# The international economic situation

*In 2007, world GDP is expected to grow at a slightly more moderate pace than last year. Growth should dip in the United States—owing to the country's real-estate crisis since early 2006—but ought to persist in Europe, where the acceleration in real income is likely to stimulate the economies' domestic drivers. The emerging countries, particularly China, India, and Russia, will probably enjoy further robust expansion. South-East Asia may even reaccelerate thanks to the halt in monetary tightening made possible by oil-price stabilization.*

*One major uncertainty still weighs on world growth between now and end-2007: the international environment could turn out to be less buoyant than expected if the U.S. real-estate market's normalization were delayed and if its crisis generated a contagion effect on other demand components. Conversely, the euro zone's domestic engines could prove surprisingly vigorous again, as in 2006.*

## Credit conditions: tightening in Europe and Japan

By and large, monetary conditions tightened in all industrialized countries. However, the prospect of a possible loosening by the Fed has slightly eased U.S. three-month rates and cushioned the impact of the upturn in U.K. and euro-zone interest rates. Meanwhile, consistently with the U.S. pattern, long-term rates started rising again in March.

The markets expect the European Central Bank (ECB) to lift key rates again by year-end. The Bank of England should also continue its rate-hike cycle, since British short-term growth prospects continue to outpace potential growth, with inflation still running high. In Japan as well, the central bank hinted at the likelihood of a fresh rate increase—just when the exit from deflation seemed very slow, particularly given the weakness of wages and salaries. In the U.S., by contrast, the markets expect that moderate economic growth and inflation will lead the Fed to trim rates in mid-year. In most emerging Asian countries, the easing of inflationary tensions led monetary authorities to stop raising key rates by fall 2006—and, in some cases, to lower them.

Since October 2006, the dollar and yen have tended to depreciate in real effective terms, notably against the euro and, to a lesser extent, the British pound. In our forecast, we have stabilized the euro/dollar exchange rate at 1.35 dollars per euro, that is, close to the level observed in recent weeks.

**Table 1**
**Industrialized countries: consolidated supply and use table**

*In real terms*

| | Quarterly change, % | | | | | | | | Annual change, % | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2006 | | | | 2007 | | | | 2005 | 2006 | 2007 |
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | | | |
| GDP | 1.0 | 0.7 | 0.5 | 0.8 | 0.4 | 0.5 | 0.5 | 0.6 | 2.4 | 2.9 | 2.3 |
| Private consumption | 0.7 | 0.6 | 0.4 | 0.8 | 0.6 | 0.6 | 0.7 | 0.6 | 2.4 | 2.3 | 2.5 |
| Public consumption | 1.0 | 0.2 | 0.5 | 0.6 | 0.4 | 0.5 | 0.4 | 0.4 | 1.3 | 1.9 | 1.7 |
| Investment | 1.7 | 0.7 | 0.3 | 0.0 | 0.5 | 0.2 | 0.6 | 0.9 | 4.8 | 3.9 | 1.5 |
| Exports | 3.5 | 1.3 | 1.0 | 2.4 | 0.4 | 1.2 | 1.3 | 1.3 | 6.1 | 9.0 | 4.9 |
| Imports | 2.7 | 0.9 | 0.5 | 0.2 | 1.2 | 0.9 | 1.2 | 1.4 | 5.9 | 6.6 | 3.6 |
| *Contributions to growth* | | | | | | | | | | | |
| Domestic demand excl. inventories | 1.0 | 0.6 | 0.4 | 0.7 | 0.6 | 0.5 | 0.6 | 0.7 | 2.7 | 2.6 | 2.3 |
| Inventories | -0.1 | 0.1 | 0.0 | -0.3 | 0.1 | 0.0 | 0.0 | 0.0 | -0.2 | 0.1 | -0.1 |
| Net exports | 0.1 | 0.0 | 0.0 | 0.4 | -0.2 | 0.0 | 0.0 | -0.1 | -0.2 | 0.2 | 0.1 |

Forecast (shaded: 2007 Q2–Q4 and 2007 annual)

Sources: national data, World Bank, INSEE computations

## Inflation profile dictated by commodity prices

Prices of non-energy industrial commodities have picked up since the start of the year. The barrel price of Brent crude oil has climbed sharply since January 2007; it reached about $65 at end-May, and we have kept it at that level for the present forecasting period.

These resurgent tensions in the commodity markets impacted producer and consumer prices *(Chart 1)*. In our scenario, the energy component will still be shaping the inflation profile at year-end. Inflation is thus set to ease until fall 2007 before moving up again by December. Core inflation should dip slightly in the U.S., post a moderate rise in the euro zone, and stay weak in Japan. In emerging Asia, inflationary tensions due to past surges in commodity prices seem to have abated.

## Economic slowdown in 2007 confined to the U.S.

Global manufacturing prospects brightened in May, in line with the trend observed since the start of the year. Year-on-year growth in world industrial production may reach approximately 6.0% in 2007, slightly down from last year *(Chart 2)*. In contrast, the global Purchasing Manufacturers' Index (PMI) in the service sector has declined since early 2007. Overall, year-on-year GDP growth in the main industrialized countries is forecast to stabilize at around 2% by December.

In the U.S., the real-estate market's downward impact on growth should ease by year-end *(see "The euro zone's main partner countries" chapter)*. The likely reduction in key interest rates and resilient household consumption, fueled by solid real income, should help to sustain activity. However, U.S. growth will probably remain below potential in 2007, while returning to a livelier pace by year-end.

Euro-zone growth should be as vibrant in 2007 as in 2006, thanks to domestic demand—in particular, the acceleration in productive investment *(see "Economic situation in the euro zone" chapter)*. Household consumption has been temporarily dampened by the January rise in Germany's standard VAT rate. Its average annual growth should nevertheless remain steady this year, with the acceleration in employment and further wage gains.

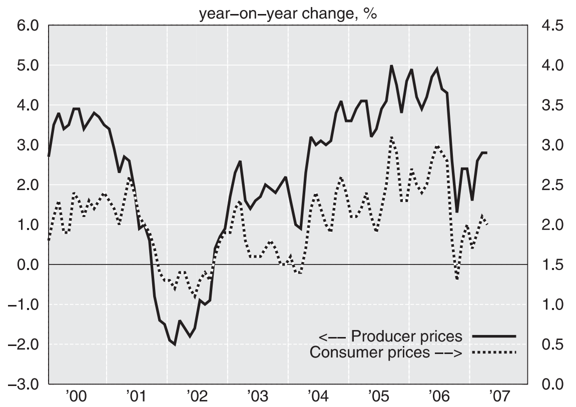
We also expect robust growth in the United Kingdom. After a very good start of the year, it should register no more than a slight dip in H2 due to the current monetary tightening. In particular, British household consumption growth is likely to slacken.

The Japanese economy is set to grow more slowly than in Q1 2007, with business investment showing signs of deceleration after the brisk growth of recent years. In South-East Asia, by contrast, our forecast calls for further strong growth. The region should continue to benefit from thriving external trade and a relatively dynamic industrial sector. At the same time, some major emerging countries, such as China, India, and Russia, should remain on a buoyant growth path.

On balance, world GDP is set to keep growing by more than 4.0% year-on-year. World demand for French products should accelerate in 2007, chiefly thanks to firm euro-zone demand; by the end of the forecasting period, its growth rate should slightly exceed its long-term average. As of mid-2007, we expect world imbalances to remain significant, particularly because of the mildness of the U.S.

1

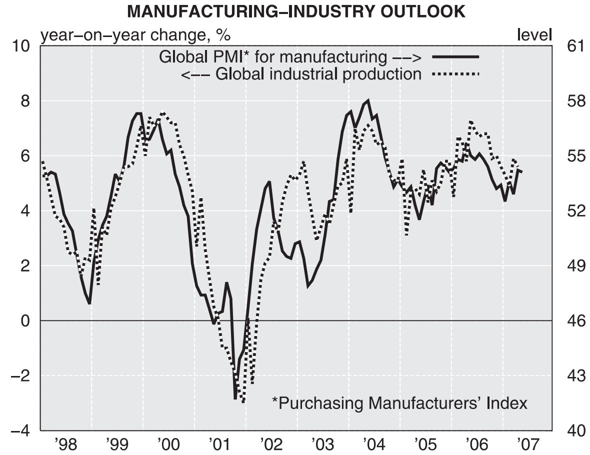
**MAIN INDUSTRIALIZED COUNTRIES: PRODUCER AND CONSUMER PRICES**




*Sources: Eurostat, BLS, ONS, Ministry of Internal Affairs and Communication, INSEE computations*

2

**MANUFACTURING–INDUSTRY OUTLOOK**




*Sources: JP Morgan/NTC, national statistical institutes, INSEE computations* slowdown. Emerging Asia is likely to keep running a large trade surplus *(Chart 3)*.

## A negative uncertainty: the persistence of the U.S. slowdown

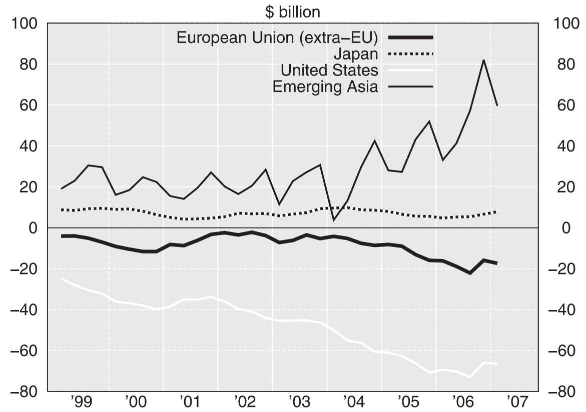
The main unknown in our scenario is the U.S. slowdown and its impact on the other zones. The exit from the real-estate market crisis remains uncertain and could be further delayed. As a result, U.S. households could adopt a cautious behavior and increase their saving ratio. Moreover, the contagion effects on countries that export massively to the U.S.—particularly Asian countries—could prove stronger than expected. On the other hand, the vigor of the cyclical rebound in the euro zone and the halt in U.S. monetary tightening may allow world growth to take off again.

As usual, the outlook for oil prices and the euro/dollar exchange rate remain uncertain. The rise in the Brent price, which began in early 2007, could continue on account of low U.S. gasoline inventories as the driving season approaches, or an increase in geopolitical tensions, especially over Iran's nuclear program. However, an easing of geopolitical tensions at a time when OPEC productive capacity is less constricted than two or three years ago could send prices down as in fall 2006. The pick-up in U.S. activity could, if confirmed, sustain the dollar—as occurred in May, when short-term indicators turned out to be better than forecast. Conversely, any delay in the real-estate market's expected improvement could send the dollar down again. ■

3

TRADE BALANCES

$ billion




*Sources: Eurostat, Japan Tariff Association, BEA, U.S. Census Bureau, other national institutes, INSEE computations*

Table 2
**Main industrialized countries: GDP**

*In real terms*

| | Quarterly change, % | | | | | | | | Annual change, % | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2006 | | | | 2007 | | | | 2005 | 2006 | 2007 |
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | | | |
| Total | 1.0 | 0.7 | 0.5 | 0.8 | 0.4 | 0.5 | 0.5 | 0.6 | 2.4 | 2.9 | 2.3 |
| United States | 1.4 | 0.6 | 0.5 | 0.6 | 0.2 | 0.4 | 0.5 | 0.6 | 3.2 | 3.3 | 1.7 |
| Japan | 0.6 | 0.4 | 0.1 | 1.3 | 0.8 | 0.5 | 0.4 | 0.4 | 1.9 | 2.2 | 2.7 |
| United Kingdom | 0.8 | 0.8 | 0.7 | 0.7 | 0.7 | 0.7 | 0.6 | 0.6 | 1.9 | 2.8 | 2.7 |
| Euro zone, of which: | 0.8 | 1.0 | 0.6 | 0.9 | 0.6 | 0.7 | 0.7 | 0.7 | 1.5 | 2.8 | 2.8 |
| Germany | 0.8 | 1.2 | 0.8 | 1.0 | 0.5 | 0.6 | 0.7 | 0.7 | 1.1 | 3.0 | 2.9 |
| Italy | 0.8 | 0.6 | 0.3 | 1.1 | 0.2 | 0.5 | 0.4 | 0.4 | 0.2 | 1.9 | 2.0 |

Forecast
Sources: national statistical institutes, World Bank, INSEE computations

# The euro zone's main partner countries

*In 2007, according to our forecast, the U.S. economy will be fueled by robust wage and salary growth, but undermined by the real-estate market crisis. GDP growth is set to decline from 3.3% in 2006 to 1.7% in 2007. In the United Kingdom, the economy should expand by 2.7%, nearly matching last year's 2.8%. Domestic demand will likely be vigorous, although the effects of monetary tightening should make themselves felt very gradually. Japan's growth, hit by an investment slowdown, is expected to average 2.7% in 2007, decelerating by year-end.*

*We expect world demand for euro-zone exports in 2007 to remain on the same downward course it has been following since 2004, owing to a slight fall-off in U.S., British, and Japanese imports this year.*

## U.S. growth livelier starting in H2

U.S. job creation is likely to post moderate gains by end-2007 because of the overall economy's slight loss of momentum. At the same time, wage growth is projected to ease somewhat, from 1.1% in Q2 to 0.9% in Q3 and Q4. However, assuming stable oil prices at $65/barrel for Brent crude and $62.50 for West Texas Intermediate (WTI), inflation should ease as well in H2, particularly thanks to the expected mild reduction in core inflation. These developments would put purchasing power on a steady growth path of 0.5-0.6% per quarter by year-end, with household consumption still rising by a fairly brisk 3.3% on an annual average.

Meanwhile, various signals seem to indicate an exit from the real-estate market crisis. First, housing starts and existing-home sales picked up in Q1 2007 *(Chart 1)*. Second, mortgage-loan applications have recovered, returning to their early-2006 level in May. Third, the housing affordability indicator [1] stabilized at a high level in Q1, close to its early-2005 value. The real-estate crisis may therefore have already peaked. However, the increase in the housing stock continues to pose the risk of further adjustment and suggests that the expected stabilization of residential investment may not occur until late 2007.

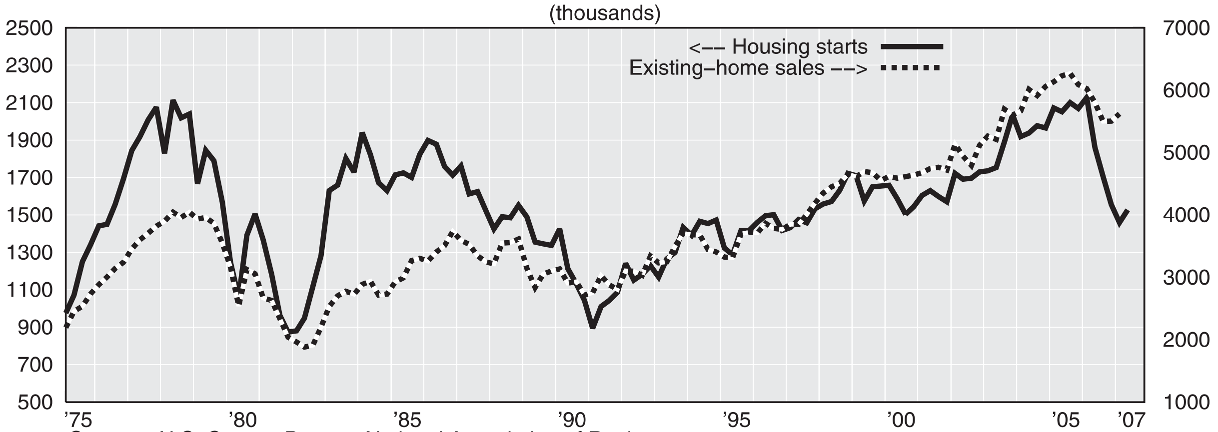
After the end-2006 slowdown, business investment revived in Q1 2007 amid a slight improvement in financing conditions. It is expected to keep rising at a moderate pace. The recent rise in the Institute for Supply Management (ISM) index in manufacturing and higher capacity utilization point to a brighter demand outlook. This should induce firms to invest, but weak margin ratios may restrain them.

1. This indicator declines when a median-income household has greater difficulty obtaining a loan to purchase a median-priced home.

**1**

**U.S. REAL–ESTATE MARKET**

(thousands)




*Sources: U.S. Census Bureau, National Association of Realtors*

By year-end, U.S. exports are expected to grow by about 1.2-1.4%, in line with rather brisk foreign demand. Imports, driven by robust domestic demand, should expand vigorously. The contribution of external trade to GDP growth, which was neutral in Q2, should therefore turn negative at around -0.1 points per quarter in H2. After stabilizing at 5.3% of GDP in H1, the trade deficit will thus widen slightly in H2.

In this scenario, U.S. GDP growth will slip from 3.3% in 2006 to 1.7% in 2007 *(Table 1)*. As in the previous issue of *"Conjoncture in France,"* the main negative uncertainty in our forecast concerns the real-estate market. Although the latest indicators available suggest a gradual exit from the crisis, the problems faced by the riskiest segment of the credit market since the start of 2007 may lead to an all-round tightening of credit-access conditions. This could delay the normalization of residential investment. Conversely, we cannot rule out a stronger-than-expected recovery in business investment.

Table 1
**United States, United Kingdom, and Japan - Supply and use table**

*in real terms*

| | Quarterly change, % | | | | | | | | Annual change,% | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2006 | | | | 2007 | | | | 2005 | 2006 | 2007 |
| | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | | | |
| **UNITED STATES (37.2%)[1]** | | | | | | | | | | | |
| **GDP** | **1.4** | **0.6** | **0.5** | **0.6** | **0.2** | **0.4** | **0.5** | **0.6** | **3.2** | **3.3** | **1.7** |
| Consumption | 1.2 | 0.6 | 0.7 | 1.0 | 1.1 | 0.5 | 0.7 | 0.7 | 3.5 | 3.2 | 3.3 |
| Private investment [2] | 2.0 | -0.4 | -0.3 | -2.4 | -0.9 | -0.6 | 0.2 | 0.8 | 7.5 | 2.9 | -3.1 |
| Government expenditures [3] | 1.2 | 0.2 | 0.4 | 0.8 | 0.2 | 0.8 | 0.5 | 0.5 | 0.9 | 2.1 | 2.1 |
| Exports | 3.3 | 1.5 | 1.7 | 2.6 | -0.2 | 1.4 | 1.2 | 1.2 | 6.8 | 8.9 | 5.0 |
| Imports | 2.2 | 0.4 | 1.4 | -0.7 | 1.4 | 0.9 | 1.1 | 1.5 | 6.1 | 5.8 | 3.3 |
| **Contributions:** | | | | | | | | | | | |
| *Domestic demand excluding inventories* | *1.4* | *0.4* | *0.5* | *0.5* | *0.6* | *0.4* | *0.6* | *0.7* | *3.8* | *3.1* | *2.1* |
| *Inventories* | *0.0* | *0.1* | *0.0* | *-0.3* | *-0.2* | *0.0* | *0.0* | *0.0* | *-0.3* | *0.2* | *-0.4* |
| *Net exports* | *0.0* | *0.1* | *0.0* | *0.4* | *-0.2* | *0.0* | *-0.1* | *-0.1* | *-0.3* | *0.0* | *0.0* |
| **UNITED KINGDOM (5.6%)[1]** | | | | | | | | | | | |
| **GDP** | **0.8** | **0.8** | **0.7** | **0.7** | **0.7** | **0.7** | **0.6** | **0.6** | **1.9** | **2.8** | **2.7** |
| Consumption | 0.0 | 1.1 | 0.3 | 1.0 | 0.6 | 0.9 | 0.7 | 0.6 | 1.4 | 1.9 | 3.0 |
| Total investment | 2.2 | 1.2 | 2.1 | 2.6 | 1.7 | 1.5 | 1.2 | 0.9 | 3.0 | 6.5 | 7.1 |
| Public consumption [4] | 0.7 | 0.7 | 0.7 | 0.8 | 0.4 | 0.5 | 0.5 | 0.5 | 3.0 | 2.8 | 2.3 |
| Exports | 9.3 | 2.3 | -11.1 | -0.4 | -0.6 | 1.0 | 1.0 | 1.0 | 7.9 | 11.6 | -4.8 |
| Imports | 9.6 | 3.6 | -11.1 | -0.2 | -0.6 | 1.5 | 1.3 | 1.3 | 7.0 | 11.8 | -3.8 |
| **Contributions:** | | | | | | | | | | | |
| *Domestic demand excluding inventories [4]* | *0.5* | *1.1* | *0.7* | *1.3* | *0.8* | *0.9* | *0.7* | *0.7* | *2.0* | *2.9* | *3.6* |
| *Inventories* | *0.7* | *0.1* | *-0.5* | *-0.6* | *0.0* | *0.0* | *0.0* | *0.0* | *-0.2* | *0.3* | *-0.7* |
| *Net exports* | *-0.4* | *-0.4* | *0.5* | *0.0* | *0.0* | *-0.2* | *-0.1* | *-0.1* | *0.0* | *-0.4* | *-0.1* |
| **JAPAN (14.8%)[1]** | | | | | | | | | | | |
| **GDP** | **0.6** | **0.4** | **0.1** | **1.3** | **0.8** | **0.5** | **0.4** | **0.4** | **1.9** | **2.2** | **2.7** |
| Consumption | -0.1 | 0.6 | -1.0 | 1.1 | 0.8 | 0.3 | 0.5 | 0.5 | 1.5 | 0.8 | 1.8 |
| Total investment | 2.2 | 0.3 | -0.2 | 2.8 | -0.1 | 0.7 | 0.4 | 0.4 | 2.4 | 3.4 | 2.8 |
| Public consumption | 0.0 | 0.7 | 0.6 | 0.1 | -0.1 | 0.0 | 0.0 | 0.0 | 1.7 | 0.4 | 0.4 |
| Exports | 2.2 | 0.8 | 2.3 | 0.8 | 3.3 | 0.7 | 1.2 | 1.2 | 6.9 | 9.6 | 6.8 |
| Imports | 2.0 | 1.3 | -0.4 | -0.2 | 0.4 | 0.2 | 0.6 | 0.6 | 5.9 | 4.6 | 1.0 |
| **Contributions:** | | | | | | | | | | | |
| *Domestic demand excluding inventories* | *0.4* | *0.5* | *-0.5* | *1.3* | *0.4* | *0.4* | *0.4* | *0.4* | *1.7* | *1.3* | *1.8* |
| *Inventories* | *0.0* | *0.0* | *0.2* | *-0.1* | *0.0* | *0.0* | *0.0* | *0.0* | *-0.1* | *0.0* | *0.0* |
| *Net exports* | *0.1* | *-0.1* | *0.4* | *0.2* | *0.5* | *0.1* | *0.1* | *0.1* | *0.3* | *0.8* | *0.9* |

Forecast

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

## U.K. growth as vigorous in 2007 as last year

In the United Kingdom, GDP growth should remain vigorous in 2007, still largely fueled by domestic demand. The monetary tightening begun in mid-2006 [2] has so far been unable to calm inflationary tensions, nor has it yet slowed the economy: GDP gained another 0.7% in Q1, as in the two previous quarters. So far, the rate hikes have had only a modest impact on the residential real-estate market. In 2007, consumption should therefore continue to be stimulated by positive real-estate wealth effects (*Chart 2*). The further rise in housing prices should allow British households to extract liquidity from their real-estate assets via mortgage loans for a few more months.

The easing of inflation should give additional momentum to household expenditures in the quarters ahead. One factor in this process will be the cuts in gas and electricity prices by British Gas and EDF Energy in H1. Against this background, a new increase of 25 bps in the key rate should bring inflation under its medium-term target of 2%, according to the members of the Bank of England's Monetary Policy Committee. Meanwhile, the current wage dynamics should persist owing to greater tensions in the labor market: unemployment (according to British standards) stood at a modest 2.7% in May. Household purchasing power should therefore accelerate slightly in 2007 *(Table 2)*. Nevertheless, the rise in key rates is expected to gradually aggravate the interest burden on households, all the more so as most of their debt—already exceeding 150% of gross disposable income in Q4 2006—consists of variable-rate loans. On balance, U.K. household consumption should remain lively in 2007, with a mild slowdown not expected until H2. Residential investment is also likely to lose momentum this year because of tighter financing conditions.

Equipment investment should remain lively, stimulated by the combination of vibrant domestic demand and stronger foreign demand. In fact, business leaders are relatively optimistic about their short-term prospects: the April survey by the Confederation of British Industry (CBI) indicates a rather positive production outlook. The latest Purchasing Managers' Index (PMI) surveys report optimism in both services and manufacturing. Given the steadily growing pressure on productive capacity as well, the Q1 dip in non-residential investment was probably a transient phenomenon. The only gradual dampening effect on industrialists' investment plans at year-end may come from earlier hikes in key interest rates. Business investment should thus continue to grow at nearly the same pace as in 2006.

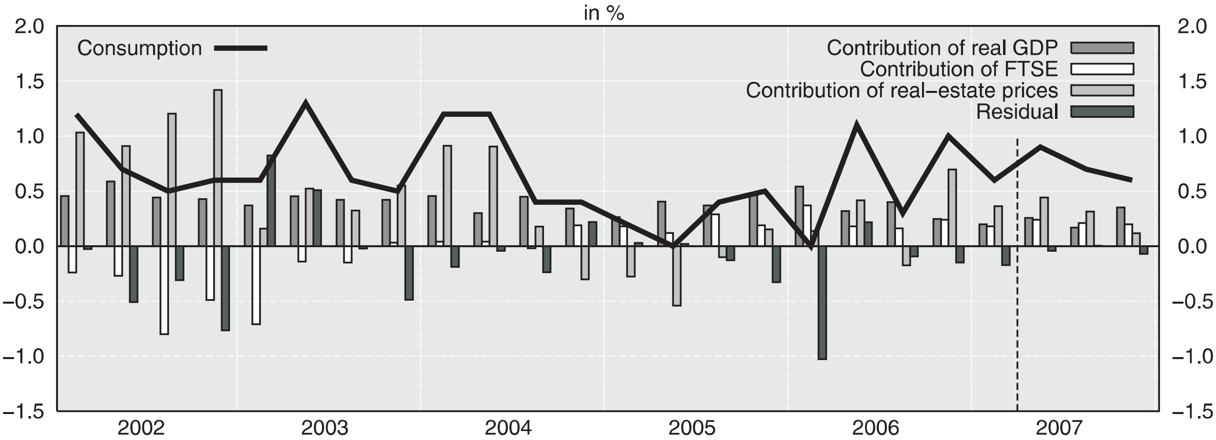
After bottoming out in Q1, British exports are poised to accelerate and should return to a growth path close to that of world demand for U.K. products. A contributing factor will be the more moderate rise in sterling's effective exchange rate since the start of 2007. Imports, as well, are set to rebound in Q2, thanks to robust domestic demand and livelier export growth.

2. 25 basis points in August 2006, November 2006, January 2007, and May 2007.

**2**

**U.K. CONSUMPTION EQUATION**

in %




*Sources: ONS, Central Statistical Office, Halifax, Financial Times, INSEE* *Forecasts to right of dotted line*

How to read this chart:
The curve shows quarterly consumption growth. Consumption is modeled by an econometric equation that comprises real gross disposable income (GDI), real-estate prices, and a financial-wealth indicator (the Financial Times Stock Exchange [FTSE] index). The bars show the contribution to growth made by each of these variables, as well as by the equation's residual. For example, in Q1 2007, consumption grew 0.6%. Real GDI contributed 0.2 points to the rise, financial wealth 0.2 points, and real-estate prices 0.4 points. The residual is equal to -0.2 points.

Overall, Britain's GDP should suffer no more than a mild deceleration by year-end, gaining 0.7% in Q2, and 0.6% in both Q3 and Q4. Given the high statistical overhang, average annual growth is projected to ease from 2.8% to 2.7%—hardly a genuine slowdown. The main uncertainties are the speed of the real-estate market's adjustment to monetary tightening and, more generally, the transmission lags between monetary policy and the real economy.

## A gradual dip in Japanese growth in 2007

Japan will likely have trouble making a clean exit from the deflation that has been weighing on its economy since 1998. Admittedly, real-estate prices have been rising steadily in the largest Japanese cities, particularly Tokyo. However, some deflation mechanisms could persist longer than forecast. Consumer prices excluding energy and food are expected to keep falling on a year-on-year basis, with wage growth still very limp at year-end. The growth in business lending remains rather shaky, as evidenced by the new decline in loans issued by the major national banks in April.

Low wage growth will likely undercut household consumption in the quarters ahead. After building up in recent years, labor-market tensions have eased somewhat, as suggested by the fallback in the supply/demand ratio since early 2007. The recent pattern in the labor market is therefore unconducive to wage growth, all the more so as Japanese firms are still facing pressures on their production costs, notably because of higher commodity prices. As a result, most large corporations granted only very modest pay raises in the spring wage talks ("Shunto"). Yet the latest Tankan survey, in which a growing number of firms report undermanning, indicates that employment should rise in the coming quarters. This did not

3. Machinery orders—excluding demand from power firms and for ships—are a leading indicator for capital spending 3-6 months ahead.

Table 2
**United States, United Kingdom, and Japan - Household accounts**

%

| | Average annual changes | | | |
|---|---|---|---|---|
| | 2004 | 2005 | 2006 | 2007 |
| **United States** | | | | |
| Non-farm payroll employment | 1.1 | 1.7 | 1.9 | 1.1 |
| Average wage per head | 4.3 | 3.3 | 4.5 | 4.2 |
| Nominal gross disposable income | 6.4 | 4.1 | 5.5 | 5.7 |
| Private consumption deflator | 2.6 | 2.9 | 2.7 | 2.1 |
| Real gross disposable income | 3.8 | 1.2 | 2.8 | 3.6 |
| Saving ratio | 2.0 | -0.4 | -1.0 | -0.9 |
| **United Kingdom** | | | | |
| Dependent employment | 1.0 | 0.9 | 0.8 | 0.7 |
| Average wage per head | 3.3 | 3.8 | 3.7 | 3.7 |
| Nominal gross disposable income | 3.4 | 5.1 | 3.7 | 3.6 |
| Private consumption deflator | 1.5 | 2.4 | 2.5 | 2.0 |
| Real gross disposable income | 1.9 | 2.7 | 1.2 | 1.6 |
| Saving ratio | 3.7 | 5.3 | 4.9 | 3.5 |
| **Japan** | | | | |
| Total employment | 0.2 | 0.4 | 0.4 | 0.6 |
| Average wage per head | -1.2 | 0.5 | 1.2 | 0.1 |
| Nominal gross disposable income | 0.7 | 0.2 | 0.8 | 1.1 |
| Private consumption deflator | -0.7 | -0.8 | -0.3 | -0.4 |
| Real gross disposable income | 1.4 | 1.0 | 1.1 | 1.5 |
| Saving ratio (net) | 3.6 | 3.0 | 3.3 | 2.9 |

Forecast
1. Statistical overhang in Q2 or annual average (Japan: income and saving ratio)
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

prevent household confidence from slipping in Q1 2007, particularly as regards durable-goods purchasing intentions. Consumption growth should thus weaken in Q2 2007, before regaining some momentum in H2 with the expected rise in employment and mid-year bonus distributions.

After a Q1 dip, business investment is projected to revive in Q2, thanks to the mild rebound at end-2006 in machinery orders excluding ships and energy [3] and high capacity utilization. Later on, faced with weak domestic demand, Japanese firms are likely to trim their investment. This scenario is outlined in the April Tankan results, which indicate executives' gloomier outlook for sales and profits to year-end *(Chart 3)*. This moderation in capital spending by Japanese firms is also corroborated by the sharp fall in machinery orders in Q1 2007, which should persist in Q2 according to Economic and Social Research Institute (ESRI) forecasts.

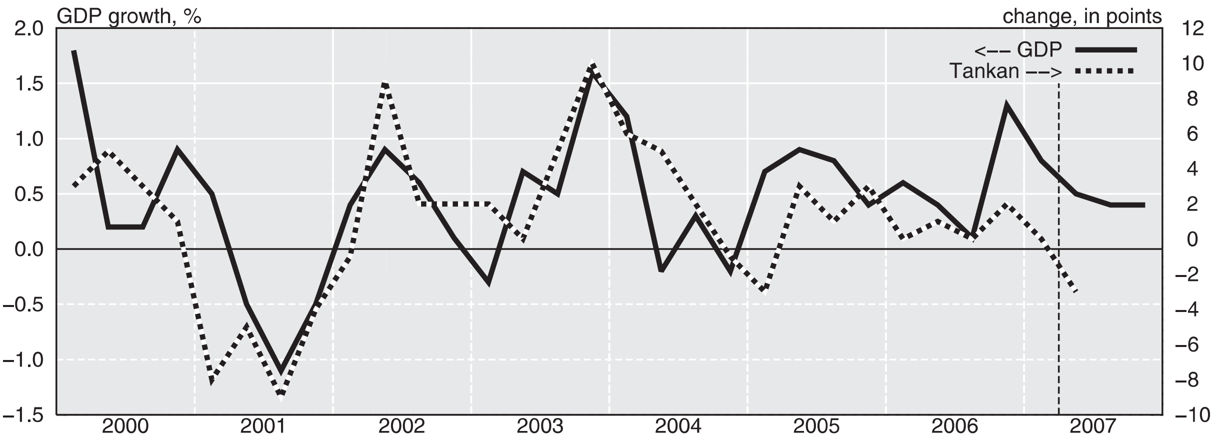
Japanese exports accelerated sharply in Q1 2007, notably thanks to the economic rebound in South-East Asia and despite weaker U.S. demand.

In the quarters ahead, Japan should continue to benefit not only from a very favorable exchange rate for its international trade, but also from vigorous industrial activity in the main Asian countries. China, for instance, shows no tangible sign of slowdown at present. The upswing in domestic demand, particularly business investment, observed in most Asian economies should stimulate Japanese exports. However, these are forecast to stall in Q2 2007, adjusting from their unusual peak at the start of the year. Japan's exports should then regain some vitality, but without returning to their early-2007 growth rate. Meanwhile, imports slowed in Q2 but should reaccelerate slightly in H2, in step with domestic demand.

On balance, Japan's average annual GDP growth is forecast to quicken from 2.2% to 2.7% in 2007. ■

3

**JAPAN : GDP AND TANKAN**
**(business–sentiment indicator, all firms and industries)**




*Sources: Bank of Japan, Economic and Social Research Institute (ESRI)* *Forecasts to right of dotted line*

## Box : How synchronized are Asian economic cycles?

### Favorable economic conditions in Asia

Industrial activity is expected to remain brisk in South-East Asia (including China) until end-2007, with countries in the region continuing to benefit from vibrant external trade and rising domestic demand.

The Chinese economy shows no tangible sign of slowdown. Its year-on-year GDP growth—already above 10% in Q4 2006—topped 11% in Q1 2007. Booming exports and strong investment growth remain the chief engines, despite the central bank's successive rate hikes. This pattern should persist between now and year-end. The year-on-year growth of industrial production might even accelerate, as hinted by the recent profile of the production component in the PMI index, which rose from an average 52.9 in Q1 2007 to 54.6 in May.

Growth is expected to remain vigorous in the rest of South-East Asia as well as in 2007. Last year's inflationary tensions due to higher commodity prices—particularly in Indonesia and Thailand—are dissipating. We therefore expect the monetary easing begun by most of the region's central banks to continue through late 2007. This general lowering of interest rates will stimulate business investment in the quarters ahead. The industrial rebound registered at the start of the year should thus gain momentum in the coming quarters. That is, in fact, the scenario suggested by the rise in the leading indicator in South Korea, Taiwan, and Thailand between January and May 2007. In other words, the South-East Asian countries should benefit from lively domestic demand and robust Chinese growth.

### China and South-East Asia: two distinct cyclical dynamics

Given the divergence that has developed in the past year between the U.S. and Asian countries—principally China—it is important to analyze the links that may exist between the respective cycles of all these countries. We need to examine with special attention Asia's capacity to sustain its growth despite the U.S. slowdown, particularly if the latter accelerates.

For some Asian economies, short-term survey data are available but not for a period long enough to permit cyclical analysis. We have therefore chosen industrial production as the benchmark short-term indicator for the period from January 1994 to March 2007. For consistency with Chinese data, our estimates concern year-on-year changes. Some specific preliminary processing was required: we adjusted China and Taiwan data for the Chinese New Year effect [1] and Indonesian data for the Ramadan effect.[2]

Our analysis of the correlation between South-East Asian countries [3] (China, South Korea, Taiwan, Thailand, Indonesia, and Malaysia) and the economies linked to them (Japan and United States) offers two major lessons:

- The behavior of industrial production in the main Asian countries, except Japan and Taiwan, seems relatively independent of the U.S. industrial cycle, whatever the lags specified for the U.S. industrial production index (IPI).
- Of all the countries studied, the one whose IPI is most closely correlated with the U.S. is Japan. The Japanese IPI is also strongly correlated with the other Asian countries. Japan therefore seems to act as an external-trade intermediary between the U.S. and emerging Asia.

By extracting a specific factor for each country and constraining these factors to similar cyclical characteristics (period and attenuation), we reach the same conclusions *(Table 1)*. The Chinese cycle appears weakly correlated with those of other countries of the region, which, by contrast,

1. As the date of the Chinese New Year is determined by the traditional Chinese lunar-solar calendar, the event can occur in January or February. In the period studied, celebrations began on the following dates: Feb. 10, 1994, Jan. 31, 1995, Feb. 19, 1996, Feb. 7, 1997, Jan. 28, 1998, Feb. 16, 1999, Feb. 5, 2000, Jan. 24, 2001, Feb. 12, 2002, Feb. 1, 2003, Jan. 22, 2004, Feb. 9, 2005, Jan. 29, 2006.
2. As the month of Ramadan is determined by the Muslim calendar, the date falls about ten days earlier each year in the Gregorian calendar. Therefore, the Ramadan effect does not always concern the same month of the Gregorian calendar.
3 Although Hong Kong and Singapore theoretically follow a similar economic cycle, we have excluded them from the scope of investigation because of the inadequate length or frequency of their data series.

Table 1
**Correlation of country-specific factors**

| | Thailand | Taiwan | Indonesia | China | South Korea | Japan | U.S. | Malaysia |
|---|---|---|---|---|---|---|---|---|
| Thailand | 1.00 | 0.25 | 0.58 | -0.08 | 0.56 | 0.49 | -0.27 | 0.52 |
| Taiwan | | 1.00 | 0.02 | 0.16 | 0.41 | 0.52 | 0.45 | 0.49 |
| Indonesia | | | 1.00 | -0.06 | 0.52 | 0.41 | 0.02 | 0.59 |
| China | | | | 1.00 | -0.06 | 0.12 | -0.06 | -0.08 |
| South Korea | | | | | 1.00 | 0.41 | 0.23 | 0.63 |
| Japan | | | | | | 1.00 | 0.33 | 0.70 |
| U.S. | | | | | | | 1.00 | 0.36 |
| Malaysia | | | | | | | | 1.00 |

Sources: national statistical institutes, INSEE form a rather synchronized group. The estimation of a model with two common factors instead of one confirms this dichotomy between China and the other countries of emerging Asia: the first factor explains 85% of the variance of the Chinese IPI, whereas the second accounts for 30-78% depending on the country *(Table 2)*. The economic cycles of South-East Asian countries—in particular, their industrial cycles—are thus effectively synchronized to some extent, but their common dynamic is relatively unconnected with that of the Chinese economy *(Chart)*. ■

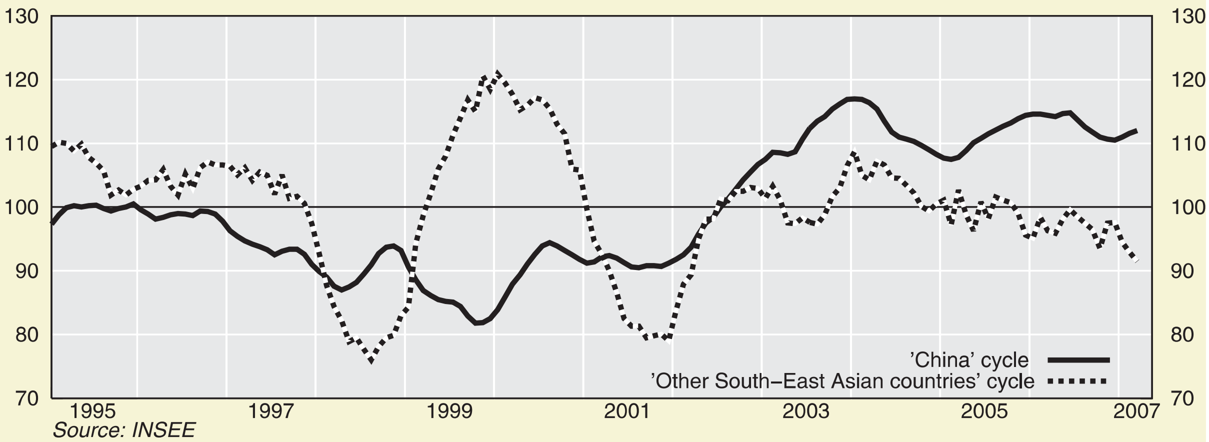
**Table 2**
**Two-factor model - weight and breakdown of variance**

| | Thailand | Taiwan | Indonesia | China | South Korea | Japan | U. S. | Malaysia |
|---|---|---|---|---|---|---|---|---|
| Factor-1 weight | 1.00 | 0.89 | 0.61 | 2.63 | 1.29 | 0.18 | 0.55 | 1.20 |
| Factor-2 weight | 1.00 | 0.83 | 1.51 | 0.15 | 1.59 | 0.92 | 0.31 | 1.83 |
| Share of factor 1 | 2 | 3 | 1 | 85 | 3 | 0 | 4 | 3 |
| Share of factor 2 | 30 | 29 | 40 | 3 | 55 | 51 | 16 | 78 |

Sources: national statistical institutes, INSEE

1

**THE TWO MAIN CYCLICAL FACTORS IN SOUTH–EAST ASIA**




*Source: INSEE*

# Economic situation in the euro zone

*Euro zone GDP grew 0.6% in Q1 2007. Its main engine has been investment (up 2.5%), while the positive 0.5-point contribution of inventory rebuilding appears to have offset a strong negative 0.5-point contribution of external trade. Germany posted a surprisingly vigorous performance, whereas the Italian economy slowed.*

*Household consumption should make up for its 0.1% decline during the rest of the year. The job-market improvement and further wage gains are forecast to drive household spending, which ought to rise 1.7% in 2007—roughly the same pace as last year—despite the increase in German value added tax (VAT).*

*Investment growth is projected to continue accelerating to 6.1% in 2007. External trade should contribute negatively to GDP growth because of weaker world demand and the persist firmness of domestic demand. On average, euro-zone GDP growth should match its 2006 figure of 2.8%.*

## Positive economic trend should persist in 2007

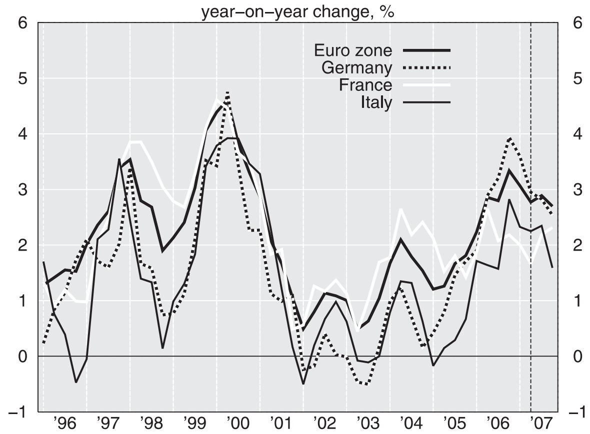
GDP growth slowed in Q1 2007 in the main euro-zone countries except France, which underperformed the zone in late 2006 *(Chart 1)*. Despite the impact of the German VAT increase on household consumption, domestic demand stayed firm thanks to a sharp 2.7% rebound in equipment investment, which had sagged in H2 2006. As in Q4 2006, large inventory changes offset the variation in the trade balance: the two components respectively contributed a positive 0.5 points and a negative 0.5 points to GDP growth *(Table 1)*. Because of the wide swings in the contributions of external trade and inventories in late 2006/early 2007, the two aggregates should be smoothed over the two quarters concerned: when their Q4 2006 and Q1 2007 values are averaged, the contributions of inventories and external trade are nearly zero. In those two quarters, exports and imports posted average growth rates of 1.9% and 1.6% respectively, which are more representative of current trends.

Since early 2007, the business climate in euro-zone industry has stabilized at a high level, despite divergent trends in the main countries *(Chart 2)*. The cyclical differentials peaked in January, then began to converge. However, despite stabler business sentiment in the zone as a whole, industrial production rebounded in Q1. These unusual fluctuations in the past six months may be partly due to a dampening by inventory changes of the unexpected acceleration of foreign demand at end-2006.

**1**

**MAIN EURO–ZONE COUNTRIES: GDP GROWTH**

year–on–year change, %

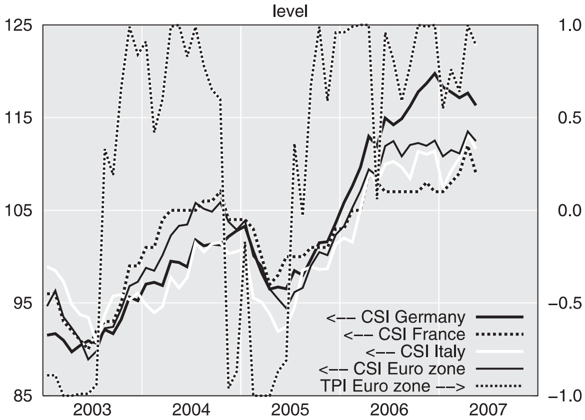



*Sources: Eurostat, Destatis, INSEE, Istat* *INSEE forecasts to right of dotted line*

**2**

**COMPOSITE ˝SYNTHETIC˝ SURVEY INDICATORS (CSIs) AND CYCLICAL TURNING–POINT INDICATOR (TPI)**

level




*Sources: DgEcfin, Ifo, INSEE, INSEE computations*

By contrast, business surveys in the service sector have registered steadily growing optimism since early 2007. They point to balanced growth in the main economic sectors in the quarters ahead, with a rebound in manufacturing and the persistence of a high service-sector contribution to growth. Construction-sector activity is expected to sag because of Germany and Spain; after benefiting from favorable weather conditions in Q1, its positive contribution to growth will probably cease. Euro-zone GDP should grow 0.7% per quarter until year-end, repeating its 2006 performance with an annual average rise of 2.8%.

## Household consumption should stay firm

German household purchases ahead of the VAT rise apparently had a very limited impact on the change in euro-zone private consumption in late 2006. But the price shock in Germany caused the aggregate to lose 0.1% in Q1 2007. Another contributing factor was the unusual weakness of a traditional engine of aggregate euro-zone consumption: Spanish household consumption, which gained a modest 0.2% in Q1 versus a quarterly average of 1.0% in the past four years.

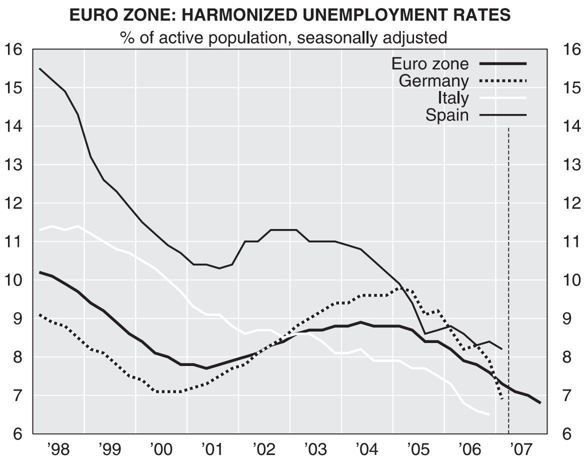
Table 1
**Euro-zone and main countries: GDP and its components**

*annual and quarterly changes, %*

| | 2006 | | | | 2007 | | | | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | | | |
| **GERMANY (29.4%)[1]** | | | | | | | | | | | |
| **GDP** | **0.8** | **1.2** | **0.8** | **1.0** | **0.5** | **0.6** | **0.7** | **0.7** | **1.1** | **3.0** | **2.9** |
| Household consumption | 0.8 | -0.1 | 0.7 | 0.3 | -1.4 | 1.1 | 0.8 | 0.8 | 0.3 | 0.9 | 0.7 |
| Total GFCF | 0.1 | 4.3 | 1.2 | 1.2 | 4.2 | -0.5 | 1.3 | 1.6 | 1.0 | 6.5 | 7.5 |
| Public consumption | 1.6 | -0.3 | 0.7 | -0.3 | 2.1 | 0.0 | 0.0 | 0.0 | 0.6 | 1.5 | 2.1 |
| Exports | 5.2 | 0.7 | 4.3 | 6.0 | -1.2 | 1.7 | 2.1 | 2.1 | 7.1 | 13.4 | 8.6 |
| Imports | 5.8 | -0.6 | 4.0 | 1.1 | 3.7 | 1.8 | 2.5 | 2.5 | 6.7 | 11.9 | 9.9 |
| **Contributions:** | | | | | | | | | | | |
| *Domestic demand excl. inventories* | *0.8* | *0.7* | *0.8* | *0.2* | *0.3* | *0.6* | *0.7* | *0.8* | *0.7* | *2.0* | *2.1* |
| *Inventory change* | *0.0* | *0.0* | *-0.3* | *-1.6* | *2.2* | *0.0* | *0.0* | *0.0* | *0.1* | *-0.4* | *0.9* |
| *Net exports* | *0.1* | *0.5* | *0.5* | *2.4* | *-2.0* | *0.0* | *0.0* | *0.0* | *0.3* | *1.4* | *-0.1* |
| **ITALY (17.9%)[1]** | | | | | | | | | | | |
| **GDP** | **0.8** | **0.6** | **0.3** | **1.1** | **0.3** | **0.5** | **0.4** | **0.4** | **0.2** | **1.9** | **2.1** |
| Household consumption | 0.5 | 0.4 | 0.5 | 0.3 | 0.7 | 0.4 | 0.3 | 0.3 | 0.6 | 1.5 | 1.8 |
| Total GFCF | 1.8 | 0.4 | -0.4 | 2.0 | 0.7 | 0.9 | 0.9 | 0.9 | -0.2 | 2.5 | 3.5 |
| Public consumption | -0.3 | -0.1 | 0.2 | 0.0 | 0.1 | 0.1 | 0.0 | 0.0 | 1.5 | -0.3 | 0.2 |
| Exports | 2.3 | 1.3 | -1.8 | 4.3 | 0.4 | 0.5 | 1.0 | 1.0 | 0.0 | 5.4 | 4.1 |
| Imports | 1.2 | 0.3 | 2.2 | 1.7 | -0.9 | 0.5 | 1.0 | 1.0 | 1.0 | 4.4 | 2.6 |
| **Contributions:** | | | | | | | | | | | |
| *Domestic demand excl. inventories* | *0.6* | *0.3* | *0.3* | *0.6* | *0.6* | *0.4* | *0.4* | *0.4* | *0.6* | *1.3* | *1.8* |
| *Inventory change* | *-0.1* | *0.0* | *1.1* | *-0.1* | *-0.7* | *0.0* | *0.0* | *0.0* | *-0.1* | *0.4* | *-0.2* |
| *Net exports* | *0.3* | *0.3* | *-1.1* | *0.7* | *0.4* | *0.0* | *0.0* | *0.0* | *-0.3* | *0.3* | *0.4* |
| **EURO ZONE (27.8%)[2]** | | | | | | | | | | | |
| **GDP** | **0.9** | **0.9** | **0.6** | **0.9** | **0.6** | **0.7** | **0.7** | **0.7** | **1.6** | **2.8** | **2.8** |
| Household consumption | 0.5 | 0.3 | 0.7 | 0.4 | -0.1 | 0.8 | 0.7 | 0.7 | 1.6 | 1.8 | 1.7 |
| Total GFCF | 1.2 | 2.1 | 1.0 | 1.5 | 2.5 | 0.7 | 1.2 | 1.4 | 2.8 | 5.0 | 6.1 |
| Public consumption | 1.1 | 0.1 | 0.6 | 0.4 | 0.8 | 0.3 | 0.3 | 0.3 | 1.4 | 2.0 | 1.9 |
| Exports | 3.6 | 1.0 | 1.4 | 3.5 | 0.3 | 1.2 | 1.4 | 1.4 | 4.4 | 8.2 | 5.8 |
| Imports | 2.7 | 0.8 | 2.1 | 1.7 | 1.6 | 1.2 | 1.7 | 1.7 | 5.3 | 7.8 | 6.3 |
| **Contributions:** | | | | | | | | | | | |
| *Domestic demand excl. inventories* | *0.8* | *0.7* | *0.7* | *0.6* | *0.6* | *0.7* | *0.7* | *0.8* | *1.7* | *2.5* | *2.6* |
| *Inventory change* | *-0.2* | *0.2* | *0.1* | *-0.4* | *0.5* | *0.0* | *0.0* | *0.0* | *0.1* | *0.1* | *0.3* |
| *Net exports* | *0.4* | *0.1* | *-0.2* | *0.7* | *-0.5* | *0.0* | *-0.1* | *-0.1* | *-0.2* | *0.3* | *-0.2* |

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

3



Source: Eurostat INSEE forecasts to right of dotted line

In one year, euro-zone unemployment has shed nearly one point, driven by Germany's steep 1.8-point decrease *(Chart 3)*. By contrast, job creation in Spain slowed during the period, while continuing to run well above those of other leading euro-zone countries. Fueled by the economic acceleration to date, the likely further improvement in the euro-zone job market should begin to put upward pressure on wages in 2007. One example is the spring round of wage agreements in the main German industries, which provide for pay raises of 3.5-4.0% over a year. At the euro-zone level, however, the upswing in the total wage bill should be dampened by the expected slowdown in Italy, where the exceptional pay raises in the civil service in 2005 and 2006 will probably not be repeated this year.

The tax policies of the main euro-zone countries should be neutral in terms of the contribution of net levies to household income growth by comparison with 2006. In 2007, real household income is forecast to gain 1.8%, or 0.8 points more than in 2006 *(Table 2)*. Euro-zone household consumption should therefore stage a vigorous 0.8% rebound in Q2. This would put its annual growth for the year at 1.7%, nearly matching the 2006 figure of 1.8%.

## Acceleration in equipment investment and a mild slowdown in construction

Investment was the main engine of euro-zone growth in Q1, rising 2.5%. Equipment expenditures jumped 2.7%, amid buoyant industrial production. Construction activity additionally benefited from unseasonally mild temperatures, particularly in Germany and France. As a result, construction investment gained 1.7% in Q1 2007.

Between now and year-end, productive investment should be fueled by brighter demand prospects and productive-capacity saturation *(Chart 4)*. In Germany, firms are also likely to complete certain investment projects in H2 in order to take advantage of more generous write-off provisions before these expire in early 2008. In Italy, the halt in the decline of the corporate margin ratio should

**Table 2**
**Euro-zone: Household accounts**

*annual and quarterly % changes*

| | 2006 | | | | 2007 | | | | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | | | |
| Total wage bill | 1.0 | 0.9 | 0.9 | 0.7 | 0.9 | 0.9 | 1.1 | 1.1 | 2.6 | 3.7 | 3.7 |
| - Employment | 0.5 | 0.5 | 0.3 | 0.3 | 0.5 | 0.5 | 0.5 | 0.5 | 0.8 | 1.4 | 1.7 |
| - Unit wage | 0.5 | 0.4 | 0.6 | 0.4 | 0.4 | 0.4 | 0.6 | 0.6 | 1.8 | 2.3 | 2.0 |
| Gross disposable income | 0.8 | 0.8 | 1.3 | 0.1 | 1.1 | 0.9 | 1.0 | 1.1 | 3.1 | 3.2 | 3.6 |
| Saving ratio (% of GDI) | 13.1 | 13.0 | 13.2 | 12.8 | 13.4 | 13.1 | 13.0 | 12.8 | 13.7 | 13.0 | 13.1 |
| Household consumption deflator | 0.6 | 0.5 | 0.4 | 0.2 | 0.5 | 0.5 | 0.4 | 0.6 | 2.0 | 2.2 | 1.8 |
| Real total wage bill | 0.4 | 0.4 | 0.4 | 0.5 | 0.4 | 0.4 | 0.7 | 0.5 | 0.6 | 1.5 | 1.9 |
| - Real unit wage | 0.0 | -0.1 | 0.2 | 0.2 | -0.1 | -0.1 | 0.2 | 0.0 | -0.2 | 0.1 | 0.2 |
| Purchasing power of GDI | 0.2 | 0.3 | 0.9 | -0.1 | 0.6 | 0.4 | 0.6 | 0.5 | 1.1 | 1.0 | 1.8 |

Forecast
Sources: Eurostat, INSEE computations

keep productive investment on a robust growth path. In sum, after an outstanding performance early in the year, euro-zone equipment investment will likely return to a more subdued rate of 1.0% in Q2, quickening slightly in H2. Its average annual growth should therefore improve to 6.3% in 2007.

The construction industry's exceptionally strong expansion in early 2007 is expected to undergo a correction in Q2, with construction investment losing 0.2%. The aggregate should then grow at a very moderate pace. One factor in this forecast is the apparent slowdown in the Spanish construction industry after an eight-year boom *(see "Unbuilding castles in Spain?" box)*. A second factor is the impact of the elimination of German tax incentives: although they ended a year ago, they continued to stimulate construction activity in 2006 owing to the usual lags between the issuance of building permits and work completion. On an annual average, construction investment is forecast to grow by a slightly slower 4.1% in 2007.

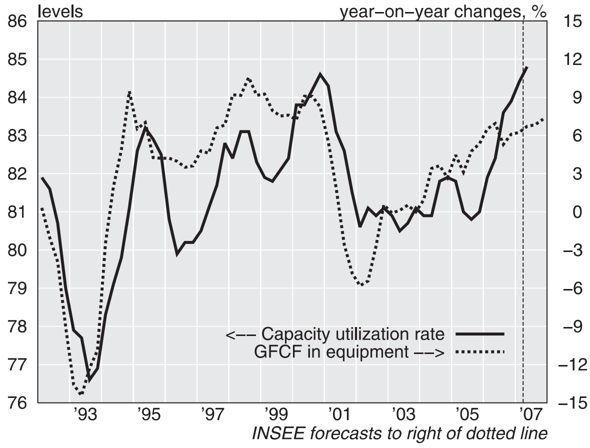
## External trade likely to make a negative contribution to growth

In line with robust industrial activity, euro-zone imports remained on a strong growth path in Q1 2007, gaining 1.6%. The exceptional end-2006 surge in foreign demand from secondary trade partners did not last into early 2007. In fact, it triggered a correction in Q1, with euro-zone exports edging up a mere 0.3%. Q1 2007 thus witnessed the opposite of the phenomenon observed at end-2006: a strong negative 0.5-point contribution of external trade to euro-zone GDP growth, but offset by inventory changes, particularly in Germany.

By year-end, exports should therefore post more moderate gains than in 2006, rising 1.2% in Q2 and 1.4% per quarter in H2 *(Chart 5)* consistently with slacker foreign demand. After a sharp rise in early 2007, import growth is expected to slow to 1.2% in Q2 then move in step with domestic demand and exports, gaining 1.7% per quarter in H2. All in all, after a positive contribution to growth in 2006, external trade is likely to detract from it in all major euro-zone countries in 2007 except Italy, with a negative 0.2-point contribution for the entire zone. ■

4

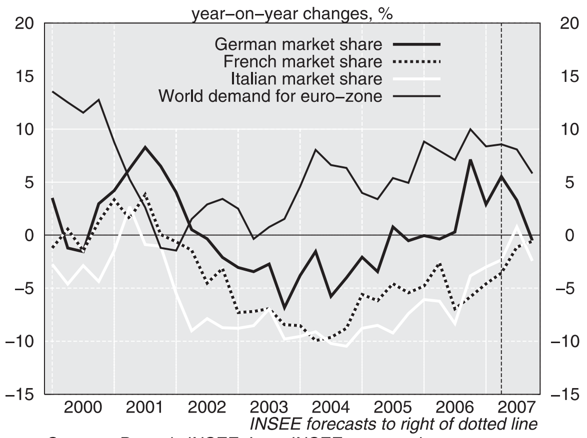
**PRODUCTIVE CAPACITY UTILIZATION RATE AND PRODUCTIVE INVESTMENT**




*Sources: Eurostat,INSEE computations*

5

**WORLD DEMAND FOR EURO-ZONE EXPORTS AND MAIN COUNTRIES' MARKET SHARE**




*Sources: Destatis,INSEE, Istat, INSEE computations*

## End of the "Kartell" of the six German institutes

In February 2007, the German Economy Ministry announced its intention to reform the organization of the joint economic forecasting exercise (*Gemeinschaftsdiagnose*), which results in the publication of the "Six Institutes" report. This semi-annual forecast (April and October), issued for over fifty years now, had been commissioned since unification from six German institutes of economic analysis: Ifo (Munich), DIW (Berlin), RWI (Essen), IfW (Kiel), IWH (Halle), and HWWA (Hamburg).[1]

For the next report, due in October 2007, the Economy Ministry has decided to launch a call for bids, repeated every three years, to select no more than four candidates. The chosen institutes will be asked to publish forecasts for the current and following years twice a year, in spring and fall, as in the present arrangement. For the spring report, the group will also have to prepare a medium-term five-year forecast. A Ministry representative will join the working group as an observer.

The major innovation is that all European economic institutes can bid, provided that they are independent and that German remains the group's working language. The main selection criteria will be the institutes' experience and the quality of their economic work. Another original feature is that institutes can submit proposals singly or with another institute in order to give greater weight to their bid (for joint proposals, the selection will count the bidders as a single institute).

Proposals were submitted in mid-May and the results of the procedure should be known by the time this report is published. ■

1. Only five institutes participated in the spring 2007 report, the evaluation authority having found the quality of HWWA work inadequate.

## Unbuilding castles in Spain?

### Spain outside the euro-zone construction cycle

Since the early 1990s, Spain's construction cycle has been highly atypical by comparison with other euro-zone countries. The real-estate sector rebounded swiftly from the 1993 crisis, and—above all—it enjoyed outstanding growth for more than a decade afterward. In 2006, Spain's residential-housing investment rate topped 9%, compared with 3-6% among its neighbors since the mid-1980s *(Chart A)*.

### Swollen capacity

The steady, decade-long rise in the residential-construction investment rate resulted in uninterrupted growth of the construction sector's share of total value added. The share jumped from 7% to 12% during the period, versus a maximum rise of 1 point among its neighbors during the same cycle (by comparison, the average share in the euro-zone was 6.4% in 2006). Since 1996, the Spanish construction sector's mean contribution to annual GDP growth has been running at 0.5 points, or 0.4 points above the euro-zone figure. In all, the Spanish construction industry accounted for nearly 0.5 points of euro-zone GDP growth in 1996-2006.

In the past ten years, Spain has been responsible for more than a third of all jobs created in the euro zone, or nearly 6 million out of 16.5 million; in the early 2000s, its share exceeded one half. Unlike in the three other major euro-zone countries, Spain's job creation did not lose significant momentum in that period. The Spanish construction industry added more than 20% of these new jobs. It thus provided one in every 12 jobs created in the euro zone in the past decade.

The construction sector's weight in the Spanish economy has nearly doubled in the current cycle. It exerts a substantial influence both on production and—indirectly—on demand via the stimulus given by new jobs to household income formation.

### A response to atypical demand among the main euro-zone countries

Two factors have fueled housing demand and hence construction-industry growth. First, Spain's demographics have been distinctly more dynamic than the euro-zone average: its population grew by an annual average 0.5% from 1996 to 2000, and has since been rising by 1.6%, as against the euro-zone's 0.4% and 0.6% respectively. This powerful performance is largely due to migrations of adult workers, who account for 55% of new entrants in the labor market. The increase in the number of households is, no doubt, even more significant, as suggested by the annual average 3.8% surge in the labor force in the past five years. The phenomenon is arguably responsible for the sustained growth in housing demand.

Second, Spain's monetary and financial integration into the euro zone has led to a sharp fall in real interest rates *(Chart B)*. Household credit access has also been facilitated by longer loan maturities, easier lending terms, and lower borrowing costs thanks to the widening use of variable-rate loans—which accounted for 93% of new real-estate loans in 2006. In sum, financing conditions have distinctly improved for households, stimulating real-estate purchases.

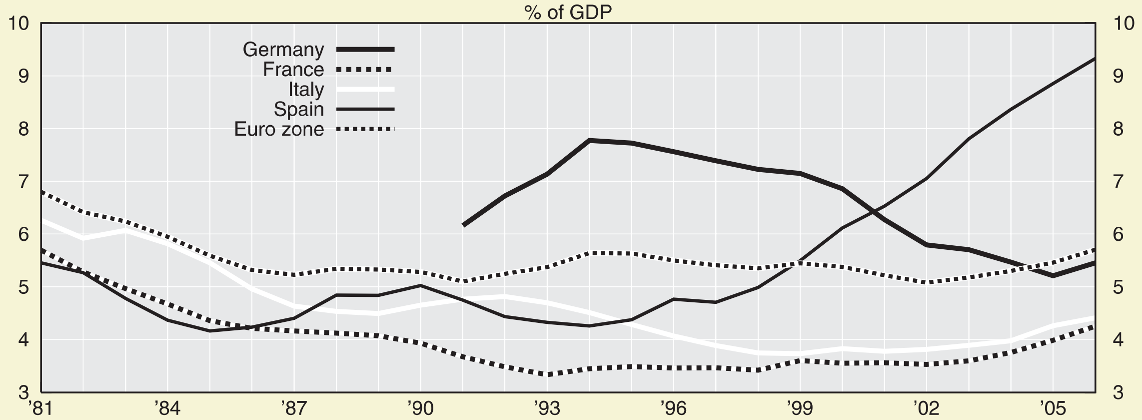
### But the recent trend calls for a downward adjustment

While the fall in interest rates has powerfully boosted construction growth in Spain since the start of the present cycle, the European Central Bank's monetary tightening may have the opposite effect. On the household demand side, the new rate hikes would discourage real-estate investment by increasing the cost of loans. On the credit supply side, households would find it harder to borrow, all the more so as the household debt ratio has literally exploded from 50% to 125% in ten years and aggravated the insolvency risk.

**A**

**RESIDENTIAL–CONSTRUCTION INVESTMENT RATE**

% of GDP




*Sources: Eurostat, INSEE computations*

The slowdown in real-estate prices since 2004 indicates that a market adjustment is under way. The implicit risk premium for holding real-estate assets has declined in the past three years—a sign that the return on construction investment has, no doubt, become inadequate *(Chart C)*.[1] It is now near the level observed before the bursting of the speculative bubble in the early 1990s. Although this pattern does not portend a correction in the coming quarters as abrupt as the one that followed the earlier bubble, it does point to the need for a further slowdown in real-estate prices and, correlatively, in construction-sector activity.

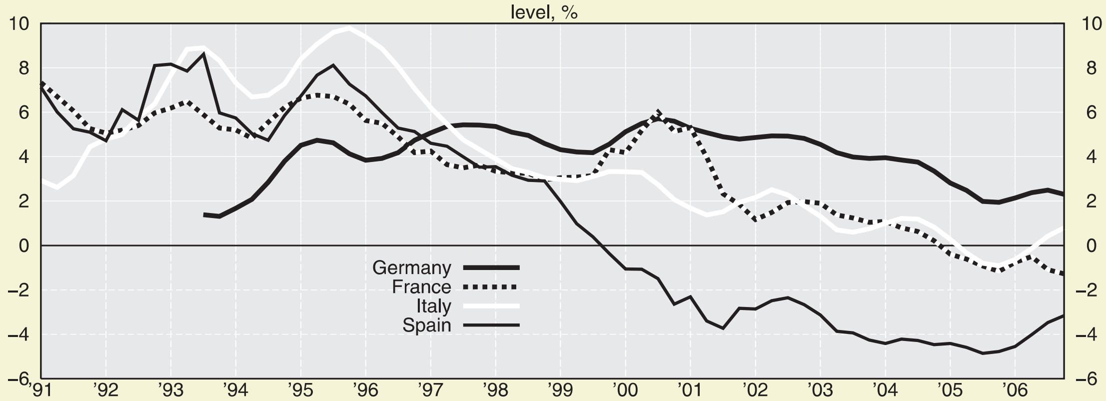
The effects of such an adjustment for the Spanish economy would not be confined to the construction sector. Typically, a construction slowdown entails a swift and drastic correction in employment levels, owing to the precariousness of work contracts in the sector. This has a perceptible impact on income. A slowdown would compound the effect of an increase in interest payments on existing loans—due to the widespread adoption of variable-rate loans—and could significantly dampen consumption and global demand. Without necessarily undermining the Spanish model, this scenario would take the economy back to a growth path closer to its potential. ■

1. The model used to determine the risk premium is described in the article "Are we seeing a bubble on the French housing market?" (A.J. Bessone, B. Heitz, and J. Boissinot), "*Conjoncture* in France," March 2005.

**B**

**LONG–TERM REAL INTEREST RATE**
**(DEFLATED BY PRICES OF RESIDENTIAL REAL–ESTATE INVESTMENT)**

level, %

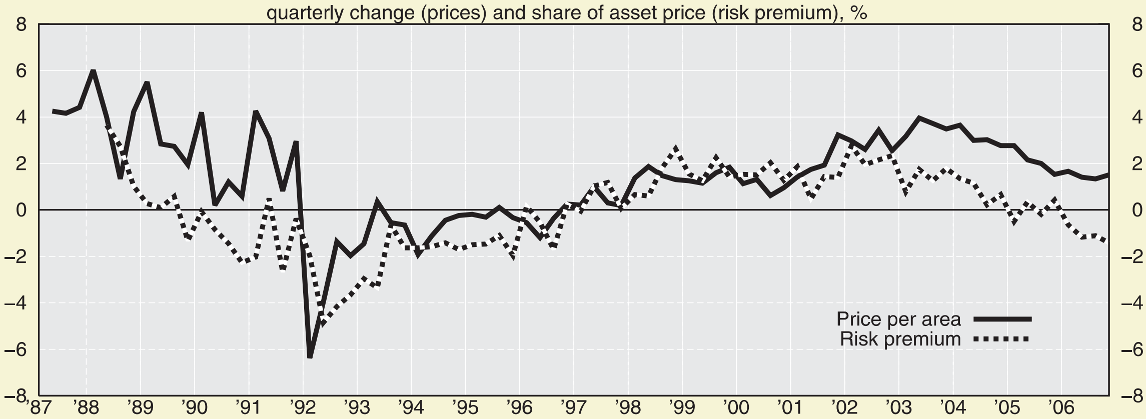



*Sources: Eurostat, INSEE computations*

**C**

**REAL–ESTATE PRICES AND RISK PREMIUM**

quarterly change (prices) and share of asset price (risk premium), %




*Sources: Banco de España, INE, INSEE computations*

# Consumer prices in the euro zone

*Since January 2007, year-on-year euro-zone inflation has been fluctuating between 1.8% and 1.9%, and is expected to stay inside that range in June 2007. Assuming a stable oil price of $65/barrel and a steady exchange rate of $1.35 to the euro, its profile in H2 will be largely shaped by energy inflation. The latter should be subject to base effects due to the wide swings in the price of Brent crude in H2 2006. We therefore expect year-on-year inflation to ease to 1.5% in August before reviving to over 2.0% by December.*

*Core inflation was spurred by the early-2007 increase in Germany's standard VAT rate. In our scenario, core inflation will keep rising to 2.0% in December, driven by high capacity utilization, the labor-market improvement, and the mild acceleration in labor costs in market services. This uptrend should, however, be dampened by lower import prices due to the euro's recent appreciation.*

## The energy component should dictate the inflation profile

In Q1 2007, the price of Brent crude oil fluctuated sharply. After a sizable decline at the start of the year, it flared up in March with the abduction of British sailors by Iran. However, as Brent did not return to its 2006 level, year-on-year energy price growth eased from 2.9% in December 2006 to 0.3% in May 2007.

Energy inflation should continue to recede to a negative 2.1% in August 2007 because of a base effect: this reflects the decline in the Brent barrel price from $70 in summer 2006 to a forecast $65 or so in H2 2007. By December, year-on-year energy inflation should converge toward its 2006 value, reaching 3.4% *(Table 1)*.

## Food inflation set to decline by year-end

Food prices (including alcohol and tobacco) lost some momentum in Q1 2007. The significant decline in fresh-produce inflation in Mediterranean countries, due to a very clement winter, more than offset the steep rise in Spanish tobacco prices. As a result, the year-on-year change in euro-zone food prices eased from 2.7% to 2.3% between December 2006 and March 2007.

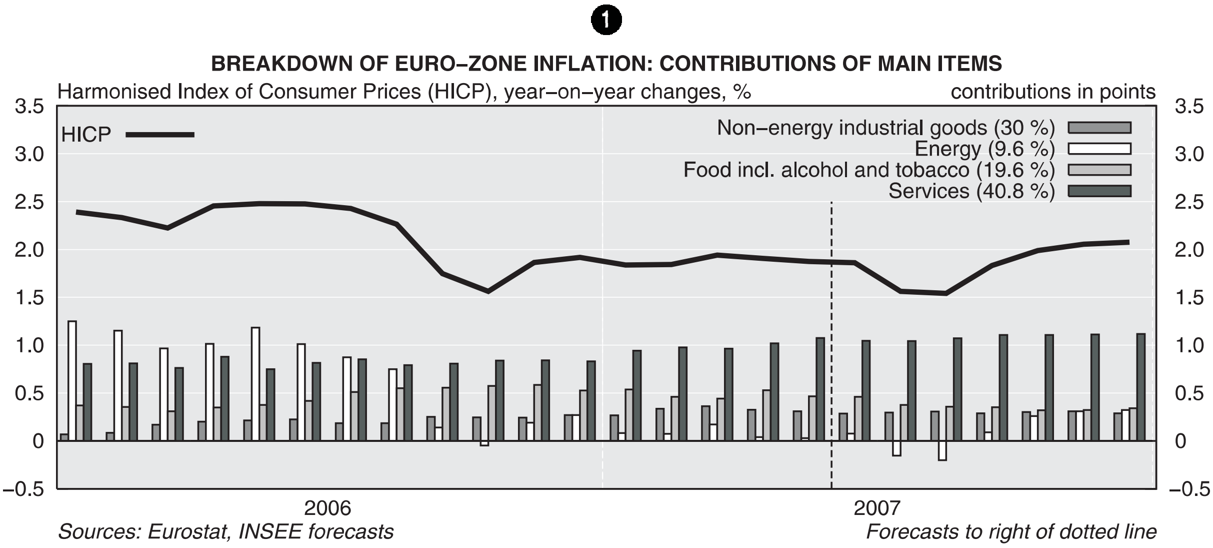
The April drought episode and the highly irregular weather in early May created adverse conditions for fruit and vegetable harvests in Europe, triggering a highly unseasonal rise in unprocessed-food prices in early Q2 2007. Assuming the

Table 1
**Euro-zone inflation**

*% changes*

| Sectors (weights in 2006 index) | Year-on-year changes | | | | | Annual average | | |
|---|---|---|---|---|---|---|---|---|
| | **June 2006** | **Dec. 2006** | **May 2006** | **June 2007** | **Dec. 2007** | **2005** | **2006** | **2007** |
| **Total (100.0%)** | **2.5** | **1.9** | **1.9** | **1.9** | **2.1** | **2.2** | **2.2** | **1.9** |
| **Food (incl. alcohol and tobacco) (19.3%)** | **2.2** | **2.7** | **2.4** | **2.4** | **1.7** | **1.6** | **2.4** | **2.1** |
| *of which Food (15.3%)* | *2.0* | *2.6* | *2.1* | *2.0* | *1.6* | *0.7* | *2.3* | *1.8* |
| *Alcohol and tobacco (4.0%)* | *2.8* | *3.2* | *3.6* | *3.6* | *2.4* | *4.9* | *2.7* | *3.3* |
| **Energy (9.2%)** | **11.0** | **2.9** | **0.3** | **0.8** | **3.4** | **10.1** | **7.7** | **0.9** |
| **Core inflation (71.5%)** | **1.5** | **1.5** | **1.9** | **1.9** | **2.0** | **1.4** | **1.4** | **1.9** |
| *of which: Non-energy industrial goods (30.7%)* | *0.7* | *0.9* | *1.0* | *1.0* | *1.0* | *0.3* | *0.6* | *1.0* |
| *Services (40.8%)* | *2.0* | *2.0* | *2.6* | *2.6* | *2.7* | *2.3* | *2.0* | *2.6* |

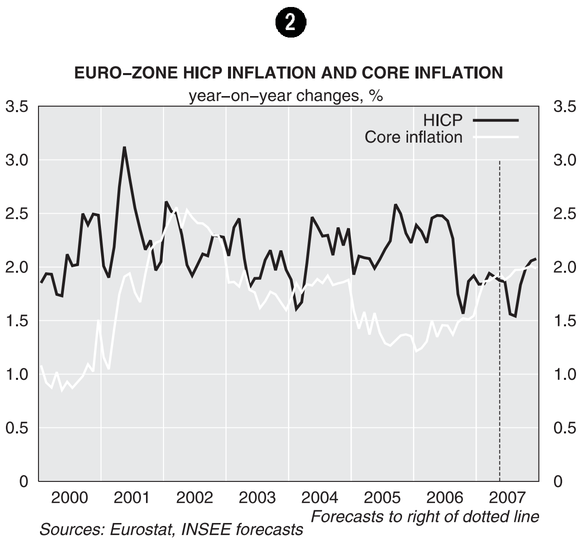
Forecast
Sources: Eurostat, INSEE forecasts




weather returns to normal, food inflation should recede this summer. A new decline is expected in October, thanks to the elimination of the effect of the year-earlier increase in German tobacco prices *(Chart 1)*.

## Core inflation on a slow uptrend

The 3-point rise in Germany's standard VAT rate on January 1 largely explains the increase in core inflation[1] from 1.5% in Q4 2006 to 1.8% in Q1 2007 *(Chart 2)*. The effect of the measure was concentrated in January for service prices but has been more scattered for non-energy industrial goods prices. Two phenomena specific to Italy also contributed to the pick-up in core inflation: first, steeper-than-usual price rises for clothing after the clearance-sale period; second, an exceptional increase in healthcare prices.




After a mild downturn in May, year-on-year non-energy industrial goods inflation should stabilize at around 1.0% until end-2007 *(Table 1)*. By lowering import prices, the euro's recent appreciation will likely offset the pressures exerted by high capacity utilization on producer prices in manufacturing. Moreover, despite recent pay raises in the German metalworking and chemical industries, the rise in unit labor costs will likely remain subdued.

After three months of stability, inflation in euro-zone services rose in April. One of the reasons was the surge in tuition fees in Germany's education sector.[2] Service prices should move to a calmer growth path as the labor market continues to improve: unemployment, at 7.2% in February, has reached a 15-year low. The slight acceleration in labor costs in market services is also projected to contribute to the increase. We thus expect service-sector inflation to reach 2.7% by end-2007 *(Table 1 and Chart 1)*.

On balance, the leveling-off of non-energy industrial goods inflation, combined with the slight acceleration in service prices, should send core inflation on a moderate growth path to 2.0% at year-end *(Chart 2)*. Energy prices are thus expected to be the chief determinant of the overall inflation profile.

1. Core inflation, as defined by Eurostat (the EU statistical institute), is not adjusted for tax measures.
2. In May 2005, the German Federal Constitutional Court authorized universities to introduce tuition fees. The universities did so for the first time in April 2007 for the summer semester, entailing a 25% rise in German education prices.

Table 2
**Euro-zone inflation by country**

*HICP, year-on-year changes, %*

| | HICP | | Core inflation | | Energy | |
|---|---|---|---|---|---|---|
| | May 2006 | May 2007 | May 2006 | May 2007 | May 2006 | May 2007* |
| Austria | 2.1 | 2.1 | 1.4 | 1.9 | 10.5 | 0.8 (0.1) |
| Belgium | 2.8 | 1.3 | 1.6 | 1.5 | 13.2 | -3.4 (-0.4) |
| Finland | 1.7 | 1.3 | 0.6 | 1.5 | 13.1 | -0.5 (0.0) |
| France | 2.4 | 1.2 | 1.4 | 1.6 | 12.6 | -1.4( -0.1) |
| Germany | 2.1 | 2.0 | 0.4 | 1.9 | 13.6 | 1.9 (0.2) |
| Greece | 3.3 | 2.6 | 2.3 | 3.0 | 14.3 | -0.2 (0.0) |
| Ireland | 3.0 | 2.7 | 2.1 | 2.6 | 13.1 | 2.7 (0.2) |
| Italy | 2.3 | 1.9 | 1.7 | 1.8 | 10.5 | -0.2 (0.0) |
| Luxembourg | 3.6 | 2.3 | 2.2 | 2.1 | 15.8 | -2.0 (-0.2) |
| Netherlands | 1.8 | 2.0 | 0.9 | 1.8 | 11.0 | 4.8 (0.5) |
| Portugal | 3.7 | - | 2.4 | - | 14.0 | - |
| Slovenia | 3.4 | 3.1 | 1.5 | 2.2 | 15.0 | 2.7 (0.3) |
| Spain | 4.1 | 2.4 | 2.9 | 2.6 | 14.3 | -1.6 (-0.2) |
| **Euro zone** | **2.5** | **1.9** | **1.3** | **1.9** | **12.9** | **0.3 (0.0)** |

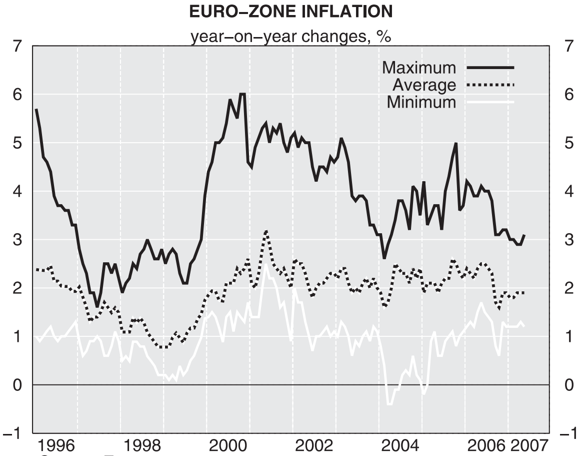
* In last column, energy-component contribution to overall inflation shown in parentheses
Sources: Eurostat, INSEE computations

## The inflation gap between euro-zone countries is stabilizing

Between January and May 2007, the gap between the highest and lowest euro-zone inflation rates stabilized at around 1.8 points. As of this writing, the country with the mildest inflation is France, at 1.2% *(Table 2 and Chart 3)*.

From December 2006 to March 2007, the inflation differential between the French and euro-zone Harmonised Indices of Consumer Prices (HICPs) widened to 0.7 points in France's favor *(Chart 4)* as the result of two factors. First, the exceptionally mild weather in France and the effects of the implementation of the second phase of the Galland Act on January 1, 2007,[3] appear to have sent food prices on a steeper downtrend in France than in the euro zone as a whole. The second factor was the German VAT hike, which was not offset by a comparable reduction in social contributions and which had repercussions throughout Q1. It contributed to a 0.3-point rise in euro-zone inflation and a corresponding increase in the differential with France. Two phenomena should narrow the gap temporarily in fall 2007. The first is the pick-up in energy inflation: we expect it to be slower in the euro zone than in France, owing to the milder decline in euro-zone fuel prices in fall 2006. The second involves food inflation, which should ease in the euro zone because of a positive base effect due to German tobacco prices (see above); in France, by contrast, food inflation is expected to revive, as the atypical fall in unprocessed-food prices in 2006 will no longer be reflected in the year-on-year figure. ■

3

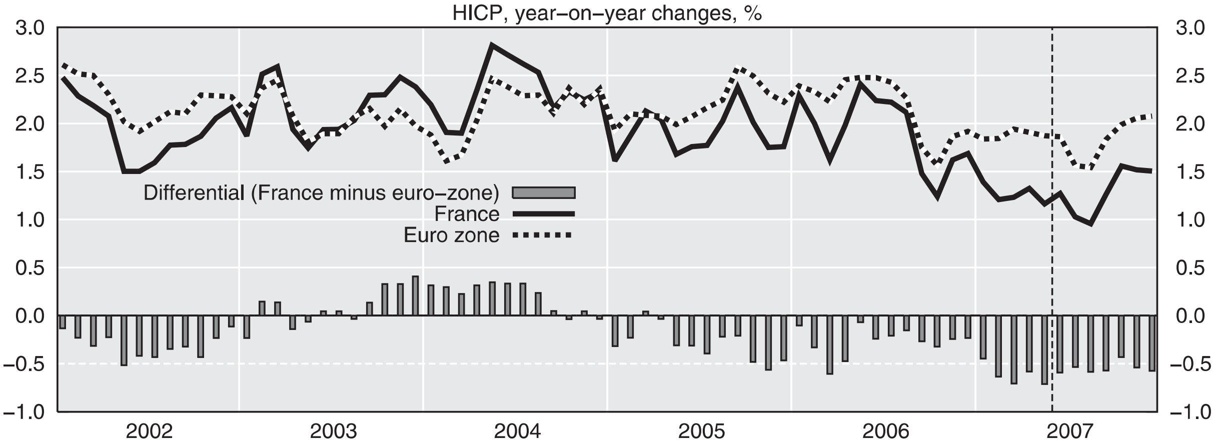


Source: Eurostat

3. The Act introduced reforms in mass retailing.

4

**HARMONISED INDEX OF CONSUMER PRICES**
**FRANCE AND EURO-ZONE**




*Sources: Eurostat, INSEE forecasts* *Forecasts to right of dotted line*