Association of Three Leading European Economic Institutes

Euro-zone economic outlook

January 11, 2012

A recession in sight

Euro-zone GDP growth remained subdued in Q3 2011 at 0.1%: a technical rebound for a few GDP components was partly offset by the deceleration in external demand, increased uncertainty stemming from the ongoing European sovereign debt crisis as well as fiscal consolidation in several member states. Private consumption expanded only modestly (+0.2%) while investment fell slightly (-0.1%). Taking stock of the deterioration of business surveys since the summer, the euro zone is expected to undergo a short recession with GDP declining around the turn of the year (-0.3% in Q4 2011 and -0.2% in Q1 2012) and stagnating in Q2 2012. Household consumption will be held back by fiscal consolidation and deteriorating labour market conditions (-0.1% in Q4 2011 and zero in both Q1 and Q2 2012). Due to weak public investment and the expected postponement of many private sector projects, total investment is expected to fall over the forecast horizon. Under the assumption that international oil prices will be stable over the forecast horizon at around USD 104 per barrel for Brent) and that the euro/dollar exchange rate fluctuates around 1.35, inflation is expected to reach 1.9% in June 2012, down from 2.8% in December 2011. This scenario is subject to various risks, in particular those stemming from possible turbulences in euro area sovereign debt markets.

Sharp decline in industrial production

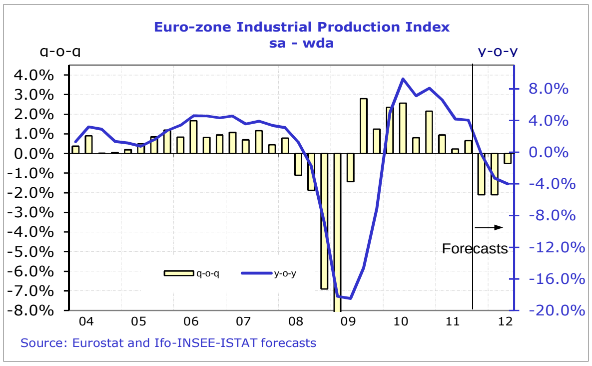
Business and consumer confidence have strongly deteriorated since August 2011. The growing tensions over sovereign debts have caused a confidence shock, and financing conditions for private agents have started to tighten in the euro-zone. In addition, external demand has slowed down due to restrictive monetary policies in some emerging markets and the subdued demand growth in advanced countries. As a result, industrial production dropped between August and October (-2.0%).

Given weak economic sentiment indicators, the expected deceleration in exports and further expected fiscal tightening in many member states of the euro-zone, union-wide industrial production is likely to fall further by 2.1% in the next two quarters. This decline will be followed by a modest improvement in Q2 2012 (-0.5%) reflecting a marginal rebound in global demand and a slight recovery in confidence due to positive signals coming from the US economy as well as a normalisation of financial markets.

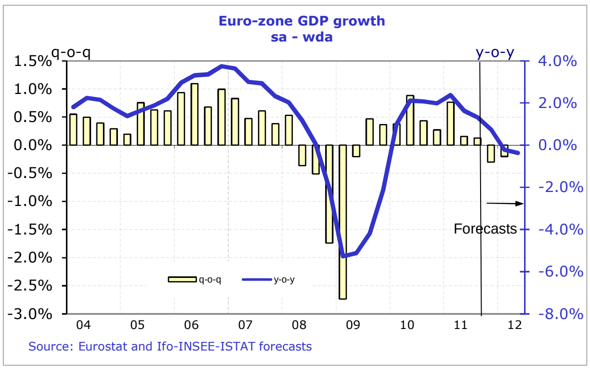
GDP expected to decline

GDP growth in the euro-zone remained weak in Q3 2011 (+0.1%) and output is expected to contract over the next quarters. This reflects negative pressures from financial markets, fiscal consolidation and a weakening in external demand. GDP is projected to fall by 0.3% and 0.2% in Q4 2011 and Q1 2012 respectively, before stabilising in Q2 2012.

After a decline by 0.5% in the previous quarter, private consumption bounced back in Q3 (+0.2 %), as some temporary factors weighing on demand during Q2 expired. However, weak consumer confidence and deteriorating labour market conditions point to subdued near-term private consumption outlook. In addition, fiscal tightening throughout Europe is likely to affect households' disposable income. In this context, private consumption is expected to almost stagnate over the forecast horizon.



Source: Eurostat and Ifo-INSEE-ISTAT forecasts



Source: Eurostat and Ifo-INSEE-ISTAT forecasts

After contracting slightly in Q2 and Q3 2011, investment-expenditure growth is expected to deteriorate further over the forecast horizon. Several factors will contribute to this unfavourable development. Persistent uncertainty is likely to trigger a postponement of many private investment projects.

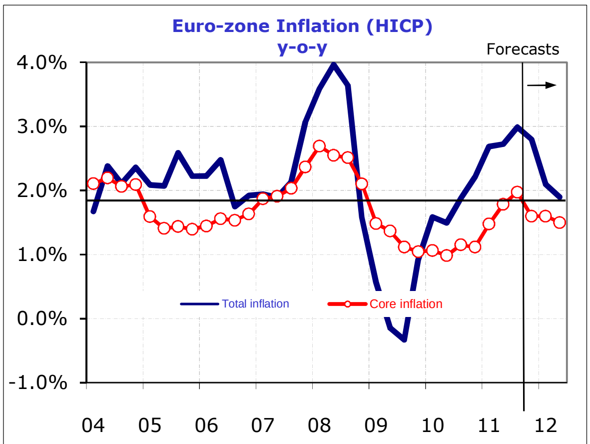
Furthermore, the recent increase in banks' financing costs and the implementation of binding macro prudential rules (Basel III) are expected to make credit conditions for firms more restrictive. Lastly, low capacity utilization as well as lacklustre mid-term prospects for domestic demand are expected to reduce the incentives to invest. Additionally, public investment will be held back by planned fiscal consolidation.

As a result, investment will decrease in the current and forthcoming quarters. However, as long as our baseline scenario materializes and financial conditions remain stable, the decline in activity should be limited..

Inflation gradually decelerating

In Q4, end-of-quarter inflation (HICP) in the euro-zone hit 2.8%, owing to past increases in international food and energy prices. The increase in the VAT rate by one percentage point in September adopted in Italy as part of its fiscal austerity package contributed only marginally to euro area inflation. Under the assumption of a *Brent* price hovering around $104 in Q1 2012 and Q2 2012, and a euro/dollar exchange rate fluctuating around 1.35, euro-zone inflation is projected to decrease to 2.1% in Q1 and 1.9% in Q2 2012. This reflects diminishing pressures from global commodity prices owing to weak international demand as well as a favorable base effect of high inflation during H1 2011.

Core inflation is projected to decrease from 2.0% in November 2011 to 1.6% at the end of Q1 2012 and decrease further to 1.5% in June 2012 as weak labour market conditions persist. Low capacity utilisation and the expected contraction in domestic demand will further limit inflationary pressures.



Source: Eurostat and Ifo-INSEE-ISTAT forecasts

2011 Forecasts, % changes, sa - wda

q-o-q / *y-o-y*	Q3-2011	Q4- 2011 forecasts	Q1 - 2012 forecasts	Q2- 2012 forecasts	2011 forecasts
IPI	**0.5** 4.0	**-2.1** -0.5	**-2.1** -3.5	**-0.5** -4.1	3.5
GDP	**0.1** 1.3	**-0.3** 0.7	**-0.2** -0.2	**0.0** -0.4	1.5
Consumption	**0.2** 0.0	**-0.1** -0.4	**0.0** -0.4	**0.1** 0.2	0.2
Investment	**-0.1** 1.2	**-0.6** 1.0	**-0.5** -1.3	**-0.1** -1.3	1.8
Inflation*	3.0	2.8	2.1	1.9	2.7

Source: Eurostat and Ifo-INSEE-ISTAT forecasts; * end-of-quarter

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:

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Next release: April 3, 2012 (date of Eurostat's third release of quarterly national accounts)

Next forecast horizon: 2012 Q3