Euro-zone economic outlook

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Association of Three Leading European Economic Institutes

Upswing moderation

Euro-zone real GDP growth recovered in Q3 after the disappointing performance in Q2. However, growth perspectives have deteriorated in response to the less supportive environment: the financial market turmoil has been persisting and inflation increased with the latest surge in oil and food prices. Real GDP is expected to expand at lower rates (0.5% in Q4 2007 and 0.4% in both Q1 and Q2 2008). Industrial production is forecasted to weaken after the strong performance in Q3, as indicated by the deterioration of business surveys almost area-widely. Private consumption is stimulated by the labour market's steady improvement, but the recent rise of food and energy prices has a dampening impact. Consumption should grow by 0.5% in Q4 2007, followed by 0.4% in Q1 and Q2 2008. Investment is expected to expand on a modest path, with rates of 0.7% in Q4 2007, 0.5% in Q1 2008 and 0.6% in Q2: the investment cycle seems to have peaked. On the assumption that oil prices stabilize at USD 90-95 per barrel of Brent and that the dollar/euro exchange rate fluctuates around 1.45 over the forecast horizon, inflation should peak at 3.0% in Q1 2008, before easing to 2.8% in Q2.

Industrial production on a downtrend

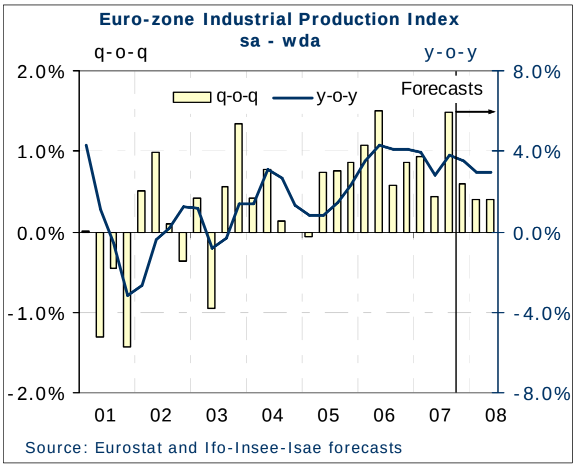
Industrial production in the euro zone expanded on a strong note in Q3 (+1.5%). Especially in Germany production boosted, reporting one of the largest increases in history (+2.0%). Also in France the rise of production was strong (+1.2%), whereas Italy posted a more moderate performance (+0.5%). The recent development of business surveys indicates a downward convergence across the main euro-zone countries, reflecting expectations of a slowdown in the coming quarters.

Industrial production should increase by 0.6% in Q4 2007, and 0.4% in both Q1 and Q2 2008. The expansion of production is mainly hindered by the expected deceleration of investment expenditures, by a lower foreign demand associated with the latest appreciation of the euro as well as by high energy prices and by less favourable financial conditions.

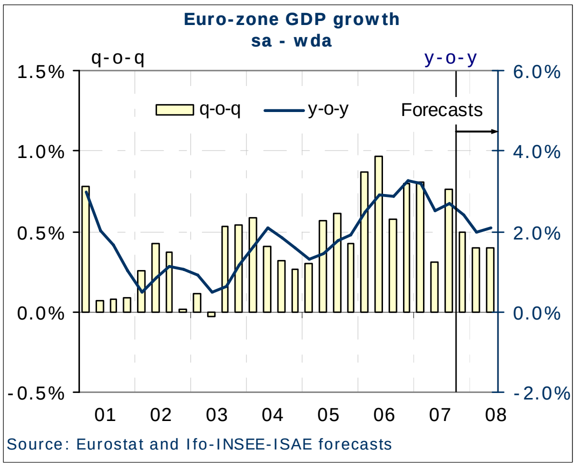
Weaker perspectives for GDP growth

Euro-zone real GDP picked up in Q3, rising by a brisk 0.8% after a disappointing 0.3% in Q2. The expansion was driven by domestic demand, while the contribution of net exports was slightly negative. Yet, growth prospects remain subdued over the forecast horizon influenced by the negative effects of multiple shocks, namely the recent surge in oil prices, the financial market turmoil and the euro appreciation.

The expansion of private consumption is expected to lose momentum in the coming quarters. The favourable situation of the labour market, as reflected by the ongoing increase of employment and further reduction of the unemployment rate, is stimulating household's expenditure; but purchasing power is being negatively affected by rising food and energy prices. Consumer confidence has fallen almost area-widely to a low level, signalling increasing pessimism. Moreover, the evolution of disposable income is hampered by a continuous sluggish nominal wage growth. Private consumption is expected to expand by 0.5% in Q4 2007, and 0.4% in both Q1 and Q2 2008.



Source: Eurostat and Ifo-Insee-Isae forecasts



Source: Eurostat and Ifo-INSEE-ISAE forecasts

Investment rebounded in Q3 after the slight downturn in Q2. The recovery was observable across all the main member states, with the exception of Spain. Despite the still high degree of capital utilization, the development of investment is expected to ease gradually in the coming quarters, as the cycle seems to have peaked. This slowdown is also influenced by the higher uncertainty arising from the financial markets turmoil associated with less favourable financing conditions. Investment should expand at rates of 0.7% in Q4 2007, 0.5% in Q1 and 0.6% in Q2 2008. At the turn of the year the pattern is affected by the expiration of tax incentives in Germany.

Overall real GDP in the euro zone is forecasted to rise by 0.5% in Q4 2007, followed by 0.4% in both Q1 and Q2 2008. If the negative shocks that affected the euro-zone economies were to fade out progressively, the economic slowdown could be only transitory.

Inflation well above the ECB's 2% reference value

Inflation surged to 2.9% in Q4 2007, after 1.9% in Q3. The acceleration was driven by increases in oil and food prices, but reflected also a significant adverse base effect stemming from a relatively stable oil price development of around USD 60 per barrel of Brent in Q4 2006. On the assumption that oil prices stabilize at USD 90-95 per barrel of Brent and that the dollar/euro exchange rate fluctuates around 1.45 over the forecast horizon, inflation should peak at 3.0% in Q1 2008, before it eases to 2.8% in Q2. Despite the assumption of stable oil prices, the main source for the sustained high level of headline inflation is – as in the previous quarter – an adverse base effect, together with a peak in food prices by the end of Q1 2008 due to a progressive transmission of food raw materials' prices past hikes.

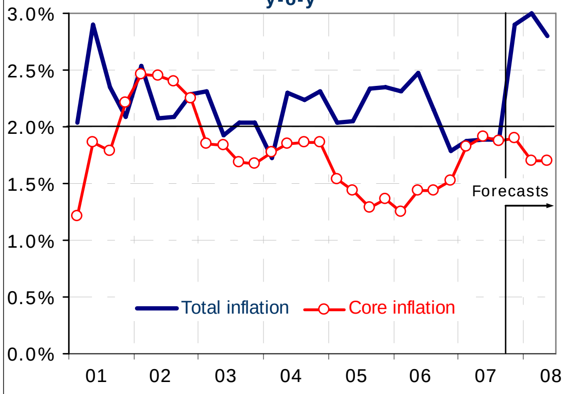
Core inflation had been remarkably stable at around 1.9% throughout the last year. It is expected to decline to 1.7% in H1 2008, basically owing to the drop out of the German VAT hike of January 1, 2007 from the price index. While the prospects of slower growth and the recent decrease in capacity utilization should help to reduce core inflation further, the past acceleration in producer prices of consumer goods and the indirect effects of rising oil prices are likely to put upward pressures on core prices.

2008 Forecasts, % changes, sa - wda

q-o-q / *y-o-y*	Q3-2007	Q4 - 2007 estimations	Q1 - 2008 forecasts	Q2 - 2008 forecasts	2007 estimations
IPI	**1.5** 3.8	**0.6** 3.5	**0.4** 2.9	**0.4** 2.9	3.5
GDP	**0.8** 2.7	**0.5** 2.4	**0.4** 2.0	**0.4** 2.1	2.7
Consumption	**0.5** 1.6	**0.5** 1.7	**0.4** 2.1	**0.4** 1.8	1.6
Investment	**1.2** 4.7	**0.7** 3.7	**0.5** 2.3	**0.6** 3.0	4.9
Inflation	1.9	2.9	3.0	2.8	2.1

Source: Eurostat and Ifo-INSEE-ISAE forecasts

Euro-zone Inflation (HICP)
y-o-y



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: **April 9, 2008 (day of Eurostat GDP second release)**
Next forecast horizon: **2008 Q3**