

Firmer, though still moderate recovery

Although industrial activity unexpectedly fell in October, reflecting widespread weakness in several countries, persistent improvements in survey indicators point to better tendencies in the following months. According to our estimates, manufacturing production, after a modest rise in Q4 2005 (0.2%), should post a moderate acceleration in Q1 2006 (0.4%) and Q2 2006 (0.5%). On the demand side, a sounder support for economic activity should come from domestic demand, reflecting the more positive behaviour of investment and a positive but restrained private consumption growth. Household consumption is expected to grow at a still moderate rate in Q4 2005 (0.3%), Q1 2006 (0.4%) and Q2 2006 (0.3%). External demand would keep providing a positive support to growth. We forecast GDP to grow by 0.4% in both Q4 2005 and Q1 2006, and by 0.5% in Q2 2006. As for consumer prices, on the assumptions that oil prices remain in the range \$57-60/barrel and the \$/euro exchange rate in the range 1.18-1.20, headline inflation should remain stable at 2.3% in Q1 2006, easing back to 2.1% in Q2.

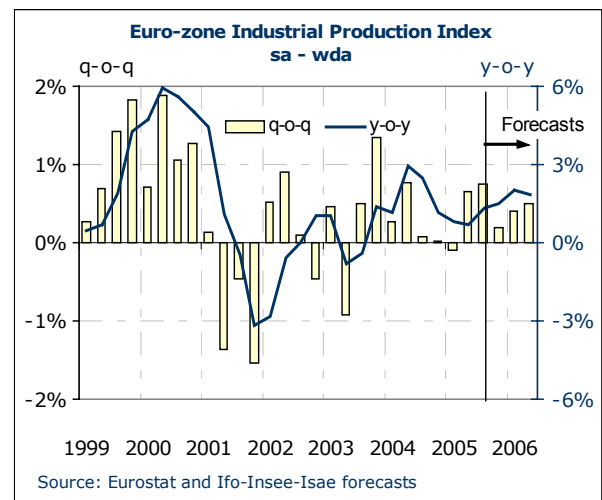
Moderate acceleration of industrial production

After the positive performance registered in Q3 2005, euro-zone industrial production fell in October, reflecting widespread and unexpected cross-country weakness, with the significant exception of Germany. The October setback should prove temporary, however, as positive business survey results have continued to indicate an improvement in manufacturing activity for the last two months of the year. As a consequence, industrial production is thought to have posted a modest average rise (+0.2%) in Q4. The pick-up by the end of 2005 should be consolidated in Q1 2006 (+0.4%), benefiting from continuing favourable demand conditions, particularly as far as exports and investments are concerned. The persistent positive evolution of business confidence would suggest that industrial production should accelerate in Q2 also, although it remains uncertain whether the more favourable manufacturing climate will be fully translated into actual production growth in all main economies. Taking this uncertainty into account, our estimates show euro-zone industrial production growth increasing slightly in Q2 2006 by 0.5%.

More balanced GDP growth

Euro-zone GDP growth recorded an acceleration in Q3 over the previous quarter (0.6%, after 0.4%), led by positive performances from fixed investment and trade. The good investment performance, confirming the encouraging signals already highlighted in the previous EZEO, was backed essentially by improved corporate profitability and better financing conditions. Healthy profits and better business confidence seem to indicate that investment should also underpin GDP growth in the

following quarters. Moreover, we expect a positive contribution from exports, due to continuing buoyant global demand and lagged effects of the weakening of the euro/USD exchange rate.



2006 Forecasts, % changes, sa - wda

q-o-q y-o-y	Q3-2005	Q4 - 2005 estimations	Q1 - 2006 forecasts	Q2 - 2006 forecasts	2005 estimations
IPI	0.8 1.3	0.2 1.5	0.4 2.0	0.5 1.9	1.1
GDP	0.6 1.6	0.4 1.8	0.4 1.9	0.5 2.0	1.5
Consumption	0.3 1.5	0.3 1.0	0.4 1.2	0.3 1.3	1.3
Inflation	2.3	2.3	2.3	2.1	2.2

Source: Eurostat and Ifo-Insee-Isae forecasts

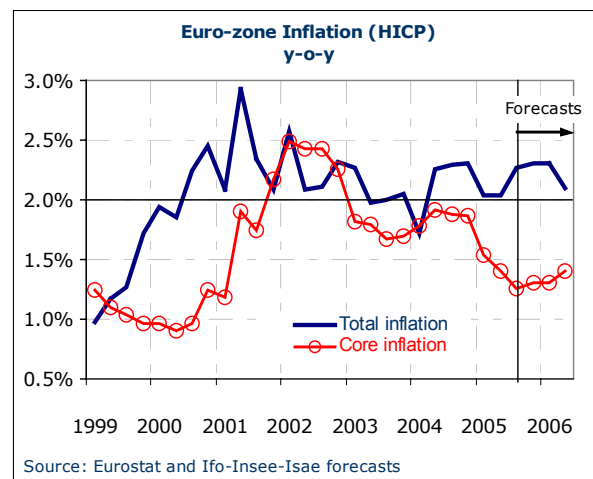
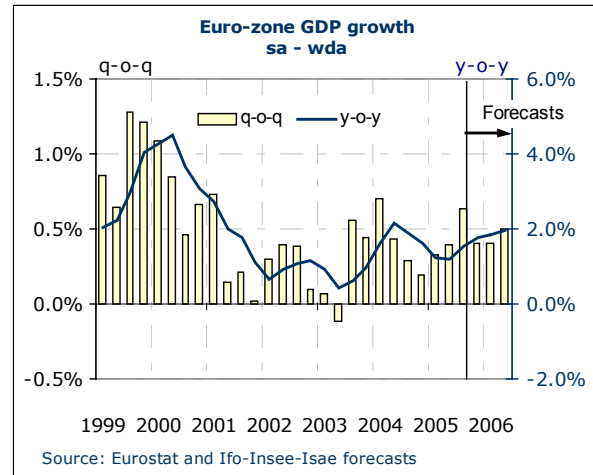
The growing propensity of firms to invest seems to be starting to have some positive effect on employment. This trend could continue in the next few quarters, albeit at quite a moderate pace. This factor, together with a decline in

inflation, could generate a moderate rise in disposable income in early 2006. Even so, euro-zone consumers are expected to maintain a cautious attitude in their expenditure decisions: in our forecasts, household consumption growth in Q4 2005 is estimated to be similar to that of Q3 (0.3%); a moderate strengthening is expected in Q1 2006 (0.4%), followed by a slight deceleration to 0.3% in Q2 2006. Overall, domestic demand, boosted by investments, could provide the main support for economic activity; also net external demand is likely to give a still positive contribution to GDP growth. Real GDP is expected to increase by 0.4% in Q4 2005. This would imply an average rise of 1.4% in 2005. A similar quarterly growth rate (0.4%) is expected in Q1 2006, followed by a slight acceleration in Q2 (0.5%), in line with industrial production.

no evident signs of second-round effects and increasing only marginally from 1.3% in Q1 2006 to 1.4% in Q2.

Inflation set to stabilize at 2.3% during Q1 2006 and to slow down to 2.1% in Q2

The decline in the oil price since the summer spike and the evidence of limited pass-through from higher energy prices has improved the inflation outlook. On the assumptions that the oil price fluctuates within the range \$57-60/barrel over the forecast horizon and that the dollar/euro exchange rate moves in the first half of the year in the range 1.18-1.20 (in line with the average level of 1.19 seen in Q4 2005), headline inflation would remain stable at 2.3% in Q1 2006, as in the second half of 2005, and is then expected to ease slightly to 2.1% in Q2 2006. This evolution would reflect contained underlying price pressures due to firmer, but still below-potential, domestic demand growth. Core inflation should remain subdued, showing



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:

**April 12, 2006 (day of Eurostat GDP second release)
2006 Q3**