

Macroeconomic Outlook

Research Department

October 2004

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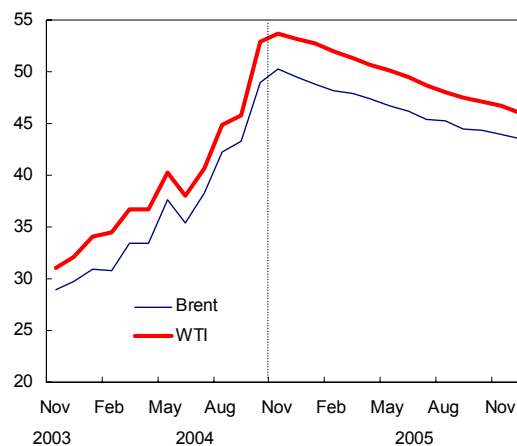
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Adjusting to the high oil price

The oil shock is less transitory than expected...

The oil price has recently reached all-time highs of \$51 for Brent Crude and \$54 for WTI. This latest upsurge, triggered in mid-September by the dual effect of the tensions in Nigeria and the damage caused by the hurricanes to oil installations in the Gulf of Mexico, has taken prices into an area where there are no particular technical barriers. What is more, the demand and supply models which generate theoretic prices 20-30% lower than those observed, have long ceased to furnish a guide to this market. The size of this gap might be a sign of the importance acquired by the speculative component, but market conditions suggest that this situation does not signal an imminent correction in prices. The adverse shocks that have built up in recent weeks have taken oil stocks to much lower than expected levels and have made price cooling during the winter most unlikely. And after that? 2005 should see the start-up of fields totalling a further 2m bbl/day (see *WEM* 24/9/2004), in the context of demand growth estimated at 1.45m bbl/day by the IEA. This means that, despite the braking effect of high oil prices on demand, in 2005 the reserve margin will remain at the current modest levels and will impede the normalisation of prices. Only in 2006 is the supply-side recovery (estimated at over 4m bbl/day) likely to start shifting the balance significantly. Futures actually price in a scenario with Brent Crude at over \$45 through to August 2005 (see figure).

Oil prices: historical averages and futures



Source: Datastream, Reuters

Negative consequences on 2004 growth have been noticeable, but not dramatic

Is this marked upward revision to the oil price estimates sufficient to signal the end of the global economic recovery? The direct cost of the oil shock can be estimated by considering the increase in the flow of fuel imports relative to GDP. This ignores the other indirect consequences (deriving from confidence, the domestic redistribution of income and, in the other direction, from oil producing country imports), which may play a major role, especially in the event of permanent shocks. However, this is a useful starting point in our impact assessment exercise. On this basis, the average increase of 36% recorded in 2004 might have shaved 0.5-0.6% off economic growth in the main advanced economies (excluding the United Kingdom, thanks to its status as an exporter) and 0.6-0.7% off China. The prices implied in futures, which see an average increase of around 15% in 2005, suggest 0.2-0.3% less growth for the advanced

economies (0.3% for China). These are significant figures for low-growth areas like Europe, and less so for countries expanding at a buoyant rate (United States, Japan) or at a gallop (China). In any case, they do not engender a significant risk of slipping into recession. Moreover, other fossil fuels have shown smaller increases, though still large (+20% for coal), which might qualify these estimates as too aggressive.

Analysis based on historical data tend to exaggerate the impact from the oil shock and the monetary policy response

Our sensitivity to the oil problem is skewed by **three shadows from the past**. First, econometric estimates are inevitably retrospective, and in the past the weight of oil within the structure of the economy was larger. In the United States commodities inputs as a percentage of total production fell from 3.8% to 3.1% between 1987 and 1997, and many other countries steadily reduced their dependence on oil, at least until the period of low prices at the end of the last decade. In the euro area, for example, the weight of fuel imports within GDP fell by 65% between 1980 and 2003. Second, if the oil spike does not generate secondary inflationary effects, then neither monetary tightening nor a rise in medium and long-term rates is triggered, both of which are due to delayed stunting effects on economic growth. On this occasion, the reaction of prices to the energy spike was particularly virtuous and the modest rise in US and European official interest rates expected in the coming quarters is not sufficient to make monetary policy actually “restrictive”.

The third assessment error contrasts with the first two and involves considering the shock as purely transitory. In contrast to the past, this time the problem relates to an excess of demand, which in turn is linked with a non-transitory process, i.e. the Asian industrial growth. The experience of these two years shows that the current global economic growth model is starting to come up against bottlenecks on the non-renewable commodities procurement front. Despite the speculative excesses to be worked through and despite the growth in supply projected in 2006-07, it is likely that prices will remain structurally higher than in the 1990s and, therefore, that the post-crisis rebound will be less pronounced than in other circumstances. But problems will also remain for metals, whose markets have already been put under pressure by the boom in Chinese demand and by financial speculation.

Commodity Prices

	2001	2002	2003	2004	2005	2006
Oil price; Brent crude spot\$/barrel	24.4 -13.8	25.0 +2.4	28.9 +15.4	39.4 +36.6	46.2 +17.4	35.5 -23.3
Non-fuel commodities price index	96.0 -4.1	96.5 +0.6	103.4 +7.1	121.4 +17.5	129.7 +6.8	126.0 -2.8
World price of metals	90.2 -9.8	87.7 -2.7	98.2 +12.0	132.3 +34.7	140.1 +5.9	125.3 -10.6
Agricultural raw materials world price	95.1 -4.9	96.7 +1.7	100.4 +3.8	105.8 +5.4	115.0 +8.7	116.7 +1.5

Levels and average annual rate of change.

Price stabilisation was only achieved by temporary quantitative restrictions imposed by the Chinese authorities on local industry, which led to a collapse in copper and steel imports. Clearly, we must not underestimate the system's ability to adjust: it is probable that a prolonged period of high prices will trigger a race

towards energy diversification, the use of surrogates and, above all, the recovery of materials and energy from waste. But this conversion process needs the incentive offered by a period of high prices, unless one assumes an imminent collapse in global manufacturing activity.

On this front, the leading indicators predict a slowdown in global economic growth. The slope of the dollar rates curve (which is moreover an important component part of the leading index) seems consistent with a slowdown in growth. This scenario looks more likely for the euro area and the second half of 2004, given the sluggishness of domestic demand on the old continent. In the United States, economic growth is likely to fluctuate just below the levels of 1H04, as economic policy becomes steadily less accommodating.

GDP Growth

	2001	2002	2003	2004	2005	2006
USA	0.8	1.9	3.0	4.4	3.4	2.8
Japan	0.4	-0.3	2.5	4.1	1.8	1.7
Eurozone	1.6	0.8	0.5	1.8	2.0	2.1
Eastern Europe	4.6	4.0	6.1	6.4	5.5	4.4
Latin America	0.5	-0.6	1.7	4.7	4.2	3.6
OPEC	2.6	1.3	-0.1	6.2	6.0	4.0
East Asia	3.8	5.7	6.0	7.0	6.7	5.9
Africa	3.7	3.0	3.1	3.8	3.9	3.6
World growth	2.4	2.8	3.8	5.1	4.5	4.0

Average percentage changes over year ahead.

(Luca Mezzomo)

United States

Macro outlook

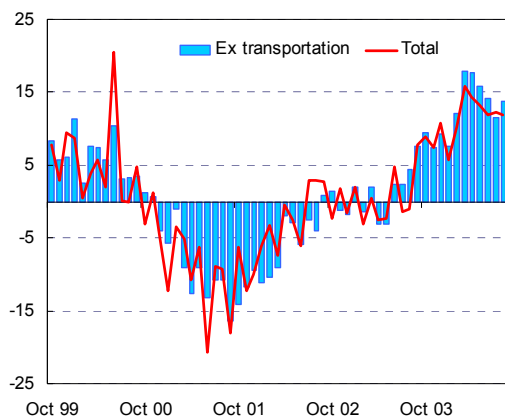
**Durable goods
consumption conditions
the trend in 3Q04 GDP**

The figures released in recent weeks point to stronger than expected growth in 3Q04 (+4.2% q/q ann. according to our estimates). The biggest surprises came from private consumption, construction spending and capital goods deliveries.

Private consumption should accelerate sharply from 1.6% q/q in 2Q04: our estimates are for +4.4% q/q (ann.). The rebound in auto sales in the quarter (+13.3% q/q ann.) should offset the more modest trend in the other items. While spending on autos is expected to grow by around 30% q/q ann., services (+4.1% q/q ann.) and non-durable goods consumption (4.5% q/q ann.) show no signs of accelerating but, at best, of holding up. Aside from the fluctuations caused by the purchase incentives, auto sales do not seem to have bullish growth prospects in 2005: the rise in interest rates and the reduced effectiveness of promotions limits the growth potential of this spending item.

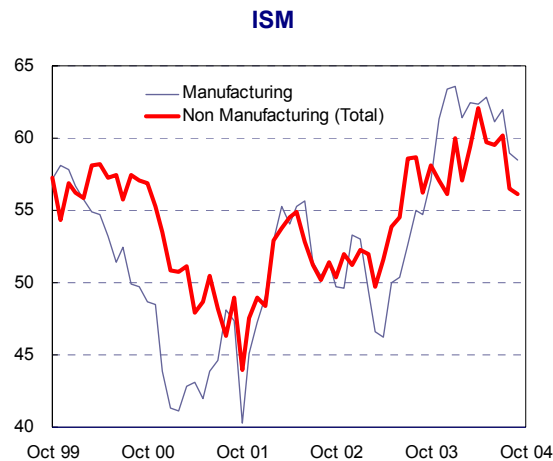
Much the same thing holds true for **construction spending**. The latest available figures indicate a 3Q04 well in excess of expectations. The indicators are consistent with residential building investment growth of around 10% q/q ann. (nominal) which, netted of prices growth (around 4% q/q ann.), should translate into a real growth rate of around 6%. In this case too, the trend in the most leading indicators sends out less encouraging signals. The figures on building permits and the sale of new homes, while very erratic, seem to be stabilising after the highs recorded in the first part of 2004.

New Orders (durable - % var. y/y)



Other positive signs for the quarter come from the figures on **capital goods deliveries**. Assuming a September in line with the first two months of the quarter, the nominal change in our proxy exceeds 16% q/q (ann.), slowing vs. 2Q04 (21.9% q/q ann.) and consistent with machinery and software spending growth of around 8% q/q (ann.). The other component of industrial investments, namely investments in structures, is expected to grow by 4%, a good result considering the +6.9% reported in 2Q04. Unlike the components mentioned above, the outlook for industrial is very positive in the next two quarters. Capital goods orders seem to be picking up, a sign that the trend in investments will continue to be very lively in the second half of 2004.

The indications we derive by aggregating the demand-side figures are fully confirmed by the trend in the supply-side indicators, **ISM and hours worked**. The former¹ signals a downturn to historically high levels (58.0) compatible with growth of around 4%; the fall in the ISM surveys is reflected in the slowdown in the trend growth rate (from 4.8% y/y to around 4% in 3Q04). The growth in hours worked (+2.8% q/q ann.) is statistically consistent with GDP growth of 4.2% q/q (ann.).



The main critical areas in the GDP estimate relate to the contribution of the foreign channel and inventories. Currently, our forecast is for a still negative foreign channel contribution and for a more modest contribution from inventories.

Medium-term outlook

The energy price spike in the first two quarters of 2004 did not have a significant impact on private consumption. The deflator of energy-related services and commodities grew by 26.7% q/q (ann.) and 26.5% q/q (ann.) in 1Q04 and 2Q04 respectively. Since this component accounts for around 5% of total consumption, the increase in energy tariffs shaved off a spending equivalent of around 0.3% in both quarters. Based on our scenario for energy commodities prices, the negative effect on 2004 consumption will be around 0.2%, corresponding to a reduction in GDP growth of just over 0.1%. However, most of this adverse effect on consumption should be behind us and in the next two quarters we should see less drainage of resources due to energy.

2004 will end on a more downbeat note due to the fluctuations in durable goods consumption. Like 2Q04, 4Q04 will also be characterised by a contraction in auto sales. The reintroduction of auto purchase incentives has greatly affected the trend in private consumption in 2004. However, the efficacy of the discounts diminishes the more frequent they become, and quite aside from the stimulus effect on the individual quarter, incentives should play a more limited role in durable goods growth in 2005. The trend in private consumption should remain in line with the trend in income, causing the saving rate to stabilise not far off the series' absolute lows. It should be stressed that this is an extremely conservative assumption: the saving rate is unreasonably low compared with the economic fundamentals and a rise in the rate would translate into a dynamic far less favourable to private consumption. In yearly average terms, 2005 should show growth of 3.0% in this demand-side component. Household spending on homes

¹ Aggregating the figures from the two surveys (manufacturing and non-manufacturing), we have constructed a composite ISM capable of capturing the trend in US GDP.

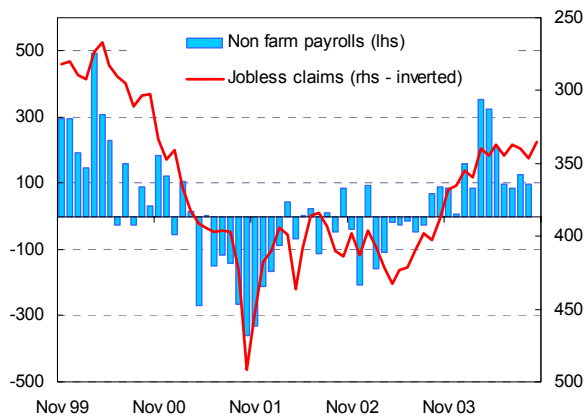
should stabilise in 4Q04 and start to slow in 2005. Signs of stabilisation are already starting to emerge and should foreshadow a decline in 2005. The spending dynamic should fall from around 10% in 2004 to zero in 2005.

Business investment should stabilise in 2005. In 2004 there was a sharp acceleration in machinery and software and stagnation in spending on structures. This trend will continue next year too. The modest rate hike and, to a greater extent, slowing final demand tend to limit the scope for investments designed to boost the scale of production. Spending on capital goods, on the other hand, will again focus on productivity gains. Growth in 2004 will remain below 10%, while in 2005 demand will fall to below 7%. Inventory accumulation should contribute around 0.5% to 2004 GDP growth. In the first two quarters of 2004 we saw sizeable inventory accumulation, which should stabilise in the second half of the year: barring a marked acceleration in final demand, we see little scope for a further upswing in the formation of working capital.

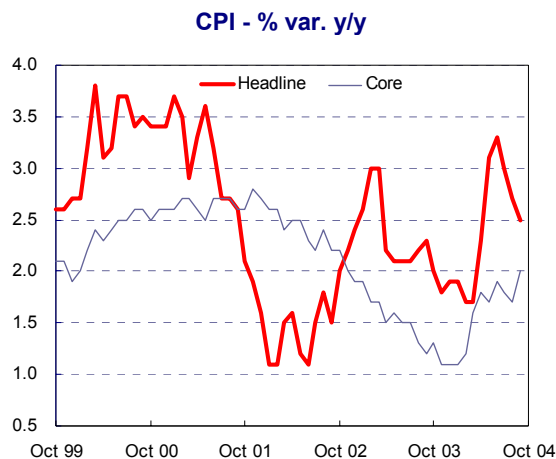
The presidential elections will mark the start of a decline in public spending. Whoever becomes the next president, greater fiscal discipline will probably be inevitable: the federal fiscal deficit should improve slightly from 3.8% to 3.5%. Spending should fall to 1.8% in 2005 from 2.3% in 2004, largely on the back of the slowdown in military spending. The federal government's non-war spending should on the other hand rise slightly (+1.6%) after falling in 2004.

The foreign trade deficit should stop expanding around the end of the year and start falling gently in 2005, concurrent with the slowdown in domestic demand. This scenario is based on a dollar which in real terms stays close to the current levels, and a global economy slowing to 2.8% from 3.4% in 2004. This suggests that the improvement in the deficit will largely be achieved by a fall in imports rather than an upturn in exports.

Non Farm Payrolls & Jobless claims ('000)



After two months of robust payrolls growth (in March and April payrolls grew by around 700,000), the labour market has stabilised at a rate of just over 120,000 per month. The decline in the participation rate has helped the unemployment rate ease to 5.4% from 5.6% in 2Q04. By end-2004 we should see an upturn in employment with average monthly growth of around 190,000 in non-farm payrolls. This rate should continue in the first half of 2005 and the unemployment rate should stabilise at 5.5%.



Last, inflation. After the spike in prices in the first half of the year, the most recent inflation dynamic shows a marked slowdown. In the short term the trend inflation rate should continue to fall, before climbing again in the latter months of 2004. In 2005 inflation should be low and falling slightly. In yearly average terms, the general index of consumer prices should fall from 2.6% to 2.2%.

United States

	2003	2004	2005	2004				2005			
				1	2	3	4	1	2	3	4
GDP (1996 US\$, y/y)	3,0	4,4	3,4	5,0	4,8	4,0	3,8	3,6	3,6	3,3	3,3
q/q annual rate				4,5	3,3	4,2	3,2	3,8	3,2	3,1	3,0
Private consumption	3,3	3,5	3,0	4,2	1,6	4,4	2,0	3,5	2,8	3,0	2,7
Fixed investment - nonresid.	3,3	9,5	6,7	4,2	12,5	8,0	7,2	6,1	5,5	5,2	5,9
Fixed investment - residential	8,8	10,1	0,6	5,0	16,5	6,1	1,1	-0,9	-2,8	-2,6	-2,6
Government consumption	2,8	2,3	1,8	2,5	2,2	2,5	2,3	1,7	1,4	1,2	1,0
Export	1,9	9,2	7,7	7,3	7,3	8,6	7,5	8,0	7,2	7,5	7,5
Import	4,4	9,8	3,1	10,6	12,6	8,2	1,7	2,3	0,9	1,7	1,6
Stockbuilding (% contrib. to GDP)	-0,1	0,5	-0,1	0,3	0,2	-0,1	-0,1	0,0	0,0	0,0	0,0
Current account (% of GDP)	-4,8	-5,7	-5,7	-5,1	-5,8	-5,9	-6,2	-6,0	-5,9	-5,7	-5,5
Federal Deficit (% of GDP)	-3,7	-3,8	-3,5								
Gov. Debt (% of GDP)	62,7	66,1	69,2								
CPI (y/y)	2,3	2,6	2,7	1,8	2,8	2,7	3,0	2,8	2,3	2,7	3,1
Unemployment (%)	6,0	5,5	5,4	5,6	5,6	5,4	5,5	5,5	5,4	5,3	5,2

Percentage annualised growth rates over previous period, if not otherwise specified.

Monetary policy: the Fed prepares a pause

Deflation is almost at an end and we are approaching a more "normal" phase of interest rate hikes

The **Federal Reserve** is now close to a second phase in its rate-hiking process, as the insurance policy against deflation will soon be at an end. **The first phase, which started in June, involved increasing interest rates (in regular though small movements) to the level where they would have been had there been no risk of deflation, ie around 2%. This removed the excess monetary stimulus that could have generated inflationary pressure within 12-18 months. In the second phase, interest rates will have to return to a neutral level, with economic**

data determining the pace of the increases. The transition to the second round of hikes is taking place in a period of uncertainty over the pace of the recovery, as employment figures show, thus reinforcing expectations of a post-November pause in the upwards rate trend.

The deciding factor for coming interest rate hikes will still be employment.

Currently, the Fed's statements about the economy are consistent with a November hike and a "measured" resumption in 2005 of an upwards trend for Fed funds. The Fed's projected rate of inflation remains moderate, showing that inflation expectations are easing, reflecting the credibility of monetary policy. **Interest rate policy decisions will now focus on the job market**, which still has room for expansion, and on growth, which most forecasts put at between 3.5% and 4% (we are below that range, with a forecast of 3.3%).

The Fed believes that the market's expectations regarding Fed funds are correct...

According to various sources at the Fed, **markets are correctly pricing in Fed policy and**, if there are signs of a slowdown in growth, the central bank will put further rate hikes on hold. The Fed will continue to make wide use of statements to guide expectations. Governor Ben Bernanke said that **FOMC statements have become a major policy tool, with a large influence on the long end of the yield curve** (see article in *Weekly Economic Monitor*, 8/10/04). Next month, the Fed may therefore prepare the markets for a pause in the interest rate hikes.

....and it will continue to guide markets through its statements.

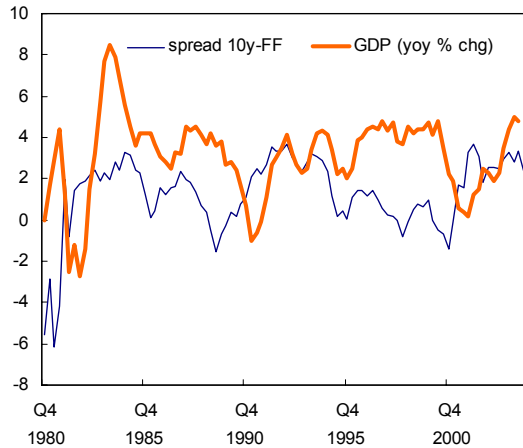
One of the recent objectives of the **Fed's statements has been to guide expectations of the path of future rate hikes through its press releases**. Several recent analyses have shown that this "path" factor is a statistically significant determinant of expectations regarding trends in Fed funds. The transformation of monetary policy in recent years towards more transparent communication has made the "path" factor explicit over the last year and a half. This was initially done by references to the fact that monetary expansion could "be maintained for a considerable period", which were followed by references to the committee being "patient" in removing monetary stimulus, and finally by references to future rate hikes being implemented "at a pace that is likely to be measured". In a paper by Gurkaynak, Sack and Swanson², the "path" factor is analysed for the period 1990-2004 and it was found that it explains roughly three-quarters of the changes in 5-10Y yields following FOMC meetings. If the central bank is credible in its desire to control inflation and prices are already in a regime of stability (inflation between 1 and 2%), then the expected short-term interest rate path (which is reflected in the yield curve) is consistent with a flattening of the curve without however, being a prelude to a period of stagnation.

In coming months, we are likely to see greater pains taken to refine the language in press statements so as to prepare the markets for the timing and speed of new hikes. This will be a difficult, since there is a lack of consensus, even within the FOMC, as to what level of interest rates is neutral. The range has been indicated at anywhere between 3% and 4.5% (Bernanke, Pianalto, Yellen, Poole) but, as has been said several times, that level depends on the condition of the economy (growth, inflation, employment market etc).

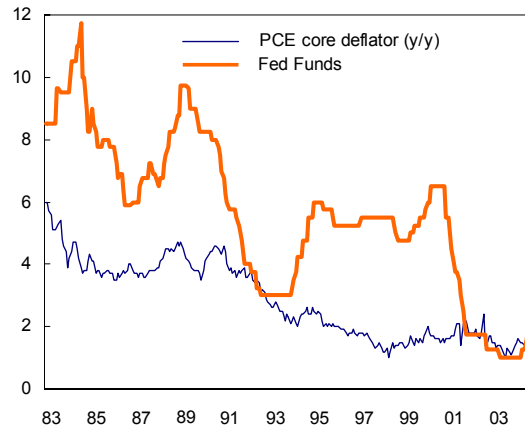
As rates stabilise and move away from zero, the use of communication strategies will gradually become less marked and less necessary, although they will remain a key tool for guiding medium-term inflation and interest rate expectations.

² R. Gurkaynak, B. Sack, E. Swanson, *Do Actions Speak Louder than Words? The Response of Asset Prices to Monetary Policy Actions and Statements*, Board of Governors of the Federal Reserve, September 2004

Curve and growth: a weakening relationship



Fed funds and PCE Core deflator



One more increase in 2004 and then a pause in 2005 to assess the strength of the recovery.

Conclusions

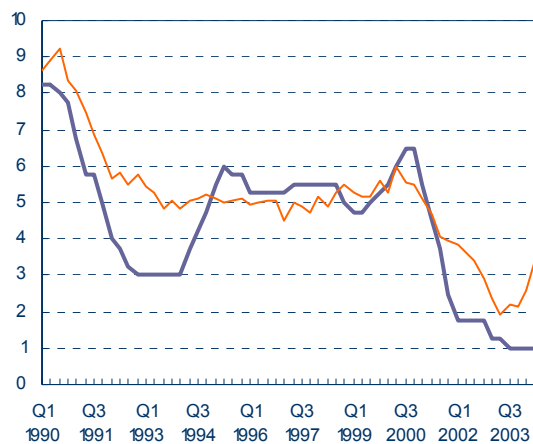
The process of raising interest rates in the United States that started in June is getting ready to enter a second phase that will bring **nominal interest rates to a neutral level**. Given favourable inflationary trends (**with the consumption deflator excluding food and energy stable at 1.4%**), **interest rate hikes are likely to be suspended after November. This will give the Fed the chance to determine where the level of neutral interest rates actually is in a situation of stable prices.** The Fed is convinced that core inflation must be pegged at around 2%, so as to cushion the economy from deflationary risks in the event of unforeseen shocks and/or an economic slowdown. As a result it is probable that the neutral level of interest rates will be at the lower end of the range estimated by economists, nearer to 3% (or just below) than 4%. By year end, the Fed will be halfway through the interest rate hike process and will no longer need to take action at every FOMC meeting.

(Sergio Capaldi - Giovanna Mossetti)

Focus: What does the Taylor Rule say?

The reasons that prompted Taylor (1993) to conceive the formula which now bears his name lie in the work of two Nobel Prize winners in Economics, Finn Kydland and Edward Prescott who, in a “revolutionary” article in 1977, highlighted problems of inconsistency over time in discretionary economic policy. In a regime of rational expectations, the policy maker’s discretion produces either economic instability or consistent but sub-optimal policies. The optimal solution in such circumstances would be to constrain economic policy to compliance with a “rule” easily understood by the public. The Taylor Rule sets the “optimal” interest rate as a function (linear) of the output gap and deviation from the inflation target.

Taylor Rule Recommendations and actual Fed Funds



For those who have to predict the monetary policy trend it is important to know that its actual conduct can be related to some “rule”. Taylor (1993) showed that the Fed’s monetary policy actions can be described with sufficient accuracy by a simple (current) inflation and output gap function. The Taylor Rule (TR) worked well for the 1980s and some of the 1990s. However, its explicative capacity has rapidly diminished since 2000. We have constructed a TR using the output gap measurement provided by the OECD and an inflation target of 2.0% y/y. The weights assigned to the inflation and output gap targets are those originally proposed by Taylor (1993). In the 1990s, and even more obviously after 2000, the Fed was more accommodating than might reasonably have been expected from the mechanical application of the dictates of the TR, and even now the gap remains very wide, despite the first 75bp increase in rates.

The TR is therefore inadequate at describing the Fed’s behaviour in the last ten years. The TR has come in for numerous criticisms, some of which have led to the enhancement of its original specification and explicative power. The Taylor Rule definition has gradually expanded to encompass a wide range of monetary policy “rules” that can be formalised in a linear relationship between growth and inflation indicators and central bank interest rates.

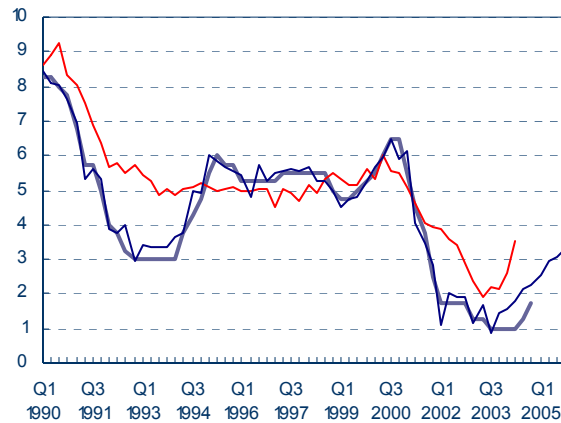
While bearing clearly in mind the limitations of this approach, we have constructed a Taylor Rule that takes account, as far as possible, of some of the most cogent criticisms and the most important refinements produced in the literature in recent years. In order to modernise the TR effectively, we must consider:

1. "Similar" monetary policy regimes. Since the end of the second world war three monetary policy regimes can be identified, broadly associated with the presidents who have steered the Fed over the last 50 years: Burns, Volcker and Greenspan. The problems addressed by the Fed in these three regimes called for different levels of sensitivity to the central bank's same objectives.
2. Measurement issues. Several variables present in the TR are hard to measure. The use of alternative methods can frequently lead to very different results that may significantly modify policy recommendations.
3. Real time data. The data is frequently revised and the figures fed into the central bank's decision-making process are often "preliminary". It follows that only the data available at the time of the decision (real time data) should be considered.
4. Data rich environment. This objection does not refer solely to the TR but to any rule that defines optimal policy purely on the basis of a "few" fundamental variables. The real decision-making process is more complex than the one summarised by the TR and regards a sizeable amount of data which cannot adequately be captured by the current level of inflation and the output gap.
5. Central banks talk. Central banks use communication to influence the public's expectations regarding the future course of monetary policy. In a regime of robust credibility, the pledge to maintain an accommodating/restrictive bias on monetary conditions can be an effective policy alternative to interest rate moves.
6. "Forward looking" nature of monetary policy. This criticism points up the "pre-emptive" nature of the central bank's action: monetary policy decisions are not dependent purely on the current state of the economy but on risk and forecasting scenarios formulated by the central bank.
7. Smoothing behaviour. The need to avoid triggering turbulence on the financial markets and to defend the credibility of its decisions may prompt the central bank to act more gradually than is envisaged by the TR.
8. Non-linearity of the reaction function. The constraint of non-negative nominal interest rates introduces non-linear terms into the optimal monetary policy rule. The omission of these terms clearly creates a problem of incorrect specification of the empirical model and problems in estimating the parameters.
9. Equity market imbalances. This objection partly relates to point 4 above. The state of the equity market is one of the variables the Fed can assess in the course of its decision-making process. However, those who underscore this aspect tend to elevate the status of the equity market on the list of the central bank's targets.

The desire to reduce the weaknesses of the TR must be tempered by the need to preserve its extreme simplicity. To neutralise the distorting effect caused by the presence of different regimes, we have restricted the analysis to the last 20 years. This decision also scales down the problem of measuring the structural variables in the economy (natural unemployment rate and real interest rate). Limiting the analysis to a recent period makes the assumption that they are constant over the entire reference period more defensible. The real time data problem is partially resolved by using – where possible – data not subject to revision, or only to small revisions. In order to include in summary form a large mass of data on the performance of the economy, we have used a summary indicator constructed by the Chicago Federal Reserve. The Fed's communication method evolved in the 1990s in a bid to enhance the transparency of the decision-making process. To

take account of this we have constructed a dummy variable on the basis of the economic assessment of the Federal Reserve Board. The forward-looking approach to monetary policy is introduced using inflation forecasts 12 months forward rather than its current values. Likewise on the growth front, we use the leading indicator of the Chicago Fed rather than the coincident indicator. To take account of the inertial behaviour of monetary policy, the rate on dollar deposits three months forward is included.

Trending Upwards



From a comparison with the TR, the explicative capacity of this specification is much improved. Moreover, the model appears to succeed in anticipating with a relatively significant margin the direction of future monetary policy moves. The discrepancy between the recent level and the level suggested by the rule seems to be due to the onset of deflationary fears within the committee that sets interest rates (FOMC). The rise in inflation and the economic recovery triggered a rate hike. However, the monetary tightening is foreshadowed too far in advance. The insurance reason linked to the deflation risk has imposed the maintenance of accommodating monetary conditions for a “considerable period of time”. Lastly, based on the available information, the model does not seem to indicate the possibility of an imminent pause in the upward trend in rates, but rather its continuation on a very gradual tightening path.

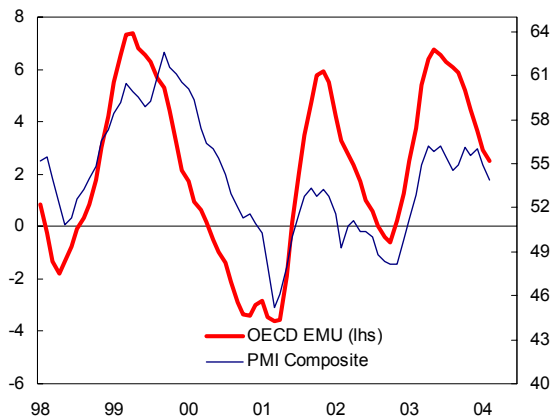
(Sergio Capaldi)

Euro area euro: physiological slowdown and oil related uncertainties

The pleasant surprises of early 2004 do not mean the good performances will continue.

In the euro area, the first half of 2004 was marked by positive surprises on the EU economy. This also affected our estimates for the current year which were revised to 1.8% from 1.5% expected at end-2003. However, from our viewpoint the economic information did not justify projecting forward in time the improvement that should have been followed by a natural slowdown. This phase seems to have started in the summer and is likely to last at least until the start of next year. The risks we had identified in past months, namely a violent increase in the oil price and continued uncertainty both on domestic and international issues, have unfortunately largely materialised, making progress for the EMU economy even more arduous. The **slow emergence from 2004 makes it unlikely that 2005 growth will exceed 2%.**

Cyclical indicators are worsening

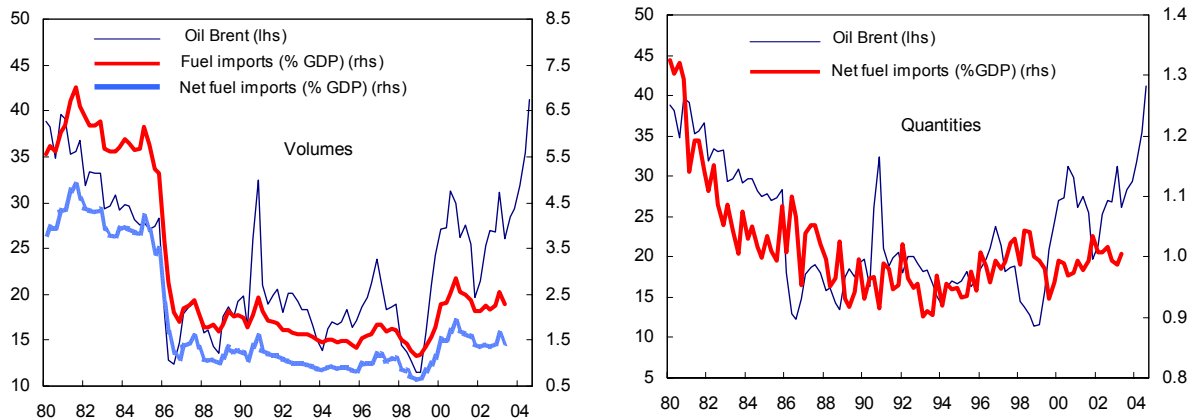


The chief risk is the increase in the oil price, but the eurozone economy is less closely linked to oil than in the past.

The most obvious risk is the record price of Brent which has gone above USD 50. Since the beginning of the year, there has been a more than 70% increase which was combined with siphoning off of liquidity that is detrimental to the euro area. However, **the weight of nominal fuel imports within euro area GDP was around 1.5%³ in mid-2003, 65% less than at the start of the 1980s.** Breaking down the fall in the weight of energy imports within GDP, 35% is **due to the lower price of crude oil**, 28% to the firming of the exchange rate, and the remaining 37% to **the reduction of imported quantities within GDP, which reflects the efforts made to make more efficient use of energy.** On this front, note that the maximum effort was produced in the early 1990s (-31% vs. the early 1980s), clearly driven by the fear of tensions on the oil market. The following period of low and stable prices led to a steady increase in the percentage of energy imported per unit of product, which slashed by one-fifth the savings achieved in the previous decade.

³ The percentage is calculated net of fuel exports. Gross of this item, euro area total fuel imports come to just under 2.3% of GDP.

Oil price and energy dependency of the euro area



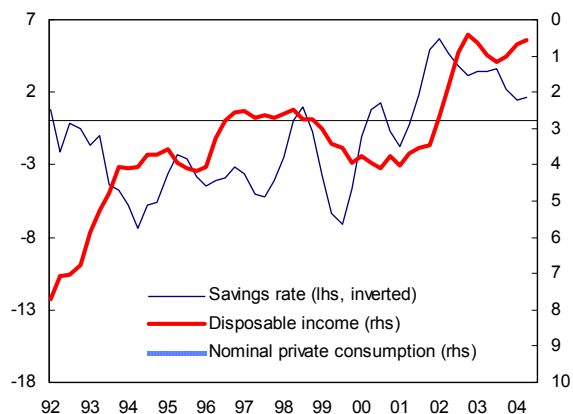
Although significant, the impact will not result in stagflation.

If we mechanically calculate the weight of the higher cost of imported energy due to the hike in the price, and assuming stable demand in terms of quantities, **the impact amounts to around 0.4% of GDP in 2004 and falls to 0.25% in 2005⁴**. Although the effect is considerable in percentage terms when set in relation to a growth rate that is struggling to top 2%, the first round effect of the oil price increase **does not seem sufficient to plunge the euro area into a stagflation spiral**. Crucial on this front is the role of euro appreciation, which has cut by around 30% the draining of resources at the expense of growth in 2004.

Consumers are cautious...

This is one the reasons why euro area consumers are still reluctant to increase their spending on goods and services and prefer to save more. Germany is a case in point where, despite a moderate acceleration in disposable income following the tax reforms and a tentative rise in employment, consumption has slowed in nominal terms too.

Nominal income, savings, and consumption



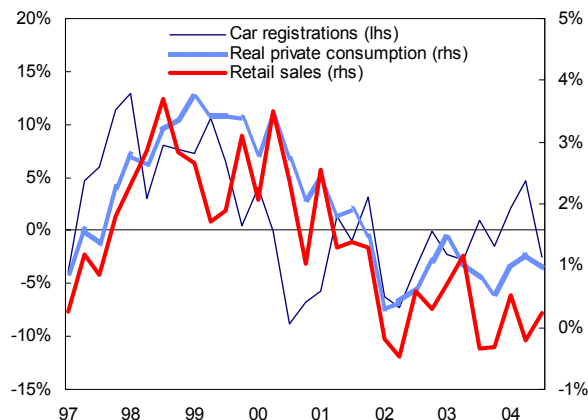
⁴ *These estimates only refer to the impact effect and provide a useful indication of magnitude, but should be treated with caution. Note too that this calculation in any case overstates the direct impact since it fails to distinguish between imports of crude oil and natural gas, the price of which has a far more modest dynamic. On the other hand, it is reasonable to assume that the costs resulting from the change in relative prices will make even greater the loss of product due to the shock.*

At the same time, the saving rate continues to increase and reached 11% in 2Q04, as in 1996. The increase in savings seen in 2001-2002 was an attempt to re-accumulate wealth after the stock market collapse, while the continuation of the trend into early 2003 was due to the concerns about the situation in the Middle East. It is very likely too that awareness of the need to reform the welfare state to put public finances back into order, together with uncertainty over how the reforms will affect employment, have also had an effect which may not yet be exhausted.

...consumption is languishing...

As a result, even though the expansion in euro area employment remained positive (0.2% y/y in 2Q04) and consumer lending (at just under 12% of total consumption) grew at 6.5% y/y in August up from 5.1% in 2Q04 **private consumption remained flat during the summer**, slowing down even more than in the preceding quarter. New car registrations were down (we estimate -3.7% q/q) and even the improvement in retail sales to -0.2% from -0.3% q/q in 2Q03 proved to be insignificant.

Retails sales, car registrations, and real private expenditure



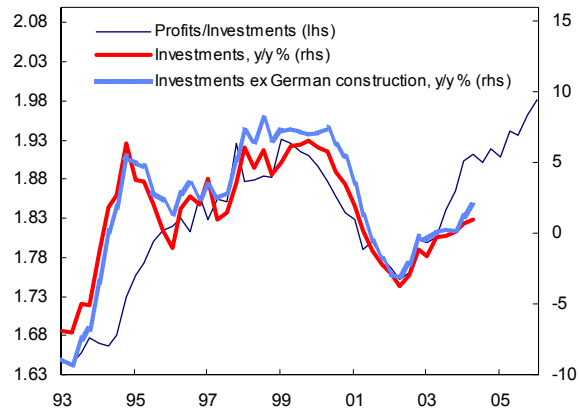
...but confidence is improving

That, however, is partly a result of the correction in French consumer spending, which soared during the first half of the year following the temporary tax measures, the effect of which is now beginning to wear off. In general, **household confidence is improving**, as shown by an EU Commission survey at its highest level since 2002, buoyed mainly by an improved view of job prospects. **The expected spread of the recovery to the labour market will strengthen this trend and help foster a more normal spending attitude in the coming quarters.**

Investment has rounded the corner...

The behaviour of the **business sector** regarding investment decisions should also normalise in the coming quarters after the disappointments in the first half of the year when the quarterly capital accumulation trend was slightly negative. On closer scrutiny, one cannot fail to notice the **weight of the collapse in the building sector in Germany**, shrinking by 2.4% in quarterly average terms. Netted of this sector, whose weight within total euro area investments is just under 14%, the trend in capital accumulation found renewed vigour in summer 2003 and gradually strengthened thereafter, showing a quarterly growth rate of 0.6% in the last three quarters.

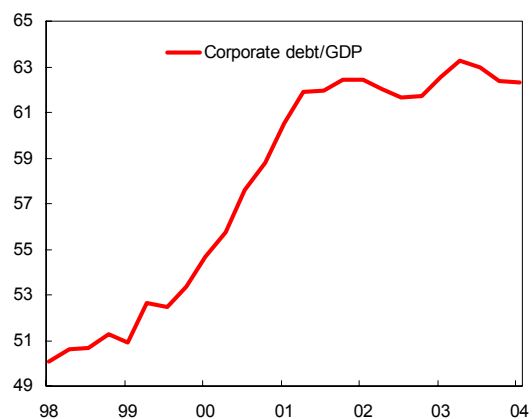
Business profits and investments



...thanks to profits, but growth is low due to companies' debt

One of the factors that has contributed to the reawakening of corporate demand is the **return to profitability**, which has brought the ratio of gross profits to investments to its highest level since the series began. In comparison with past observations, the level of investment should have been more than was actually recorded during the upturn. The explanation is most likely to be found in **corporate debt**, which continued to grow more rapidly than GDP until mid-2003. After that point, however, it appears that the trend reversed, probably because companies preferred to **use the plentiful financial resources at their disposal to strengthen the balance sheet before expanding or renewing production capacity**. We expect this process to continue in the next quarters and that, together with the uncertainty over the global outlook and the still relatively low rate of capacity utilisation – around half a standard deviation below the historical average also in 2004.Q3 - will limit the trend in fixed investments.

Corporate debt is still high



The uncertainty over the outlook, as stated above, relates to two factors: the impact of the oil shock and the trend in global demand and its effects on euro area exports. Until now, these two factors have made a significant contribution to

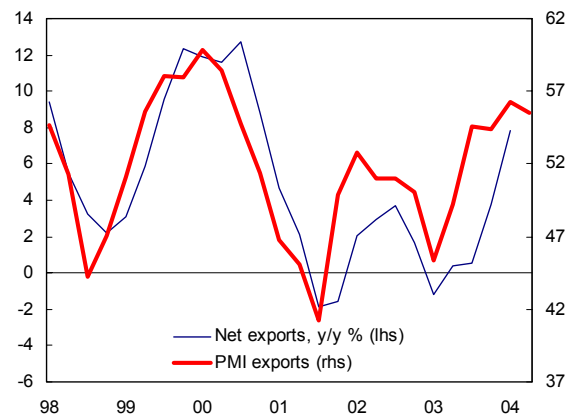
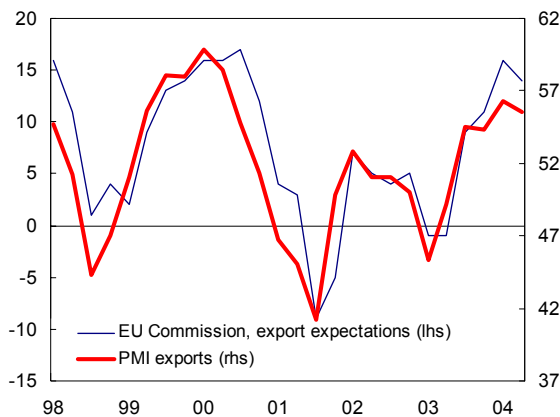
the recovery with the trend accelerating to 8.1% in 2Q04 from -1.4% one year ago. This, however, is insufficient to halt the slowdown of international trade⁵. Exports have overtaken imports, which picked up from a low of 1.1% to the 6.5% shown in the most recently published figures. **The contribution of international trade to growth was significant in the last two quarters—alone, it accounted for just under 70% of GDP growth.**

The contribution to GDP growth by foreign trade will decline but will remain positive

The outlook remains moderately positive for foreign trade when one considers that the consensus forecasts for global growth in 2005 have been trimmed by just one-tenth since July. The geographic split is even more favourable to euro area exports in light of the upward revision to the estimates for eastern Europe whose weight as an outlet market for EMU products grew from under 9% in the second half of the 1990s to over 11% in 2003.

The contribution of net exports will remain positive but will fall from an estimated 0.6% in 2004 to 0.2% in 2005. That will occur due to the higher rate of increase in imports which will be stimulated by the expected strengthening in domestic demand in addition to the appreciation of the currency.

Foreing trade: moderately positive outlook



⁵ Oxford Economics estimates that the international trade index for eurozone goods grew by 11.8% in 2Q04. Even if that was overestimated by a couple of percentage points, the growth of world trade would still exceed eurozone exports.

Inflation in line with the ECB target despite the dear oil

Inflation will slow despite soaring Brent prices, as weak demand will limit the transmission of the shock to other sectors

For September, euro area inflation was revised down to 2.1%, just below the Eurostat flash estimate of 2.2%. The impact of the oil price spike is certainly feeding through into energy and petrol prices, and this will become more and more evident on the composite index in the coming months. However, **the slowdown in the food price dynamic and the lack of inflationary pressures in the rest of the basket help (and will continue to help) keep inflation under control.**

The risk of an upswing in inflation in the euro area in the coming months looks limited. Even though Brent Crude prices are at all-time highs, in percentage terms – which is the crucial factor in calculating the impact on inflation – the present shock is far less severe than the one observed in 1999-2000. In addition, most of the impact of the oil price spike has already come through in the first part of the year. The energy component added around 0.6% to the composite price index between January and June; assuming that oil prices will fluctuate around \$50 in the coming months, as expected by the futures market, this contribution would not exceed 0.8% by late 2004-early 2005. In other words, *ceteris paribus*, the contribution of energy to inflation will be two-tenths more than in September. In 2005, based on futures prices falling slightly vs. the current levels, in annual average terms the contribution of energy will be positive and broadly the same as that estimated for 2004.

Inflationary pressures on the core index

With Brent at such high price levels, it is **far more important** with respect to inflation risks to see whether the **tensions on the energy component are feeding through to the other spending items.** Currently inflationary pressures on the core rate look very slight. However, core inflation ex-energy has been “stuck” in the range 1.9-2.1% for almost two years, not showing (at least apparently) any reaction to the prolonged widening of the output gap. As we have repeatedly said, the lack of a decline in core inflation is largely due to the hike in administered prices. To this end we have constructed an indicator of the degree of diffusion of inflationary pressures in the 12 items of the HICP, stripped of the energy product items (see box). **Since the beginning of 2004, the index is signalling a clear cooling down of inflationary pressures:** in the last six months to August the m/m change in the core index ex-energy was 15% lower – for at least 0.05% - than the average monthly change recorded in the last four years. L'indicatore sulle pressioni inflazionistiche da noi costruito (vedi riquadro) segnala **a partire da inizio 2004 un chiaro raffreddamento delle pressioni inflazionistiche.** Negli ultimi sei mesi in media la variazione m/m del core ex-energia è stata del 15% inferiore – per almeno uno 0,05% - rispetto alla variazione media mensile registrata negli ultimi quattro anni. Contrary to what happened in the '99-00 period, the increases in the energy component are in no way spreading to other core inflation items.

The trend in core CPI is a function of labour costs and exchange rates in addition to pressure from demand

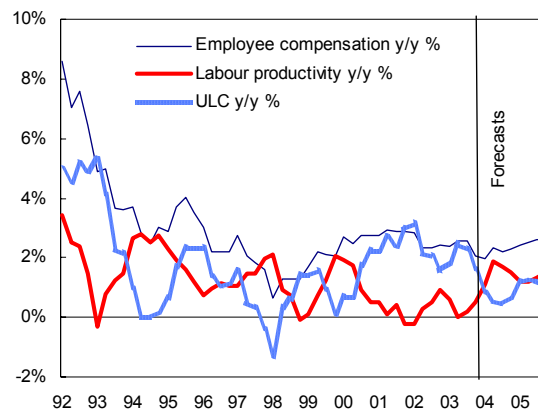
That is so partly because there are other **items which are more important determinants of core prices**—first and foremost, **the structure of unit prices and exchange rates**, in addition to the above-mentioned pressure on demand seen in the output gap. We have updated our core inflation econometric model to 3Q04. The regression's fit deteriorates significantly from 2Q03: ie from the implementation of the first measures on government-set prices. In four of the five quarters between 2Q03 and 2Q04, the residuals were greater than one standard error of the regression, with one error to the downside in the model. Clearly, the apparent inability of the model to predict inflation is most likely due to the series of

Oil shock sparks deflation

government-introduced measures, the effects of which cannot be captured by underlying fundamentals. We therefore used dummy variables for those periods showing the most significant estimation errors, which resulted in the model's coefficient of determination returning to the same level as for the previous period ($r^2=80\%$). Implicitly, **the sum of the dummy variables provides an estimation of the quantitative impact of government measures. It confirms that the trend rate of core CPI in 3Q04 was inflated by about 0.8% by factors other than fundamentals. In the absence of those factors, core inflation would have come down to about 1% at the end of 2003, as forecast.**

This would have been a normal consequence of a 3% effective real appreciation of the euro and of a **slowdown, according to our estimates, to 0.6% in unit labour costs growth in 2004**, compared to 2.1% y/y in 2003⁶. Moreover, the output gap, estimated with the Hodrick-Prescott filter, remains in negative territory even though it is already narrowing this year due to the fact that the filter shows potential growth declining to 1.6%. That estimate appears fairly pessimistic and implicitly introduces a downside risk to CPI core forecasts since the output gap would be wider if potential growth were only 2%, ie the lower bound of the range estimated by the ECB. Moreover, **the negative sign in front of the coefficient estimated for the output gap shows the way in which the deflationary effects of the energy shock will be passed on, reducing growth and increasing the output gap.**

Labour cost in check



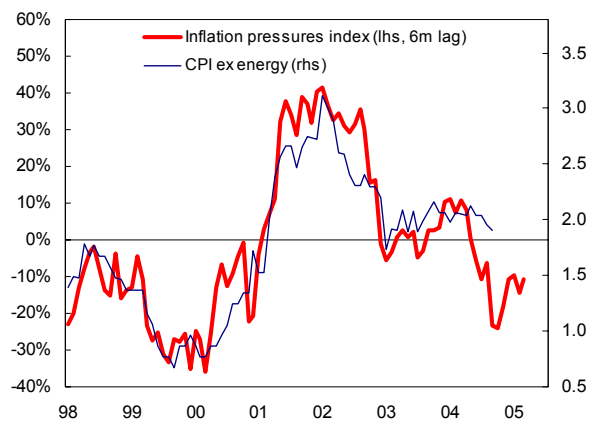
Based on the model, core CPI is forecast to slow from its current level of 2.1% to 1.5% in the second half of 2005. Yet again, however, measures announced on government-set prices, such as the increase in tobacco prices in Germany or the introduction of fees for medical examinations in France, will keep core price inflation high, adding around 0.3% to the rate by the end of next year. **Core CPI should therefore close 2005 at a cruising speed of 1.8% y/y, three-tenths of a point below its current level.** This scenario is consistent with our indicators on inflationary pressures.

⁶ It should, however, be remembered that part of the slowdown is probably only apparent since reflects the change in methodology of sampling the cost of labour in Germany and France at the end of 2003.

An indicator of inflationary pressures in the euro area

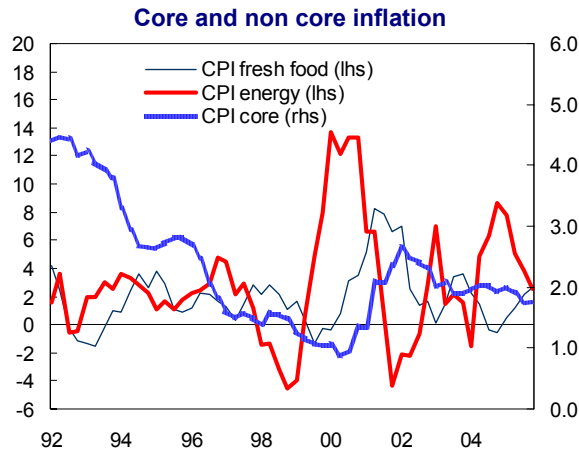
Since the inflation figures are not seasonally adjusted, it is much harder (e.g. than with the US inflation figures) to extrapolate from the monthly change a slowdown or an acceleration in current inflationary pressures. To this end we have constructed a diffusion index of inflationary pressures in the 12 items of the HICP. Every month, each item emits a “signal” of “1” (“-1”) if the monthly change in the item is greater than (less than) the average monthly change in that item in the last four years for a given epsilon of 0.05%. If the month-on-month movement is within the range -0.05%/+0.05% the signal is zero. The value of the monthly index is obtained from the average of the signals on the 12 items weighted for the weight of each item within the core basket. The last six months average is then calculated for the monthly index so constructed. The indicator therefore captures the degree of diffusion of inflationary pressures in the core index in the previous six months. It can range from -100% to +100%, in extreme cases in which all the items in the last six months have emitted a disinflationary or inflationary signal. Since it captures information on the price dynamic in the last six months, it traces with a fair degree of approximation the dynamic in the trend inflation rate (which covers the last twelve months) for the next six months; barring significant inflationary highs concentrated a limited number of items (as is currently happening with administered prices).

Inflationary pressure on CPI ex energy



Increases forecast for the energy CPI...

In addition to core CPI, the other two components of overall CPI are the energy CPI and fresh food CPI. The first is basically a function of the price of Brent and the €/€ exchange rate, the annual average of which is expected to be broadly stable. **Assuming that the euro-denominated oil price remains virtually stable at the current levels (€39.6 in the first half of October), the trend dynamic in the energy CPI will fall from just under 9% in the current quarter to a more sustainable 2.5% at the end of next year, when the contribution to the overall price dynamic will fall to 0.2%, six-tenths below the estimated figure for the current quarter.**



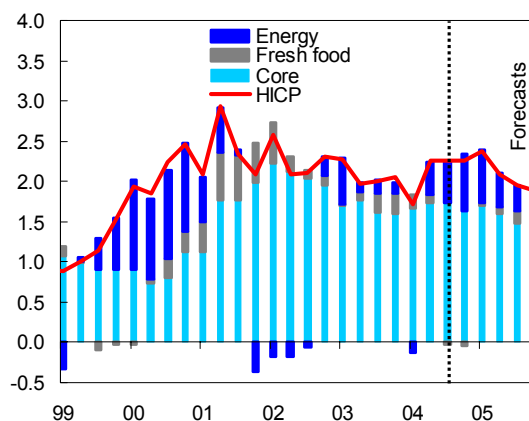
... and for the fresh food CPI

With respect to the **fresh food CPI**, the trend line normally has **seasonal peaks**. Exceptions to this rule were only seen, even in recent years, following unpredictable, exceptional occurrences such as the outbreak of BSE in spring 2001, the extreme cold that accompanied the changeover to the euro at the beginning of 2002 and the bird flu epidemic in Holland at the beginning of 2003. Curiously, even though food prices rose more quickly than forecast in summer 2003 as a result of the heatwave that hit Europe, if we insert a dummy variable, this deviation becomes no longer statistically significant. Conversely, in recent quarters, the increases actually observed have been more moderate than the model predicted. We can therefore expect that the deflationary effect of food will peak in the final months of 2004, while in **2005 this item will have a positive effect on price changes (0.1% annual average) albeit less than the figure recorded for the period 2001-2003 (0.3%)**. That contribution will continue to increase during the year reaching its peak, albeit moderate, of 0.2% in the fourth quarter.

Barring new external shocks, the CPI headline will descend to below 2% in the second half of 2005.

In summary, we expect that after the September trough, euro area inflation will temporarily start to accelerate again in coming months to levels of around 2.3%-2.4% by the end of 2004-beginning 2005 due to the effect of rising oil prices. Then from next spring we should observe a gradual reduction which, barring further shocks, will bring inflation down to below 2% in the second half of 2005. **The average for next year is forecast to be 2.1%, the same as the estimate for this year, confirming that in current conditions the oil shock will not have severe repercussions on consumer prices.**

Inflation below 2% in the summer of 2005



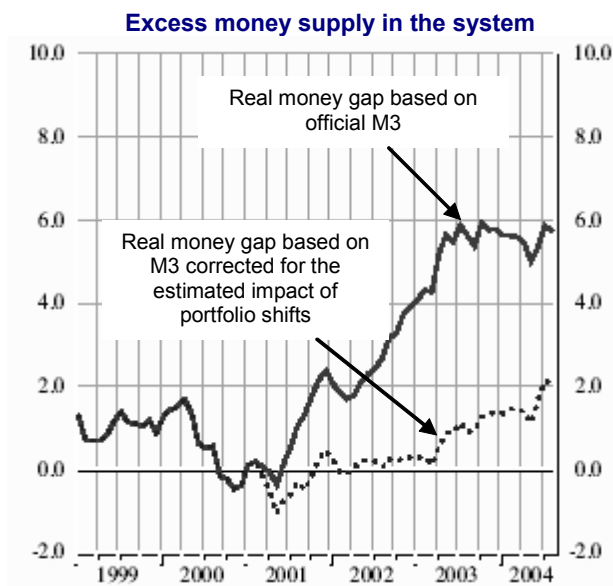
Monetary policy: what if the ECB were right on growth?

The ECB faces a dilemma

The salient point of recent announcements to the markets by the ECB, was the admission of **greater uncertainty over future developments in the economic situation**. The crucial factor for growth and inflation is again the oil price, which has risen to new all-time highs. Of course, **an increase in the price of crude means that monetary authorities need to pursue the conflicting objectives of containing inflation and stimulating growth with the only instrument they have: interest rates**. Currently, the central bank is keeping the refi rate stable at 2%, but stresses that this is a historically low level. **Future decisions will depend on which will emerge as the more evident of the two risks dependent on the price of Brent crude, downward for GDP and upward for the CPI.**

If the ECB were right about growth, interest rate increases would be very near

It is worth **considering the implications of the views on the economy as voiced by the ECB**, which expects growth to maintain the rate shown in the first half of the year. This would take the trend change to over 2% as early as 3Q04, the preliminary figures on which will be available in mid-November. At the same time, the inflation rate should remain above 2% through to next spring, even though it will be driven solely by energy product prices. In this scenario we would have growth “consolidate” at the potential rate and negative real interest rates, as well as excess money supply, i.e. an indigestible cocktail for a central bank determined to maintain price stability over the medium term. **The most logical reaction, therefore, would appear to be a moderate increase in refinancing rates in order to progressively normalise the level of real interest rates.**



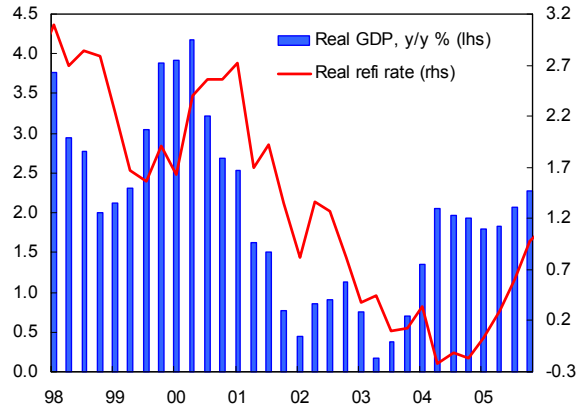
Source: ECB

Do not consider that our monetary policy is too accommodative

With this reasoning, **the date could be as early as December**, when the ECB’s new macroeconomic projections to 2006 will be published. A positive outlook for growth would provide the justification for the first hike in interest rates since the end of 2000. Yet, Jean-Claude Trichet felt it necessary to explain that the governing council “*do not consider that our monetary policy is too*

accomodative". This consideration will delay any change in official interest rates for at least a few months.

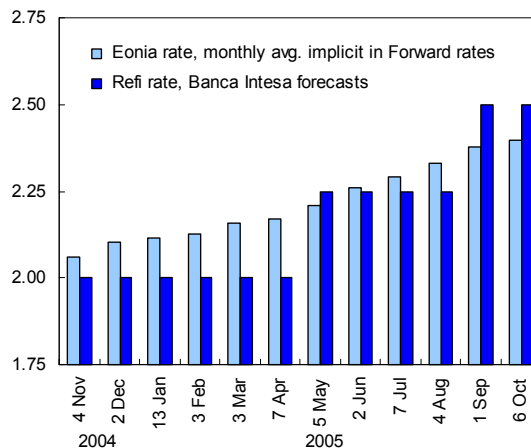
Real short-term rates and economic growth



We believe, however, that the central bank is over-optimistic

Our own forecasts, like those of the market, **have for some time indicated that the first hike will be in spring 2005**. In fact, **we believe that the ECB is over-optimistic with respect to the real economy** in the second half of 2004. As illustrated above, we believe that euro area GDP growth will temporarily slow as a result of weak domestic demand. Uncertainties over future developments therefore have the upper hand, and it is advisable to **delay rate increases until private consumption and investment recover**. **Even if the rate of inflation does finally stabilise at a level of below 2% during 2005, a rate increase would in any case be justifiable unless further stimulus to the economy is required.**

Short-term rates forecasts



In conclusion, **coming press conferences will most likely continue the aggressive communications strategy pursued by the ECB, which never seems to back up its words**. Even if growth is in line with ECB forecasts, after listening to Trichet, it does not appear realistic to expect that the central bank will

become any more restrictive in coming weeks. Indicators leading to a more radical change in the ECB's interest rate stance will only be seen in the next few months. These will have to reflect ECB optimism, meaning that GDP will have to show no signs of slowing down q/q, and confidence indicators will have to reverse their declining trend of the past few months.

(Giada Giani - GianLuigi Mandruzzato)

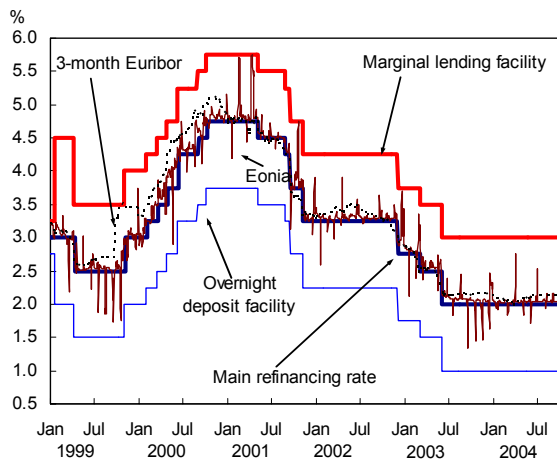
Euro Area

	2003	2004	2005	2004				2005			
				1	2	3	4	1	2	3	4
GDP (constant prices, y/y)	0,5	1,8	2,0	1,4	2,0	2,0	1,9	1,8	1,8	2,1	2,3
- q/q change				0,7	0,5	0,4	0,3	0,5	0,5	0,6	0,5
Private consumption	1,0	1,1	1,6	0,7	0,3	0,0	0,4	0,5	0,5	0,4	0,6
Fixed investment	-0,5	1,0	3,3	-0,1	0,1	0,3	0,8	1,1	1,0	0,7	1,0
Government consumption	1,7	1,5	1,4	0,1	0,5	0,3	0,3	0,4	0,3	0,3	0,3
Export	0,3	6,4	6,5	1,6	3,1	1,1	1,9	1,5	1,3	1,6	1,5
Import	2,2	5,7	6,7	0,5	2,8	0,8	1,8	1,8	1,6	1,4	1,6
Stockbuilding (% contrib. to GDP)	0,4	0,3	0,0	-0,1	0,0	0,2	-0,2	0,1	0,1	0,0	0,0
Current account (% of GDP)	0,3	0,4	-0,1	0,7	0,4	0,5	0,2	0,0	-0,2	-0,2	0,1
Deficit (% of GDP)	-2,7	-3,0	-2,9								
Debt (% of GDP)	69,6	70,1	70,7								
CPI (y/y)	2,1	2,1	2,1	1,7	2,3	2,2	2,3	2,3	2,1	2,0	1,9
Industrial production (y/y)	0,3	2,2	2,6	0,0	0,9	0,4	1,4	0,1	0,7	0,8	0,5
Unemployment (%)	8,9	9,0	8,8	8,9	9,0	9,0	9,0	8,9	8,8	8,8	8,7
3-month Euribor	2,33	2,10	2,56	2,06	2,08	2,12	2,14	2,28	2,46	2,65	2,84
EUR/USD	1,13	1,22	1,19	1,25	1,20	1,22	1,22	1,20	1,18	1,18	1,20

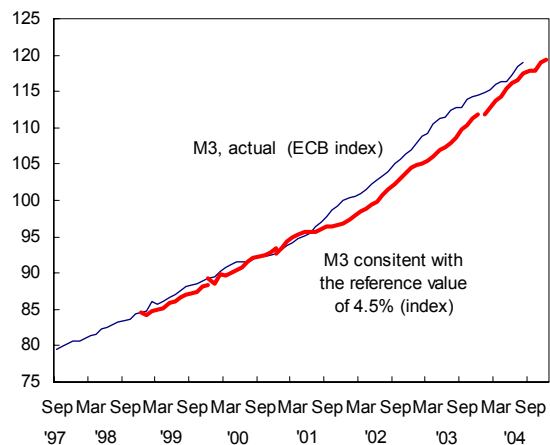
Percentage variations over previous period, if not otherwise specified.

	GDP (y/y)			HICP (y/y)		
	2003	2004	2005	2003	2004	2005
Germany	-0,1	1,4	2,1	1,1	1,6	1,0
France	0,5	2,4	2,3	2,2	2,3	1,8
Italy	0,4	1,1	1,5	2,8	2,2	2,0
Spain	2,5	2,6	3,0	3,1	3,1	2,5
Netherlands	-0,9	1,1	1,8	2,2	1,3	1,6
Belgium	1,1	2,5	3,0	1,5	1,7	1,7
Austria	0,7	1,7	2,7	1,3	1,7	1,5
Finland	2,1	2,9	3,5	1,3	0,3	2,6
Ireland	3,6	5,0	5,6	1,1	1,7	1,7
Portugal	-1,2	1,7	2,9	2,2	2,3	1,8
Greece	4,3	4,0	2,7	2,8	2,2	2,0
Luxembourg	0,1	1,4	3,2	3,1	3,1	2,5
EU-12	0,5	1,8	2,0	2,1	2,1	2,1

Main short-term rates

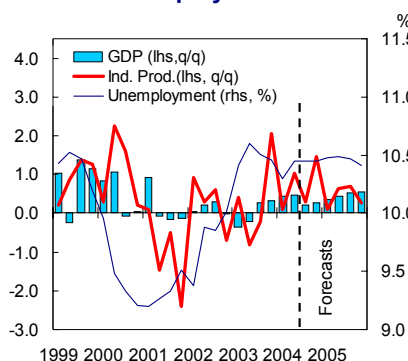


Monetary aggregates dynamics

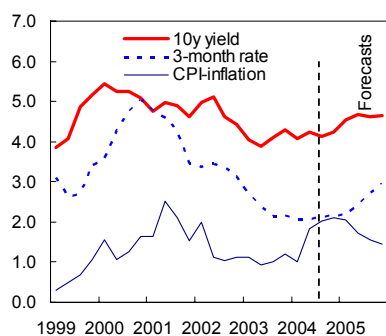


Germany

GDP production and unemployment



Interest rates and inflation



The German economy experienced a period of unsustainable growth in the early part of 2004 but now looks set to return to more manageable levels. Once again, continuing inertia in consumer spending and a lack of business confidence in the recovery evidenced by cautious new investment were behind the slowdown. Also dragging down the economy was the construction industry, which fell by 0.2% q/q after a decline of 5% in the first part of the year. Excluding the construction industry, the German economy grew by an average of 0.8% q/q in the first half. But the upswing was driven solely by exports, which contributed 1.7%, while consumer spending and investment in machinery remained stagnant. Domestic demand remains weak, but employment figures are showing encouraging signs (+0.2% y/y in July, in line with the improvement of sector indicators which continued in September), giving rise to optimism that better times are not far off. It is clear that savings rates, which peaked at 11% in 2Q04, must fall again before consumer spending can take off. This is only likely to happen as the economy improves, and as the EUR 7 billion tax cuts forecast at the beginning of 2005 begin to take effect. We therefore confirm that our growth estimates are lower than those of the consensus.

The rise in CPI inflation—boosted initially by government-set prices and then by the sharp rise in Brent prices, which were 70% higher than at the beginning of the year—also helped put the brakes on demand. This is the only reason for the upwards adjustment of our inflation outlook to 1.8%, from our original forecasts of 1.4% and 1.1% for June 2004 and June 2005 respectively. Excluding energy, the competitiveness of German products has increased thanks to the downward trend in unit labour costs which has continued virtually unabated since 2Q02.

Opportunities to boost the economy through fiscal measures are limited, especially until Germany completes the reform of its welfare state. However, the recent easing in the EU Stability and Growth Pact conditions should protect Germany from sanctions in 2005 despite a deficit/GDP ratio which is still higher than 3%.

(GianLuigi Mandruzzato)

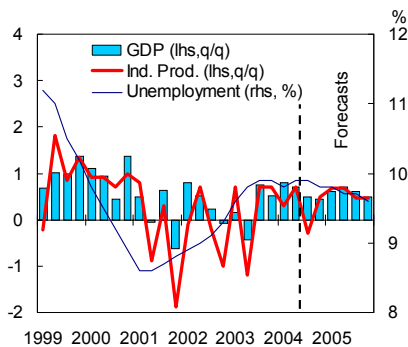
Germany

	2003	2004	2005	2004				2005			
				1	2	3	4	1	2	3	4
GDP (1995 prices, y/y)	-0.1	1.3	1.5	0.8	1.5	1.4	1.4	1.3	1.2	1.6	1.9
- q/q change				0.4	0.5	0.2	0.3	0.3	0.4	0.5	0.6
Private consumption	0.0	-0.4	1.1	0.0	0.1	0.1	0.2	0.4	0.2	0.3	0.4
Fixed investment	-2.2	-2.3	3.8	-2.8	-1.0	0.5	0.9	1.6	1.2	0.7	0.9
Government consumption	0.1	0.2	1.1	-0.3	0.3	0.3	0.3	0.3	0.2	0.3	0.2
Export	1.8	9.0	5.9	4.3	3.2	0.5	1.3	1.4	1.2	1.7	2.5
Import	3.9	6.1	6.6	1.2	2.2	1.7	1.5	1.9	1.1	1.5	1.9
Stockbuilding (% contrib. to GDP)	0.9	0.5	-0.2	-0.2	0.0	0.4	-0.1	-0.2	-0.1	0.0	-0.3
Current account (% of GDP)	2.3	3.6	3.0	4.0	4.9	2.4	3.4	2.6	3.6	2.2	3.7
Deficit (% of GDP)	-3.8	-3.7	-3.3								
Debt (% of GDP)	64.6	66.8	68.5								
CPI (y/y)	1.1	1.7	1.7	1.0	1.8	2.0	2.1	2.1	1.7	1.6	1.4
Industrial production (y/y)	0.1	2.6	2.5	0.1	1.0	0.3	1.5	0.1	0.6	0.7	0.3
Unemployment (%)	10.5	10.4	10.5	10.3	10.4	10.4	10.5	10.5	10.5	10.5	10.4
3-month Euribor	2.34	2.11	2.56	2.06	2.08	2.12	2.17	2.20	2.40	2.70	2.95
10-year yield	4.09	4.17	4.62	4.08	4.24	4.14	4.23	4.53	4.67	4.63	4.64
Effective exch.rate (1990=100)	124.6	125.5	124.0	126.2	125.1	125.5	125.3	124.1	123.8	123.4	124.4

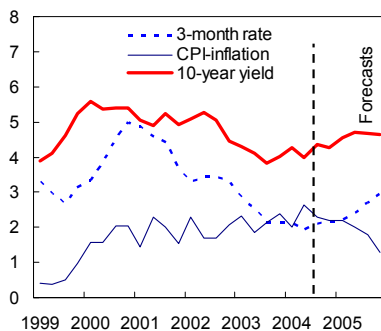
Percentage variations over previous period, if not otherwise specified.

France

GDP production and unemployment



Inflation and interest rates



After a much more encouraging first half than expected, **the French economy is beginning to slow down**. The slowdown was apparent in 3Q04, with **estimated growth at 0.5% q/q**, from 0.7% in 2Q04. **This was mainly due to consumer spending**. Monthly indicators suggest that private consumption growth has been more modest since the summer, owing partly to the recent rise in unemployment. In the next few months, however, we should begin to see the effect of government measures to boost employment and consumer spending set out in the 2005 budget in September. A look at the confidence indicators demonstrates increasing consumer confidence over both inflation and employment, showing that **although declining, consumer spending still remains the driving force for growth**.

Investments delivered a strong performance. Confidence is at its highest level since 1Q01 and benefits from the stability of low interest rates and government incentives for companies (reduction in corporate income tax, extension of professional tax exemption on new investment and tax credit for SMEs to research new markets and employ apprentices). By contrast, the export balance is still negative, owing partly to the stronger euro, although the deficit is gradually expected to improve. Public spending curbs will be introduced next year following the expenditure freeze set in the 2005 budget. Combined with healthy growth, this should encourage a **significant fall in the deficit/GDP ratio** from the expected 3.6% for this year to just over 3.0% in 2005 (compared with the government's target of 2.9%).

The inflation rate, adversely affected in the past few months by high oil prices, **is likely to fall below 2.0% next year, owing partly to a 2% cut in retail prices** in September, which will be accompanied by a further reduction of 2% in 2005.

(Asmara Jamaleh)

France

	2003	2004	2005	2003				2004				2005		
				4	1	2	3	4	1	2	3			
GDP (constant prices, y/y)	0.5	2.4	2.3	1.0	1.6	2.8	2.5	2.5	2.3	2.3	2.4			
- q/q change				0.5	0.8	0.7	0.5	0.4	0.6	0.7	0.6			
Private consumption	1.7	2.5	2.2	0.4	1.0	0.6	0.5	0.7	0.4	0.6	0.6			
Fixed investment	0.1	3.8	3.3	0.9	0.8	1.6	1.3	0.8	1.0	0.4	0.5			
Government consumption	2.5	2.8	1.9	0.9	0.5	0.9	0.5	0.4	0.5	0.5	0.3			
Export	-2.6	3.1	6.4	1.6	0.5	1.0	0.6	1.1	1.6	2.3	2.0			
Import	0.3	7.8	8.0	2.8	1.2	3.9	1.8	1.7	2.0	1.8	1.6			
Stockbuilding (% contrib. to GDP)	-0.2	0.8	0.5	0.2	0.2	0.6	0.2	0.0	0.2	0.0	0.0			
Current account (% of GDP)	0.4	-0.1	-0.6	-0.1	0.2	-0.3	0.1	-0.4	-0.5	-0.9	-0.4			
Deficit (% of GDP)	-4.1	-3.9	-3.9											
Debt (% of GDP)	63.8	65.1	66.5											
CPI (y/y)	2.2	2.3	1.8	2.4	2.0	2.6	2.3	2.2	2.2	2.0	1.8			
Industrial production	-0.4	1.4	2.0	0.7	0.3	0.7	-0.3	0.5	0.7	0.7	0.5			
Unemployment (%)	9.8	9.9	9.7	9.9	9.8	9.9	9.9	9.8	9.8	9.7	9.7			
3-month Euribor	2.41	2.09	2.81	2.12	2.12	1.96	2.12	2.17	2.51	2.95	2.98			
10-year rate	4.07	4.19	4.62	4.02	4.26	3.99	4.37	4.16	4.47	4.74	4.72			
Effective exch.rate (1990=100)	106.0	106.7	105.6	106.6	107.1	106.3	106.7	106.5	105.7	105.5	105.3			

Percentage variations over previous period, if not otherwise specified.

Italy: slowdown expected by end of 2004

In the first half of 2004, the Italian economy recorded its strongest growth for three and a half years. GDP grew by an average of 0.4% q/q, with the y/y figure rising to 1.2%, from 0.1% at the end of 2003. The resurgence is due almost entirely to an upswing in domestic demand. **The strong housing market appears to be responsible for the faint recovery seen at the beginning of 2004**, although to a lesser extent than in France, Spain and the UK. Household consumption benefited from an upturn in spending on durable goods—in continuation of the trend already started in mid-2003—following the boom in house buying. Investment is also rising again, and around half of the increase was due to construction investment. Domestic demand therefore increased by an average of 0.7% q/q. This upturn was however mainly matched by a sharp reduction in stock levels—destocking shaved more than six-tenths of a point off growth in the first half of 2004—rather than to any increase in production, which continues to fall. Net exports, hit by the strong euro, practically gave no contribution to GDP growth.

In our view, the upturn in domestic demand in the first half of the year is likely to be only temporary. Preliminary data for 3Q04 shows **domestic demand slowing in the second half of 2004**. Given sluggish global growth, net exports are likely to have zero impact in 2004 and a slightly negative impact in 2005. These trends confirm our forecast of **annual GDP growth at 1.1% in 2004 and 1.5% in 2005**.

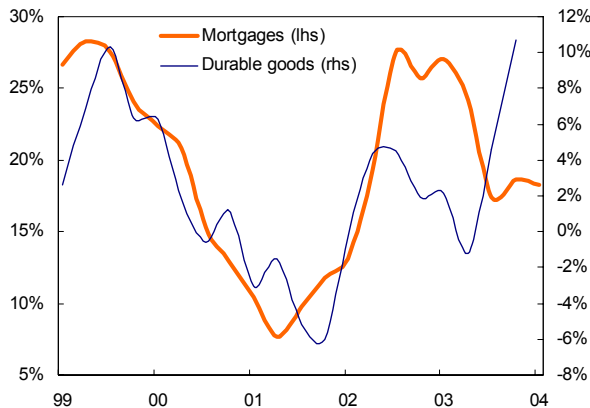
Consumer spending on durables props up expenditure

Quarterly fluctuations aside, average growth in consumer spending during the past four quarters came to a not insignificant 0.4% q/q, driven almost exclusively by spending on durable goods. Spending on non-durables remained broadly flat (+0.1%, y/y, in 2Q04). This anomaly may be due to the financial difficulties of medium-low income families—more sensitive to the price of non-durable goods—whose purchasing power has been eroded by higher oil prices and higher perceived inflation. We forecast a slowdown in consumption in the second half of the year, since:

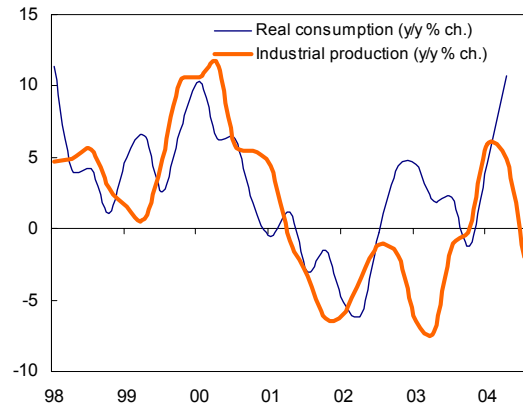
1. around half the effect of the higher oil price in Italy has not yet had a knock-on impact on electricity and heating costs. Between January and August, fuel and energy price increases cost Italian households around an extra EUR 1.8 billion (0.2% of annual disposable income). By the end of the year, **around EUR 3 billion in purchasing power (0.35% of disposable income) may be lost**. This is almost 0.5% of consumer spending.
2. **spending on durable goods may now have reached a turning point** and looks likely to slow down. New car registrations, which underpinned growth in the first part of the year, decreased by 4% q/q in 3Q04 and sector surveys predict a further slowdown by the end of the year. Production of durables—the only sector keeping manufacturing output afloat in the first few months of the year—fell sharply in the summer quarter, and as foreign exports are at a standstill, a slowdown in consumer demand is highly likely.

Consumer spending will therefore increase by an annual average of 1.2% in 2004, in line with real income increases against a backdrop of a stable saving rate. In 2005, probable tax rate cuts are likely to be offset by other restrictive measures, so the **effect of the budget on households is estimated to be broadly neutral**. The oil price—at an annual average of USD 45—will also dampen spending, which will therefore not grow by more than **1.4% in 2005 either**. The risks are to the downside, however: a marked deterioration in the public finances next year could lead to a sharp rise in the savings rate, which would obviously hit consumer spending.

Mortgages and durables consumption
(y/y % ch.)



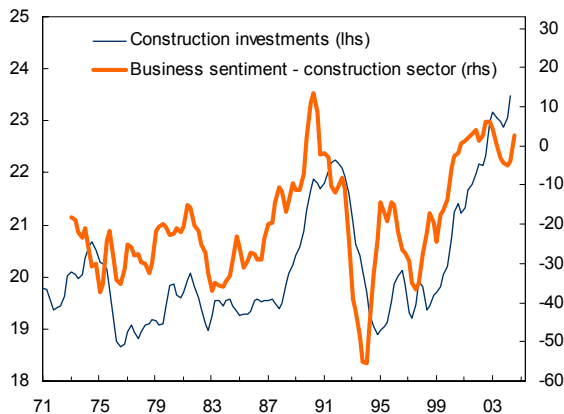
Durable goods: consumption and production



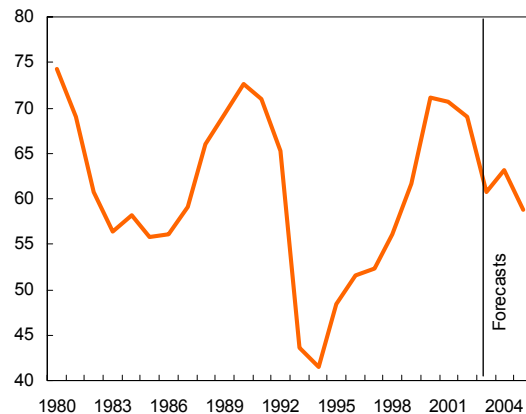
Investment has not yet taken off

Although gross investment started to pick up in the first half of 2004 (+2% q/q, on average), it is likely to be only a temporary rebound after the lull in 2003 (when the gross figure dropped by 2.1% and net investments plummeted 12%) rather than the start of a new phase of investment. The production of capital goods likely declined by more than 1% in 3Q04 q/q, and since business confidence is currently at a low ebb, an upturn is unlikely in the final months of the year. Investments (excluding construction) will slow in the second half of 2004, implying an annual average growth rate of 3%. **Business investments are expected to remain sluggish** into 2005 as well; the rationalisation of fixed capital is still under way: next year, investment growth will not be enough to replace obsolete plant. Gross investment growth (excluding construction) is therefore forecast at 2.5% in 2005. By contrast, after a brief hiatus last year, construction investment has resumed its momentum due to renewed activity in both the residential and commercial housing markets. Investment in this sector has reached record highs and confidence surveys show no sign of a downturn. We expect that 2004 will close with respectable average annual growth of 3.2%, and only a slight downturn next year (2.8%).

Construction investments
(quarterly data - euro bn, constant prices)



Net fixed investment
(euro bn - constant prices)



Exports flat

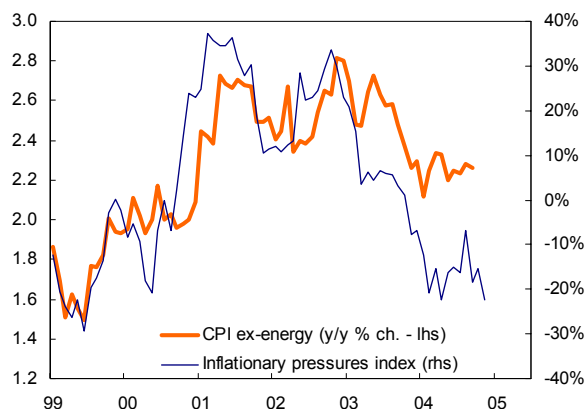
After a positive start in 2Q04, net exports are expected to have no impact on growth in the second half of the year due to the forecast slowdown in the global economy; they are likely to make a slightly negative contribution next year. Exports showed noticeable growth in the summer months, but this was partly due to higher average unit costs rather than volume of sales. Weak domestic demand will prevent the import trend being significantly higher than that of exports.

Lower core inflation, headline inflation stable

Despite soaring oil prices, inflation in Italy fell in September to its lowest level since 1999. **A fall in food prices** was responsible for pushing the rate down, following the exit from the index computation of the fruit and vegetable price rises seen in summer 2003. Another causal factor could be the slump in grocery sales which is pushing the retail industry towards increasingly aggressive pricing. Lower food inflation has more than offset the high energy prices which had a greater impact during the first few months of the year. As it is the percentage change in oil prices that matters for inflation, prices are unlikely to rise significantly in the next few months while Brent crude prices remain high.

Inflationary pressures on the rest of the basket of goods still remain very low. Excluding fresh food and energy, core inflation has fluctuated around 2.2-2.3% for several months, bolstered by occasional increases in administered such as cigarettes. For several months the monthly change in many of the items tracked by the CPI has been lower than the average monthly changes recorded in the last few years. Our inflationary pressures index shown in the graph below compares current year's monthly variations with those of the past few years, and shows that fears of a rise in inflation in the next few months are currently unfounded. Core inflation is therefore likely to make a gradual **return to 2%**, while **overall inflation in Italy should remain moderate for the next few months.** After an expected rise in October to 2.2%, pushed up by the recent peaks in oil prices, inflation should then fall to around 2.1% in the final months of the year, with an annual average for 2004 of 2.2%. We forecast that, following the fall in food prices, and with no expected change in oil prices from around USD 45 into next year, the average inflation rate will remain at 2004 levels (2.2%) in 2005.

Few inflationary pressures on core CPI



Public finances: 2005 the year of truth?

The 2005 budget is still bogged down in parliament. We confirm our previous estimate that, of the EUR 24 billion of tax cuts planned, around half will be effectively implemented in 2005. We therefore expect the budget deficit to rise from around 3% of GDP this year to 3.5% in 2005. At this stage, it is not yet clear how the government intends to finance the tax cuts. If it is not able to do so sufficiently, our deficit forecast for next year will be thrown into serious doubt.

What is certain is that we will not see any serious consolidation of the public finances before mid-2006. Given the growing divergence between the deficit of the public administration (which counts towards the Maastricht parameters) and the state sector borrowing requirement (which impacts more directly on debt and already makes up 4.5% of GDP in 2004) it seems highly likely that there will be some nasty surprises on the budget deficit front in 2005.

(Giada Giani)

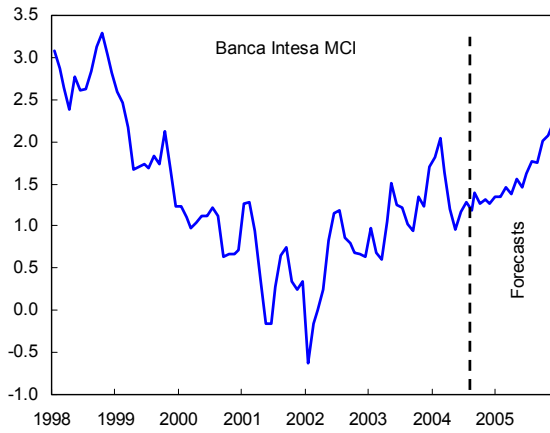
Italy

	2003	2004	2005	2003					2004			2005		
				4	1	2	3	4	1	2	3	1	2	3
GDP (constant prices)	0.4	1.1	1.5	0.1	0.8	1.2	1.0	1.3	1.2	1.4	1.6			
- q/q change				0.0	0.5	0.3	0.2	0.3	0.5	0.5	0.4			
Private consumption	1.2	1.2	1.4	-0.3	1.1	-0.3	0.2	0.4	0.4	0.5	0.4			
Fixed investment	-2.1	3.1	2.6	-0.4	2.6	1.4	0.0	0.4	0.8	0.9	0.5			
Government consumption	2.2	1.3	1.5	0.7	-0.6	0.7	0.7	0.2	0.4	0.3	0.3			
Export	-3.9	3.8	4.1	-3.8	-1.1	4.7	1.4	0.9	0.8	0.8	0.2			
Import	-0.6	3.7	4.8	-1.6	0.4	2.7	1.1	1.7	1.1	0.8	0.7			
Stockbuilding (% contrib. to GDP)	0.6	-0.5	0.0	0.8	-0.2	-0.5	-0.2	0.2	0.1	-0.1	0.1			
Current account (% of GDP)	-1.4	-1.2	-1.3	-1.0	-1.2	-1.7	-0.7	-1.1	-1.3	-1.3	-1.3			
Deficit (% of GDP)	-2.4	-3.0	-3.5											
Debt (% of GDP)	107.2	108.3	109.6											
CPI (y/y)	2.8	2.2	2.0	2.7	2.3	2.3	2.0	2.0	2.1	2.0	2.0			
Industrial production	-0.4	-0.4	0.2	-0.2	-0.4	-0.1	-0.5	-0.1	0.3	0.1	0.3			
Unemployment (%)	8.7	8.7	8.3	8.7	8.7	8.7	8.6	8.6	8.5	8.4	8.3			

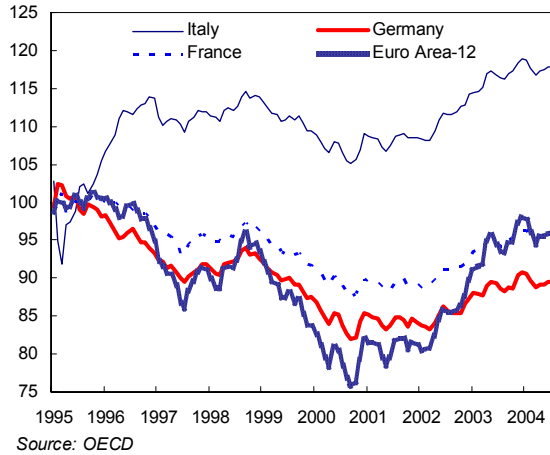
Percentage variations over previous period, if not otherwise specified.

The situation at a glance

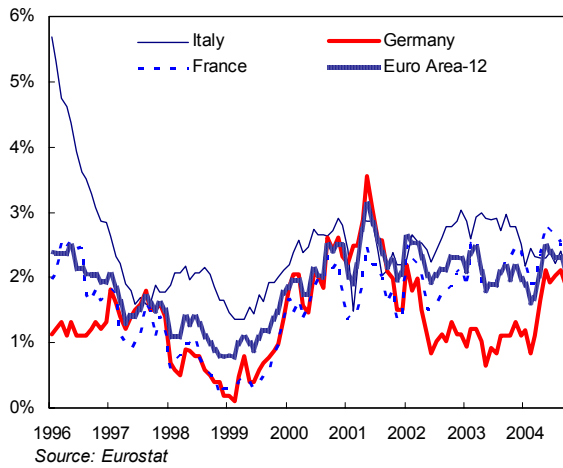
Monetary conditions in the euro area



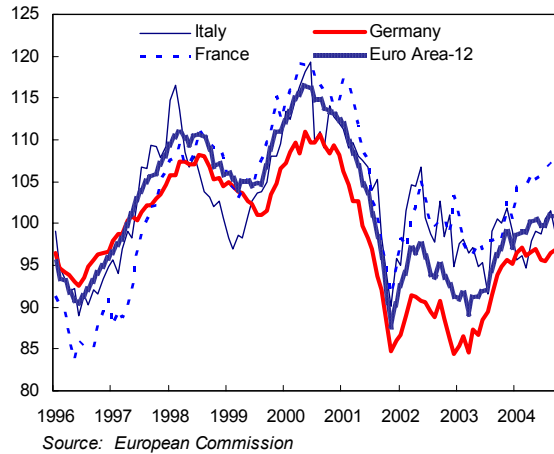
Effective exchange rate



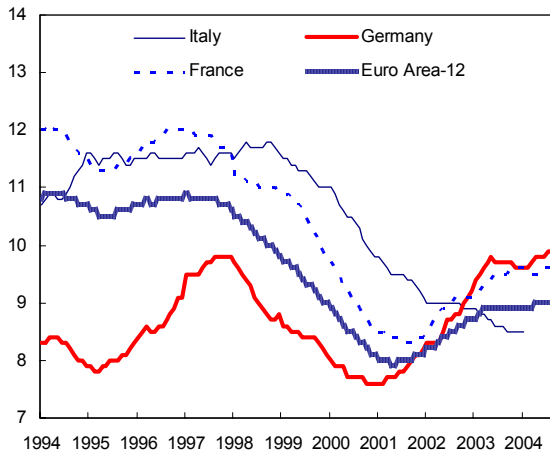
Harmonised inflation rate



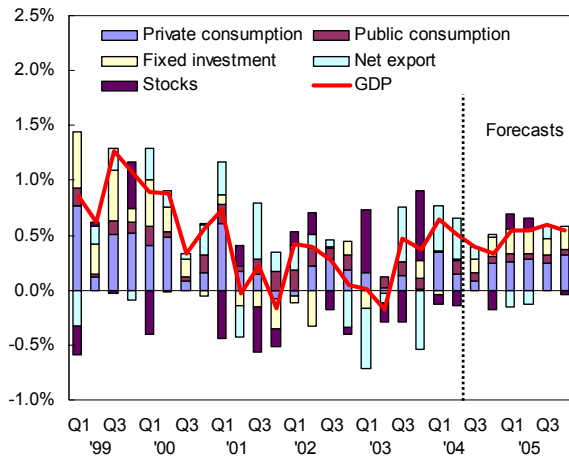
Business confidence



Unemployment rate

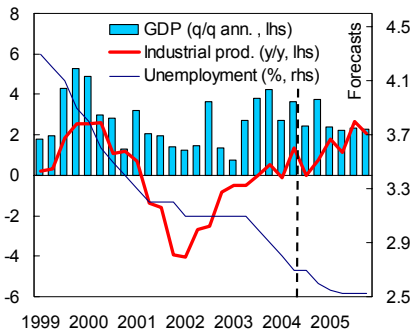


Ue-12: contributions to gdp

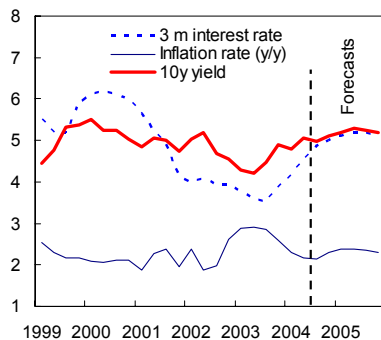


United Kingdom

The business cycle



Interest rates and inflation



Economic growth in the UK has been excellent, exceeding potential. After growth of 2.3% last year, 2004 should close with a figure of 3.3%, slightly above expectations.

Although **domestic demand remains strong**, the best performances came, surprisingly, from investments and exports, rather than consumer spending, which came in lower than forecast. Investments benefited from a looser monetary policy than the market was expecting a few months ago. Implicit rates forecast for December 2005, which stood at 5.75% last June, are now even lower than 5.0%. As for foreign demand, net exports are expected to improve gradually due to a fall in the exchange rate (sterling is currently over-valued, especially against the dollar). Public spending, which increased this year, will be cut in 2005.

News since June is that the interest rate rises carried out since last November have started to bring about the desired effect, cooling the housing market. As a result, households are not taking on as much debt and spending is lower. **Consumer spending growth decreased from 1.1% q/q to 0.6% in 2Q04 and is expected to decelerate further at 0.6% in 3Q04. As a result, we estimate that in the third quarter, GDP growth slew down from 0.9% to 0.6% q/q.** However, we think this is just a lull before growth bounces back again, helped by consumer spending. Although the housing market is slowing down, the job market situation is improving, with unemployment falling for five consecutive quarters now. Even so, consumer price inflation is still surprisingly low. Given the inflationary pressures at the top end of the production chain, consumer inflation is expected to rise again in the next few months. Following the lull in 3Q04, we think that increasing consumption and inflation will prompt the Bank of England to **keep raising interest rates, with at least another hike of 25 bp**, unless convincing signs emerge that the economy is cooling off.

(Asmara Jamaleh)

United Kingdom

	2003	2004	2005	2003				2004				2005		
				4	1	2	3	4	1	2	3			
GDP (constant prices, y/y)	2.2	3.3	2.7	2.9	3.4	3.6	3.2	3.1	3.1	2.7	2.7			
- q/q change				1.0	0.7	0.9	0.6	0.9	0.6	0.6	0.6			
Private consumption	2.3	3.2	2.5	0.6	1.2	0.6	0.6	0.8	0.5	0.6	0.6			
Fixed investment	2.2	6.5	4.3	1.9	1.6	2.4	0.9	1.1	1.0	0.9	1.0			
Government consumption	3.5	4.3	2.7	2.1	0.8	0.4	1.0	0.6	0.6	0.6	0.6			
Export	0.1	2.3	6.6	1.6	-1.0	1.5	1.8	1.9	1.5	1.5	1.5			
Import	1.3	4.7	7.1	3.1	0.3	1.1	1.4	2.1	1.8	1.8	1.7			
Stockbuilding (% contrib. to GDP)	0.0	0.0	0.1	0.4	-0.2	0.0	-0.2	0.2	0.1	0.0	0.0			
Current account (% of GDP)	-1.9	-2.3	-2.8	-1.9	-1.9	-2.3	-2.4	-2.5	-2.7	-2.8	-2.9			
Deficit (% of GDP)	-3.1	-3.0	-2.8											
Debt (% of GDP)	39.8	40.7	41.7											
RPIX (y/y)	2.8	2.2	2.4	2.6	2.3	2.2	2.1	2.3	2.4	2.4	2.4			
Industrial production	-0.1	0.5	1.9	0.2	-0.4	1.2	-1.0	0.9	0.6	0.6	0.4			
Unemployment (%)	3.0	2.7	2.5	2.9	2.8	2.7	2.7	2.6	2.6	2.5	2.5			
3m GBP Libor	3.69	4.63	5.15	3.88	4.15	4.51	4.87	5.00	5.10	5.20	5.20			
Long Gilt	4.46	4.98	5.24	4.90	4.78	5.06	4.99	5.10	5.20	5.30	5.25			
GBP/USD	1.63	1.82	1.77	1.71	1.84	1.81	1.82	1.81	1.80	1.78	1.76			
Effective exch.rate (1990=100)	100.2	104.8	105.2	100.2	104.0	105.2	104.8	105.3	106.5	105.9	105.3			

Japan: “cruising speed”, with some downside risks

Growth slowing although still above potential with continuing modest deflation

Growth in Japan slowed down mid-year, but is still on a positive path and above potential, which is estimated at between 1.5 and 2%. After two quarters of extraordinary growth (7% annualised q/q) in late 2003 and early 2004, owing to economic growth in the US and China and to a sharp upturn in consumer spending, Japanese **GDP** growth rates are settling down to more sustainable levels. Having slowed to 1.2% in 2Q, owing partly to a drop in public investment and inventories, growth is likely to **stabilise at 1.8-2% in the second half of this year and throughout 2005. Price levels are confirming expectations that very moderate deflation (about -0.2%) will drag on into 2005, with inflation only forecast to turn positive again towards the end of 2006.** Japan will consequently also be affected by the global slowdown in 2005, but will experience a smooth transition towards positive growth driven by private domestic demand. The contribution from the public sector will continue to decline as the government attempts to put its accounts back into order.

Monetary policy will therefore remain unchanged until 2006

In its September report on the economy, the BoJ remained positive. According to the central bank, growth is moving into a period of adjustment, but is still heading towards sustainable recovery, even without external stimulus, at a “cruising speed” that is a little above potential. Exports and production are still trending up, albeit slightly more slowly, and both confidence and corporate earnings continue to improve with positive effects on the consumer sector. Persistent, although moderate, deflation means that monetary policy will remain unchanged for some time, probably at least until mid-2006.

Recent data shows that some of the second-quarter weakness has continued into the third quarter with business and consumption indicators below forecasts. However, the outlook is still consistent with growth at cruising speed: in August orders increased by 5.4%, and industrial output 9.9%. Consumer spending, on the other hand, suffered a setback with unemployment holding constant at 4.8%. The most recent Tankan survey was upbeat in its forecast of increasing investment spending over the next three quarters, while indices of consumer confidence are still at high levels, despite having declined somewhat in the past two months. Net export growth has dropped sharply, and is expected to only be marginally positive next year.

The situation in Japan, as in the rest of the world, is less dynamic, although more stable, than a year ago. To date, the measures introduced to set the economy back on its feet mean that GDP growth is now being driven by the private sector. **Average growth in consumption for 2004 will be 1.6% and private investment will rise by about 10%, while exports should increase by an average of 14% in 2004,** with growth rates stabilising around 7-8% in coming years. The public sector has almost completely lost its role as a growth driver, with public investment down for the fifth year in a row (-14% in 2004, after -11% in 2003) and total spending up by 2%.

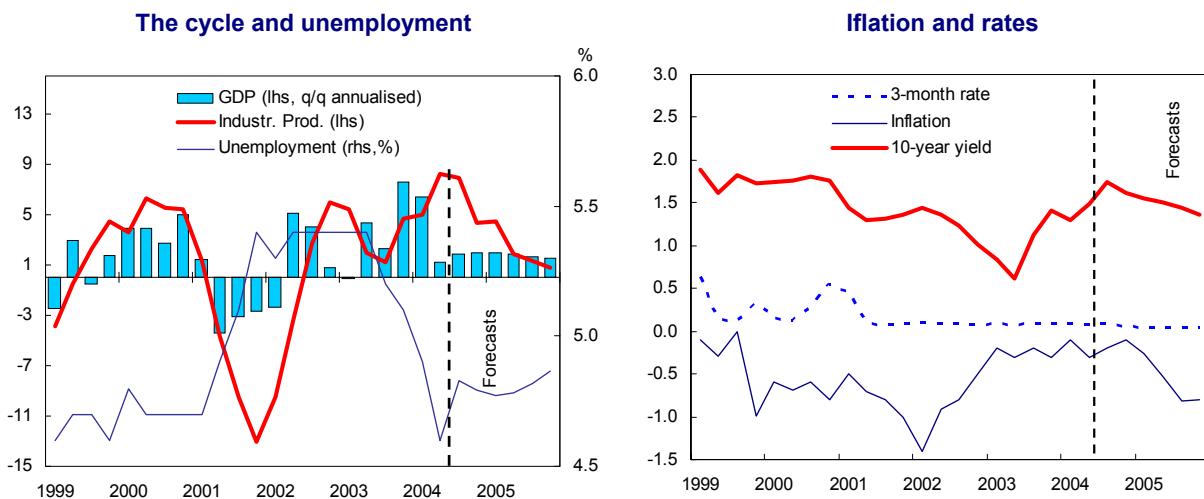
There are two risks ahead: a global economic slowdown and the effects of structural reforms on government finances and pensions

There are **two risks inherent in this scenario, both of which point to the possibility of lower growth rates for 2005.** The first, in common with the rest of the global economy, is related to the price of **oil**, while the second is peculiar to Japan and relates to the government’s **reform** package.

With respect to **oil**, all forecasts of the effect of energy prices on the Japanese economy agree that the impact on general inflation will be moderate. Based on IEA forecasts using the OECD model, a permanent increase of USD 10 in oil

prices (from levels of around USD 25), pushes inflation up by only **0.2% per year**, less than half the amount estimated by the model for the US and the eurozone. Growth, however, is cut by an estimated 0.4% a year. Based on figures available for net fuel imports, the considerable increase in prices during 2004 appears to have reduced average growth by 0.5% and may trim a further 0.3% in 2005. The BoJ has itself confirmed that the impact of oil on Japanese inflation is very modest, although following the last meeting of the monetary policy committee, Toshihiko Fukui stated that the central bank will have to monitor its impact on prices and growth.

The **reform package is likely to have mixed effects**. In the short term, it is likely to have an adverse effect on growth (given likely tax hikes over the next two years), while in the medium term, the net effect will be positive since the measures will include privatisations and a streamlining of the public sector in coming years, which will undeniably benefit the overall performance of the economy.



Time for reform

In a fairly encouraging economic situation with growth at above potential for two years in a row and deflation almost defeated, the economy appears solid enough to permit implementation of the government's long list of proposed reforms. The measures aim to slim down, rationalise and decentralise the public sector, and make the pension system viable. The reforms will affect the public finances both directly and indirectly, and so an economic upturn is absolutely necessary to ensure that they do not plunge the economy back into recession.

The major reforms announced by the government at the end of last year relate to the main problem areas of public finance: pensions, the relationship between central and local government finances and the size of the public sector.

The **pension system** has already been the subject of some reforms this year. These, combined with other measures announced at the end of 2003, are aimed at balancing pension contributions and benefits, as the generation of baby boomers approaches retirement age. The objective is to avoid placing the burden of the greying population solely on today's young people. Pension reform will inevitably hit consumer spending growth over the next few years.

The secondary focus is the “trinity reform” that entails action on 1) state subsidies to local authorities; 2) transfer of revenue to local authorities (reform of local allocation tax); and 3) redistribution of taxes (transfer of the tax base).

Finally, to gradually reduce the weight of the public sector in the economy and make it more flexible and efficient, the government proposes the ambitious (and politically risky) plan to privatise the postal agency.

Positive medium-term effects...

As stated above, **reducing the burden of the public sector** on the economy will initially entail the restructuring and subsequent privatisation of the post office. According to the plan, announced on 10 September, the service is to be split into four separate entities over three years. This ambitious project is likely to have positive medium-term effects on growth and the stock market. The only effect next year however will be the impact of the announcement itself, confirming the government's favourable market orientation. The four new entities will focus respectively on postal services, banking, insurance and a postal “network” (the role of which has not been clearly defined). The schedule is as follows: phase 1 will take place between the publication of implementing legislation (expected in March 2005) and March 2007. This phase will entail separating the organisation of the four entities (allocation of staff, pension liabilities, renegotiation of contracts, reorganisation of capital etc).

During phase 2 (from 2007 to 2017), the government will be the sole shareholder of a holding company controlling the four entities, and the employees of those entities will no longer be public sector workers, since their contracts will be put on an equal footing with private sector employees'. Each of the four new companies will be regulated by the sector body responsible for the services that each provides. To all intents and purposes, each of the four companies will be profit-oriented and independently managed. The government has announced that two-thirds of the banking and insurance companies' share capital will be offered to the public during this phase, but has made no mention of if/when the other two companies will be privatised.

Although the plan was opposed in parliament by both members of the government and the opposition, it now seems to be proceeding smoothly as a result of the prime minister's determination to introduce wide-ranging reforms. There are still some risks linked to the fact that postal deposits provide the funds for a significant amount of JGB purchases. But passing implementing legislation by March should give an important signal to the markets with respect to the credibility of a structural reform plan which will improve the growth potential of the economy most burdened by ageing population in coming years.

... with short term risks

The effects of the other aspect of the reforms entailing a thoroughgoing overhaul of the entire tax system will already be felt in the next few months: this, in addition to changes in legislation relating to the functioning and organisation of local government, will be an important aspect of decentralising administration and taxation. After years of expansionary fiscal policy, the government debt/GDP ratio is around 170% and the budget deficit is about 6-7% of GDP. Although the government expects to reduce public spending following the rationalisation of the public sector, it also plans to take steps to increase tax revenues. In a situation of increasing costs linked to the ageing population, the government intends to increase its tax receipts to the same level as other industrialised countries. This represents a short-term risk to growth.

The budgets of the last ten years have reduced tax rates to levels that are significantly below those of other countries. Ministry of Finance figures show that nominal tax revenues are currently the same as they were in 1986 (then equal to 13.5% of GDP, now 8%), while personal income taxes amount to about 6% of GDP. Some 80% of income tax payers are taxed at the minimum rate of 10%. Less than 1% are taxed at the maximum rate of 37.5%. Sales tax (VAT) is also much lower than in Europe and most of the US.

The government needs the reforms to rationalise the tax system and ensure it can fund growing pension obligations. The first step of the plan is to abolish the flat tax deductions introduced by the 1998 reform, thus increasing **tax receipts by about JPY 3.5 trillion, or just over 1% of household disposable income**. The government has not indicated exactly when (and how fast) this will happen, but it is expected to begin in the next few months. The measure is almost certain to be introduced since it will serve as the basis for the transfer of tax receipts of around JPY 3 trillion to local authorities in the next fiscal year. There are currently three suggestions as to timing: immediate implementation in fiscal year 2005, or spreading the introduction over two or three years. In 2005, the government plans to launch a pensions squeeze by increasing contributions and abolishing tax relief on pension benefits. Following the initial reform of income tax, the government will then increase the consumption tax in two stages, from 5% to 7% in 2007 (with expected revenue of JPY 5 trillion) and subsequently to 10%.

Japan

	2003	2004	2005	2003					2004				2005		
				4	1	2	3	4	1	2	3	1	2	3	
GDP (constant prices, y/y)	2.5	4.1	1.8	3.5	5.1	4.3	4.2	2.8	1.8	1.9	1.9				
q/q annual rate				7.6	6.4	1.3	1.8	2.0	2.0	1.8	1.7				
Private consumption	0.8	3.1	2.1	4.4	4.2	2.6	1.9	1.8	2.1	2.2	2.1				
FI - private nonresidential	9.6	10.2	4.0	29.6	8.3	4.9	4.0	5.4	4.3	3.3	2.9				
FI - private residential	-0.8	2.3	3.9	-3.4	2.2	1.8	2.6	3.7	4.3	5.1	4.2				
Government investment	-10.5	-14.1	-5.0	-6.9	-13.7	-25.2	-5.9	-3.4	-3.1	-3.4	-2.0				
Government consumption	1.0	1.6	1.4	1.6	2.1	1.3	1.9	1.3	1.4	0.6	2.3				
Export	10.1	14.2	5.4	22.6	19.1	14.9	0.9	5.0	8.6	4.3	3.3				
Import	5.0	9.5	10.0	11.2	12.8	7.8	9.2	9.1	11.5	10.4	10.8				
Stockbuilding (% contrib. to GDP)	0.3	0.3	0.1	-0.2	0.4	-0.3	0.2	0.0	0.0	0.1	0.1				
Current account (% of GDP)	3.2	3.5	2.7	3.4	3.9	3.8	3.4	3.1	3.0	2.8	2.6				
Deficit (% of GDP)	-7.7	-7.8	-7.8												
Debt (% of GDP)	134.5	148.0	154.9												
CPI (y/y)	-0.3	-0.2	-0.6	-0.3	-0.1	-0.3	-0.2	-0.1	-0.3	-0.5	-0.8				
Industrial production	3.3	6.3	2.1	16.6	2.1	11.0	2.6	2.0	2.5	0.5	0.2				
Unemployment (%)	5.3	4.8	4.8	5.1	4.9	4.6	4.8	4.8	4.8	4.8	4.8				
3-month CD rate	0.09	0.08	0.05	0.09	0.09	0.08	0.09	0.05	0.05	0.05	0.05				
10-year rate	0.99	1.54	1.46	1.41	1.31	1.49	1.74	1.62	1.55	1.51	1.44				
JPY/USD	115.9	108.7	103.0	108.8	107.2	109.8	109.9	108.0	105.0	103.0	101.0				
Effective exch.rate (1990=100)	131.5	136.2	145.6	135.9	136.1	136.5	134.8	137.2	142.2	145.5	149.0				

Percentage annualised growth rate over previous period, if not otherwise specified.

Even though, in general terms, the reform plan shows the government is aware of the challenges to be faced in years to come - ie how to fund pensions and slash debt from the huge levels accumulated in the 1990s - **its implementation is obviously not without risk**. The Japanese economy is still in deflation, albeit moderate, and the global economy is slowing down. The first part of **tax reform is therefore likely to be implemented over two or three years, so as not to jeopardise the recovery**. Then the other reforms will be implemented gradually in future years depending on the performance of the economy. If this is the case, then the **abolition of tax deductions will cut disposable income by about 0.6%, while the new pension measures will trim off a further 0.2%. The**

effect on GDP is forecast to be 0.3% (assuming that individuals offset the effect on consumption by a modest reduction in their savings rate).

Conclusions

The Japanese economy will slow down in 2005, with **growth just below 2% (still above potential) and deflation stabilising at about -0.2%**, which is more or less in line with 2004. **Implementation of tax reforms creates risks for consumption**, but the deregulation and increased efficiency that should follow the reorganisation of the public sector should at least partly compensate for the direct effects of the tax squeeze introduced in 2002. The feared global slowdown caused by the **increases in the oil price, together with China's "soft landing"** could ultimately dampen Japanese growth, shaving a few tenths of a percent off forecast growth rates but **without, however, derailing the process of setting the Japanese economy back on its feet.**

(Giovanna Mossetti)

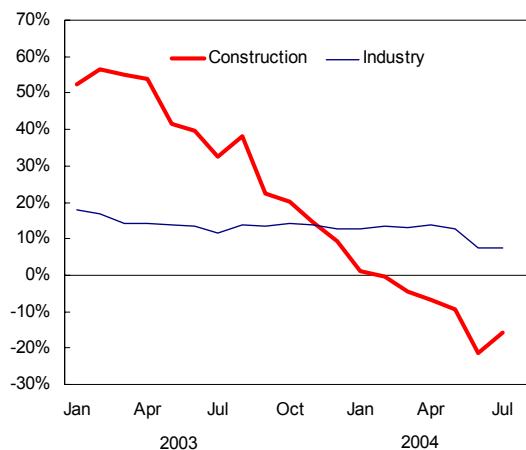
China: selective slowdown

		2002	2003	2004(p)	2005(p)
GDP	a/a	8.0	9.4	9.1	7.9
Consumption	a/a	6.1	7.3	9.9	8.9
Capital investment	a/a	16.7	22.7	19.0	9.9
Inflation	a/a	-0.8	1.2	4.4	3.3
Balance of trade	mld USD	+44.2	+32.8	+10.2	+13.6

Source Banca Intesa, OEF

Restrictive policies introduced by the Chinese government to cool the overheating economy seem to be taking effect. The industrial value added index peaked last March (19.4% y/y) and, by July growth had already eased to 15.5%. The selective nature of the measures can be seen by their greater effect on the most critical sectors. Lending to the construction sector contracted by 15.7% y/y compared to an increase of 7.5% to industry. Although the number of new buildings constructed in April was growing by 26% y/y, by July it was only 4% above last year. The credit squeeze also dampened growth in car sales from 76% in 2003 to 3.7% in July 2004. As a result, steel and copper imports dropped by 36% and 40%, respectively y/y. In the meantime, increasing oil prices may have shaved 0.6% off economic growth this year and will also hold it back in 2005. Given this combination of factors, we have revised our GDP growth forecasts downwards for this year and next.

China: growth of loans from financial institutions, by sector
(y/y change)



Looking at the consequences of overheating, inflation fell to 4.4% from its peak of 4.8% in July. The fact that foodstuffs and energy are the most dynamic components suggests that the increase in prices is in large part attributable to external factors (oil) and to the difficulties of managing a partly market-based, partly planned economy. This last factor creates distortions in incentives. Specifically, the increase in food prices is also linked to the conversion of farmland for building purposes by local authorities that receive a considerable part of their revenues from the sale of expropriated land. This has led to a collapse in cereal production. Central government is attempting to remedy the situation by introducing measures to protect agricultural land and to support farmers' income

(tax relief, subsidies etc)—apparently with some success judging by this year's increase in production. Price increases, however, have reduced the already very low standards of living and created tensions among the urban workforce. It is, therefore, likely that the two trends (support to farming and inflation) could lead to an increase in the elasticity of labour costs per employee.

How great is the risk that the slowdown could set off a recessionary spiral? The spider's web of administrative measures that is slowing Chinese economic growth could be quickly dismantled if their impact turns out to be greater than desired. At that point, there would be an unsterilised inflow of currency reserves, and growth in the money supply would accelerate. In addition, China's competitive advantage is too great to think that the inflow of direct investments could abruptly dry up. As a result, the hypothesis of a permanent slowdown reducing growth to levels below 7% seems unlikely for the time being.

On the other hand, increasing industrialisation and car use in China are beginning to create serious problems on two fronts: raw material supplies and the quality of the environment (the latter having deteriorated due to incentives to increase coal use for electricity generation). Combined with the complexity of the transition to a market economy, these two factors could force China to bring down its high rates of growth.

As regards China's controversial exchange rate policy, we still believe that the authorities may prudently ease the fixed exchange rate regime by introducing a fluctuation band or by linking the renminbi to a basket of currencies including the euro as well as the dollar. If this were combined with a modest revaluation, it could help to limit inflation and the consequent erosion of real wages. However, the timing of such a move is impossible to predict.

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