Association of Three Leading European Economic Institutes

Euro-zone economic outlook

July 6, 2011

GDP growth moderating after a strong Q1

After a strong rebound in Q1 (0.8%), GDP growth in the Euro-zone is expected to decelerate markedly in Q2 (0.3%) and then grow at a moderate rate in Q3 and Q4 (0.4%). Due to less dynamic emerging markets and world trade, domestic demand is seen to be the main driving force of the GDP growth over the forecasting horizon. Nevertheless, private consumption in the Euro-zone should lose momentum in Q2, mainly as a result of the expiration of the wreckage bonus in France. Consumption should be more robust in H2 (0.3% per quarter), driven by a moderate growth in real wages and inflation stabilization. Under the assumption that Brent oil price stabilizes at USD 115 per barrel and that the euro/dollar exchange rate fluctuates around 1.44 over the forecasting horizon, inflation should hover around 2.7%. After a strong deceleration in Q2, mainly as a correction of the rebound in construction in Q1, total investment should reverse to a moderate recovery trend in Q3 and Q4. The expansion is due to the still accommodating monetary conditions, the gradually improving firms' profit prospects and the convergence of capacity utilization to its long run average. The euro area-wide development masks a substantial heterogeneity in the cyclical position of individual member States.

Further moderation in industrial production

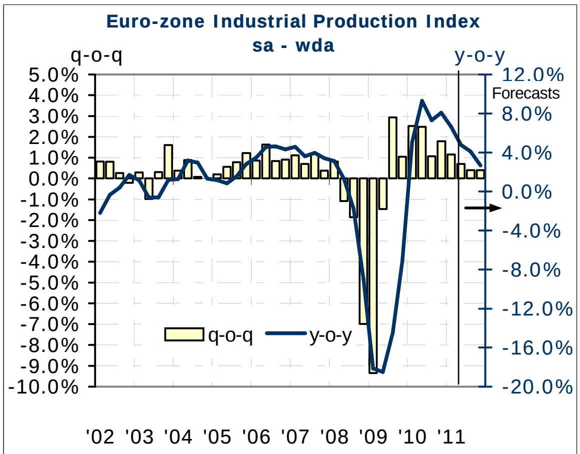
Since March, the global business climate has generally deteriorated due to a moderating growth in the emerging markets, renewed financial uncertainties and concerns about the growth outlook for the US. International economic prospects also worsened due to the earthquake in Japan which led to disruption in global supply chains.

In the Euro-zone, business surveys as well as PMIs have pointed downward in the last three months, signalling weaker production expectations and export order books. In line with these indications, a further moderation of Euro-zone industrial production growth is expected in Q2 (0.7%), Q3 and Q4 (0.4% per quarter).

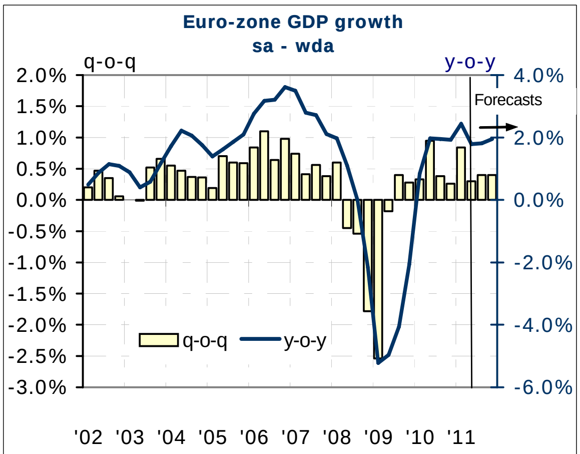
GDP correcting the pick up in Q1

After a strong rebound in Q1, largely driven by internal demand, GDP growth in the Euro-zone is expected to decelerate in Q2 (0.3% following 0.8%) and grow moderately in H2 (0.4% per quarter). As the expansion of world demand is expected to moderate, consumption and investment should be the main driving forces of GDP growth over the forecast horizon. However, this mean forecast masks substantial differences among individual countries and cyclical positions are expected to remain uneven.

The unemployment rate has stabilized over the past two quarters in the euro-zone, and should slightly decline over the forecasting horizon, but will however still remain at a high level. Despite persistent slack in labour market, real wages should grow in the next quarters thanks to negotiations of nominal wage increases (notably in Germany) and a stabilization of the inflation rate.



Source: Eurostat and Ifo-INSEE-Istat forecasts



Source: Eurostat and Ifo-INSEE-Istat forecasts

Private consumption in the euro-zone should lose momentum in Q2 (0.1% after 0.2% in Q1 2011) mainly due to the effects of the expiration of the wreckage bonus in France. However, consumption growth rate should recover and stabilize in Q3 and Q4 (0.3% per quarter). The dynamic of consumption will remain moderate due to the ongoing fiscal consolidation in many member countries via tax hikes and cuts in transfer payments to households.

Over the forecast horizon, equipment investment should moderate slightly in line with economic activity. Construction investment should normalize after the weather-related rebound in Q1. All in all, total investment should decelerate in Q2 and follow a moderate trend in Q3 and Q4 (0.6% and 0.7%). This expected expansion is due to the still accommodating monetary conditions, the gradually improving firms' profit prospects and the convergence of capacity utilization to its long run average.

2011 Forecasts, % changes, sa - wda

q-o-q *y-o-y*	Q2 - 2011 forecasts	Q3 - 2011 forecasts	Q4- 2011 forecasts	**2011 average**
IPI	**0.7** 4.8	**0.4** 4.1	**0.4** 2.7	**4.5**
GDP	**0.3** 1.8	**0.4** 1.8	**0.4** 2.0	**2.0**
Consumption	**0.1** 0.9	**0.3** 1.0	**0.3** 0.9	**0.9**
Investment	**0.4** 1.8	**0.6** 2.6	**0.7** 3.7	**3.0**
Inflation	2.7	2.8	2.7	**2.7**

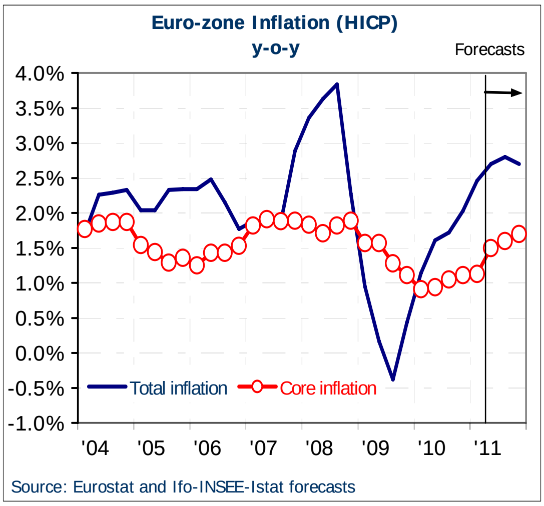
Source: Eurostat and Ifo-INSEE-Istat forecasts

Inflation stabilizing

In June, headline inflation stabilized at 2.7%, discounting lower impact from energy and food prices. The external pressures are expected to ease, due to oil prices stabilization, while some upward inflationary impulses would emerge because of the diffusion of past increases in commodity prices to core inflation.

After reaching a peak of $118 per barrel in Q2, the Brent price would hover around $115/barrel in Q3 and Q4; meanwhile, the dollar/euro exchange rate would stabilize at 1.44 in the second half of 2011. Based on this assumptions, the annual rate of change of HICP is expected to increase slightly (2.8%) at the end of Q3. The stabilization of oil prices should contribute to the slow down in headline inflation (2,7% in December).

Over the forecasting horizon, domestic inflationary pressures would remain subdued because of the still high level of unemployment. Core inflation is forecasted to increase over the next quarters albeit at a moderate pace, reaching 1,7% at the end of the 2011.



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 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 third release of quarterly national accounts.

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

- Ifo Konjunkturprognose, Ifo
- Conjoncture in France, INSEE
- ISTAT

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Next release: October 5, 2011 (date of Eurostat's third release of quarterly national accounts)
Next forecast horizon: 2012 Q1