Association of Three Leading European Economic Institutes

Euro-zone economic outlook

July 4, 2012

Weak prospects for the Euro-zone

Output in the Euro-zone is expected to decline in Q2 (-0.2 %) and Q3 (-0.1%) and to recover slowly in Q4 (0.1%). Global demand is projected to improve moderately and net exports to be the main driving force of the mild recovery over the forecast horizon. However, unfavorable labor market conditions and impacts of fiscal consolidation will continue to dampen household disposable income. Sluggish consumer confidence, is expected to lead to a decrease in private consumption in Q2 and Q3 (-0.2 %, -0.1% respectively) and stagnation in Q4. In Q2, credit conditions will continue to be tight in some countries. Credit supply is projected to remain limited as bank lending is affected by the need for banks to raise capital and the subdued economic outlook. Therefore, investment is expected to fall in 2012 (-0.7% in Q2, -0.5% in Q3, -0.3% in Q4). Under the assumption that oil prices stabilize at USD 98 per barrel of Brent in Q3 and Q4 and that the euro/dollar exchange rate fluctuates around 1.25, inflation is projected to fall from 2.4% in Q2 to 2.0% in the second half of 2012. This reflects diminishing pressures from global commodity prices and weak internal demand. The risk outlook is balanced as weaker global demand may add to financial market pressures, but market confidence could be supported by the evolution of the European framework to manage sovereign and financial risks.

Industrial production falls

In the Euro-zone, business surveys have pointed down over the past months as a result of the uncertainty stemming from political developments in Greece and renewed concerns about the soundness of the Spanish banking sector.

Accordingly, Euro-zone industrial production is expected to fall in Q2. As a result of a slight acceleration in demand from the US and emerging markets, the pace of decline in industrial production is projected to slow over the forecast horizon (-1.0% in Q2, -0.7% in Q3 and -0.5% in Q4).

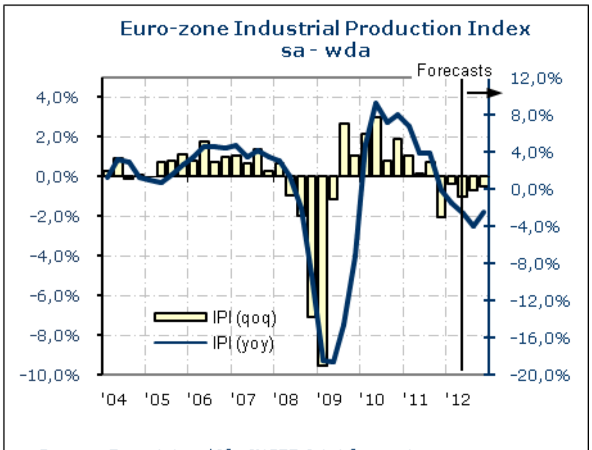
GDP growth back in negative territory

Euro-zone growth would be dampened by consolidation measures, a deteriorating labour market and tight credit conditions. GDP is expected to decline in Q2 and Q3 (-0.2%, 0.1%) before recovering slightly in Q4 2012 (0.1%).

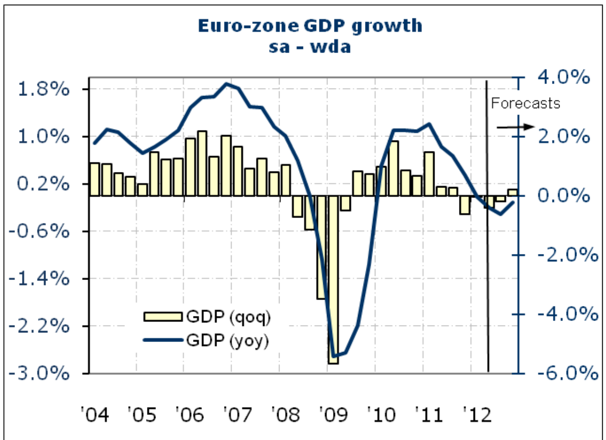
The risk outlook is balanced. If the tensions surrounding sovereign debts were to intensify, activity could keep falling back until the end of the year. On the other hand, growth could pick up more sharply if confidence were rapidly restored notably thanks to the evolution of the European framework to manage sovereign and financial risks.

The improvement in external demand is the main factor contributing to the stabilization of the activity at the end of 2012. Demand from emerging countries is projected to accelerate, reflecting fiscal and monetary stimuli. The recent depreciation of the euro should improve export competitiveness of Euro-zone countries.

Fiscal consolidation plans throughout Europe will weight on household disposable income.



Source: Eurostat and Ifo-INSEE-Istat forecasts



Source: Eurostat and Ifo-INSEE-Istat forecasts

Deterioration of the labour market and sluggish consumer confidence point to a decline in private consumption.

Private consumption would therefore fall in Q2 and Q3 (-0.2%, -0.1%) and stagnate in Q4.

Credit supply is expected to remain tight due to the tensions in financial markets and the need for banks to raise capital to comply with Basel III rules. Weak economic outlook in the Euro-zone would limit private investments, while public investment are expected to remain subdued as a result of the ongoing fiscal consolidation. Total investment is projected to fall over the forecast horizon (-0.7% in Q2, -0.5% in Q3 and -0.3% in Q4).

2012 Forecasts, % changes, sa - wda

q-o-q / *y-o-y*	Q2 - 2012 forecasts	Q3 - 2012 forecasts	Q4 - 2012 forecasts	**2012 average**
IPI	**-1.0** / -2.6	**-0.7** / -4.0	**-0.5** / -2.5	**-2.7**
GDP	**-0.2** / -0.4	**-0.1** / -0.6	**0.1** / -0.2	**-0.3**
Consumption	**-0.2** / -0.4	**-0.1** / -0.8	**0.0** / -0.3	**-0.6**
Investment	**-0.7** / -3.0	**-0.5** / -3.1	**-0.3** / -2.8	**-2.9**
Inflation*	2.4	2.0	2.0	**2.3**

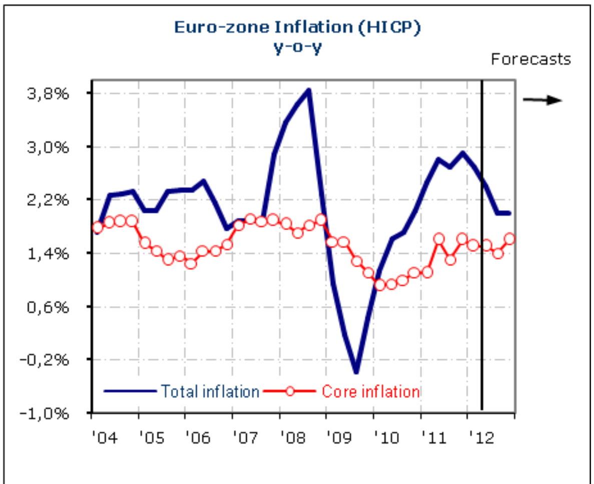
Source: Eurostat and Ifo-INSEE-Istat forecasts,*end of period

Inflation should ease

In Q2, headline inflation continued to decline from 2.6% in April to 2.4% in June. This trend reflects diminishing pressures from global commodity prices and the still weak internal demand.

Under the assumption that oil prices fluctuate around 98 dollar per barrel of Brent and the dollar/ euro exchange rate is at 1.25 on average in the second half of the year, inflation is expected to decrease to 2.0% in September and to stabilize at this level in December.

Given the persistent worsening of the labor market, inflationary pressures should remain moderate. Core inflation should slightly decrease, from 1.5% in Q2 to 1.4% in Q3. It should increase to 1.6 % in Q4 due to the expected VAT increase in Italy.



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, 2012 (date of Eurostat's third release of quarterly national accounts)
Next forecast horizon: 2013 Q1