	0.4	11.7
Euro zone	2.0	2.4	1.7	1.8	0.7	9.8

Source : Eurostat

Finally, the tendency towards a narrowing of differentials in the case of core inflation (excluding energy and food) that has been seen since the beginning of 2003 came to an abrupt end in spring 2004, with the maximum differential widening by 1.3 of a point between February and July 2004, to reach 3.2%[(3)], before falling back to 2.4% in October. Core inflation in fact then declined in Finland, the country where it had already been lowest, as well as in the Netherlands, Ireland and Luxembourg, whereas it rose in Greece and Spain, countries where it was already above the European average.

Core inflation set to remain stable at just below 2% before easing in H1 2005

Core inflation has nevertheless remained fairly stable, fluctuating between 1.6% and 1.9% since May 2003. In October 2004 it stood at 1.8%. This tendency is expected to continue into the beginning of 2005, as a result of the continuing slow pace of wage increases in the leading countries of the zone. Thereafter, core inflation is expected to decline as a result of the exit from the year-on-year calculation of the sharp rise posted in the first two quarters of 2004 following the reform of the German healthcare system[(4)]. It is expected to be 1.8% in December 2004 and 1.5% in June 2005.

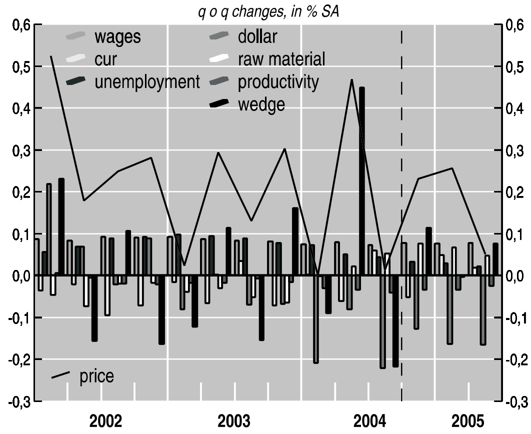
The rise in prices of services, the principal component of this indicator, has been stable since the beginning of 2004, reaching 2.6% in October. This stability is expected to persist within the time horizon of this forecast, standing at 2.6% in December 2004 and 2.4% in June 2005.

Inflation in prices of manufactures, the second-largest component of core inflation, has also remained on a stable tendency of the order of 0.8%, year on year. In the final part of 2004 and the first half of 2005, prices of manufactures are likely to be held

3

CONTRIBUTIONS TO THE EVOLUTION IN PRICE OF MANUFACTURED GOODS

q o q changes, in % SA

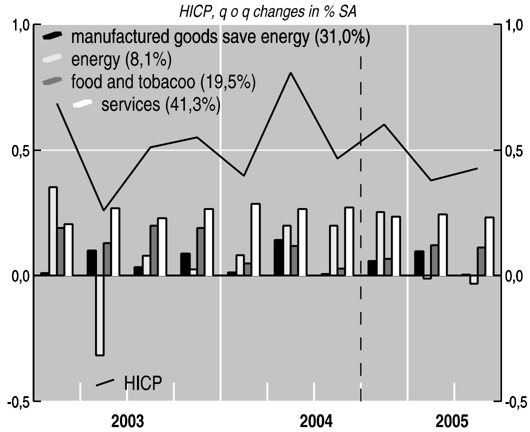


forecasts after the dotted line

5

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

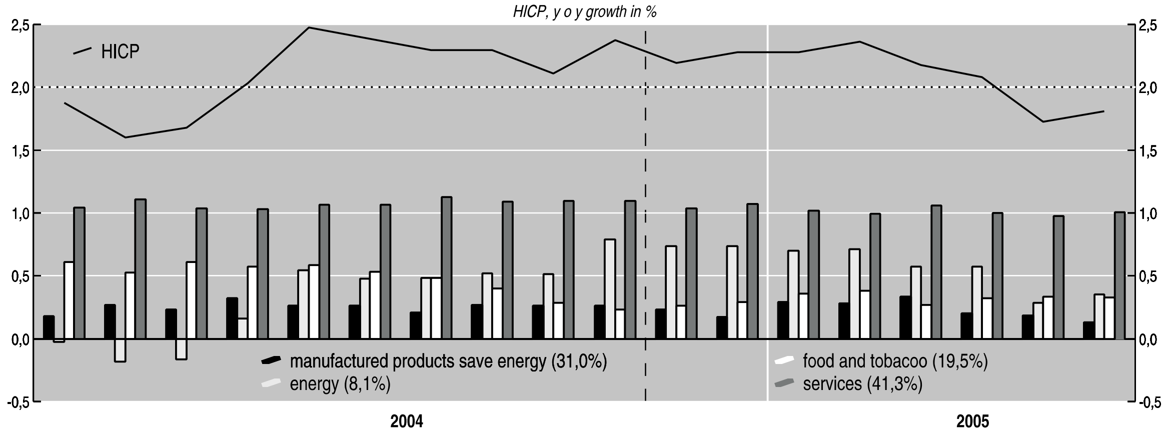
(4) This was responsible for a rise of 0.3 of a point in core inflation, thanks to a reduction in reimbursement rates. Since the HICP is calculated using prices net of social security reimbursements, the result was to push up prices as measured by this index.

4

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

back by the tendency for the euro to appreciate, but the influence of this factor is likely to be largely cancelled out by the effects of the rise in raw material prices *(cf. graph 4)*. As a consequence, the year-on-year increase in prices of manufactures, which was 0.8% in October 2004, is expected to decline to 0.6% in December and 0.4% in June 2005. ■