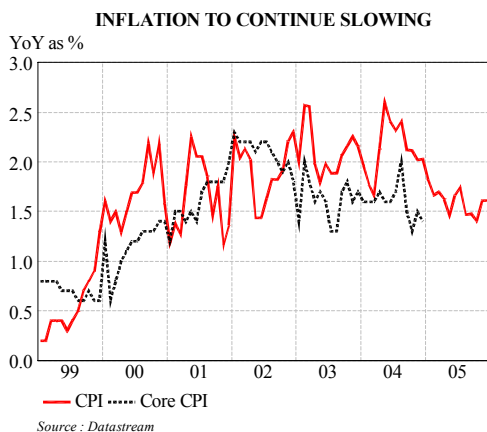


## GOOD NEWS FOR CONSUMERS: LOW INFLATION IN 2005

- After remaining stable in November, consumer prices gained 0.1% over December (+2% yoy). Averaged over the year, inflation will therefore have been high in 2004, at 2.1%, representing a modest price increase. Underlying inflation was 1.4%.
- Consumer prices are likely to slow this year under the combined effect of the stronger euro, which limits imported inflation, the drop in oil prices, the decision not to increase excise duties and the absence of tension of the labour and goods markets. Reflecting the lack of domestic inflationary pressure, underlying inflation should stabilise at around 1.5%, although it may temporarily accelerate in the first half of the year due to the past increase in some intermediate goods prices and the possibility of higher rents.

### Food and energy prices: diverging trends

The slight rise in prices last December (+0.1%) brought inflation back to 2%. Total inflation has been falling non-stop since the summer (2.4% in August).



This slowdown is partly linked to the dip in food prices (17.1% of the index): favourable weather conditions contributed to the fall in fresh produce costs while the price of other food products, which slowed considerably (+0.2% yoy in December) benefited from last June's retail price freeze (INSEE estimates the impact of this agreement on inflation at -0.2pts in 2004). According to INSEE's retail price index, consumer goods prices fell by 1.1% between September and November, in contrast to a 0.3% increase over the same period in 2003. However, there is reason to fear that, in the absence of any new agreement to bring a further price reduction in 2005, non-perishable food prices will start to rise in the first half of the year. And if we consider the usual seasonal price increases, the price of fresh produce would also be likely to accelerate (up 3% mom in December, stagnant year on year).

Energy prices have started to slow whereas they had accelerated sharply in the wake of the Brent oil price surge between July and October: after peaking at +19.6% yoy in October, the rise in the price of petroleum products eased to +16.4% yoy in December as oil prices fell from the record levels seen in previous months and the dollar continued to tumble. This fall could steepen in the first half of 2005 (our central scenario assumes an average oil price of USD 43bbl and a euro worth USD 1.30). In contrast, electricity prices should rise over the first six months of the year, limiting the slowdown in energy prices

Assuming there is no further increase in tobacco prices, the fact that the January 2004 hike in tobacco duties is not taken into account in determining the rise in tobacco prices year on year will automatically reduce total inflation by 0.2pts at the start of 2005 (inflation excluding tobacco stood at 1.8% in December).

### Underlying inflation should accelerate a little over the first half-year

Looking beyond the slowdown in the volatile components of inflation, we need to consider the fundamental issue of the intensity of domestic inflationary pressures: these remain slight. Underlying inflation was just 1.4% in December, down from 1.5% in November.

In the manufacturing sector, consumer price growth was very limited in 2004: down 0.1% yoy in December after a peak of +0.4% in August. It is likely to accelerate somewhat in coming months due to past increases in industrial commodity prices (+16.9% yoy in local currencies and +7.7% in euros in December). The impact of higher commodity prices on producer prices has so far been limited, though: pulled up by energy goods (+10.5% yoy in November) and intermediate goods (+4.6%), producer prices have gained 3.1% yoy, but the increase in the producer prices of consumer goods alone remains weak (+0.2%). Faced with slack demand, businesses downstream of the production process can only pass on a small proportion of the higher cost of intermediate goods: stiff international competition – heightened by the appreciation of the euro – is restricting pricing power while the restoration of profitability means a degree of leeway is now available.

Two other factors are at play: 1) the stronger euro and the end of textile production quotas will weigh on the price of manufactured goods imports; 2) if, despite the increase in the minimum wage, unit labour costs were to accelerate slowly in the absence of any labour market tension (excluding some sectors and qualifications), productivity gains in the manufacturing industry – close to 6% in 2004 – would slow in line with the productivity cycle. Hence a significant increase in unit labour costs.

All things considered, the consumer price of manufactured goods should accelerate very slightly in the first instance before slowing due to the improvement in base product prices, which should be virtually stagnant throughout the year.

Service prices (44% of the index), which were up 2.5% yoy in December, should pick up slightly in 2005, continuing the trend started in 2002. Transport service prices will reflect the past increase in oil prices. Above all, given the leap in the construction cost index over Q3 (+4.6% yoy after +3.9% and +3.3% in Q2 and Q1), which reflects the strength of building demand and surge in commodity prices (copper and nickel in particular), we can expect a significant acceleration in rents (6.1% of the index). In contrast, the reform of the health insurance system, effective as of January, will have little impact on INSEE's calculation of inflation.

All in all, underlying inflation should rise very slightly in the first half of the year. Total inflation will fall to 1.7% in mid-2005 due to tobacco and energy prices and should average out at 1.6% over the year, down half a point on 2004.

**Caroline de Tinguy – +33 1 42 14 93 49**

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