Euro-zone economic outlook

July 12, 2007

Association of Three Leading European Economic Institutes

Healthier domestic demand

The persistently positive business climate in the euro zone is pointing to a maintained positive trend for industrial production: following an increase of 0.7% in Q2, manufacturing activity should gain momentum in the second half of the year, rising by 0.9% in both Q3 and Q4. The bright prospects are underpinned by booming investment and, after the temporary setback in Q1 linked to the German VAT hike, by more buoyant consumption expenditure. Investment should rise by 1% in Q2, 1.2% in Q3 and 1.4% in Q4, being sustained by the current high level of capacity utilization; private consumption is expected to rise by 0.8% in Q2 and 0.7% in Q3 and Q4, reflecting the influence of an improving labour market. GDP is expected to grow by 0.7% in each quarter of the forecast horizon, leading to a yearly growth rate of 3.0% for 2007. On the assumption of oil prices at USD 70 per barrel and a dollar/euro exchange rate of around 1.35, headline inflation would stabilise at 1.9% in Q3, before climbing to 2.2% in Q4; on an annual-average basis, inflation rate will set at 2% in 2007.

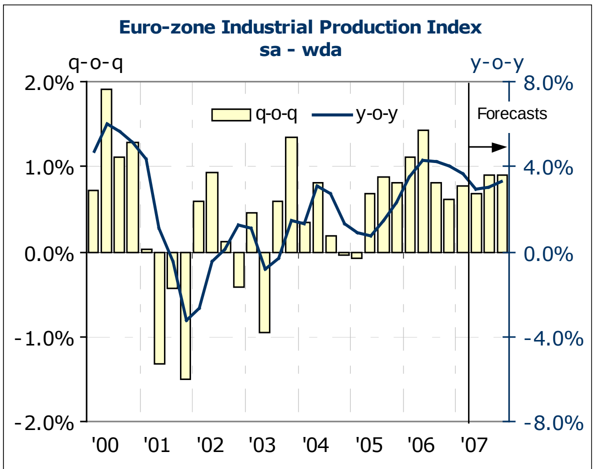
Industrial production to strengthen in H2

Euro-zone industrial production rose by 0.8% in Q1 2007, accelerating over the previous quarter. This dynamic growth was driven by Germany and France, while Italy posted a negative performance. Readings of business surveys since the beginning of the year hint at a narrowing of the gap between confidence climates in the main euro-zone countries; this could signal a more synchronous evolution of their manufacturing sectors in the second half of the year. The relative stabilization at high levels of the confidence climate in the three main countries and, especially, the ongoing improvement in German order books point to a persistent upturn in euro-zone industrial production in the coming quarters of 2007.

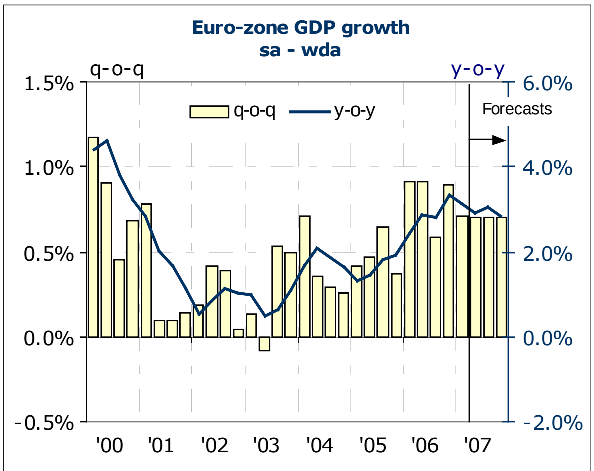
From this perspective, the widespread positive performances of manufacturing registered in May largely compensated for the fall seen in the previous month, which was mostly due to the unusual distribution of working days. After a marginal deceleration in Q2 (+0.7%), the strengthening would pave the way for significant rises of +0.9% in both Q3 and Q4, benefiting from the healthy growth expected in firms' investment expenditure.

Sustained GDP growth

Real GDP growth slowed down in Q1 2007, but less intensely than previously thought. The VAT hike in Germany depressed household consumption and net exports had a negative impact, compensating for the surge in Q4 2006. Positive contributions came from investment and inventories. Despite the gradual monetary tightening, investment will continue to fuel economic activity, sustained by a high degree of capacity utilization. After a slight dent in Q2 (1% q–o–q), due to a correction in construction after the exceptionally mild winter, we expect a gradual acceleration of overall investment (1.2% and 1.4% in Q3 and Q4), thanks to the performance of the business component.



Source: Eurostat and Ifo-INSEE-ISAE forecasts



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The boost in Q4 is also partly explained by bringing forward investment in Germany, where favourable depreciation rules will expire at the end of this year. Given the quarterly profile, investment should rise by 6.3% on average in 2007.

After the setback in Q1, household consumption should strengthen in subsequent quarters, thanks to the positive evolution of labour market and the favourable consumer confidence in the euro zone. All in all, private consumption is expected to rise by 0.8% in Q2 and by 0.7% in both Q3 and Q4. This would mean an average increase of 1.9% in 2007. The impetus from domestic demand, taken together with the slightly negative contribution from net exports, would give rise to GDP growths of 0.7% in each quarter of the forecast horizon. On average, GDP would increase by 3.0% in 2007.

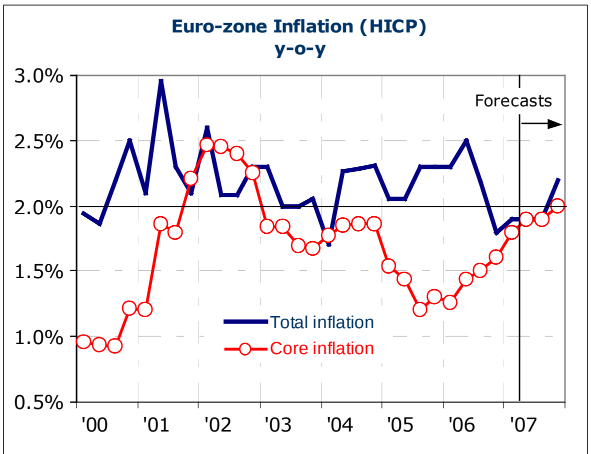
Inflation edges up by year end

Despite the upward movement in oil prices in recent months, the year-on-year growth rate of HICP stood at 1.9% in Q2 2007, unchanged from Q1. On the assumption that in the second half of the year the Brent price remains stable at USD 70 per barrel and the dollar/euro exchange rate stays in the neighborhood of 1.35, overall index will move in step with core inflation in Q3 (+1.9%). It will edge up, on account of an adverse base effect of energy prices, to 2.2% in Q4, when core inflation, reflecting domestic demand pressures, should rise slightly to 2%. Average HICP inflation is expected to be 2% in 2007, in line with the ECB's target for medium-term price stability.

2007 Forecasts, % changes, sa - wda

q-o-q / *y-o-y*	Q1-2007	Q2 - 2007 estimations	Q3 - 2007 forecasts	Q4 - 2007 forecasts	2007 forecasts
IPI	**0.8** 3.7	**0.7** 2.9	**0.9** 3.0	**0.9** 3.3	3.2
GDP	**0.7** 3.1	**0.7** 2.9	**0.7** 3.0	**0.7** 2.8	3.0
Consumption	**0.0** 1.4	**0.8** 1.9	**0.7** 1.9	**0.7** 2.2	1.9
Investment	**2.4** 7.1	**1.0** 5.9	**1.2** 6.2	**1.4** 6.1	6.3
Inflation	1.9	1.9	1.9	2.2	2.0

Source: Eurostat and Ifo-INSEE-ISAE forecasts



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

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Next release: **October 11, 2007 (date of Eurostat's second release of quarterly national accounts)**

Next forecast horizon: **2008 Q1**