

Tentative recovery facing high oil prices

The uneven performance of the euro-zone economies leaves open the possibility of slow but steady recovery in a context of high oil prices. GDP is still thought, as in the former outlook, to have shown modest growth of 0.4% in Q3 and is expected to increase by 0.3% on the next quarter, with the annual rate up to 1.3% for 2005. The improvement would continue in the first quarter of 2006 (0.4%). Meanwhile, industrial production is likely to show a similar time pattern, with a rise of 0.4% in Q3 2005, followed by 0.3% in Q4 and 0.4% in Q1 2006. The euro-zone is waiting for an improvement in domestic demand to trigger more robust GDP growth. Encouraging signals from business and consumer surveys still have to be confirmed. However, even if that were the case, the threat of inflation (2.3% for the last two quarters of 2005, and 2.4% in Q1 2006) and considerable uncertainty regarding the oil prices could put the euro-zone tentative recovery at risk.

The slowing down of industrial production has been halted

Industrial production in the euro-zone is still characterised by a high degree of heterogeneity across countries. The rebound in Q2 2005 (0.5%) hides differing situations and does not reflect a common trend. In France, industrial production stagnated, whereas it increased by 0.5% in Germany and 1.2% in Italy.

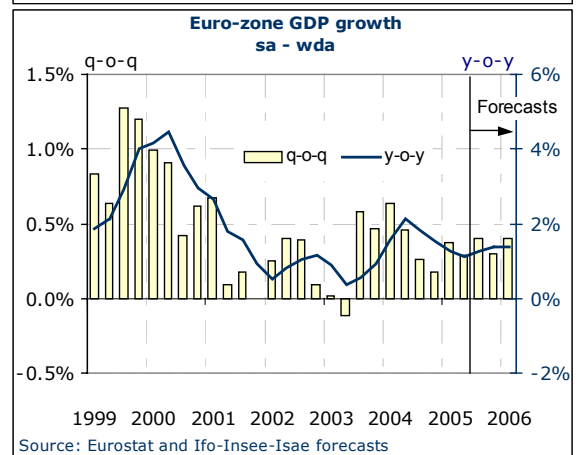
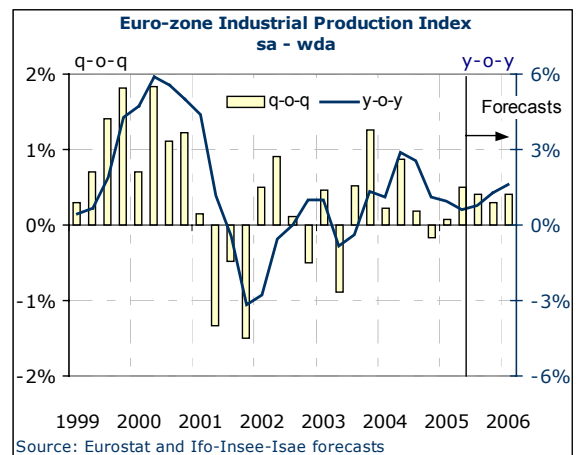
In all countries, however, a robust recovery was observed in business surveys for September 2005 and during the whole third quarter, marking a break with previous quarters specifically as regards the level of foreign orders. This seems to be in line with stronger world demand in H2 than in H1. Industrial production is accordingly estimated to have increased moderately in Q3 (0.4%) and is likely to continue at about the same pace until the beginning of 2006.

Consequently, our forecasts on industrial activity have been revised upwards. The business climate in the euro-zone is showing a firm recovery in comparison with the first half of the year, despite the oil-price hike.

GDP may confirm its steady pace

Euro-zone GDP grew in unbalanced fashion by 0.3% in Q2 2005, propped up by a slight recovery in exports but heavily constrained by weak domestic demand.

On the one hand, private investment, pushed up by orders (with a carry-over of 0.8% for Q3 2005 in July, and positive changes in survey



opinions until September) went on sending encouraging signals. At the beginning of the year, the weakening of construction in Italy and Germany, partly due to bad weather condition, is thought to have been followed by a pick-up already evident in Italy, whereas in Germany a

carry-over of 3.4% in construction orders had been observed in August.

On the other hand, the structural sluggishness of the labour market still persists and will continue to hold back domestic demand. Moreover, the economy could suffer from the inflation due to the oil prices. Domestic consumption is still slow in taking off. Its growth is likely to have rebounded slightly to 0.3% in Q3 2005 (essentially due to strong French consumption) after the almost stagnation in Q1, partly explained by the oil-price hike.

Consumption is therefore not on the point of prompting an acceleration in GDP growth between now and the end of the forecast horizon, being set to remain at the same pace until the beginning of 2006. Its annual average growth rate for 2005 would in the end come out at 1.2%.

The threat of inflation throughout H2

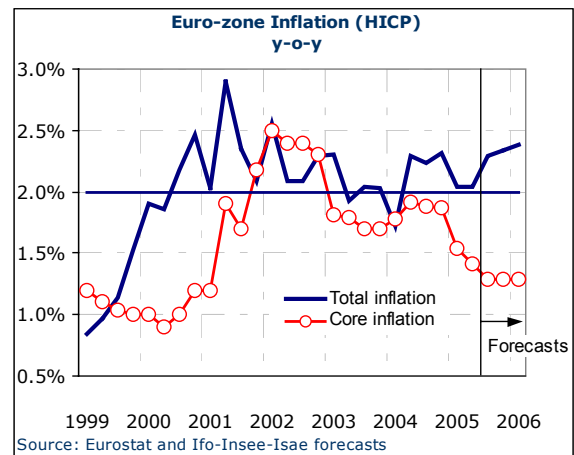
Under the assumption that oil prices keep on fluctuating between 60 and 65 \$/barrel and that the Euro/Dollar exchange rate stabilizes around 1.21 until Q1 2006, inflation is expected to jump to 2.3% from 2.0% in Q2 2005. The bulk of this sharp acceleration comes from energy as a result of the recent rise in motor fuel prices.

This figure of well above 2% is liable to generate concern over price stability in the medium term, as no decrease, however slight, is forecast. On the contrary, the harmonized inflation rate is likely to peak at 2.4 % in Q1 2006 due to lagged or indirect impacts of the increasing costs of raw materials. These

2005/2006 Forecasts, % changes, sa - wda

q-o-q	Q2 - 2005	Q3 - 2005	Q4 - 2005	Q1 - 2006	2005
y-o-y		estim.	forecasts	forecasts	forecasts
IPI	0.5	0.4	0.3	0.4	0.9
	0.6	0.8	1.3	1.6	
GDP	0.3	0.4	0.3	0.4	1.3
	1.1	1.3	1.4	1.4	
Consumption	0.1	0.3	0.2	0.3	1.2
	1.3	1.4	0.7	0.9	
Inflation	2.0	2.3	2.3	2.4	2.2

Source: Eurostat and Ifo-Insee-Isae forecasts



projections include the initial effects of Dutch health insurance reform that will come into force on January 1, 2006 and will lower inflation rate by 0.2 percentage points on the annual average, according to ECB estimates. Core inflation will nevertheless remain subdued at 1.3% until then, reflecting the downward pressure on the prices of non-energy goods due to a sustained weak domestic demand and an ongoing moderate wage growth.

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 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

Contacts:

- Gebhard Flaig +49 (0) 89 92 24 1379
- Karine Berger +33 (0) 1 41 17 60 59
- Sergio De Nardis +39 (0) 64 44 82 310

Next release:

Next forecast horizon:

January 12, 2006 (day of Eurostat GDP second release)
2006 Q2