Sharper-than-expected slowdown in Europe

The economic situation remains unusually uncertain. One year after the outbreak of the financial turmoil, the situation in the international financial system continues to be fragile with several key credit markets still severely disrupted. Moreover, commodity prices, especially energy and food prices, have soared since the last quarter of 2007, fuelling inflation and severely constraining the leeway for monetary policies, even if they have fallen back somewhat in recent weeks. Business and consumer confidence has declined significantly, to levels well below the long-term averages in many sectors and regions. Output has started to fall in several advanced economies, reinforced by a bust in the housing sector that is spreading more widely than expected earlier. Although growth has remained robust so far in emerging economies, a global economic slowdown is looming.

In the EU, GDP contracted by 0.1% in the second quarter of 2008 (and by 0.2% in the euro area). The drop in output is partly explained by a payback from unexpectedly strong growth in the first quarter, which was to a certain extent caused by temporary factors. However, in addition, soaring commodity prices, the deepening financial turmoil and a housing shock in several countries caused confidence to deteriorate, capital costs to increase further and consumer-price inflation to surge, thus putting a brake on domestic demand.

Looking ahead, recent soft and hard data point to a persistent weakness of economic activity in the EU. Although external economic conditions have improved somewhat in recent weeks and the labour market situation remains relatively favourable, adverse confidence effects, along with sharp corrections in housing and construction markets in some Member States, may increasingly take a toll.

Based on an update of the outlook for the seven largest EU economies, GDP growth for 2008 has been revised down to 1.4% in the EU and to 1.3 % in the euro area. The downward revision is relatively broad-based with significant revisions for the United Kingdom and Spain, while growth remains strong in Poland.

Consumer price inflation has continued to drift up in recent months, fuelled by high commodity prices. Inflation in 2008 is projected to average 3.8% in the EU and 3.6% in the euro area. However, with the impact of past increases in energy and food prices on the year-on-year rate of change in consumer prices declining in the coming months, inflation could be at a turning point. Future developments in commodity markets, as well as the capacity to contain second-round effects, will be key for the inflation outlook in the EU and the euro area.

A sharper global slowdown

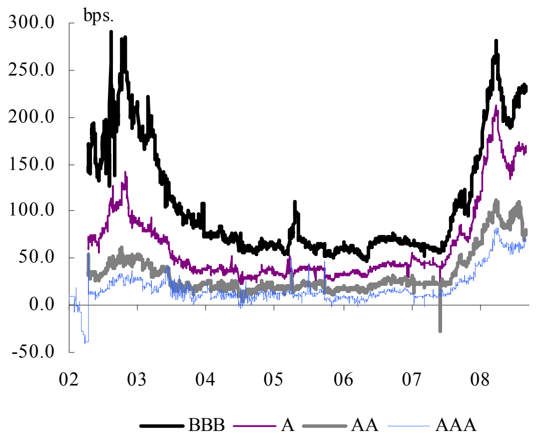
The global economic situation and outlook remain unusually uncertain. On the back of the protracted turmoil in the financial sector, soaring commodity prices and, for some countries, a bust in their housing sector, output in most advanced economies have started to fall in the second quarter.

In some cases, advanced economies appear to be close to a technical recession, while inflation is at a record high. Although emerging economies have, so far, weathered the global headwinds better, inflation and the fall in demand in OECD countries are starting to take a toll.

The financial turmoil entering a second year

The financial turmoil has now entered its second year. Overall, the situation remains fragile as losses continue to mount and confidence in key financial markets is not yet restored. Unsecured lending in interbank markets remains disrupted. Central banks have continued to respond to the turmoil by ensuring adequate liquidity in the banking system.

Graph 1: Corporate yield spreads in the euro area



After a brief recovery following the quick rescue of Bear Stearns earlier this year, sentiment in financial markets has deteriorated over the summer months. The outlook for a sharper-than-earlier-expected global economic slowdown in the second half of this year and beyond has raised concern that the financial turmoil may deepen further. In particular, a deceleration in real economic activity could amplify problems in the financial sector by decreasing the capacity of companies and households to service their debt-repayment obligations. This could lead to an increasing rate of loan delinquencies causing further bank losses, even for secured loans as asset valuation becomes more vulnerable to declines in growth and business sentiment. This, in turn, might cause banks to tighten their lending standards further, making it more difficult for companies to secure the necessary external finance. While the risk of such a vicious circle, often referred to as a "negative feedback loop", has increased, it remains a tail event.

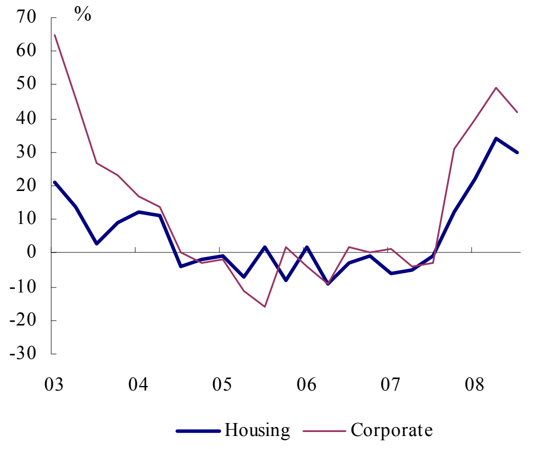
Concerns about financial market developments have also caused a renewed "flight to quality" among investors, with widening spreads over the summer between risk-free benchmark bond yields and yields on relatively risky investments. More recently, however, 3-month euro-area interbank spreads appear to have stabilised, albeit at a relatively high level.

Banks have been at the centre of the financial turmoil since the outset and the sector continues to experience serious problems. Globally, banks have recorded losses and write-downs of slightly above USD 500 billion (bn), of which about 170 bn has been reported by banks within the EU (and slightly more than 100 bn in the euro area) according to market analysts; and further losses are expected in the months ahead. To strengthen their balance sheets, banks have raised about USD 350 billion of new capital since the beginning of the turmoil. However, raising capital has become increasingly difficult in view of lower bank earnings due to higher financing costs and mounting credit write-downs.

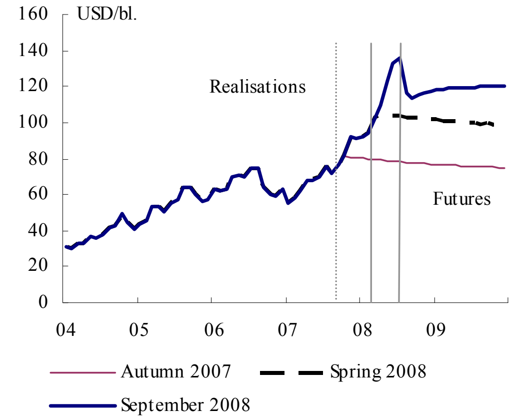
The decline in bank earnings has resulted in tighter lending standards and higher borrowing costs since the outset of the turmoil. According to the July 2008 bank-lending survey for the euro area, banks have tightened lending standards for the fourth consecutive quarter and plan to continue doing so in the third quarter of 2008. It should be noted that the net tightening remained stronger for large enterprises than for small and medium-sized enterprises (SMEs), presumably because bigger enterprises are more likely to be clients of large banks, which, in turn, have been so far more heavily affected by the financial turmoil. Banks tightened lending standards for consumer credit for the third consecutive quarter.

There is, however, no credit crunch in the EU or the euro area as a whole at present. The impact of tighter lending standards on actual bank lending has been very gradual. Bank lending to euro-area private sector is slowing (from 10.7% YoY in April to 9.4% in July). A slowdown of lending to households, which started before the outbreak of the turmoil, has been the main source of this deceleration. Falling house prices and reduced investor demand for asset-backed securities and covered bonds have led banks to reduce their exposures to the mortgage market. Notwithstanding tighter lending standards, bank lending to non-financial corporations remains strong, growing at 13.2% in the same period. The slowdown in credit aggregates appears to be due mainly to lower demand for loans, driven by traditional determinants (activity and interest rates), rather than to credit supply constraints.

Graph 2: Net tightening of bank lending standards



Graph 3: Oil price assumptions in the Commission's forecasts



Average oil prices remain high, in spite of recent decline

Oil prices are currently at least four times the levels of five years ago in US-dollars (USD) terms, and have at least tripled in euro terms. Sustained strong demand growth, particularly in emerging economies, together with the fact that demand is proving rather unresponsive to high oil prices are the main factors explaining high oil prices. In addition, oil producers have difficulties with maintaining an adequate level of supply. Taken together, these factors result in a tight oil market. Moreover, geopolitical and weather-related risks also increase uncertainty about supply.

A weaker outlook for global growth and a somewhat improved supply have allowed oil prices to decline in recent weeks. Prices have come down from a peak of 146 USD/bl. on 4 July to below 110 USD/bl. at the beginning of September, but spot and futures markets remain volatile.

Based on futures market prices, oil prices are assumed to average just above 114 USD/bl. in 2008, i.e. up by 13% compared with the spring forecast, see Graph 3.

Looking forward, in the short term, falling demand due to the worsening economic outlook and expected new production capacity should mitigate upward price pressure. Nevertheless, uncertainties will remain high, as demand in emerging markets remains relatively strong and there may be delays in bringing additional supply on-stream.

Is a global slowdown looming on the horizon?

GDP growth proved surprisingly strong in the first half of 2008 in most parts of the world. These positive outcomes, together with upward revisions to 2007 data, point to a slight upward revision of world growth (excl. the EU) for 2008 as a whole relative to the spring forecast.

Looking ahead, however, growth in the second half of 2008 is set to decelerate more markedly than expected in the spring, reflecting a delayed impact of the shocks. Although a full assessment of the outlook for 2009 will only be carried out in the next fully-fledged forecast in November 2008, these developments in the global economy seem to suggest a significant downward revision for 2009.

US economic activity, in particular, held up surprisingly well in the first half of 2008, following a small decline in the final quarter of 2007. GDP growth increased to 0.2% QoQ in Q1 and to 0.8% in Q2. An aggressive monetary easing over the past year, a large fiscal stimulus package in February and the dollar depreciation, which has brought about a strong improvement in net exports, have supported economic activity. Tax rebates were disbursed faster than expected and households seem to have spent a significant share of them already in the second quarter.

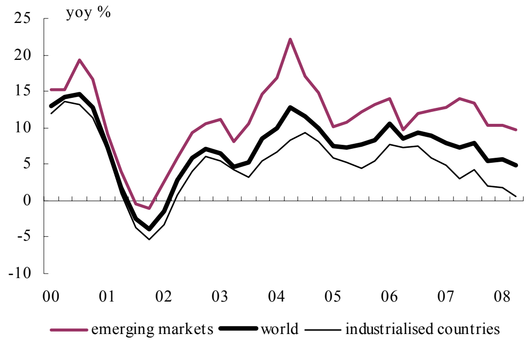
However, the fiscal stimulus is only temporary and its effect on GDP growth is expected to fade in the second half of the year. Although the annual growth rate for 2008 has risen, due to the strong performance in the first half of the year, the underlying growth momentum remains weak. Continued decline in house prices and a weakening of the labour market could depress consumer spending for an extended period. Although net exports should continue to provide some offset, GDP growth is expected to turn negative in the second half of 2008. Headline inflation, however, which has been driven up by surging energy prices recently, should fall substantially in the near term.

In other *advanced economies*, the global slowdown and the impact of high energy prices are increasingly being felt. In Japan, after an unexpectedly strong first quarter, GDP contracted by 0.6 percent in the second quarter, its worst quarterly performance in seven years, while industrial production has contracted for two consecutive quarters.

A relatively high dependence on imported energy and raw materials and a heavy reliance on manufacturing make Japan more vulnerable to high commodity prices and a global manufacturing slump. Nevertheless, a relatively healthy financial position of the corporate sector (incl. banks), low inventory levels in most manufacturing sectors and the recent downward correction in oil prices should help contain downside risks.

The Canadian economy, despite its sound macroeconomic fundamentals, is experiencing a growth slowdown due to falling US demand and a considerable appreciation of the Canadian dollar in recent years. Domestic demand, however, remains sturdy and core inflation low, which provide a good basis for a swift recovery.

Graph 4: Imports of goods by region



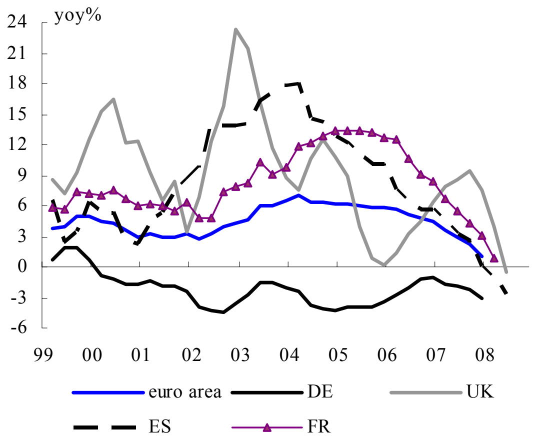
Source: CPB Netherlands Bureau for Economic Policy Analysis

Emerging economies contributed significantly to global growth (accounting for more than two-thirds in 2007 and in the first half of 2008), despite the weak performance of advanced economies. This may, however, change as the persistent slowdown in advanced economies has started to affect them.

In China, despite weaker exports due to sluggish global demand and a moderate appreciation of the renminbi, strong investment and consumption kept GDP growth high in the first half of 2008 (at 10.4% year-on-year). In most other emerging Asian countries, however, recent data point towards a marked deceleration of economic activity, led by a slowdown in export growth. In some cases, a tightening of monetary policy in response to higher energy and food prices and worsening consumer and business confidence are also weighing on domestic demand.

Several Latin American countries have continued to show relatively fast growth despite weakening global demand. Russia's economic performance has also remained strong, although industrial production is slowing and a reassessment of political risks has caused a partial reversal of capital inflows.

Graph 5: Real residential property prices



Housing is increasingly weighing on the outlook

The adverse effects of the global financial turmoil are reinforcing ongoing adjustments in housing markets. Housing markets in many countries, including several EU Member States, have been buoyant over the past decade, driven by low real interest rates and – in some countries – rapid demographic changes. Real residential property prices, however, started to decelerate in the middle of this decade in the euro area, and it is now reaching negative territory (Graph 5). Among the largest EU countries, Spain, France and the United Kingdom have experienced particularly sharp turnaround in their house markets.

A downturn in housing markets is likely to affect overall economic activity adversely. Private consumption demand may be muted by adverse wealth effects stemming from the decline in house prices. Wealth effects are usually thought to be less strong in the euro area than in the US, but can be important in countries with high home-ownership rates or a more widespread use of housing collateral for household credit, or when the size of house-price correction is substantial. At the same time, construction activity is suffering from the lower profitability of housing investment as well as the more limited availability of credit. Sharp construction downturns are already being observed in Spain, France and Ireland.

Looking ahead, the ongoing softening of housing markets is likely to persist. As a result, both housing investment and private consumption are likely to expand at subdued paces in countries that are affected.

Solid growth performance of the European economy has come to an end

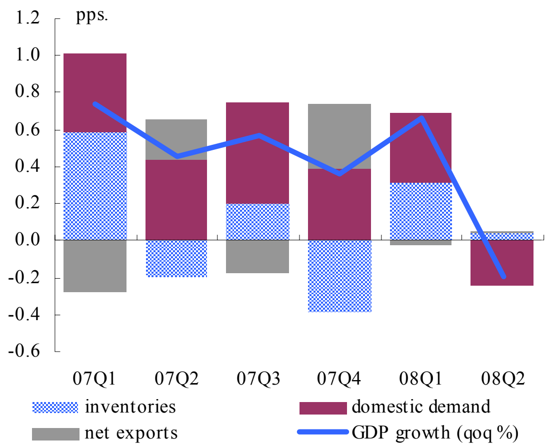
The EU economies entered 2008 on a sound note. Economic activity expanded above trend, at 0.7% (quarter-on-quarter (QoQ)) in the euro area and 0.6% in the EU. In view of the shocks facing the EU economy since mid-2007, this performance was above market expectations and the Commission's spring forecasts of 0.5% for the euro area.

The main driver of GDP growth in the first quarter was investment, particularly construction investment, which was boosted by the favourable winter weather in some countries. Equipment investment remained healthy, still benefiting from high levels of capacity utilisation and corporate profits. The performance of private consumption was more subdued, in line with the poor performance of retail sales and the deterioration of consumer confidence, undermined by tighter credit conditions and the acceleration of inflation, which squeezed households' disposable income.

Partly due to the unwinding of the temporary effects observed in the first quarter and partly due to the weakening of the underlying growth momentum, a correction was to be expected for the second quarter. Euro-area GDP declined, by 0.2% (QoQ), for the first time since the inception of the common currency area. Economic activity marginally declined also in the EU (-0.1%) but far below the Commission's spring forecasts (of +0.2% for the euro area and +0.3% for the EU).

Overall, the performance of GDP was somewhat less negative than expected by most market analysts, at the time of the release.

Graph 6: Contributions to GDP growth in the euro area



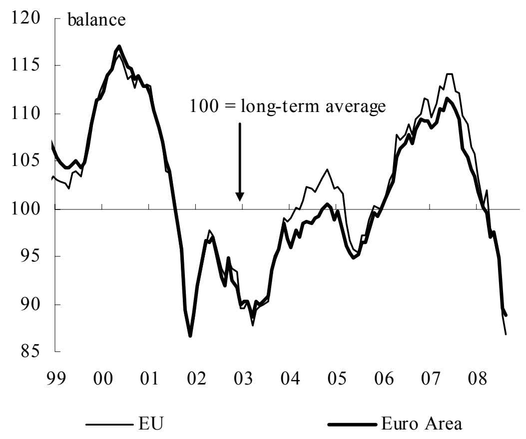
The decline in GDP in the euro area was entirely attributable to domestic demand factors in the second quarter of 2008. The poor performance of household consumption was mainly due to weak real incomes induced by the sharp increase in oil prices, some moderation in labour market conditions and by tighter lending standards for households. Gross fixed capital formation contracted because of the construction setback after the strong first quarter, but also as a result of a more subdued demand weighing on business confidence, particularly in the UK. Exports slowed substantially, likely reflecting the weakening of global demand and the past appreciation of the euro, which has diminished the competitiveness of euro-area producers.

Imports, however, also decelerated markedly mirroring the slowdown of domestic demand. As a result, the contribution of net exports to GDP growth was negligible in the second quarter.

Survey indicators points to a further weakening in the coming months

Looking ahead, a broad-based decline in survey indicators throughout the summer suggest a further weakening of the underlying growth momentum in the EU economy in the second half of 2008.

Graph 7: The Commission's economic sentiment indicator (s.a.)



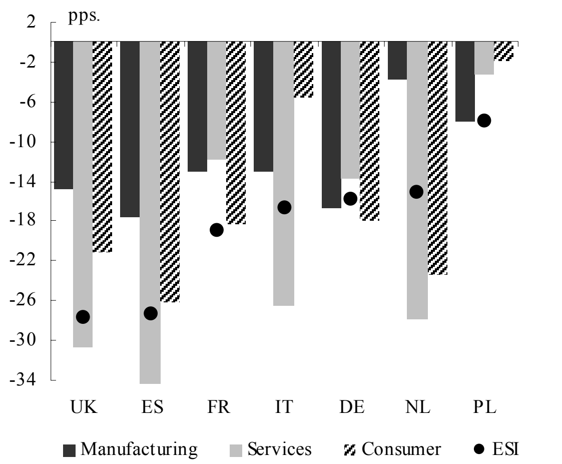
The European Commission's economic sentiment indicator continued to fall during the summer. It is now significantly below its long-term average for both the EU and the euro area. In August, economic sentiment in the EU reached its lowest level since December 1993.

The fall in confidence has spread to all sectors of the economy. In services, confidence was already below its long-term average at the time of the spring forecast, while confidence in manufacturing held up somewhat better. Since then, however, sentiment in manufacturing has deteriorated significantly. In August, industrial confidence reached its lowest level since May 2005.

High oil prices, a strong euro – in spite of recent declines – and the slowing global economy are the main factors that are weighing on business conditions. Capacity utilisation slipped again in the second quarter, but it is still well above its historical average.

The Purchasing Managers' Indices (PMI) broadly confirm this message. The overall PMI index continued on a declining trend during the summer, though there was a marginal improvement in August compared to July.

Graph 8: Change in Commission's key confidence indicators
(July 2007 - August 2008[1])



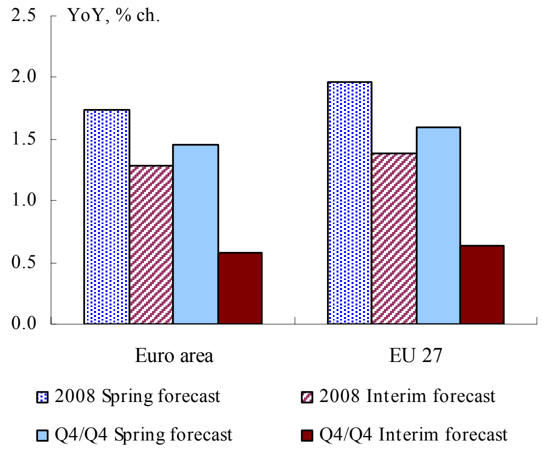
The fall in confidence indicators is by now broad-based across Member States by now. Since the outbreak of the financial turmoil last summer, the decline in the overall economic sentiment indicator has been particularly large in Spain and the UK. More recently, confidence has deteriorated sharply also in the other larger EU economies – except for Poland, where the deterioration has been moderate.

Like business confidence, consumer confidence has also fallen rapidly since July 2007 in most Member States.

Sizeable downward revisions for the EU and euro-area growth

Based on the individual updates for Germany, Spain, France, Italy, the Netherlands, Poland, and the United Kingdom (which are presented in greater detail in the country-specific sections below), GDP growth is expected to stall in the third quarter in both the euro area and the EU.

Graph 9: Comparison of spring and interim forecast



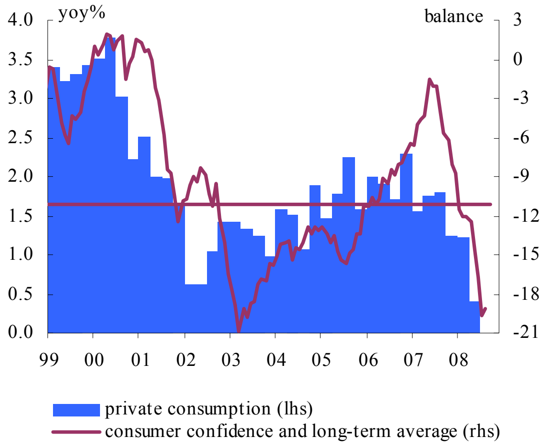
In the fourth quarter, reflecting a somewhat more benign outlook in the larger EU economies but Spain and the UK, economic activity is expected to expand slightly (by 0.1%) in both the euro area and the EU. Compared to the Commission's spring forecast (+0.4% for both quarters and regions), this represents a sizeable downward revision of the growth prospects.

The downward revision for annual growth in 2008 is due to data revisions for 2007, a weaker-than-expected second quarter, and the significantly weaker outlook for the second half. These factors taken together bring the annual growth rate for 2008 down to 1.3% in the euro area and 1.4% in the EU. This is a downward revision of the annual GDP growth by 0.4 pp. in the euro area and 0.6 pp. in the EU compared to the spring projections.

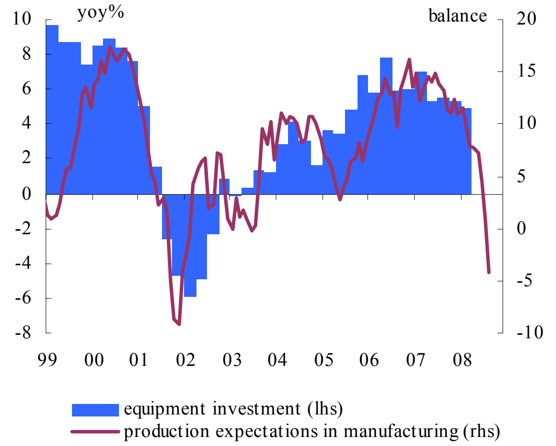
The revisions might look at first sight relatively limited in light of the significant worsening of the external conditions and their interactions with internal dynamics. In fact, given the stronger-than-expected first quarter, the annual averages mask the slower growth momentum from the second quarter onwards. The magnitude of the downward revisions becomes clearer when comparing the year-on-year growth rates for the fourth quarter that have been revised down by 0.9 pp. in the euro area and a full percentage point in the EU (see Graph 9).

[1] July 2008 for France.

Graph 10: Consumer confidence and private consumption



Graph 11: Equipment investment and production expectations



Domestic demand is foreseen to remain weak over the forecast horizon. Renewed consumption strength after a very meagre first half of the year would be needed to support economic activity at this juncture. In this regard, a continuation of the benign oil price dynamic observed in recent weeks and the projected easing of inflation in the fourth quarter would certainly help.

However, consumer and retail confidence has continued to deteriorate in the third quarter and the willingness to make major purchases was at a record low in August. In addition, the labour market, an important driving force of household spending in the EU is not sending a reassuring message.

Firms' employment expectations continued to soften in the first half of the year and the signs of weakness multiplied in the third quarter, particularly in the manufacturing sector. The number of unemployed is on the rise since March of this year in the euro area. As the labour market usually lags the economic cycle, even more subdued developments may be expected for the near future. Lastly, consumption of durable goods will be adversely affected by the downturn in the housing cycle and tighter financial conditions.

Investment in construction, particularly in those EU countries where house prices had risen significantly over the past decade, will suffer from the ongoing house-price correction. In these Member States, growth of bank lending for housing is decelerating and building permits have weakened considerably. Investment in equipment is expected to settle at lower levels than the recent buoyant trend. Most of the corporate sector is still enjoying good fundamentals and above long-term average levels of capacity utilisation. However, business confidence is declining markedly in both manufacturing and services. Faltering retail sales are adding to worries for the business sector. Production expectations in the manufacturing sector are currently at their lowest level since the third quarter of 2001. Stock depletion in the current subdued environment is likely to require a scaling back of production. In addition, the cost of capital has increased, bank lending to corporates is slowing and corporates' profitability, although still high, may be squeezed by the direct and indirect effects of the commodity price increases and the observed acceleration of unit labour costs. Overall, this points to a weakening of the outlook for investment in equipment.

Some of the external conditions have improved slightly in recent weeks. While remaining very high, oil prices have receded substantially from their mid-July peak. The nominal and effective exchange rates of the euro have depreciated over the summer, though they remain above their long-term average. However, the typical lags in the reaction of trade flows to exchange-rate movements may imply that the strong euro will continue to be a drag on euro-area exports for a while. In addition, as the most important factor for euro-area exports will remain the developments in external demand, the decelerating trend in world trade does not bode well for the export outlook. Import growth should also decelerate, reflecting the expected slowdown in domestic demand.

Inflation at a turning point?

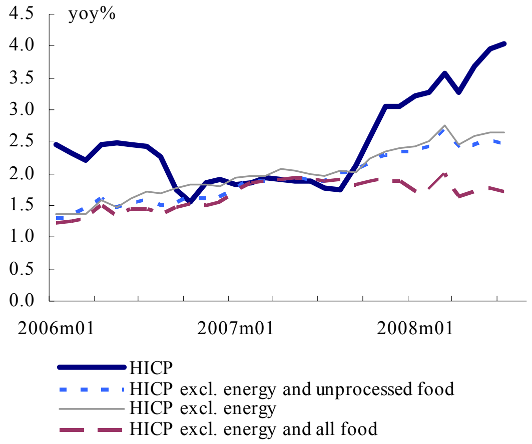
Consumer price inflation rose rapidly in the first half of 2008 in the euro area, to 3.5%, thus 0.2 pp. higher than in the spring forecast and up from 2.1% in 2007. In the EU it was 3.7%, 0.3 pp. higher than in the spring forecast and compared to 2.3% last year.

The headline inflation rate started to accelerate last autumn driven by soaring oil and food prices and reinforced by unfavourable base effects. It decelerated slightly in August, to 3.8%, in the euro area. Although it implied a certain decline from the record-high level reported in July (4.0%), it was running above the 2% threshold for the eleventh consecutive month.

The surge in oil prices has increased the contribution of the energy component to headline inflation from 0.1 pp. in July 2007 to 1.7 pps. one year later. Similarly, the recent unprecedented acceleration of world food commodity prices has inflated the contribution of the food component from 0.4 pp. to 1.2 pps. The contribution was larger for the processed than the unprocessed food component, unlike periods of agricultural price increases in the past.

Among the measures of underlying inflation, HICP inflation excluding energy and unprocessed food (core inflation) grew from 2.1% in the second half of 2007 to 2.5% in the first half of 2008. Similarly, HICP inflation excluding energy only increased from 2.2% to 2.6%. In contrast, HICP inflation excluding energy and all food decreased slightly from 1.9% to 1.8%.

Graph 12: Headline and core inflation, euro area

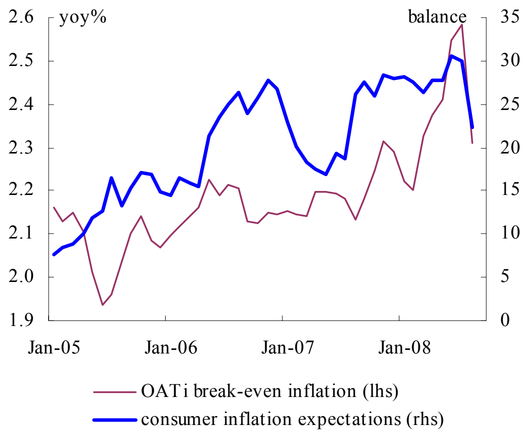


The increase in core inflation can be attributed mainly to processed food, where inflation increased from 1.9% in July 2007 to 7.2% one year later. Services inflation was stable, at 2.5% on average for the past 12 months, while inflation in non-energy industrial goods decreased from 1% in the second half of 2007 to ¾% in the first half of 2008.

Between July 2007 and July 2008, producer-price inflation surged from 1.9% to 9.0%, on the back of accelerating prices of energy and food input products, as well as rising wages. However, high profit margins and increased competition in some countries and sectors, together with a projected lower demand could put a lid on further price increases.

Turning to wage indicators, the growth of nominal compensation per employee remained subdued (at 2.2% YoY) until Q3 of 2007, but increased thereafter to 2.8% in Q4 and 2.9% in the first quarter of 2008. Total hourly labour costs grew at an annual rate of 3.3% in the first quarter of 2008 (up from 2.9% in Q4 last year). The annual growth rate of unit labour cost, which stood unchanged in the first quarter of 2008 at 2.4%, remains at its highest rate in five years. The rise in wage pressures can be largely attributed to tighter labour markets and continued high capacity utilisation, as well as the nominal wage indexation schemes existing in several countries.

Graph 13: Inflation expectations, euro area



According to various measures, consumers' and producers' inflationary expectations moderated somewhat in August, apparently affected by the movements in oil prices, whilst remaining at relatively elevated levels.

Looking ahead, the outlook for inflation in 2008 has been revised upwards, with sizeable upward revisions for all of the largest Member States. HICP inflation is now expected to average 3.6% in the euro area and 3.8% in the EU this year. This adds about half a percentage point to consumer price inflation in the euro area and about 0.2 pp. for the EU compared to the spring 2008 forecast.

The upward revision is mainly due to higher-than-expected inflation in the second quarter and more pronounced lagged effects of oil and food price increases registered since last autumn. Inflation is now expected to peak in the third quarter of 2008 at 4.2% in the EU and at 3.9% in the euro area, and decrease gradually thereafter.

The projected moderation in inflation results from the assumed reduced inflationary impulses from commodity prices, base effects turning favourable as last year's surge of oil and food prices gradually cease to impact the inflation rate, as well as expected lower demand and a cyclical downswing in the labour market.

So far, there has been only a limited evidence of second-round effects. However, the risk of such effects cannot be excluded, especially if the inflationary expectations were to become less well-anchored. Moreover, the oil market remains tight, despite the current easing of prices, and any renewed oil price hikes will worsen the inflation prospects in the EU.

Some signs of weakness also in the labour market and as regards public finances

The improvement in employment has weakened. The number of employed increased by 0.3% in Q4 in 2007 and Q1 this year in both the euro area and in the EU, implying a certain slowdown compared to previous quarters. The year-on-year growth in employment declined to 1.6% in Q1 in both the euro area and in the EU.

The rate of unemployment has remained broadly unchanged in the past few months in both regions, following the continuous declines during the previous three years. In July, the unemployment rate stood at 7.3% in the euro area and at 6.8% in the EU. However, increased divergences across EU countries have emerged, with a rapid deterioration in labour-market developments in Spain counteracted by continued slight improvements in many other Member States, including Germany, France and Poland.

Employment developments can usually be expected to follow GDP growth with a lag. In its spring forecast, the Commission projected employment growth at 0.8–0.9% in 2008. In light of the current downward revisions of the growth projection, the outlook for employment should also turn more unfavourable. For the near term, this view is supported by the marked recent deterioration in the survey data concerning employment expectations of businesses and households.

Turning to public finances, the information available suggests that the 2008 budgetary position in the EU and the euro area could also be worse than expected in the spring forecast. This is to a significant degree due to lower output growth and its impact on tax revenues. In a few countries, expansionary fiscal measures also play a role. Obviously, in countries with a rapid economic downturn and where the slowdown is combined with composition effects – e.g. due to the end of tax-rich domestically-driven demand growth or the reversal of an asset boom – the deterioration in public finances is more pronounced, while in countries where economic activity has upheld reasonably well, budgetary developments are broadly in line with expectations.

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

Not only external forces behind the sharper-than-expected downturn in growth and up-tick in inflation

When now updating the outlook for GDP and inflation this year, it is clear that the risks to growth and inflation highlighted in our spring forecast in April 2008 have mostly materialised. In particular, commodity prices continued to soar, well beyond the assumptions on which the spring forecast was based.[2] Oil prices averaged 122 USD per barrel in the second quarter of 2008, compared with the 104 USD assumed in the forecast (Graph 3). Other commodity prices, such as agricultural commodity prices, remained elevated in the second quarter of 2008. Some weather-related factors may have played a role in the case of food prices.

Higher commodity prices fuelled inflation, thereby putting a brake on real disposable income and private consumption growth.

Moreover, the turmoil in the financial markets has proven more persistent than assumed in the spring. Sentiment in financial markets has significantly deteriorated over the summer months, following a brief recovery earlier this year. The need for a government rescue package for the US mortgage market-makers Fannie Mae and Freddie Mac was a clear warning that the turmoil was far from being over. Furthermore, a sharper-than-earlier-expected global economic slowdown has also raised concerns that the financial distress may deepen and widen further.

The deterioration in external conditions (including commodity prices) interacted with lower domestic growth dynamics to result in the weak performance noted in the second quarter in both the EU and the euro area. Other indicators, such as industrial production, orders and retail sales, also point to a deceleration in the underlying growth momentum in both regions in recent months. All this suggests that the external headwinds not only had a direct adverse impact on inflation and capital costs, but also an indirect one on confidence that, in turn, significantly weakened domestic demand.

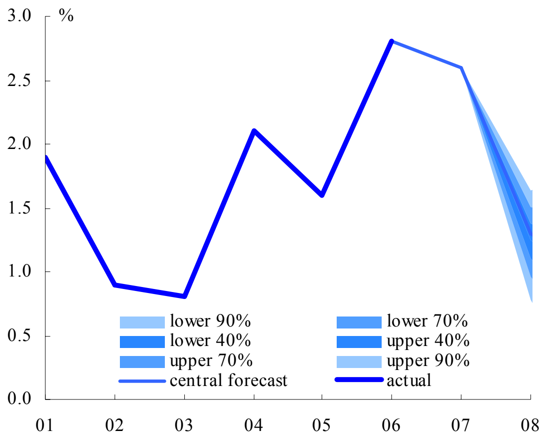
Looking forward, a full assessment of the risks will only be carried out in our next fully-fledged forecast scheduled for early November. Nevertheless, based on the partial assessment carried out in the interim forecast, activity is expected to remain subdued and downside risks prevail.

Turning to the risks for the current update more explicitly and regarding the *external environment*, developments in commodity and financial markets will continue to be the key factors shaping the growth outlook and downside risks to our assumptions in this regard are apparent. Although, the US economy has outperformed earlier expectations for the first half of this year, this was partly attributable to fiscal stimulus that is expected to have a temporary effect on growth. At the same time, the fall-out from the housing downturn, the credit crunch and higher energy prices is unlikely to have fully materialised so far. Developments in this regards remain a source of considerable downside risk.

As to *internal factors*, some of the EU and euro-area economies are also affected by domestic imbalances and/or by their capacity to adapt in view of their exposure to the financial turmoil and surging commodity prices. While there are specific circumstances in each country, significant corrections in the construction sector in combination with a sizeable external imbalance (such as Spain) or with a large and exposed financial sector (i.e. the United Kingdom), point to non-negligible tail risks in some countries.

[2] The external assumptions in the Commission's forecasts are derived from market expectations at the time of the forecast, using a 10-day average to filter out market volatility. See box on technical background to the interim forecast on page 20 for a detailed description of the current set of assumptions.

Graph 14: Risks to the euro-area growth outlook



On the upside, growth in the US could rebound sooner and/or more strongly than expected. The resilience and underlying growth of emerging markets may also surprise positively. Within the EU economies, the labour market performance in some economies, especially Germany, has proved stronger than expected, which could, in combination with a falling inflation rate, provide a greater support to household consumption than assumed in our current forecast. Finally, commodity prices could also decline more rapidly than futures suggest, easing the inflationary pressures.

Graph 14 quantifies these risks in terms of possible deviation of output growth from the main scenario. The graph shows the impact various combinations of risks could have on euro-area GDP growth (weighted by their probability). The relatively narrow fan, at the current juncture, is explained by the fact that there are only two quarters remaining in 2008, while the fan chart refers to the annual growth rate.

At a 90% confidence interval, GDP growth in the euro area could be 0.2 pp. lower in 2008 relative to the central scenario if downside risks materialise. But growth could also be up to 0.1 pp. higher if the upside risks to the outlook were to materialise.

As regards *the inflation outlook*, the risks identified in the spring forecast of a further up-tick in commodity prices have materialised and have had a first-round adverse impact on consumer price inflation.

Moreover, some indirect effects have also been observed, as evidenced by the acceleration in inflation in some energy and food-related services, such as transportation. While the expected slowing of employment growth and competitive pressures from globalisation could limit the overall acceleration of wage demand, still relatively tight labour markets in some sectors and/or Member States, as well as the use of wage-indexation in others, may lead to higher wage growth than assumed.

On the other hand, in view of a general moderation of growth, domestic inflationary pressures should ease, supported by favourable base effects, particularly if commodity prices were to decline faster than futures prices currently suggest.

Overall, the economic situation and outlook remains unusually uncertain – especially for periods beyond the forecast horizon of this interim forecast. Risks to the growth outlook remain more on the downside, while risks to the inflation outlook more on the upside as the euro area might witness some second-round effects on inflation in the rest of the year, although there is no evidence of any wide-spread effects so far.

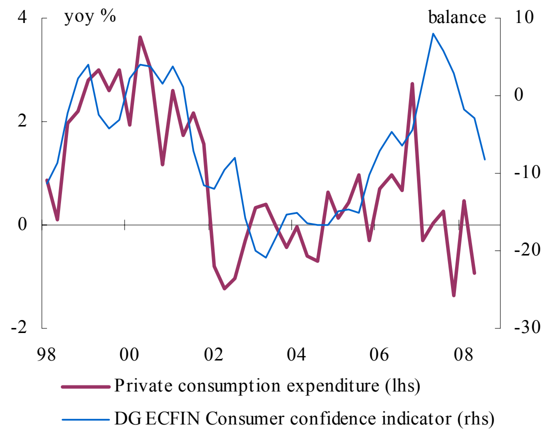
Growth and inflation prospects in the seven largest EU economies

1. Germany – marked slowdown despite sound fundamentals

Real GDP in Germany decreased by 0.5% in the second quarter, having grown by an exceptionally strong 1.3% in the first quarter. Overall, economic activity thus remained fairly resilient in the first half of the year. It even expanded slightly more strongly than expected in the spring forecast, despite a deteriorating global economic environment. The contraction in the second quarter reflected mainly weaker gross fixed capital formation – largely due to a reversal of construction activity that was boosted by the favourable weather conditions in the first quarter – and sustained sluggish private consumption, which has been declining for three consecutive quarters. At the same time, net exports continued to contribute positively to growth, even though this was mainly due to a deceleration in imports that more than compensated for a simultaneous drop in export growth.

Although economic fundamentals remain strong, the growth outlook for the second half of this year has clearly deteriorated as higher inflation and the global economic slowdown are taking their toll. Robust employment growth, falling unemployment and rising wages have been insufficient so far to give any major boost to private consumption, with food and energy price hikes constraining disposable income and weighing heavily on consumer confidence, which is weakening rapidly. While price competitiveness remains strong, exports are likely to be held back by lower growth in major trading partners. Moreover, despite the continued sound profit situation and the strong balance-sheet position of the corporate sector, which also implies a relatively limited impact of tightened credit conditions on private sector investment, the marked deterioration in business confidence during recent months is set to dampen investment growth. Taking into account the recent, significant decline in industrial production, a further contraction of economic activity in the third quarter cannot be excluded. However, with inflationary pressures gradually receding in the second half of the year, a recovery of private consumption from its current low levels is expected to contribute to growth picking up again in the fourth quarter.

Graph 15: Germany - consumer confidence and private consumption



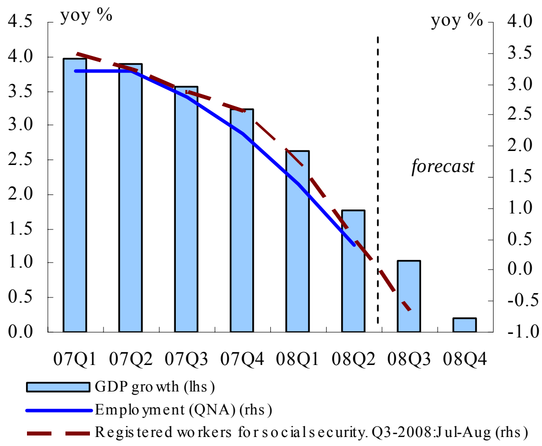
On the back of rising food and energy prices, annual inflation peaked at 3.5% in July 2008. Due to base effects and with little evidence of any second-round effects so far, this rate is expected to come down gradually until the end of the year to well below 3%.

2. Spain – a sharp worsening of economic prospects

Economic activity in Spain is forecast to slow down to around 1½% in 2008, ¾ of a percentage point lower than the spring forecast. This sharp slowdown is mainly explained by the contraction of the housing sector on the economy which has been aggravated by the persistence of the turmoil in the financial sector and the higher than expected inflation stemming from higher oil prices. The Spanish economy's double-digit current-account deficit, together with higher oil dependence than other European economies, are reinforcing the effect of the shocks on its economic activity.

The moderation in growth in annual terms mirrors a contraction of domestic demand during the second half off the year in all components with the exception of public consumption. Private consumption alone, due to its high share of GDP, is largely responsible for the lower economic expansion overall and is in line with developments of its economic fundamentals. Stagnating employment creation, mainly as a result of the contraction of the construction sector, and additional inflationary pressures are bringing about a deceleration of households' real disposable income. Moreover, access to credit for consumption, which in normal circumstances would partially alleviate a slowing growth of real disposable income, seems to be becoming more difficult as financial standards tighten. Likewise, investment is expected to decline during the second half of 2008 as a result of both the ongoing adjustment of the construction sector, which already started last year, and a weaker investment in equipment on reflecting worsened business expectations. Overall, GDP is projected to decline by 0.1% and 0.3% in Q3 and Q4 respectively.

Graph 16: Spain - employment and GDP growth



Concerning the external sector, the growth contribution of net exports is expected to turn positive in 2008. While imports are forecast to slow down in line with the moderation in domestic demand, exports would maintain a relatively good performance, in spite of the projected deceleration among the main export partners, as sluggish domestic demand seems to be spurring Spanish exporters to open up new foreign markets.

Inflation rose sharply, to 4.7%, in the second quarter of 2008. This is 0.6 of a percentage point above the spring forecast. The inflationary rebound is mainly explained by the increases in energy and food prices. The inflation differential vis-à-vis the euro area has widened during the last quarters, rising from about ½ percentage point in summer 2007 to cross the threshold of one percentage point. In 2008, even though inflation is projected to decline by the end of the year to around 4%, the price increase for the year as a whole is not expected to depart substantially from the figure of 4½%. The existence of wage indexation clauses raises the risk of persistence of inflationary pressures, although second-round effects are not evident so far.

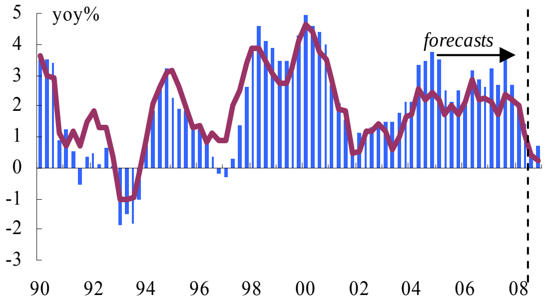
3. France – growth stalling

The French economy lost momentum in the first half of 2008. GDP grew by 0.4% in Q1, as forecasted in the spring, but contracted sharply in Q2, by 0.3%, the weakest performance since the fourth quarter of 2001. The disappointing performance in the second quarter largely reflects the unexpected scope of the decline in investment and the very negative impact on growth of net trade in line with the contraction of the largest European economies, while private consumption, the traditional main engine of growth provided only a limited support for economic activity.

Real GDP is expected to be almost flat in the second half of 2008, resulting in an annual growth rate of 1.0%, i.e. around half a percentage point lower than projected in the spring forecast. The available indicators for economic activity are rather negative. In both the services and the manufacturing sectors, the PMI indicators have fallen slightly below the critical threshold of stagnating activity, while in the construction sector the sentiment indicator seems to have stabilised at a low level in July. On the demand side, the deceleration in foreign demand, associated with a relatively strong euro (despite its more recent decline), and still unfavourable cost competitiveness, will continue to negatively affect export growth. Private consumption will remain subdued as households disposable income will be dampened by still-high inflation in Q3. In addition, the deterioration in labour market conditions, noticeable in the levelling off of the unemployment rate at 7.6% in Q2 (after declining for two years), will not help improve the consumer confidence, which was at a historically low level in July. Investment is expected to put a drag on growth, as in Q2. Both productive and residential investment would suffer from the tightening of credit conditions and the growing credit cost (rises in mortgage interest rates and in interest rates to corporations), as well as from low demand expectations. In particular, residential investment is likely to contract again in the coming quarters in view of the limited number of housing starts. All in all, GDP will, at best, stagnate in the third quarter of 2008.

For the fourth quarter, GDP is projected to increase by 0.1%, supported by slightly stronger private consumption, which will benefit from lower inflationary pressures and some positive impact from measures adopted at the beginning of 2008 to support purchasing power.

Graph 17: France - GDP and domestic demand growth



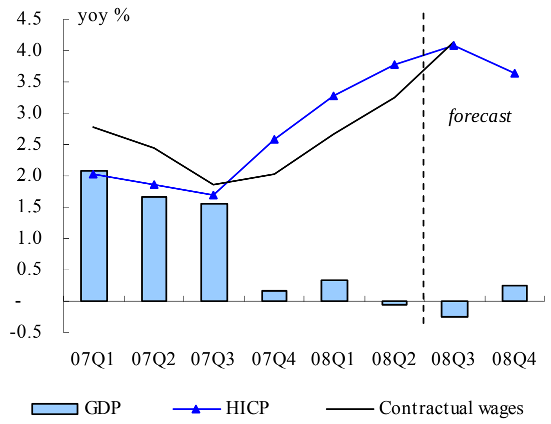
Inflation in 2008 is expected to turn out at 3.5%, around half a percentage point higher than in the spring forecast, due to the acceleration of prices in the second quarter (+3.7% YoY) and the historical peak recorded in June and July (+4.0% YoY for each month). The main sources for the sustained high level of headline consumer prices were the surges in food and energy inflation in the second quarter. Inflation should remain close to 4% in the third quarter of 2008 and then ease to reach 3.3% in the fourth quarter, on the assumption of broadly stable oil prices and due to a gradual reversal of base effects. In addition, so far there is no evidence of second round effects, apart from the traditional annual indexation of the minimum wage on inflation.

4. Italy – economic growth at a standstill

A marked slowdown of the Italian economy has been under way since mid-2007 and economic activity entered 2008 on a negative note. After the expected rebound in the first quarter, to 0.5% QoQ, real GDP is estimated to have contracted again by 0.3% QoQ in the second quarter. The outcome for the first half of this year is thus somewhat lower than in the Commission's spring forecast. For the coming months, business confidence indicators for both the services and the manufacturing sectors suggest that economic activity remains subdued. In the current quarter, real GDP is forecast to stay flat QoQ (but negative YoY) and to increase only marginally in the final quarter. Economic activity in 2008 as a whole is expected to grow by 0.1% only. This represents a downward revision of the already weak growth forecast in spring of 0.5% and implies no growth impulse into 2009.

The stagnation of the economy mainly reflects the evolution of domestic demand. Under the impact of accelerating prices and negative wealth effects, private consumption has been lacklustre since the final quarter of 2007. It is expected to resume slightly in the final months of this year as inflation declines. As a consequence of the reduced demand and profitability as well as tighter financial conditions, firms have scaled back their investment plans. Residential investment is also bound to slow down as loans for house purchases have seen a sharp deceleration. As for the external sector, imports are contracting in line with domestic demand developments, while exports are slowing down after the rebound recorded in the first quarter of the year. Prospects for the coming months remain unfavourable under deteriorating competitiveness and slowing world demand. Regaining cost competitiveness remains a challenge.

Graph 18: Italy - real GDP growth, inflation and contractual wages



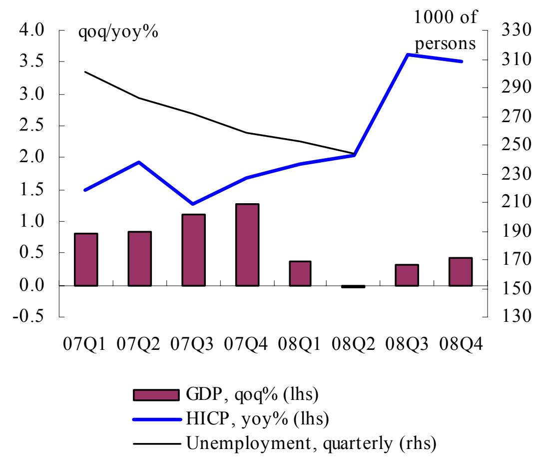
After reaching 3.8% in the second quarter, inflation is estimated to have peaked at around 4% in the third quarter. Under the assumption of lower energy prices, inflation should decelerate in the fourth quarter. Overall, year-on-year inflation in 2008 is expected to average 3.7%. However, accelerating domestic input prices could weigh on the diffusion and duration of inflationary pressures. Recent sizeable increases in wages despite low productivity growth, combined with still-limited competition in the non-tradable sector, may hamper a rapid decline of inflation.

5. The Netherlands – moderate growth in a cooling global environment

In the course of the first half of 2008, economic activity slowed down considerably. After a robust QoQ increase of 0.4% in the first quarter, QoQ growth was flat in the second quarter, which is the lowest quarterly growth since the beginning of 2005. The main factor explaining this poor growth performance was a downward correction of investment, which had expanded strongly in the first quarter, linked to some large incidental one-offs such as the purchase of airplanes; overall investment surprised on the positive side as it rose by 4.5% in the first half, whereas net exports provided a negative contribution to growth of 0.7%, which reflects the sensitivity of the Dutch economy to the economic slowdown, especially in the euro area.

In the second half of the year, GDP is expected to grow moderately, with quarterly growth of 0.3% and 0.4% in the third and fourth quarters respectively. Government expenditure is essentially driving growth. After a flat first half, it is expected to catch up also in view of a spending increase decided in the Spring memorandum. Private consumption growth is expected to be subdued, as high energy prices and an increase in indirect taxes in July have a negative impact on households' real disposable income. Furthermore, the financial turmoil and the international economic slowdown seem to be having a large negative impact on consumer confidence, which is currently at a very low point. As for investment, despite higher-than-expected growth in the first half of the year, the underlying trend is weakening. There will be some downward pressure from an expected slowdown of demand combined with tightening credit conditions.

Graph 19: the Netherlands - GDP growth, inflation and unemployment rate



The labour market still remains tight, with a very low rate of unemployment of around 3% (the lowest in the EU), and a high level of unfilled job vacancies. Despite this tightness, the latest round of wage bargaining concluded with moderate pay rises, and this could also be the case for the rest of the year, in view of the recent withdrawal of the VAT increase originally planned by the government for early 2009. Inflation is expected to peak in the third quarter, especially for energy and unprocessed food, and also in view of the increase in indirect taxes in July. The decline of the price of oil as from July is likely to imply a decrease in inflation in the fourth quarter.

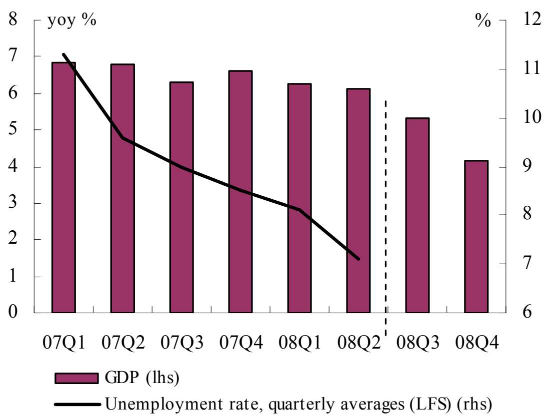
6. Poland – still robust growth in spite of worsening external conditions

Economic activity continued to be strong in the second quarter of 2008. GDP growth is estimated to have reached 1½% quarter-on-quarter, about 0.4 percentage point higher than in the Commission services' spring forecast. The positive growth surprise was due to continued strong private consumption and a less negative contribution of net exports. GDP growth is expected to weaken to around ⅔ quarter-on-quarter during the remainder of the year.

For 2008 as a whole, GDP is expected to grow by 5.4 %, which is ¼ percentage point higher than in the spring forecast. This follows from the better-than-expected result in the first half of 2008.

Domestic demand will continue to be the main driver of growth, with a key role for private consumption and gross fixed capital formation. Lower external demand due to slower growth in the EU and appreciation of the Polish currency will, however, slow down the Polish economy in the second half of the year.

Graph 20: Poland - quarterly GDP growth and unemployment rate



Consumption growth is being supported by rising nominal wages caused by a tight labour market. Between the first and second quarter of 2008, the employment rate increased by almost 1 percentage point and the unemployment rate was reduced correspondingly to 7.1%, which means nearly 150,000 people found a job. The improvement is expected to continue, albeit at a much slower pace due to emerging skill mismatches and a worsening economic situation.

After reaching 4.3% year-on-year in the second quarter of 2008, inflation is set to peak at around 4 ¾% in the third quarter on the back of strong wage demands, higher fuel prices and base effects from the previous year. Furthermore, expected hikes in energy utility prices will put pressure on inflation in the fourth quarter. Thus, inflation for 2008 has been revised upwards compared to the spring forecast from 4.3% to 4.5%.

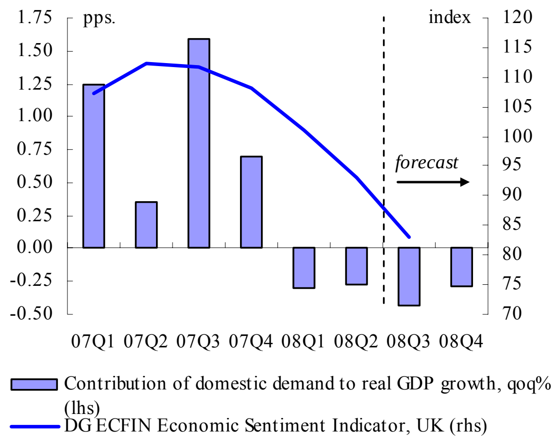
7. The United Kingdom – domestic demand contracts as economy comes to a standstill

In the first half of 2008 economic activity in the UK slowed rapidly. In the first quarter growth of real GDP halved to 0.3% QoQ and in the second came to a standstill; after annual growth of 3.1% in 2007, this amounted to a slowdown in year-on-year growth from 2.3% in the first quarter to 1.4% in the second. In both quarters domestic demand contracted, subtracting 0.3% points respectively from quarterly growth. Consumer spending remained robust in the first quarter but dipped slightly in the second. Fixed investment contracted markedly in both quarters, particularly in the second, thereby substantially dampening growth. A sizeable rebound in inventories compensated for the investment weakness in the second quarter. Imports fell appreciably throughout the first half, against the background of broadly stable exports. The labour market began to turn: overall employment fell marginally and unemployment increased somewhat in the second quarter. Emerging perceptions of the UK's sharply weaker performance, given its greater exposure to the ongoing weakness in both credit and equity markets, contributed to a further depreciation of the pound sterling. Between February and September this was around 7% on a nominal effective exchange rate basis, bringing total sterling depreciation to 15% since July 2007. UK policy rates were cut by a cumulative 50 basis points in February and April, but not further, given the sharply worsened inflation performance.

GDP growth in the second half of 2008 is expected to turn negative, with output contracting slightly in each quarter, driven by a continued weakening of domestic demand. Private consumption is likely to fall somewhat due to the combined impact of tighter credit conditions for household borrowing, weakening housing and labour markets and inflation-induced stagnation in real disposable income. Investment levels are expected to weaken further on account of still-tight credit conditions, an uncertain business environment, both domestic and external, as well as a negative housing market outlook. While the lower exchange rate is likely to support export growth in the medium term, in the short-term weakness in overseas markets will constrain output gains from this source.

Overall, GDP growth for the entire year is forecast to fall to 1.1%, well under half that of the preceding year and more than ½% point weaker than expected in the Commission services' spring 2008 forecast.

Graph 21: the United Kingdom – domestic demand and economic sentiment indicator



The year-on-year HICP inflation rate in July 2008 rose sharply to 4.4%, up from 3.8% in June. Inflation is expected to peak in the third quarter 2008 due to higher gas and electricity prices, and will be lifted by base effects from the previous year. These inflationary pressures are also evident in high producer price inflation, which reached 10.2% in July 2008, the highest rate in over 25 years. Average HICP inflation in 2008 is expected to be 3.5%, somewhat higher than forecast in the spring, although inflationary pressures are expected to be progressively mitigated by demand weakness.

Table 1: Real GDP growth

	Quarterly GDP forecast (%, quarter-on-quarter) 2008				Annual GDP forecast (%, year-on-year) 2008	
	2008/1	2008/2	2008/3	2008/4	*Spring forecast April 2008*	Interim forecast Sep. 2008
Germany	1.3	-0.5	-0.2	0.2	*1.8*	1.8
Spain	0.3	0.1	-0.1	-0.3	*2.2*	1.4
France	0.4	-0.3	0.0	0.1	*1.6*	1.0
Italy	0.5	-0.3	0.0	0.1	*0.5*	0.1
Netherlands	0.4	0.0	0.3	0.4	*2.6*	2.2
Euro area	**0.7**	**-0.2**	**0.0**	**0.1**	***1.7***	**1.3**
Poland	1.4	1.5	0.7	0.6	*5.3*	5.4
United Kingdom	0.3	0.0	-0.2	-0.2	*1.7*	1.1
EU27	**0.6**	**-0.1**	**0.0**	**0.1**	***2.0***	**1.4**

Table 2: Consumer price inflation

	Quarterly HICP forecast (%, year-on-year) 2008				Annual HICP forecast (%, year-on-year) 2008	
	2008/1	2008/2	2008/3	2008/4	*Spring forecast April 2008*	Interim forecast Sept. 2008
Germany	3.1	3.0	3.3	2.7	*2.9*	3.0
Spain	4.5	4.7	5.0	4.0	*3.8*	4.5
France	3.3	3.7	3.8	3.3	*3.0*	3.5
Italy	3.3	3.8	4.1	3.6	*3.0*	3.7
Netherlands	1.9	2.0	3.6	3.5	*2.7*	2.8
Euro area	**3.4**	**3.6**	**3.9**	**3.4**	***3.1***	**3.6**
Poland	4.5	4.3	4.8	4.4	*4.3*	4.5
United Kingdom	2.4	3.4	4.4	4.3	*2.8*	3.6
EU27	**3.6**	**3.9**	**4.2**	**3.7**	***3.6***	**3.8**

*Box: **Technical background to the interim forecast***

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 3 November 2008). This interim forecast updates the outlook of the spring 2008 economic forecast of 28 April (http://ec.europa.eu/economy_finance/publications/specpub_list9253.htm). The cut-off date for this interim forecast to take new information on board was 4 September 2008.

The interim forecast updates the outlook for seven 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) as regards real GDP growth and HICP inflation for the current year. These updates are prepared using indicator-based forecasting models 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. These countries account for 80% of the European Union and almost 85% of the euro area in terms of nominal GDP. The outlook for the smaller Member States, which have tended to grow faster than the larger ones, have not been 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 revision for the smaller Member States is equal to that 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 is presented in unadjusted form. As 2008 is a leap year, the working day adjustment is likely to be positive, estimated at 0.1 pp. for the euro area.

External conditions

This forecast is based on a set of external assumptions. These assumptions are based on market expectations at the time of the forecast. To shield the assumptions from possible volatility during one specific trading day, averages from a 10-day reference period have been used for all technical assumptions.

The technical 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 3 September, implying an annual average of USD/EUR of 1.51.

Interest rates assumptions are, since spring 2007, market-based instead of expert-based. These assumptions should be interpreted with caution, as market-based assumptions do not only reflect policy rate expectations, but also liquidity conditions in this period of market uncertainty. Short-term interest rates for the euro area are derived from future 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. As a result, the short-term rate is at 4.8% and the long-term interest rates at 4.1% in 2008 for the euro area.

The outlook for oil prices is based on futures prices. The price for a barrel of Brent crude oil is projected at 114.1 USD/barrel in 2008 (corresponding to 75.6 EUR/barrel). This would be 12.9 USD/barrel (or 10.3 EUR/barrel) higher than assumed in the spring 2008 forecast, reflecting maintained strong demand from e.g. emerging markets and geopolitical uncertainties.

Global demand in 2008 is revised downwards, following the recent distress in the financial markets and a weaker outlook for the US. However, a still relatively strong growth in emerging markets, especially China, limits the overall easing of global growth. Global GDP growth is thus forecast to slow to 3.7% in 2008 (down from 4.8% in 2007).

World trade is also set to slow in 2008, with growth in export and import volumes of goods estimated at below 6%.