

Some moderation of growth in the pipeline

Euro-zone GDP confirmed its momentum on Q2, with above-potential growth for the second consecutive quarter (0.9%, after 0.8% on Q1). Business climate, after having increased in the former quarters, stabilized at high levels since June; industrial production should be still robust in Q3 before leveling off gradually at the forecast horizon, slowed down by external demand. Domestic demand is set to remain supportive, thanks to robust consumption growth, but quarterly pattern will be influenced by VAT reform in Germany at the turn of the year. All in all, GDP is bound to increase by 2.7% in 2006, accelerating strongly from 1.5% in 2005. On the technical assumption that the oil price fluctuates around 65\$ per barrel, and euro/dollar exchange rate stays within a range of 1.27-1.30, headline inflation is expected to follow its downward trend until the end of the year, reaching 2.2% in Q3 and 2.1% in Q4, then jump to 2.5% on Q1 2007, mechanically pushed up by the German VAT reform.

Moderate slowdown in industrial production, after a robust Q3

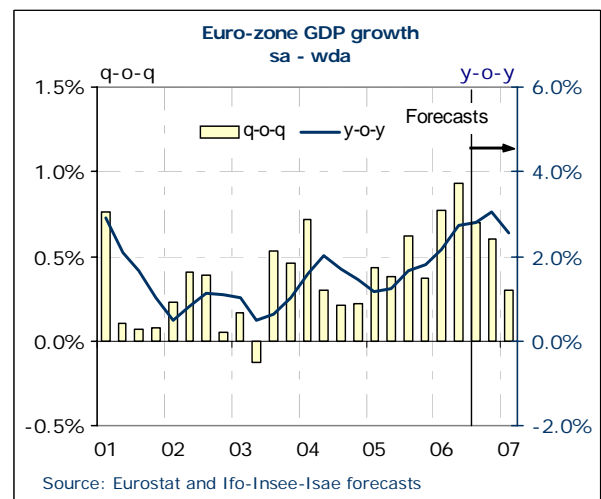
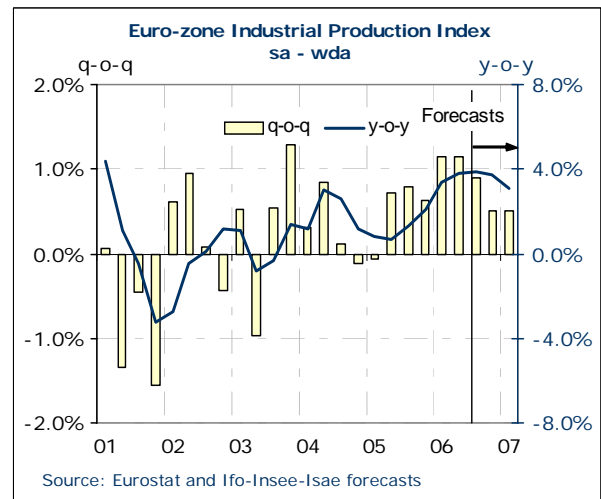
After the remarkable rise in H1 2006, industrial production appears still robust in Q3, thanks to positive performances in August in the three main countries. Manufacturing activity should slow down in the subsequent quarters, also reflecting the leveling off in the business climate indicators of the last readings.

Industrial production is expected to still grow at a very positive pace in Q3 (0.9% q-o-q), before slowing down to 0.5% in Q4 2006 and in Q1 2007. The deceleration would be induced by the loss of momentum in world trade over the forecast horizon, as a consequence of the expected slackening in the United States and a temporary pause in some emerging Asian economies.

Slower GDP growth but still domestically generated

Euro-zone GDP recorded firm growth rate in H1 2006, led by the positive performance of both domestic and external demand.

Euro-zone GDP is expected to moderate in the second half of the year. On one hand, external demand is going to provide reduced support to growth. On the other hand, euro-zone consumption is going to remain firm in H2, albeit growing more slowly than in H1: improvements on labour market underpin consumption, but household income remains constrained by the lacklustre wage growth. The quarterly time-pattern is likely to be affected at the turn of the year by VAT rise in Germany.



After an increase of 0.4% in Q3 2006, euro-zone consumption is set to accelerate slightly in Q4 (0.5%), before stalling in Q1 2007 (0.0%) as the moderate trend in households' expenditures is going to be entirely offset by the negative income effect of German VAT

increase, whose impact could range between -0.3 and -0.4 pp.

Following the leap in Q2, the outlook for investment is likely to remain supportive over the forecast horizon, although at a lower pace. Credit conditions remain favorable, despite the recent tightening of monetary policy which is moving from an expansionary to a neutral stance. Investment is expected to decelerate slightly with respect to H1, growing by 1.5% in Q3 and by 1% both in Q4 2006 and Q1 2007.

All in all, real GDP is expected to grow by 0.7% in Q3 and by 0.6% in the final quarter of the year, posting the annual growth rate at 2.7%. In Q1 2007, a temporary slowdown will occur (0.3%), mainly due to the German tax hike.

Inflation set to ease in Q4 2006 before rebounding strongly in Q1 2007

The recent large fall in oil prices together with a slight appreciation of the euro, has led to a sharp slowdown in HICP inflation, with the growth of consumer prices decreasing from 2.4% in Q2 to 2.2% in Q3.

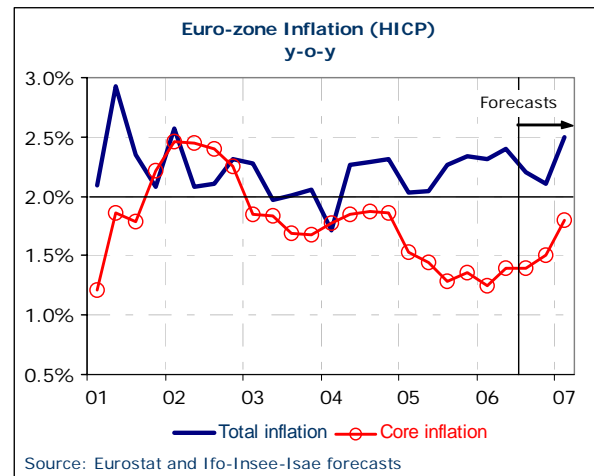
On the assumptions that oil price stabilises around 65\$/barrel and that the euro/dollar exchange continues to fluctuate between 1.27-1.30 within the forecast horizon, headline inflation is expected to decrease slightly to 2.1% in Q4 2006. The downward trend is bound to be temporarily interrupted at the beginning of next year due to the increase in the main German VAT rate, expected to raise the euro zone harmonized index by 0.3 percent. The HICP is likely to peak at 2.5% in Q1 2007.

The strengthening in domestic demand and the moderate pass-through from past energy and raw materials prices increases is set to be reflected in core inflation, edging up from 1.5% in Q3 to 1.6% in Q4 2006 and to 1.9% in Q1 2007 (but remaining stable net of the German VAT increase).

2006 Forecasts, % changes, sa - wda

q-o-q y-o-y	Q2-2006	Q3 - 2006 estimations	Q4 - 2006 forecasts	Q1 - 2007 forecasts	2006 forecasts
IPI	1.1 3.8	0.9 3.9	0.5 3.7	0.5 3.1	3.7
GDP	0.9 2.7	0.7 2.8	0.6 3.0	0.3 2.6	2.7
Consumption	0.3 1.7	0.4 1.5	0.5 1.9	0.0 1.2	1.7
Investment	2.1 4.8	1.5 5.1	1.0 5.7	1.0 5.7	4.8
Inflation	2.4	2.2	2.1	2.5	2.3

Source: Eurostat and Ifo-Insee-Isae forecasts



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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, investment 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

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Next release:

January 12, 2007 (day of Eurostat GDP second release)

Next forecast horizon:

2007 Q2