Association of Three Leading European Economic Institutes

Euro-zone economic outlook

October 6, 2010

Growing at a lower pace

Euro-zone GDP picked-up in Q2 (+1.0%), owing to the world trade dynamism and to a rise in domestic demand. Investment rebounded at a rate of 1.5% in Q2 due to improved business perspectives as well as to a weather-related postponement of construction investment in Q1 2010. GDP growth in the euro-zone is expected to go back to lower pace over the forecast horizon (+0.4% in Q3, +0.3% in Q4 and +0.2% in Q1 2011). Private consumption would flatten (+0.1% per quarter), as the labor market is likely to remain fragile. Furthermore, the boost to income provided by the fiscal stimulus is to wane by Q4 in Germany, and is already counter-acted by fiscal consolidation in other euro-zone countries. Investment should increase further but at a slowing pace: foreign demand is loosing momentum and financial market uncertainty increased as a result of the recent sovereign-debt crisis while production capacities remain under-utilized and credit conditions are still restrictive. Moreover, construction investment in Q3 should be dragged down by the counter-effect of the sharp rise in Q2. Under the assumption that the oil price stabilizes at USD 77 per barrel of Brent and that the dollar/euro exchange rate fluctuates around 1.30 over the forecast horizon, inflation should edge down slightly by December 2010 to 1.7%.

Industrial production is moderating

Industrial production increased by 2.4% in both Q1 and Q2 2010, but has weakened since June. This reflects a deterioration of sales expectations, as well as industrial new orders and business expectations that are dimming in September.

Industrial production is forecasted to moderate in the coming quarters. External demand should soften in line with the deceleration of growth in the US, as well as in emerging Asia and Latin America. Moreover, the prospects of a reversal of fiscal policy towards consolidation in many member states are likely to exert a dampening effect on domestic demand.

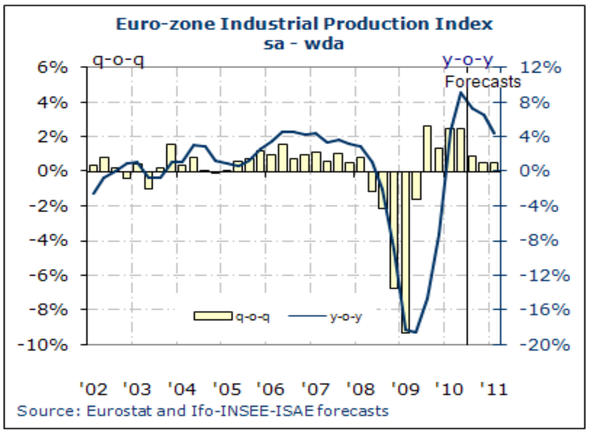
All in all, industrial production is forecasted to increase by 0.9% in Q3 and by 0.5% both in Q4 2010 and Q1 2011.

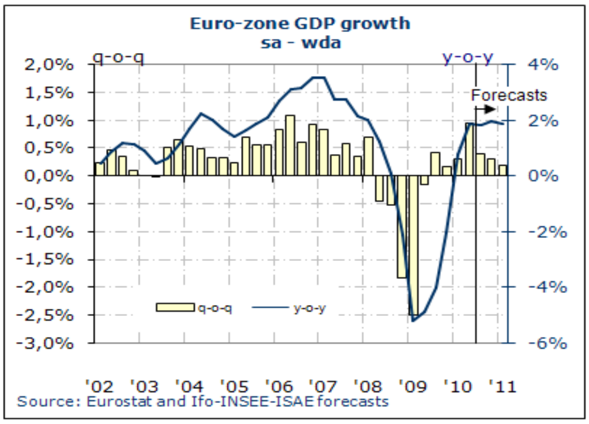
Headwinds on GDP

Real GDP in the euro-zone expanded in Q2 (+1.0%), with a record high in Germany (+2.2%). This sustained growth owed to the dynamism of exports, in a context of vigorous demand from both advanced and emerging economies, as well as to an upswing of internal demand.

This relatively robust pace of growth in H1 should wane at the forecast horizon.

Stronger GDP stimulated euro-zone employment which stabilized in H1 and is expected to grow slightly in the coming quarters, as suggested by improving hiring prospects in business surveys. However, unemployment has stayed at 10% over the past five months, and should continue to weigh on nominal wages. Moreover, the efforts towards fiscal consolidation in many member countries are expected to hold back the growth of disposable income. Accordingly, private consumption in the euro-zone is expected to lose momentum (+0.1% over the next three quarters).





Due to weak pressures on production capacity, slowing down in global demand, persisting credit constraints and renewed uncertainties on European sovereign-bond markets, growth in equipment investment should moderate over the forecast horizon. Moreover, construction investment is expected to contract in Q3 2010, after a weather-related rebound in Q2. Total investment is therefore expected to edge down to 0.3% in Q3, followed by +0.5% in Q4 and +0.3% in Q1 2011. The expiration of favourable depreciation rules in Germany at the end of the year would also contribute to the slight acceleration in investment in Q4 2010.

Overall, the pace of the euro-zone recovery is projected to lose momentum over the forecast horizon, due to the deceleration of external demand in a context of fiscal consolidation efforts by national governments. GDP would grow by 0.4% in Q3, 0.3% in Q4 and 0.2% in Q1 2011. The annual GDP growth in 2010 would amount to 1.7%.

Inflation should stabilize by December

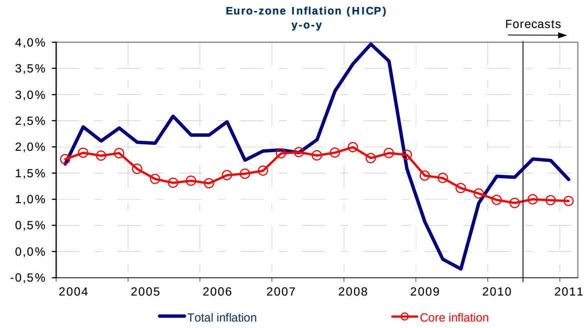
In Q3 end-of-quarter, inflation (HICP) in the euro-zone increased to 1.8% due to a raise in food prices, and to a lesser extend, in energy prices. Under the assumption of a *Brent* price around $77 and a dollar/euro exchange rate fluctuating around 1.30 over the forecast horizon, euro-zone inflation will marginally slow down at the end of the year (+1.7%) in a context of global stabilization of food and energy prices. It would slightly slowdown in March 2011 due to a base-effect stemming from energy prices that were particularly high in March 2010.

Core inflation is forecasted to be stable at 1.0% over the next quarters. Rising commodity prices should start diffusing to core inflation. Yet, this effect would be balanced by the high level of unemployment weighing on wages and by the persistence of excessive production capacities.

2010/2011 forecasts, % changes, sa - wda

q-o-q *y-o-y*	Q2 - 2010	Q3 - 2010 estimations	Q4 - 2010 forecasts	Q1 - 2011 forecasts	2010 forecasts
IPI	**2,4** 9,1	**0,9** 7,1	**0,5** 6,3	**0,5** 4,4	6,6
GDP	**1,0** 1,9	**0,4** 1,9	**0,3** 2,0	**0,2** 1,9	1,7
Consumption	**0,2** 0,5	**0,1** 0,7	**0,1** 0,6	**0,1** 0,5	0,6
Investment	**1,5** -1,2	**0,3** 0,2	**0,5** 2,0	**0,3** 2,7	-1,0
Inflation*	1,4	1,8	1,7	1,5	1,5

Source: Eurostat and Ifo-INSEE-ISAE forecasts, * end-of-quarter



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: **January 5, 2011 (date of Eurostat's second release of quarterly national accounts)**

Next forecast horizon: **2011 Q2**