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Economic growth revised slightly in 2007, with downside risks increasing

The European economies started 2007 on a strong note with GDP expanding by 0.7% quarter-on-quarter (q-o-q) in both the euro area and the EU, driven, above all, by buoyant investment. Real GDP growth eased to 0.3% q-o-q in Q2 in the euro area (0.5% in the EU), in contrast to survey data still pointing to robust growth.

A rapid re-pricing of risk following problems originating in the US sub-prime mortgage market triggered a crisis in the financial markets this summer. The global economy was generally sound ahead of the recent turbulence and, thus, in a relatively good position to weather the current turmoil, at least if it proves to be short-lived. Albeit Central Banks intervention to inject liquidity has helped to stabilise the market, the turmoil has tilted the balance of risks clearly to the downside. This is particularly the case for the US, where housing demand fell sharply.

Against this background, the update of the outlook for the seven largest EU economies indicates that, although activity will be revised down slightly in the third and fourth quarter for the euro area and in Q4 for the EU, the positive outlook for the EU from the spring forecast is largely maintained. This follows from several factors: first, the global environment remains relatively supportive; second, even if survey data weakened somewhat, they remain at high levels mirroring generally sound fundamentals; third, the favourable developments in the labour markets are expected to underpin private consumption.

Overall, GDP growth is revised down marginally to 2.5% in the euro area and 2.8% in the EU this year (-0.1 pp. compared to the spring forecast). This reflects the weaker-than-expected Q2 and the downward revisions of Q3 and Q4, partly offset by the impact of a somewhat stronger-than-expected Q1.

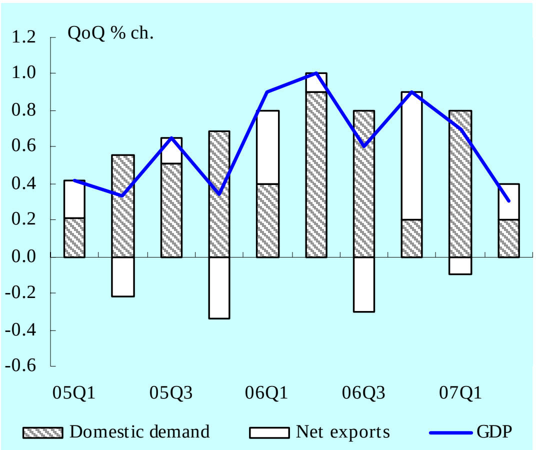
In August, euro-area consumer price inflation remained below the 2% threshold for the twelfth month in a row. A strong increase in oil prices in 2006 caused favourable base effects this year. They are one of the main factors behind the limited rise in HICP so far in 2007. On the other hand, core inflation has increased somewhat, reflecting e.g. the impact of the German VAT hike. Looking ahead, the projections for HICP inflation in 2007 have been revised upwards by about 0.1 pp. in both areas to 2.0% in the euro area and 2.2% in the EU. However, this revision is only visible in the updated outlook for the euro area due to rounding effects. It follows mainly from the higher-than-expected inflation in Q2 and the projected impact of rising commodity prices.

The EU economies started 2007 on a strong note

The euro-area and the EU economies entered 2007 on a sound note, with GDP expanding by 0.7% quarter-on-quarter (q-o-q) in the first quarter. Investment provided the main contribution to the expansion, reflecting high levels of capacity utilisation, still favourable financing conditions, healthy corporate profits and an overall positive outlook. Companies also increased stocks significantly, having depleted inventory levels in the last quarter of 2006, especially in Germany where budgetary measures caused a front-loading of demand that caused an exceptionally strong run-down of inventories in Q4 2006.

In contrast to survey data, which pointed to continued robust growth in the second quarter, real GDP growth eased to 0.5% q-o-q in the EU and to 0.3% in the euro area. The disappointing performance of the euro area (compared to the projected 0.6%) is the result of a number of downward surprises coming from some Member States: especially France, Italy and the Netherlands.

Graph 1: GDP growth and contributions, euro area



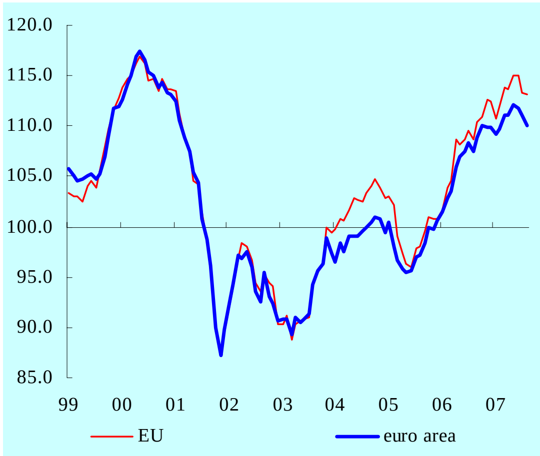
The second-quarter growth should be interpreted with some caution. The figures were affected by the impact of the unusually mild winter weather in Q1 on construction investment, reversed subsequently by harsher weather causing a marked downturn in Q2. However, they could also reflect the fact that the cycle has turned, a development, which could be reinforced by the impact of the recent turmoil in the financial markets. In any event, the peak of the cycle appears to be behind us.

The contribution of domestic demand to GDP growth was reduced by investment spending, which contracted for the first time in five years (see Graph 1). The rebound of private consumption is, on the other hand, an encouraging sign, as in the spring forecast private consumption was expected to gradually take over as the main engine of growth. Similarly, net exports provided a slightly positive contribution to GDP growth in Q2.

Survey indicators weakened somewhat lately, but remain at high levels

Looking ahead, the recent distress in the financial markets appears to have had a certain, but relatively limited negative impact on business and consumer confidence so far. Even though most survey data have started to decline, they remain at high levels indicating continued firm real GDP growth in coming quarters.

Graph 2: The European Commission's economic sentiment indicator (s.a.)



The upward trend in the European Commission's economic confidence indicators appears to have come to a halt and started to reverse in most sectors in July (Graph 2). In the euro area, for instance, the sentiment deteriorated in all sectors except in retail trade in July/August. Despite this weakening, all sectoral confidence indicators remain well above their long-term averages in both the euro area and the EU.

The Purchasing Managers' Indexes (PMI) for manufacturing and services continue to display diverging trends. While in the manufacturing sector confidence has been on a gradual downward path since the summer of 2006, in the services sector it is holding up better, although slightly deteriorating in August. Nevertheless, both indices remain firmly in the zone that indicates expansion.

Several national survey indicators have also declined somewhat in recent months, but remain above their historical averages, suggesting GDP growth around potential (such as the German IFO and Belgian NBB indexes).

Despite recent turmoil, the global economic environment remains relatively favourable

A widespread and disorderly re-pricing of risk triggered turmoil in the financial markets during the summer, causing stock markets to tumble and volatility in foreign-exchange markets to surge. The turmoil originated in the US sub-prime mortgage market. However, due to securitisation creating complex financial instruments, the unrest has spread much wider. In money markets, a lack of confidence in counterparties drove up money market rates. While Central Banks intervened at several occasions, conditions in money markets have not yet normalised. 3-month inter-bank lending rates continue to be at elevated levels and the overnight inter-bank lending rate reached a six-year high in early September, reflecting ongoing difficulties for banks to raise funds. Given the persistence of underlying confidence problems, markets display a high degree of risk aversion and are still operating far from normal.

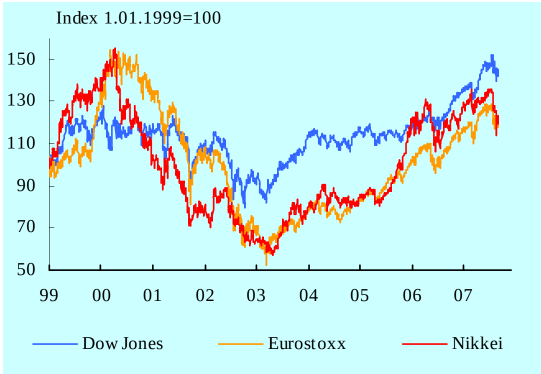
As investors rushed to low-risk assets, long-term government bond yields declined by some 0.4 pp. in the US and 0.2 pp. in the euro area, while corporate bond spreads rose by around 0.5 pp. Although the markets recovered towards the end of August, stock market indices are down by around 5% compared to their highs in mid-July, but still significantly higher than a year earlier, see Graph 3.

The turmoil took place against the backdrop of a continuously strong, though somewhat moderating pace of expansion in the world economy. The economies should thus be in a relatively good position to weather the turbulence, at least if the disruption remains short-lived.

Any lasting impact of the turmoil on the global economy will crucially depend on the time it takes for the markets to revert to an orderly functioning, the degree of re-pricing of risks and tightening of credit conditions that will persist after the turbulence, and whether consumer and investor confidence will be negatively affected by the developments in the financial markets.

It is clearly too early to quantify the possible impact on the global economy. Almost all of the hard data refer to the period before the distress in the financial markets and the effect on soft data appears, so far, limited. However, the turmoil has clearly tilted the balance of risks to the downside, not only for the global outlook, but also for that of the EU and the euro area.

Graph 3: Stock market indices



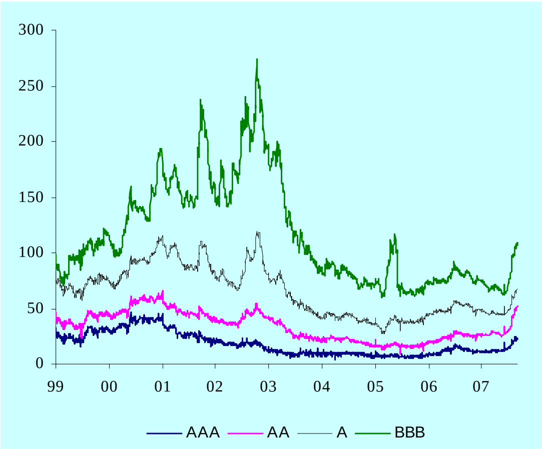
At present, the global economy is expected to grow somewhat faster in 2007 than forecast in the spring. This may appear surprising considering the financial turmoil, but follows from the stronger growth in emerging markets that more than offsets the downward revision of US growth. World GDP growth (excl. EU) is expected to amount to 5¾% this year, adding a fifth year of a very growth-supportive international environment.

In the *US*, leading indicators point to a deeper and longer-lasting correction of the housing sector than expected earlier (further reinforced by the developments in the financial markets), although for the annual growth outlook this year, the impact is reduced by the rebound in real GDP growth in Q2. A worsened outlook for private consumption and residential investment in the second half of 2007 would, together with the impact of a reduced carry-over from 2006, limit overall GDP growth to just below 2%.

The outlook for *Japan* remains broadly unchanged for 2007. Although second-quarter growth showed an unexpected decline, this was partly compensated by a relatively strong first quarter. The Japanese economy continues to benefit from firm demand in Asia, which offsets the temporary soft patch in private domestic demand growth.

In *China*, GDP growth has surprised on the upside, yet again. Both fixed investment and exports have continued to outperform expectations and real GDP growth amounted to 11.5% year-on-year (y-o-y) in the first half of 2007.

Graph 4: Corporate bond spreads in the euro area



The impact of the turbulence on the financial market also appears contained, with the Shanghai Stock Exchange increasing and the Central Bank raising its main interest rate on 21 August in its combat against fast-rising consumer and asset prices. Following a slight deceleration towards the end of the year, real GDP growth is expected at more than 11% for the year as a whole.

After a peak in July of almost 78 US dollar/barrel, *oil prices* declined in August, but have now stabilised in the 70-75 US dollar/barrel range. A general retreat from risky assets amidst increased financial market volatility coupled with concerns about the ongoing weakness of the US economy and its implications for oil demand were the main factors behind the decline in prices.

However, oil prices still remain at an elevated level, reflecting the tight situation in the oil market and continued risks for supply disruptions in important oil exporting countries, such as Iraq, Iran and Nigeria. According to the futures market, oil prices are assumed to amount to 68 US dollar/barrel in 2007 (i.e. up by 1¾ US dollar/barrel compared to the spring outlook).

The appreciation of the *euro* accelerated during the early summer and the euro reached a record high against the US dollar (at 1.38 on 24 July) and the yen (at 168.68 on 13 July). However, the foreign-exchange markets have thereafter also been affected by the turbulence as risk aversion rose. This caused an unwinding of carry trades and the Japanese yen appreciated by about 8% against the euro. The US dollar also appreciated, reflecting e.g. an increased awareness of euro-area banks' exposure to the US sub-prime mortgage market.

When markets calmed down somewhat in the second half of August, some of these trends were partly reverted. Based on the assumption of constant nominal exchange rates for the remainder of the year, the bilateral USD/EUR would (at 1.35 USD/EUR) remain largely unchanged from the spring forecast, implying an appreciation of the nominal effective exchange rate of 2.6%.

Following several years of exceptionally favourable *financing conditions*, the tightening of monetary and financial conditions have been reinforced by the recent crisis. In view of unusually low risk spreads in past years, a general re-pricing of risk has been expected. But as the shift in investor sentiment took place in an abrupt fashion, markets were unsettled.

The tightening became particularly visible in a sharp rise of inter-bank lending rates and, to a lesser extent, in a correction in equity prices and a rise in corporate spreads. The impact is partly cushioned by a weakening in the euro's effective exchange rate and a decline in long-term interest rates. Following market expectations, futures contracts have only priced in a low probability of a further interest-rate hike. In the present situation, expectations derived from market instruments reflect to a certain degree also liquidity conditions and need to be interpreted with caution. Renewed volatility can furthermore not be excluded. However, based on current market expectations, short and long-term interest rates are only slightly higher than assumed in the spring forecast this year (up by 0.1-0.2 pp.).

Positive outlook largely maintained for 2007

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 in the euro area is set to rebound in the third quarter of 2007 to 0.5% q-o-q. However, it should be stressed that uncertainty is unusually large as regards the second half of this year, especially for

Q4, when the impact of the turmoil in the financial market could influence confidence and growth to a greater extent, which, in turn, could imply a more marked deceleration in 2008.

Based on currently available information, the update for the euro-area aggregate points to a growth rate of 0.5% q-o-q in both Q3 and Q4 implying a downward revision of 0.1 pp. each quarter compared to the fully-fledged spring forecast. Reflecting the more gradual moderation of the UK outlook, the EU is expected to grow by 0.6% q-o-q in Q3 and 0.5% in Q4 (i.e. revision of the outlook for Q4 only). As a consequence of this and, in particular, the weaker-than-expected outcome for Q2, annual GDP growth is revised downwards by 0.1 pp. in both areas as compared to the spring forecast, to 2.5% for the euro area and 2.8% for the EU.

Domestic demand is expected to continue to be the main contributor to GDP growth in both the euro area and the EU, with output set to be increasingly driven by private consumption. This reflects *inter alia* the persistent signs of improvement in the European labour markets, not least in Germany. The unemployment rate fell below 7% in both the EU and the euro area during the summer, a level not seen since the early 1980s. Consumer confidence remains, at least so far, well above its long-term average, even if a certain decline has been noted in recent months.

Judging from the European Commission's investment survey, investment volumes in the manufacturing sector are expected to remain buoyant, although it should be noted that this survey stems from June 2007.

Looking further ahead, the updated outlook for 2007 (i.e. the downward revision of the third and fourth quarters for the euro area (Q4 for the EU) and the annual outlook by 0.1 pp. in both areas) points to a somewhat reduced growth momentum in 2008. In addition, the possible impact of the distress in the financial markets is likely to affect the coming year, notably through a tightening of credit conditions across the board.

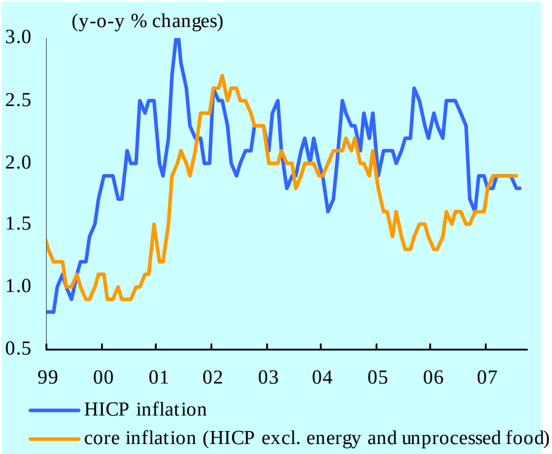
The impact of the lower carry-over from 2007 and the re-pricing of risks would need to be carefully assessed against other changes in the global environment. On current expectations, for instance, the slowdown in the US economy is expected to be more pronounced, but relatively short-lived. In the course of next year, US GDP growth is projected to return to its long-term trend. However, a deeper and more long-lasting correction in the housing market can not be excluded. The next fully-fledged forecast by the Commission, due in early November, will provide a more detailed assessment of these issues.

Inflation remained contained in the first half of 2007 due to favourable base effects

Consumer price inflation was 1.9% in the first half of 2007 in the euro area, broadly in line with the spring forecast for 2007 and declining from the previous year. It was 2.2% the EU, slightly higher than foreseen in the spring forecast, but still relatively contained compared with 2006. At 1.8% in August headline inflation in the euro area was running below the 2% threshold for the twelfth consecutive month. As oil prices rose strongly during summer 2006, peaking in early August, favourable base effects in energy prices largely account for the limited increase in (y-o-y) energy inflation in recent months.

In contrast, core inflation increased by 0.3 pp. between December 2006 and July 2007. This up-tick seems mostly related to the VAT increase in Germany. Indeed, excluding energy prices, producer price inflation (which excludes VAT) remained broadly unchanged between December 2006 and July 2007. This took place in a context of decelerating demand compared to the second half of 2006. On the other hand, although employment continued to grow at a healthy pace, pressure from wage developments still appeared limited.

Graph 5: Headline and core inflation, euro area



Some upward pressures continued to develop in the price of services in the first half of 2007. These were, however, compensated for by muted developments in energy prices. Meanwhile, developments in prices of unprocessed food crept up slowly. Moreover, industrial price pressures at the producer level remained moderate in the first half of 2007 (rising by around 2½ % on average, after 5% in 2006). Nevertheless, some sub-components suggest that price pressures may still be in the pipeline. In addition, money and credit growth kept rising at a swift pace in July, the fastest since the introduction of the euro in 1999.

Turning to wage indicators, compensation per employee increased by 2.5% in Q1 (up from 1.8% in 2006Q4), while total hourly labour costs grew at an annual rate of 2.2% in the first quarter of 2007 (stable from 2006Q4).

Inflation set to increase, to just above 2%

Looking ahead, the aggregated outlook for inflation in 2007 has been revised slightly upwards, based on upward revisions in some of the updates for the largest Member States. HICP inflation is now expected to average 2.0% in the euro area and 2.2% in the EU this year. This adds about 0.1 pp. to consumer price inflation for both areas compared to the spring 2007 forecast, although due to rounding effects this is only visible as regards the euro area.

This upward revision is mainly due to higher-than-expected inflation in Q2 in some countries and a more pronounced increase towards the end of the year in others. The swings in energy inflation come on top of some pressures on core inflation in an economic environment characterised by a closing of the output gap. The above-trend expansion in 2006 and early 2007 has significantly reduced the slack in the EU economy, driving capacity utilisation rates clearly above the late-2000 peak. On the other hand, the rise in unit labour costs has remained subdued so far thanks to still well-behaved wage inflation and significant productivity gains.

On balance, headline and, possibly, core inflation are likely to drift slightly higher in the second half of 2007 as the favourable base effects come to an end. Looking further ahead, however, domestic inflationary pressures could ease if tighter financing conditions start to dampen GDP growth.

Continued improvement in the labour market and public finances

In the first half of 2007, the labour market has continued to improve. For the euro area, employment growth accelerated to around 1.5% in 2006, representing around 2 million new jobs (3 million in the EU). In the first quarter of 2007, employment grew by 0.4% q-o-q in both the euro area and the EU and data for Q2 for some Member States indicate that employment growth continued at a similar pace. Given that employment growth typically lags output growth, employment growth should, by and large, continue throughout 2007. Meanwhile, the euro-area unemployment rate fell by around 1 pp. within a year, to 6.9% in July 2007 (an annual average of 7.3%), the lowest level in more than a decade; it even reached 6.8% in the EU. This is attributable to a large extent to the strong cyclical upswing at the end of 2006 and the beginning of 2007. However, available estimates also point to a clear and continuous fall in the structural rate of unemployment, currently estimated at around 7½% for the year 2007.

In line with the still firm GDP growth and inflation projections for 2007, labour market developments are expected to remain favourable. This is in line with survey data being still above long-term averages. In this respect it is encouraging to note that hiring intentions in the services sector, which is the largest employer, improved further in August.

Turning to public finances, the information available suggests that, despite the slight downward revision of economic activity, government revenues in 2007 are likely to be somewhat higher in several Member States than expected in the spring forecast. At the same time, expenditures may be more dynamic in some of these countries. As a result, the 2007 budgetary position for the EU as a whole could be close to what was predicted in the spring forecast. A full assessment of the prospects for public finances will be carried out in the Commission's autumn forecast.

Risks to the forecast clearly tilted to the downside

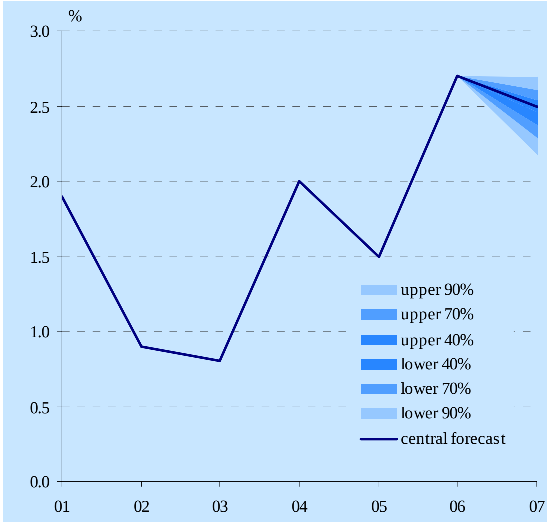
The spring forecast identified the risks to the outlook as being broadly balanced in 2007, but tilted to the downside in 2008.

Developments since then have confirmed a number of downside risks for 2007, not least a worsened outlook for the US economy and re-pricing of risks in the financial markets. In particular, the possible impact of the financial market turmoil may affect the (global) economy via three channels.

First, the deterioration in the US housing market may trigger a markedly more pronounced slowdown in the US. Given the influence of the United States economy on the world economy, a slowdown in growth in the US will have some impact on the rest of the world, in particular in Europe. Second, a persistent distress in the financial markets may lead to a tightening of financing conditions that goes beyond the normalisation of the pricing of risk.

Added to this could be effects from a worsening of the balance sheets of companies and households, due to a fall in asset prices. Finally, there could be an adverse shift in consumer and investor confidence.

Graph 6: Uncertainty linked to the euro-area GDP forecast



These risks, if they materialise, will mainly impact on the real economy in 2008 and beyond. However, some of these risks could have some effects already this year. They would come on top of other risks, already identified in the spring forecast, such as higher oil prices and changes in exchanges rates.

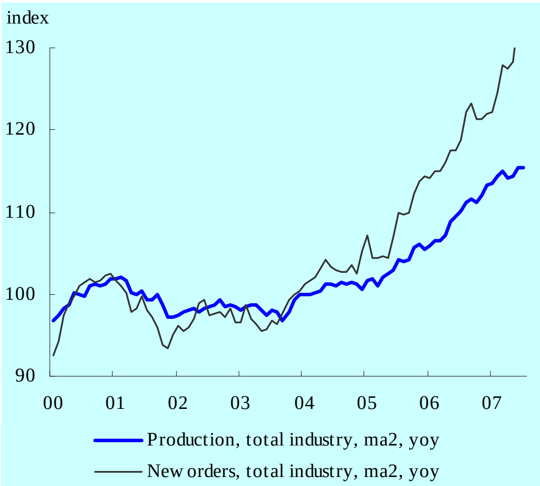
Graph 6 provides a quantification of these risks in terms of possible deviations of output growth from the main scenario. More specifically, the graph shows the impact various combinations of risks could have on euro-area GDP growth, the outcomes being weighted by the probability of their occurrence. At a 90% confidence interval, GDP growth in the euro area could be more than 0.3 pp. lower in 2007 compared to the central scenario if all negative factors materialise. But growth could also be up to 0.2 pp. higher if the positive risks to the outlook were to materialise, which would presuppose, in particular, that calm is quickly restored in financial markets and that the expected tightening of credit conditions proves transitory.

Growth and inflation prospects in the seven largest Member States

1. Germany – temporary factors aside, robust underlying growth

Underlying activity in Germany remains robust, but was recently influenced by temporary factors. Buoyant growth in 2006, driven also by anticipation effects in the forefront of the VAT increase, was followed by a corresponding shortfall in demand in the first half of 2007. Nevertheless, a significant contraction in private consumption in the first quarter was dampened by a substantial growth contribution from inventories and unusual warm weather conditions that provided a temporary boost to construction. As a consequence, the negative impact of front-loading housing investment became visible only in the second quarter, with a seasonally-adjusted drop of nearly 5%. Growth in Q2 remained positive, however, because private consumption started to recover moderately and investment in machinery and equipment continued to provide firm support.

Graph 7: Germany – production and new orders



The persistently favourable outlook is backed by hard and soft business cycle indicators. Strong growth of manufacturing output is outpaced by incoming orders, raising order levels even further. Firms therefore take an optimistic view on the business situation as reflected by the economic sentiment indicators. In addition, the continuous brightening of the labour market should support a further recovery in private consumption.

The recent turmoil on financial markets has dented both consumer and enterprise expectations somewhat, although the economic impact is not yet clear. So far, only few German banks have been affected and a wider banking crisis is not in sight. However, risk premia for credits to private consumers and enterprises have increased. While a stronger effect cannot be ruled out, the limited impact of the crisis so far suggests only a marginal downward revision of the growth forecast for the remaining quarters and the average of the year.

Price effects of the VAT hike, the introduction of university tuition fees in some *Länder* and recently higher food prices led to an increase in the annual inflation rate to 2%. However, under the assumption of relatively stable oil prices and wage increases being mainly accommodated by productivity gains, stronger inflationary pressure is not in sight. Thus, from a small up-tick around the turn of the year, inflation should start to decelerate again in the coming quarters.

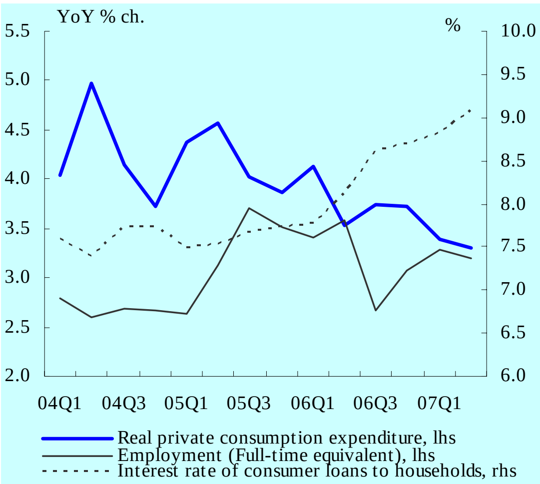
2. Spain – growth still firm in 2007

In Spain, GDP grew by 0.9% in quarterly terms in the second quarter of 2007, down from 1.0% in the first quarter. For the year as a whole, economic activity is anticipated to expand by 3.7%, unchanged from the spring forecast.

In this year, the economy is showing a similar pace of growth and growth composition as in 2006, in which GDP was exclusively based on domestic demand. In spite of a slightly higher-than-projected growth during the first semester of 2007, economic expansion might be less dynamic during the second half of the year, as both private consumption and investment in construction growth could decelerate due to past tightening of monetary conditions and weaker wealth effects associated to both financial and real estate assets. Concerning the external sector, the most recent available information would suggest that Spanish imports continue to outstrip exports and, as a result, the negative contribution of net exports to GDP growth would not depart significantly from 1 percentage point in 2007.

Inflation declined to 2.4% in the second quarter of 2007. This is 0.1 percentage point above the spring forecast. The inflation differential vis-à-vis the euro area has narrowed during the last quarters and, from 1½ percentage points in summer 2006, it has bottomed out at around half of a percentage point recently. In spite of a projected rebound of inflation at the end of the year on the basis of energy and food price developments, the average price increase for the year as a whole would remain at around 2.5%.

Graph 8: Spain – private consumption, employment and interest rates



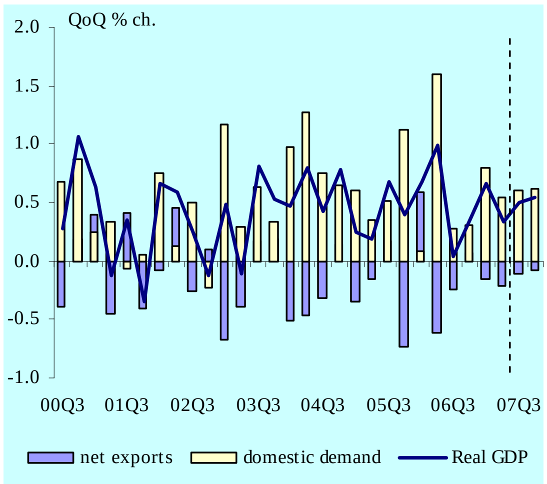
3. France – sizeable downward revision compared to the spring forecast

The French economy lost momentum in the second quarter of 2007, and for the year as a whole GDP growth is projected to be 1.9%, close to the rate recorded in 2006. This estimate is half point below the Commission services' spring forecast and is also due to the downward revision of the quarterly GDP growth in 2006. The disappointing performance in the second quarter of 2007, with GDP increasing by only 0.3% q-o-q, largely reflects the unexpected stagnation of business investment.

Concerning the outlook for the remainder of the year, the recent financial turmoil is likely to discourage firms' investment plans, although demand expectations still remain healthy. Private consumption could remain the engine of growth, with real personal disposable income supported by tax cuts introduced with the budget for 2007, combined with muted inflation. Even if the expansionary effect on annual GDP growth of the package of measures introduced at the end of the summer is expected to be marginal, it is likely to boost households' confidence, which has so far shown encouraging readings in 2007 and should contribute to support both private consumption and housing investment in the coming months considering that the last outlook for construction is still well oriented.

The latest business surveys reveal that foreign demand addressed to France continues to be fairly robust. Without repeating the relatively good performance of 2006, growth in French exports could continue to be relatively sustained (French exports increased by 1¼% per quarter in the first half of 2007, after a modest growth in 2006Q4). However, import growth should stay strong in response to the robustness of final demand and, thus, the net contribution of the external sector should remain negative.

Graph 9: France - GDP growth and contributions

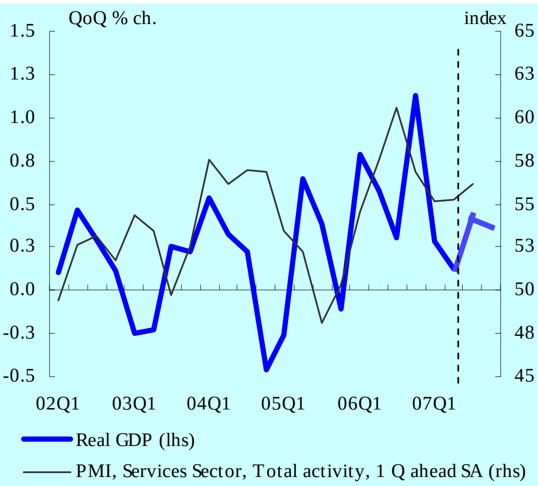


Inflation in 2007 is expected to turn out at 1.4%, in line with the spring forecast. Industrial producer prices of final consumption goods have been subdued, providing evidence that second-round effects from high raw material prices have been contained up to now. On the back of slightly less favourable cyclical conditions and considering the recovery in employment, unit labour costs are forecast to gradually increase. Thus, core inflation, as measured by the HICP excluding food and energy prices, should be close to 1½%, while energy inflation should be rather weak this year.

4. Italy – growth slightly below potential in the second half of 2007

Following a weak real GDP growth in the first quarter of 2007, at 0.3% q-o-q, the GDP estimate released in August point to a mere 0.1% quarterly increase in Q2. Also reflecting the strong acceleration in Q4 2006, the carry-over for real GDP growth in 2007 as a whole is at 1.5% after the first two quarters. For the second half of the year, business confidence indicators for the services and the manufacturing sectors suggest that economic activity is likely to record a moderate expansion. Quarterly GDP growth is forecast at 0.4% in Q3 and 0.3% in Q4 of 2007, slightly below its potential. Economic growth in 2007 as a whole is expected to be 1.9%, in line with the spring forecast.

Graph 10: Italy - GDP growth and confidence in the services sector



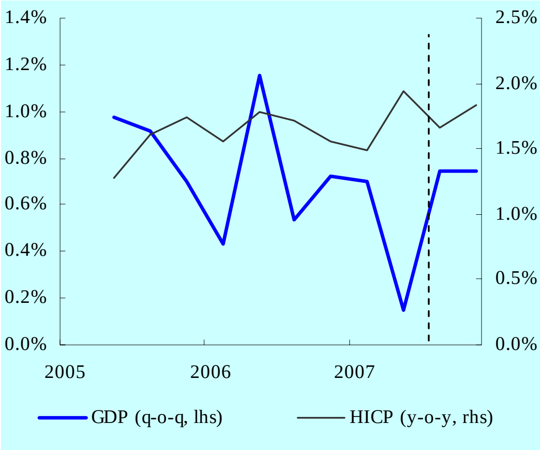
Private consumption was the main driver of GDP growth in the first quarter, despite the slowdown in employment growth. Positive indications for the services sector and buoyant growth of VAT receipts up to the month of August suggest that domestic demand will continue being the main driver of growth throughout the year. After the strong increase recorded in the last part of 2006, exports have decelerated. However, combined with moderate import dynamics, net exports are expected to provide a positive contribution to GDP growth in 2007. By sector, the quarterly contraction in industrial production in Q1 and Q2 suggests that the contribution of manufacturing to overall GDP growth in 2007 will be less sizeable than in 2006. In contrast, the services sector is holding up well.

The forecast for annual HICP inflation in 2007 is at 1.9%, in line with the spring forecast and lower than the 2.2% rate in 2006. Besides the lower contribution to annual inflation from energy prices, the liberalisation measures adopted so far have contributed to a deceleration in the HICP, in particular through lower telecommunication prices.

5. The Netherlands – rebound expected after disappointing second quarter

After two consecutive quarters of strong growth (0.7% q-o-q), GDP grew at a disappointing rate of 0.2% in the second quarter of 2007. One factor explaining the poor growth performance was a slowdown in the production of the chemical and steel industries. Moreover, whereas in the first quarter the unusually mild weather supported construction activity, in the second quarter bad weather conditions hampered production therein. Furthermore, both quarters were adversely affected by a 22% reduction in the production of mineral gas as compared to the first half of 2006. However, as the underlying growth impetus remains strong, GDP growth is expected to regain strength in the second half of the year, and annual GDP should come out around 2.5% in 2007.

Chart 11: The Netherlands – GDP growth and consumer price inflation



Continued healthy economic growth prospects will put further strain on the already tight labour market. The unemployment rate fell from 3.9% on average in 2006 to 3.4% in July and, over 2007, is expected to average just above 3%. Although contractual wage increases have been relatively modest to date, wage drift is expected to lead to some upward price pressures towards the end of 2007. At the same time the global increase in agricultural prices is expected to start feeding into the HICP. However, these upward price pressures are counteracted by a low increase in regulated housing rents from the second half of the year onwards and a flattening out contribution of energy prices to inflation. Total HICP is left relatively unaffected and annual inflation is thus expected at 1.7% in 2007.

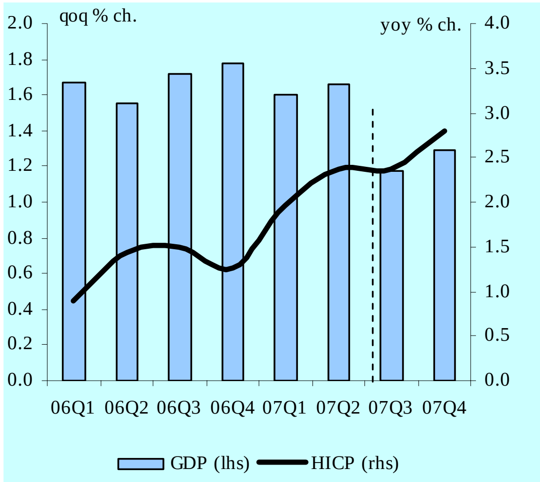
6. Poland – buoyant economic growth

Economic activity continued to be strong in the second quarter of 2007. GDP growth is estimated to have reached 1.7% quarter-on-quarter, about ½ percentage point higher than in the Commission services' spring forecast. The positive growth surprise was due to continued strong gross capital formation, and accumulation of stocks in particular.

For 2007 as a whole, GDP is expected to grow by 6½%, which is ½ percentage point higher than in the spring forecast. This follows from the better-than-expected result in the second quarter of 2007 and a positive outlook for the remaining part of the year, where GDP is expected to grow at around 1¼% quarter-on-quarter.

Domestic demand will continue to be the main driver of growth, with a key role for robust gross fixed capital formation and strong consumption. Consumption growth is supported by strong wage increases (owing to a tax wedge cut and a tightening labour market) and a recovery in the labour market. Between the first and second quarter of 2007, the employment rate increased by ca. 1.2 percentage points, while the unemployment rate was reduced by nearly 1.7 percentage point to 9.6%, which means nearly 300 thousand people found a job. The improvement is expected to go on, albeit at a slower pace, mainly due to emerging skill mismatches.

Chart 12: Poland – GDP growth and consumer price inflation



HICP inflation reached 2.4% year-on-year in the second quarter of 2007, ¼ percentage point higher than in the spring 2007 commission services' forecast. Strong wage demands, fuelled also by labour shortages in certain segments of the market, and higher food and fuel prices will put upward pressure on inflation. Due also to exchange rate developments, the mitigating impact of import prices on inflation is assumed to be less important than in the recent past. Thus, inflation for 2007 has been revised upwards compared to the spring forecast from 2.0% to 2.4%.

7. The United Kingdom – still robust growth, albeit moderating

In the first half of 2007 economic activity in the UK remained strong. In the first and second quarters of 2007, real GDP grew by 0.7% and 0.8% q-o-q respectively and by 3.0% y-o-y in each quarter, slightly stronger than the Commission services' spring 2007 forecast. Domestic demand accounted for the entire increase in GDP, whereas net exports made a small negative contribution to growth in the second quarter. Consumer spending remained buoyant, accounting for half of the increase in GDP in each quarter, in part due to the resilience of housing market activity. However, data on disposable income in the first quarter showed a drop in the saving ratio from 3.9% in the last quarter of 2006 to 2.1%, the lowest for over 40 years. A sharp drop in fixed investment in the second quarter, notwithstanding robust growth in business investment, was more than compensated for by the positive contribution of inventories.

GDP growth in 2007 is expected to slow in the second half of the year, to 0.7% q-o-q in the third quarter and to 0.5% in the final quarter. Survey evidence up to August reported steady consumer confidence and still buoyant activity in the services sector. Going forward, however, past monetary tightening is expected to feed through to lower household consumption expenditure and to tighter business investment. GDP growth for the entire year is forecast to reach 2.9%, slightly higher than that in the preceding year and than the Commission services' spring 2007 forecast.

The year-on-year HICP inflation rate in July 2007 fell sharply from 2.4% in the previous month to 1.9%, below the official target of 2% for the first time since March 2006. However, the rate of inflation is expected to increase back to slightly more than 2% during the rest of 2007. The recent floods in the UK are expected to contribute to higher food prices later this year. At the same time, oil prices, which had dropped sharply in the second half of 2006, are expected to exert upward pressure on petrol prices. Therefore, average HICP inflation in 2007 is expected to be 2.4%, slightly higher than forecast in the spring.

Chart 13: The United Kingdom – GDP growth and consumer price inflation

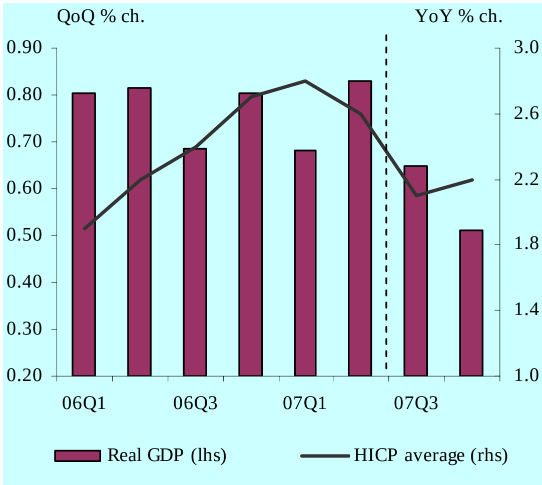


Table 1: Real GDP growth

	Quarterly GDP forecast (%, quarter-on-quarter)				**Annual GDP forecast** (%, year-on-year)		
	outcome data		forecast data		2006	2007	
	2007/1	2007/2	2007/3	2007/4	*Outcome 2006*	*Spring forecast May 2007*	Interim forecast Sep. 2007
Germany	0.5	0.3	0.5	0.5	*2.9*	*2.5*	2.4
Spain	1.0	0.9	0.6	0.6	*3.9*	*3.7*	3.7
France	0.7	0.3	0.5	0.5	*2.0*	*2.4*	1.9
Italy	0.3	0.1	0.4	0.3	*1.9*	*1.9*	1.9
Netherlands	0.7	0.2	0.7	0.7	*3.0*	*2.8*	2.5
Euro area	**0.7**	**0.3**	**0.5**	**0.5**	***2.8***	***2.6***	**2.5**
Poland	1.6	1.7	1.2	1.3	*6.1*	*6.1*	6.5
United Kingdom	0.7	0.8	0.7	0.5	*2.8*	*2.8*	2.9
EU27	**0.7**	**0.5**	**0.6**	**0.5**	***3.0***	***2.9***	**2.8**

Notes: (a) Data for 2007/1 and 2007/2 are estimates released by Eurostat. Where possible, the quarterly growth rates are working-day and seasonally-adjusted, whereas the annual projections are unadjusted.

Table 2: Consumer price inflation

	Quarterly HICP forecast (%, year-on-year)				**Annual HICP forecast** (%, year-on-year)		
	outcome data		forecast data		2006	2007	
	2007/1	2007/2	2007/3	2007/4	*Outcome 2006*	*Spring forecast May 2007*	Interim forecast Sep. 2007
Germany	1.9	2.0	2.1	2.3	*1.8*	*1.9*	2.1
Spain	2.5	2.4	2.3	2.9	*3.6*	*2.4*	2.5
France	1.4	1.4	1.4	1.6	*1.9*	*1.5*	1.4
Italy	2.0	1.9	1.8	2.0	*2.2*	*1.9*	1.9
Netherlands	1.5	1.9	1.5	1.8	*1.7*	*1.5*	1.7
Euro area	**1.8**	**1.9**	**1.9**	**2.2**	***2.2***	***1.9***	**2.0**
Poland	2.0	2.4	2.4	2.8	*1.3*	*2.0*	2.4
United Kingdom	2.8	2.6	2.1	2.2	*2.3*	*2.3*	2.4
EU27	**2.2**	**2.1**	**2.0**	**2.3**	***2.3***	***2.2***	**2.2**

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 9 November 2007). This interim forecast updates the outlook of the spring 2007 economic forecast of 7 May (http://ec.europa.eu/economy_finance/publications/european_economy/forecasts_en.htm). The cut-off date for this interim forecast to take new information on board was 6 September 2007.

The interim forecast updates the outlook for the seven largest Member States (based on an average of the ranking in terms of both population and nominal GDP), i.e. France, Germany, Italy, the Netherlands, Poland, Spain and the United Kingdom, 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 more than 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. The weaker-than-expected quarterly growth rate of GDP in 2007Q2 could be reinforced by difficulties with working-day adjustment.

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 exchange and interest rates as well as for oil prices.

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 22 August to 4 September.

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 4.3% and the long-term interest rates at 4.2% on average in 2007 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 68.0 USD/barrel in 2007. This would be 1.8 USD/barrel higher than assumed in the spring 2007 forecast, reflecting maintained strong demand from e.g. emerging markets and geopolitical uncertainties.

Global demand in 2007 is revised slightly upwards (by 0.3 pp.), despite the recent distress in the financial markets. A weaker outlook for the US is fully offset by stronger growth in emerging markets, especially China. Real GDP growth for the world (excluding the EU-27) is thus forecast to remain largely unchanged, at 5.7% in 2007 (down from 5.8% in 2006). World trade also remains largely unchanged in 2007, with growth in export and import volumes of goods estimated at around 9% and 8½%, respectively, (excluding the EU-27).