

Mild slowdown under way

The euro zone's international environment became less supportive during the summer; the US real-estate crisis has been deepening, and financial markets have suffered from a confidence crisis whose impact remains hard to assess. GDP growth should, however, recover from its Q2 weakness, posting 0.6% in Q3 2007 and 0.5% in Q4 2007 and Q1 2008. Private consumption should continue to benefit from the past improvement in the labour market: it should finally increase at the same pace as GDP, but the VAT-related dip in Q1 will probably not be fully offset. Investment, by contrast, is expected to decelerate slightly at the forecast horizon, apart from a one-time acceleration in late 2007. Under the technical assumption that the oil price will fluctuate between \$75 and \$80 per barrel and that the euro/dollar exchange rate will stabilize around \$1.40/€, inflation is expected to jump to 2.3% in Q4 2007 before easing slightly to 2.2% at the start of 2008.

Industrial production on a soft downtrend

Euro-zone business confidence surveys peaked in H1 2007. Confidence has been clearly trending down since end-Q2, although the turning-point occurred at different moments in the main euro-zone countries. However, the slowdown in industrial production—from 1.0% in Q1 to 0.5% in Q2—has been much more pronounced than what the business surveys had suggested.

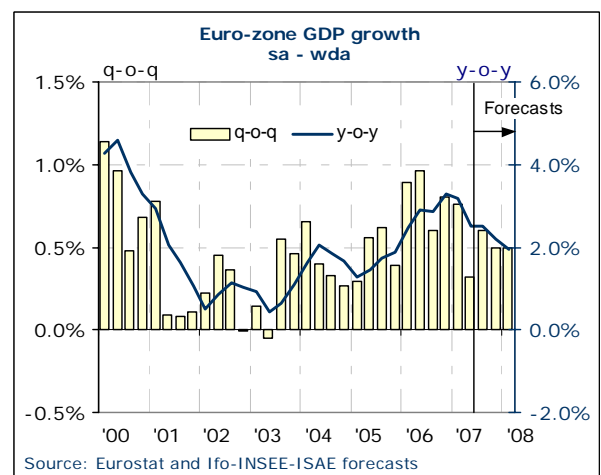
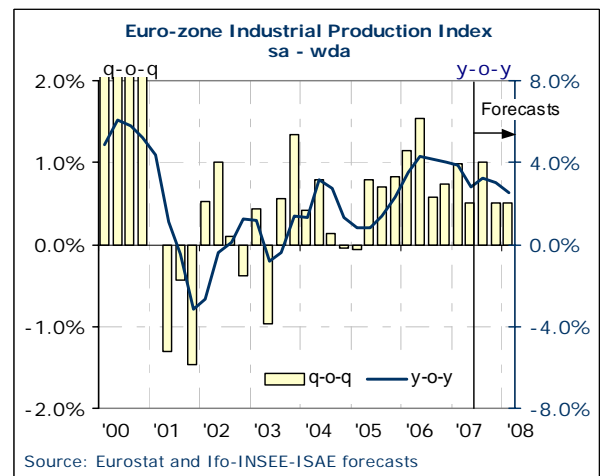
As a consequence, industrial production growth should record a technical rebound to 1.0% in Q3, but is expected to return to a more moderate pace of 0.5% in Q4 2007 and Q1 2008.

Firmer consumption should restore some momentum to GDP

The euro-zone posted disappointing GDP growth in Q2 2007. Domestic demand was hampered by a collapse in residential investment, especially in Germany, while private consumption did not recover from the Q1 dip as fast as expected. External trade contributed positively to GDP growth, thanks to a further deceleration of imports.

The euro-zone labour market registered further positive developments in the H1 2007, with strong job creation and a steady decrease in the unemployment rate. The slowdown of GDP growth since the beginning of 2007 may, however, temper its dynamics in H2, and upward pressures on wages may therefore remain subdued.

Despite a steadily improving labour market, households' saving ratio increased sharply in early 2007, especially in Germany and France. The modest upturn in private consumption in Q2 left some room for further catch-up in the forthcoming quarters. It should allow household



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expenditures to keep growing at a brisk rate of 0.6% in Q3 and 0.5% in Q4 2007 and Q1 2008, while the rise in personal disposable income is expected to lose some momentum.

Investment was affected in H1 2007 by the impact of the unusually mild winter in Q1 on construction investment. It decreased by -0.2% in Q2 2007 after its strong Q1 gain of 1.9%. The less accommodative financial conditions and slacker internal and external demand should result in a gradual investment slowdown at the forecast horizon. A one-time acceleration to 1.2% is, however, expected in Q4 2007, triggered by a change in the German depreciation law that comes into effect in January 2008.

The euro-zone economy is forecast to grow by 2.6% in 2007, nearly matching its brisk 2006 pace of 2.9%. On a quarterly basis, GDP growth would reach 0.6% in Q3, easing to 0.5% in Q4 2007 and Q1 2008.

Inflation set to increase

Inflation remained stable at 1.9% in Q3 2007. The contributions of its main volatile components (energy and food prices) stayed at their Q2 levels. Under the assumptions that Brent oil will fluctuate between \$75 and \$80 per barrel, and that the euro-zone exchange rate will hold steady at \$1.40/€, energy prices should contribute significantly more to inflation in Q4 2007, due to an adverse base effect. Inflation is forecast to surge to 2.3% in that quarter.

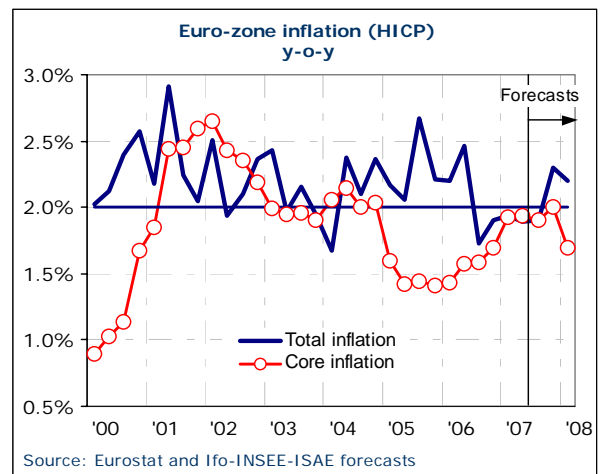
In Q1 2008, inflation should decelerate by 0.1 point to 2.2% as the effect of last year's VAT

hike in Germany vanishes. However, inflationary pressures from the saturation of productive capacity, wage tensions and further increases in food prices will prevent inflation from decreasing by the full VAT-related base effect of 0.3 point.

2007/2008 forecasts, % changes, sa - wda

q-o-q y-o-y	Q2 - 2007	Q3 - 2007 estimates	Q4 - 2007 forecasts	Q1 - 2008 forecasts	2007 estimates
IPI	0.5 2.8	1.0 3.3	0.5 3.0	0.5 2.5	3.2
GDP	0.3 2.5	0.6 2.5	0.5 2.2	0.5 1.9	2.6
Consumption	0.6 1.5	0.6 1.6	0.5 1.7	0.5 2.2	1.5
Investment	-0.2 4.3	1.0 4.5	1.2 4.0	0.7 2.8	5.0
Inflation	1.9	1.9	2.3	2.2	2.0

Source: Eurostat and Ifo-INSEE-ISAE forecasts



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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
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 (date of Eurostat's second release of quarterly national accounts)

Next forecast horizon: 2008 Q2