

Springtime for domestic demand

Real GDP growth in the euro zone has gained momentum in spring 2006. The expansion was mainly driven by private consumption and net exports. The prospects of economic activity remain promising. Real GDP is expected to rise by 0.6% in Q2, followed by 0.5% in Q3 and by 0.6% in Q4. Industrial production remains strong in the wake of the good shape of the industrial sector, showing an annual growth rate of 3.0% in 2006. This prospect is supported by the latest development of business surveys, which have predominantly improved. Consumption is expected to increase by 0.6% in Q2, 0.4% in Q3 and 0.5% in Q4 thanks to better labour market conditions. Investment is likely to rise by 0.8% in the next three quarters. As for consumer prices, on the technical assumption that the oil price fluctuates around \$70/barrel and the \$/euro exchange rate stays within a range of 1.26-1.30, headline inflation is bound to decrease from 2.5% in Q2 to 2.1% in Q4.

Industrial production growth remains stable

Industrial production in the euro zone experienced a strong increase of 1.0% in Q1 2006, largely driven by the extensive impulse in Germany and Italy. The good shape of the industrial sector indicates a continuous optimistic environment. Recent readings of the business surveys signal significant improvements of confidence indices. Especially in Germany, but also in Italy, business surveys have enhanced; solely in France business surveys have recently deteriorated, reflecting persistent sectoral difficulties.

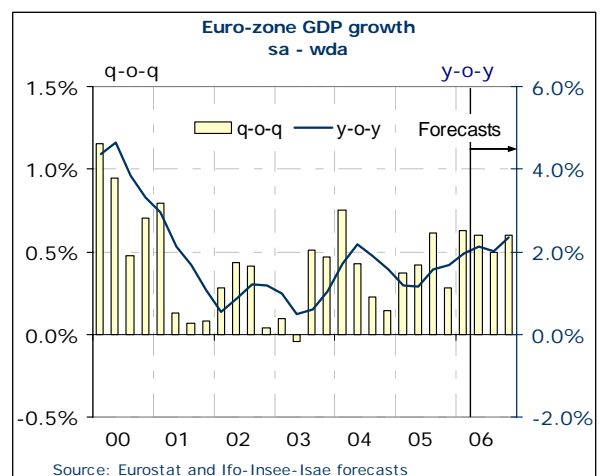
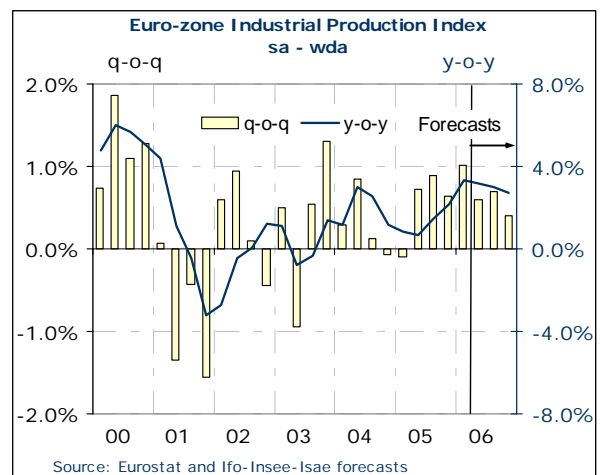
Industrial production is expected to retain stable but slightly lower growth rates in the coming quarters. Production decelerates in Q2 2006, with a rate of 0.6%, before it accelerates modestly in Q3 2006, with a rate of 0.7%, because of a robust raise in May and June. Production decelerates in Q4 2006, slowing to 0.4% in association with the build-up in inventories.

Real GDP is gaining momentum

Real GDP increased by 0.6% in Q1 2006, after 0.3% in Q4 2005. The rise was mainly stimulated by private consumption, which recovered significantly. Expectations about real GDP growth are sanguine for the next quarters.

Private consumption is likely to go on enhancing thanks to the continuous improvement on the labour market. Employment has steadily increased, accompanied by a further decline in the unemployment rate. The development on the labour market supports household income, but slack wage dynamics still mitigate its evolution. A 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.



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Therefore, private consumption is expected to rise by 0.6% in Q2, followed by 0.4% in Q3 and 0.5% in Q4. However, the modest acceleration in Q4 is only transitory, stemming from a shift in expenditures in Germany in anticipation of the VAT tax increase that becomes effective at the beginning of 2007. This effect shifts euro-zone consumption growth by approximately 0.1 percentage points in Q4.

Investment rebounded strongly in Q1 2006, and prospects remain favourable for the rest of the year. First, for firms, expectations about returns are still promising; second, production is likely to rise thanks to the better shape of the industrial sector; and third, long-term interest rates are expected to stay at a relatively low level. Investment is likely to grow at the same pace as in Q1, by 0.8% each quarter.

As a whole, real GDP will grow by 0.6% in Q2, and by 0.5% and 0.6% in Q3 and Q4. The main stimulus comes from domestic demand; though, external trade provides a positive but slight contribution due to an ongoing robust world economic expansion. Overall, real GDP is expected to increase by 2.1% in 2006.

Inflation still under control

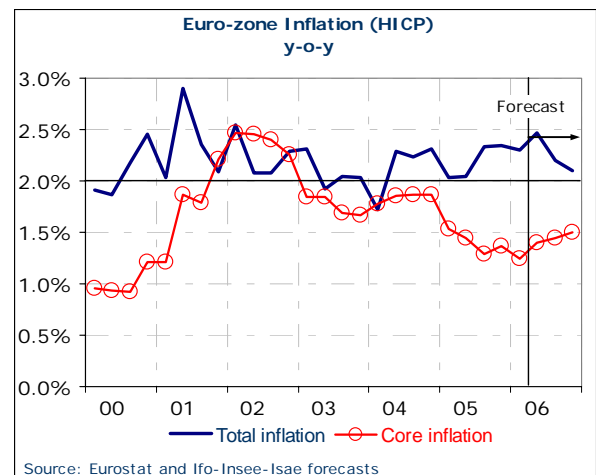
The renewed upward shift in oil prices in April 2006, reaching USD 70 per barrel of Brent, was only in part compensated by an appreciation of the euro from 1.20 in Q1 to 1.26 USD in Q2. It led to a marked increase in consumer price inflation in Q2. On the assumption that oil prices stabilize around USD 70 and that the dollar/euro exchange rate fluctuates between 1.26 and 1.30 over the forecast horizon, headline inflation will return to more moderate

levels, at 2.2% in Q3 and 2.1% in Q4. While direct HICP effects of past oil price increases are phasing out gradually, there are still no signs of second-round effects. Yet, core inflation is expected to rise steadily from 1.2% in Q1 to 1.5% by the end of the year, which basically reflects the strengthening in domestic demand.

2006 Forecasts, % changes, sa - wda

q-o-q y-o-y	Q1-2006	Q2 - 2006 estimations	Q3 - 2006 forecasts	Q4 - 2006 forecasts	2006 forecasts
IPI	1.0 3.3	0.6 3.2	0.7 3.0	0.4 2.7	3.0
GDP	0.6 2.0	0.6 2.1	0.5 2.0	0.6 2.3	2.1
Consumption	0.6 1.7	0.6 1.9	0.4 1.8	0.5 2.1	1.9
Investment	0.9 3.4	0.8 3.0	0.8 2.7	0.8 3.4	3.1
Inflation	2.3	2.5	2.2	2.1	2.3

Source: Eurostat and Ifo-Insee-Isae forecasts



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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, investment 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: October 12, 2006 (day of Eurostat GDP second release)
Next forecast horizon: 2007 Q1