

Euro-zone recovery: resilient

Euro-zone GDP growth softened in Q4 2010 (to +0.3%, after +0.4% in Q3), due to a weather-related postponement of construction investment, notably in Germany and in France, and to a slowdown in global activity, which dampened the area export growth. Consumption rebounded at a rate of 0.4%, in part attributable to a strong growth in French automobile consumption, driven by the prospect of the scrappage bonus expiration on 31 December 2010. GDP in the euro-zone is expected to accelerate in Q1, moderating somewhat over the forecast horizon (+0.5% in Q1 2011, +0.4% in Q2 and Q3). Private consumption growth would flatten (around +0.2% per quarter), as the euro-zone labor market as a whole is likely to remain fragile, with uneven developments across member States. Furthermore, both fiscal consolidation in many euro-zone countries and inflation would dampen households real income. Under the assumption that the oil price stabilizes at USD 113 per barrel of Brent and that the euro/dollar exchange rate fluctuates around 1.38 over the forecast horizon, inflation should stabilize at 2.6 % in June and in September 2011, from 2.2% in December 2010. Investment is expected to rebound in Q1, owing to a sharp rise in the construction sector and to improved growth prospects. In Q2 and Q3, it should increase further but at a lower pace, because of a loss of momentum in foreign demand and financial market increased uncertainties at the beginning of 2011: new tensions have emerged surrounding the sovereign debt of some euro zone states, particularly Ireland, Greece, and Portugal; the political tensions in the Middle East and North Africa are raising fears of a lasting rise in oil prices, and of a resulting tightening of monetary policy in order to curb inflation; lastly, the earthquake in Japan might cause prolonged supply-chain disruptions in some key economic sectors.

Industrial production on track

Industrial production increased by 1.8% in Q4 2010, but has weakened in December and in January (+0.3%), in the wane of the construction sector's deterioration related to record low temperatures in Europe.

Industrial production is forecasted to be resilient over the coming quarters (+1.2% in Q1, +0.7% in Q2 and Q3). Business surveys as well as PMIs are globally improving, and production expectations are pointing up. In February, business climate in the industry hit a new 10 years high, notably in Germany with an unprecedented level. The euro-zone manufacturing sector is showing ongoing signs of improvement, with manufacturing production growth at +0.7% in January, after +1.0% in December.

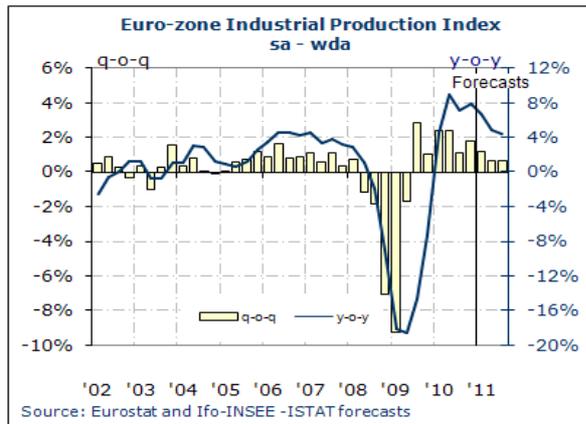
However, the latest March readings of business surveys are pointing to a moderation of euro-zone activity in Q2 and Q3. The expected softening in world trade momentum - in particular because more restrictive economic policies in China are likely to curb the activity-, high energy prices and financial uncertainties, might start to soften entrepreneurs' prospects.

GDP is expected to pick up in Q1 2011

Real GDP in the euro-zone is expected to expand in Q1 2011 (+0.5%), lifted by Germany and, to a lesser extent, by France. This relatively sustained growth would owe to the dynamism of exports, in a context of more

vigorous demand from advanced economies, as well as to an upswing of investment. It would soften slightly at the forecast horizon (+0.4% in Q2 and in Q3).

Euro-zone GDP recovery stimulated euro-zone employment which stabilized at the end of 2010 and is expected to grow modestly in the coming quarters, as suggested by globally improving hiring prospects in business surveys. However, unemployment remains high in a number of member States. Consequently, although the nominal wage negotiated in the past months, notably in Germany, is expected to increase, real wage should stagnate in the euro-zone as a whole. Inflation rose significantly in Q1, due to the rise in oil and food prices. It should continue to weigh on households purchasing power in the coming quarters. Moreover, the efforts towards fiscal consolidation in many member countries are expected to hold back the growth of disposable income. Accordingly, private consumption in the euro-zone should lose momentum (+0.2% in Q1, +0.1% in Q2, and +0.2% in Q3). The surge in French consumption at the end of 2010, due to the scrappage bonus expiration, is in particular expected to have an adverse backlash effect on Q2 consumption.



Equipment investment should rebound in Q1, in line with the activity. However, in a context of enduring underutilization of production capacity, and renewed uncertainties on financial markets, growth in equipment investment should moderate over the forecast horizon. Moreover, after a weather-related rebound in Q1, construction investment is expected, in turn, to contract in Q2 2011. Total investment should therefore accelerate in Q1 (+1.3%), then edge down to 0.5% in Q2, followed by +0.6% in Q3.

Inflation

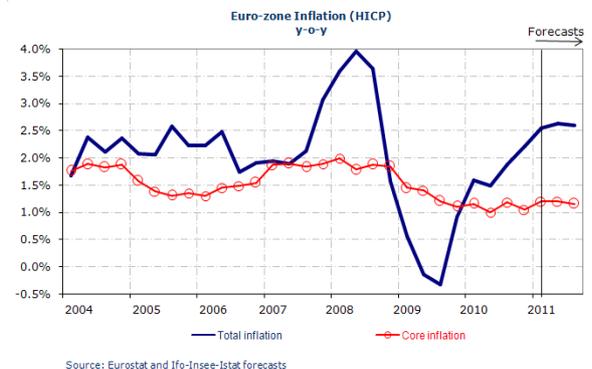
Inflation (HICP) in the euro-zone increased to +2.2% in Q4 end-of-quarter, and to +2.6% in Q1, due to the surge in oil prices and, to a lesser extent, in food prices. Under the assumption of a *Brent* price around \$113, subject to political developments in the Middle East and North Africa, and a euro/dollar exchange rate fluctuating around 1.38 over the forecast horizon, euro-zone inflation would stabilize at +2.6% in June and in September.

Core inflation is forecasted to be stable at +1.2% over the next quarters. The ongoing diffusion of the rise in commodities prices to core inflation would be balanced by the high level of unemployment weighing on wages and by the persistence of idle production capacities.

2011 Forecasts, % changes, sa - wda

| q-o-q | Q4 - 2010 | Q1 - 2011 | Q2 - 2011 | Q3 - 2011 | 2011 |
|-------------|-----------|-----------|-----------|-----------|-----------|
| y-o-y | | estimates | forecasts | forecasts | over-hang |
| IPI | 1,8 | 1,2 | 0,7 | 0,7 | 4,6 |
| | 7,9 | 6,7 | 4,9 | 4,5 | |
| GDP | 0,3 | 0,5 | 0,4 | 0,4 | 1,6 |
| | 2,0 | 2,1 | 1,5 | 1,6 | |
| Consumption | 0,4 | 0,2 | 0,1 | 0,2 | 0,8 |
| | 1,1 | 1,0 | 0,9 | 0,9 | |
| Investment | -0,5 | 1,3 | 0,5 | 0,6 | 2,0 |
| | 1,0 | 2,6 | 2,3 | 1,9 | |
| Inflation* | 2,2 | 2,6 | 2,6 | 2,6 | - |

Source: Eurostat and Ifo-Insee-Istat forecasts, * end-of-period



Methodological note

This quarterly publication is prepared jointly by the German IFO institute, the French INSEE institute, and the Italian ISTAT institute. The forecast methods are shared by the three institutes. They are based on time-series models using business surveys by national institutes, Eurostat, and the European Commission. The joint two-quarter-ahead forecast covers euro-zone industrial production, GDP, consumption, investment, and inflation. Publication is timed to coincide with Eurostat's second release of quarterly national accounts.

Further economic analysis for each country (Germany, France, Italy) is available by:

- Ifo Konjunkturprognose, Ifo
- *Conjoncture in France*, INSEE
- <http://en.istat.it/>

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Next release: July 6, 2011 (date of Eurostat's second release of quarterly national accounts)

Next forecast horizon: 2011 Q4