Association of Three Leading European Economic Institutes

Euro-zone economic outlook

April 3, 2012

Tensions ease but growth remains sluggish

In accordance with our latest forecast, Euro-zone GDP declined by 0.3% in Q4. Both external and internal demand dropped. The European sovereign debt crisis affected the real economy via the increase of credit costs and private investment declined by 0.5%. Private consumption fell (-0.5%) as a result of weak consumer confidence and declining purchasing power. The slowdown of international trade, mostly within the Euro-zone, put a drag on exports. However, at the beginning of 2012, financial tensions have eased, thanks to the adoption of new fiscal consolidation measures in some member countries, to the strengthening of budgetary discipline in the euro area and to the interventions of the European Central Bank. As a result, business confidence has slightly rebounded since the beginning of the year.

The Euro-zone is expected to recover slowly (-0.2% in Q1, 0.0% in Q2 and +0.1% in Q3). In fact, it would still face some headwinds. Fiscal consolidation and deteriorating labour market conditions will weigh on household consumption. The loosening of financial tensions would slowly ease credit standards but investment is likely to remain sluggish. Finally, oil prices have increased since the start of 2012, thanks to geopolitical troubles, and further increases cannot be excluded. Under the assumption that oil prices will be stable over the forecast horizon at around USD 125 per barrel for Brent) and that the dollar/euro exchange rate fluctuates around 1.33, inflation is expected to reach 2.2% in September 2012, down from 2.6% in March 2012. This scenario is subject to various risks: renewed financial turbulences, possible social tensions in some countries due to deteriorating labour market and fiscal reforms, growth prospects in emerging countries.

Easing of financial tensions

Faced with the surge in financial tensions since the summer 2011, the European authorities have taken several steps aimed at muting nervousness in financial markets. In particular, the European Central Bank implemented in December 2011 and February 2012 two exceptional long-term refinancing operations. Besides, the European countries agreed to strengthen fiscal monitoring while most of them have adopted further fiscal consolidation measures to move fiscal positions back on a sustainable path. These measures led to an easing of the risk premia on several countries' sovereign bonds. Business confidence, albeit still at a low level, have also slightly bounced back since the beginning of 2012.

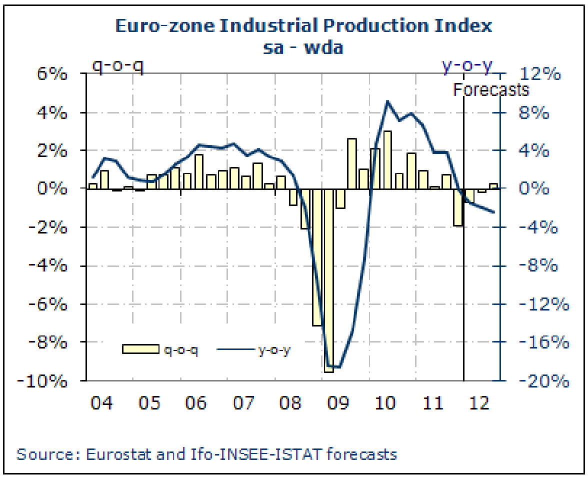
Sluggish industrial production growth

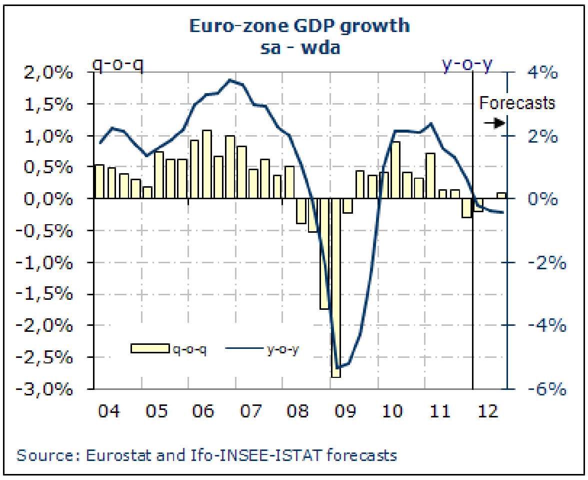
Industrial production fell sharply in Q4 2011 (-1.9%), dampened by the decline of both external and internal demand. Given the overhang of industrial production in January and the low level of business surveys, industrial production is expected to keep declining in Q1 2012 (-0.7%). It would be subdued in Q2 (-0.2%) and grow slightly in Q3 (+0.3%).

GDP recovers slowly

In Q4 2011, Euro-zone GDP fell by 0.3%. This unfavourable outcome was largely the result of financial turbulences stemming from the European debt crisis and the intensifying fiscal consolidation efforts in most member states. Exports declined in Q4, penalized by the decrease of demand in the Euro-zone. Over the forecast horizon, exports would accelerate as trade within the Euro-zone would pick up and demand outside the Euro-zone would remain dynamic. Activity would slowly improve: -0.2% in Q1, 0.0% in Q2 and +0.1% in Q3 2012.

Private consumption fell in Q4 2011 by 0.5%. It would remain weak over the forecast horizon. The labour market will likely keep on deteriorating, and nominal wages growth is expected to remain weak. Besides, households' disposable income would suffer from the tightening of fiscal policy implemented in most countries of the area. The recent rise in energy prices would weigh on households' purchasing power.





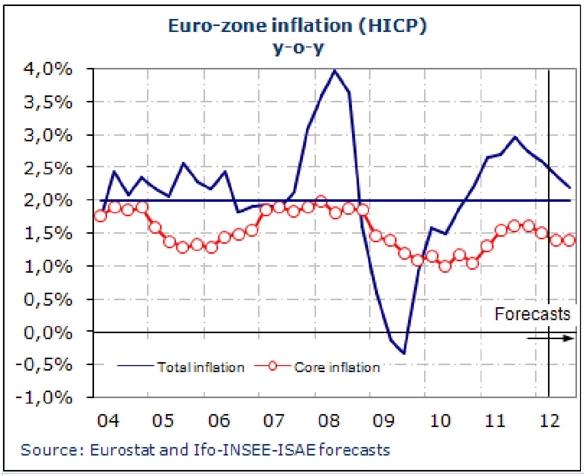
Total investment substantially suffered from the increased tensions on financial markets. These tensions spread to the real economy, via the tightening of credit conditions. The easing of the tensions is likely to support credit access for firms but its effect will be felt slowly. Credit supply would improve but remain tight over the forecast horizon, given the implementation of binding macro prudential rules (Basel III).

Private investment would progressively recover, while public investment would remain subdued, as a result of the ongoing fiscal consolidation. All in all, investment would still decline in Q1 (-0,9 %) and Q2 (-0,4 %) before growing again in Q3 (+0,3 %).

Inflation gradually decelerating

After reaching a peak in Q3 at 3.0%, end-of-quarter inflation (HICP) in the Euro-zone is decreasing, down to 2.6 % in Q1 2012. Over the forecast horizon, inflationary pressures should remain weak given the weakness of domestic demand but the rise in energy prices should hinder the downward trend in inflation. Under the assumption of a Brent price hovering around $125 in Q2 2012 and Q3 2012, and a dollar/euro exchange rate fluctuating around 1.33, euro-zone inflation is projected to decrease to 2.4% in Q2 and to 2.2% in Q3 2012.

Core inflation is expected to slightly decrease from 1.5% in Q1 to 1.4% in Q2 and Q3. The rise of unemployment over the forecast horizon would lead to moderate wage increases and the inflationary pressures would remain moderate.



2012 Forecasts, % changes, sa - wda

q-o-q / *y-o-y*	Q1 - 2012 forecasts	Q2 - 2012 forecasts	Q3 - 2012 forecasts	2012 overhang
IPI	**-0,7** -1,5	**-0,2** -1,9	**0,3** -2,3	-1,7
GDP	**-0,2** -0,2	**0,0** -0,4	**0,1** -0,4	-0,3
Consumption	**-0,2** -0,9	**-0,1** -0,5	**0,0** -0,8	-0,6
Investment	**-0,9** -1,7	**-0,4** -2,0	**0,3** -1,5	-1,5
Inflation*	2,6	2,4	2,2	2,7

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 third release of quarterly national accounts.

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

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Next release: July 4, 2012 (date of Eurostat's third release of quarterly national accounts)
Next forecast horizon: 2012 Q4