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Scenario lines 2006-2007
Europe... the razor's edge

For 2007, we are forecasting that economic activity outside Europe, and principally in the United States, will be less upbeat than at present, that the euro will on average firm up somewhat, that the ECB's key rates will be higher, and that fiscal policy will be more restrictive in a number of euro zone countries. We would add for good measure that the outlook for the oil market is still uncertain and it is therefore wiser to assume that prices will stay close to their current levels or slightly below. In short, it is a curious mix of unfavourable factors, some external, others domestic, but all potentially explosive. **And yet, when we consider the outlook for economic growth in Europe, we are not tempted to descend into extreme pessimism.**

Of course, growth is set to slow in 2007, but 2006 has in many ways been outstanding. After the false starts of 2002 and 2003, it has been a year of genuine economic recovery, perceptible among businesses and households alike, in all countries and all sectors. Furthermore, the recovery was driven by firmer domestic demand and went hand-in-hand with a sharp improvement in the labour market. Since mid-year, however, the business climate has been deteriorating and so the pace of activity is going to slow, while remaining robust until the end of the year. Real GDP growth should top 2.5% in 2006, as against 1.5% on average between 2000 and 2005. If it were to slow to its historic average of 2%, it would not be a disaster.

Even if much of its trade takes place within its borders, Europe is not a closed economy. More especially, the correlation between its business cycle and that of the United States has tended to strengthen over the past decade on the back of more closely integrated trade and financial flows. Very often, also, the two regions have responded to common shocks. **Direct exposure to a strictly US shock such as the housing crisis is more limited *a priori*. It is also more bearable if, as seems to be the case, European growth has gained a degree of autonomy through the classic investment-employment-spending cycle, and if the United States does not slide into recession.**

Apart from a bout of weakness at the start of the year, the dollar has put up an outstanding resistance to the euro, when we think that the anticipated directions of short-term rates will be partially decoupled until end-2007, with a pause, then a fall in the United States and increases followed by a pause in the euro zone. **A stronger euro is still a risk, but in that case, the fundamentals would provide a cushion: the euro is not under-valued and the euro zone is currently running external deficits.**

In fact, we are more attentive to domestic risks, linked to higher interest rates and, more importantly, to fiscal tightening options. The ECB has no reason to deviate from its present objective, which is to deprive monetary policy of its expansionary character. We believe we are likely to see one more rate increases beyond end-2006. And in our projection of a Europe treading a delicate path between the pitfalls, we do not see the ECB cutting rates in 2007 when inflation is forecast to be above target for the eighth year in a row. Clearly, as interest rates rise, we are likely to see the beginnings of a credit squeeze, ultimately leading to a cooling of the housing boom discernible here and there (although not in Germany). It is a support for household spending which, while it may not disappear entirely, looks set to moderate.

Simultaneously, higher taxes or public spending cuts will make inroads into disposable income. On the basis of historical markers, Germany's sharp VAT increase seems to be a direct ticket to recession. We should remember, however, that corporate and households will have had over a year to ready themselves for the shock. We believe that much of it can be absorbed by commercial margins, which are high, rather than by household purchasing power, which remains under pressure.■

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Concerns for 2007, but no breakdown

Growth was higher than forecast in the second quarter of 2006. The employment uptrend should help generate a greater degree of self-sustaining growth. But there are still plenty of worries about risks to euro zone growth in 2007.

Growth picked up sharply in the euro zone in the first half of 2006. Q2 GDP advanced 0.9% qoq and Q1 growth was revised upwards from 0.6% to 0.8% qoq. **Over the quarter, growth seems to be more balanced and, more importantly, more robust than in the past**. Non-inventory domestic demand proved the main engine driving activity. Investment saw a sharp rise, at 2.1% qoq, although household consumption slowed to 0.3% qoq. Foreign trade also contributed 0.1 percentage point to growth. In terms of regional contributions, apart from Italy, all the other big economies contributed to the trend, with growth rates ranging from 0.8% to 1.1% qoq. The carry-over effect for GDP growth at the end of the first half of 2006 stands at 2.1%.

The basis for robust, more self-sustaining growth now seem to be in place, in our view, at least in the short term and especially in the big economies. Investment is trending up and is even accelerating in some countries, such as Germany. Industrial capacity utilization rates have moved above their long term average. In addition, the labour market continues to improve. The unemployment rate for the euro zone as a whole has fallen to its lowest level, 7.8% in July 2006, since 2001. Employment even posted its biggest increase in over five years, rising 1.2% year-on-year in 2Q 2006. The employment upturn should lead to higher incomes and hence to more private consumption. **Consequently, we have upped our 2006 growth forecast by 0.3 percentage point to 2.6%, giving quarterly growth rates of around 0.5-0.6% in Q3 and Q4.**

Failing any major upset, therefore, above-potential growth now seems assured for 2006. The real doubts, though, concern the growth profile for 2007. Confidence surveys have peaked and are starting to backtrack. The scenario featuring stronger growth does not seem to be undermined, however, as confidence indices are still trending above their long-term average. The recent dips in the surveys are more a reflection of greater uncertainty about the threats to euro zone growth in 2007. At domestic level, these uncertainties focus on budgetary upsets in Italy and Germany. The planned German VAT hike in early 2007 is in this respect the main risk, but its effects are likely to be limited (***see Germany***).

The ECB's rate hikes are also a risk, especially for the housing market. But given the rate levels forecast for 2007, this particular risk seems minor in our view. On the external front, apart from uncertainties about the past effects of oil price rises and the euro's appreciation, the main risk is linked to the effects of a slowing housing United States market. In our projection, these effects should be very modest (***see United States***). **Euro zone growth seems likely, therefore, to slow only slightly in 2007, to 2%.**

Inflation, for its part, is running above the 2% threshold, coming in at 2.3% in August, while core inflation is under control, at 1.3% in August. **In 2007, core inflation is likely to pick up as a result of several converging factors: 1)** improved activity levels should hand more "pricing power" to business; **2)** the VAT rate hike in Germany will impact underlying inflation. Core inflation looks set to fall slightly, though, as a result of the expected drop in energy prices and of basis effects.

In view of which, both headline and underlying inflation seem likely to converge towards an annual average pace of around 2.2% in 2007.■

EMU	2005	2006	2007	2005				2006				2007			
				Q1	Q2	Q 3	Q4	Q1	Q2	Q 3	Q4	Q1	Q2	Q3	Q4
GDP	1.5	2.6	2.0	0.4	0.4	0.6	0.3	0.8	0.9	0.7	0.6	0.3	0.4	0.5	0.5
Private Consumption	1.4	1.9	1.7	0.0	0.4	0.7	0.1	0.7	0.3	0.7	0.6	0.2	0.3	0.4	0.4
Investment	2.8	4.4	3.1	0.5	1.2	1.2	0.4	0.9	2.1	1.0	0.8	0.5	0.6	0.6	0.6
Change in Inventories (a)	0.0	-0.1	0.0	0.0	-0.1	-0.1	0.4	-0.4	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Net Exports (a)	-0.3	0.4	0.1	0.2	-0.2	0.1	-0.3	0.5	0.1	0.1	0.0	0.0	0.0	0.1	0.1
Industrial Production	1.2	3.2	1.9	-0.1	0.6	1.0	0.6	1.0	1.0	0.5	0.3	0.4	0.6	0.4	0.4
Unemployment Rate	8.6	7.7	7.3	8.8	8.7	8.5	8.4	8.2	7.9	7.6	7.4	7.4	7.4	7.3	7.3
CPI (yoy, %)	2.2	2.3	2.2	2.0	2.0	2.3	2.3	2.3	2.4	2.2	2.0	2.6	2.2	2.1	2.2

(a) contribution to GDP growth (%)

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ECB: no dilemma, no qualms, higher rates

Ever since the single currency was created, the chief failing among forecasters has been to systematically overestimate growth and, conversely, to underestimate inflation, and the same bias can be seen in the ECB's forecasts. But from this point of view, 2006 looks set to be an exception because while inflation will once again come in (slightly) above last year's forecast level, growth should also see an unforeseen increase. In short, if you look at the central bank's behaviour from the angle of the trade-off between growth and inflation (the basic tenet of the celebrated Taylor rule), the ECB is currently facing no dilemma facing the ECB.

On every side, the signals are all pointing in a single direction: more rate increases. With robust growth, increases in the industrial capacity utilization rate, strong credit, the overheating of certain housing markets, chronic overshooting of inflation targets, higher inflation expectations, an uptick in core inflation and the first signs of a return to business pricing power, it would be hard to find a reason why the ECB should *not* increase rates. The ECB has begun to return to a monetary policy in line with growth and inflation trends – in other words, to increase short-term rates to a range of 3.50-4%. That job is not yet finished and, on the basis of the current pace of rate increases, will not be completed before Spring 2007.

Of course, there are downside risks to growth forecast for 2007, with the combined impact of the US housing shock, the VAT shock in Germany, and the residual effects of the latest oil shock. **These risks may prevent monetary policy from becoming restrictive. But it would take a major upset in global growth for the ECB to backtrack and cut its rates in 2007. That is not our central projection.**■

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Efforts to clean up budgets

Above-potential growth in 2006 should improve the euro zone's public finances, especially in the big economies. Germany and France, and to a lesser degree Italy, should post significantly higher tax receipts in 2006, **with public deficits shrinking as a result. For Germany and France, we expect fiscal deficits to fall below the 3% of GDP threshold in 2006.** The improvement, however, is largely business-climate related so that public debt ratios are likely to go on rising in 2006.

In 2007 we should see different budgetary stances in the big economies.

In Germany and Italy, powerful remedial measures to clean up the public finances are planned (***see following pages***). These measures should cut fiscal deficits, but given the inertia of debt, public debt/GDP ratios seem likely only to stabilize at best in 2007.

In France, the government has decided to implement plans for a gradual reduction in public debt designed to bring it to 58 % of GDP by 2010, compared with 66.8 % in 2005. To achieve this target, the fiscal deficit will have to be cut permanently and even balanced to 2010. A reduction in the fiscal deficit on this scale seems difficult, however, as failing consistently above-potential growth, it implies a continued strong reduction in the structural deficit through lower spending and/or higher taxes.

For 2007, with growth hovering around its potential level, and given lower spending and support measures (income tax cuts, a reform of the employment premium, etc.), the deficit should be slightly reduced: 2.5% of GDP (from 2.7% in 2006).■

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Recovery cycle gets underway

The French economy saw outstanding growth of 1.2% qoq in the second quarter of 2006. Activity was sustained by domestic demand. The upturn in employment and the various demand support measures should help consolidate the recovery in 2007.

The French economy continued to improve in the first half of 2006. In fact, activity speeded up considerably in Q2, with an unprecedented rebound of 1.2% qoq, the best quarterly performance since 4Q 2000. Growth was sustained by domestic demand and the rate of increase in household consumption remained significant at 0.8% qoq, while business investment leapt by 2.3% qoq. But the biggest contribution to growth can be attributed to changes in business inventories, at 0.8 point. This partly offsets the reverse trend in the previous quarter. Lastly, foreign trade clipped half a percentage point of GDP growth during the quarter. At the end of the first half, the growth carry-over stands at 1.9%.

What prospects for the second half and 2007?

We are unlikely to see a repeat of the second quarter's performance, although French growth looks set to remain upbeat. We are forecasting growth rates of around 0.5-0.6% per quarter through the end of 2006, which would take growth for the year as a whole to 2.3%. This short-term scenario is borne out by the economic activity data and by business surveys which, as in the rest of the euro zone, are either stabilizing or falling (in industry) but continue to reflect a positive short-term outlook.

Domestic demand looks set to continue to drive activity. There are growing signs of a pick-up in employment and the unemployment rate continues to edge downwards, falling to 8.9% in July 2006, its lowest level since 2002. Employment rose by 0.3 % in 2Q 2006 compared with 0.2 % in Q1, the highest quarterly rate since 2001. In addition, ever since the start of the recovery in mid-2005, this trend seems to have been gathering pace, with net job creations in the first half of 2006, at 81,300, higher than those of 2005 as a whole (76,600). This corroborates the message sent by hiring intentions in the business surveys, which remain in expansionary territory. The rebound should foster an upturn in incomes from activity over the coming quarters. The expected fall in energy prices should also bolster household purchasing power. Moreover, the various consumer support measures, including the reform of the employment premium, income tax cuts and the tax ceiling (the *bouclier fiscal*) in 2007 should all strengthen this trend in 2007, so that household consumption should grow at close to its trend level.

On the investment front, a further spurt seems unlikely. However, it should remain positive as order books are well-filled. According to the July survey of investment in industry, business leaders are expecting a 4% increase in their 2006 investment expenditures compared with 2005 – although this was one percentage point less than in the previous survey. The industrial capacity utilization rate is now running above its long-term trend.

The upturn in demand from other countries around Europe should continue to benefit exports. Imports could also see a sustained uptrend, however, in line with strong domestic demand. The contribution of net exports to growth is likely to be slightly negative as a result.

Lastly, the French economy could be exposed to the adverse effects of a further surge in oil prices, a stronger euro, or a sharp growth slowdown in the United States or in Germany. In our projections, these risks seem limited, however. **All in all, we are forecasting average growth of 2.2 % for the French economy in 2007.■**

France	2005	2006	2007	2005				2006				2007			
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP	1.2	2.3	2.2	0.1	0.0	0.7	0.3	0.4	1.2	0.5	0.5	0.4	0.6	0.5	0.5
Private Consumption	2.2	2.8	2.6	0.5	0.1	0.9	0.6	0.9	0.8	0.6	0.5	0.6	0.7	0.6	0.6
Investment	3.7	3.6	3.1	0.8	0.6	1.7	1.0	0.0	1.7	0.6	0.8	0.7	0.8	0.7	0.7
Change in Inventories (a)	0.0	-0.1	0.1	0.1	0.0	-0.4	0.3	-0.7	0.8	0.0	0.0	-0.1	0.0	0.1	0.0
Net Exports (a)	-1.0	-0.4	-0.5	-0.5	-0.2	0.1	-0.6	0.5	-0.5	-0.1	-0.1	-0.1	-0.1	-0.2	-0.1
Industrial Production	0.0	1.5	1.4	-0.8	-0.4	0.7	-0.5	0.7	1.4	-0.3	0.2	0.2	1.3	-0.3	0.2
Saving Rate	15.0	14.6	14.7	15.0	15.1	14.9	15.1	14.6	14.8	14.6	14.3	14.3	14.9	14.8	14.7
Unemployment Rate	10.0	9.1	8.8	10.1	10.1	9.9	9.7	9.6	9.1	8.9	8.8	8.8	8.8	8.8	8.7
CPI (yoy, %)	1.7	1.8	1.8	1.7	1.7	1.9	1.6	1.8	1.9	1.7	1.7	1.9	1.6	1.7	1.8

(a) contribution to GDP growth (%)

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Recovery to be tested by 2007 VAT reform

The resilience of Germany's economy was confirmed in the second quarter. The triggering of a virtuous domestic momentum driven by rising employment and domestic demand should allow it to take the forthcoming VAT shock and a slowdown in the US economy in its stride.

With the second quarter even better than the first, growing 0.9% qoq compared with 0.7% qoq in Q1, signs of a more robust recovery are accumulating. For 2006 as a whole we are forecasting higher-than-potential growth of 2.5%, ahead of a marked slowdown in 2007, to 1.6%.

Data for Q2 confirmed that the rebound observed in Q1 was more than a statistical correction reflecting the end of the crisis in the construction sector. On the contrary, German industry across the board seems bursting with good health once more. Carry-over effects on growth raise hopes of an outstanding 2006, especially as private consumption is expected to surge at year-end. Households are very likely to bring forward some of their spending to 2006, especially that involving consumer durables, in order to get in before the impending increase in VAT on 1 January 2007. In this respect, the mystery of the Q2 drop in private consumption (down 0.4% qoq) remains largely unexplained. If the figure is not revised upwards, we should expect to see a substantial adjustment in Q3. Whatever happens, household consumption is forecast to grow 1.1% in 2006, after four successive years when it fell or stagnated.

At a more fundamental level, activity now appears to be sustained by a domestic momentum and not just by foreign trade. In the first place, investment is again a growth factor. Total GFCF contributed 0.7% to GDP growth in Q2. Moreover, until this summer, the data for real activity confirmed the positive trend in industrial production and order books. Business climate indicators, however, have fallen back from their June high, itself a record. Yet the IFO's level is still consistent with robust second-half growth. More importantly, as the improving employment situation grows more visible by the month, it could lead, by the end of the year, to purchasing power gains and hence higher private consumption. This virtuous chain of events would allow the German economy to be more self-sustaining and take any slowdown in the US economy in its stride without too much trouble.

In this very buoyant environment, the main risk likely to specifically affect Germany in 2007 is, of course, the 3 percentage point hike in the standard rate of VAT, which will rise from 16% to 19% on 1 January next. A painful increase in economic terms, the reform is also questioned at budgetary level, as the fiscal deficit is falling faster than expected due to the strength of higher tax receipts. Clearly, it will have a short-term mechanical impact, just as it will boost inflation by around one percentage point[1]. The global impact in private consumption should remain more modest, however, at -0.3% yoy, as a result of a recovery in mid-2007. In the longer term, second-round effects could kick in, affecting not only the inflation rate but also consumption and hence growth.

These estimates should be qualified, however, because there is no past experience to directly compare with the current reform, which is unprecedented in both scale and timing. In particular, the fact that it was announced as early as end-2005 suggests that it may have been largely factored in already by households and businesses alike. While some retailers took advantage of the recent World Cup to adjust their prices, others transformed the VAT increase into a sales argument, promising to hold prices steady in 2007.

The central argument that the German economy will withstand the shock derives mainly, in our view, from the robust health of German firms. After a long period of convalescence, and on the strength of their new-found competitiveness, German firms are posting comfortable margins which they can use to absorb part of the price increase. In view of which, the negative impact of the VAT increase on inflation, and ultimately on household consumption, should be modest.■

1– As the standard rate of VAT applies to around three-fifths of goods and services in the HICP index, if the full 3% increase were to be passed on to prices, it would boost inflation by 1.8%. If only part of the rise is passed on, we estimate that the reform will have an impact of 0.9% in additional inflation. This figure is consistent with Bundesbank projections.

Germany	2006	2007	2006			
			Q1	Q2	Q3	Q4
GDP	2.5	1.6	0.7	0.9	0.8	0.7
Private Consumption	1.1	0.8	1.1	-0.4	0.8	0.8
Investment	5.0	3.4	-0.6	3.5	1.4	1.0
GFCF in capital goods	6.6	3.5	2.3	2.5	0.8	1.0
GFCF in construction	3.1	2.4	-2.9	4.6	0.6	1.0
Change in Inventories (a)	0.1	0.0	-0.5	0.5	-0.2	0.0
Net Exports (a)	0.5	0.4	0.4	0.1	0.2	0.0
Industrial Production	4.1	2.3	4.6	4.7	4.0	3.2
Unemployment Rate	10.8	10.2	11.3	11.0	10.6	10.4
CPI (yoy, %)	1.8	2.4	2.0	2.0	1.6	1.6

(a) contribution to GDP growth (%)

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Head-butting the public deficit

Stronger than forecast growth, with its additional tax receipts, raises hopes for a drop in the fiscal deficit in 2006. But to restore the public finances to lasting health, fiscal austerity remains necessary. This is the main risk to the economy in 2007.

With an annualized rise in its GDP of almost 2% in the first half of 2006, Italy is experiencing its highest economic growth in five years. While the business climate started deteriorating in mid-year, its level is still consistent with positive short-term growth. Domestic demand, and more especially investment, is the main source of growth. At the same time, Italy is riding the coat-tails of economic recovery among its trading partners, leading to a sharp increase in its exports. The country no doubt is continuing to lose market share, but for the time being, foreign trade has stopped adversely affecting growth performance.

Household consumption has picked up, reflecting an improvement in the determinants of disposable income (employment, wages), but it is true that we are starting from a very low point. Given the low growth potential, the strength of job creations is a continual surprise. Part of this is down to better use of official figures on the inflow of immigrant workers. The rapid increase in wage gains bolsters purchasing power, but the downside of these higher wages is that they are structurally handicapping Italy's competitiveness. Inflation has been relatively inert over several quarters despite the surge in energy prices and is rising slightly above a pace of 2% per year. In short, if it wasn't for the prospect of a stint of fiscal austerity, no doubt household confidence and spending would be higher.

The direction of fiscal policy is the main issue in Italy, especially for the rating agencies and investors, on the lookout for any signs of any real improvement in the public finances. After he returned to head the government, Mr Romano Prodi made deficit reduction his priority objective, which is the very least we could expect from a former president of the European Commission. A credible sign of this commitment was the appointment of Mr Tommaso Padoa-Schioppa, a former member of the ECB, as Economics Minister. He outlined his plan of action in a 5-year budget programme (DPEF), published in July.

Italy	2006	2007	2006 Q1	2006 Q2	2006 Q3	2006 Q4
GDP	1.6	1.3	0.7	0.5	0.4	0.3
Private Consumption	1.7	1.3	0.9	0.3	0.4	0.4
Investment	3.4	2.6	2.1	1.2	0.7	0.6
GFCF in capital goods	2.5	2.8	2.1	0.7	0.8	0.8
GFCF in construction	2.7	2.0	1.4	0.1	0.7	0.5
Change in Inventories (a)	-0.6	0.0	-0.6	-0.1	0.0	0.0
Net Exports (a)	0.3	-0.1	0.2	0.2	-0.1	-0.1
Unemployment Rate	7.1	6.9	7.3	7.0	7.0	6.9
CPI (yoy, %)	2.1	2.0	2.1	2.2	2.2	2.0
Public deficit (% of GDP)	-3.8	-3.4	-	-	-	-

(a) contribution to GDP growth (%)

The objective is to bring the budget deficit back below 3% of GDP in 2007. To achieve this, the DPEF plans for budget savings of 35 billion euros (2.1% of GDP), most of which is to come from spending cuts. The level of savings, reduced in early September to 30 billion, is designed to finance growth support measures (and notably a cut in the cost of labour) and deficit reduction measures in almost equal parts.

The authorities are not ducking the fact that a genuine improvement drive involves an increase in the primary budget surplus, i.e., excluding debt interest payments. The time of one-off measures now seems over. Yet there are doubts as to whether the programme can be applied without triggering a full-on recession and, at the end of the day, widening the deficit. In its estimates, the DPEF is acting as if a turn of the budgetary screw involving a 1.6% of GDP increase in the primary surplus would only cut growth by 0.3%, despite the worldwide economic slowdown. The calculation is somewhat perplexing. Nor have any details of the proposed spending cuts been released as yet.

That said, it is very difficult at this stage to know how big the 2006 deficit will be. Initially the target had been set at 3.5 % of GDP. It was lifted, after the elections, to a range of 4.1-4.6% on the assumption that the Berlusconi government had left a "hole" in the state's coffers. Since then, the estimates have been revised downwards towards 3.8 %. Some even say that the surplus receipts collected would leave a deficit not very far from the 3% of GDP limit in 2006. Whatever the case, the clean-up of the public finances has to remain a priority in a country where public debt is running at over 100% of GDP.■

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Housing risk still looming

Till now, the facts have contradicted the doomsayers who claim that Spain is over-dependent on the resilience of its housing market. But things are perhaps changing. A slowdown seems to have begun in this sector and growth looks set to cool going forward.

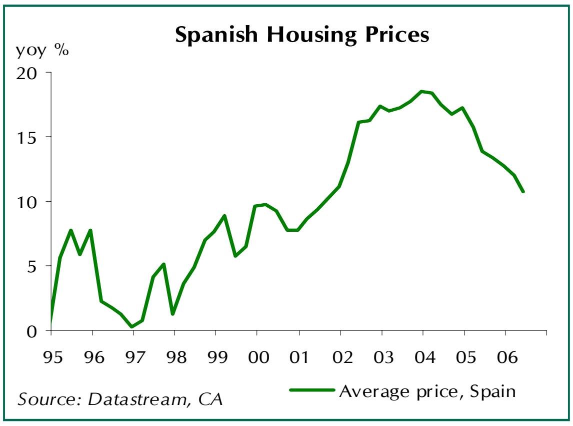
Spain's growth trend seems immutably set at 3.5% per year, for an increase in real GDP of 0.8-0.9% per quarter. And thus it has been the case for the past eight quarters. At first sight, therefore, Spain has not posted any particular improvement in 2006, unlike its European partners. Does that mean that it is definitively flying above the external turbulence? The answer is no. There are definitely a number of cyclical shifts, but the evidence for them lies buried deep in the national accounts. Looking there, **one notes that a sort of re-balancing is underway in the wellsprings of growth.** Foreign trade continues to be a drag on the economy, but its negative contribution to growth has been falling over the past eighteen months. Symmetrically, the positive contribution of domestic demand is being eroded, particularly with respect to household consumption.

Over the past decade, Spanish households have simultaneously driven and been the prime beneficiaries of strong economic growth. The virtuous circle of employment-incomes-demand worked perfectly against a backdrop of falling interest rates (a single currency effect) and growth in the workforce (the outcome of massive immigration). The housing construction sector found itself at the point where the twin shocks of supply (more jobs) and demand (more consumer and investment spending) intersected. As time went on, however, the imbalances began building up, with a rapid increase in the household debt rate, excessive inflation compared with Spain's trading partners, and hence a loss of competitiveness, plus speculative behaviour on the housing market.

In an economy where most lending is at variable rates, the perceptible uptrend in rates in recent months (and likely to continue in the short term) means that a housing market downturn is the main risk facing the Spanish economy. At this stage, the signals emerging from the sector are not all consistent.

Spain	2006	2007	2006			
			Q1	Q2	Q3	Q4
GDP	3.5	2.5	0.9	0.9	0.7	0.6
Private Consumption	3.3	2.7	0.4	0.8	0.7	0.7
Investment	5.7	3.4	1.3	1.4	0.9	0.8
GFCF in capital goods	6.5	3.9	1.1	0.3	1.0	1.0
GFCF in construction	6.0	2.9	1.9	2.0	0.7	0.7
Change in Inventories (a)	0.4	-0.1	0.3	-0.1	0.1	0.0
Net Exports (a)	-1.2	-0.9	0.0	-0.1	-0.3	-0.2
Unemployment Rate	8.3	8.0	8.8	8.2	8.1	8.1
CPI (yoy, %)	3.7	2.9	4.0	3.9	3.7	3.2
Public deficit (% of GDP)	1.1	0.4	-	-	-	-

(a) contribution to GDP growth (%)



Source: Datastream, CA

On the one hand, housing prices are decelerating. In the second quarter, their annualized increase stood at only 10.8% for the country as a whole, compared with an increase of 18.5% at the top of the cycle in late 2003 *(**see graph**)*. If we were to extrapolate this moderating trend, we would move towards a zero increase in prices, if not a fall, by late 2007. Regardless of where they go in future, the slowing of housing prices is already a factor that will adversely impact construction activity and knock on into overall growth. It also represents an upset for households and indirectly for the banks. We believe that consumption and construction investment are set to slow within our forecasting timeframe. Without making too much of this, it will be enough to justify the loss of around one percentage point of growth in 2007.

At the same time, one has to admit that mortgage lending is hardly slowing, any more than the delivery of building permits. It is also worth noting that new housing starts (including social housing) were still in excess of 700,000 units a year at mid-2006, which is 70% higher than in France, for a population approximately one third smaller. In short, the factors of vulnerability are strong at both macroeconomic and sector level (construction, banks), as Spain's central bank regularly reminds us. **There does come a time when one has to start listening to the doomsayers.■**

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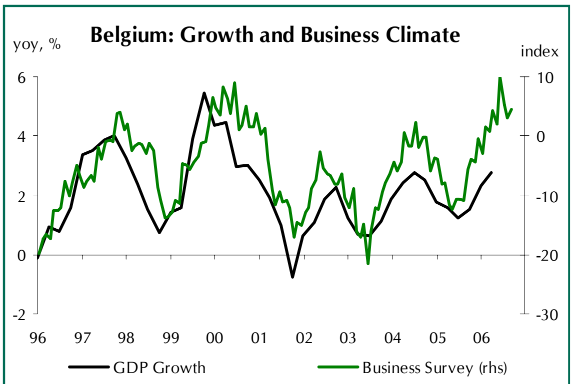
Less upbeat external environment

A second quarter GDP growth figure confirmed the economic improvement heralded at the start of the year. We should be cautious, however, as business climate indicators are falling and the external environment is becoming less upbeat.

Belgium saw sustained economic activity in the first half. The first quarter growth figure was revised upwards from 0.8% to 0.9%, while second quarter performance was equally robust at 0.8%.

All components of domestic demand contributed to growth. Household consumption rose by 0.5% in Q2 and investment remains dynamic, rising 4.6% in Q1 and 3.7% in Q2. Given this, growth to date for 2006 already stands at 2.2%.

We must be cautious, however, as regards the prospects for year-end and for 2007. From its peak in June, the monthly business climate survey fell, mainly as a result of a drop in orders. Even if exports improve, the trade balance is likely to make a negative contribution to growth in 2006. In the first half, imports grew more rapidly and, going forward, the still high exchange rate and the German VAT increase are likely to be unhelpful to foreign trade. Consequently, we are forecasting growth of around 2.6% this year, and of 2.1% in 2007.■



Source: National Bank of Belgium

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Domestic demand still robust

Against a backdrop of economic recovery across Europe, the Netherlands will see more sustained growth this year. The public finances are healthy, while inflation is low and below the euro zone average.

In an upbeat global economic environment, first-half results are satisfactory. Economic activity grew by 0.5% in the first quarter and then rebounded by 1.2% in the second, taking the growth carry-over for 2006 to 2.3%.

The trade balance is again positive, with resilient exports largely explained by re-exports. Adjusted for the transfer of healthcare spending to public consumption, household consumption has started to rise once more. The main factors at work here are the increase in household purchasing power and the improving employment situation: unemployment has fallen below the 4% threshold. In parallel, the first quarter again saw sustained investment.

In fact, compared with previous years, the rebound in domestic demand will be the main component of increased GDP in 2006. However, the pace of growth is set to slow in the second half as external demand becomes less buoyant.

The austerity fiscal policy pursued for the past few years has brought the public deficit back into balance. Despite tax breaks for businesses and support for household purchasing power in this election year, the deficit seems unlikely to exceed 0.4% of GDP in 2006 and should be balanced in 2007 thanks to further sustained growth.

Inflation was stable at around 1.3% during the first part of the year but should pick up in conjunction with higher activity and the recent hikes in petroleum product prices. Inflation should come in at 1.9% next year, moving closer to the euro zone average.■

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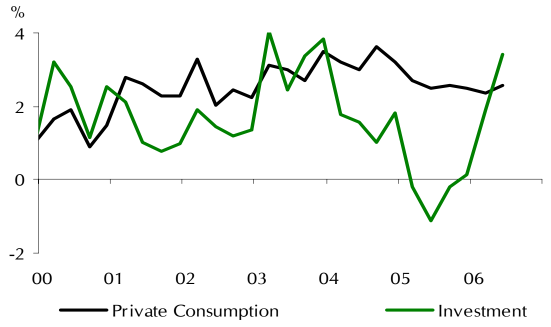
Surprise increase in growth

Greece's economic growth is currently forging ahead at 4% per year. Household demand is sustained by a buoyant housing market and continued low interest rates, offsetting high inflation and a tight fiscal policy.

Because Greece's national quarterly accounts are not seasonally adjusted, it is no easy matter to measure flash growth. Yet it looks as if, as in the rest of the euro zone, activity and demand are accelerating. Over twelve months, GDP growth comes out at 4.1% in mid-2006. The main support comes from household consumption, which is showing no signs of flagging. This is partly because interest rates are still low in nominal and real terms. What's more, investment, especially in construction, seems to be rebounding after a short adjustment phase in the wake of the 2004 Athens Olympics (***see chart***).

The robust nature of activity is stoking imports to the extent that foreign trade is having a negative impact on growth. The current account deficit is widening and seems likely to come in at close to 10% of GDP in 2006! As regards the fiscal deficit, the cyclical improvement, together with a raft of structural adjustment measures, should push the fiscal deficit down to 3% of GDP, or slightly less, in 2006.■

Greece: Contribution to GDP Growth



Source: Datastream, CA

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Overcoming structural handicaps

Despite the constraints holding back growth, such as a tight fiscal policy and a lack of competitiveness, Portugal is seeing a rebound. GDP should rise by 1.4% in 2006, i.e., more than between 2001 and 2005. This rebound will probably prove to be short-lived, alas.

The economic improvement that was perceptible at the start of the year has gained strength in recent months. GDP growth accelerated sharply, by 0.9% in Q2, a pace similar to the euro zone's. The unemployment rate began falling at end-2005 and is now falling more rapidly, boosting private consumption. That said, households are still constrained by their vulnerable financial situation and a course of fiscal austerity.

The Portuguese economy is reaping the full benefit of the cyclical rebound at work everywhere in Europe. A few encouraging signs are already visible on the foreign trade front. This does not stop the current account deficit from being substantial, at around 8 % of GDP. But while the external imbalance, in the framework of monetary union, is not a short-term constraint, the same cannot be said for the fiscal deficit. Which is why the government, in order to deal with an excessive deficit procedure, has plans for austerity measures involving around 1.5 percentage point of GDP for this year.

Austerity means higher taxes, fighting tax evasion, and the demise of some forms of corporatism, especially in the public sector. The fiscal deficit should be less than 5% of GDP in 2006 as against 6% last year.

Even if the government seems determined to continue down this path, it will no doubt have to postpone the point when it comes back below the critical 3% of GDP threshold until after 2008 – the deadline set by the European Union. In the meantime, economic growth will be constrained.■

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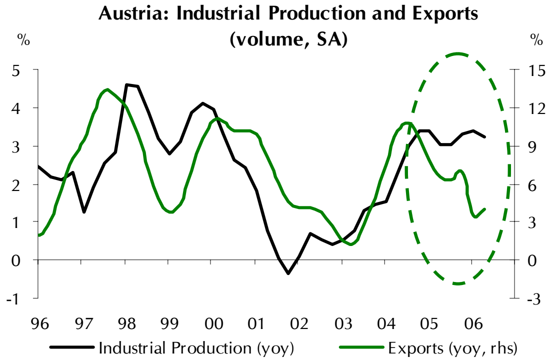
Domestic demand consolidates

With growth proving more robust, at 2.8% in 2006 compared with 2.6% in 2005, the challenge now facing the Austrian economy is to make domestic demand more independent of the German business cycle.

Austria did as well as its German neighbour in the second quarter, with growth of 0.9% qoq, confirming the resilience of its economy. Q2 activity was fuelled by foreign trade, which contributed 0.4% to GDP growth. At domestic level, the good news came from investment, where the Q2 increase was higher than the first quarter's, at 2.2% qoq. Companies are therefore forecasting more strong domestic demand so that activity should remain buoyant until year-end.

Although private consumption did not take off in the second quarter (2% yoy), the historically high level of household confidence suggests that some spending has simply been deferred. Industrial production should continue to grow by around 3% per year despite slowing volume of exports. We foresee an above-potential growth rate of 2.5% in 2006. The scale of the slowdown expected in 2007 will then partly depend on how well Austria's German trade partner resists the shock of its VAT increase.■



Source: Datastream, CA

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A dynamic economy at odds with its imbalances

Ireland's economic performance is brilliant. But the economy is faced with increasingly marked imbalances, including an overheating housing market and wage inflation. Growth is likely to remain upbeat, however, out to the end of 2007, at above 5%.

Ireland saw strong GDP growth of 5.5% in 2005 and of 4.4% in the first quarter of 2006 (annualized). The unemployment rate is low and the public finances are strong. And at 29.6%, Ireland has the lowest debt-to-GDP ratio of the European Union.

Despite this impressive performance, the current growth rate cannot be extrapolated as it stands. This is because **growth is currently sustained by household consumption and a buoyant housing market, but no longer by exports.**

In the housing market, the sharp increase in prices went hand-in-hand with a substantial rise in household debt, at a time of monetary tightening. To make matters worse, most mortgages are at variable rate. Elsewhere, the competitiveness of Irish businesses has eroded due to the joint effects of wages rising faster in Ireland than among its main trading partners, and the euro's appreciation against the US dollar.

What's more, the openness of this small country makes it vulnerable to a US slowdown. The other cause for concern is prices. The inflation gap between Ireland and the rest of the euro zone is widening again, and is being fuelled by robust domestic demand. Since the start of 2006, Ireland's inflation has topped the euro zone average by around one percentage point.

Although this raises the question as to how sustainable these imbalances are, GDP growth should nevertheless peak in 2006 at 5.7% before slowing slightly in 2007 to 5.3%.■

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Leading the euro zone

Finland posted unprecedented economic performance in the first half of 2006, pointing to one of the highest growth rates in a decade, at close to 6%.

Although the sharp first quarter rebound of 2.1% qoq was largely attributable to one-off factors after Q4 2005 activity had been slowed by prolonged strikes in the paper industry, the second quarter figures leave one in no doubt about the robust good health of the Finnish economy.

Activity is still being fuelled by household consumption and foreign trade, in roughly equal proportions.

With qoq growth of 1.9% in Q2, or 6.6% year-on-year, Finland is again leading the EU over the first half as a whole. We are forecasting a GDP growth rate of 5.7% in 2006 (with carry-over growth already at 5.1%), against a backdrop of the lowest inflation in the euro zone at 0.8% in 2005, and a forecast 1.4% for 2006.

In parallel, the unemployment rate continues to trend down, reaching 7.8% by mid-year, which is exactly the average rate for the euro zone. Some 70,000 jobs have been created since the start of 2005. The government budget is running a comfortable surplus of around 3% of GDP and fiscal policy is likely to remain neutral overall in 2007.

As a result, the only mid-term risk factors involve housing price trends and household debt, both of which are upwardly mobile, although not excessively so at this stage.

Lastly, at this kind of growth rate, the Finnish economy could come up against supply constraints in 2007 both in terms of production capacity and on the labour market.■

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Slippery slope!

Swiss GDP grew by "only" 0.7% (qoq) in 2Q 2006, compared with 0.8% (qoq, figure revised downwards) in Q1. This looks like the start of a modest economic slowdown in Switzerland, before the euro zone peaks.

These days, the Swiss franc looks like a second-hand euro: it no longer enjoys its safe-haven character, while the level of interest rates served on the franc, which is less than that of most currencies, has weakened it against the euro. Moreover, the prospect of the 24 September referendum on the use of Swiss National Bank profits had raised the spectre of limitations to the central bank's independence, and could cost the Federal government around 800 million francs a year in lost direct receipts.

This is no reason to forget that the Swiss national finances are in relatively good shape when compared with those of the euro zone. In 2004, gross public debt (local authorities plus central government) totalled 53.5% of GDP, whereas net debt amounted to 34.1%.

What's more, we do not share the analysis which says that the SNB (Swiss National Bank) is pursuing a looser policy than the ECB. In other words, several more interest rate hikes are still in the pipeline, but a more hawkish message from the SNB seems necessary to talk up the weak franc. That is not where things are going right now. The Swiss National Bank's decision to increase the target fluctuation range of the 3-month Libor key rate by 25bp, to 1.25%-2.25% on 14 September, was preceded a few days earlier by an announcement signalling that, in terms of growth, the cyclical peak was behind us.

At this stage, monetary policy is still expansionary and a median level of 2%, even 2.25%, is probable at year-end.■

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Another monetary tightening in November

Although economic activity is set to slow somewhat during the second half of 2006, inflation will take longer to fall. That is why, in prudent fashion, the Bank of England (BoE) will continue to tighten its monetary policy in November in order to keep inflation expectations under control.

After getting back to its potential growth rate of 2.5% at the start of the year, UK growth perked up slightly during the second quarter. Even if the link between the property market and household consumption spending is not as strong as it was, the housing sector recovery has still dragged household consumption higher in its wake, at an annualized half-yearly rate of 2.5%, compared with 1.4% in the second half of 2005. This has combined with robust household demand, a good export performance and sustained business investment to boost overall GDP momentum. On the inflation front, spurred by surging oil prices, the CPI picked in the spring. In August, it peaked at 2.5% year-on-year, significantly above the BoE's target rate of 2%.

Consequently, on 25 August, the BoE's Monetary Policy Council (MPC) upped its base rate by 25bp to 4.75% in a move that wrong-footed the markets and was not unanimously supported within the MPC. According to the minutes of the September meeting, the MPC voted unanimously at its meeting to keep rates on hold. The committee is comfortable with its August Inflation Report forecast for GDP growth and inflation. Moreover, it considers that its decision to raise the base rate in August was a good one. It was not so clear at the press conference in August where the Committee appeared to have some hesitations.

The minutes confirmed that the current monetary tightening cycle is not over. In fact, the MPC views the hike in August as a reduction in the "degree of monetary accommodation". This suggests a majority of the members of the MPC think the base rate is below its neutral level. Moreover, the debate focused on the fears of a rise of long-term inflation expectations and its impact on the next pay-round. **That is why we now anticipate pre-emptive hike of 25bp in November to 5%.**

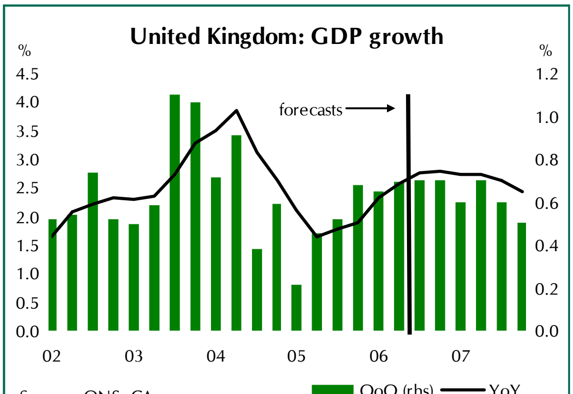
Next year, the BoE is expected to raise its base rate again in February to 5.25% with inflation still around 2.4% up to the first quarter of 2007 and GDP growth around its potential in 2007. Nevertheless, this move will be strongly data dependant. Economic growth will be adversely affected by the two hikes in 2006 and the downside risks on the activity will likely still be there. For starters, the forecast slowdown in the United States and the more modest one in the euro zone are likely to prompt greater caution among business leaders. Furthermore, the impact of the hike in the key rate should rein in activity in construction and retail. Lastly, sterling's appreciation could shackle export performance.

We are also concerned that a sharp deceleration in household demand from this September could add to the slowdown in activity due to the growing burden of higher borrowing costs plus increases in electricity and gas bills and university top-up fees. The financial situation of households is already under pressure. The number of personal bankruptcies rocketed in the second quarter of 2006 with over 88,000 households filing for bankruptcy in the preceding twelve months. Growth in salaries should remain modest as the wave of immigration from the recent crop of EU enlargement countries will restrict any increases.

Faced with downside risks that are putting pressure on demand, and a slowdown of inflation below its target, the central bank would prefer a monetary *status quo* for the rest of 2007.■

United Kingdom	2006	2007	2006 Q1	2006 Q2	2006 Q3	2006 Q4
GDP	2.7	2.6	0.7	0.7	0.7	0.7
Private Consumption	2.3	2.8	0.3	0.9	0.7	0.9
Investment	5.0	3.4	2.0	0.6	1.0	1.0
Change in Inventories (a)	0.1	-0.1	0.4	-0.5	0.2	0.0
Net Exports (a)	-0.3	-0.1	-0.4	0.2	-0.1	-0.1
Industrial Production	0.5	0.4	0.9	0.2	0.2	0.2
Saving Rate	5.4	5.4	6.0	5.0	5.5	5.1
Average Income (yoy)	4.7	4.7	4.4	4.7	5.1	4.6
Unemployment Rate ONS	3.0	3.1	2.9	3.0	3.0	3.0
CPI (HICP, yoy, %)	2.3	2.1	2.0	2.2	2.4	2.5

(a) contribution to GDP growth (%)



Source: ONS, CA.

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Pressure on Riksbank to hike further

The domestic economy is strong and net exports continue to contribute positively to growth, suggesting a further gradual rise in capacity utilisation going forward. This will maintain the pressure on the Riksbank to continue hiking rates in this cycle. Combined with the recent regime shift in Sweden this will generate a stronger SEK.

Going into the fourth quarter of the year the onus is very much on the prospects of further rate hikes in Sweden, with recent short-term statistics confirming a booming economy in the first half of the year and continued strength going into the latter half of 2006. Indeed, domestic demand is expected to continue to drive the economy with consumption supported by stronger labour markets while high capacity utilisation is seen underpinning investment.

Also, the political regime shift (centre-right coalition replacing Social Democrats) will lead to lower taxes, both on private income and property, and if anything that will add further stimulus to the economy going forward. As for external demand slower growth in key export markets will result in weaker demand from abroad although to some extent this will be offset by past weakness in the SEK exchange rate.

In terms of policy implications high and rising capacity utilisation will maintain the pressure for higher rates in Sweden, and the Riksbank is certain to continue hiking the repo by another 50bps to 3% by year-end. Indeed, despite having hiked rates by a total of 100bps this year some 50bps of that tightening has arguably been offset by stronger equity markets, at least according to our Swedish Financial Conditions Index (FCI).

This further underlines the view that risks to rates are skewed to the upside and dependent on upward surprises in monthly inflation statistics. As for the SEK the new government's privatisation plans of state-owned enterprises will combine with a gradual and favourable shift in interest rate differentials to add to the case for a stronger currency.■

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Low CPI cancels out bullishness elsewhere

The Norwegian economy is continuing to generate above trend growth, further fuelling already tight labour markets and supporting the view of a gradual build-up of the inflationary potential in the economy. The weak NOK exchange rate is adding to the inflationary potential and taken together this will ensure further and continued policy tightening.

The mainland Norwegian economy is on track for GDP growth in excess of 3% this year, driven primarily by strong investment but also a gradual improvement in private consumption. Looking ahead stronger labour markets will continue to provide support for private consumption while real interest rates, still around historical lows, will combine with high utilisation of capacity to maintain strength in investment. Demand from abroad will weaken but past and current NOK currency weakness is likely to cushion any deterioration in the external balances.

Policy wise the Norges Bank will remain committed to further rate hikes, pressurised by tight labour markets and robust economic activity. Indeed, labour markets are arguably as strong today as they were in 1997/1998 when they eventually contributed to a very aggressive tightening campaign (some 475bps of rate hikes from mid-97 to mid-98). The timing and the pace of tightening will however be dependent on the development in spot inflation.

The recent trend has been for softer than expected inflation, which consequently would be consistent with a continued cautious and gradual approach, i.e. hiking rates in "small and not too frequent steps".

Risks skewed to the upside though. It is worth noting that despite the 25bps rate hike to 3.00%, policy has softened by an overall 60bps since the last MPC meeting on 16 August, all according to our Norwegian Financial Conditions Index.■

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Coming soon: two new European Union additions

In its last report, European Commission recommend that Bulgaria and Romania should join the EU on 1 January 2007. EU leaders are to approve the recommendation by the end of the year. Safeguard clauses can be taken up if reforms are too slow.

Since the start of the year, Romania and Bulgaria have stepped up their efforts to meet their commitments to the European Commission and targeting EU integration on 1 January 2007. It would appear, however, that neither country is completely ready. For the first time in the history of enlargement, the EU authorities have opted to recommend the deployment of safeguard clauses, which can be taken up to three years after accession and are likely to concern areas in which the countries have not managed to apply European Community "acquis".

More hard work needed, can do better…

Only weeks from joining the EU, Romania and Bulgaria continue to show structural weaknesses in areas such as the legal system, anti-corruption resources, minority rights, effective border controls, and efforts to narrow the gap in sectors such as agriculture and energy. These are the points that the Commission has headlined in its various reports.

Once in the EU, the two countries are therefore likely to remain under surveillance in order to pursue the reforms needed to ensure that their economies work better. And it is also probable that, despite their agitated political environments and fragile coalitions, their governments will continue to observe not only the EU's strictures, but the IMF's also.

Another major challenge which has not received much attention is the need to restructure labour markets. Although Romania's unemployment rate is only 6% of the workforce, what this mostly reflects is the rigidity of the labour market. At the end of the day, the two new entrants, after striving to meet nominal convergence criteria, will need to speed up their real convergence in order to position themselves on healthier long-term growth tracks.

… But marks for economic policies are improving

In the meantime, growth rates remain high with an estimated 6.2% for Romania and 5% for Bulgaria in 2006. It's worth noting that since the start of the year, the Romanian economy has seemed more dynamic than that of its Bulgarian neighbour. To a considerable extent, these growth rates are still driven by domestic demand due to rising wages and easy credit, as well as investment.

In Bulgaria and Romania, however, austerity policies are aiming to avoid overheating, even if this means curbing growth. Credit restrictions are designed to slow the growth of lending, while Romanian interest rates have been hiked several times in succession.

Despite these measures and surging exports (up 26% in Bulgaria in the first half of 2006), the countries' trade balances are still largely in deficit as a result of imports. The rise in imports is being fuelled by domestic demand and by investment-related capital inflows. As a result, these imbalances are burdening the current account balance, with -10.1% and -13.4% of GDP forecast in Romania and Bulgaria for 2006.

Foreign Direct Investment is financing a proportion of the current account deficit–four-fifths of it in Romania over the first five months of the year. But the capital inflows could diminish as a result of slowing privatizations, at which point, the countries could start borrowing again.

The Bulgarian central bank still intends to maintain its currency board and has announced that it wants to join ERMII as soon as possible. But the euro peg leaves it very little room for manoeuvre with respect to core inflation, exchange rate pressures and ballooning credit. In Romania, the leu is trending upwards, rising 5% against the euro in the first half.

Yet, if economic policies are unable to contain overheating and the deteriorating current account balance, we should start to worry about the currencies coming under greater pressure. This could also lead to renewed downward pressure on the leu, higher inflation and doubts about the sustainability of Bulgaria's currency board.

So, although the Romanian and Bulgarian economies are in better shape, their growth is driven by domestic demand and involves risks in terms of the current account deficit. Yet the vulnerability of these fundamentals does not seem to be a blocking factor for a European Commission which has mostly issued recommendations about structural aspects. For the time being, the financial, social and economic impacts of joining the European Union are hard to call. The two latest small additions to the EU family will need to take up the challenge of reforms to maximize the benefits to be derived from their new community. After 1 January 2007, the keys to success will be in their own hands.■

Key Indicators

Source: EIU –2006e	Romania	Bulgaria
Real Growth (%)	6.2	5.0
Inflation (yoy, %)	7.3	7.4
Budget Balance (% of GDP)	-2.1	2.8
Public Debt (% of GDP)	22.2	25.5
External Debt (% of GDP)	37.5	57.8
Current Account Balance (% of GDP)	-10.1	-13.4

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Central banks vigilant against rising inflationary risks

As expected, the monetary authorities in Central Europe, except Poland, raised their key interest rates during the summer. This monetary tightening reflects rising inflationary pressures across the region against the background of robust economic growth and continued interest rate hikes by the ECB.

In Hungary, the tightening has been most aggressive with the central bank (MNB) raising interest rates by a cumulative 175bp since the historic low of 6% in effect during September 2005-June 2006. Consumer prices and core inflation accelerated to 3,5% and 2,4% yoy, respectively in August, driven by surging food prices and pass-through from forint weakness into various components. Inflation will rise further in September due to price hikes and higher taxes resulting from the government's fiscal program.

The unfavourable basis effects are not expected to dissipate until the first half of 2007 with a peak of around 7%. Faced with the new challenge, the MNB will remain vigilant and in order to keep inflationary expectations in check and to prevent selling pressures on the forint, additional tightening moves, are expected in the coming months.

The Hungarian economy has entered a phase of necessary adjustment. The more restrictive policy mix should reduce the macroeconomic imbalances over time provided the policymakers stay the course against the background of political uncertainties caused by the leak of PM's internal speech.

In Slovakia, the central bank (NBS) raised its key interest rate by a cumulative 75bp to 4,75% as consumer prices and core inflation accelerated to 5,1% and 2,8%, respectively in August.

A weaker currency and regulated energy price hikes explain the higher prices while the NBS needs to tighten further to prevent rising cost-push pressures from building into inflationary expectations. The proposed fiscal stance of the new government also points toward additional NBS hikes in the months ahead. However, the degree of tightening may be limited by an expected inflation peak in October due to favourable basis effects. Finally, the central bank is committed to bring down inflation to meet the Maastricht criterion by mid-2008, required for euro zone entry in 2009.

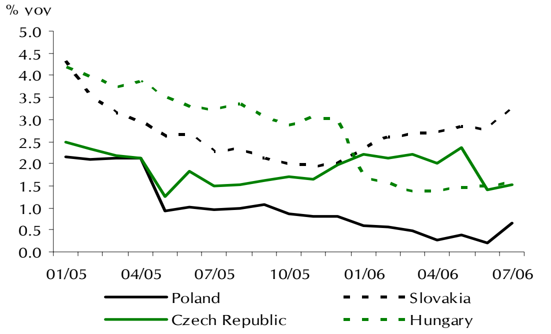
In the Czech Republic, the central bank (CNB) raised interest rates by a cumulative 50bp to 2,50%. August consumer prices accelerated to 3,1%, while core inflation picked up to 1,5%.

In contrast to its neighbours, recent koruna strength reduces the risk of imported inflation. On the other hand, the fiscal outlook has deteriorated and the CNB is concerned that this would stimulate an already strong economy and pose upside risks to the inflation outlook. All things considered, it is probably premature to interpret the latest rate hike as the beginning of a sustained tightening cycle and the negative differential with ECB rates is expected to persist in the foreseeable future.

Finally, **in Poland,** the central bank (NBP) does not appear to be in a hurry to raise its interest rates from their all-time low of 4,0% in effect since the end of February 2006. To be sure, the headline consumer price index ticked up to 1,6% in August as did the core inflation (to 1.4%) against the background of accelerating economic growth and drought-caused higher food prices.

Although the NBP's inflation target of the -1%/+1% fluctuation band around 2,5% has been attained, the beginning of a monetary tightening process is still some months away. However, the monetary authorities are likely to intensify their vigilance in view of the uncertainties around the 2007 budgetary process currently underway.■

Central Europe: core inflation is on the rise



Source: Datastream

Economic and financial scenario of Crédit Agricole Group — at 06/27/09

ECONOMIC SCENARIO

	GDP (Annual Rate)			Inflation (average)			Public sector bal. (% of GDP)			Current account bal. (% of GDP)		
	2005	2006	2007	2005	2006	2007	2005	2006	2007	2005	2006	2007
Europe	2.5	3.1	2.6	2.9	3.2	3.0	-	-	-	-	-	-
EMU	1.5	2.6	2.0	2.2	2.3	2.2	-2.4	-2.1	-1.9	-0.3	-0.3	-0.1
Germany	1.1	2.5	1.6	2.0	1.8	2.4	-3.3	-2.8	-2.4	4.1	4.0	4.5
Spain	3.5	3.5	2.5	3.4	3.7	2.9	1.1	1.1	0.4	-7.4	-8.5	-8.3
France	1.2	2.3	2.2	1.7	1.8	1.8	-2.9	-2.7	-2.5	-1.6	-1.7	-1.0
Italy	0.1	1.6	1.3	2.0	2.1	2.0	-4.1	-3.8	-3.4	-1.6	-1.8	-1.9
United Kingdom	1.9	2.7	2.6	2.0	2.3	2.1	-3.3	-3.2	-3.2	-2.2	-2.5	-2.2
Sweden	2.7	3.9	3.0	0.5	1.6	1.9	1.2	1.5	1.2	7.1	7.5	6.2
Switzerland	1.9	2.9	2.2	1.2	1.6	1.9	-1.4	-0.8	-0.8	13.8	13.5	13.0
Hungary	4.1	4.3	2.4	3.3	6.6	4.1	-7.5	-10.1	-6.8	-7.4	-7.0	-5.5
Poland	3.3	5.0	4.7	0.7	1.5	2.5	-4.3	-4.4	-4.2	-1.4	-2.0	-2.4
Czech Republic	6.0	6.0	5.2	2.2	2.9	3.0	-2.6	-3.3	-3.8	-2.1	-2.4	-3.4

FINANCIAL SCENARIO

Interest Rates	06/27/09	2005					2006					2007				
		Q1	Q2	Q3	Q4	Ave.	Q1	Q2	Q3	Q4	Ave.	Q1	Q2	Q3	Q4	Ave.
EMU																
Refi rate	3.00	2.00	2.00	2.00	2.25	2.06	2.50	2.75	3.00	3.50	2.94	3.75	3.75	3.75	3.75	3.75
3-month Euribor	3.38	2.15	2.11	2.18	2.49	2.23	2.82	3.06	3.38	3.65	3.22	3.90	3.95	3.95	3.95	3.94
10-year rate (a)	3.66	3.74	3.14	3.18	3.31	3.34	3.80	4.08	3.66	4.15	3.92	4.10	4.00	4.00	4.00	4.03
United Kingdom																
Base rate	4.75	4.75	4.75	4.50	4.50	4.63	4.50	4.50	4.75	5.00	4.69	5.25	5.25	5.25	5.25	5.25
3-month Libor	5.02	4.93	4.70	4.53	4.58	4.69	4.58	4.70	5.02	5.30	4.90	5.40	5.30	5.30	5.30	5.33
10-year rate (a)	4.51	4.74	4.21	4.32	4.14	4.35	4.45	4.78	4.51	4.80	4.63	4.90	5.00	5.00	5.00	4.98
Switzerland																
3-month rate	1.78	0.68	0.63	0.71	0.91	0.73	1.17	1.44	1.78	2.25	1.66	2.50	2.50	2.50	2.50	2.50
10-year rate (a)	2.44	2.24	1.96	1.87	2.03	2.03	2.47	2.83	2.44	3.15	2.72	3.15	3.20	3.10	3.10	3.14
Sweden																
Discount rate	2.50	2.00	1.50	1.50	1.50	1.63	2.00	2.25	2.50	3.00	2.44	3.25	3.75	3.75	3.75	3.63
3-month interbank rate	2.86	2.12	1.65	1.70	1.97	1.86	2.27	2.51	2.86	3.20	2.71	3.45	3.90	3.85	3.80	3.75
10-year rate	3.61	3.63	2.99	3.04	3.29	3.24	3.64	4.04	3.61	4.45	3.93	4.45	4.55	4.35	4.30	4.41
United States (as reference)																
Fed Funds target rate	5.25	2.75	3.25	3.75	4.25	3.50	4.75	5.25	5.25	5.25	5.13	4.75	4.50	4.50	4.50	4.56
3-month eurodollar rate	5.32	3.08	3.48	4.04	4.50	3.77	4.97	5.45	5.32	5.40	5.28	4.80	4.75	4.75	4.80	4.78
10-year rate (a)	4.65	4.55	3.98	4.37	4.45	4.34	4.91	5.20	4.65	4.60	4.84	4.50	4.50	4.60	4.70	4.58
Exchange Rates	06/27/09	Q1	Q2	Q3	Q4	Ave.	Q1	Q2	Q3	Q4	Ave.	Q1	Q2	Q3	Q4	Ave.
EUR 1 = ...$	1.27	1.30	1.21	1.21	1.18	1.22	1.21	1.28	1.27	1.35	1.28	1.34	1.33	1.30	1.30	1.32
...£	0.67	0.69	0.68	0.68	0.69	0.68	0.70	0.69	0.67	0.70	0.69	0.69	0.69	0.68	0.67	0.68
...CHF	1.58	1.55	1.55	1.56	1.55	1.55	1.58	1.56	1.58	1.55	1.57	1.53	1.52	1.52	1.51	1.52
...SEK	9.30	9.19	9.47	9.33	9.38	9.34	9.43	9.20	9.30	9.15	9.27	9.10	9.07	9.05	9.00	9.06
...DKK	7.46	7.47	7.46	7.48	7.44	7.46	7.45	7.46	7.46	7.40	7.44	7.35	7.35	7.35	7.35	7.35
...PLN	3.98	4.08	4.04	3.92	3.86	3.98	3.94	4.04	3.98	4.10	4.01	4.05	4.00	3.90	3.85	3.95

(a) computed on an annual basis

Note: quarterly figures and forecasts are end-of-period data.

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