

Catching up with the world economy

The fourth quarter of 2005 saw weak GDP growth of 0.3% in the euro zone, due to a slowdown in all components of demand. Economic activity is expected to rebound moderately in 2006, increasing by 0.5% in Q1 and 0.6% in Q2 and Q3. The weakness of domestic demand is raising concern about the sustainability of the current growth pattern, despite positive signs of an upswing in investment. Household expenditure is still lacking solid support from the labour market fundamentals and will rise by 0.4% in Q1 2006, followed by 0.5% in the next two quarters. Below-potential domestic demand and the fading of past oil price hikes, with no evidence of second-round effects, is likely to encourage a slowdown in inflation in the next few quarters, from +2.3%, y-o-y, in Q1 2006 to +1.9% in Q3.

The recovery in industrial production still lacking balance

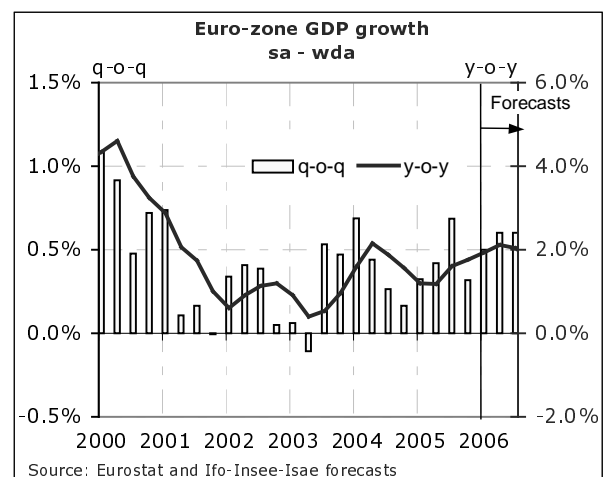
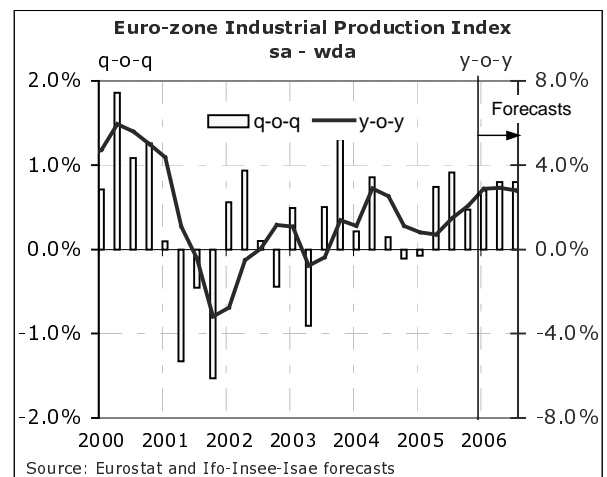
The last quarter of 2005 again showed significant differences among the major euro-zone countries. France and Italy experienced negative rates of industrial growth, whereas Germany substantially outperformed the rest of the zone. In the euro zone as a whole, industrial production posted a slowdown, growing by 0.5% after 0.9% in Q3, failing to match the optimism shown by manufacturers' expectations, which have been improving steadily since August 2005.

If the positive signals coming from the surveys persist, industrial activity seems likely to experience a slight rebound in Q1 2006, with growth of 0.7% (q-o-q), followed by 0.8% in the next two quarters, on the back of buoyant external demand and, to a lesser extent, a recovery in investment.

GDP gaining momentum

The confirmation of the upturn in investment, which has posted strong year-on-year growth in the past three quarters, barely offset the slowdown in private consumption in Q4. The external trade deficit widened, in contrast to the previous quarter.

Growth prospects for 2006 are still unbalanced. Further improvements in the international environment of the euro zone are expected, giving impetus to external demand. Favourable financial conditions and high mark-up ratios in the past few quarters are set to underpin firms' investment decisions, despite the recent rises in the European Central Bank's key rates.



The upswing in the investment cycle is being counter-balanced by the sluggishness of private consumption. The moderate recovery in full-time unsubsidised job creations, as well as the stagnation of wages in real terms, will probably continue to hinder growth of household

disposable income. A possible one-off boost to German private consumption from the holding of the FIFA World Cup in Q2 is unlikely to affect euro-zone consumption as a whole. Under these circumstances, private consumption is expected to rise by 0.4% in Q1 and by 0.5% in Q2 and Q3.

All things considered, GDP will grow by 0.5% in Q1 and by 0.6% in each of the next two quarters, with a positive contribution from investment to domestic demand.

Inflation set to edge progressively lower within the forecast horizon

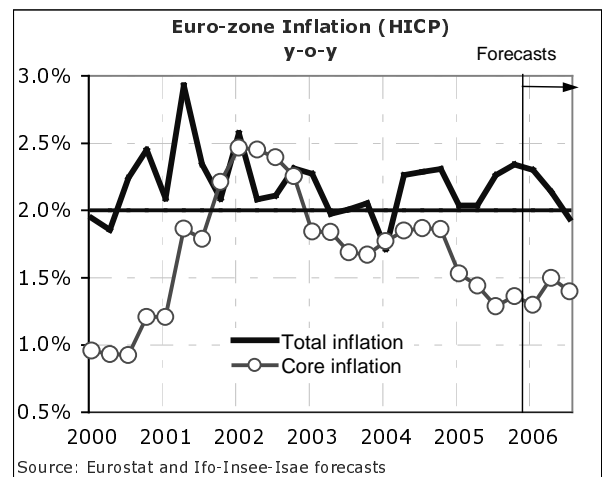
After a fresh upturn in oil prices in the early part of 2006, headline inflation will gradually slow down, led by the easing of the energy component. On the assumption that oil prices keep on fluctuating around 60 \$/barrel and that the dollar/euro exchange rate remains stable at around 1.20 until Q3 2006, inflation is expected to decrease to +1.9% in Q3 from +2.3% in Q1 2006.

The strengthening of GDP growth, in a context of below-potential domestic demand, should not threaten the containment of underlying price pressures. Core inflation is therefore forecast to increase slightly from +1.3% in Q1 to +1.5% in Q2 before easing back to +1.4% in Q3, confirming our hypothesis of limited pass-through from the past high levels of energy and raw material prices.

2006 Forecasts, % changes, sa - wda

q-o-q y-o-y	Q4 - 2005	Q1 - 2006 estimates	Q2 - 2006 forecasts	Q3 - 2006 forecasts
IPI	0.5 2.1	0.7 2.9	0.8 2.9	0.8 2.8
GDP	0.3 1.8	0.5 1.9	0.6 2.1	0.6 2.0
Consumption	0.1 1.1	0.4 1.4	0.5 1.6	0.5 1.5
Inflation	2.3	2.3	2.1	1.9

Source: Eurostat and Ifo-Insee-Isae forecasts



Methodological note

This publication is jointly produced by the German Ifo institute, the French Insee institute and the Italian Isae institute. The forecasts are built up with the help of different forecasting tools shared by the three institutes, using time series models based on business surveys by national institutes, Eurostat and the European Commission.

A joint two-quarter-ahead forecast will be made on a quarterly basis for industrial production, GDP, consumption and inflation for the euro-zone. The release of the forecast coincides with the quarterly national accounts second release by Eurostat.

More in-depth economic diagnoses for each country (Germany, France, Italy), can be found in:

- *Ifo Konjunkturprognose*, Ifo
- *Conjoncture in France*, Insee
- *Abridged Quarterly Report*, Isae

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Next release:

July 12, 2006 (day of Eurostat GDP second release)

Next forecast horizon:

2006 Q4