

## Reassuring prospects for euro-zone growth

*In 2006, the euro zone recorded its steepest real GDP growth since 2000, at 2.8%. Both domestic and external demand contributed positively to this figure. GDP growth is likely to slow temporarily to 0.5% in Q1 2007, bouncing back to 0.6% in Q2 and Q3. Industrial production is expected to stabilize at a reasonably high level. Germany's VAT hike should have a weaker impact on euro-zone consumption than initially forecast: private-consumption growth is expected to stabilize at 0.4% in Q1, gradually accelerating to 0.5% in Q2 and 0.6% in Q3, in line with the strengthening of the labour market. Investment should continue to expand by 1.0% per quarter. Assuming an oil price of \$60-65 per barrel and an exchange rate of about \$1.30 per euro, headline inflation—thanks to negative contributions by energy prices—should decline to 1.6% in Q2 and 1.7% in Q3 2007 after a small jump to 1.9% in Q1.*

### Industrial production moving on divergent paths

Euro-zone business surveys have been stalling for the past six months at slightly below their spring 2006 peak. However, industrial production in the zone's main countries exhibits different profiles that will not necessarily converge at the forecast horizon. The external-demand slowdown may affect these profiles in varying degrees, while domestic demand—particularly investment—will be driven by country-specific factors.

After the modest end-2006 figure, chiefly due to weak French performance, industrial production is expected to rebound by 0.8% in Q1 2007. In the following quarters, it should stabilize at slightly below its early-2006 level, gaining 0.6% in both Q2 and Q3, with Germany outperforming its main partners.

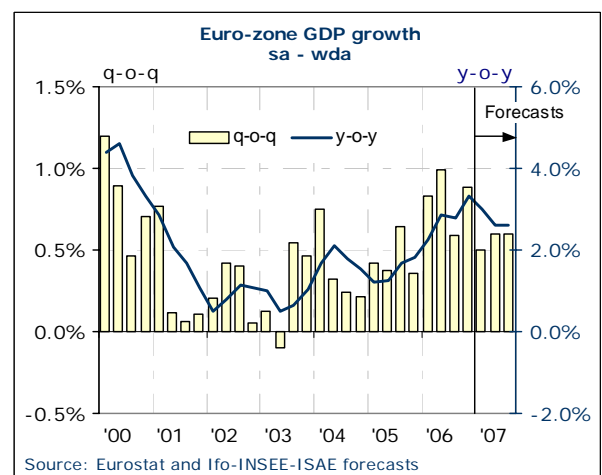
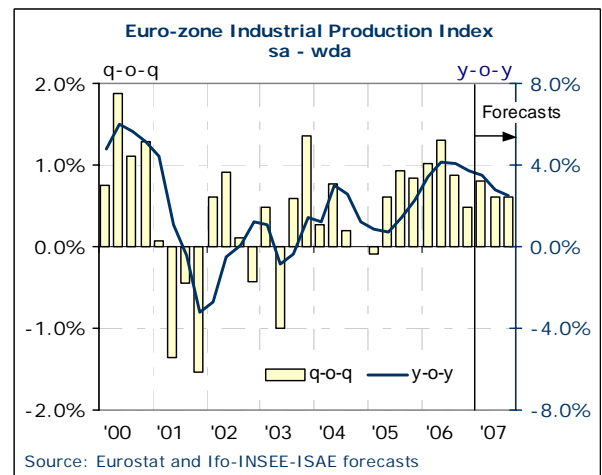
### Domestic-driven GDP growth should confirm last year's recovery

Real GDP growth regained some vigor in Q4 2006 despite further deceleration of industrial production. The euro-zone's exports to its main trade partners declined, in the wake of the US slowdown. Meanwhile, the contribution of net exports was boosted by vibrant and largely unexpected demand from secondary trade partners—chiefly Russia, China, and oil-producing countries—partly offset by changes in inventories.

The lagged effects of robust GDP growth in 2006, together with overall positive demand prospects, should sustain the pick-up in employment that began last year. However, households' disposable income will benefit only

in part from better labour-market conditions, as wage growth is expected to remain moderate.

All in all, consumption fundamentals are gradually improving, as attested by the steady



## Association of Three Leading European Economic Institutes

rise in household confidence. Owing to the German VAT hike, private-consumption growth is expected to remain weak at 0.4% in Q1 2007 before gradually returning to a stable path of 0.5% in Q2 and 0.6% in Q3.

Investment accelerated sharply in 2006 thanks to the recovery of the German construction sector. Uncertainties about the international environment and the reaction of consumption to the German tax shock may have temporarily hampered investment growth in H2 2006. But these concerns proved less justified than initially feared, and investment is set to continue expanding by about 1.0% per quarter at the forecast horizon.

In the first three quarters of 2007, real GDP growth will be driven by domestic demand, with significant contributions from investment and private consumption. By contrast, net external trade will not provide the same momentum to GDP growth as in late 2006. Real GDP will grow 0.5% in Q1 2007, then 0.6% in Q2 and Q3.

### Inflationary pressures likely to be contained

The German VAT increase in January caused core inflation to jump from 1.5% in Q4 2006 to 1.8% in Q1 2007, in line with expectations. The significant drop in oil prices at end-2006, the euro's steady appreciation since Q4 2006, and the subdued dynamics of food prices during the winter significantly counteracted the increase in core inflation in Q1 2007; headline inflation rose from 1.8% in Q4 2006 to 1.9% in Q1 2007.

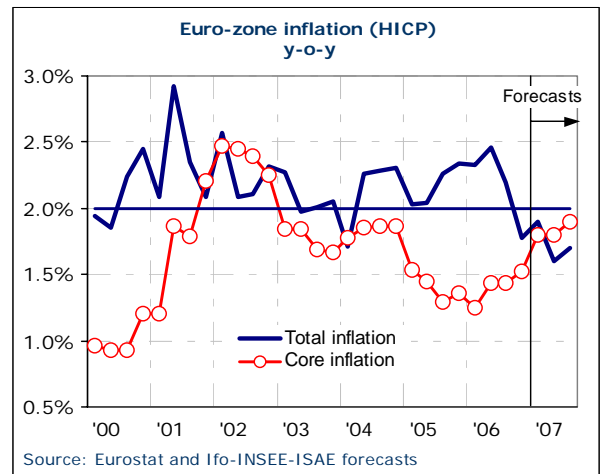
Assuming an oil price in the range of \$60-65 per barrel and a broadly unchanged euro/dollar

exchange rate, the base effects on the energy component of inflation will push it down to 1.6% in Q2 and 1.7% in Q3.

2007 forecasts, % changes, sa - wda

q-o-q y-o-y	Q4 - 2006	Q1 - 2007 estimates	Q2 - 2007 forecasts	Q3 - 2007 forecasts
IPI	0.5 3.7	0.8 3.5	0.6 2.8	0.6 2.5
GDP	0.9 3.3	0.5 3.0	0.6 2.6	0.6 2.6
Consumption	0.4 2.0	0.4 1.9	0.5 2.0	0.6 1.9
Investment	1.5 5.8	1.0 5.7	1.0 4.5	1.0 4.6
Inflation	1.8	1.9	1.6	1.7

Source: Eurostat and Ifo-INSEE-ISAE forecasts



### Methodological note

This quarterly publication is prepared jointly by the German Ifo institute, the French INSEE institute, and the Italian ISAE institute. The forecasts are produced with the help of tools shared by the three institutes, using time-series models based on business surveys by national institutes, Eurostat, and the European Commission.

Our joint two-quarter-ahead forecast covers euro-zone industrial production, GDP, consumption, investment, and inflation. Publication is timed to coincide with Eurostat's second release of quarterly national accounts.

Fuller economic analysis for each country (Germany, France, Italy) is available in:

- [Ifo Konjunkturprognose](#), Ifo
- [Conjoncture in France](#), INSEE
- [Abridged Quarterly Report](#), ISAE

#### Contacts:

- Gebhard Flaig +49 (0) 89 92 24 1375
- Benoît Ourliac +33 (0) 1 41 17 59 63
- Sergio De Nardis +39 (0) 64 44 82 310

#### Next release:

**July 12, 2007 (date of Eurostat's second release of quarterly national accounts)**

#### Next forecast horizon:

**2007 Q4**