International overview

World growth should remain firm in 2007, despite the clear slowdown of the U.S. economy expected from Q4 onward. Robust expansion should persist in the emerging countries, with China in the lead. The euro zone and Japan will probably experience a slight loss of momentum at year-end.

Our forecast shows a slowdown in world economic activity in H1 2008, with this fall's oil-price rise dampening household consumption. Tighter financing conditions due to the financial crisis should slow investment in the main industrialized countries. And the real-estate crisis will probably produce its first indirect effects on U.S. domestic demand beyond its direct effect on household investment. This will impact exports to the U.S.

We can identify three potential downward forces up to mid-2008: a new increase in oil prices, a worsening of the U.S. real-estate market crisis, and—most critically—a wider propagation of financial and banking disturbances. Conversely, the dynamism of emerging economies could attenuate the world slowdown more significantly than expected.

A dip in world growth by mid-2008

In October 2007, the Global Purchasing Managers' Index (PMI) in industry eased back to its mid-2005 level, while the PMI in services has fallen sharply since June *(Chart 1)*. The year-on-year increase in world industrial production[1] could thus slip below 5.5% in Q4 2007, after 6.3% in 2006. World growth should therefore dip, largely because of the main industrialized countries. Our forecast shows year-on-year GDP growth weakening from 2.7% in Q3 2007 to 2.3% in Q4 2007.

In the main industrialized countries, the slowdown should persist into mid-2008 *(Tables)*. In the United States, the real-estate market downturn should continue to strongly inhibit growth up to mid-2008. Household consumption is set to weaken as a result of wealth effects in both the real-estate and financial sectors (given the bearish stock-market mood), and slower gains in employment. U.S. growth will thus be weak, staying below its potential through mid-2008. The euro-zone economy is also projected to slow: productive investment may have passed the peak

1. United States, European Union, Japan, China, India, Russia, Canada, Latin America excluding Venezuela, South Korea, Malaysia, Philippines, Singapore, Taiwan, and Thailand.

Table 1
Industrialized countries: consolidated supply and use table

In real terms

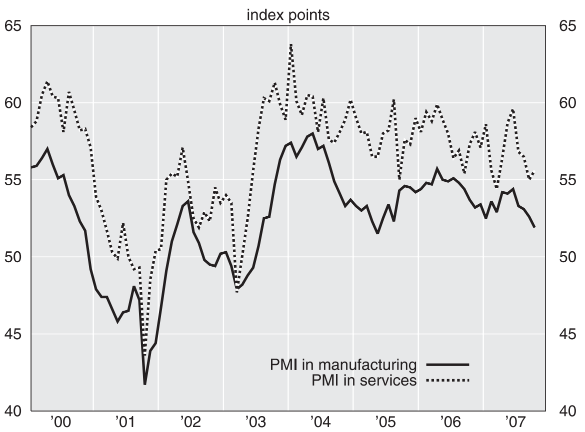
	Quarterly change, %										Annual change, %		
	2006				**2007**				**2008**		**2006**	**2007**	**2008 ovhg***
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**			
GDP	1.0	0.8	0.3	0.8	0.5	0.5	0.9	0.4	0.4	0.4	2.8	2.4	1.5
Private consumption	0.8	0.6	0.3	0.8	0.5	0.4	0.6	0.5	0.4	0.4	2.4	2.3	1.5
Public consumption	0.9	0.2	0.3	0.5	0.3	0.6	0.7	0.3	0.3	0.3	1.6	1.8	1.2
Investment	1.2	1.0	-0.2	0.2	0.2	-0.1	0.2	-0.7	-0.4	-0.2	3.5	0.5	-0.9
Exports	3.3	1.3	0.5	2.7	0.9	1.3	3.4	2.0	1.4	1.4	8.6	6.7	6.0
Imports	2.4	0.9	0.3	0.6	1.1	-0.2	1.6	1.0	0.5	0.5	6.5	2.9	2.4
Contributions to growth													
Domestic demand excl. inventories	0.9	0.6	0.3	0.7	0.5	0.3	0.5	0.3	0.3	0.3	2.5	2.0	1.2
Inventories	-0.1	0.1	0.1	-0.3	0.1	-0.1	0.2	0.0	0.0	0.0	0.1	-0.1	0.1
Net exports	0.1	0.0	0.0	0.4	-0.1	0.3	0.2	0.1	0.1	0.1	0.1	0.5	0.4

Forecast — *ovhg: overhang
Sources: national data, World Bank, INSEE computations

of the cycle begun in 2003, and the real-estate market is showing signs of weakness in several euro-zone countries. Moreover, the external-trade contribution to GDP growth should turn negative in H1 2008, owing to the stronger euro and softer world demand. After a buoyant 2007, the U.K. economy is poised to weaken in H1 2008 owing to a slowdown in domestic demand, particularly household consumption. Japan should register moderate growth by end-2007. Its domestic demand will likely remain constrained by the lack of a wage recovery.

Strong growth should persist in the major emerging countries—notably China, India, and Russia—but, as in the developed economies, with a mild loss of momentum. In Asia, the investment cycle appears to have peaked in mid-2007. Overall, global trade imbalances should narrow somewhat by mid-2008, with the U.S. external deficit shrinking as a proportion of GDP, but Asia still running large surpluses, with no downward tilt from the recent profile.

1 - Declining business expectations



Sources: JP Morgan / NTC

Year-on-year world GDP growth should dip to 4.4% at the end of H1 2008, down from 5.0% in early 2007 *(Chart 3)*. In this slacker international environment, world demand for French products is set to rise at a more moderate pace by mid-2008. At the end of the forecasting period, it should be growing by less than its long-term average.

Monetary policies subjected to conflicting demands in the main industrialized countries

Global financial markets have experienced strong turbulence since August as a result of the U.S. subprime crisis. Tensions on short-term rates persist despite action by central banks, and spreads between 3-month money-market interest rates and central-bank key rates remain wide. The crisis, like the economic slowdown, could justify accommodative monetary policies; by contrast, inflationary pressures would provide an argument for tightening. If monetary policy-makers take account of exchange-rate movements —particularly of the euro against the dollar—this would create a tightening bias in the U.S. and an accommodative bias in the euro zone. In this scenario, the Fed and the Bank of England would loosen their monetary policy, at least temporarily, to support economic activity; the euro zone, instead, would choose to keep key rates at their present level. If inflationary pressures persist, however, a rate hike in the euro zone cannot be ruled out. The sole exception would be Japan: its economic situation—limp growth, low inflationary pressure, significant impact of the financial crisis—would warrant preserving the status quo, but the Bank of Japan still seems very determined to normalize its key rates as soon as possible by lifting them.

Table 2
Main industrialized countries: GDP

In real terms

	Quarterly change, %										Annual change, %		
	2006				2007				2008		2006	2007	2008 ovhg*
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2			
Total	**1.0**	**0.8**	**0.3**	**0.8**	**0.5**	**0.5**	**0.9**	**0.4**	**0.4**	**0.4**	**2.8**	**2.4**	**1.5**
United States	1.2	0.6	0.3	0.5	0.2	0.9	1.2	0.3	0.3	0.4	2.9	2.2	1.7
Japan	0.5	0.8	-0.1	1.3	0.8	-0.5	0.4	0.2	0.5	0.5	2.4	1.8	1.1
United Kingdom	0.8	0.8	0.7	0.8	0.8	0.8	0.7	0.6	0.3	0.3	2.8	3.1	1.6
Euro zone, of which:	0.9	1.0	0.6	0.8	0.8	0.3	0.7	0.5	0.4	0.4	2.9	2.6	1.4
Germany	0.9	1.3	0.7	1.0	0.5	0.3	0.7	0.5	0.4	0.5	3.1	2.7	1.6
Italy	0.8	0.6	0.3	1.1	0.3	0.1	0.4	0.2	0.3	0.3	1.9	1.8	0.9

Forecast *ovhg: overhang
Sources: national statistical institutes, World Bank, INSEE computations

Commodity prices expected to drive up inflation

The price of Brent crude oil has risen sharply since August, from $70 per barrel to over $90 in November. We expect it to fluctuate around $90 dollars during the entire forecasting period, up from $75 in our October forecast. Meanwhile, agricultural prices—particularly for cereals and dairy products—should stay on their recent uptrend, owing to the supply/demand imbalance.

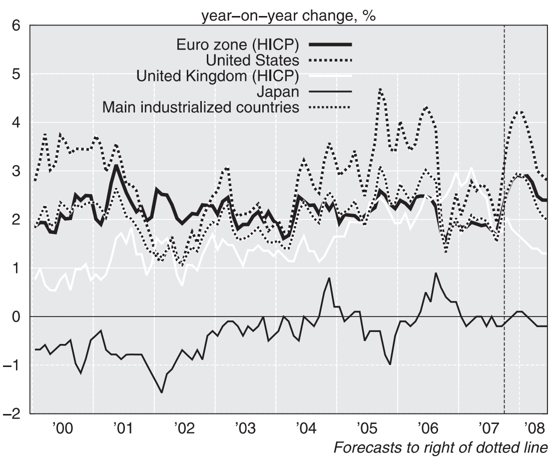
This sharp rise in commodity, energy, and food prices will impact producer and consumer prices. Year-on-year inflation in the main industrialized countries should therefore keep rising until early 2008, before ebbing slightly over the forecasting horizon *(Chart 2)*. Core inflation should remain broadly stable, however, with the disinflationary impact of the economic slowdown offsetting the diffusion effects of higher commodity and energy prices. According to our forecast, core inflation will ease slightly in the U.S., remain weak in Japan, but continue to rise in the euro zone.

Chief uncertainty: the impact of the financial crisis on the real economy

Once again, therefore, oil prices are hampering the world economy, and a low level of U.S. gasoline reserves could undermine our barrel-price hypothesis. Conversely, if the global economic slowdown is more abrupt than expected, or if geopolitical tensions ease, oil prices could fall below the $90 forecast.

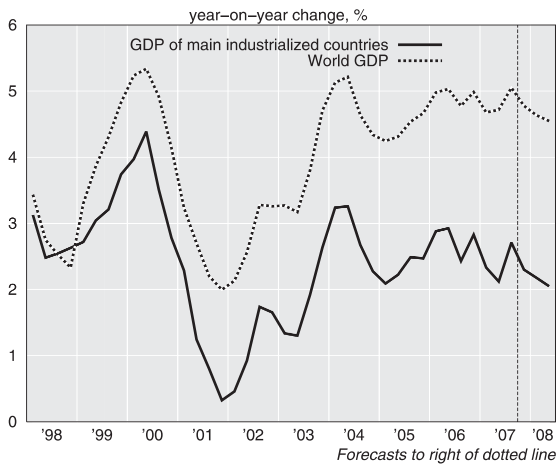
But the main uncertainty surrounding this scenario is the impact of the financial crisis. Tighter financing conditions and greater risk aversion could restrain investment more severely than our baseline assumption. Moreover, the deterioration in the U.S. real-estate market might exceed our forecast, curbing U.S. household consumption more strongly. U.S. growth would be all the more affected, with a possible contagion to regions that export massively to the U.S.—particularly Asia. Conversely, the resilience of emerging economies could attenuate the world slowdown more significantly than expected. ■

2 - Consumer prices



Sources: national statistical institutes; World Bank; INSEE estimates forecasts

3 - A dip in world GDP growth by mid-2008



Sources: national statistical institutes; World Bank; INSEE estimates forecasts

The euro zone's main partner countries

The U.S. economy expanded by a surprising 1.2% in Q3 2007. However, this excellent performance is unlikely to be repeated in the coming quarters, which are forecast to register growth rates of only 0.3-0.4%. The persistence of the real-estate crisis and the rise in food and energy inflation are cramping household demand. Access to financing will probably be tightened for both individual and corporate borrowers, whose expenditures will thus be restrained.

The U.K. economy is forecast to register moderate gains of 0.6% in Q4 2007 and 0.3% per quarter in H1 2008. Resurgent inflation and softer real-estate prices should cause a sharp slowdown in household consumption in H1.

Japanese growth will also probably be impacted by the international slowdown and the persistence of anemic consumption. GDP growth should be artificially dragged down in Q4 2007, then driven up in H1 2008, by non-recurring fluctuations in construction investment due to the tougher building-permit regulations introduced in June 2007. After advancing by a meager 0.2% in Q4 2007, the Japanese economy is forecast to rebound to 0.5% per quarter in H1 2008.

U.S. growth set to weaken by H1 2008

With inflation rising and the effects of the real-estate crisis spreading to the rest of the economy, U.S. growth is expected to lose steam in the quarters ahead. Residential investment should post further declines of 5.6% in Q4 2007, 5.5% in Q1 2008, and 4.0% in Q2 2008. Various signals suggest persistent difficulties in the real-estate market: first, homebuilders' confidence and sales of existing homes have been heading down since February; second, housing inventories—measured in months of sales—remain high. The residential-investment rate does not seem to have reached the troughs observed in earlier real-estate crises (*Chart 1*).

This stubborn decline in residential investment is now accompanied by a weakening of real-estate prices, which should restrain consumption in the coming quarters (*see box in "Asset wealth and consumption" chapter*).

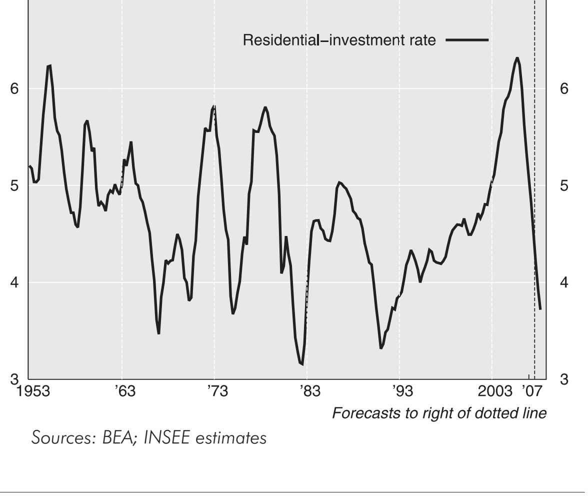
The somewhat slacker expansion is forecast to cause a gradual slowdown in employment growth by summer 2008. Wage growth should also decelerate very mildly from 1.0% per quarter in 2007 to 0.9% per quarter in H1 2008, owing to the labor market's slight deterioration.

The surge in prices of food commodities, particularly cereals and dairy products, will drive up inflation, whose year-on-year growth should top 3.0% in late 2007 before easing back to 2.5% in mid-2008. Real-income growth is thus projected to weaken to a modest 0.4% per quarter in H1 2008.

Consumption may also be dampened by tighter credit conditions. We therefore expect U.S. household consumption to gradually lose momentum by mid-2008, its growth rate declining to 0.4%-0.5% in H1 2008.

Business investment, as well, is expected to post weaker growth of 0.8% in Q4 2007, given the October slowdown in the industrial production index for capital goods and lower capacity utilization. The greater financing difficulties faced by businesses and low growth expectations do not augur well for an investment rebound: the slackness should persist in H1 2008.

1 - Continued decline in U.S. residential-investment rate



Sources: BEA; INSEE estimates

By then, however, foreign trade should be driving growth. In the next three quarters, imports are likely to lose momentum in step with domestic demand. Assuming a stabilization of the exchange rate at about $1.45 per euro, and given the vigor of euro-zone imports in particular, U.S. exports should continue to grow at a brisk pace of 2.5% in Q4 2007 and 2.0% per quarter in H1 2008.

The main uncertainty surrounding the U.S. economy still concerns the real-estate crisis and the ensuing financial crisis. The real-estate market is a

Table 1
United States, United Kingdom, and Japan: Supply and use table

in real terms

	Quarterly change, %								Annual change,%		
	2006		**2007**				**2008**		**2006**	**2007**	**2008**
	Q3	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**			**ovhg***
UNITED STATES (37.2%)[1]											
GDP	**0.3**	**0.5**	**0.2**	**0.9**	**1.2**	**0.3**	**0.3**	**0.4**	**2.9**	**2.1**	**1.6**
Consumption	0.7	1.0	0.9	0.3	0.7	0.6	0.5	0.4	3.1	2.9	1.7
Private investment [2]	-1.2	-1.8	-1.1	0.8	-0.1	-1.6	-1.8	-1.2	2.4	-3.2	-3.8
Government expenditures [3]	0.2	0.9	-0.1	1.0	0.9	0.4	0.4	0.4	1.8	2.0	1.7
Exports	1.4	3.4	0.3	1.8	4.4	2.5	2.0	2.0	8.4	8.0	7.9
Imports	1.3	0.4	1.0	-0.7	1.0	0.8	0.0	0.0	5.9	2.3	1.1
Contributions:											
Domestic demand excluding inventories	*0.3*	*0.5*	*0.4*	*0.6*	*0.6*	*0.2*	*0.1*	*0.2*	*2.9*	*1.9*	*0.9*
Inventories	*0.0*	*-0.3*	*-0.2*	*0.1*	*0.2*	*-0.1*	*0.0*	*0.0*	*0.1*	*-0.3*	*0.0*
Net exports	*-0.1*	*0.3*	*-0.1*	*0.3*	*0.3*	*0.1*	*0.2*	*0.2*	*-0.1*	*0.5*	*0.7*
UNITED KINGDOM (5.6%)[1]											
GDP	**0.7**	**0.8**	**0.8**	**0.8**	**0.7**	**0.6**	**0.3**	**0.3**	**2.8**	**3.1**	**1.6**
Consumption	0.2	1.1	0.7	0.8	1.0	0.5	0.3	0.3	2.0	3.1	1.6
Total investment	2.7	3.3	1.1	-0.9	1.6	0.4	0.2	0.2	8.2	5.6	1.2
Public consumption [4]	0.5	0.7	0.5	0.4	0.3	0.6	0.5	0.5	2.5	1.9	1.6
Exports	-13.0	0.2	0.2	0.2	2.7	1.9	0.2	0.2	10.3	-4.1	3.1
Imports	-10.1	-0.5	1.1	-0.4	3.9	1.5	0.6	0.7	9.8	-1.9	4.1
Contributions:											
Domestic demand excluding inventories [4]	*0.8*	*1.4*	*0.7*	*0.4*	*1.0*	*0.5*	*0.3*	*0.3*	*3.2*	*3.3*	*3.3*
Inventories	*0.2*	*-0.8*	*0.4*	*0.2*	*0.2*	*0.0*	*0.1*	*0.1*	*-0.2*	*0.3*	*0.3*
Net exports	*-0.3*	*0.2*	*-0.3*	*0.2*	*-0.5*	*0.0*	*-0.1*	*-0.2*	*-0.2*	*-0.5*	*-0.5*
JAPAN (14.8%)[1]											
GDP	**-0.1**	**1.3**	**0.8**	**-0.5**	**0.4**	**0.2**	**0.5**	**0.5**	**2.4**	**1.8**	**1.1**
Consumption	-0.9	1.2	0.6	0.2	0.3	0.5	0.2	0.2	2.0	1.7	0.9
Total investment	-0.5	2.1	0.3	-2.6	-0.8	-1.4	1.4	1.4	1.3	-0.8	0.2
Public consumption	0.4	-0.3	0,.2	0.3	0.2	0.0	0.0	0.0	-0.4	0.6	0.2
Exports	2.2	1.0	3.2	1.0	2.6	1.5	1.2	1.2	9.6	7.9	4.9
Imports	-0.2	-0.3	1.0	0.7	-0.2	0.5	0.5	0.5	4.2	1.5	1.5
Contributions:											
Domestic demand excluding inventories	*-0.6*	*1.1*	*0.5*	*-0.4*	*0.0*	*0.0*	*0.4*	*0.4*	*1.4*	*0.9*	*0.6*
Inventories	*0.1*	*0.0*	*0.0*	*-0.1*	*-0.1*	*0.0*	*0.0*	*0.0*	*0.2*	*-0.1*	*-0.1*
Net exports	*0.4*	*0.2*	*0.4*	*0.1*	*0.5*	*0.2*	*0.1*	*0.1*	*0.8*	*1.0*	*0.7*

Forecast — *ovhg: overhang
1. Country's share of OECD GDP (1995 PPP, 2003 volume)
2. Investment by enterprises and households
3. Government consumption and investment
4. Includes consumption by non-profit institutions
Sources: BEA, ONS, Economic and Social Research Institute (ESRI), INSEE forecasts

growing burden on the U.S. expansion, both directly via household residential investment and indirectly via the wealth effect on consumption. Financial-market tensions could lead to further tightening of credit access conditions. Conversely, consumption could remain buoyant if the wealth effects were overestimated, and the dollar's past depreciation—which favors exports—could sustain U.S. growth more than expected.

Slowdown in British household demand

Like the U.S., the U.K. should experience a sharp slowdown in early 2008, owing to the turnaround in its real-estate market. Household-investment growth is expected to remain vibrant in Q4 2007 at 1.0%, but should slow to 0.5% per quarter in H1 2008 because of the earlier rise in interest rates and tighter credit conditions.

The real-estate wealth effect, which drove household demand in 2007, should ease significantly as real-estate prices enter a slower growth path or even decline. As a result, households may extract less liquidity from the mortgage market.

We also expect mildly slower growth in British households' purchasing power. In Q3, U.K. wages appear to have regained some vigor, but slower productivity gains may cause this growth to stall. Furthermore, as 60% of loans are taken out at variable rates, the four successive interest-rate hikes will increase the cost of loan repayments and place an additional burden on household budgets. Lastly, the steep rise in commodity prices, in particular for oil and food, should impact consumer prices by end-2007.

We therefore expect household consumption to start weakening at the end of this year, after a vigorous performance since the start of 2007 that included a 1.0% gain in Q3 (*Chart 2*). Household demand should thus gradually begin to lose momentum in Q4 2007.

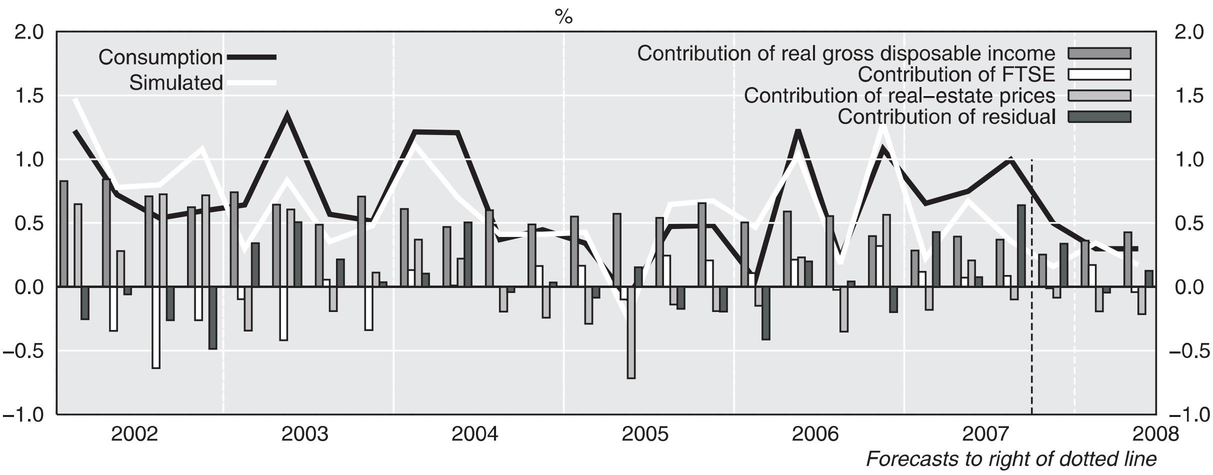
Business investment, which has been steadily slowing in 2007, is not expected to grow over the forecasting horizon, owing to the softer demand outlook and rises in lending rates.

This scenario is substantiated by the latest business surveys, which indicate greater pessimism. The October Confederation of British Industry (CBI) survey shows a further decline in output expectations after a mild improvement in Q3. The same is true of the latest surveys of purchasing managers in the service sector, whose indices have been heading downward since September.

Job creation remained brisk in Q2 and Q3. As a result, the unemployment downtrend has persisted, with the national unemployment rate easing to 2.6% in October. But, in the quarters ahead, the employment market is likely to lose this momentum as the economy slows.

After a vigorous upswing, British GDP growth is projected to ease to 0.6% in Q4 2007 and 0.3% per quarter in H1 2008, largely because of the sharp slowdown in household demand. The economy is nevertheless on track to a good performance in 2007, with average annual GDP growth of 3.1%. In the months ahead, activity is forecast to weaken, putting the statistical overhang for GDP growth at only 1.6% in June 2008. The main uncertainty surrounding this forecast concerns the scale of the real-estate market slowdown and its impact on consumption.

2 - U.K. consumption forecast to decline with slowdown in real-estate prices

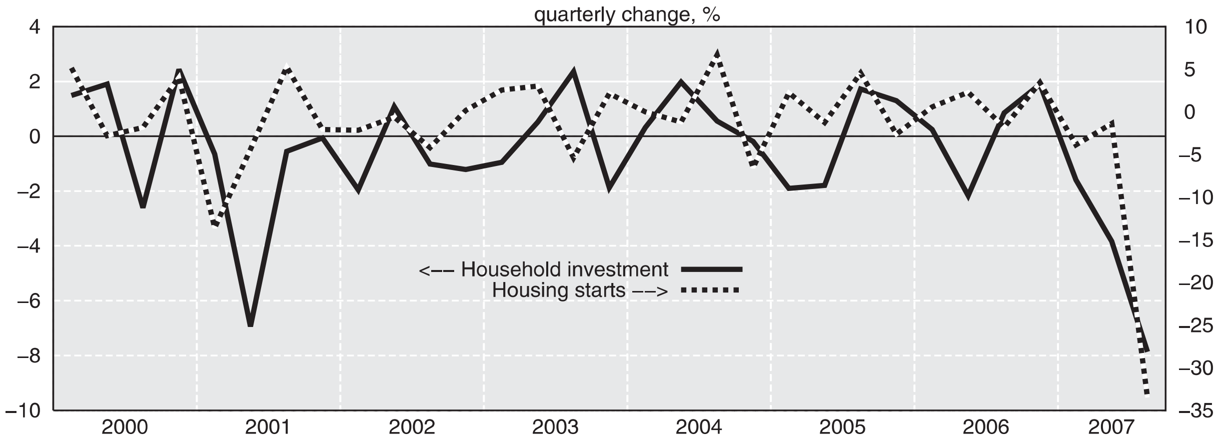


Sources: INSEE estimates; ONS; Financial Times

Japan: growth likely undermined by weak domestic demand

At end-2007, Japan will still not have effectively pulled out of deflation. The impending domestic-demand slowdown leaves little room for improvement on that front. While higher energy and commodity prices are helping to push inflation back above zero, the Japanese economy remains subject to deflationary pressure. We expect core inflation (excluding energy and food) to remain negative in H1 2008.

3 - Temporary drop in Japanese household investment



Sources: Economic and Social Research Institute; Ministry of Land, Infrastructure and Transport

Table 2
United States, United Kingdom, and Japan: Household accounts

%

	Average annual changes			
	2005	2006	2007	2008*
United States				
Non-farm payroll employment	1.7	1.9	1.3	0.7
Average wage per head	3.3	4.3	4.5	2.8
Nominal gross disposable income	4.7	5.9	5.8	4.2
Private consumption deflator	2.9	2.8	2.5	2.2
Saving ratio	0.5	0.4	0.6	0.7
United Kingdom				
Dependent employment	1.0	0.9	0.6	0.6
Average wage per head	4.0	4.0	3.6	2.1
Nominal gross disposable income	5.5	3.6	2.8	2.9
Private consumption deflator	2.4	2.4	2.1	1.1
Saving ratio	5.6	5.0	3.0	3.3
Japan				
Total employment	0.4	0.4	0.4	0.1
Average wage per head	0.4	1.3	-0.1	0.5
Nominal gross disposable income	0.2	1.8	0.7	-
Private consumption deflator	-0.8	-0.3	-0.5	0.2
Saving ratio (net)	3.0	3.3	2.9	-

Forecast
*Statistical overhang in Q2
Sources : BEA, BLS (U.S.); Central Statistical Office, Department of Employment, ONS (U.K.); Economic and Social Research Institute (ESRI), Ministry of Public Management, Ministry of Labour (Japan); INSEE

Wages moved on a steeper downward path in Q3 2007, shedding 1.6% year-on-year after a 1.5% loss in Q2. They are unlikely to recover in the short run, as rising commodity prices continue to constrain Japanese production costs.

The employment outlook is admittedly brighter. In the September Tankan survey, a growing number of firms reported a labor shortage. Employment could therefore improve in the quarters ahead, correcting the abnormal Q3 loss of 0.6% that followed a Q2 gain of 0.5%. But the improvement in jobs would not suffice to offset the negative impact of declining real wages on household income.

The latter trend has caused a recent erosion in Japanese households' confidence—particularly as reflected in their intentions to purchase consumer durables—and consumer-loan applications have fallen. Consumption growth is therefore likely to remain weak in the quarters ahead.

Softer domestic demand and a worsening international environment should inhibit business investment in H1 2008, a scenario corroborated by the Tankan survey and machinery orders. We forecast a modest rebound in capital-goods investment in early 2008.

As regards foreign trade, Japan should continue to benefit from the relative buoyancy of its main Asian partners' economies in the coming quarters. In Q3 2007, exports rose thanks to the still-vibrant Asian market and a temporary rebound in U.S. demand. Later, however, exports should gradually slow under the combined effects of slacker world growth and the yen's appreciation against the dollar, which totaled 9.0% between July and end-November. Import growth should remain moderate in the quarters ahead, owing to limp domestic demand.

A non-recurring factor is likely to disrupt the Japanese growth profile in late 2007 and early 2008: the effect of stricter building-permit regulations introduced in June, which have considerably lengthened issuance procedures. As a result, construction starts have dropped since June, causing a spectacular fall in household residential investment (-7.9% in Q3 2007 and -7.0% expected in Q4), and business construction investment. However, the measures taken by Japanese authorities to clear bottlenecks have led to a recovery of construction starts in October. We thus expect robust growth in construction investment by households and firms in H1 2008. These exceptional swings in construction investment should have the artificial effect of driving Japanese economic growth down to 0.2% in Q4 2007 then up to 0.5% per quarter in H1 2008. ■

Economic situation in the euro zone

The euro zone's GDP rebounded 0.7% in Q3 2007. The upswing occurred in all the leading countries of the zone, where activity had slowed in Q2.

The outlook for end-2007 and early 2008 has nevertheless deteriorated, according to the latest confidence surveys. After an overall stagnation at the start of the year due to the increase in German VAT, household consumption is expected to act as the zone's main growth driver again. However, within our forecasting period, household consumption will likely be cramped by the slowdown in purchasing power due to surges in food and energy prices. Productive investment appears to have passed the peak of the cycle begun in 2003, while the real-estate market shows signs of weakness in several euro-zone countries. Lastly, the world economic slowdown and the euro's appreciation will probably halt the positive contribution of external trade to GDP growth.

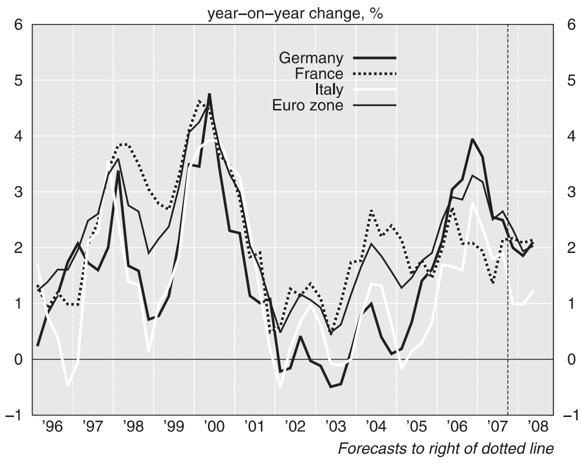
Euro-zone GDP stayed on a vigorous uptrend in 2007, gaining an estimated 2.6%. But this performance, close to that of 2006, masks a slowdown begun in Q2. We thus expect gains of only 0.4% per quarter in H1 2008, i.e., below the potential growth rate.

Brisk euro-zone growth expected to persist in 2007

After its strong 2.9% increase in 2006, the euro zone's average annual GDP growth is expected to register only a mild loss of momentum in 2007, easing to 2.6%. However, since the Q4 2006 peak, a gradual slowdown is under way. The peak was recorded in all of the zone's leading countries, with the notable exception of France. Having stayed on the sidelines of its neighbors' acceleration in 2006, the French economy has not significantly slowed either *(Chart 1)*.

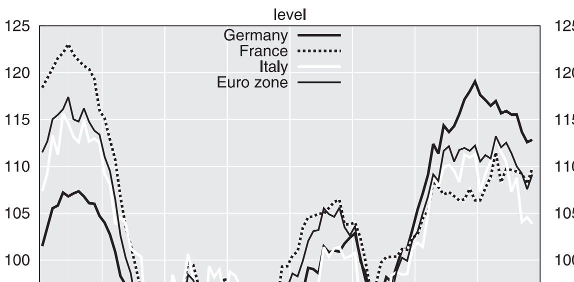
Yet the 0.7% growth rebound in Q3 2007 has been accompanied by a downturn in the industrial confidence surveys first observed in April, which accelerated in the following months. In the service sector as well, business surveys began to register a loss of confidence in September. The pattern concerns all the euro-zone countries except France, where the confidence figures did not improve in line with those of the partner economies in 2006 *(Chart 2)*. On balance, the surveys suggest that the summer upturn, which partly corrected an atypically low Q2, was only transient. Industrial production is likely to slow at year-end. However, activity in the service sector, which usually follows survey turnarounds with greater inertia, should remain fairly brisk. We expect euro-zone GDP growth to slow to 0.5% in Q4 2007, and 0.4% in Q1 and Q2 2008. This would put the statistical overhang for 2008 at 1.4% in mid-year.

1 - Main euro-zone countries: GDP growth



Sources: Eurostat; Destatis; INSEE; Istat

2 - Composite "synthetic" indicators (CSIs) from industry surveys



Sources: European Commission; Ifo; INSEE; INSEE estimates

The contributions of the main demand components to GDP growth in 2007 should continue to display the same differences among the three leading euro-zone countries as last year *(Chart 3)*. The likely outcome for 2007 is as follows:
– Consumption remained the strongest driver in France and Italy; in Germany, by contrast, it weakened, as its rebound since Q2 did not suffice to offset the Q1 decline due to the VAT increase.
– Exports continued to provide the strongest impulse to German growth in 2007, despite a distinctly less buoyant international environment; in Italy and in France, external trade made a negative contribution.
– Investment, by contrast, stalled in all three countries, apparently reflecting the end of the expansionary cycle begun in 2003.

In the zone as a whole, the growth of the main demand components was very likely more balanced than in 2006, the slowdown in domestic demand having been offset by a significant contribution of external trade.

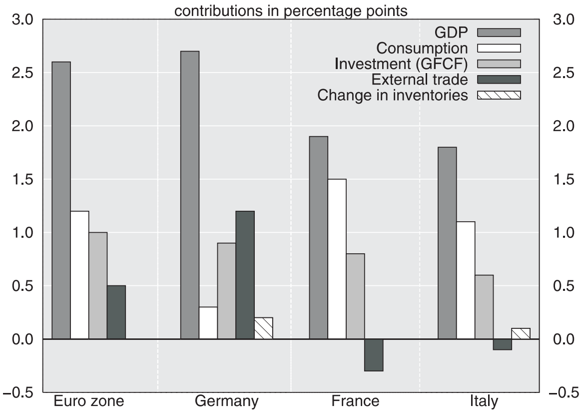
Table 1
Euro zone and main countries: GDP and its components

annual and quarterly changes, %

	2006				2007				2008		2005	2006	2007	2008 ovhg*
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2				
GERMANY (29.4%)[1]														
GDP	**0.9**	**1.3**	**0.7**	**1.0**	**0.5**	**0.3**	**0.7**	**0.5**	**0.4**	**0.5**	**1.0**	**3.1**	**2.7**	**1.6**
Household consumption	0.8	0.2	0.4	0.8	-2.0	0.8	0.5	0.4	0.4	0.4	0.1	1.1	-0.2	1.5
Total GFCF	-2.2	6.1	1.2	1.9	2.1	-1.2	0.6	1.6	0.1	0.4	1.3	7.0	5.4	1.5
Public consumption	0.5	-0.1	0.5	0.0	1.8	0.0	-0.1	0.0	0.2	0.2	0.5	0.9	1.9	0.3
Exports	4.9	1.8	3.3	5.3	-0.3	0.8	3.1	1.9	1.5	1.5	7.4	12.9	8.5	5.9
Imports	3.8	0.7	3.5	1.3	2.3	-1.8	3.9	1.9	1.5	1.5	6.9	11.5	6.5	5.6
Contributions:														
Domestic demand excl. inventories	*0.2*	*1.2*	*0.6*	*0.7*	*-0.5*	*0.3*	*0.5*	*0.4*	*0.3*	*0.4*	*0.5*	*2.1*	*1.2*	*1.2*
Inventory change	*0.0*	*-0.4*	*0.1*	*-1.6*	*2.0*	*-1.1*	*0.4*	*-0.1*	*0.0*	*0.0*	*0.0*	*-0.1*	*0.2*	*-0.1*
Net exports	*0.7*	*0.5*	*0.0*	*1.9*	*-1.0*	*1.1*	*-0.2*	*0.1*	*0.1*	*0.1*	*0.5*	*1.1*	*1.2*	*0.4*
ITALY (17.9%)[1]														
GDP	**0.8**	**0.6**	**0.3**	**1.1**	**0.3**	**0.1**	**0.4**	**0.2**	**0.3**	**0.3**	**0.2**	**1.9**	**1.8**	**0.9**
Household consumption	0.5	0.5	0.7	0.2	0.7	0.5	0.2	0.3	0.3	0.3	0.6	1.5	1.9	1.0
Total GFCF	1.8	0.9	-1.0	2.2	0.6	0.2	1.5	0.8	0.6	0.6	-0.2	2.5	3.0	2.4
Public consumption	-0.3	-0.1	0.3	-0.1	0.0	-0.1	0.2	0.0	0.1	0.1	1.5	-0.3	0.1	0.3
Exports	2.2	1.5	-1.9	4.1	0.2	-1.4	0.9	0.4	0.4	0.4	0.0	5.4	2.3	1.1
Imports	1.2	0.4	2.0	1.8	-1.2	-0.2	2.4	0.8	0.6	0.6	1.0	4.4	2.5	2.8
Contributions:														
Domestic demand excl. inventories	*0.6*	*0.4*	*0.2*	*0.5*	*0.6*	*0.3*	*0.5*	*0.3*	*0.3*	*0.3*	*0.6*	*1.3*	*1.8*	*1.1*
Inventory change	*-0.1*	*-0.1*	*1.1*	*-0.1*	*-0.6*	*0.1*	*0.4*	*0.0*	*0.0*	*0.0*	*-0.1*	*0.4*	*0.1*	*0.2*
Net exports	*0.3*	*0.3*	*-1.0*	*0.6*	*0.4*	*-0.3*	*-0.4*	*-0.1*	*-0.1*	*-0.1*	*-0.3*	*0.3*	*-0.1*	*-0.5*
EURO ZONE (27.8%)[2]														
GDP	**0.9**	**1.0**	**0.6**	**0.8**	**0.8**	**0.3**	**0.7**	**0.5**	**0.4**	**0.4**	**1.6**	**2.9**	**2.6**	**1.4**
Household consumption	0.7	0.4	0.5	0.5	0.0	0.6	0.5	0.5	0.4	0.4	1.6	1.9	1.5	1.5
Total GFCF	0.6	2.7	0.9	1.6	1.8	0.0	0.9	0.7	0.4	0.5	2.8	5.1	4.7	1.8
Public consumption	1.0	0.2	0.5	0.4	0.9	0.2	0.6	0.2	0.2	0.2	1.4	1.9	2.0	0.8
Exports	3.0	1.5	1.0	3.0	0.9	0.8	2.5	1.4	1.0	1.0	4.7	7.7	6.3	4.2
Imports	2.2	1.2	1.7	1.7	1.4	0.1	2.7	1.5	1.2	1.2	5.5	7.4	5.6	4.6
Contributions:														
Domestic demand excl. inventories	*0.7*	*0.8*	*0.5*	*0.7*	*0.6*	*0.4*	*0.6*	*0.5*	*0.4*	*0.4*	*1.7*	*2.5*	*2.2*	*1.4*
Inventory change	*-0.2*	*0.0*	*0.3*	*-0.4*	*0.4*	*-0.4*	*0.2*	*0.0*	*0.0*	*0.0*	*0.0*	*0.1*	*0.1*	*0.1*
Net exports	*0.3*	*0.1*	*-0.2*	*0.5*	*-0.2*	*0.3*	*-0.1*	*0.0*	*-0.1*	*-0.1*	*-0.2*	*0.3*	*0.3*	*-0.1*

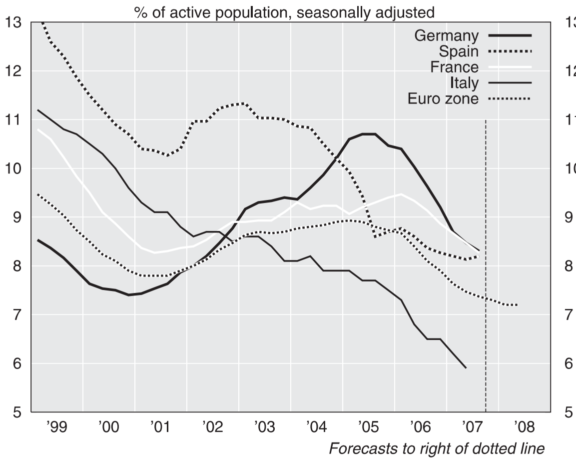
Forecast
*ovhg: overhang
1. Share of euro-zone GDP
2. Share of OECD GDP
Sources: Eurostat, Destatis, Istat

3 - Main euro-zone countries: contributions to GDP growth (forecast) in 2007



Sources: Eurostat; Destatis; INSEE; Istat

4 - Euro zone: harmonized unemployment rates



Sources: Eurostat

Household consumption restrained by rising inflation

The growth of euro-zone household income will probably quicken from 3.7% in 2006 to 4.2% in 2007 *(Table 2)* thanks to the significant improvement in the labor market, with employment gaining an estimated 1.9%. The decline in the unemployment rate *(Chart 4)* should thus stimulate wage growth, expected to reach 2.1%. In Germany, the wage restraint observed since the early 2000s appears to be ending. However, the diffusion of pay raises negotiated in some industries to the entire economy remains sluggish. In Italy, by contrast, wage growth is slowing sharply, but we expect the downtrend to ease over the forecasting horizon as new civil-service pay raises are scheduled for early 2008. The efforts to trim budget deficits in the main euro-zone countries—chiefly Germany and Italy—are not expected to result in higher direct taxes on household income in 2007.

Between now and mid-2008, we forecast further brisk growth in euro-zone employment and wages, but the excess food and energy inflation projected in the coming quarters should hamper the rise in household purchasing power *(see "Consumer prices in the euro zone" chapter)*. The growth of the latter aggregate accelerated from 1.6% in 2006 to an estimated 2.2% in 2007 thanks to the price slowdown at the start of the year, but should register a sharp deceleration in H1 2008. The statistical overhang for purchasing-power growth in 2008 should reach a modest 1.3% in mid-year.

Table 2
Euro zone: Household accounts

annual and quarterly changes, %

	2006				2007				2008		2005	2006	2007	2008 ovhg*
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2				
Total wage bill	0.9	1.1	0.5	0.8	1.5	0.9	0.8	1.1	1.1	0.8	2.5	3.4	4.1	3.1
- Employment	0.3	0.6	0.3	0.4	0.6	0.6	0.3	0.4	0.4	0.3	0.9	1.6	1.9	1.2
- Unit wage	0.6	0.5	0.2	0.4	0.9	0.3	0.5	0.7	0.7	0.5	1.6	1.9	2.1	1.9
Gross disposable income (GDI)	0.6	1.1	0.7	1.0	1.2	0.9	1.2	1.0	1.0	0.8	3.2	3.7	4.2	3.2
Saving ratio (% of GDI)	13.4	13.5	13.3	13.6	14.3	14.0	14.1	13.7	13.7	13.8	13.8	13.4	14.0	13.7
Household consumption deflator	0.5	0.6	0.5	0.2	0.4	0.6	0.5	1.1	0.6	0.2	2.1	2.2	2.0	2.0
Real total wage bill	0.4	0.5	0.1	0.6	1.1	0.3	0.3	0.0	0.5	0.6	0.5	1.3	2.1	1.2
- Real unit wage	0.1	-0.1	-0.2	0.2	0.5	-0.3	0.0	-0.4	0.1	0.3	-0.5	-0.3	0.2	-0.1
Purchasing power of GDI	0.1	0.6	0.3	0.8	0.7	0.3	0.7	-0.1	0.4	0.6	1.1	1.6	2.2	1.3

Forecast
*ovhg: overhang
Sources: Eurostat, INSEE computations

After stagnating in Q1, household consumption became the main driver of GDP growth again in Q2 and Q3 2007, contributing 0.3 points in each quarter. However, we expect its average annual growth to slow from 1.9% in 2006 to 1.5% this year for two reasons. The first is the impact of the Q1 downturn in German consumption due to the VAT hike. Second, after surging at the start of the year, the household saving ratio remained high in the following quarters. In our scenario, it will subsequently decline in response to the slowdown in real-income gains, enabling households to keep their consumption on a growth path. In H1 2008, household consumption should therefore remain the chief growth engine, rising 0.4% per quarter.

Construction investment posted a modest rebound after its Q2 decrease, which in turn followed a spike in winter 2006/2007 due to unseasonably mild weather. German construction, which posted brisk gains in 2006 after a ten-year crisis in the sector, already seems to be slowing. Construction growth slowed in France as well in 2007. Moreover, fears of a real-estate recession have intensified significantly in several euro-zone countries, notably Spain, Finland, and Ireland. Nevertheless, construction investment is estimated to have grown by a still-vigorous 4.3% in 2007, the same pace as in 2006. By contrast, the statistical overhang for growth in 2008 is forecast at only 0.3% in mid-2008.

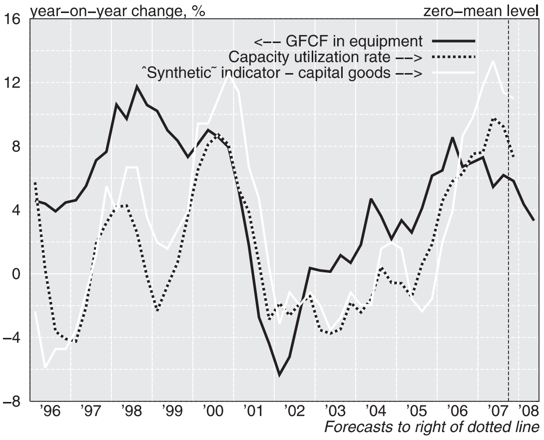
The investment slowdown appears to signal the end of the cycle

Equipment investment has slowed since early 2007 after a four-year acceleration. For the past six months now, European businesses have been reporting cutbacks in productive capacity utilization rates, and capital-goods producers expect the investment slowdown to continue (Chart 5). The investment cycle begun in 2003 thus seems to be ending in Germany. The downswing should also concern Italy, although the country has thus far stayed on the sidelines of the European cycle. Like its partners, Italy should be affected by the worsening business outlook and tighter financing conditions, caused by interest-rate hikes and the financial turbulence that erupted in summer 2007. At end-2007, however, equipment investment should be temporarily boosted in Germany prior to the expiration of tax incentives in early 2008. The aggregate will have grown by an estimated 6.1% in 2007, versus 7.2% in 2006, but the statistical overhang for 2008 is expected to reach only 2.7% in mid-year.

Euro-zone external trade likely to suffer from the global economic slowdown

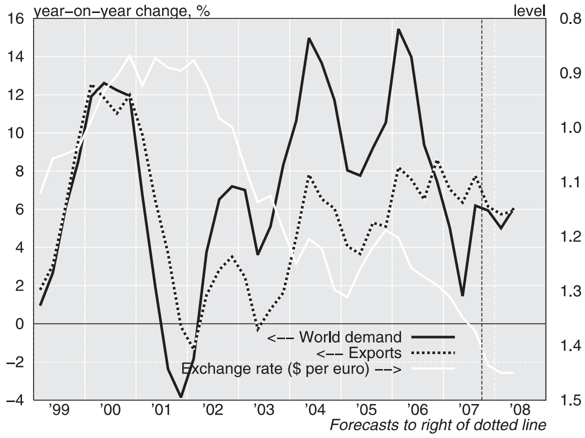
The deterioration of the euro zone's international environment (*see "International overview" chapter*) has not yet translated into a sharp export slowdown. Yet, for the past year, world demand for euro-zone products—both intra- and extra-zone—has been distinctly less vibrant than in previous years. Its average year-on-year growth stands at 5.0%, compared with an average of over 10.0% between 2003 and 2006, and the euro's effective exchange rate has appreciated by nearly 5.0%. In Q3 2007, export growth accelerated even further to 2.5%, but external trade ceased to contribute positively to GDP growth. Over the forecasting horizon, export growth should gradually decelerate from 1.4% in Q4 2007 to 1.0% per quarter in H1 2008. This will be due to softer world demand and price-competitiveness losses caused by the stronger euro *(Chart 6)*.

5 - GFCF in equipement and business survey indicators



Sources: Eurostat; INSEE estimates

6 - Euro-zone: exports, world demand, and exchange rates



Sources: DGTPE; Eurostat; INSEE estimates

In H1 2007, euro-zone imports were somewhat limp by comparison with changes in domestic and external demand. This slackness should be offset in the coming quarters, with gains of 1.5% in Q4 2007 and 1.2% per quarter in H1 2008. The overall contribution of foreign trade to GDP growth in the forecasting period should be slightly negative. ■

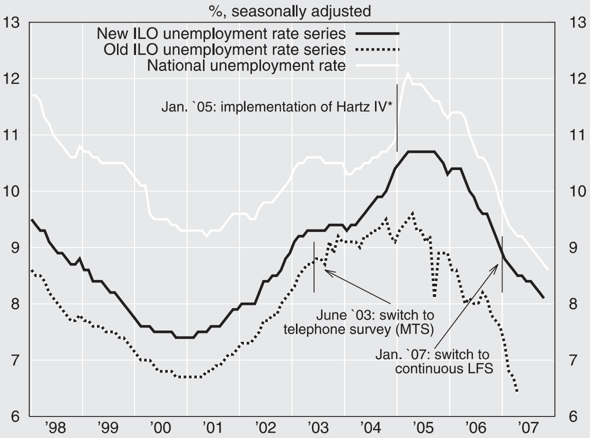
Box 1 - The new ILO unemployment rate... in Germany

With the publication of September 2007 data, the German unemployment rate on International Labor Office (ILO) criteria was drastically revised in level terms: the April 2007 figure was raised by 2.1 points *(Chart)*. The source used to determine the rate has changed. As in France, the German federal statistical office, Destatis, now relies on a continuous labor-force survey that meets the European Union's Labor Force Survey (LFS)[1] requirements.

Before October 2007: annual labor-force survey and MTS telephone survey

Before 2005, Germany used an annual LFS to determine an ILO unemployment rate just once a year. Monthly changes in the rate were then estimated from the variations in the number of job-seekers registered with the Federal Employment Agency. In January 2005, Destatis replaced the annual LFS with a continuous survey to comply with EU recommendations. The sample size was designed to allow the monthly calculation of an ILO unemployment rate from that single survey, with the goal of dispensing with Employment Agency data. According to Destatis, these administrative data were no longer a relevant indicator for tracking monthly fluctuations in ILO unemployment.[2] Methodological problems prevented the immediate monthly use of the continuous LFS. In agreement with Eurostat and pending resolution of these issues, Destatis computed ILO unemployment from the ILO Monthly Telephone Survey (MTS), a pilot survey on employment conducted since April 2003. Each month, 30,000 volunteer respondents were interviewed, resulting in a high non-response rate: 50% in the first wave and an additional 10% in each new wave. The MTS was the sole source for calculating the unemployment rate from June 2003 to April 2007.[3] Compared with the annual LFS, the use of the MTS led to a sharp downward revision of the German ILO unemployment rate as well as a high volatility in the series.

Old and new ILO unemployment rate series and national unemployment rate in Germany



Sources: Destatis; Bundesagentur für Arbeit

Since October 2007: continuous labor-force survey

In late October 2007, after major methodological improvements, Destatis published a new monthly series for ILO unemployment, computed from the continuous LFS. The latter is incorporated into the Mikrozenzus, the largest monthly survey of households in Europe, which has been in existence for 50 years. In the LFS segment, 35,000 people are questioned every month.

The new raw series is available from January 2007. Destatis has back-cast a seasonally-adjusted series using a method for benchmarking the annual LFS to (1) the monthly profiles of the continuous LFS observed since 2005 and (2) the monthly changes in the number of job-seekers recorded by the Employment Agency.[4] The employment figure, which allows the determination of the labor force in the denominator, is still computed from the national accounts.[5]

On average, 800,000 more unemployed persons

The new ILO unemployment series differs substantially from the old one: on average, it has 800,000 more unemployed persons since January 2005, or 1.5 points of unemployment. Destatis explains the discrepancy as follows: first, the survey's compulsory status and the face-to-face interviewing method have increased the response rate to over 95% on an annual-average basis; second, the sampling method is different and "job-seeking" is defined less restrictively than in the MTS.

1. While ILO unemployment, which allows European comparisons, seems to carry increasing weight in the public debate, the indicator most closely followed in Germany until now has been the "national unemployment rate." This counts as unemployed all persons registered at the Federal Employment Agency as jobless or as working less than 15 hours a week. Under ILO criteria, registration at the agency is not required, but a person must not have worked even a single hour in the reference week in order to be counted as unemployed.
2. At the time, Destatis believed that the Hartz IV reform of 2005, which changed the eligibility rules for unemployment benefits, would have a purely regulatory impact on the number of job-seekers enrolled at the agency (*"Conjoncture in France," March 2005, box p. 11, "The Hartz IV reform has artificially increased the number of jobseekers in Germany"*: http://www.insee.fr/en/indicateur/analys_conj/archives/march2005_f1.pdf).
3. Created in 2005, the new series was back-cast to June 2003. The former calculation method was maintained for the period prior to that date. Since April 2007 and the abolition of the MTS for legal reasons, Destatis had provisionally estimated German ILO unemployment using administrative data from the Employment Agency.
4. The continuous LFS series are not long enough to estimate a seasonal adjustment. Until 2011, they will be seasonally adjusted in parallel with the series of job-seekers registered at the agency. For more details on the back-casting and seasonal adjustment of the new series, see http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/UNEMPLOY_GERMANY_2007/EN/UNEMPLOY_GERMANY_2007-EN.PDF.
5. Eventually, employment will also be computed from the LFS, as in some other EU countries. For the time being, however, the estimates based on national accounts are regarded as more robust.

The new, revised series does not call into question the decline in ILO unemployment observed in the recent period, but the downtrend appears to have begun later—in late 2005 rather than early 2005—and to have been more modest. With the old series, ILO unemployment had posted a mild average decline of 50,000 in 2005, followed by a steeper fall of 460,000 in 2006. The new series, instead, shows a steep average increase of 400,000 in 2005 and a more moderate decline of 350,000 in 2006. For 2005, the change in the ILO unemployment rate is now more consistent with the 0.5% job destructions recorded and the strong wage restraint (real wages shed 1.6%). Moreover, its profile now matches that of household confidence, which did not visibly improve until end-2005. The revision has raised Germany's ILO unemployment rate for April 2007 from 6.4% to 8.5%. By way of comparison, the harmonized rates stood at 8.5% in France as well, and 7.5% in the euro zone. ■

Box 2: France less vulnerable to a U.S. slowdown than its neighbors

While not the likeliest scenario, the risk of a U.S. recession has increased. The real-estate crisis that is weakening the American economy[1] is compounded by the financial disturbances that erupted this summer. Such a shock would have a negative impact on other economies, particularly via foreign trade. VAR (Vector AutoRegressive) econometric models offer an assessment of the effects. We estimated a VAR model with three variables (U.S. GDP, national exports, and national GDP) for the three main euro-zone countries—Germany,[2] France, and Italy—over the period 1981-2006. We then used the model to determine the effects on each country of a 1% contraction in U.S. GDP after several quarters.

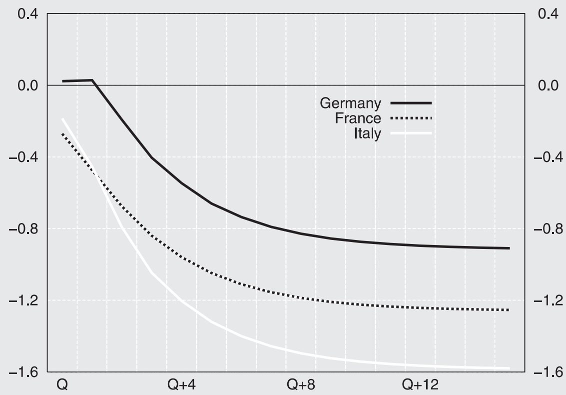
In Germany, exports would slow sharply, losing a total 0.9 points. But the slowdown would be smaller than for Germany's neighbors: 1.3 points in France and 1.6 points in Italy *(Chart 1)*. Yet the U.S. share of total exports is higher for Germany (9%) than for Italy (8%) or France (7%). The elasticity of exports relative to U.S. demand is lower in Germany than in France or Italy. This may be because German products are more differentiated and therefore less liable to substitution with U.S. products in the event of recession than French or Italian products.

Conversely, the same fall in U.S. GDP would trigger an immediate decline in German growth of 0.14 points, twice the value observed in France *(Chart 2)*. Italy would not be significantly affected immediately but would suffer a sharper slowdown by the following quarter. The Italian contraction would soon outpace the French loss and match Germany's. In the long term, Germany and Italy would thus be affected to a similar degree: their growth would be cut by a total 0.4 points. France would be slightly better protected against a U.S. slowdown, shedding 0.3 points.

Our model thus suggests that a contraction in U.S. GDP would impact Germany as hard as Italy, and more than France, whereas German exports would be less affected than Italian and French exports. This apparent paradox is partly due to the nominal share of foreign trade in GDP: it is significantly larger in Germany (31% on average over the estimation period) than in Italy (23%) and France (24%). Thus, although a U.S. slowdown appears to have a milder effect on Germany's exports than on those of its main neighbors, German GDP growth would nevertheless register a comparable or greater contraction in the medium term, owing to its greater dependence on external trade. ■

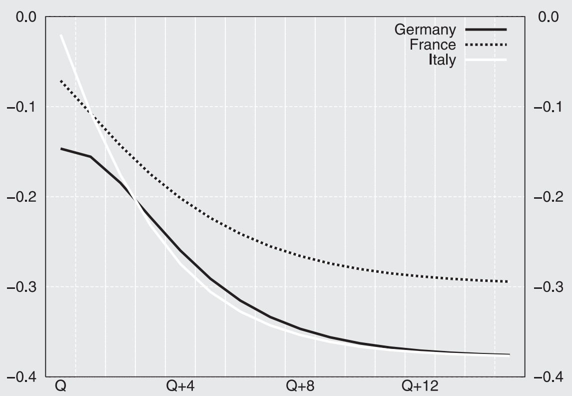
1. "Conjoncture in France," March 2007, box p. 32, "Real-estate crisis and economic recessions in the United States: is there a link?": http://www.insee.fr/en/indicateur/analys_conj/archives/march2007_f1.pdf.
2. Before 1991: West Germany.

1- Effect of U.S. slowdown on exports by main euro-zone countries



Sources: BEA; Destatis; INSEE; Istat; INSEE estimates

2- Effect of U.S. slowdown on GDP of main euro-zone countries



Sources: BEA; Destatis; INSEE; Istat; INSEE estimates

How to read the charts: the curves plot the response functions—estimated by means of 3-variable VAR models—of euro-zone countries' exports and GDP to a long-term negative shock of 1.0% on U.S. GDP. They describe the variables' reaction over time to an unexpected decline in U.S. growth. For example, German GDP growth would lose 0.14 points instantaneously (all other things being equal: Chart 2), 0.25 points in 4 quarters, and 0.4 points in all.

Consumer prices in the euro zone

After its August low, euro-zone inflation rebounded to 2.6% in October 2007, owing to the acceleration of oil and commodity prices. At year-end, the volatile components of the price index—energy and unprocessed food products—should keep driving overall inflation up to 3.0% in December. In H1 2008, inflation is expected to ease, reaching 2.7% by June.

"Core" inflation as measured by Eurostat has stabilized at about 1.9% since June. It should gradually abate until the end of H1 2008, as the effects of Germany's VAT hike—implemented on January 1, 2007—wear off. We accordingly forecast core inflation of 1.7% in June 2008.

Year-on-year rise in energy prices: 9.4% in January 2008, 4.6% in June

Euro-zone energy inflation has flared up since September. First, the price of Brent crude oil surged this fall to a peak in November, whereas it had dropped in the same period last year. Second, electricity and gas prices gained an average 3% in Italy and Spain in October. As a result, we expect year-on-year energy-product inflation to reach 8.6% at end-2007 *(Table 1)*.

The aggregate should keep rising in January 2008, to 9.4%. This is because Germany's leading electricity producers have announced tariff increases of as much as 10%, owing to the surge in production costs. Year-on-year growth in energy prices should then ease to 4.6% in June *(Table 1 and Chart 1)*, assuming a stabilized price for Brent oil of $90 per barrel and an exchange rate of $1.45 per euro.

Food inflation fueled by agricultural commodities

Food prices—which, by convention, include tobacco prices—accelerated sharply between June and October, reflecting the surge in agricultural-commodity prices. The effects of the surge have been particularly strong in Germany, where the year-on-year change in food products excluding unprocessed foods has risen steeply. However, the October 2006 rise in German tobacco prices is no longer included in the computation of the year-on-year change.[1] This has attenuated the increase for the food category as a whole. We expect food inflation to rise to 4.4% in

1. The increase in tobacco prices in Spain in January 2007 and in France in August 2007 does not outweigh the phase-out of the German rise.

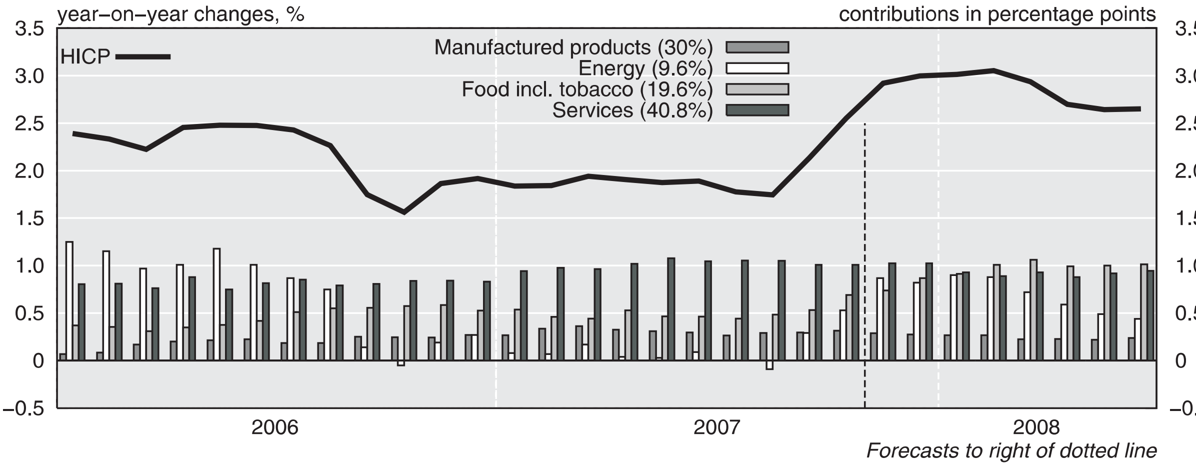
Table 1
Euro-zone inflation

% changes

Sectors (weights in 2007 index)	Year-on-year changes: June 2006	Dec. 2006	June 2006	Oct. 2007	Dec. 2007	June 2008	Annual average: 2005	2006	2007
Total (100.0%)	2.5	1.9	1.9	2.6	3.0	2.7	2.2	2.2	2.1
Food (incl. alcohol and tobacco) (19.6%)	2.2	2.7	2.4	3.5	4.4	5.2	1.6	2.4	2.8
of which: Food (15.6%)	*2.0*	*2.6*	*2.1*	*3.8*	*4.9*	*6.0*	*0.7*	*2.3*	*2.7*
Alcohol and tobacco (4.0%)	*2.8*	*3.2*	*3.6*	*2.5*	*2.5*	*2.1*	*4.9*	*2.7*	*3.4*
Energy (9.6%)	11.0	2.9	0.9	5.5	8.6	4.6	10.1	7.7	2.5
Core inflation (70.8%)	1.5	1.5	1.9	1.9	1.8	1.7	1.4	1.4	1.9
of which: Non-energy industrial goods (30.0%)	*0.7*	*0.9*	*1.0*	*1.1*	*0.9*	*0.8*	*0.3*	*0.6*	*1.0*
Services (40.8%)	*2.0*	*2.0*	*2.6*	*2.5*	*2.5*	*2.3*	*2.3*	*2.0*	*2.5*

Forecast
Sources: Eurostat; INSEE forecasts

1 - Breakdown of euro-zone inflation: contribution of main items



Sources: Eurostat; INSEE forecasts

December as the result of two factors. First, commodity inflation remains strong; second, the drop in fresh-vegetable prices at end-2006, due to an unusually warm fall, should not be repeated this year.

Food inflation should keep rising to 5.4% until March 2008, followed by a decline until June. Unprocessed-food prices rose in early spring 2007, whereas they usually start trending down in that season.[2] However, the easing of food inflation should be partly offset by the further acceleration in the price of cereal- and milk-based food products. We therefore expect that food inflation will still be as high as 5.2% in June *(Table 1)*.

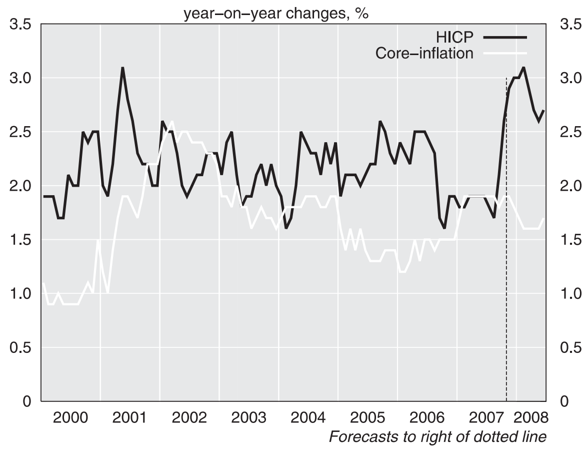
Gradual slowdown in core inflation

Since June, core inflation as measured by Eurostat—i.e., excluding food and energy but including indirect taxes—has been stable at around 1.9% in the euro zone. It should gradually decline until June 2008, with the dissipation of the effects of the German VAT hike of January 1, 2007. The prospect of slower growth and the recent decrease in capacity utilization should help to reduce core inflation. Nevertheless, the past acceleration in producer prices of consumer goods and the spread of the oil-price surge will likely put pressure on core prices. We thus forecast core inflation at 1.7% in June *(Table 1 and Chart 2)*, i.e., slightly above its level prior to the German VAT increase.

2. The April 2007 drought episode and unstable weather in early May reduced the fruit and vegetable harvest in Europe, triggering a rise in unprocessed-food prices—an unusual phenomenon in early Q2.

Since early H2 2007, inflation in manufactured products has held steady at around 1.0%. It should dip very slightly in December, to 0.9% (year on year). This is due to the fact that the growth in prices of manufactured goods gradually gained momentum in late 2006 ahead of the January 2007 VAT hike. In H1 2008, euro-zone inflation in manufactured products should stay on this mild downtrend to reach 0.8% in June 2008 *(Table 1)*. First, the German VAT increase had a gradual impact in early 2007; second, the scenario of a mild economic slowdown and the dip in capacity utilization—despite its persistence at a high level—should help ease price tensions somewhat in the short run. This slowdown will probably be attenuated by the recent acceleration in producer prices of consumer goods and in oil prices.

2 - Euro-zone HICP and core inflation



Sources: Eurostat; INSEE forecasts

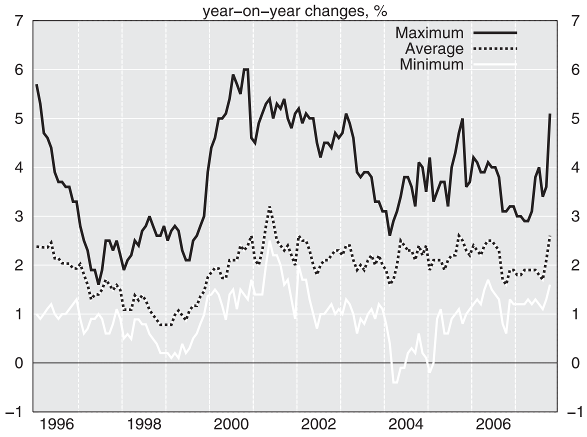
Service-sector inflation posted a mild decline to 2.5% in October. This is because the European Commission's decision to order the reduction in the Eurotariff[3] led to a reduction in telecom-service prices in September and October 2007. The dissipation of the effects of Germany's VAT rise should allow a further decline in euro-zone service-sector inflation over the forecasting horizon. Labor costs in the sector have been relatively stable for a year now, and would therefore have a neutral impact on inflation in the short run. Service-sector inflation is expected to reach 2.3% at the end of H1 2008 *(Table 1)*.

Inflation differentials between euro-zone countries are widening

Between June and October 2007, the differential between the highest and lowest inflation in the euro zone widened from 2.5 points to 3.5 points *(Chart 3)* , owing to runaway inflation in Slovenia[4] *(Table 2)*.

In the same period, the inflation gap between the French HICP and the euro-zone index stabilized at around 0.5 points in France's favor *(Chart 4)*. This differential should be eliminated as the effects of the German VAT increase disappear from the year-on-year computation. ■

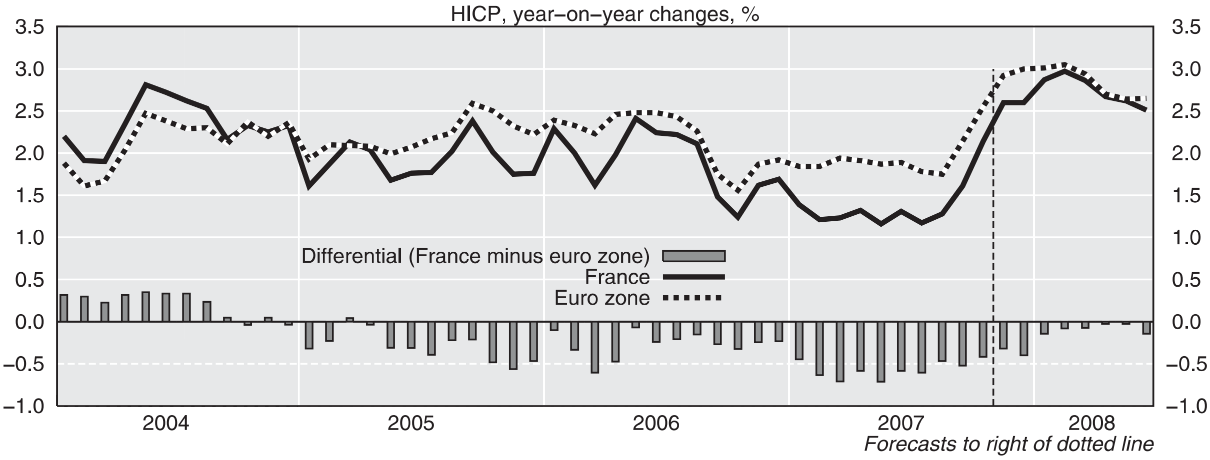
3 - Euro-zone inflation



Source: Eurostat

3. Price of cellphone calls from or to a euro-zone country.
4. The Slovene central bank believes that the country's inflation was mainly due to domestic factors. The high rate of core inflation in October confirms this *(Table 2)*.

4 - Harmonised index of consumer prices (HICP) France and euro zone



Sources: Eurostat; INSEE forecasts

Table 2
Euro-zone inflation by country

HICP, year-on-year changes, %

	HICP		Core inflation		Energy	
	October 2006	October 2007	October 2006	October 2007	October 2006	October 2007*
Austria	1.3	2.9	1.5	1.8	-1.8	7.8 (0.6)
Belgium	1.7	2.2	1.4	1.3	-0.2	4.3 (0.4)
Finland	0.9	1.8	1.2	1.4	-4.5	5.3 (0.4)
France	1.2	2.1	1.5	1.6	-1.7	5.2 (0.5)
Germany	1.1	2.7	0.8	2.0	-0.2	6.3 (0.7)
Greece	3.1	3.0	2.7	2.6	-0.6	7.7 (0.5)
Ireland	2.2	3.0	2.9	2.0	-2.1	5.8 (0.5)
Italy	1.9	2.3	1.8	1.9	1.5	3.1 (0.3)
Luxembourg	0.6	3.6	2.0	2.1	-9.6	10.1 (1.1)
Netherlands	1.3	1.6	1.1	1.0	2.2	5.0 (0.5)
Portugal	2.6	2.5	2.5	1.8	-0.9	6.3 (0.6)
Slovenia	1.5	5.1	1.4	3.0	-0.9	5.4 (0.7)
Spain	2.6	3.6	2.7	2.4	-1.9	7.0 (0.7)
Euro zone	**1.6**	**2.6**	**1.5**	**1.9**	**-0.5**	**5.5 (0.5)**

* In last column, energy-component contribution to overall inflation shown in parentheses
Sources: Eurostat; INSEE computations