LETTER

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The global economic outlook in autumn 2007

This study was prepared under the authority of the Treasury and Economic Policy General Directorate and does not necessarily reflect the position of the Ministry of the Economy, Finance and Employment.

- The US economy began showing signs of slowing in mid-2006, notably due to the downturn in home building. Because of the specific nature of this shock, its impact on the economies of Japan, the eurozone and the emerging countries stayed limited. Growth remained pretty strong, particularly in the eurozone, fuelled by very buoyant investment and exports. The slowdown in the second quarter of 2007 (in Japan and the eurozone) appears to have been caused by short-term factors that do not cancel out this healthy uptrend.

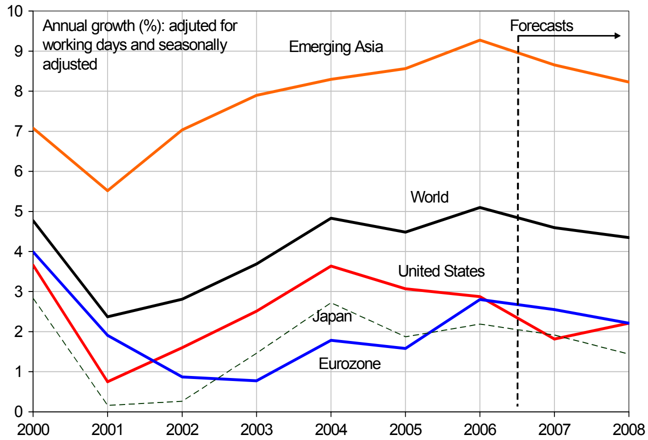
- Tensions in the financial markets in summer 2007 drove up risk premia and led to tougher lending conditions in the United States. These developments are likely to weigh on the US economy (and to a lesser extent on other countries such as the United Kingdom and Spain) by reducing investment in residential property and household consumption. In the corporate sector, businesses are in sound financial condition-thanks notably to relatively high cash flow-which should help them to avoid a sharp investment slowdown.

- Despite these tensions, eurozone growth is forecast to remain buoyant in 2007 (2.6%), while the US economy is forecast to slow significantly, to 1.8%: the process of decoupling is set to continue.

- In 2008, with the slowdown in home building abating and with faster business investment, US activity would gradually accelerate up to an annualised growth rate of around 2.5% by year-end. During the same period, the eurozone is expected to grow at a rate close to its potential (roughly 2%).

- Growth in Japan is forecast to be better balanced (with more consumption and lower exports) but no longer to exceed its potential. In emerging Asia, slightly weaker investment would largely be offset by increased consumption, so that growth is forecast to remain robust.

GDP growth worldwide



Source: national accounts.

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DIRECTION GÉNÉRALE DU TRÉSOR ET DE LA POLITIQUE ÉCONOMIQUE

1. The decoupling between the United States and the other major economies observed in 2006 and early 2007 seems to have been less clear cut in Q2 2007, though largely for short-term reasons

Growth in the eurozone, Japan and the emerging countries held up well in the face of the deteriorating US economy, between Q1 2006 and Q1 2007. US GDP growth slackened sharply over the period, from 3.3% to 1.5% year-on-year. The eurozone, on the other hand, accelerated from 2.4% to 3.2%, and likewise the United Kingdom, from 2.4% to 3.0%. In Asia, Japanese growth worked out to 2.6% year-on-year in Q1 2007, as in Q1 2006, while the emerging countries continued to register very brisk growth (around 11% for China), buoyed by their strong integration into the global trade system and the uptrend in commodity prices for the countries producing them.

This decoupling has its source in the specific nature of the US slowdown, triggered by the slump in home building (see box 1).

Three recent cyclical developments (apart from financial market tensions) may be thought to have reduced this decoupling for the rest of 2007 and 2008 for the eurozone and Japan. However, these developments appear to be more short-term than enduring:

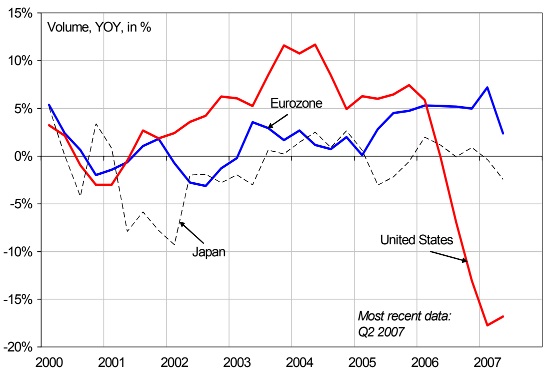
- US economic growth in Q2 far exceeded that of the other major developed economies: the United States economy bounced back significantly, with a 3.8% annualised growth for the quarter, coming after 0.6% the previous quarter, whereas there was a significant slowdown in the eurozone (with 1.4%, coming after 2.8% on an annualised basis), and above all Japan, with a negative 1.3%, coming after 2.9% growth);
- Manufacturing activity in the major industrialised countries slowed, with trade decelerating;
- In the eurozone and Japan, the construction sector suffered a correction in Q2, after registering very strong activity in Q1-due to a mild winter notably.

Box 1: **A negative shock in the housing market specific to the United States**

The slowdown in the United States in 2006 had its roots in the downturn in home building. The previous run-up in property prices in the US ended up curbing household purchasing power (despite the surge in high-risk or sub-prime lending), and contributed to a fall in house purchases. This drove up inventories of unsold homes (because building activity was slow to adjust to falling demand) and put a brake on growth in house prices. As a result, home building has declined since Q2 2006.

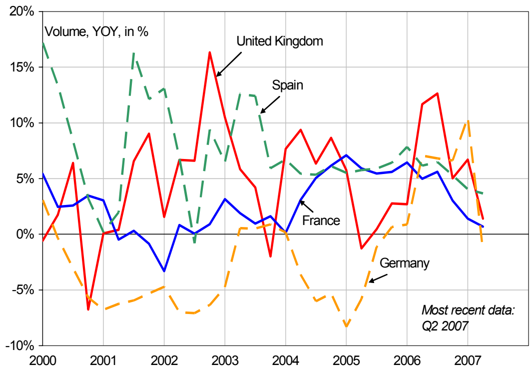
No equivalent trend has been observed in the rest of the world (see chart 1). As a result, residential investment powerfully supported growth in the eurozone in 2006 (especially in Spain, as has been the case for several years, and more briefly in Germany in 2006). In the United Kingdom, both house prices and house buying remain buoyant despite rises in Bank of England key rates. Despite a tendency to slower growth in the construction sector in Europe in early 2007, in Germany notably (see chart 2), there seems little likelihood of a downturn in the eurozone property sector comparable to the one seen in the United States, due to the specific nature of the US housing crisis. That is because there has been no fall in household purchasing power or surge in subprime lending in the eurozone. In Japan, meanwhile, the upturn in house prices, one of the signs this country is emerging from its deflationary period, sparked a revival in house building in 2006 (which no longer acted as a brake on growth), although this slipped back again in the first half of 2007. In China, construction in 2006 continued to be one of the country's main growth drivers despite tighter credit controls.

Chart 1: residential investment worldwide



Sources: BEA, Eurostat, Cabinet Office.

Chart 2: residential investment in Europe

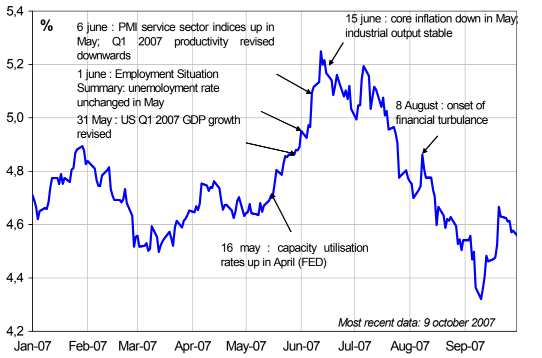


Sources: INSEE, INE, ISTAT, Destatis, UK ONS.

1.1 The rebound in US growth in Q2 2007 is probably temporary

America's high growth rate in the second quarter in fact conceals a sharp slowdown in the main components of domestic demand, namely much weaker consumption and a continuing fall in residential investment. Imports were lacklustre as a result. The strong Q2 growth was mainly due to the positive external contribution (+1.3 percentage point of GDP out of a total of 3.8% on an annualised basis) and to the unexpected bounce back in business property construction. After having upgraded their growth and interest-rate expectations from mid-May to mid-June in response to the flow of cyclical news pointing to an upturn in Q2, the bond markets then revised their expectations downward throughout the summer, even before tensions began to appear on the financial markets in early-August (see chart 3).

Chart 3: 10-year US Treasury bond yields in 2007



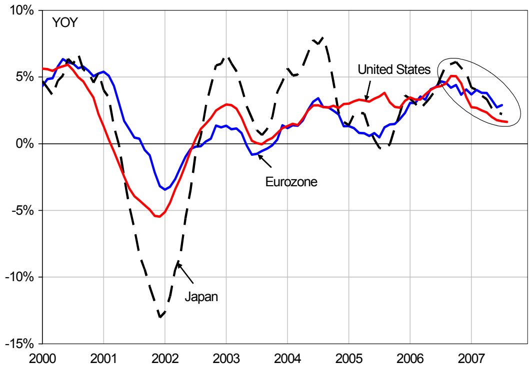
Source: Datastream

1.2 The slowdown in industrial activity and imports in many developed countries, including the eurozone, appears to be transitory and is not expected to prevent an investment upturn in the second half of 2007

In the United States, Japan and, to a lesser extent, the eurozone, industrial activity and trade have slackened relative to their mid-2006 pace (see charts 4 and 5).

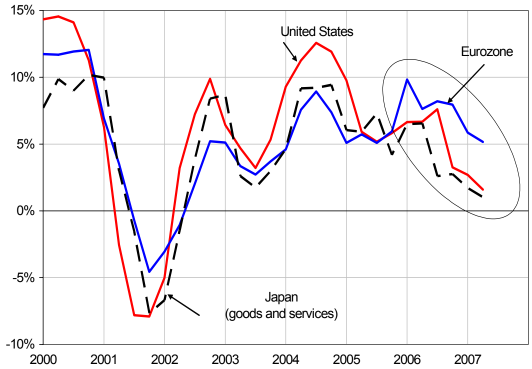
However, business cycle surveys do not appear to be signalling a cyclical slowdown in activity (see chart 6). In the United States, growth in producer goods investment is consequently expected to revert progressively in 2008 to a rate closer to its long-term level thanks to fundamentals that remain sound (healthy profits, high production capacity utilisation rates, relatively low long-term interest rates, etc.). That is what is suggested by the persistence since March 2007 of a business climate in industry above the threshold indicating a contraction. The business outlooks for the eurozone and Japan also are above their long-term levels, and business investment is expected to pick up in the second half of 2007.

Chart 4: industrial output, excluding construction



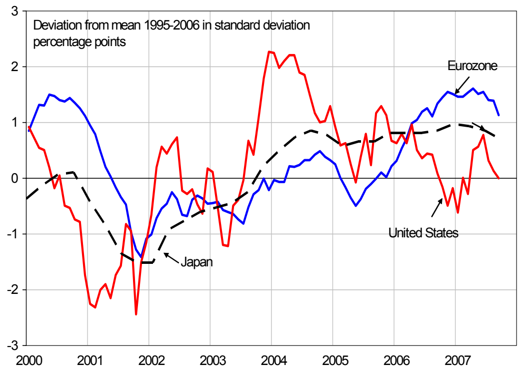
Sources: Eurostat, Fed, Japan Statistics Bureau.

Chart 5: world imports of goods (yoy growth)



Sources: BEA, Eurostat, Cabinet Office.

Chart 6: World business climate (mfg. industry)



Sources: European Commission, NAPM, TANKAN.

1.3 The slackening of construction and consumption in Europe and Japan in the first half was due to temporary factors

In the eurozone and Japan, apart from slower growth in external trade and industrial output as described above, the slowdown in activity in the first half of 2007 reflects trends in the construction sector and consumption. In the United Kingdom too, although GDP growth remained strong in Q2, some of the steam had gone out of residential investment and consumption.

In the construction sector, part of the downturn in activity in the eurozone stemmed from short-term factors. The Q2 slowdown in construction (in Germany, Italy and France in particular) was partly due to the after effects of a mild winter, which had supported activity in the previous quarters. In Germany there was the added consequence of the robust growth in house building in 2006 as a result of the large number of building permits signed the year before (before the expiration in December 2005 of tax measures to support house building). Only the slowdown in house building in Spain in Q2, brought on by the delayed negative effects of the ECB's interest-rate rise, was expected and is likely to persist. As a result, aggregate residential investment could pick up in the second half of the year, as indicated by the healthy level of confidence among building and public works contractors in the eurozone and the improved trend in building permits in Germany. It would nevertheless remain below the past growth rate owing to tighter credit. In the United Kingdom too (where building has been very vigorous in recent years), and in Japan, building activity slowed significantly in the first half. In the UK, however, it is likely to be sustained by rising property prices, as demand continues to outpace supply.

Box 2: **the eurozone is relatively unaffected directly by a slowdown in US imports**

The current US economic slowdown was triggered by a shock specific to the housing sector in the United States, where production requires relatively few imports (mainly wood and metal products). Provided the American slowdown concentrated on the housing sector did not spread to other components of demand (business investment or household consumption), it would result in a moderate slowdown in imports.

A slowdown in US imports would have a negative impact on activity in countries that export to the United States. For example, there is a correlation between American growth and European exports to the United States, as illustrated by the case of Germany (see chart 7). Despite this apparent correlation, the eurozone is, *a priori*, relatively unaffected by this direct effect: exports of goods to the United States represent only 15% of eurozone goods exports, and exports of goods from the eurozone account for only 15% of eurozone GDP.

Including services, eurozone exports to the United States thus account for only 3% of eurozone GDP. Consequently, the direct impact on the eurozone of a US slowdown (i.e. the impact caused by a slowdown in exports to the United States) is low compared with the impact on Canada, Mexico and Asia, which are much more open in terms of the share of exports in their respective GDPs. For a complete calculation of the impact of a slowdown in US imports *via* the trade channel, the following factors would have to be taken into account:

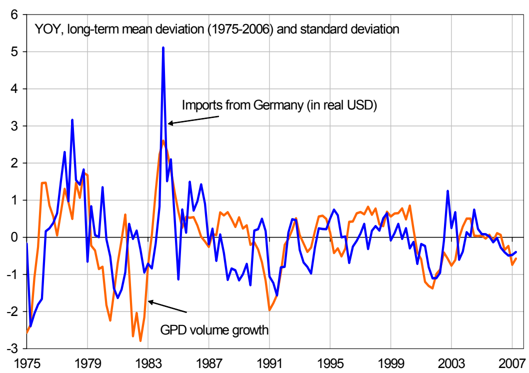
- the domestic macroeconomic feedback in each country:

  - the reduction in imports from countries that export to the United States (this could be considerable in the case of countries that create only a small portion of the value added to the products exported) tends diminish the negative impact on their growth,
  - on the contrary, the knock-on effects on the country's domestic demand (investment and consumption slowdown resulting from the initial slowdown in GDP) tend to boost the negative impact;

- echo effects on world trade as a whole: reductions in imports from countries directly affected by the US slowdown accentuate the world trade slowdown, such that the countries are affected not only by reduced exports to the United States but also by those to other countries with trade links to the United States.

An analysis of these effects based on the structure of world trade (see table 1) shows that the total impact *via* the trade channel of a US slowdown of 1 percentage point would be around ¼ percentage point of GDP for the eurozone after a few quarters. For the emerging Asian countries, the total impact is estimated at around ½ percentage point of GDP.

Chart 7: GDP growth and imports from Germany



Sources: BEA, Census.

Table 1: short-term impact of a 1 percentage point drop in US GDP

	Total effect (including echo effect) with macroeconomic feedback for imports		Direct effect (without echo effect) with macroeconomic feedback for imports	
Ranking of countries by total impact in descending order (in GDP percentage points)	with knock-on effects on domestic demand	excluding knock-on effects on domestic demand	with knock-on effects on domestic demand	excluding knock-on effects on domestic demand
United States	-1,2	-1,1	-1	-1
Canada	-1,2	-0,6	-0,9	-0,6
Hong-Kong	-0,7	-0,4	-0,3	-0,3
China	-0,6	-0,3	-0,4	-0,2
Taiwan	-0,6	-0,3	-0,3	-0,2
Singapore	-0,6	-0,4	-0,3	-0,2
South Korea	-0,6	-0,3	-0,2	-0,2
Emerging Asia	***-0,5***	***-0,3***	***-0,3***	***-0,2***
Japan	-0,4	-0,1	-0,2	-0,1
Germany	-0,3	-0,1	-0,1	-0,1
UK	-0,3	-0,1	-0,2	-0,1
Netherlands	-0,3	-0,1	-0,1	-0,1
India	-0,3	-0,1	-0,2	-0,1
Euro zone	***-0,3***	***-0,1***	***-0,1***	***-0,1***
Italy	-0,3	-0,1	-0,1	-0,1
France	-0,2	-0,1	-0,1	0
Spain	-0,2	-0,1	-0,1	0

Sources: IMF and Chelem (July 2006), DGTPE calculations.

Concerning consumption, the profile observed in Germany between Q4 2006 and Q2 2007 is as one would expect (with purchases brought forward in the last quarter of 2006, a sharp decline in Q1, and a rebound in Q2), but the Q1 decline was greater than expected. The upturn in wages observed in the first half and the decline in unemployment could pave the way for a rebound in the coming quarters.

Consumption has slowed in Japan and the United Kingdom also. In the United Kingdom it is possible that this trend will not reverse, with the diminished property wealth effect and higher interest charges on variable-rate mortgages. In Japan, despite the Q2 slowdown, consumption remains on a more dynamic path than in 2006 and is forecast to remain buoyant in expectation of a recovery in per capita wages.

2. The financial tensions of summer 2007 are expected to have a moderate impact on the economy, especially in the eurozone

A combination of fears that the risks of default on American subprime home loans have been underrated and uncertainties surrounding securities backed by these loans has pushed up risk premia in global financial markets. If this had proved durable, it would have sent a common shock throughout all regions.

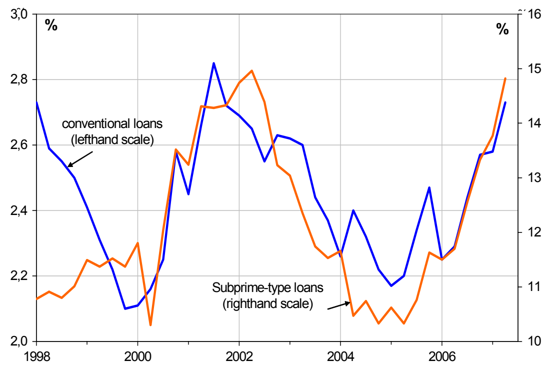
2.1 Reappraisal of the risk of default on US subprime loans lies at the root of these financial tensions

US consumer purchasing power appeared to have bottomed in the course of 2005, as house prices were on a sharp rise. Financial institutions developed subprime-type loans in response to this situation. These were aimed at those sections of the population customarily excluded from the ranks of home buyers, chiefly because they lacked sufficient funds.

The strong growth in these loans temporarily revived housing demand, until these newcomers to the market were themselves no longer sufficient to compensate for the steady deterioration in consumer purchasing power brought on by the steep rise in prices. At that point, supply outran demand, construction firms having failed to foresee this risk, and the housing crisis set in half-way through 2006, leading to a clear slowdown in house prices.

Parallel to this slowdown in house prices, mortgage default rates began to rise (see chart 8). For households with variable-rate loans, this may have been exacerbated by the FED raising its key rates. But there must have been an additional effect, specific to subprime loans, namely that borrowers were heavily reliant on rising house prices to repay their loans. For example, because households were able to postpone the first instalment on their loan for one or two years, some borrowers bought with the sole intention of reselling before starting repayments, hoping thereby to realise a substantial capital gain thanks to the price increase in the meantime (house prices rose at an annual rate of over 10% in 2005). In regions where prices fell, it became impossible to resell these houses and some households found themselves unable to keep up their payments.

Chart 8: Default rates by type of mortgage loan



Source: Mortgage Bankers Association.

2.2 Uncertainty over market participants' exposure to the risk of subprime default has affected the interbank markets

In late-2006 and early 2007, home loan default rates rose sharply (particularly on subprime-type loans). These loans were securitised and sold to financial investors, which spread the default risk across a large number of complex financial products. Because the risk had the potential to affect a large number of investment funds, this increase in defaults-which had been unexpected even though historically not extraordinary-triggered a wave of mistrust among investors. This prompted a first rise in risk premia. It should be noted that, while potential losses are relatively small (estimated at around 130 billion dollars out of around 1,300 billion dollars in total subprime outstandings), the problem stems from a lack of confidence in the valuation of risks, the markets having suddenly awoken to the fact that these securities could be riskier than previously thought (and hence over-valued) at the time of purchase.

The mid-August financial tensions reflect the spread of this investor distrust throughout the credit markets, leading to a reassessment of risk premia, this time affecting securities not directly linked to home loans (e.g. commercial paper-backed securities, equities, emerging country loans, and so forth). In addition, this "classically" created liquidity problems and a "flight to quality", in other words to Treasury bills and notes, in a context of asymmetric information regarding the degree of risk exposure and doubts over the specialised agencies' ratings, thus pushing up interbank rates.

2.3 The impact of tighter credit on businesses should be limited, thanks to their sound finances

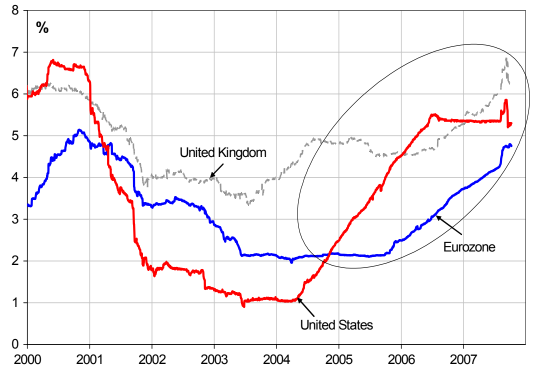
These financial tensions could lead to tighter lending conditions (not only higher interest rates, but also tougher requirements in terms of guarantees or down payments, etc.), which could in turn drag down investment and consumption.

For businesses, the risks appear to be limited, however, given that their financial condition appears to be sound overall (especially in Germany, Japan and the United Kingdom). This suggests that the pace of investment should be relatively unaffected by a possible future credit tightening.

2.4 On the other hand, the situation of households looks more fragile in certain countries, thereby limiting the prospect of house building and consumption supporting growth

With regard to the potential effects of these financial tensions on households, residential investment is likely to be penalised above all in the United States, where recently it was supported by the expansion of risky lending (which appears to be drying up), and where house prices have stopped rising. This latter factor penalises consumption, moreover, *via* the wealth effect. There are also risks in those countries where households combine a high level of debt with a relatively high level of debt service as a proportion of their income, especially where they have borrowed at variable interest rates (these have risen sharply over the past three years, see chart 9). This concerns Spain and the United Kingdom chiefly.

Chart 9: 3-month interest rates



Source: Datastream.

3. France's international environment is likely to be more benign in 2008 than in 2007

On the reasonable assumption that tensions on the financial markets subside, France's international environment is likely to be more benign in 2008, with US growth recovering progressively. This scenario depends on two main imponderables, one negative for the entire world economy (namely a worsening crisis of confidence in the financial markets), the other positive for the eurozone (i.e. accelerating productivity through structural reforms).

3.1 Activity is likely to pick up in the United States and to a lesser extent in the eurozone, though without fuelling inflationary pressures

Despite tensions in the world's financial markets, the decoupling of the eurozone is expected to continue until the end of 2007, the United States continuing to be dragged down by falling residential investment and the slowdown in household consumption (due to the negative property wealth effect and rising unemployment). Given the growth already achieved for 2007 at the end of the first half (2.1% for the eurozone versus 1.6% for the United States), average annual US growth in 2007 is expected to be distinctly lower than for the eurozone (1.8% versus 2.6%).

In 2008, with the decline in US house building steadily abating and a continuing upturn in business investment, activity in the United States is forecast to gather pace, reaching an annualised growth rate of around 2.5% in Q4 2008. At the same time the eurozone is forecast to go on growing at close to its potential: accelerating German consumption (fuelled by rising earnings) would partly be offset by the world trade slowdown resulting from weak US growth, by the delayed effects of the euro's appreciation since 2006, by a slightly restrictive policy mix, and by fading positive effects resulting from property wealth trends in Spain. Assuming raw materials prices stabilise, eurozone inflation would remain subdued in 2007 and 2008 at close to 2%. It would continue to decline in the US owing to slower rent increases.

3.2 World growth could be hurt if the financial crisis took a turn for the worse. Conversely, eurozone growth could be greater if the observed productivity spurt proved to be structural

3.2.1 Internationally tighter credit would drag down growth

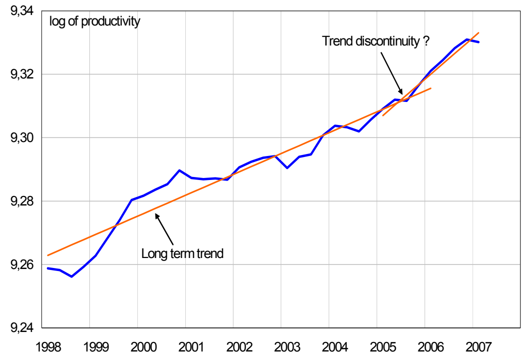
The tensions that arose in the markets this summer prompted a reassessment of risks. In the central scenario adopted, these fluctuations are assumed to have no significant impact on financial institutions' lending policies, notably thanks to their high market capitalisations and healthy profitability.

The assumption of a hefty and widespread international deterioration in lending conditions for both households and business is not currently considered to be the most likely. However, a "low" scenario has been built on the basis of this assumption. In this scenario, US growth could fall to 1.5% next year. Eurozone growth would slow by around 0.5 percentage point under the combined impact of weaker domestic demand and a slowdown in the US.

3.2.2 Conversely, the eurozone could see more sustained growth thanks to stronger productivity gains

The central scenario's forecast assumes that the eurozone's potential growth remains unchanged. However, labour productivity has gathered pace in the eurozone over the past several quarters (see chart 10). This acceleration certainly has a cyclical dimension, with activity generally taking off faster than employment.

Chart 10: apparent labour productivity in the eurozone



Source: Eurostat.

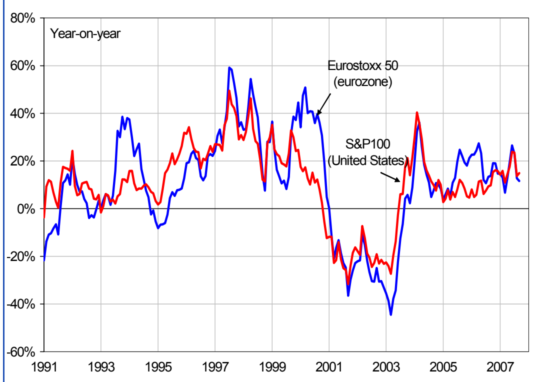
Box 3: **Financial channels and business climates**

Business cycles on either side of the Atlantic have tended to be closely-linked in the past, as shown in chart 12. Beyond direct effects *via* foreign trade, this phenomenon also stems in part from agents' expectations and interactions between the financial markets. In the recent period, however, business climates have clearly evolved at different rates, as can be seen from chart 12, thereby lending credibility to the hypothesis of a decoupling of these cycles.

The way in which stock market movements have closely followed each other (see chart 11) can partly be accounted for by the multinational nature of large quoted companies. The latter would be hurt by lower profits at their American subsidiaries in the event of a US slowdown. Moreover, a decline in the flow of American capital onto the European markets would also penalise the European stock markets. But this proximity of stock market indices also bears traces of the global shocks affecting the world economy. Empirically, equity markets correlation is high, especially if the American stock market tumbles sharply; however, this phenomenon has weakened since 2005. Similar stock market movements can act as a factor spreading the American slowdown to the other economies, chiefly with rising volatility, which raises the cost of credit, and a negative wealth effect on the consumption of equity-owning households. A 10% equity price fall in the eurozone would depress activity by 0.1 percentage point of GDP two years out (see DPAE no. 76, June 2005).

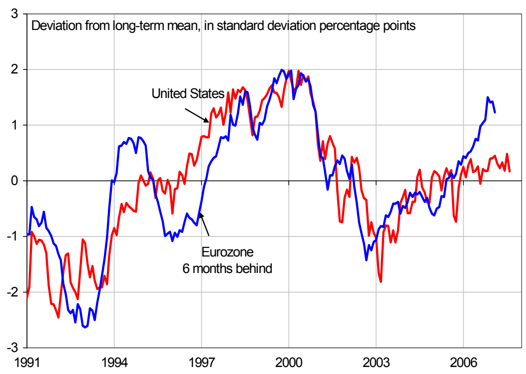
Consumer confidence (see chart 12) and business climate on either side of the Atlantic also move closely in line with each other over long periods, due to linkage between the financial markets and also the international dimension of companies and the geographical diversification of household investments. This phenomenon was particularly clear cut at the end of the 1990s, with the eurozone lagging 3 quarters behind the United States. On the other hand it has diminished sharply since the beginning of 2006.

Chart 11: stock market indices



Source: Datastream.

Chart 12: consumer confidence



Source: Conference Board, European Commission.

Beyond this, many of the reforms carried out by our partners in recent years should boost structural labour productivity gains in the eurozone. This notably applies to reforms to promote competition in goods and services, those aimed at boosting R&D spending, and reforms designed to improve labour skills (particular in higher education).

A greater potentiel growth would create room for a more accommodating monetary policy, so that activity could move back up to its trend. A rate cut would stimulate investment by lowering the cost of capital. In addition, the expectation of higher profits would push up asset prices, which would also be supported by a fall in long-term rates. Households' financial wealth would rise, stimulating their consumption. In 2008, the positive impact on growth in the eurozone could work out to +0.5 percentage point relative to the central scenario.

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Table 2: main findings of the international scenario

Annuel change (%)	2005	2006	2007 (p)	2008 (p)
GDP growth (gross figures)				
United States	**3.1**	**2.9**	**1.8**	**2.2**
Japan	**1.9**	**2.2**	**2.0**	**1.6**
United Kingdom	**1.8**	**2.8**	**2.9**	**2.3**
Eurozone	**1.5**	**2.8**	**2.6**	**2.3**
Germany	0.8	2.9	2.6	2.3
France	1.7	2.0	2-2.5	2-2.5
Italy	0.1	1.9	1.7	1.5
Spain	3.6	3.9	3.8	2.8
Netherlands	1.5	3.0	2.3	2.2
Belgium	1.1	3.2	2.7	2.3
Central an Eastern Europe	**4.2**	**5.6**	**4.8**	**4.5**
Russia	**6.4**	**6.7**	**6.5**	**6.2**
Latin America	**4.5**	**5.2**	**4.6**	**4.2**
Amerging Asia	**8.3**	**9.0**	**8.6**	**8.2**
.... of which China	**10.2**	**11.1**	**11,2**	**11.6**
World	**4.5**	**5.1**	**4,6**	**4.4**
World demand for French products	6.8	9.3	4.7	6.4
World trade	8.0	9.7	5.7	7.4
Price of oil (Brent, in $)*	55	65	68	73
Euro-dollar exchange rate*	1.24	1.26	1.35	1.37

* Oil price and exchange rate forecasts are based on the assumption of a freeze on August 22, 2007 at USD 73 for oil, at the average rate for the previous 15 days for the exchange rate.

(p) : DGTPE forecasts.

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