

# Interim forecast September 2011



## Recovery stalls amid financial market crisis

*Economic growth in the EU is slowing. GDP grew strongly in the first quarter of 2011, but slowed down substantially in the second. Over the summer, signs of a more extensive weakening in global demand and world trade emerged, as the recovery lost steam in the US, and growth in some emerging market economies has moderated somewhat. Hopes that the sovereign debt crisis would gradually fade were disappointed. Financial market conditions deteriorated sharply over the summer on the back of sovereign debt concerns in the euro area and anxiety about the outlook for growth and fiscal sustainability in the US.*

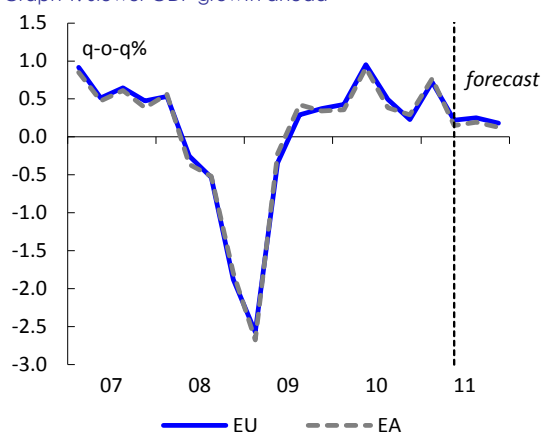
*Growth in the second half of 2011 is now expected to be subdued, coming to a virtual standstill towards the end of the year. The soft patch predicted in the spring forecast is now likely to deepen but will not result in a double dip. This subdued outlook is underpinned by the weakening of consumption growth, the deterioration of business and consumer sentiment, the likely impact of the financial market stress on confidence and investment cost, the drag from accelerated fiscal tightening in some Member States and the expected slowdown of external demand.*

*GDP growth for 2011 as a whole is set to remain unchanged from the Commission's spring 2011 forecast for the euro area (1.6%) and to be slightly lower for the EU (1.7%). This is essentially due to the stronger-than-expected first quarter. However, based on an update for the seven largest EU Member States, the quarterly growth profile has been revised down considerably. Growth projections for the EU are now at 0.2% in both the third and the fourth quarter, revised down by 0.2 and 0.3 percentage points, respectively. For the euro area, growth is projected at 0.2% in the third and 0.1% in the fourth quarter, also revised down by 0.2 and 0.3 percentage points respectively. The downward revisions concern all the Member States under review, suggesting both a common factor and a re-coupling of growth dynamics. Nonetheless, growth is expected to remain uneven across Member States.*

*Inflation in the EU is now expected to moderate faster than was envisaged in the spring. After surging in the first half of 2011, commodity prices have recently declined somewhat. With weaker economic growth going forward, HICP inflation in the EU and the euro area is also now expected to moderate slightly more quickly, reaching respectively 2.9% and 2.5% for the year as a whole, and remaining above 2% until the end of 2011.*

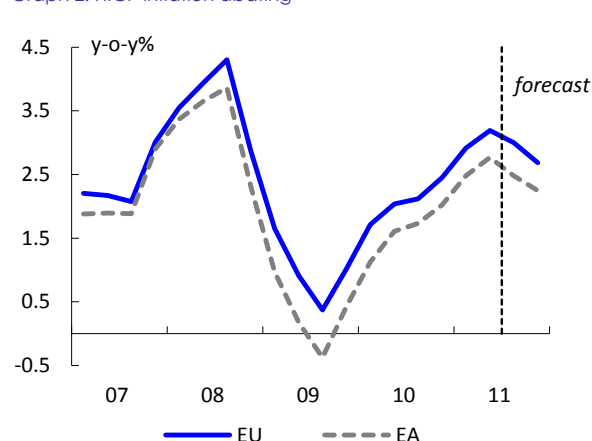
*High uncertainty prevails at the current juncture. Some of the downside risks considered in the spring forecast have now materialised. Nonetheless, the risks to growth remain clearly tilted to the downside. Conversely, risks to the inflation outlook have now abated somewhat since spring and are considered as balanced.*

Graph 1: Slower GDP growth ahead



Source: European Commission

Graph 2: HICP inflation abating



Source: European Commission

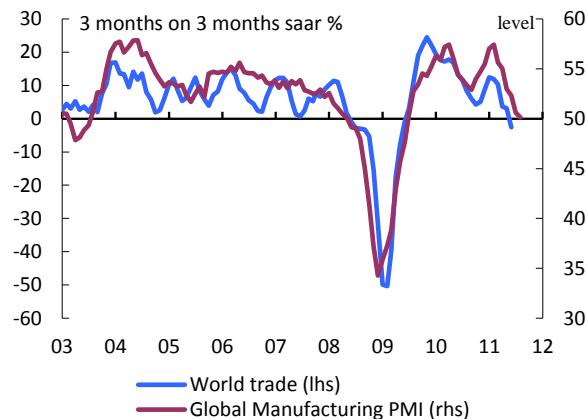




### World growth is losing steam

The pace of the *world economy* has slowed in the first half of 2011. In advanced economies, the expected progressive shift from public to private demand has been delayed, leading to subdued growth and persistently high unemployment. The deceleration of growth has been especially marked in the US, where the need for deleveraging, weak labour markets and a beleaguered housing market are still weighing on consumer and business confidence. Most emerging economies continued to display robust growth, although this has moderated in some Asian countries on the back of slower external demand. In addition, economic policy tightening – imposed to prevent overheating in several emerging economies – has also put a damper on growth.

Graph 3: Softening global growth and trade



Source: CPB - Netherlands Bureau for Economic Policy Analysis, European Commission

Even though the recent slowdown partly reflects temporary factors, such as high commodity prices and global supply-chain disruptions caused by the Japanese natural disasters, the short-term growth prospects remain weak. Global financial markets deteriorated sharply during the summer. Moreover, weak employment and consumption prospects continue to weigh on the economic outlook.

Looking ahead, leading indicators point to a continued moderation in the world economy in the second half of 2011. World trade has decreased across most regions in the second quarter of 2011 and indicators suggest a continuation of this weak

trend in the third quarter. The global Purchasing Managers Index (PMI) for manufacturing has declined since March and reached the lowest level in two years in August. Overall, global output is projected to grow by some 4% in 2011, which is a downward revision of about ½ pp. compared to the spring forecast.

At the time of finalising this interim forecast, the global economy is weak and a double-dip recession, although unlikely, cannot be excluded. The downside risks to the global growth outlook have increased compared to those highlighted in spring, especially as some risks have materialised. Confidence among consumers and investors has weakened in advanced economies over past months, and took a clear additional downward shift in August as a result of the sovereign debt challenges, the political gridlock in the US over the debt ceiling and governance tensions in Europe. Overheating pressure in many emerging markets and still-high oil prices – considering the cooling global cycle – also pose risks to the recovery. The lack of progress in reducing global imbalances further complicates the global risk outlook.

### Financial markets stress has intensified over the summer

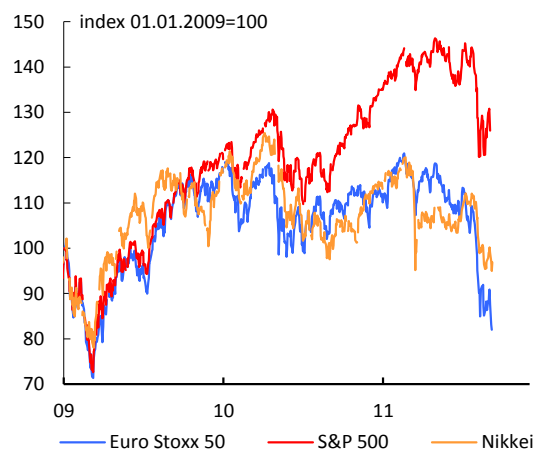
Over the past months, tensions in sovereign debt markets in the euro area have increased and spread further, on account of rising uncertainty about public debt sustainability. Concerns about a global economic slowdown and the protracted political negotiations on raising the US federal debt ceiling have added to stress in markets, while the measures agreed by the euro-area Heads of State and Government only temporarily calmed the markets. Benchmark long-term interest rates dropped sharply, to below 2% for the 10-year maturity, both in the US and the euro area, amid an investor flight to quality and the prospect of slowing growth in the global economy. Meanwhile, equity markets corrected sharply with banking sub-indices being particularly affected. The correction in stock prices seems to go beyond what could be expected from a reassessment of the growth outlook alone and rather seems to reflect a general shift in risk sentiment (cf. box on page 7).



Renewed tensions in the banking sector pose a downside risk for the real economy, though overall lending conditions have so far remained favourable.

Tensions in the interbank money market have increased again, and bank funding has become more difficult. In the money market, the 3-month Libor-OIS spread has widened significantly since June and, at around 75 basis points, is now at the highest level since spring 2009. The amount of overnight deposits at the ECB has also risen strongly, to over 150 bn euro in early September, indicating that banks are hoarding cash rather than lending to each other. In early August, the ECB re-introduced a 6-month refinancing operation and announced that full liquidity allotment will be available at least until the second quarter of 2012. Investor concerns about an erosion of banks' asset quality and funding risks seem to have increased, although many banks have pre-funded for the current year. The cost of insuring EU bank bonds against default has risen significantly as reflected in the increase in banks' CDS prices. If bank funding problems persist, the need for deleveraging is likely to impact on bank lending behaviour. This would in turn deepen and broaden the transmission of financial market stress to the real economy.

Graph 4: Stock prices falling



Source: Reuters and European Commission

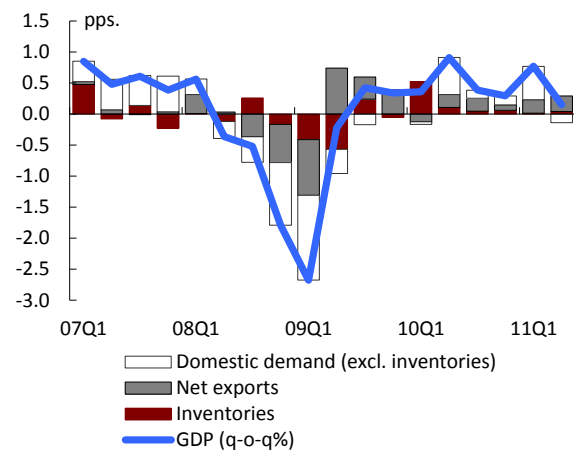
Financing costs for non-financial corporations and households have so far increased only moderately and remain low by historical standards. Over the past months, for non-financial corporations, the increase in the cost of issuing shares has been offset largely by a decrease in the cost of bank loans. For households,

the cost of long-term loans for house purchases has remained stable. These aggregate developments however mask some cross-country heterogeneity, with lending rates in Member States with sovereign debt problems having increased more markedly. The latest ECB data points to a slight slowdown in euro-area bank lending to the private sector in July. Credit standards for both loans to non-financial corporations and housing mortgages have been tightening moderately. Demand for bank loans has been slowing down and is expected to remain subdued in the months ahead. Overall, there are no signs of serious credit constraints for the time being.

#### A slowdown of the economic recovery

The recovery in the *EU economy* is slowing. Following a robust 0.8% q-o-q growth in the first quarter of this year, GDP grew by a meagre 0.2% in the second quarter in both the EU and euro area. This was partly a pay-back for the strong first quarter and remained broadly in line with the Commission's spring forecast.

Graph 5: A rebalancing of euro-area growth on hold

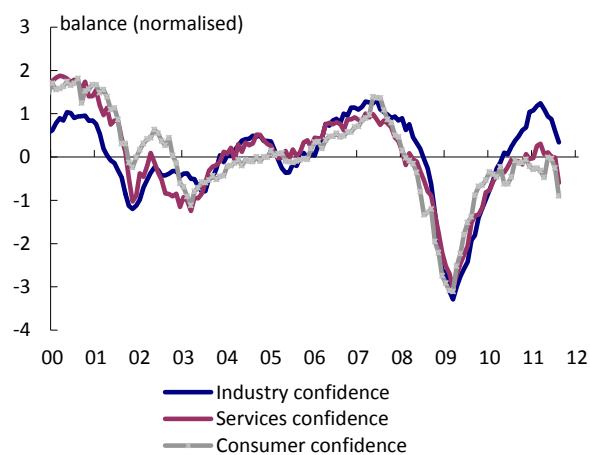


Source: European Commission

While some rebalancing of growth towards domestic demand had been observed in the first quarter, net exports have again taken over as the main contributor to growth in the second quarter. Exports expanded by 0.6% q-o-q, down from 2.2% in the first quarter, reflecting the weakening in global demand and world trade. At the same time, imports grew by 0.4%, leading to a positive contribution of net trade to growth of 0.1 pp. Gross fixed capital formation

grew by 0.4% q-o-q, down from 1.2% in the first quarter. Both private and government consumption contracted by 0.1%. As a result, the contribution of domestic demand to growth was nil. Ongoing balance-sheet adjustment in the private sector is likely to contribute to the weakness of domestic demand. Inventories made a small positive contribution to growth (0.1 pp.). The slowdown in the second quarter reflects not only the impact of higher oil prices, but also less buoyant global growth and increased uncertainty in the wake of the looming sovereign debt concerns in Europe and elsewhere.

Graph 6: Deterioration in business and consumer confidence

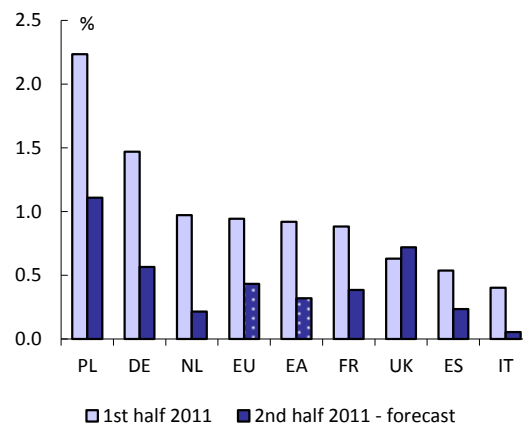


Source: European Commission

Looking ahead, GDP growth is set to moderate in the second half of the year, suggesting a period of weak growth in the EU that is longer and more pronounced than the soft patch expected in the spring forecast. The expected further softening in the global economy and sovereign debt concerns are set to continue to weigh on growth during next half of the year, and possibly beyond the time horizon of this Interim forecast. Based on an update of the outlook for the seven largest Member States, GDP is now expected to expand by 0.2% in both the EU and euro area in the third quarter, and by 0.2% in the EU and 0.1% in the euro area in the fourth. This represents a considerable downward revision compared to the quarterly profile expected in the spring forecast (0.2 pp. and 0.3 pp. respectively in the third and fourth quarter).

Uncertainty and weaker external demand are weighing on consumer and business confidence. Both business and consumer sentiment have deteriorated sharply since the spring. The Commission's Economic Sentiment Indicator (ESI), starting from a very high level, has followed a downward trend since it peaked in March 2011. In August, the decline pushed the indicator below its long-term average. It stands now at its lowest level since January 2010. While surveys show a marked deterioration in their forward-looking components, the weakening in confidence is broad-based and households' and companies' assessments of the current situation are also on a downward trend. The deterioration in confidence is observed among all the largest EU Member States, suggesting a strong common element in the change in the outlook. The composite PMI for the euro area has followed a trend similar to the ESI and in August it was approaching the 50 point threshold between contraction and expansion of economic activity.

Graph 7: A broad-based deceleration in GDP growth across Member States



Source: European Commission

### Growth forecast for the EU economy revised down

For 2011 as a whole, GDP growth is now forecast at 1.7% in the EU and 1.6% in the euro area. It thus remains unchanged in the euro area compared to the spring forecast and represents a 0.1 pp. downward revision for the EU. While the annual growth figures have hardly changed thanks to the stronger-than-expected first quarter, the quarterly profile for the second half of the year has been revised downwards



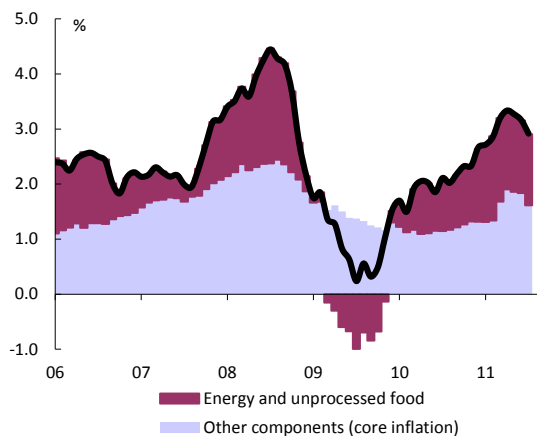
significantly, reflecting the slowdown in world growth, sovereign debt concerns and the deterioration in business and consumer confidence.

The downward revision for the second half of the year is broad-based across EU countries. However, growth rates remain different across the Member States covered by the interim forecast. Annual growth in 2011 in Poland and Germany is projected at 4.0% and 2.9% respectively, while in Italy and Spain the recovery is more muted with a projection of 0.7% and 0.8% respectively.

### Inflation pressures abating in the EU

In the first half of 2011, developments in *consumer-price inflation* were dominated by volatile, but on the whole rising, global commodity prices and weak labour markets. Nevertheless, inflation seems to have peaked in the second quarter of 2011, driven on the one hand by still high energy prices and by downward base effects on the other.

Graph 8: EU inflation pressures abating



Source: European Commission

Euro-area headline HICP inflation rose to 2.8% in the second quarter of 2011, in line with the spring forecast. Core inflation (i.e. HICP inflation excluding energy and unprocessed food) reached 1.8% in the same period, about  $\frac{3}{4}$  pp. higher than in 2010. In the EU, headline inflation was 3.2% in the second quarter, less than 0.1 pp. higher than in the spring forecast.

Feeble labour market conditions kept *wage growth* at a moderate pace in the euro area in the first quarter

of 2011. At the same time, the year-long fall in annual unit labour cost seems to have come to a halt, reflecting an increase in compensation per employee equal to productivity gains.

Looking ahead, the headline inflation rate for 2011 is slightly revised down both in the EU and the euro area (-0.1 pp. compared to the spring forecast) and is expected to reach 2.5% and 2.9% respectively. However, within the euro area, projected developments are somewhat divergent, with the Netherlands being the only Member State with an upward revision, following lagged increases in administered gas prices in reaction to oil-price increases in the first half of 2011. Outside the euro area, inflation has been revised up in the UK on account of announced increases in energy prices due in the second half of the year.

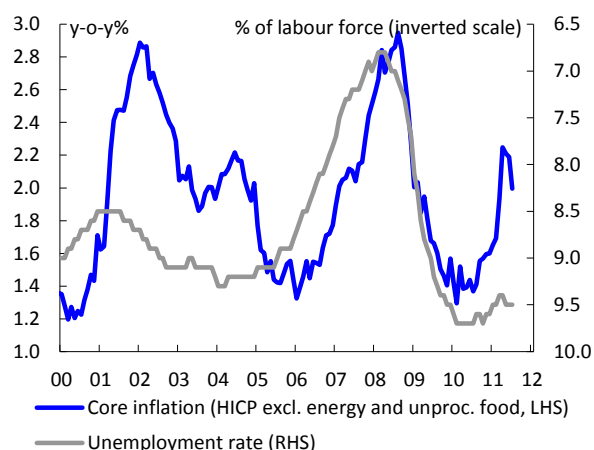
As already highlighted in the spring forecast, inflation is set to stay fairly high in the second half of 2011 and ease only gradually towards the end of the year, without posing a risk to medium-term price stability. This profile follows the fading direct impact on inflation of both past hikes in commodity prices and the changes in taxation in some Member States. Furthermore, import prices are expected to moderate to some degree, reflecting less buoyant growth outside the EU. The remaining slack in the economy and weak labour market conditions are expected to keep inflation in check, though core inflation is set to gradually continue on a rising trend, in line with slowly recovering wage and unit labour cost growth.

### Flagging recovery weighs on labour markets

With the recovery in its third year, *labour market* conditions in the EU and the euro area have been gradually improving over recent quarters. Since the beginning of the recovery in 2009, labour input in terms of hours worked in the euro area has picked up. Since autumn last year the number of persons employed has also moved up (by 0.5% in the EU and 0.3% in the euro area in the first quarter of 2011). The delayed and more moderate response in headcounts represents the reversion of the working-hour adjustment that characterised the downturn during the crisis.



Graph 9: EU underlying inflation pressures remain contained



Source: European Commission

The unemployment rate has been almost stable in 2011, remaining at around 9½% in the EU and at around 10% in the euro area – only marginally lower than a year ago. As compared to mid-2010, the aggregate hides divergent developments across the reviewed Member States, with some reporting improvements of up to 1 pp. (e.g. Germany) and others recording deteriorations of up to 1 pp. (e.g. Spain). With the recovery slowing in 2011, the prospects for further improvements in the EU and the euro area have waned somewhat. According to both survey indicators of firms' employment expectations as well as the PMI employment index, both households and corporates have revised their employment expectations downwards.

Turning to *public finances*, the available information suggests that, despite a downward revision of economic growth in the second half of 2011, the budgetary outcome for the EU and the euro area as a whole will be close to the one projected in the spring forecast. Government revenues are likely to be broadly in line with what was previously expected and additional consolidation measures have been taken in some Member States since the publication of the spring forecast.

A full assessment of prospects for public finances and the labour market will be carried out in the Commission's upcoming autumn forecast.

### Downside risks to the growth outlook

Some of the downside risks to earlier forecasts – such as financial turmoil and a lower momentum of global growth - have materialised and entered the central scenario. However, new risks have also emerged, and the risk balance for the EU *growth outlook* remains tilted to the downside for 2011 and beyond.

First, while the financial turmoil has already had an impact on confidence, a more substantial spillover to other market segments and to the real economy cannot be excluded. Uncertainty about the implementation of policy measures to combat the sovereign debt crisis, and doubts about their appropriateness, continue to alarm financial markets. The baseline forecast scenario depends crucially on the ability of economic policy to prevent or interrupt negative feedback loops between sovereign debt concerns, banking sector fragility and slowing growth. Second, significant fiscal sustainability challenges are yet to be tackled not only inside the EU but also in key countries outside. The resulting fiscal consolidation efforts may weigh more on domestic demand than currently envisaged. Third, the inflation concerns in some of the emerging market economies may trigger more measures than currently envisaged and make the EU's external environment more difficult than assumed in the forecast.

Turning to the upside, should global growth turn out more resilient than assumed in the baseline, EU exports would benefit more than expected. A larger decline in oil prices could bring somewhat larger respite to real income and consumption.

Risks to the *inflation outlook* in 2011 seem to be balanced. The considerable slack remaining in the economy and markedly lower inflation expectations should keep underlying inflation in check. However, sharp price increases in some asset classes may signal the risk that excess liquidity starts to fuel HICP inflation. Moreover, continuing political tensions in some oil-exporting countries could cause abrupt changes in oil prices that would constitute risks to price stability in the short to medium term.



### Box: The Fall of Stock Prices: Causes and Consequences

Stock prices in Europe and the US have declined by more than 20% over the summer (cf. graph 4). This box examines what drivers can explain such a substantial fall in equities and what are its potential consequences for GDP growth. The impact on growth depends on the duration but also on nature of the shock. Standard investment models and empirical evidence suggest that temporary shifts in stock prices have only negligible effects on capital formation and economic growth. Different scenarios are simulated in a three country version (EA-US-RoW) of the Commission's macroeconomic model QUEST III to examine possible explanations for the marked stock market decline – the growth slowdown, expectations concerning fiscal consolidation and a re-assessment of risk. These scenarios shed light on the likely impact of the fall in stock prices on economic activity in the short term.

Share prices reflect discounted corporate profit expectations. Against the background of a slowing global economy and increased concerns about sovereign debt, the fall in share prices could reflect mainly a shift towards a more pessimistic growth outlook but also a re-assessment of financial market risks. A central question for investor concerns the way public finances are consolidated. The 2010 autumn forecast argued that the short-term growth impact of fiscal retrenchment depended crucially on the policy mix applied. In the simulations below, it is assumed that debt levels will gradually be brought back to 60% over the next two decades, but different assumptions are applied concerning the consolidation strategies (i.e. expenditure-based vs. revenue-base). Concerning the stance of macroeconomic policies in the short run, given their restricted room for manoeuvre it is assumed that central banks keep the policy rate constant and fiscal policy only responds by letting automatic stabilisers play.

A shift in investors' assessment of the growth outlook alone does not explain the magnitude of the stock-market declines observed over the summer. The first scenario (see table, line 1) assumes a downward revision in the expected 'speed of recovery', captured in the model by a drop of expected potential growth of 0.5 pp. in 2012 and 2013 respectively. This leads to a fall of GDP relative to its baseline value of slightly more than 0.5 pp. and a drop of stock prices close to 1%. Looking additionally at the role of fiscal consolidation (scenarios 2a-c), the results depend strongly on the assumptions about the type of measures. If the consolidation is 'expenditure-based' (scenario 2a), the short-term decline of stock prices is small. The positive and permanent crowding-in effects from improved public finances get priced into current stock prices and offset the negative short-term effects on economic activity resulting from the cuts in government spending. If, on the other hand, investors expect that consolidation will be achieved predominantly via tax increases, stock prices decline more markedly (see scenarios 2b and 2c). An increase in 'corporate taxes' has direct negative effects on net corporate profits and dividends. An increase of 'labour taxes' affects profits indirectly, to the extent it is shifted onto wages.

The recent marked decline of stock prices is best explained by a re-assessment of investor risks. However, the impact on growth, investment and consumption depends crucially on the duration of the shock. In simulation 3, an immediate 20% fall of stock prices – calibrated to approximate the actual decline over the summer – is generated by an increase in risk premia charged by lenders. If confidence is restored within one month (scenario 3a), the fall in stock prices is quickly reversed (and the average stock price decline over the year small) with hardly any negative effects for the real economy. Should risk premia remain high over a year, however, investment will fall, negatively affecting capital formation and growth (see line 3b). Higher risk premia directly affect capital costs, so firms scale back and - anticipating that the crisis will be temporary - delay planned investment. In this scenario, investment declines by close to 7% and GDP growth falls by 1 pp. over the year. For comparison, in 2009, following the sharp re-assessment of risks in global financial markets, the subsequent fall in investment reached a magnitude of 20%. The wealth effect on consumption remains negligible in the model as private savings are shifted to consumption thanks to lower deposit rates.

Table 1: Shocks, the stock market and the real economy (1st-year-growth effect)\*

	GDP	Consumption	Investment	Stock prices
(1) Revising the speed of recovery	-0.59	-0.91	-0.56	-0.87
(2a) Consolidation (expenditure based)	-0.39	0.68	0.13	-0.32
(2b) Consolidation (labour taxes)	-0.62	-1.30	-0.00	-3.39
(2c) Consolidation (via corporate taxes)	-0.79	-0.37	-2.86	-7.27
(3a) Confidence shock (1 month)	-0.04	0.00	-0.22	-0.71
(3b) Confidence shock (1 year)	-1.08	0.05	-6.74	-12.18

\* All figures shown in the table are deviations of growth rates from their baseline values.



## Growth and inflation prospects in the seven largest Member States

### 1. Germany – growth moderation after a vigorous start into 2011

German real GDP is projected to grow by 2.9% in 2011, i.e. 0.3 pp. more than expected in the spring forecast. This upward revision reflects the economy's very dynamic start into 2011, while prospects for the second half of the year are more moderate than forecast earlier.

Real GDP expanded vigorously by 1.3% q-o-q in the first quarter of 2011, partly due to temporary factors. Some payback for this strong performance in terms of slower subsequent quarterly GDP growth was to be expected. In the event, real GDP edged up by a mere 0.1% in the second quarter. The impact of the shutdown of nuclear energy plants is an additional special factor which helps put this subdued performance into perspective. Positive growth contributions came from non-construction investment and inventories. Imports expanded more strongly than exports, so that net external trade acted as a drag on growth. Private consumption disappointed, possibly reflecting not only the pickup in inflation, but also increased uncertainty.

While the second-quarter performance is likely to have understated the underlying growth momentum, risks have nevertheless increased and indicators point to continued moderation in growth in the second semester relative to the beginning of the year. The external environment has deteriorated over recent months, consumer confidence has been dampened by mounting uncertainty amid the ongoing debt crisis, and firms' assessment of the business outlook has been on a downward trend since spring, albeit starting from a high level. However, capacity utilisation remains high and the backlog of orders should continue to underpin production as well as investment especially in the third quarter. Furthermore, still-favourable labour market developments and the moderation of inflation should mitigate the impact of uncertainty on private consumption. Overall, growth should be predominantly driven by domestic demand, given the projected slackening of exports in the second half of the year and still-lively import growth.

After inflationary pressures had intensified on the

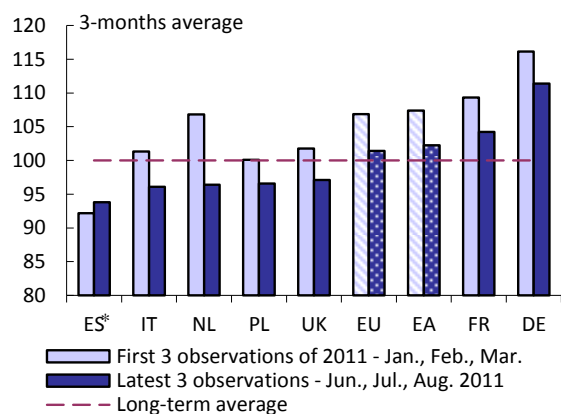
back of rising oil prices in late 2010 and early 2011, consumer-price inflation is now slowing. HICP inflation is set to average 2.3% for the year as a whole, 0.3 pp. less than in the spring forecast, mainly because of abating energy prices.

### 2. Spain – weaker external environment weighs on the recovery

The Spanish economy gained some momentum at the beginning of 2011. Real GDP growth surprised on the upside in the first quarter at 0.4% q-o-q, driven mainly by exports and an acceleration in public consumption ahead of the local and regional elections in May. In the second quarter, growth slowed to 0.2%, with net exports and strengthening private consumption being the main drivers.

High private-sector imbalances accumulated during the housing boom and record-high unemployment continue to weigh on the outlook for the Spanish economy. Moreover, a weakening global environment and heightened uncertainty are expected to negatively affect growth prospects in the remainder of this year, prompting some deceleration in growth in the third and fourth quarter. Thanks to the better-than-expected first half, Spanish real GDP is, however, still projected to expand by 0.8% in 2011.

Graph 10: Worsening of Commission's Economic Sentiment Indicators (ESI) across Member states



\* Possible break in ES series in May 2011

Source: European Commission

Private consumption is set to remain subdued as a result of still substantial household debt and high





unemployment. Public consumption is set to shrink further, after the temporary spike in the first quarter, as Spain continues with its ambitious fiscal consolidation programme. Investment is recovering only slowly in an environment of high corporate indebtedness, excess capacity and difficult access to credit. Hence, net external demand continues to be the main driver of the Spanish economy. Spanish exports have so far maintained their momentum, with growing importance of markets outside the EU.

Inflation is forecast to reach 2.9% in 2011, up from 1.8%<sup>1</sup> last year. This is mainly due to increasing oil prices in the first half of the year and administered price increases. In the meantime, oil prices have come down from their peak and stabilized at a lower level. Moderating wage growth has resulted in lower unit labour costs, easing inflationary pressures. In the remainder of 2011, inflation is expected to further decline due to base effects, as the inflationary impact of past increases in VAT, excise duties and electricity prices gradually fades.

### 3. France – growth hinging on the resilience of confidence

After real GDP expanded by 1.5% in 2010 the economy continued accelerating in the first quarter of 2011 and grew by 0.9%. However, it came to a halt in the second quarter, partly reflecting exceptional factors such as the after-effect of the car-scrapping premium and very uneven growth contributions from inventories. Netted out of these elements, the declining growth profile of the first part of the year would have been softer. For the second half of the year, GDP is expected to increase by a moderate 0.2% in each quarter, which should translate into 1.6% for the year as a whole.

The downward revisions compared to the Commission's spring forecast are mainly due to negative confidence effects weighing on domestic demand, as well as a less buoyant external environment than expected in spring. Private consumption is projected to weaken in the second

half of the year. Unemployment, already high since 2009, has increased further over the last three months. As a result, disposable income will turn out weaker, despite a softening outlook for inflation. The high uncertainty associated to the ongoing debt crisis is weighing on consumer confidence but is also increasingly affecting investment decisions.

Against the background of weaker consumption growth and retreating capacity utilisation, investment is expected to weaken in the coming two quarters. Even though interest rates are set to remain low by historical standards and the latest fiscal consolidation measures are not expected to significantly affect economic activity, given their size (0.05% of GDP in 2011), the unusually high uncertainty about the growth outlook is weighing strongly on investment.

Only minor support is expected from export demand. To the extent that lower expectations for domestic demand should drive imports down, GDP growth could still benefit from the contribution of the external sector. However, exports are forecast to decelerate as well, in line with the deterioration in the global outlook.

The annual HICP inflation forecast is broadly in line with previous projections (2.1% instead of 2.2%), as the impact of lower oil prices is offset by various measures associated with the latest fiscal package, notably the increase of excise taxes.

### 4. Italy – a halting recovery

The Italian economy has been recovering at a modest pace since the trough of the recession in 2009. Real GDP expanded by 1.3% in 2010 as a whole, but in quarterly terms growth already eased in the second half of 2010, to just 0.1% in the fourth quarter. This sluggish performance continued in the first quarter of 2011, when Italy's real GDP expanded by only 0.1%. In the second quarter, however, GDP growth picked up somewhat (0.3%), contrary to most other euro-area countries, on the back of a rebound in industrial production.

Recent developments point to a relapse in economic activity in the second half of 2011. Moderating global demand is set to weigh on exports, which have driven the recovery so far. Still weak labour market

<sup>1</sup> As of January 2010, the Spanish Statistical Institute adopted a new methodology for calculating inflation, without updating it for previous years. This break in the series leads to a growth rate of 2% for 2010 inflation in Spain.



conditions and inflationary pressures are expected to restrain real disposable income and thus dampen private consumption. Finally, the recent tensions in financial markets are set to increase firms' financing costs and thus adversely affect their investment decisions. Similarly, forward-looking consumer and business confidence indicators, have fallen markedly over the last few months.

Quarter-on-quarter, real GDP is expected to remain flat in the second half of the year, which for 2011 as a whole implies growth of 0.7% – a 0.3 pp. downward revision compared to the Commission's spring 2011 forecast.

After picking up in 2010, the rate of HICP inflation continued to rise in the first half of 2011, mainly due to sustained energy-price increases. In spite of still weak demand, some second-round effects from higher commodity prices were observed in the second quarter of 2011, notably in transport services. By contrast, contractual wage increases remained moderate, mainly thanks to the reformed wage bargaining framework using forecast HICP inflation excluding imported energy prices as a benchmark. Assuming slightly decreasing oil prices in the second half of the year, inflation is expected to ease somewhat and reach 2.6% in 2011 on average, in line with the Commission's spring 2011 forecast.

#### **5. The Netherlands – weak growth continuing into the autumn**

Following a relatively strong fourth quarter in 2010 and first quarter in 2011, the economic recovery slowed markedly in the second quarter of 2011, with real GDP growing by 0.1% q-o-q. This development is due to a pronounced weakening in both domestic and external demand. Private investment contracted by 1.8% on a quarterly basis after a significant pick-up by 7.7% in the first quarter. In addition, private consumption fell for the second quarter in a row, in line with the falling trend in real disposable income in a setting of higher inflation and fiscal retrenchment. The positive contribution of net exports declined in the second quarter. The outlook for the remainder of 2011 is for a positive, yet moderate growth. The Dutch economy is expected to grow by 0.1% in both the third and fourth quarter, implying an annual

growth of 1.7%, compared to the 1.9% in the Commission's spring 2011 forecast.

The 0.2 pp. downward revision mainly reflects worsened global growth prospects, leading to a deceleration in trade. The growth in exports, which has been the major driver of the ongoing economic recovery, is expected to moderate in the remainder of 2011. Private investment is also expected to remain subdued in view of receding business confidence in response to global economic uncertainties. Private consumption is forecast to remain weak for the remainder of the year, following the decline in consumer confidence since the start of 2011, negative real wage growth and adverse wealth effects emanating from the housing and stock markets. In this context, a broad-based recovery will hinge on the resolution of the sovereign debt crisis to help restore confidence in the private sector.

The HICP inflation rate rose significantly in the first half of 2011, averaging 2.2% compared to 0.9% in 2010. In July, inflation for the Netherlands exceeded the euro-area average. Inflation is expected to remain relatively high for the remainder of 2011, averaging 2.5% over the year. The projected pick-up in inflation in the second half of 2011 mainly results from the sharp rise in oil and gas prices that started towards the end of 2010. Oil and gas prices have lagged effects on inflation in the Netherlands via the biannual adjustment of energy prices based on past price developments.

#### **6. Poland – externally-driven slowdown looms**

Real GDP growth is projected to reach 4% in 2011 following 3.8% in 2010. While the year-on-year growth figure is unchanged from the Commission's spring forecast, the quarterly profile has changed. Stronger-than-projected growth in the first half of the year is offset by a worsening outlook for the remainder of the year.

Following a strong first quarter, economic activity continued to be robust in the second quarter of 2011, with real GDP growth reaching 1.1% q-o-q. Growth was driven by domestic demand, increasing on the back of rebuilding inventories and accelerating investment growth. High capacity utilisation levels, soaring profitability and improved access to credit



spurred the revival of private investment adding to rising public outlays. Consumption kept growing, by 0.9% q-o-q, supported by an improving labour market situation.

Looking ahead, real GDP growth is projected to ease to 0.6% and 0.5% q-o-q respectively in the third and fourth quarter of 2011. The economic deceleration in the EU and world trading partners is set to take its toll on Poland's exports, initially affecting manufacturing, as evidenced by the recent weak readings of industrial production and leading indicators. Going forward, the deteriorating global outlook is expected to further drag down exports and consumer and producer confidence, translating into more sluggish employment growth towards the end of 2011. Moreover, easing of real wage growth is expected to limit the potential for a further rebound of private consumption. Investment growth is set to reflect continued public capital spending and the recovery in private outlays.

HICP inflation reached 4% y-o-y in the second quarter of 2011, a notch lower than in the Commission's spring forecast. It is expected to gradually ease to around 3.5%, the upper bound of central bank's inflation target, in the last quarter of the year, reflecting lower growth of food and fuel prices and decelerating domestic and external demand growth.

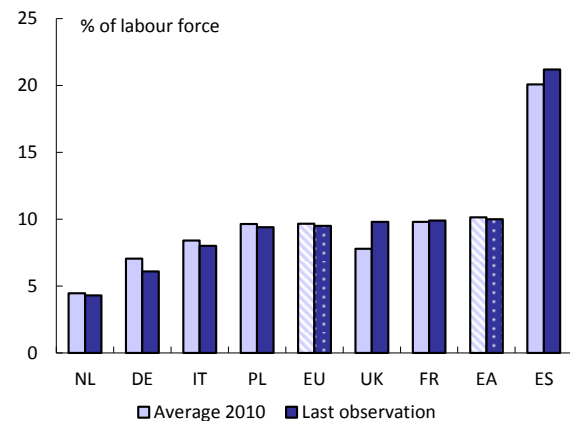
## 7. The United Kingdom – economic recovery moderating but growth remaining positive

In the second quarter of 2011, UK GDP increased by 0.2% q-o-q, following an increase of 0.5% in the first quarter. The Commission's spring forecast had predicted a rise of 0.6% in the second quarter but this did not materialise due to exceptional events. These included an additional bank holiday due to the royal wedding, record warm temperatures and supply-chain problems in the wake of the Japanese earthquake. Both the construction and services sector grew over the previous quarter. However, production contracted, likely owing to lower energy consumption during the hot weather. The Office for National Statistics estimates that temporary factors may have reduced growth by 0.5 pp. in the second quarter, masking a stronger underlying dynamic.

Although these temporary factors fade, economic

growth is expected to remain sluggish in the second half of 2011 as persistently high inflation and the ongoing fiscal consolidation curtail consumption. The annual growth rate is being revised down from 1.7% to 1.1% largely due to worse-than-expected performance in the first half of the year and the loss of momentum in the world economy. The growth that had been predicted through net exports has not materialised because of a fall in global demand, despite the continued low value of sterling, and this is not likely to change in the near future. Conversely, corporate investment has shown signs of recovery but has yet to play a vital role in driving growth.

Graph 11: Diverging unemployment developments across Member States



Source: European Commission

HICP inflation stood at 4.4% in the second quarter of 2011, just 0.1 pp. below the Commission's spring forecast. The fundamental drivers of this inflation appear to be the increased VAT rate, higher commodity prices and sterling's depreciation. The impact of these factors has been unexpectedly long-lived; however since sterling remains well above its recent lows, oil prices have fallen back significantly and no further VAT rises are planned, inflation is still expected to fall significantly beyond the forecast horizon. Nevertheless, there is likely to be a spike in inflation later in the year due to rising home energy prices. As the price rises announced by energy companies were larger than assumed in the spring forecast, the forecast for 2011 inflation has increased from 4.1% to 4.4%.



Table 1: Real GDP growth

	Quarterly GDP (%, quarter-on-quarter)				Annual GDP (%, year-on-year)		
	Outturn		Forecast		Outturn	2011 (forecast)	
	2011/1	2011/2	2011/3	2011/4	2010	Spring forecast May 2011	Interim forecast Sept. 2011
Germany	1.3	0.1	0.4	0.2	3.7	2.6	2.9
Spain	0.4	0.2	0.1	0.1	-0.1	0.8	0.8
France	0.9	0.0	0.2	0.2	1.5	1.8	1.6
Italy	0.1	0.3	0.0	0.0	1.3	1.0	0.7
Netherlands	0.8	0.1	0.1	0.1	1.8	1.9	1.7
<b>Euro area</b>	<b>0.8</b>	<b>0.2</b>	<b>0.2</b>	<b>0.1</b>	<b>1.8</b>	<b>1.6</b>	<b>1.6</b>
Poland	1.1	1.1	0.6	0.5	3.8	4.0	4.0
United Kingdom	0.5	0.2	0.4	0.3	1.4	1.7	1.1
<b>EU27</b>	<b>0.7</b>	<b>0.2</b>	<b>0.2</b>	<b>0.2</b>	<b>1.8</b>	<b>1.8</b>	<b>1.7</b>

Source: European Commission

Table 2: Consumer-price inflation

	Quarterly HICP (%, year-on-year)				Annual HICP (%, year-on-year)		
	Outturn		Forecast		Outturn	2011 (forecast)	
	2011/1	2011/2	2011/3	2011/4	2010	Spring forecast May 2011	Interim forecast Sept. 2011
Germany	2.2	2.5	2.5	2.0	1.2	2.6	2.3
Spain	3.2	3.3	2.8	2.3	2.0*	3.0	2.9
France	2.0	2.2	2.1	2.1	1.7	2.2	2.1
Italy	2.3	2.9	2.5	2.5	1.6	2.6	2.6
Netherlands	2.0	2.4	2.8	2.7	0.9	2.2	2.5
<b>Euro area</b>	<b>2.5</b>	<b>2.8</b>	<b>2.5</b>	<b>2.2</b>	<b>1.6</b>	<b>2.6</b>	<b>2.5</b>
Poland	3.6	4.0	3.7	3.4	2.7	3.8	3.7
United Kingdom	4.1	4.4	4.9	4.2	3.3	4.1	4.4
<b>EU27</b>	<b>2.9</b>	<b>3.2</b>	<b>3.0</b>	<b>2.7</b>	<b>2.1</b>	<b>3.0</b>	<b>2.9</b>

\* Break in the series in January 2010. Consistent methodology yields 1.8% inflation in 2010.

Source: European Commission

Questions and comments on the September 2011 Interim forecast should be directed to:  
[ECFIN-INTERIM-FORECAST@ec.europa.eu](mailto:ECFIN-INTERIM-FORECAST@ec.europa.eu)



## BOX: TECHNICAL BACKGROUND TO THE INTERIM FORECAST

### Technical background

This interim forecast updates the outlook of the spring 2011 economic forecast of 13 May 2011. The cut-off date for this interim forecast to take new information on board was 6 September 2011. In February 2006, the Commission presented the first of what are now twice-yearly interim forecasts with the objective of updating its comprehensive spring and autumn economic forecasts (with the next fully-fledged forecast scheduled for 10 November 2011).

The interim forecast updates the outlook for the seven largest EU Member States, i.e. Germany, Spain, France, Italy, the Netherlands, Poland and the United Kingdom (which are the largest in the EU based on an average of the ranking in terms of both population and nominal GDP). The update covers real GDP growth and HICP inflation for the current year. These updates are prepared using indicator-based forecasting models and/or judgemental forecasting techniques.

Estimates for the European Union and the euro area are prepared using the nominal GDP-weighted updates for the largest Member States. In terms of nominal GDP, these countries account for 79% of the European Union, while the five euro-area Member States account for 83% of the euro-area aggregate. The outlook for the smaller Member States has not been individually updated. The Commission has made projections for the euro area and the EU using the updates for the five and seven largest Member States respectively, and assuming that the revisions to GDP and inflation for the smaller Member States are proportionate to those of the larger ones.

Quarterly data are updated with the latest available information. When comparing quarterly with annual GDP growth it must be kept in mind that, whenever possible, quarterly data are adjusted for both seasonal influences and the number of working days while annual data are presented in unadjusted form. Calendar factors are relatively small in 2011 and amount to less than -0.1 pp.

### External conditions

This forecast is based on a set of external assumptions. Technical assumptions are used for exchange rates, interest rates and oil prices. To shield these assumptions from possible volatility during one specific trading day, averages from a 10-day reference period have been used.

The assumption as regards exchange rates has been standardised using fixed nominal exchange rates for all currencies. They are kept constant based on the averages from 10 days up to 2 September, implying e.g. an annual average of USD/EUR of 1.42.

The market-based interest-rate assumptions should be interpreted with caution, as they do not only reflect policy rate expectations, but also liquidity conditions, particularly in a period of market uncertainty. Short-term interest rates for the euro area are derived from futures contracts. Long-term interest rates for the euro area, as well as short- and long-term interest rates for Poland and the UK are calculated using implicit forward swap rates, corrected for the spread between the 3-month interbank interest rate and the 3-month swap rate. In this forecast, the euro-area short-term rate is assumed to be at 1.33% and the long-term interest rates at 2.71% in 2011.

The outlook for oil prices is based on futures prices. The price per barrel of Brent crude oil is projected at 111.5 USD/barrel in 2011 (corresponding to 78.9 EUR/barrel). This would be 5.9 USD/barrel lower (or 4.1 EUR/barrel lower) than assumed in the spring 2011 forecast.

Global demand in 2011 has been revised downwards, following the downward revision to the GDP growth in the US and some Asian countries while most emerging economies continue to display robust growth. Global GDP growth, excluding the EU, is now forecast to decelerate to around 4% in 2011, about ½ pp. lower than expected in the spring forecast. Compared with 2010, world trade growth is set to halve in 2011, with growth in export and import volumes (excluding the EU) estimated at around 7% (down by ¼ pp. from the spring forecast).

### Acknowledgements

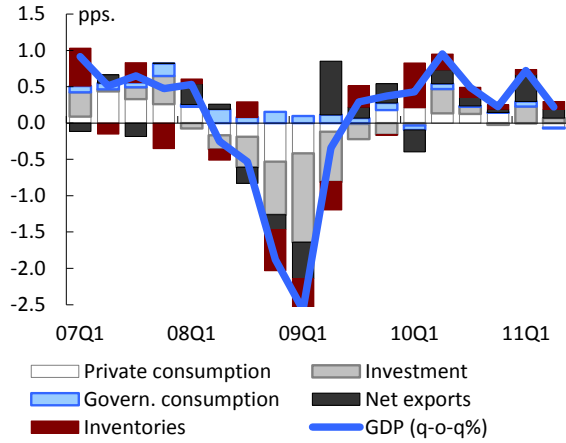
This report was prepared in the Directorate-General for Economic and Financial Affairs under the direction of Marco Buti, Director-General, Servaas Deroose, Deputy Director General and Elena Flores Gual, Director of the "Policy strategy, coordination and communication". Executive responsibilities were attached to Reinhard Felke, Head of Unit for "Forecasts and economic situation", Björn Döhring, Head of Sector for "Macro-economic forecasts & short-term economic developments" and the forecast coordinators, Laura González Cabanillas and Michał Narożny. The report benefited from contributions by Davide Balestra, Paolo Battaglia, Piotr Bogumił, Chris Bosma, Mateo Capó Servera, Mercedes De Miguel Cabeza, Oliver Dieckmann, Julien Genet, Laura González Cabanillas, Michael Grams, Javier Jareño Morago, Bettina Kromen, Karolina Leib, Anton Mangov, Olivia Mollen, Marco Montanari, Michał Narożny, Manuel Palazuelos Martínez, Magdalena Morgese Borys, Vito Ernesto Reitano, Adriana Reut, Valérie Rouxel-Laxton, Julien Rousselon, Thomas Springbett, Sara Tägtström and Ann-Louise Winther. Statistical and layout assistance was provided by Daniela Porubská. Language editing was provided by Chris Maxwell.





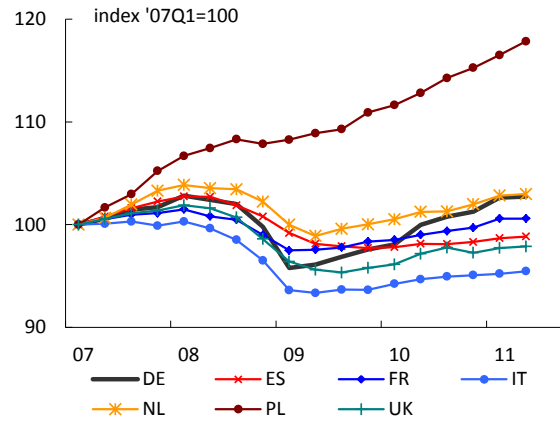
**ANNEX: SELECTED GRAPHS**

Graph A.1: Contributions to GDP growth in the EU



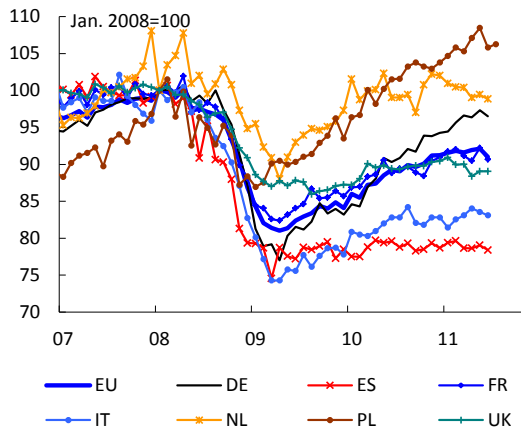
Source: European Commission

Graph A.2: GDP levels in selected Member States



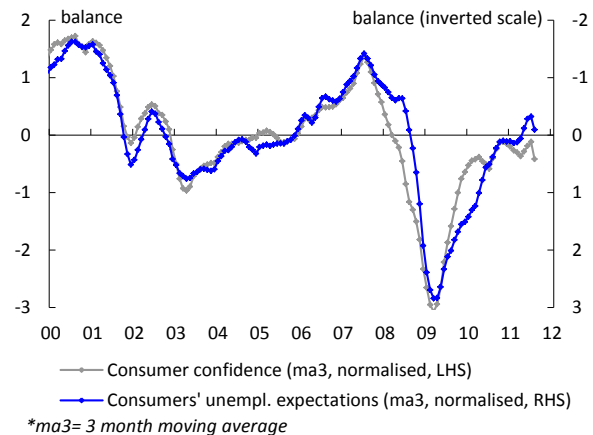
Source: European Commission

Graph A.3: Industrial production levels in the EU and selected Member States



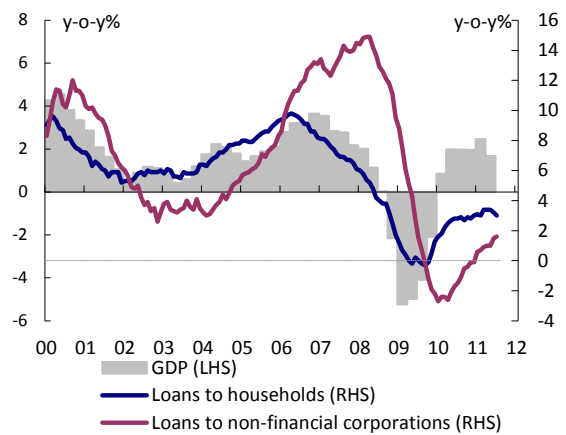
Source: European Commission

Graph A.4: Consumer confidence and unemployment expectations in the EU



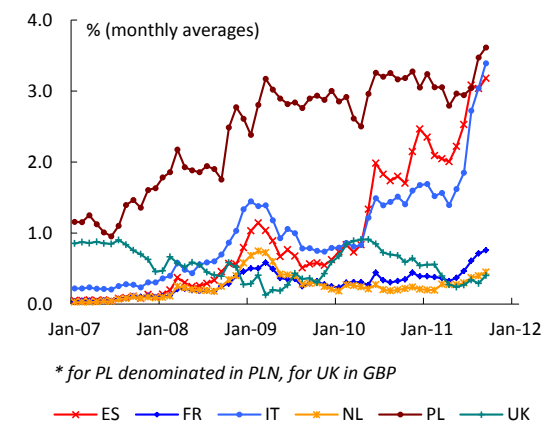
Source: European Commission

Graph A.5: Bank lending to households and non-financial corporations in the euro area



Source: European Commission and European Central Bank

Graph A.6: Sovereign-bond spreads in selected Member States



Source: Reuters and European Commission