

October, 11th 2016

Modest expansion lying ahead

The expansion of Eurozone gross domestic product lost some momentum in Q2 2016 (+0.3%), as investment and private consumption slowed down, partly due to weather related factors. Economic activity is expected to accelerate slightly over the forecast horizon (+0.3% in Q3 2016 then +0.4% in Q4 2016 and Q1 2017) on the back of a strengthening of external demand and a stabilization of private-consumption growth. The latter should be mainly driven by the gradual improvement of labour market situation and buoyant growth in real disposable income due to low inflation. Investment is forecast to rebound in H2 2016 albeit at a slow pace. Under the assumptions that the oil price stabilises at \$47 per barrel and that the Euro/Dollar exchange rate fluctuates around 1.12, headline inflation is expected to remain well below 2% (+0.7% in Q4 2016 and +1.3% in Q1 2017). The Brexit referendum in the UK is unlikely to have any significant short-term impact on trade flows with the Eurozone but would put some limited downward pressure on investors' confidence if political prospects in the European Union became cloudier.

Gradual recovery of industrial production after weak summer 2016

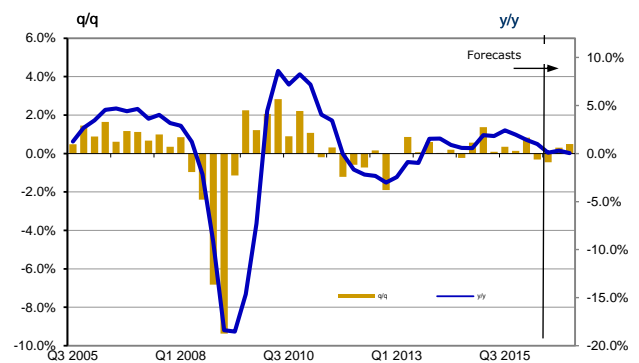
Business surveys in Europe have been volatile in recent months, sending mixed signals, partly due to rising political uncertainty, notably because of the Brexit and terror attacks in France and Germany. After a decrease in Q2 (-0.3%), industrial production fell sharply in July, as a result to lacklustre growth in external demand. Industrial production is expected to record a further decline in Q3 2016 (-0.5%), and to gradually recover in Q4 2016 and Q1 2017 (+0.3% and +0.5% respectively), on the back of brightening prospects for external demand and a modest pick-up in investment.

Moderate growth in aggregate activity

In the second quarter of 2016, eurozone GDP slowed (+0.3% after +0.5% in Q1), mainly because of a temporary weaker expansion in investment and private consumption. The growth contribution of net foreign trade improved, however, mainly due to weaker imports. A moderate growth in aggregate activity is expected over the forecast horizon (+0.3% in Q3 2016 and +0.4% in the following two quarters). The slight acceleration should be mainly driven by a modest but solid expansion in private consumption. Furthermore, external demand is projected to gain momentum over the winter months as the negative effects of the inventory cycle in the US fade out and public spending programmes in China and Japan start kicking in. Finally, aggregate investment in the Eurozone is also forecast to gradually rebound.

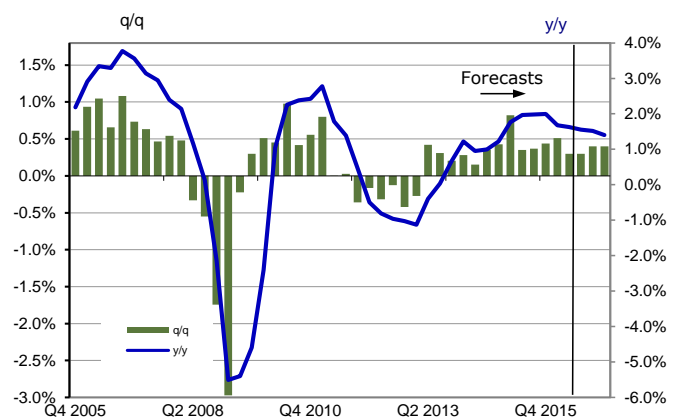
Given the low inflation rate, negotiated nominal wage increases, namely in Germany, and the gradual improvement of overall labour market conditions – the unemployment rate has been steadily declining while employment rising for more than two years – private households' real disposable income is projected to grow

FIGURE 1 | Eurozone Industrial Production Index sa-wda



Source: Eurostat and Ifo-Insee-Istat forecasts

FIGURE 2 | Eurozone GDP Growth sa-wda



Source: Eurostat and forecasts Ifo-Insee-Istat

further over the coming quarters. Accordingly, after a temporary slowdown (+0.2% in Q2 2016), private consumption should expand at a stable rate of +0.4% per quarter over the forecast horizon. Equipment investment unexpectedly declined in Q2 2016 and production of investment goods as well as order-books in this branch of industry slightly deteriorated in July. However, capacity utilisation is high. Accordingly, equipment investment is expected to grow slowly in Q3 2016 and accelerate gradually next. Indicators for construction investment are consistent with a technical rebound in Q3 after the weather-related decline in Q2 2016. In particular, growth in construction investment was unusually strong in Q4 2015 and Q1 2016 due to the mild winter. Accordingly, the slowdown in Q2 2016 was mainly due to a weather effect as construction returned to normal levels. This should allow a modest rebound in aggregate investment in Q3 2016 (+0.4%) after stagnation in the previous quarter. In the following two quarters, gross fixed capital formation should slightly accelerate further on the back of strengthening external demand, favourable refinancing conditions and reduced spare capacity.

Inflation to pick up again

After falling to -0.1% year-on-year in Q2 2016, headline inflation is expected to amount to 0.3% in Q3 and to accelerate to 0.7% in Q4 2016 and 1.3% in Q1 2017. It would be driven by the phasing out of the base effect of the previous energy price decline, and under the assumption that the Brent price remains stable at \$47 per barrel while the Euro/Dollar exchange rate fluctuates around 1.12.

Risks

Political uncertainty has increased. Even if the Brexit referendum has so far not triggered massive turbulences in the eurozone economy, uncertainty regarding the future political orientation in the European Union, the UK and the US could weight on investment.

TABLE 1 | Forecasts 2016

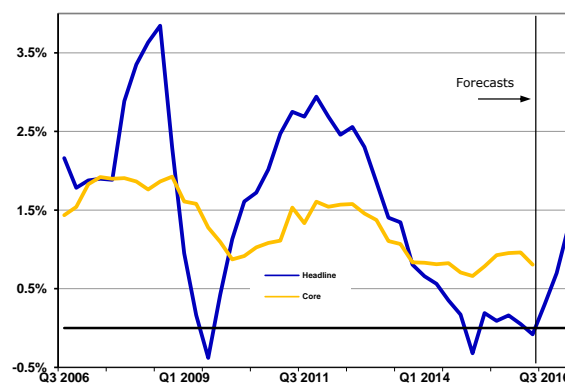
% changes, seasonal and working day adjusted

	Q3/2016		Q4/2016		Q1/2017		2016 average
	q/q	y/y	q/q	y/y	q/q	y/y	
IPI	-0.5	0.1	0.3	0.3	0.5	0.0	0.7
GDP	0.3	1.6	0.4	1.5	0.4	1.4	1.6
Consumption	0.4	1.5	0.4	1.6	0.4	1.4	1.7
Investment	0.4	2.2	0.6	1.4	0.6	1.6	2.1
Inflation		0.3		0.7		1.3	0.2

Source: Eurostat and Ifo-Insee-Istat forecasts

FIGURE 3 | Eurozone Inflation

Harmonised Index of Consumer Price (HICP), y-o-y



Source: Eurostat and Ifo-Insee-Istat forecasts

Methodological note

This quarterly publication is prepared jointly by the German IFO institute, the French INSEE institute, and the Italian Istat institute. The forecast results are based on consensus estimates building on common macroeconomic forecast methods by the three institutes. They are based on time-series models using auxiliary indicators from business surveys by national institutes, Eurostat, and the European Commission. The joint three-quarter forecast covers Eurozone industrial production, GDP, consumption, investment, and inflation. Further economic analysis for each country (Germany, France and Italy) is available by:

- Ifo Konjunkturprognose, Ifo
 - Conjoncture in France, INSEE
 - Istat
- Next release: January 11th, 2017 | Next forecast horizon: 2017 Q2