

# The international economic situation

Despite still having to cope with high energy prices, the world economy is set to remain brisk in H1 2006. The firm outlook for activity in all regions of the world is confirmation that the impact of the oil shock can be expected to remain muted to a great extent during this period. In particular, competitive pressures are likely to limit the risks of any generalised build-up of inflation. Even so, divergences in the performance of different industrialised countries are likely to persist and this can be expected to generate discrepancies in the evolution of external balances.

## The prospects for world activity steady at a high level

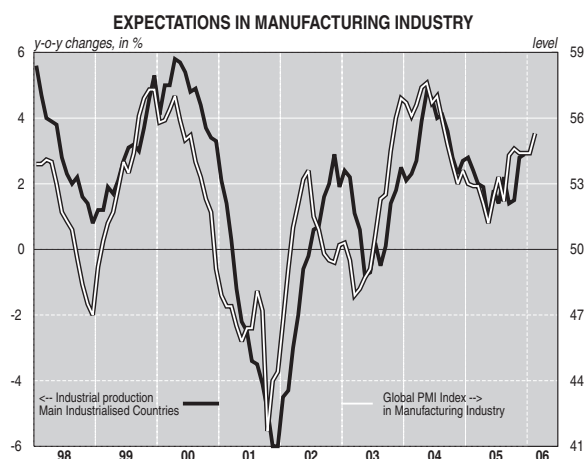
The end of 2005 saw growth in all the industrialised economies (United States, Japan, United Kingdom and the euro zone) remaining firm. The temporary slowdown in the American economy and the continuing modest performance posted by the euro zone were offset by the very lively upturn in the Japanese economy, testifying to the solidity of the recovery in the domestic components of demand.

At present, in all regions of the world, the prospects for production are at relatively high levels. In manufacturing, the prospects for global activity have remained virtually stable between November 2005 and January 2006 and even picked up in February. This would be consistent with the maintenance of growth of industrial production in the leading industrial countries at around 3%, year on year (see Graph 1). For its part, the global PMI<sup>(1)</sup> index in the services sector again came out at a high figure in February.

These various elements argue in favour of the maintenance of an average GDP growth rate in the major industrialised zones between 2 1/2 and 3 1/2% per year. Industrial activity remains flourishing in Asia, with this dynamism spilling over to all the economies. As a result, world trade can be expected to remain firm, so that demand in French export markets can be expected to be close to, or even slightly above, its long-period average.

(1) The Purchasing Managers' Index (PMI) reflects the short-term business climate.

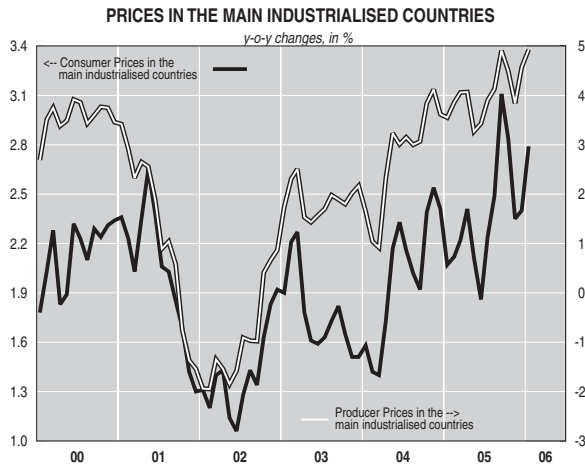
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## The impact of the higher oil prices is being limited to diffusion to prices of other inputs

The “muted” nature of the impact of the oil shock seems likely to be confirmed. The price per barrel of Brent was standing slightly above \$60 in the early part of March. Prices of other raw materials continue to post sharp increases. This is notably true of petroleum derivatives, but also of metals. In these circumstances, producer prices have been rising substantially since mid-2005 in most of the industrialised countries. However, the pressures on consumer prices that emerged at the end of last summer have eased slightly (see Graph 2), including in most Asian countries. This ebbing of inflation is in fact likely to continue between now and mid-2006. On the assumption that the Brent price stabilises at around \$60/barrel, the decline in the energy components should in fact continue. The easing of core inflation in the various countries should also persist since, despite the past price rises, wage growth has so far remained moderate in the industrialised zones. This suggests that the impact of the energy shock is unlikely to go beyond the stage of diffusion to prices of other inputs.

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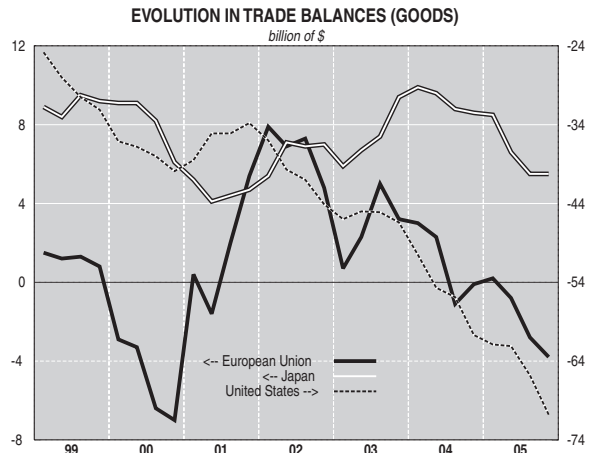
**With financing conditions remaining generally attractive, the discrepancies between demand growth in different OECD countries are set to persist, leading to a persistence of trade imbalances**

Few marked evolutions have been seen on the currency markets in recent months, apart from the slight depreciation of the dollar in real effective terms since November 2005. In these circumstances, the euro/dollar exchange rate has been assumed stable at 1.20 throughout the forecast period, close to its present level.

At the same time, financing conditions seem likely to remain generally attractive. Admittedly, there have recently been rises in short-term interest rates in the United States, but rates have remained more inert in the other industrialised zones. Between now and mid-2006, fresh interest-rate hikes are to be expected on both sides of the Atlantic. However, long rates are likely to remain relatively unaffected by the rises in key rates until mid-year, as they have done until now.

Despite this generally favourable environment, there are likely to remain marked performance differences among industrialised countries between now and mid-2006. The strength of domestic demand in the United States and, to a smaller extent, in Japan and the United Kingdom, are likely to continue to contrast with the levels of demand expected in the euro zone. These differences are likely to be mainly due to divergences in the momentum shown by real incomes and, more marginally, in the amplitude of investment cycles. As a result, while annual growth rates will probably be around 4.2% in the United States and 3.0% in Japan, growth in the euro zone will probably remain limited to 2.0%.

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Reflecting this discrepancy in demand, a continuation of recent tendencies is to be expected in the evolution of the trade balances of the various zones (*see Graph 3*): a further widening of the American deficit; a stabilisation — or even improvement — in the Japanese surplus thanks, in particular, to the continuous depreciation of the yen in the past year; and, finally, a slow deterioration in the position of the European Union, especially under the impact of the higher oil bill. ■



## The euro zone's international environment

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

	Quarterly % change								Annual % change		
	2004		2005				2006		2004	2005	2006 (c.o.)
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2			
<b>UNITED STATES (37.2%)<sup>(1)</sup></b>											
<b>GDP</b>	<b>1.0</b>	<b>0.8</b>	<b>0.9</b>	<b>0.8</b>	<b>1.0</b>	<b>0.4</b>	<b>1.2</b>	<b>0.9</b>	<b>4.2</b>	<b>3.5</b>	<b>2.9</b>
Consumption	1.1	1.1	0.9	0.8	1.0	0.3	1.2	0.9	3.9	3.6	2.9
Private investment <sup>(2)</sup>	2.0	1.7	1.7	2.3	2.0	1.1	1.6	1.5	9.7	8.1	5.2
<i>Nonresidential investment</i>	<i>2.8</i>	<i>2.5</i>	<i>1.4</i>	<i>2.1</i>	<i>2.0</i>	<i>1.3</i>	<i>1.8</i>	<i>1.6</i>	<i>9.4</i>	<i>8.7</i>	<i>5.7</i>
<i>Residential investment</i>	<i>0.7</i>	<i>0.4</i>	<i>2.3</i>	<i>2.6</i>	<i>1.8</i>	<i>0.6</i>	<i>1.3</i>	<i>1.3</i>	<i>10.3</i>	<i>7.1</i>	<i>4.4</i>
Government expenditures <sup>(3)</sup>	0.5	0.2	0.5	0.6	0.7	-0.2	0.6	0.6	2.2	1.8	1.5
Exports	1.3	1.7	1.8	2.6	0.6	1.4	1.5	1.4	8.4	7.0	4.6
Imports	1.1	2.7	1.8	-0.1	0.6	3.0	2.0	1.8	10.7	6.4	6.0
<b>Contributions:</b>											
<i>Domestic demand excluding stocks</i>	<i>1.2</i>	<i>1.1</i>	<i>1.0</i>	<i>1.1</i>	<i>1.2</i>	<i>0.3</i>	<i>1.3</i>	<i>1.0</i>	<i>4.6</i>	<i>4.1</i>	<i>3.1</i>
<i>Change in private inventories</i>	<i>-0.1</i>	<i>0.0</i>	<i>0.1</i>	<i>-0.5</i>	<i>-0.1</i>	<i>0.4</i>	<i>0.0</i>	<i>0.0</i>	<i>0.3</i>	<i>-0.3</i>	<i>0.2</i>
<i>Net exports</i>	<i>0.0</i>	<i>-0.2</i>	<i>-0.1</i>	<i>0.3</i>	<i>0.0</i>	<i>-0.3</i>	<i>-0.2</i>	<i>-0.1</i>	<i>-0.7</i>	<i>-0.3</i>	<i>-0.5</i>
<b>UNITED KINGDOM (5.6%)<sup>(1)</sup></b>											
<b>GDP</b>	<b>0.4</b>	<b>0.6</b>	<b>0.2</b>	<b>0.5</b>	<b>0.4</b>	<b>0.6</b>	<b>0.5</b>	<b>0.6</b>	<b>3.2</b>	<b>1.8</b>	<b>1.8</b>
Consumption	0.9	0.5	0.0	0.3	0.6	0.7	0.6	0.8	3.6	1.9	2.2
Total investment	-0.3	0.9	0.8	0.2	2.8	-0.8	0.8	1.4	5.2	3.3	2.7
<i>Enterprise investment</i>	<i>1.8</i>	<i>-0.2</i>	<i>-0.3</i>	<i>1.0</i>	<i>0.6</i>	<i>-1.0</i>	<i>0.5</i>	<i>1.0</i>	<i>3.3</i>	<i>1.6</i>	<i>1.0</i>
<i>Household investment <sup>(4)</sup></i>	<i>-0.8</i>	<i>1.6</i>	<i>-3.9</i>	<i>4.4</i>	<i>0.3</i>	<i>1.0</i>	<i>1.0</i>	<i>1.0</i>	<i>6.5</i>	<i>1.0</i>	<i>3.8</i>
<i>Public investment <sup>(4)</sup></i>	<i>-9.8</i>	<i>4.3</i>	<i>19.3</i>	<i>-12.6</i>	<i>20.2</i>	<i>-10.0</i>	<i>2.0</i>	<i>4.0</i>	<i>12.7</i>	<i>16.6</i>	<i>2.7</i>
Public consumption <sup>(5)</sup>	0.3	0.4	0.3	0.7	0.8	0.8	0.5	0.5	3.0	1.9	2.0
Exports	0.9	0.9	0.4	3.4	0.7	1.1	1.2	1.2	4.6	5.2	4.2
Imports	1.4	2.3	-1.3	2.5	2.1	0.3	1.4	1.8	6.7	4.8	4.7
<b>Contributions:</b>											
<i>Domestic demand excluding stocks</i>	<i>0.6</i>	<i>0.5</i>	<i>0.2</i>	<i>0.3</i>	<i>1.1</i>	<i>0.5</i>	<i>0.6</i>	<i>0.8</i>	<i>3.9</i>	<i>2.2</i>	<i>2.3</i>
<i>Change in private inventories</i>	<i>-0.1</i>	<i>0.4</i>	<i>-0.5</i>	<i>-0.1</i>	<i>0.0</i>	<i>-0.2</i>	<i>0.0</i>	<i>0.0</i>	<i>0.1</i>	<i>-0.3</i>	<i>-0.2</i>
<i>Net exports</i>	<i>-0.2</i>	<i>-0.4</i>	<i>0.5</i>	<i>0.1</i>	<i>-0.4</i>	<i>0.2</i>	<i>-0.1</i>	<i>-0.2</i>	<i>-0.8</i>	<i>0.0</i>	<i>-0.3</i>
<b>JAPAN (14.8%)<sup>(1)</sup></b>											
<b>GDP</b>	<b>0.1</b>	<b>-0.2</b>	<b>1.3</b>	<b>1.4</b>	<b>0.2</b>	<b>1.3</b>	<b>0.8</b>	<b>0.7</b>	<b>2.3</b>	<b>2.7</b>	<b>2.8</b>
Consumption	0.4	-0.6	1.3	0.8	0.4	0.9	0.5	0.5	1.9	2.2	1.9
Total investment	-0.5	0.6	1.8	1.4	1.3	0.0	1.4	1.1	1.0	3.4	3.3
<i>Private investment</i>	<i>0.4</i>	<i>0.8</i>	<i>2.4</i>	<i>1.5</i>	<i>1.5</i>	<i>0.7</i>	<i>1.4</i>	<i>1.1</i>	<i>4.1</i>	<i>6.2</i>	<i>4.0</i>
<i>Nonresidential investment</i>	<i>0.5</i>	<i>0.8</i>	<i>3.3</i>	<i>2.3</i>	<i>1.5</i>	<i>0.4</i>	<i>2.0</i>	<i>1.5</i>	<i>4.6</i>	<i>7.9</i>	<i>4.8</i>
<i>Residential investment</i>	<i>0.1</i>	<i>0.4</i>	<i>-1.3</i>	<i>-1.9</i>	<i>1.6</i>	<i>2.1</i>	<i>1.0</i>	<i>1.0</i>	<i>2.0</i>	<i>-0.7</i>	<i>3.7</i>
<i>Public investment</i>	<i>-3.8</i>	<i>0.1</i>	<i>-0.5</i>	<i>1.0</i>	<i>0.3</i>	<i>-2.7</i>	<i>0.0</i>	<i>0.0</i>	<i>-8.8</i>	<i>-5.9</i>	<i>-1.6</i>
Public consumption	-0.2	0.6	0.8	0.3	0.4	0.3	0.2	0.2	2.0	1.8	0.8
Exports	0.5	1.2	-0.3	3.5	3.1	3.5	3.0	2.5	13.9	6.9	10.1
Imports	1.7	2.3	0.0	2.2	3.2	-0.9	2.2	1.8	8.5	6.2	5.1
<b>Contributions:</b>											
<i>Domestic demand excluding stocks</i>	<i>0.1</i>	<i>-0.1</i>	<i>1.3</i>	<i>0.8</i>	<i>0.6</i>	<i>0.6</i>	<i>0.7</i>	<i>0.6</i>	<i>1.7</i>	<i>2.3</i>	<i>2.0</i>
<i>Change in private inventories</i>	<i>0.2</i>	<i>0.0</i>	<i>0.1</i>	<i>0.4</i>	<i>-0.4</i>	<i>0.2</i>	<i>0.0</i>	<i>0.0</i>	<i>-0.2</i>	<i>0.2</i>	<i>0.0</i>
<i>Net exports</i>	<i>-0.1</i>	<i>-0.1</i>	<i>0.0</i>	<i>0.2</i>	<i>0.0</i>	<i>0.6</i>	<i>0.1</i>	<i>0.1</i>	<i>0.8</i>	<i>0.2</i>	<i>0.8</i>

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

Sources: BEA, ONS, Economic and Social Research Institute, Insee

fecting gasoline and gas prices. Japanese households' wage incomes rose strongly in Q4 2005 (+2.9%, following -3.3% in Q3), mainly because of the exceptionally high end-year bonuses. This improvement in wage incomes is in fact likely to continue in H1 2006. The spring wage negotiations (shunto) that began in mid-January will probably be the occasion for trade unions to obtain increases in remuneration.

The labour market situation should therefore be generally favourable to increases in earned income in the three countries (see Table 2). However, in the case of Japan two factors are liable to limit the rise in real income. The fact that the country is only gradually emerging from a period of deflation means that the consumption deflator is likely to remain negative and this will tend to curb wage growth. In addition, the abolition of certain tax breaks granted to households in 1999 and totalling 1600 billion JPY took effect in January 2006. In the United States, on the other hand, the ebbing of inflation, under the impact

**TABLE 2 : UNITED-STATES, UNITED KINGDOM AND JAPAN : HOUSEHOLDS ACCOUNTS**

(in %)

	Annual changes			
	2003	2004	2005	2006 (*)
<b>United-States</b>				
Non-farm dependent employment	-0.3	1.1	1.5	1.3
Average wage per head	2.9	4.3	4.6	2.9
Nominal gross disposable income	4.3	6.1	4.3	4.8
Private consumption deflator	1.9	2.6	2.8	1.6
Saving ratio (absolute level)	2.1	1.8	-0.4	-0.1
<b>United Kingdom</b>				
Dependent employment	1.0	1.0	1.0	0.2
Average wage per head	3.5	3.6	3.7	3.2
Nominal gross disposable income	4.7	3.5	4.5	3.4
Private consumption deflator	1.9	1.2	2.0	1.5
Saving ratio	5.4	4.4	5.3	5.0
<b>Japan</b>				
Total employment	-0.2	0.2	0.4	-0.1
Average wage per head	-1.3	-1.5	0.8	1.5
Nominal gross disposable income (dependent household)	-1.2	0.4	1.1	1.3
Private consumption deflator	-0.9	-0.6	-0.8	-0.4
Saving ratio	4.0	3.1	3.0	2.8

(\*) For the United States and for the United Kingdom, statistical carryover at end-Q2 2006.

(\*) For Japan, annual average 2006

Source : BEA, BLS, Central Statistical Office, Department of Employment, ONS, Economic and Social Research Institute, Ministry of Public Management, Ministry of Labour, Insee

of the decline in the energy components, is likely to provide additional support for purchasing power, enabling it to show a distinct acceleration compared with H2 2005. In the United Kingdom, too, it is the continuing wage momentum, combined with the decline in inflation, that can be expected to fuel the rise in real income. UK consumer prices slowed down in January for the fourth consecutive month (to 1.9%, year on year).

These various factors mean that household demand, on the back of purchasing power gains, can be expected to accelerate in the first half of this year in the euro zone's principal industrialised trading partners. In addition, two one-off factors are liable to encourage spending by American households. First, the temporary adverse shock directly attributable to the ending of automobile discounts that took place at the end of 2005 will have lost its effect; the statistical carryover of retail sales was in fact already very positive at the end of February (+2.1% in volume). Second, residential housing investment will probably be boosted by the reconstruction needed following the hurricane damage, as can already be seen in the upturn in housing starts seen at the beginning of this year. In the United Kingdom, the main factor responsible for the upturn in retail sales is likely to be the revival of the housing market seen since mid-2005 (see box "Comparison of the economic performances of the United Kingdom and the euro

zone"). In addition, the Bank of England's decision to hold its key rate at 4.50%, following the one-quarter-point cut in August, can be expected gradually to efface the impact of past rate rises. Note, however, that, even if UK household confidence is restored, the weakness of retail sales (statistical carryover of 0.6% at end-February, compared with a rise of 1.6% in Q4 2005) is pointing to a slight slowdown in spending in Q1 2006. Meanwhile, housing investment is likely to pick up, thanks also to the acceleration in real income and to low mortgage rates. This recovery is already been seen in the rise in the volume of housing transactions.

### The relative firmness of prospects for activity and the continuing generally favourable financing conditions are likely to underpin growth in investment

The dynamism of both domestic and foreign demand is likely to motivate corporate investment projects. A strengthening of capital spending is in fact already being suggested by a wide range of indicators, the most prominent being the general rise in capacity utilisation rates (see Graph 2). Capital goods orders in the United States have also been very firm since the end of 2005. The same is true of Japan,

## The euro zone's international environment

where the obsolete state of the plant and machinery now in place is likely to mean a revival in replacement investment.

Moreover, the results of corporate business surveys are encouraging. In the United States, the outlook for activity, following three consecutive months' decline, rose in February for industry and has remained at a relatively high level for the non-manufacturing sector. The reconstruction efforts needed following the hurricanes are likely to constitute an additional support factor for corporate investment. In the United Kingdom, the latest CBI surveys of industry, for January and February, show an improvement in expectations of output in the next three months. Similarly, the Tankan survey in Japan for Q4 2005 testifies to firms' intentions to increase their investment in capital goods in coming quarters, despite downward revisions in profit expectations.

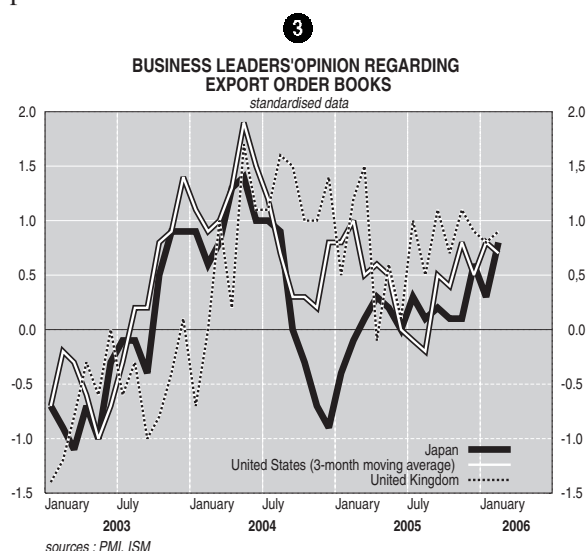
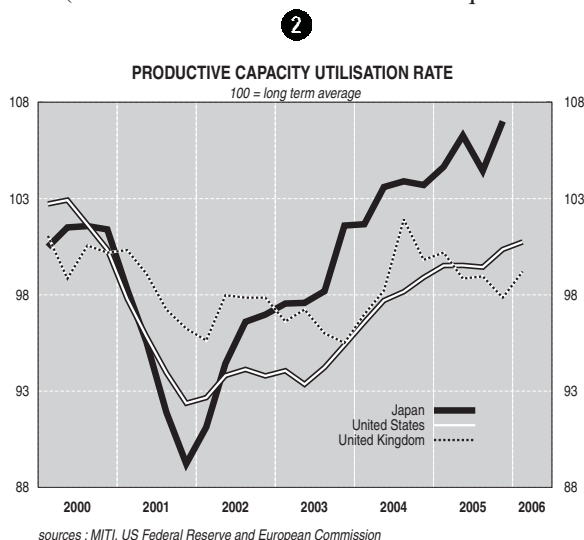
Finally, financing conditions are likely to remain generally attractive. In the United States, despite the upward phase of the key rate cycle that has now lasted continuously since June 2004, the latest Fed survey shows that the percentage of banks tightening the conditions of their lending to firms is tending to stabilise. In addition, recent profit levels and the restoration of self-financing capacity can be expected to facilitate the financing of investment projects. The financial situation of Japanese firms has also improved and they are therefore likely to be unaffected in the short term by the Banque of Japan's decision to abandon its policy of massive injections of liquidity into the banking system. In the United Kingdom, lending conditions are as attractive as ever, with interest rates on loans to businesses virtually stable at a relatively low level (around 5%, compared with 13% at the beginning of the 1990s). Nevertheless, investment decisions will have been substantially affected in the recent past by the decline in industrial production (-0.6% and -0.8% in the final two quarters of

2005) and the industrial recovery is still looking fragile. In these circumstances, growth in UK corporate investment is likely to remain subdued, permitting no more than a stabilisation of the investment ratio.

### The domestic driving forces for growth are liable to encourage growth in imports and hence in world trade as a whole

In the United States and the United Kingdom, imports are likely to maintain their momentum as a result of the reinvigorated domestic demand. However, despite the growth in exports, foreign trade as a whole is likely to hamper growth in these countries in coming quarters. Japanese exports, by contrast, are likely to feel the full benefit of the strength of activity in the principal Asian trading partners, where industrial output seems for the moment to be unaffected by the high oil prices. Japanese exports should also benefit from the tendency of the yen to depreciate, which has now lasted for almost a year.

The knock-on effect on world trade from the euro zone's international environment, which can already be seen in the firmness of export order books (see Graph 3), could well find itself weakened if certain potentially adverse factors affecting activity rates in these three countries were to materialise. In particular, the tax rises affecting Japanese households could at some stage hold back their spending. In the United Kingdom, there is the possibility of monetary tightening, motivated by the tangible upturn in activity. In the United States, the real estate market may suffer more of a hard landing than is currently expected, given that the demand for mortgages is showing signs of weakening and the accessibility of housing is deteriorating because of the surge in prices. ■



### BOX: COMPARISON OF THE ECONOMIC PERFORMANCES OF THE UNITED KINGDOM AND THE EURO ZONE

For more than four years now, the United Kingdom has managed to achieve a growth rate higher than that of its main European partners. Between mid-2001 and mid-2005, the average growth differential between the United Kingdom and the euro zone amounted to 1.2 of a point in favour of the former. This difference is explained mainly by divergences in the momentum of domestic demand and, more particularly, private consumption. However, the gap has recently tended to narrow, since spending by UK households has slowed down along with house prices. Growth rates in the United Kingdom and the euro zone are now completely similar.

It was the year 2001 that marked the real uncoupling between the growth rates of the United Kingdom and continental Europe. From that time on, euro-zone growth slowed down, from 4.0% in 2000 to 1.9% in 2001 and then 0.7% in 2003. By contrast, the United Kingdom showed astonishing resistance to the bursting of the high-tech bubble. Although UK growth also almost halved in 2001 (to 2.2% from 4.0% in 2000), it then maintained this new momentum until 2004. This better performance is explained by the more favourable evolution of domestic demand. Admittedly, fiscal policy was more expansionary in the United Kingdom, one result of this being that growth in public consumption was greater than in the euro zone. At a more fundamental level, however, it was household consumption that generated the growth differences<sup>(1)</sup> (see Graph A), growing in the UK at rates of more than 2% throughout the period under consideration, compared with slightly less than 1% in the euro zone.

This phenomenon is to be attributed in the first place to the fact that wage compensation rose faster in the United Kingdom. Except in 2002, the difference in growth in real incomes between the two economies was particularly wide (of the order of 2 points), mainly because of more rapid wage growth. On the other hand, differences in job creation rates were relatively insignificant, although the UK unemployment rate declined almost continuously (from 5.1% in 2001 to 4.7% in 2004), in contrast to that of the euro zone, which increased continuously over the same period (7.9% in 2001, 8.9% in 2004). Furthermore, following the bursting of the stock-market bubble, the Bank of England made cuts totalling two points in its key rate during 2001 (from 6% to 4%), and UK households were able to take full advantage of this because most of their borrowing is at variable rates. During the same period, the European Central Bank reduced its key rate by 1 point (from 4.75% to 3.75%). Thereafter, until mid-2003, evolutions in monetary policy were fairly similar in the United Kingdom and in the euro zone. Lastly, UK household consumption was underpinned by the high

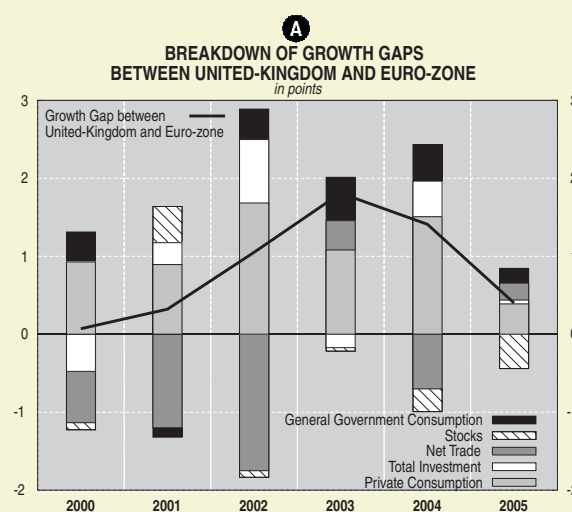
(1) Note that in 2001 and 2002 the contribution of foreign trade to the growth difference between the two economies was greater than that of consumption. However, this negative contribution is explained mainly by the rise in UK imports and hence also by the strength of domestic demand.

household indebtedness ratio, which rose steadily from 2001 on, reaching more than 135% of gross disposable income in 2005.

However, the main explanation for the dynamism of consumption in United Kingdom lies in the evolution of the residential property market. The consumption equation presented below provides a good illustration of the extent to which the "housing wealth effect" has acted as driving force for the strength of UK households' spending (see Graph B). When the financial bubble burst, the rise in property prices more than compensated for the drop in the FTSE index and this substantially contributed to maintaining the level of consumption. From November 2003 on, however, successive increases in the Bank of England's key rate brought about an easing of house prices. The impact of this slowdown on consumption was particularly visible in 2005, when its growth fell to 1.2% from 2.3% the previous year. The gap between activity rates in the United Kingdom and the euro zone was automatically reduced as a result.

Finally, throughout the period 2001-2005 it was the production of domestic services that was the main beneficiary of the strength of UK household spending, so that the growth difference between the United Kingdom and the euro zone was mainly concentrated on tertiary activities (averaging 1.4 of a point). Differences in the growth of value added in industry were smaller (averaging 0.4 of a point), this time in the euro zone's favour. This structural weakness of the UK manufacturing sector led to increased imports of industrial products and, in the end, to a virtually permanent negative contribution to growth from foreign trade.

To sum up, the UK economy posted better performance than the euro zone between 2001 and 2004, mainly because households were benefiting from a housing wealth effect, from strong wage income growth and from low in-



source : Eurostat

terest rates. Since 2005, on the other hand, following the soft landing of the housing market and the consequent easing of consumption in the United Kingdom, the gap has started to narrow (0.4 of a point in 2005). ■

### Estimation of an consumption equation for British households :

$$\Delta LCONSO = 0,004 + 0,23 \Delta LCONSO_{-2} + 0,14 \Delta LY - 0,11 \Delta LY_{-2} + 0,02 \Delta LF + 0,24 \Delta LPX$$

(4,21)    (2,57)                    (2,89)                    (-2,26)                    (2,89)                    (7,03)

$$-0,23(LCONSO_{-1} - 2,06 - 0,10 LF_{-1} - 0,68 LY_{-1} - 0,15 LPX_{-1})$$

(-5,02)                    (15,65)    (9,86)                    (33,22)                    (15,71)

$$R^2 = 0,51$$

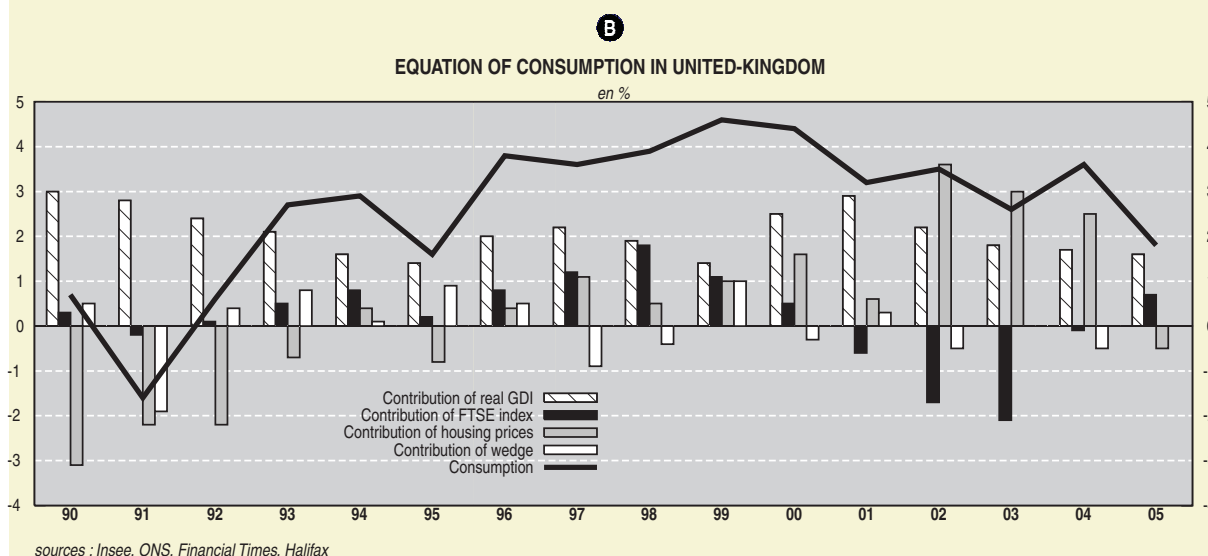
With :

LCONSO : logarithm of households' consumption in volume

LY : logarithm of the real gross disposable income

LF : logarithm of the FTSE index

LPX : logarithm of real Halifax housing prices.





# The economic situation in the euro-zone

After accelerating for three quarters, euro-zone GDP growth slipped back to 0.3% in Q4. The slowdown was particularly marked in the three largest countries of the euro-zone (France, Germany, Italy), with growth stagnating in Germany, in particular. By contrast, growth in the other countries remained lively. The declines in foreign trade and in private consumption following an exceptional third quarter are the explanation for this temporary slowdown.

The early part of 2006 would see GDP growth installed at a rate close to its trend value (0.5% per quarter) with a statistical carryover of +1.6% at the end of Q2, compared with annual growth of 1.4% in 2005. Domestic demand is still looking fragile (see Graph 1) as a result of the easing of consumption linked to the weakness of household income. However, a strengthening of investment seems to be perceptible. Moreover, the firmness of world demand is likely to continue to benefit exports from the zone and foreign trade should therefore make a positive contribution to growth.

## Q4 2005 witnessed a pause in euro-zone activity, accompanied by wide inter-country disparities

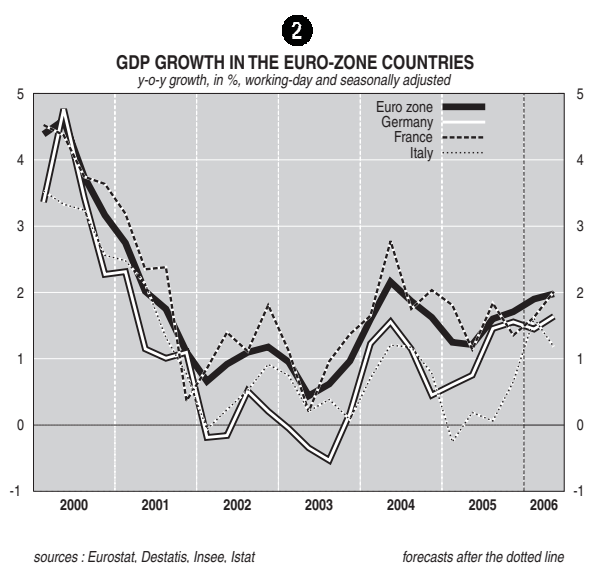
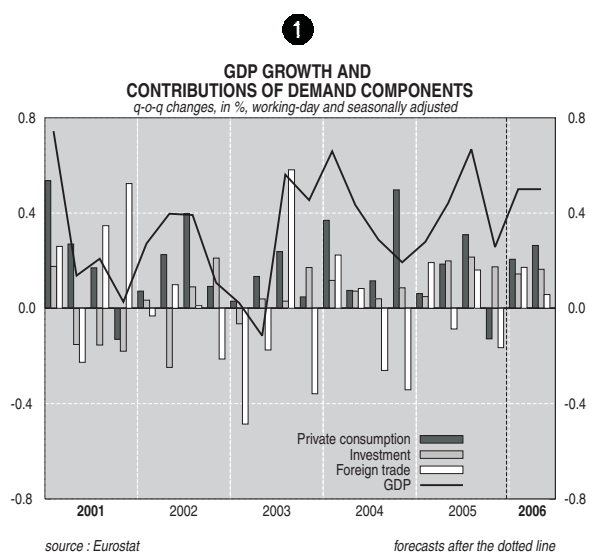
The results for Q4 2005 testify to the fragility of the upturn that began in mid-2005, pending the consolidation of the domestic determinants of growth (see Table "Euro-zone GDP" and Graph 2).

Industrial production posted a slowdown (to 0.5% in Q4 from 0.9% in Q3), hit by a weakening of external demand compared with Q3. In France and Italy, industrial production actually declined. In Germany, by contrast, industrial production remained dynamic, out of step with the rest of the zone.

Business surveys for industry in the early part of 2006 have continued to indicate an improvement in the euro-zone business climate (see Graph 3). GDP growth seems set to return to a rate close to its trend value (0.5% per quarter), underpinned by the gradual upturn in the investment cycle and by strong world demand. Growth disparities between countries seem likely to fade: German GDP should grow at the same rate as the zone as a whole; growth in Italy would be slightly below that of the zone (see box "Can we detect a cyclical gap between the industries of the euro-zone's major countries since 2005?").

## Modest growth in household consumption likely, linked to the stagnation of real wages

Household consumption declined by 0.2% in Q4 2005. Wage restraint was maintained throughout the year, without the improvement in the labour market permitting any significant increase in household purchasing power (no change in the first two quarters of the year - see Table "Euro-zone household accounts"). In Germany, household consumption slumped by 0.6% in the final quarter, whereas it remained the main driving force for growth in France and Spain (see Graph 4).



# The economic situation in the euro zone

## GDP IN THE EURO ZONE AND IN THE PRINCIPAL MEMBER COUNTRIES

(% change)

	Quarterly changes										Annual changes			
	2004				2005				2006		2003	2004	2005	2006 c.o.
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2				
<b>GERMANY (29.4%)<sup>(1)</sup></b>														
<b>GDP</b>	<b>0.5</b>	<b>0.2</b>	<b>-0.1</b>	<b>-0.1</b>	<b>0.6</b>	<b>0.3</b>	<b>0.6</b>	<b>0.0</b>	<b>0.5</b>	<b>0.5</b>	<b>-0.2</b>	<b>1.1</b>	<b>1.1</b>	<b>1.3</b>
Household consumption	0.5	-0.2	0.0	0.8	-0.4	0.0	0.3	-0.6	0.0	0.3	0.1	0.2	0.2	-0.1
Total GFCF	-1.9	-0.3	0.9	-0.4	-1.2	0.3	1.8	0.7	0.8	0.8	-0.7	-1.5	0.2	2.9
Public consumption	-1.0	-0.5	0.4	-1.9	0.5	1.5	0.4	-1.6	-0.2	-0.2	0.1	-1.6	0.1	-1.0
Exports	3.3	3.2	-0.5	0.5	2.1	1.1	4.9	0.5	2.0	1.9	2.3	8.3	6.6	6.6
Imports	1.6	2.0	2.4	0.5	-1.1	2.1	5.2	1.1	1.2	1.6	5.0	6.1	5.5	6.4
<b>Contributions :</b>														
Domestic demand ex. stocks	-0.2	-0.2	0.2	0.0	-0.4	0.3	0.6	-0.5	0.1	0.3	0.1	-0.2	0.0	0.3
Inventory change	0.0	-0.1	0.6	-0.1	-0.2	0.3	-0.1	0.8	0.0	0.0	0.6	0.5	0.2	0.6
Foreign trade	0.7	0.6	-1.0	0.0	1.2	-0.3	0.2	-0.2	0.4	0.2	-0.9	0.8	0.9	0.4
<b>ITALY (17,9%)<sup>(1)</sup></b>														
<b>GDP</b>	<b>0.5</b>	<b>0.3</b>	<b>0.4</b>	<b>-0.4</b>	<b>-0.5</b>	<b>0.7</b>	<b>0.3</b>	<b>0.2</b>	<b>0.3</b>	<b>0.4</b>	<b>0.4</b>	<b>1.0</b>	<b>0.2</b>	<b>1.1</b>
Household consumption	1.2	-0.5	-0.1	0.4	0.0	0.6	0.4	0.2	0.3	0.5	1.4	1.0	0.9	1.2
Total GFCF	3.4	0.5	-1.4	-1.6	-1.0	1.6	1.3	0.5	0.5	0.5	-1.8	1.9	-0.9	2.3
Public consumption	-0.3	0.3	0.1	0.3	0.2	0.4	0.0	0.1	0.1	0.0	2.3	0.7	0.8	0.3
Exports	-1.5	3.7	4.2	-4.2	-4.6	5.2	2.9	1.5	1.2	1.0	-1.9	3.2	0.7	5.8
Imports	-0.2	1.7	1.1	0.2	-2.8	4.2	1.1	1.5	1.3	1.1	1.3	2.5	2.3	4.9
<b>Contributions :</b>														
Domestic demand ex. stocks	1.3	-0.1	-0.3	0.0	-0.2	0.7	0.5	0.2	0.3	0.4	0.9	1.1	0.5	1.2
Inventory change	-0.5	-0.1	-0.1	0.7	0.1	-0.3	-0.7	0.0	0.0	0.0	0.3	-0.3	0.1	-0.4
Foreign trade	-0.4	0.5	0.8	-1.1	-0.5	0.3	0.5	0.0	0.0	0.0	-0.9	0.2	-0.4	0.3
<b>SPAIN (10,2%)<sup>(1)</sup></b>														
<b>GDP</b>	<b>0.8</b>	<b>0.7</b>	<b>0.8</b>	<b>0.9</b>	<b>0.8</b>	<b>0.8</b>	<b>0.9</b>	<b>0.9</b>	<b>0.8</b>	<b>0.8</b>	<b>2.9</b>	<b>3.1</b>	<b>3.4</b>	<b>2.8</b>
Household consumption	0.7	1.0	1.4	1.5	0.7	1.0	1.1	1.2	0.8	0.8	2.6	4.4	4.4	3.1
Total GFCF	0.3	1.1	1.4	2.6	1.8	1.6	1.1	2.1	1.1	1.0	5.6	4.9	7.2	4.4
Public consumption	2.3	2.3	1.7	1.2	-0.2	1.1	1.9	1.7	1.5	1.5	4.8	6.0	4.5	5.2
Exports	1.9	0.0	1.4	-1.0	-1.8	2.7	2.2	-1.2	1.5	1.5	3.6	3.3	1.0	3.5
Imports	2.8	1.7	3.4	2.0	-1.0	3.3	3.3	0.9	1.9	1.9	6.0	9.3	7.1	6.6
<b>Contributions :</b>														
Domestic demand ex. stocks	0.9	1.3	1.5	1.8	0.9	1.2	1.3	1.6	1.0	1.0	4.2	5.0	5.3	4.0
Inventory change	0.2	0.0	0.0	0.0	0.1	-0.1	0.0	-0.1	0.0	0.0	0.2	-0.1	0.0	-0.1
Foreign trade	-0.3	-0.5	-0.7	-0.9	-0.2	-0.3	-0.5	-0.6	-0.2	-0.2	-1.5	-1.8	-1.9	-1.1
<b>EURO ZONE (27,8%)<sup>(2)</sup></b>														
<b>GDP</b>	<b>0.7</b>	<b>0.4</b>	<b>0.3</b>	<b>0.2</b>	<b>0.3</b>	<b>0.4</b>	<b>0.7</b>	<b>0.3</b>	<b>0.5</b>	<b>0.5</b>	<b>0.7</b>	<b>1.8</b>	<b>1.4</b>	<b>1.6</b>
Household consumption	0.6	0.1	0.2	0.9	0.1	0.3	0.5	-0.2	0.4	0.5	1.0	1.4	1.4	0.9
Total GFCF	0.6	0.4	0.2	0.4	0.2	1.0	1.1	0.8	0.8	0.8	0.8	1.8	2.2	2.8
Public consumption	-0.1	0.4	0.4	0.0	0.0	0.8	0.9	0.0	0.3	0.3	1.7	1.1	1.3	1.1
Exports	1.8	2.5	1.2	0.3	-0.9	2.0	3.4	0.5	1.8	1.6	1.2	5.9	3.9	5.6
Imports	1.2	2.4	2.0	1.3	-1.5	2.3	3.1	0.9	1.4	1.5	3.0	6.2	4.7	5.5
<b>Contributions :</b>														
Domestic demand ex. stocks	0.5	0.2	0.2	0.6	0.1	0.5	0.7	0.1	0.4	0.5	1.1	1.4	1.5	1.3
Inventory change	0.0	0.1	0.3	0.0	0.0	0.0	-0.2	0.4	0.0	0.0	0.2	0.4	0.1	0.1
Foreign trade	0.2	0.1	-0.3	-0.3	0.2	-0.1	0.2	-0.2	0.2	0.1	-0.6	-0.1	-0.3	0.1

Forecast

(1) Share of euro-zone GDP

(2) Share of OECD GDP

Sources : Eurostat

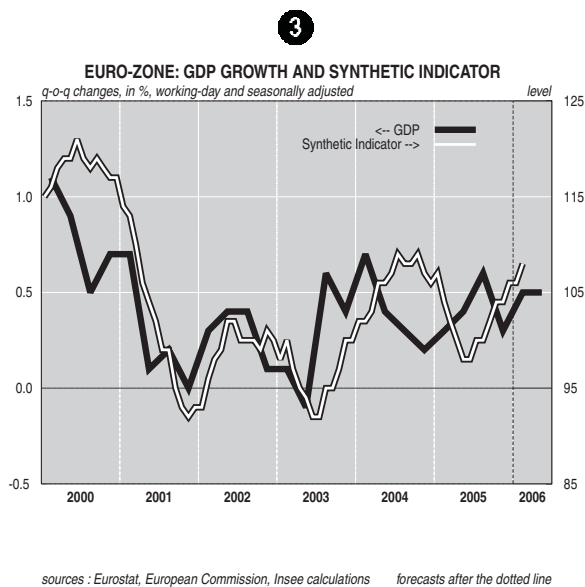
# The economic situation in the euro zone

## ZONE EURO : HOUSEHOLDS ACCOUNTS

(Annual and quarterly % changes)

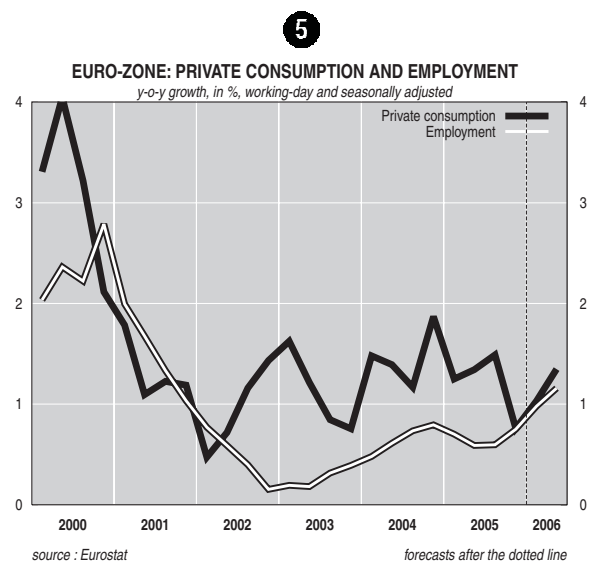
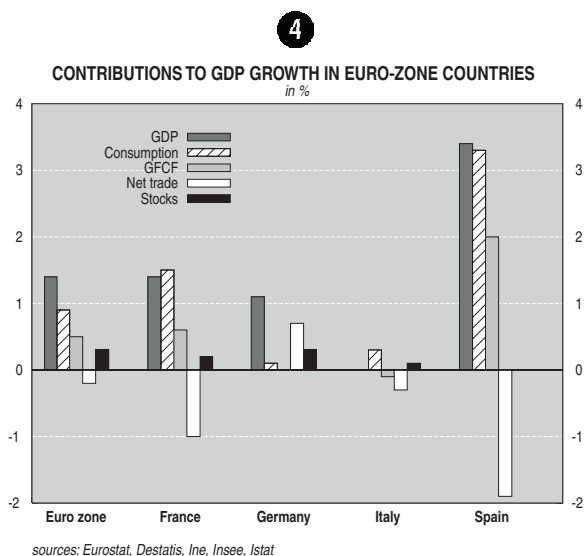
	2003	2004	2005	2006 co	2004				2005				2006	
					Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Total wage bill	2.6	2.6	2.3	2.4	1.1	0.7	0.0	0.7	0.9	0.4	0.4	0.8	0.8	0.9
- Employment	0.3	0.7	0.6	0.8	0.2	0.2	0.2	0.1	0.1	0.1	0.3	0.2	0.3	0.3
- Unit wage	2.3	2.0	1.7	1.5	1.0	0.4	-0.2	0.6	0.8	0.3	0.1	0.6	0.5	0.6
GDI	2.9	2.1	2.5	2.2	0.7	0.6	0.3	0.1	1.0	0.8	0.7	0.5	0.7	0.8
Saving ratio (% of GDI)	13.1	12.0	11.4	11.2	12.5	12.4	12.1	11.1	11.5	11.6	11.1	11.3	11.3	11.2
Households Consumption deflator	2.0	2.0	1.9	1.5	0.6	0.6	0.5	0.3	0.4	0.4	0.7	0.5	0.4	0.4
Real total wage bill	0.6	0.7	0.4	0.8	0.6	0.1	-0.4	0.4	0.4	0.0	-0.3	0.3	0.4	0.5
- Real unit wage	0.3	0.0	-0.2	0.0	0.4	-0.2	-0.7	0.3	0.3	-0.1	-0.6	0.1	0.1	0.2
Purchasing power of GDI	0.9	0.2	0.6	0.7	0.1	0.0	-0.2	-0.2	0.6	0.4	0.0	0.0	0.3	0.4

Forecast (MZE model)  
Sources : Eurostat, Insee calculations

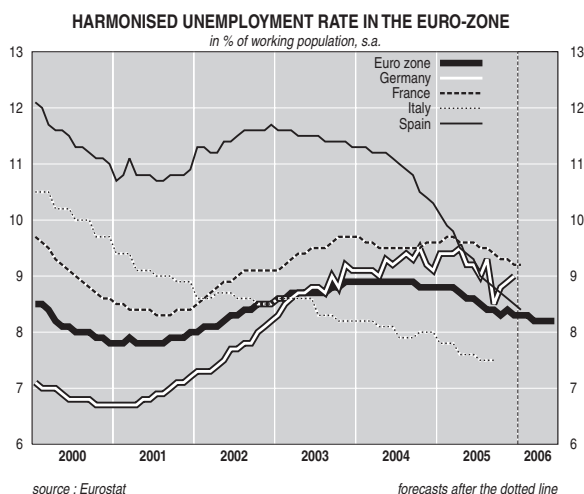


No encouragement for a clear-cut upturn in private consumption is to be found in the fundamentals. The moderate nature of the recovery in employment (around 0.3% per quarter, see Graphs 5 and 6) and the stagnation of wages in real terms are likely to mean slackness in household income. On the other hand, inflation should gradually ease during H1 2006 (to 2.1% in June from 2.4% in January), giving a slight boost to household purchasing power (growth of 0.3% and 0.4% in Q1 and Q2, respectively).

As a result, private consumption can be expected to accelerate in the first half of the year (quarterly growth rates of 0.4% and 0.5%), as indicated by the substantial upturn in retail sales in the early part of the year, with the statistical carryover for the first quarter amounting to 0.7% in January. In Q2, consumption can be expected to receive a one-off boost from the organisation of the football World Cup in Germany. Major sporting events of this kind traditionally increase sales of consumer goods and activ-



6



ity in the hotels and catering sector. It has been assumed in the forecast that this will lead to 0.3% additional consumption growth in Germany.

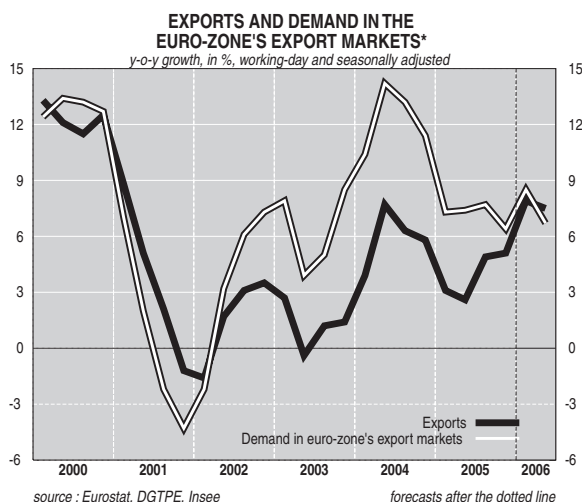
Public consumption is likely to lag behind private consumption and show disparities within the euro zone. In the largest countries of the euro-zone, tighter control of public spending can be expected in order to meet the criteria of the Stability and Growth Pact. In Spain, by contrast, the budget surplus should provide room for manoeuvre in increasing public consumption.

## The euro zone as a whole likely to benefit from the strong world demand

Exports to outside the zone were held back in Q4 2005 by the weakness of growth in world demand (1.0%). The exceptionally large Airbus deliveries in Q3 adversely affected French and German export growth in the final quarter. Trade within the zone also slowed down, hampered by the easing of activity in the major countries. In the end, growth in euro-zone exports was 0.5%, down on the strong showing of the two previous quarters.

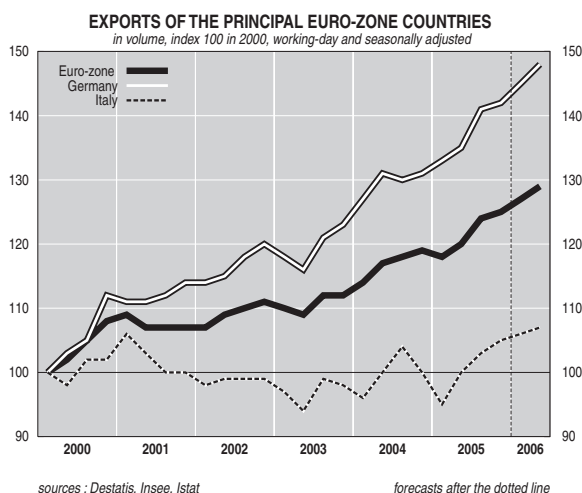
In the early part of 2006, the past depreciation in the euro's effective exchange rate (amounting to 5.9% between February 2005 and February 2006 in nominal terms) should give some support to the competitiveness of the zone as a whole, whose exports would be mainly boosted by the strength of demand in partner countries (see section "The euro-zone's international environment"). This would mean a reestablishment of their traditional determinants, with world demand the essential driving force (see Graph 7).

7



Germany's sectoral and geographic specialisation continues to ensure more dynamic world demand for its exports than for those of the rest of the zone. In fact, German export growth is likely to remain faster than demand in its overseas markets because of the cost-competitiveness gains generated by the continuing wage restraint. Conversely, Italy will probably have to cope with a continued rise in wage costs and tend to lose market share in the traditional consumer goods sectors where it faces competition from the emerging economies of Europe and Southeast Asia (see Graph 8).

8



Spain's foreign trade remains hampered by the cyclical discrepancy vis-à-vis the rest of the euro zone, with the strength of consumption fuelling import growth while at the same time exports will be limited by the slackness of domestic demand in the other countries. In addition, the growth differential in unit

vis-à-vis the euro zone (of the order of 1 1/2 percentage points) is likely to persist. The resulting deterioration in Spanish cost-competitiveness can be expected to continue to have an adverse effect on the country's trade balance.

## Productive investment slightly firmer in the early part of 2006

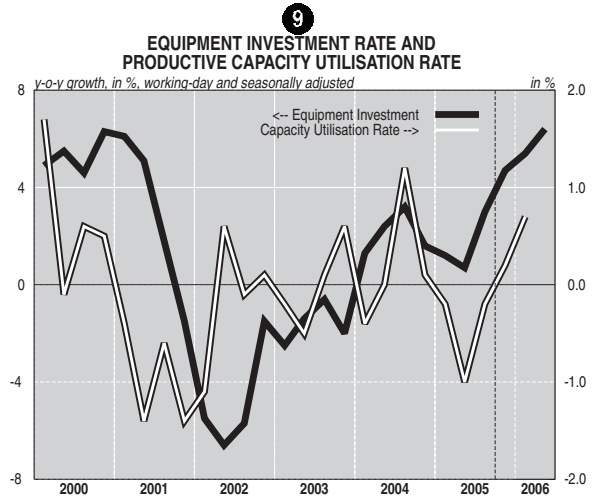
The investment ratio touched a low point in the middle of 2005, before recovering substantially in Q3. The launching of an upswing in the investment cycle was not called into question by the slowdown in activity in Q4, with the year-on-year rise in productive investment amounting to 4.1%, compared with 2.7% in the previous quarter.

For almost a year now, business leaders have been expecting an improvement in the outlook for their activity. They also reported pressure on productive capacity in the final part of 2005 (see Graph 9). They can therefore be expected to step up their capital investment, with a rise of roughly 1.0% per quarter in 2006.

Despite the recent rise in the European Central Bank's key rates, long rates remain at historically low levels. As a result, the financing conditions for investment remain favourable. Furthermore, the recent re-building of corporate margins enables firms to envisage new investment projects financed out of their own resources. The mark-up ratio in 2005 exceeded its 1998 level (see Graph 10).

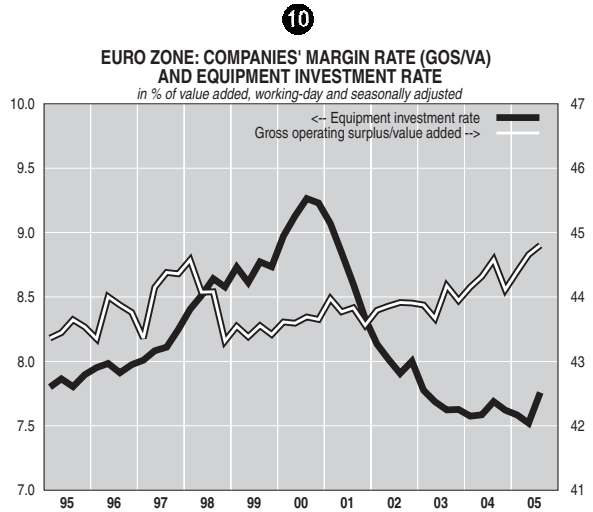
Growth in investment in construction is thought to have remained slightly positive in Q4 2005 (+0.3%). For the euro zone as a whole, the situation in the construction sector seems to be improving. In Germany and Italy, the recovery that began in the last part of 2005 seems to be continuing in the early part of 2006 (see Graph 11). In France and especially in Spain, growth in the building and public-works sector is likely to continue to be underpinned by housing loans. As a result, investment in this sector is expected to grow by 0.3% per quarter in 2006.

Total investment should therefore grow by 0.8% in the first two quarters of 2006. ■

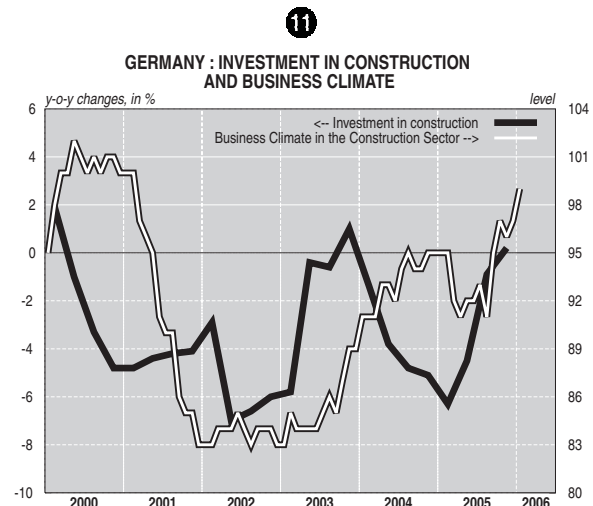


source : Eurostat, European Commission

forecasts after the dotted line



source : Eurostat



source : Eurostat, European Commission

### BOX : CAN WE DETECT A CYCLICAL GAP BETWEEN THE INDUSTRIES OF THE EURO-ZONE'S MAJOR COUNTRIES SINCE 2005 ?

European business surveys of manufacturing industry, after posting declines in the first half of 2005, started to recover in July. In the three major countries of the euro-zone (Germany, France and Italy), the surveys touched low points in June, May and April respectively. Since then, survey results have improved virtually continuously until February 2006, reaching historically high levels in Germany and Italy, in particular. However, these generally similar evolutions mask situations that are quite different from one country to another at a more refined level.

The divergences can be seen in a phase diagram, showing the evolution in the balance of opinions in industry surveys, as well as in Insee's synthetic indicator (IS, standing for "Indicateur synthétique du climat d'affaires")<sup>(1)</sup> for each country and for the zone as a whole (see Graph A). The German and Italian synthetic indicators have been rising faster, led in Germany by opinion regarding the production outlook and in Italy by opinion regarding order books. The diagram for France, on the other hand, turned out to be down on the diagrams for Germany, Italy and the euro zone, suggesting that French surveys are lagging behind those of the two other countries and of the zone as a whole. This result is to be compared with the situation in 1999, when France was in advance of its European partners at the time of the cyclical turning-point that occurred in May of that year (see Graph B). When the analysis is limited to surveys of industry, France is shown to have posted a less vigorous improvement in its business climate since mid-2005 than its European partners.

A more precise measure of cyclical disparities emerging from the surveys makes it possible to situate them in a historical perspective. The model used for the purpose is a dynamic factor model, a variant on the Economic Disparity Indicator (EDI) developed by Lenglard, Mora et Toutlemonde<sup>(2)</sup>. The data used come from the five usual balances of opinion in the industrial surveys carried out by Ifo in Germany, Insee in France and Isae in Italy. A Common Factor and EDIs for each individual country are extracted from these data. The EDI is a qualitative indicator making it possible to estimate evolutions in the gap between the

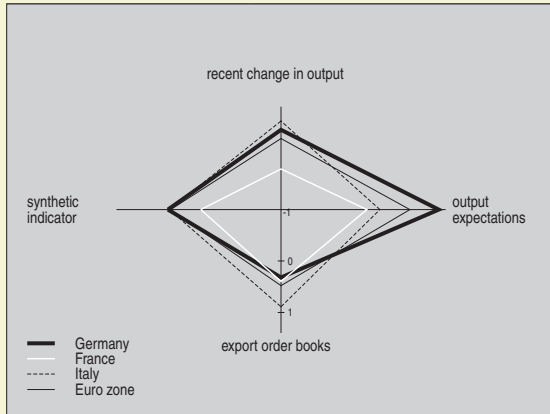
business climate in the industry of a particular country and the business climate in all three countries, measured by the Common Factor.

The evolution in the EDIs of Germany, France and Italy tend to qualify the results obtained from evolutions in the balances of opinion (see Graph C). In H2 2005, the German and Italian positions improved in relation to the combined situation of the three countries, as the latter improved. The French position improved temporarily at the beginning of the summer. According to the evolutions in EDIs, Italy is shown to have made up a cyclical gap that was recorded in the early part of the year, while France remained in phase with the situation for all three countries. On the other hand, however, expectations of industrial business leaders in Germany are shown to have improved much faster than in the other two countries.

However, the evolutions in both the EDIs and in the Common Factor, as well as the changes in cyclical positioning, seem to have been of much smaller amplitude than in the past (see Graph D). In 1999, in particular, the upturn that began in the euro zone as a whole had revealed substantial cyclical leads and lags between the three countries and an advanced position for France that were reflected in substantial differences in growth. In conclusion, there do not seem to have been any real discrepancies between the manufacturing sectors of the large euro-zone countries in 2005. Germany shows a slight lead, while France and Italy have once again been in phase with the common economic situation in the early part of 2006. This means that since 2001 there has been a convergence in the business climates for industry in the three countries, helped by the absence of marked cycles. ■

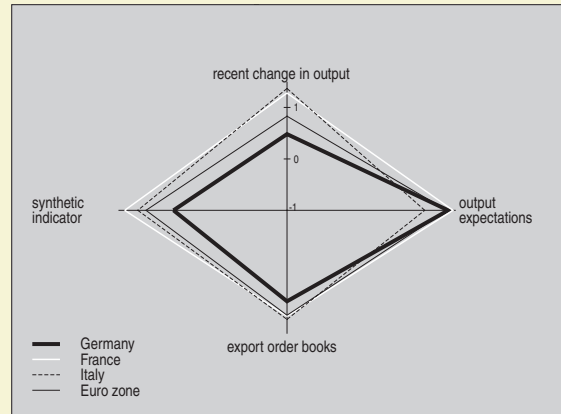
(1) The Composite Synthetic Indicator is extracted from the balances of the responses to surveys of industry using factor analysis. It summarises the information common to all the balances. It is published every month in Insee's "Informations Rapides" « Enquêtes européennes de conjoncture mensuelles ».  
(2) Disparities in the economic climate within the euro zone", note in this series for December 2002.

**A**  
**CHANGES IN BALANCES OF OPINION FROM JULY 2005 TO JULY 2006**  
*in points of standard deviation*



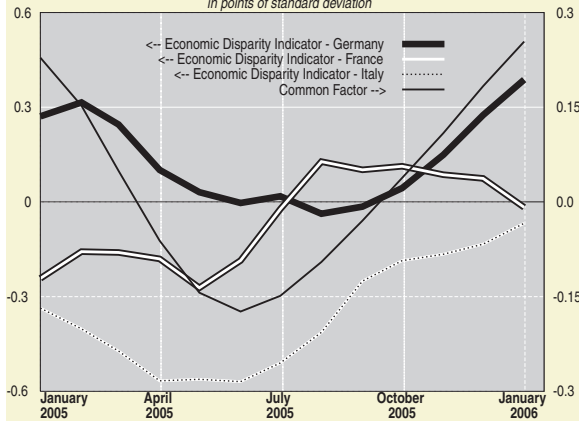
source : Ifo, Insee, Isae, Insee calculations

**B**  
**CHANGES IN BALANCES OF OPINION FROM MAY TO NOVEMBER 1999**  
*in points of standard deviation*



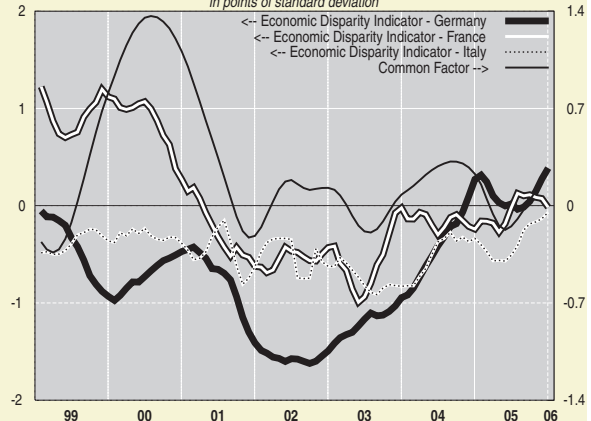
source : Ifo, Insee, Isae, Insee calculations

**C**  
**COMMON FACTOR AND ECONOMIC DISPARITY INDICATOR IN 2005**  
*in points of standard deviation*



source : Insee calculations

**D**  
**COMMON FACTOR AND ECONOMIC DISPARITY INDICATOR SINCE 1999**  
*in points of standard deviation*



source : Insee calculations

# Consumer prices in the euro zone

The last part of 2005 saw inflation in the euro zone tracking the year-on-year pattern of energy prices, returning to 2.2% in December. Under the impact of the easing of energy prices, inflation differentials within the zone narrowed but continued to reflect heterogeneous cyclical positioning. This decline was interrupted, however, starting at the beginning of 2006, as a result of the upturn in oil prices, so that euro-zone inflation stood at 2.3% in February.

In H1 2006, on the assumptions that the Brent price stabilises at \$60/barrel and that the euro-dollar exchange rate is 1.20, core inflation<sup>(1)</sup> is expected to rise to 1.5%, while the year-on-year rise in energy prices should ease back. All things considered, inflation should gradually decline to 2.1% in June 2006.

## The oil shock's last fling

Following a fresh upturn in oil prices in the early part of 2006, the year-on-year price increase came out at 2.3% in February. The tendency for inflation to ease seen towards the end of 2005 (a year-on-year rise of 2.2% in December, down from 2.6% in September) failed to be confirmed.

However, on the assumptions that the Brent price stabilises at \$60/barrel and that the euro-dollar exchange rate is 1.20 during the forecast period, inflation is expected to ease slightly, to stand at 2.1% in June 2006 (see Graph 1).

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

Following the succession of surges in the Brent price seen in the autumn of 2005, the year-on-year rises in energy prices reached new record levels (15.0% in September 2005). In the wake of movements in the crude oil price, it then eased back towards the end of the year, reaching 11.2% in December before later recovering in the early part of 2006 to stand at 12.5% in February (see Table 1). The forecast is that the rise in energy prices will decline in line with the stabilisation of crude oil prices (see Graph 2 showing quarterly changes). Although in Q2, as a result of the indexing of prices of gas and electricity on the price of oil, past rises can be expected to have a positive influence on the year-on-year rise in prices of energy, this is expected to decline to 9.0% in June 2006 following the slight upturn posted in January.

Food prices (see Graph 3) accelerated substantially in H2 2005, bringing their year-on-year increase to 1.7% in December, notably because of the strength of prices of fresh produce and the increase in tobacco prices that took place on 1 September 2005 in Germany. In H1 2006, the rise in foodstuff prices is expected to level off gradually and return to its long-period average (to stand at 1.0% in June 2006, down from 1.4% in December 2005). As a result, food prices as a whole should slow down in the absence of any sharp rises in tobacco prices in the euro zone<sup>(2)</sup>. The year-on-year rise in food prices would then amount to 1.5% in June 2006, with the corresponding figure for core inflation also 1.5%.

(2) The tax measures adopted in Spain as part of the anti-smoking law that came into force on 1 Jan 2006 (e.g. the royal decree dated 10 February) are unlikely to have a major impact, given the ongoing fierce tobacco price war.

TABLE 1: EURO ZONE INFLATION

Sectors (weight in the 2006 index)	Year on year changes at end (year on year % growth of HICP)						
	Feb. 2005	June 2005	Dec. 2005	Feb. 2006	June 2006	2004	2005
<b>Total (100.0%)</b>	2.1	2.1	2.2	2.3	2.1	2.1	2.2
<b>Food (Beverage and Tobacco included) (19.3%)</b>	1.9	1.1	1.7	1.8	1.5	2.3	1.6
of which Food (15.3%)	0.5	0.4	1.4	1.6	1.0	1.0	0.7
Beverage and Tobacco (4.0%)	7.2	3.9	2.7	2.5	2.8	7.5	4.9
<b>Energy (9.2%)</b>	7.7	9.4	11.2	12.5	9.0	4.5	10.1
<b>Core inflation (71.5%)</b>	1.4	1.4	1.4	1.2	1.5	1.8	1.4
of which: Manufactured products (30.7%)	0.2	0.2	0.4	0.3	0.7	0.8	0.3
Services (40.8%)	2.4	2.2	2.1	2.0	2.4	2.6	2.3

Forecast  
Source: Eurostat

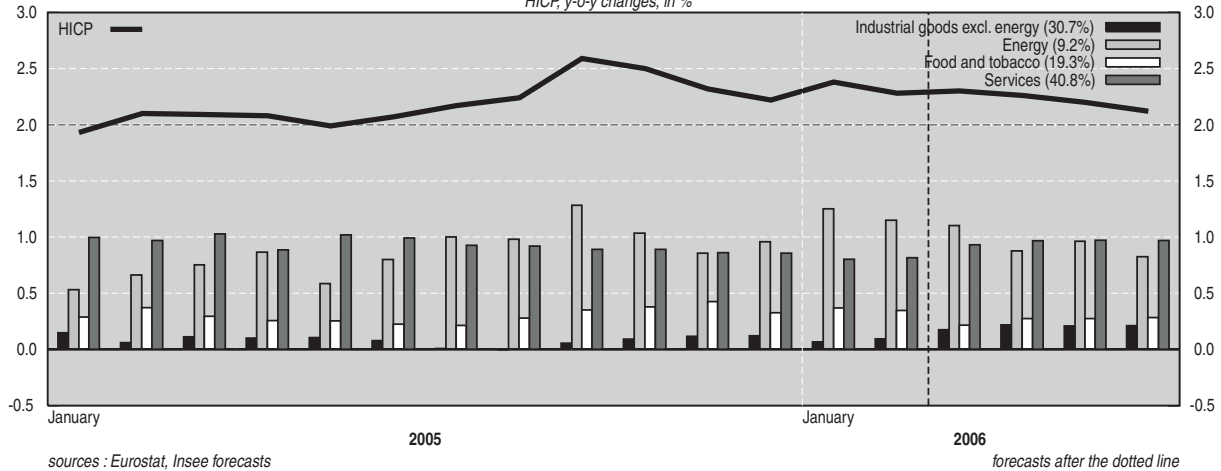


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## BREAKDOWN OF INFLATION IN THE EURO-ZONE

contributions of the main items

HICP, y-o-y changes, in %



Following a slight slowdown in the autumn of 2005, core inflation picked up towards the end of the year, returning to levels comparable to those of the first half (1.4% in December, as in June 2005). Notwithstanding an exceptionally small year-on-year rise in the early part of 2006 (stability at 1.2% in January and February in the clothing and household equipment sectors, as the result of bargain sale discounts that were particularly marked this year), core inflation seems set to rise gradually to 1.5% in June 2006. The absence of «second-round» effects of the past rises in the oil price and their limited diffusion at a time of general weakness of domestic demand in the euro zone, explain the subdued nature of this tendency (see Graph 4).

Prices of services, the principal component of this indicator, slowed down distinctly during 2005, with the year-on-year rise falling from 2.4% in January to 2.0% in December. The forecast is that the moderate wage growth in the euro zone will be reflected in a slowdown in the prices of services in H1 2006. Thereafter, thanks to the small scale of the repercussions of past rises in the oil price on prices in the

transport sector particularly, the year-on-year rise in prices of services is likely to recover only slowly to regain levels that are more traditional for this component. It is forecast to stand at 2.4% in June 2006, up from 2.1% in December 2005.

The slight acceleration in prices of manufactures, the second largest component of core inflation, is likely to be led by rises in the prices of oil and raw materials compared with 2005. Assuming stability in the oil price at around 60 \$/barrel and the euro/dollar exchange rate of 1.20, this rise in prices of manufactures would nevertheless be limited (see Graph 5). The year-on-year rise in prices of manufactures would then amount to 0.7% in June 2006, up from 0.4% in December 2005.

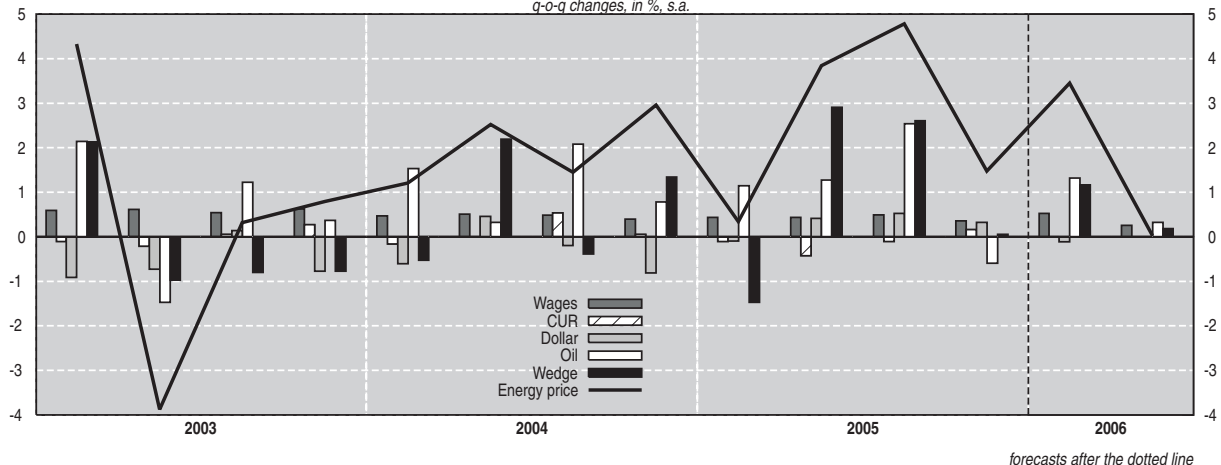
### Energy prices a major determinant of inflation differentials within the euro zone

The diversity of reactions on the part of energy prices to recent surges in the crude oil price largely explains the widening of inflation differentials be-

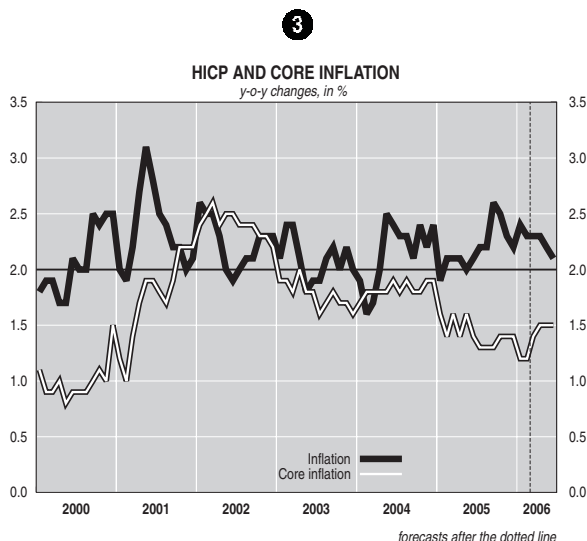
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## CONTRIBUTIONS TO THE EVOLUTION IN PRICES OF ENERGY PRODUCTS

q-o-q changes, in %, s.a.



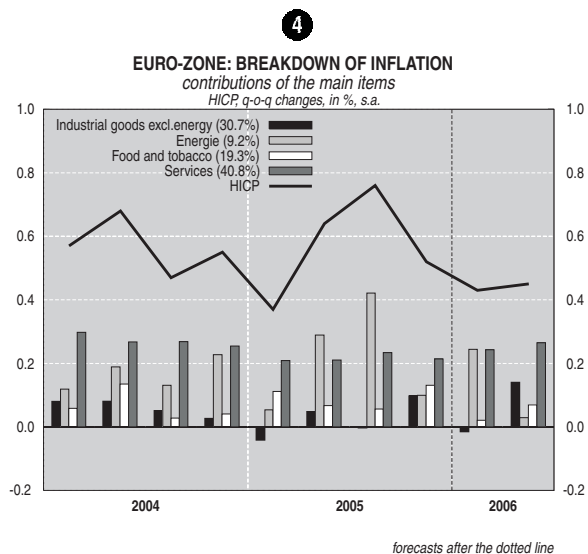
## Consumer prices in the euro zone



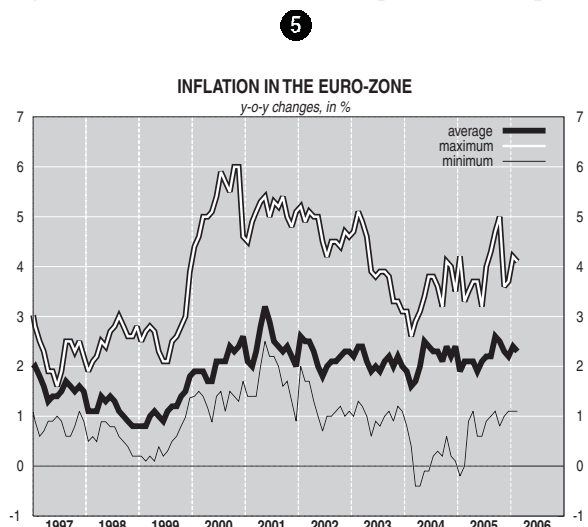
tween countries in the euro zone seen in the autumn of 2005. Under the impact of the decline in energy inflation, it was therefore natural that the maximum differential should narrow to 2.6 points in December 2005 after peaking at 4.2 points in October (see Graph 5). With the renewed firmness of oil prices in the early part of 2006, energy prices have again become the motors for inflation (contributing 1.7 of a point to overall inflation in the case of Greece, for example). The maximum inflation differential accordingly widened again in January 2006<sup>(3)</sup>.

Core inflation differentials have remained stable, with the gap between Spain and Germany amounting to 2.2 points in February 2006 (see Table 2). Cyclical differences between countries in the zone, notably in terms of growth rates, have also constituted a

(3) On the assumption of stability for the year-on-year price rise in Finland (no observed figure available), it would stand at 3.1 points in January 2006 and 3.0 points in February.



determining factor for these inflation differentials. Some countries in the zone are in fact posting fairly high levels of inflation (for example, Greece, Spain



**TABLE 2 : EURO ZONE INFLATION BY COUNTRIES**

(year on year % growth of HICP)

	HICP		Core inflation		Energy	
	February 2005	February 2006	February 2005	February 2006	February 2005	February 2006
Austria	2.3	1.5	1.6	0.7	8.8	11.4 <sub>(0.9)</sub>
Belgium	2.3	2.8	1.0	1.7	12.6	12.9 <sub>(1.3)</sub>
Finland	0.0		0.5		4.3	
France	1.9	2.0	1.5	1.2	8.7	10.5 <sub>(1.0)</sub>
Germany	1.9	2.1	0.7	0.6	6.5	14.7 <sub>(1.6)</sub>
Greece	3.2	3.1	3.5	2.1	12.1	14.4 <sub>(1.1)</sub>
Ireland	2.1		1.8		9.7	
Italy	2.0	2.2	1.9	1.5	5.9	10.6 <sub>(0.7)</sub>
Luxembourg	3.2	3.9	1.5	2.2	13.2	14 <sub>(1.6)</sub>
Netherlands	1.5	1.4	0.6	0.6	10.7	9.5 <sub>(0.9)</sub>
Portugal	2.1	2.9	2.0	1.6	8.2	13.2 <sub>(1.2)</sub>
Spain	3.3	4.1	2.6	2.8	7.6	13.4 <sub>(1.3)</sub>
<b>Euro zone</b>	<b>2.1</b>	<b>2.3</b>	<b>1.4</b>	<b>1.2</b>	<b>7.7</b>	<b>12.5<sub>(1.2)</sub></b>

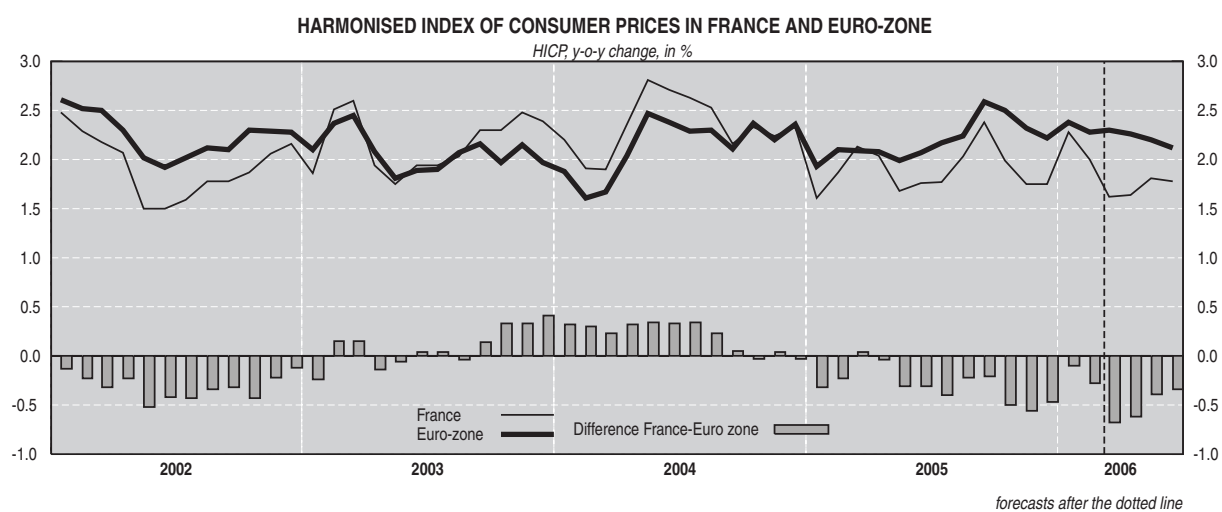
In the final column, the contribution of the energy component to overall inflation is shown in brackets.

NB : data relative to Finland are not available for February 2006. Year-on-year changes for Euro zone are based on Eurostat estimations.

Source : Eurostat, Insee calculations

## Consumer prices in the euro zone

6



and Ireland). These levels are not posing a threat of generalised inflation but reflect both certain "catch-up" phenomena and cyclical lags (see box "Small countries, tough prices").

The differential between the French HICP (harmonised index of consumer prices) and the euro-zone index amounted to 0.5 of a point in December 2005. It is expected to narrow to 0.3 of a point in June 2006 (see Graph 6). ■

## BOX: SMALL COUNTRIES, TOUGH PRICES

In the euro zone as a whole, the year-on-year price rise increased by 0.6 of a point during 2005, mainly under the influence of the energy price. On the assumption of a stabilisation of the crude oil price and limited diffusion of the rises in commodity prices, inflation in the zone can be expected to slow down gradually to 2.1% in June 2006. This return to a more moderate level of inflation nevertheless masks contrasting national situations, as shown by the maximum inflation differential, which oscillated around 3 points during 2005.

In the three large countries (France, Germany and Italy) core inflation has accelerated very little and the risk of second-round effects is low. For three other countries, on the other hand, (Spain, Greece and Luxembourg), inflation came out significantly above the euro-zone average throughout 2005 (see Graph A). At the same time, prices in Belgium, Portugal and Ireland were also relatively dynamic. Nevertheless, this excess inflation, perceptible notably in the «small» countries, although it constitutes a

curb on overall disinflation, is not creating a generalised inflationary risk, being explained in part by local phenomena of a «catch-up» nature and temporary problems of synchronisation or convergence in the case of certain economies.

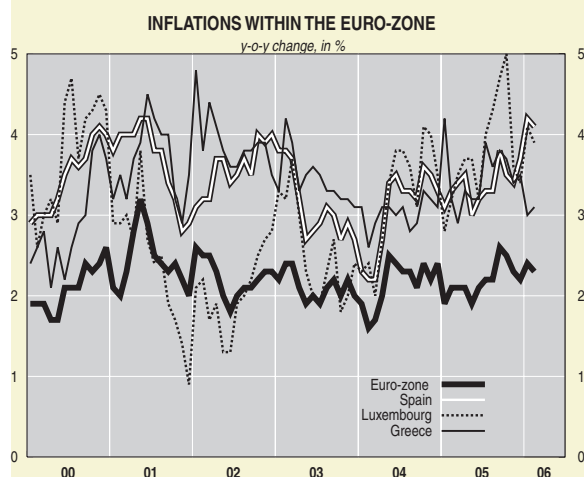
### Looking beyond the surge in the oil price...

In the autumn of 2005, the surges in the crude oil price naturally drove euro-zone inflation upwards, as shown by the peak reached in September 2005, when the year-on-year rise was 2.6%. Inflation differentials within the zone accordingly widened under the impact of the acceleration in energy prices (reaching a maximum of 4.2 points in September) before narrowing again towards the end of 2005, again in response to movements in the crude oil price. However, the contributions to overall euro-zone inflation can be very different from one country to another (see Table 2 in the section on "Consumer prices in the euro zone"). There are several possible explanations for this: different weightings of energy in national HICPs; leads and lags in the indexing of prices of petroleum products and other energy components (gas, electricity) on the crude oil price, among other things. In Portugal, for example, energy prices are still to a large extent controlled, meaning that the contribution of the energy component was smaller than in the rest of the euro zone. In Luxembourg, by contrast, rises in oil prices are passed on very fully to pump prices and make a major contribution to the rise in overall inflation.

### ... cyclical differentials and «catch-up» phenomena are helping to sustain inflation differentials within the euro zone

Even so, these sectoral considerations do not entirely explain the persistent dynamism of prices in Spain or Greece, for example. In fact, examination of the contribution of national inflation averages to the spread within the zone (see Table A) shows, for example, that Spanish infla-

A



**TABLE A : NATIONAL CONTRIBUTIONS TO INFLATION DIFFERENTIALS IN THE EURO ZONE**

	Inflation 2005	Contributions to inflation in 2005	Deviation from the mean in 2005
Austria	2.1	0.1	-0.1
Belgium	2.5	0.1	0.3
Finland	0.8	0.0	-1.4
France	1.9	0.4	-0.3
Germany	1.9	0.5	-0.3
Greece	3.5	0.1	1.3
Ireland	2.2	0.0	0.0
Italy	2.2	0.4	0.0
Luxembourg	3.8	0.0	1.6
Netherlands	1.5	0.1	-0.7
Portugal	2.1	0.0	-0.1
Spain	3.4	0.4	1.2
<b>Euro Zone</b>	<b>2.2</b>	<b>2.2</b>	<b>.</b>
Maximum differential for 2005	3.0	-	-

Eurostat. Calculations Insee

## Consumer prices in the euro zone

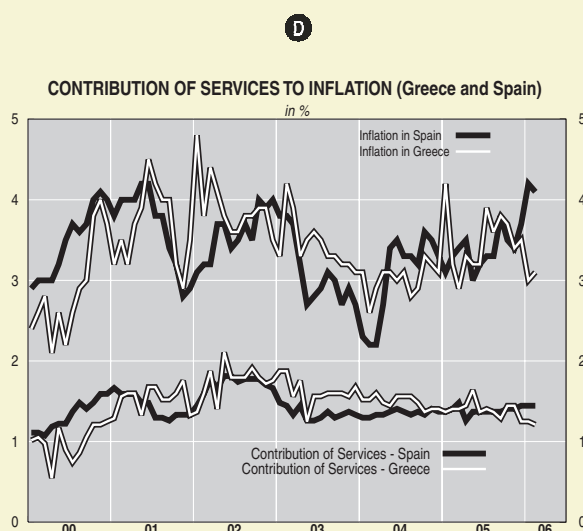
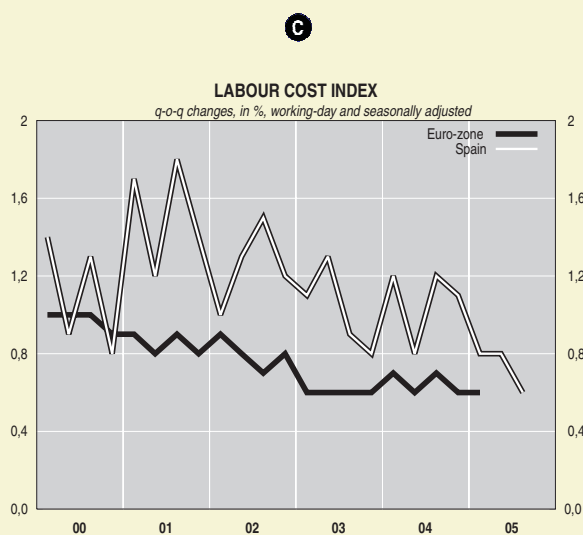
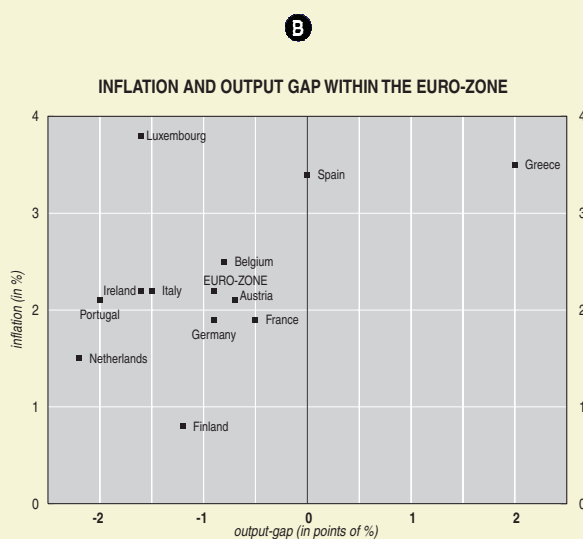
tion contributes as much to the overall figure (0.4 of a point) as does that of France even though its weight in the aggregate index is only half as great.

This increased dispersion of inflation rates is partly due to the cyclical gaps prevailing among EMU countries. Countries that are still at the top of the cycle logically have higher inflation than the zone as a whole. For example, the Netherlands, which posted an output differential of -2.2 points in 2005, has one of the lowest inflation rates in the Union (averaging 1.5% in 2005) (see Graph B). At the other extreme, Greece, with an output-gap of +2.0 points, has an inflation rate that is more than one point above the euro-zone average.

Apart from these gaps in relation to potential growth, the persistence of high levels of inflation is a reflection of the catch-up process in which countries with the most dynamic activity have been engaged in recent years: productivity levels, consumer prices or net worth per head are converging by means of particularly high inflation rates (Balassa-Samuelson effect <sup>(1)</sup>).

Spain and Greece have posted or are posting this type of competitiveness gain, reflected in faster-than-average growth in wage costs and the persistence of a high contribution of services to inflation (see Graphs C and D).

All in all, the inflation differentials should therefore be reabsorbed, partly because of the assumption of a slowdown in energy prices. However, the firm growth in Spain and Greece <sup>(2)</sup>, for example, indicates certain inflationary pressures (a climate of overheating) whereas, conversely, low-inflation countries, Germany in particular, are suffering from excessively high interest rates that are hampering recovery in activity. ■



(1) In these countries, the tradable goods sectors (manufactures) achieve rapid productivity gains permitting wage rises that are higher than the average for the zone. These rises then spread to the rest of the economy. In the sectors sheltered from international competition (services), firms adjust their prices to the rise in production costs since the competitiveness gains in the sector are limited.

(2) European Commission growth forecasts for 2006 (drawn up in the autumn of 2005): 3.2% for Spain and 3.4% per Greece, compared with 3.4% and 3.7%, respectively, the for 2005.