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Coming out of recession but uncertainty remains high

The EU economy appears to be at a turning point. Signs of improvements in the economic situation have become increasingly apparent since the start of the autumn and fears of a prolonged, deep recession are fading. Although there is still a high degree of uncertainty with significant headwinds present, tailwinds have gained strength more recently. In particular, important policy interventions have succeeded in achieving some stabilisation in the financial system and in providing support to economic activity. Notably, data for the second quarter indicate a significant easing in the pace of contraction of EU GDP (to -0.2% quarter-on-quarter after -2.4% in the first quarter). The question is whether this positive surprise reflects mostly one-off factors – or whether it is the start of a sustained recovery.

There are several reasons to be somewhat more optimistic about the near-term outlook. Financial conditions have improved markedly over the summer with several financial indicators returning to pre-crisis levels. With the global (non-EU) economy stabilising, the outlook for external trade is more encouraging. The inventory cycle is set to turn (although progress is uneven across countries). Both business and consumer confidence indicators have continued to improve in recent months across almost all sectors and countries, which also bodes well for the near-term outlook. Last but not least, the implementation of several already announced discretionary measures is planned for the current quarter.

Based on an update of the outlook for 2009 for the seven largest Member States, the growth momentum for EU GDP has therefore been revised up for the second half of this year. However, the outcome at the turn of the year proved so weak that, despite the new outlook and the better-than-expected outcome for the second quarter, the fall in GDP remains unchanged at -4% in both the EU and the euro area for the year as a whole.

As with the GDP forecast, the outlook for consumer-price inflation remains unchanged at 0.9% in the EU for 2009 (and 0.4% in the euro area). Revisions at the Member-State level are moderate and broadly offset each other. On the back of base effects from past hikes in food and energy prices, HICP inflation is expected to reach a low during the third quarter of this year. Substantial slack in the economy and the expected deceleration in wage costs point to a further decline in underlying inflation, while the headline inflation rate is expected to increase following higher commodity prices (compared to the assumptions of the spring forecast) and an expected reversal in base effects this autumn.

Looking into next year, however, uncertainty is rife. There are reasons to believe that the recovery could prove volatile and sub par. The full impact of the economic crisis on labour markets and public finances is, at least partly, still to be faced. Rising unemployment could weigh on consumption, while ample spare capacity and an anaemic credit supply might restrain investment. A further negative feedback loop can therefore not be ruled out. The financial crisis could also have long-lasting adverse effects on potential growth. On the other hand, policy measures could prove more effective in restoring financial health, thereby supporting economic activity, and in improving the functioning of the economy. Summing up, the strength of the recovery could surprise on the upside in the near term, but its sustainability is yet to be tested – and will be considered in the upcoming fully-fledged forecast in which all countries are assessed over a forecast horizon that includes 2011 (planned for the beginning of November).

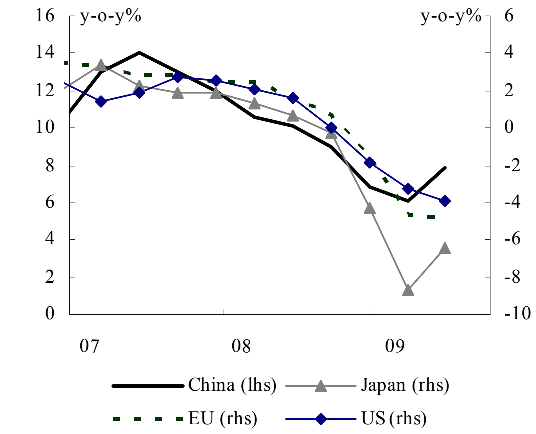
The global recession is coming to an end

Having contracted sharply last autumn, recent months have seen a stabilisation in global economic activity, with a recovery in some countries. This results in a slight upward revision to world growth in 2009, compared to the spring forecast.

Short-term indicators of global activity have clearly turned. The global PMI for manufacturing moved back into expansionary territory in August. Estimates by the CPB (Netherlands Bureau for Economic Policy Analysis) show that world industrial production increased by 2% quarter-on-quarter (q-o-q) in 2009Q2 - the strongest rise since 2003 - after two consecutive quarterly drops of above 5%. Among regions, emerging Asia recorded the strongest rebound in production. Moreover, world trade almost stabilised in 2009Q2, following steep falls in the previous two quarters.

Better-than-expected growth outcomes in the first half of 2009, notably in Asia, and a revised outlook for the second half of the year in, amongst others, the US, underpin the current stabilisation in economic activity (see Graph 1). Growth could recover more markedly in the second half of 2009 in some regions of the world, such as Asia, due to a greater resumption of trade flows and a stronger rebound in industrial production.

Graph 1: Growth in selected economies



Source: Commission services.

In the advanced economies (US, Japan and the EU) the release of better-than-expected second-quarter data came together with downward revisions to previous quarters. However, economic activity is improving and inventory data suggest that the destocking cycle is bottoming out, which bodes well for a turnaround in the coming months.

Developments in the major non-European economies: will current trends lead to a sustained recovery?

After the deepest and longest recession in more than sixty years, the *US* economy is expected to expand again in the second half of 2009. Industrial production started to increase in July and the manufacturing PMI has recovered steadily (to above 50 in August from an all-time low last December). Capital goods orders indicate a stabilisation of business equipment investment, while a massive liquidation of inventories has laid the foundation for a rebound in manufacturing output. Export volumes are increasing again and the housing market seems to have bottomed out. Government spending is also accelerating following February's massive fiscal stimulus package. However, the labour market is still depressed with unemployment rising to 9.7% in August. Payroll employment continues to fall, albeit at a diminished rate. As a result, consumer spending remains fundamentally weak, although the fiscal stimulus and subsidies for car purchases may lead to a modest expansion of real personal consumption expenditure in the third quarter.

After four quarters of negative quarterly growth, *Japanese* GDP grew by 0.9% q-o-q in 2009Q2. Exports contributed positively to growth, while private demand and inventories acted as a drag. Looking ahead, declining profits, more difficult access to credit for SMEs, still-weak external demand and inventories are expected to continue to weigh on the business environment. Investment spending is projected to be cut further. While household and public consumption have remained relatively resilient due to the implementation of stimulus packages, the situation in the labour market is deteriorating markedly, with the unemployment rate reaching its highest in the past twenty years.

In *Emerging Asia*, China is leading the way, while growth in India and Indonesia remains robust. Due to the fast implementation of its fiscal stimulus package, China was the first economy to rebound strongly in the first half of 2009. However, the package is likely to further fuel some existing imbalances. Moreover, while expansive fiscal and relatively loose monetary policies are currently having a positive impact on economic activity, the announced reduction in overcapacities could, at a later stage, lead to lower growth.

For *Russia*, growth is further downgraded, given the weaker-than-foreseen GDP outcome in 2009Q2. The outlook for *Latin America* has also deteriorated compared to earlier this year. Within the region, developments are mixed, with some signs of recovery in Brazil.

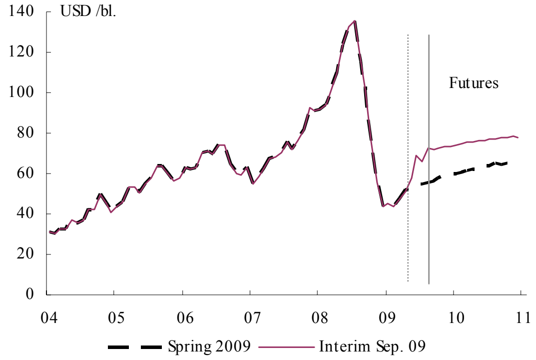
The main issues now are whether the global recovery will be sustained and what shape it will take. The current positive signs could lead to a lasting recovery, or could signal only a temporary, policy-induced respite, with shockwaves still to be expected. It is therefore important to carefully assess confirmation of the strength of the underlying recovery in the coming months. The global economy could relapse somewhat towards the end of 2009 or further out, as stimulus measures fade and re-stocking loses strength.

Commodity prices are driven up, on the back of improved sentiment

While *oil* prices had plunged to around $40/bl. at the beginning of the year, they later stabilised before rallying recently. The price of Brent reached a high for this year at $75/bl on 7 August on the back of improved sentiment. It then eased to below $70/bl (and was at $66.9/bl on 7 September). Perceived improvements in the short-term outlook, as well as OPEC's production cuts and sustained Chinese demand, have lifted oil prices. One important characteristic of the oil market is the volatility in spot prices, which adds uncertainty to the current economic outlook. Based on futures prices, oil prices are assumed to average $62/bl in 2009, an increase of 17% compared with the spring forecast (see Graph 2). Going forward, the outlook for commodity prices will increasingly depend on growth in emerging market economies, given their weight in global growth. Price movements could also be affected by financial market developments and speculations.

As for raw materials, *metals* prices have rebounded from end-2008 lows (especially copper), driven by restocking in China. Improved supplies resulting from favourable harvests have boosted global stocks of most *agricultural* commodities. This, along with weaker demand for internationally traded food commodities, has allowed prices to decline sharply from the mid-2008 heights.

Graph 2: Oil price assumptions



Source: Ecowin and Commission services.

Financial markets have recovered substantially but challenges are still significant

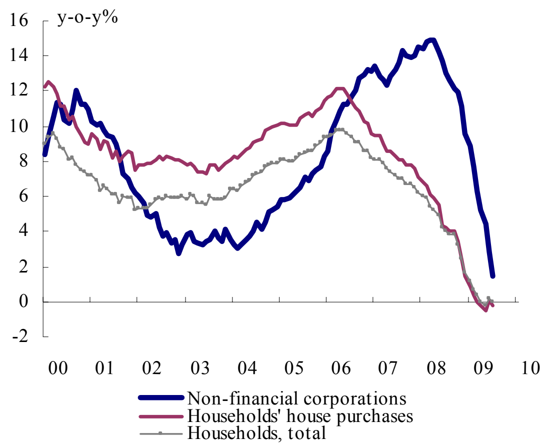
Over the past months, *financial markets* have returned to more normal conditions - the functioning of most market segments has steadily improved and investors have progressively returned to higher degrees of risk-taking. Increased confidence in the shock-absorbing capacity of the European banking system, along with signs that the fiscal stimulus packages and monetary initiatives are translating into a gradual economic recovery, have supported this normalisation.

Supported by government actions and taking advantage of improved market conditions since the spring, banks have continued to strengthen their solvency ratios and to repair and cut leverage in their balance sheets, in an attempt to stabilise their financial position. They also seem to have been, at least partially, successful in restoring internal revenue generation, thanks in some measure to the extremely low short-term refinancing rates induced by the exceptional measures taken by monetary authorities. However, despite the recovery in equity markets, raising external funds remains challenging. Indeed, while liquidity-providing initiatives by central banks, in particular the ECB, have had a beneficial effect on the short end of the money market maturity spectrum, fund-raising at the longer end remains difficult for several banks. This reflects ongoing uncertainty about the size of the additional bank losses that will be booked in the coming quarters, amid the lagging effect of feeble economic conditions on loan portfolio quality.

Deteriorating conditions in the corporate and household sector, reflected in rising numbers of corporate bankruptcies and higher unemployment rates, could further affect the credit quality of bank loan portfolios. So far, write-downs by financial companies have been concentrated in asset-backed securities and derivatives holdings. However, if the economy does not recover soon, highly indebted households and non-financial corporations could face more severe challenges, further fuelling bank losses. Given the higher indebtedness of non-financial corporations and households compared with previous downturns, recovery rates of bank loans could turn out to be comparatively low. In turn, this would adversely impact on the ability and willingness of banks to provide further financing to non-financial corporations and would incite lending institutions to tighten credit conditions even more, reinforcing the adverse feedback loops between the financial sector and the real economy.

Bank lending to the private sector has continued to moderate, although the pace of tightening of credit standards has eased considerably in recent months, in particular towards non-financial corporations. The growth rate of loans to the euro-area private sector declined to 0.6% y-o-y in July (+1.6% for loans to non-financial corporations, 0.0% for loans to households), see Graph 3. The latest results from the ECB's Bank Lending Survey suggest that supply factors are losing importance in slowing down lending activity. The slowdown may thus be more due to demand factors, such as still-weak economic activity and the ongoing housing market correction.

Graph 3: Bank lending to households and to the non-financial corporate sector



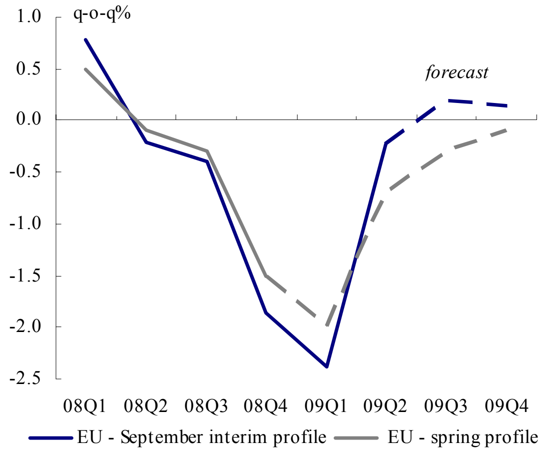
Source: ECB.

Dramatic fall in EU GDP has come to an end

The pace of contraction in *overall economic activity* slowed significantly in the second quarter of 2009. Following a cumulative decline of more than 4 pps. in the fourth quarter of 2008 and the first quarter of 2009, GDP contracted by a mere 0.2% q-o-q in the EU (and 0.1% in the euro area) in the second quarter of this year. This outcome exceeded market expectations and was also significantly better than the Commission's spring projection (-0.7%). As such, it appears that the EU economy is no longer in free fall and has started to see the end of the recession. However, the year-on-year decline of almost 5% in the second quarter of 2009 illustrates the severity of the current downturn.

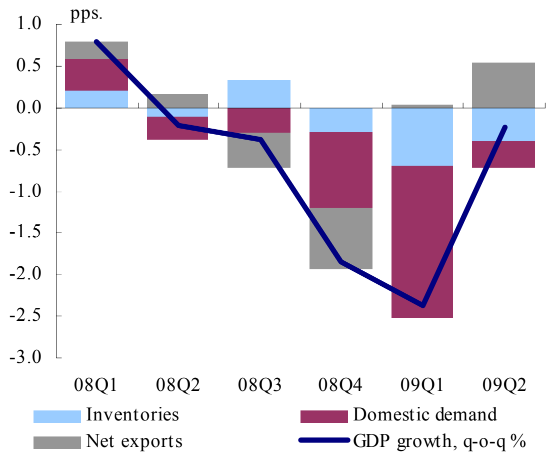
The fall in GDP in the second half of 2008 was even worse than data available at the time of the Commission's spring forecast indicated (Graph 4), with a similar pattern for the euro area. Indeed, downward revisions to historical data alone (including revisions up to the September 7 cut-off date of this interim forecast) imply a reduction of about a quarter of a percentage point in the forecast for 2009 annual GDP growth made earlier this year. The stronger than expected contraction of activity in the first quarter was thereafter compensated for by a faster than projected stabilisation in the second quarter.

Graph 4: Quarter-on-quarter growth rates, EU



Source: Commission services.

Graph 5: Contributions to growth, EU



Source: Commission services.

The picture for economic activity in the second quarter was uneven across the largest EU Member States. While GDP growth surprised on the upside in Germany and France (+0.3% q-o-q), as well as in Poland (+0.5%), a somewhat larger than expected contraction was observed in Italy (-0.5%) and Spain (-0.9%).

Consumption has proved relatively resilient…

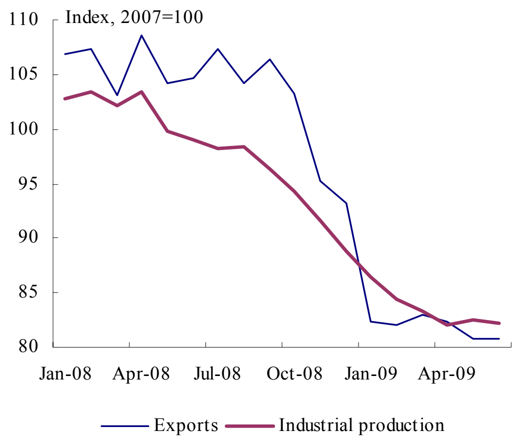
Consumption, both private and public, proved to be a stabilising factor during this recession. In the EU, household consumption contracted by around ¾%, significantly less than GDP, in both the last quarter of 2008 and the first of 2009 and broadly stabilised in the second quarter. The relative resilience of private consumption at a time when the saving rate is on the rise is largely explained by two factors, namely the strong disinflation process and support from nominal disposable income. HICP inflation has been on a downward path since August 2008, declining from 4.4% to just 0.2% in July 2009. The strength of disposable income growth can be explained by wage stickiness and lags in the response of employment to the slump in activity. The latter follows partly from policy measures such as the extension of short-term contracts (for more details see the labour market section below). Likewise, automatic stabilisers have played a role in sustaining private consumption, with discretionary measures, such as car scrapping schemes, offering additional support.

…while investment and trade flows have been heavily affected

Gross fixed capital formation has been the main source of weakness during this recession. The level of gross fixed capital formation was some 14% lower in the second quarter of 2009 than in the first quarter of 2008, with the sectoral breakdown showing that the contraction was mostly due to non-construction investment. This implies that equipment investment has been driving the business cycle. The collapse in equipment investment follows from the strong decline in manufacturing production (down by nearly 20% since spring 2008) which, in turn, has led to a sharp fall in the capacity utilisation rate (to 70%, the lowest level since the DG ECFIN survey of the manufacturing industry started in 1990), see Graph 6. In addition, gross fixed capital formation has been held back by the ongoing housing-market corrections in several Member States which have weighed on construction investment. In contrast, stimulus measures, such as public infrastructure investment, have provided increasing support to economic activity in the course of the year.

Turning to *trade*, as evidenced by the 17% fall in exports of goods and services and the 16% fall in imports since the first quarter of 2008, Europe did not escape the downturn in world trade. The pace of the contraction in exports did, however, slow in the second quarter of 2009, whereas the slump in imports accelerated. As a result, net exports contributed positively again to growth in both the EU and the euro area.

Graph 6: Industrial production and exports, euro area



Source: Commission services.

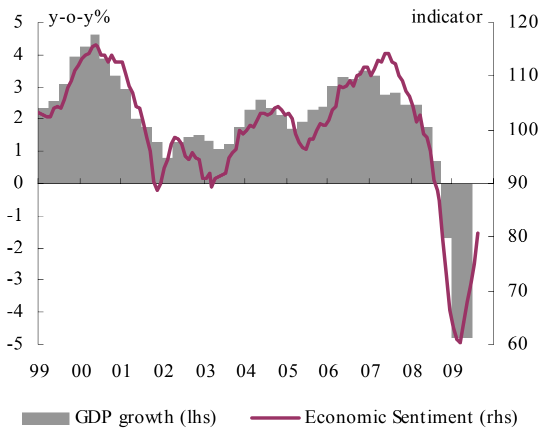
Inventory cycle advancing

Following the collapse in global demand at the turn of year and the ensuing difficulties in accessing credit, firms embarked upon massive production cuts and stock depletion. In the first and second quarters of 2009 combined, *inventories* subtracted more than 1 pp. from GDP growth in the EU (and as much as 1.5 pps. in the euro area) - the largest negative inventory contribution since the inception of the GDP series. According to the EU manufacturing survey, companies still consider stock levels to be excessive. However, this indicator is now approaching its long-term average, signalling that considerable adjustment has taken place since December 2008.

Survey indicators point to an improved business climate

Soft data have improved markedly in recent months. Based on past experience, the current levels of widely observed confidence indicators, such as the Commission's Economic Sentiment Indicator (ESI) and the Purchasing Managers' Index (PMI), are consistent with a stabilisation or, possibly, positive GDP growth in the second half of 2009 (see Graph 7). This is in contrast to the negative figures presented in the spring forecast.

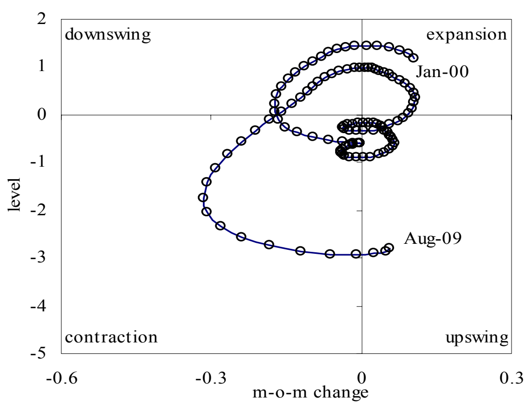
Graph 7: GDP growth and Economic Sentiment Indicator, EU



Source: Commission services.

An improvement is also evident when looking at the business-cycle tracer (see Graph 8). Having been deep in contraction territory for several months, the indicator started to turn at the end of 2008, entering into the upswing area this summer. Nevertheless, expansion territory still seems a long way off.

Graph 8: Business cycle tracer, euro area



Note: The business cycle indicator is made up from a weighted average of the five principle components from the survey series conducted in industry, services, building, retail trade and consumers.

Source: Commission services.

Encouragingly, the recent improvement in the ESI has been broad-based among sectors and Member States (although the index remains below its historical average).

The sub-indices of the PMI paint a similar picture. Moreover, the composite PMI has now surpassed the 50-point threshold that separates contraction from expansion levels. Likewise, consumer confidence has been improving since the spring in most Member States.

Short-term outlook boosted by temporary factors?

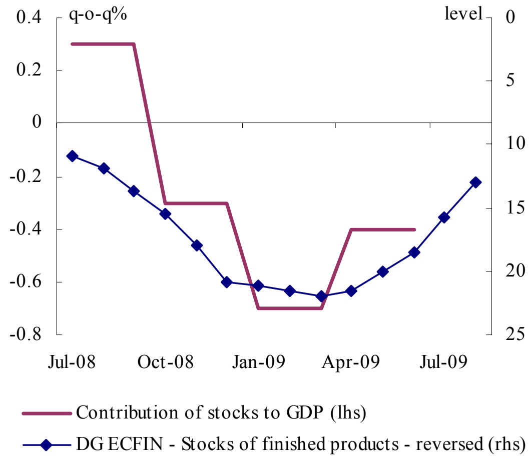
As several of the *growth supporting factors* currently at play might prove to be short lived, the strength and sustainability of the expected recovery is yet to be confirmed.

Sizeable policy interventions have succeeded in putting an end to the freefall of economic activity. An additional boost to GDP growth from public investment is likely in the second half of 2009. However, while automatic stabilisers have played an important role in dampening the adverse impact of the financial crisis, sizeable additional impulses from this source are unlikely in the quarters to come. Moreover, the termination of the scrappage schemes in several EU countries (including Germany, France and Italy) will weigh heavily on car registrations, and thus on private consumption, in the coming months. In addition, the unemployment rate is expected to rise further and the temporary absence of inflation is unlikely to be sufficient to push consumption towards a path of sustainable growth.

High frequency data for the third quarter indicate that the inventory correction is moderating and may soon be over (see Graph 9). In August, the new-orders-to-inventory ratio from the euro-area manufacturing PMI stood at its highest level since early 2007 (when the PMI was well above 50 and industrial output was still expanding). As a result, a positive contribution of inventories to GDP growth in the second half of 2009 can be expected. This effect may also prove temporary.

Notwithstanding the positive nature of recent EU data, the road ahead remains rough given the heavy reliance of the current recovery on temporary factors, and the prevailing high level of uncertainty. *GDP growth* is forecast to rebound to 0.2% in the third quarter, but growth will recede slightly in the last quarter of 2009 as some temporary factors fade away.

Graph 9: Stocks: growth contribution and assessment, EU



Source: Commission services.

Overall, the forecast for annual average GDP growth in 2009 in the euro area and the EU remains unchanged from the spring forecast. This, however, masks a substantial improvement in the growth momentum over the course of the year. The lower carry-over from last year due to the revisions of 2008 data is balanced out by higher growth starting from the second quarter of this year. As a result of the stronger growth momentum, the expected decline in year-on-year GDP growth in the fourth quarter of this year is substantially reduced relative to the spring forecast (see Table 1).

Table 1: GDP growth forecast for 2009

Decomposition of the GDP growth forecast for 2009

EU	**Spring forecast**	**Interim forecast**
Carry-over from 2008	-1.4	-1.6
Y-o-Y in Q4	-3.1	-2.3
Annual average	-4.0	-4.0
euro area	**Spring forecast**	**Interim forecast**
Carry-over from 2008	-1.4	-1.6
Y-o-Y in Q4	-3.1	-2.3
Annual average	-4.0	-4.0

Source: Commission services.

Looking beyond the forecast horizon

The upward revision of growth prospects for the second half of this year implies a positive risk for the 2010 forecast of about half a percentage point compared with the spring forecast (due to a higher carry-over at the end of 2009). In addition, the stabilisation in key financial markets and encouraging hard and soft data in recent months offer support for the period beyond 2009, i.e. beyond the horizon of this interim forecast. However, several of the temporary factors that are set to boost growth in the short term are likely to diminish over time. A lasting and sustainable recovery might need more time to materialise.

Low inflation supports private consumption

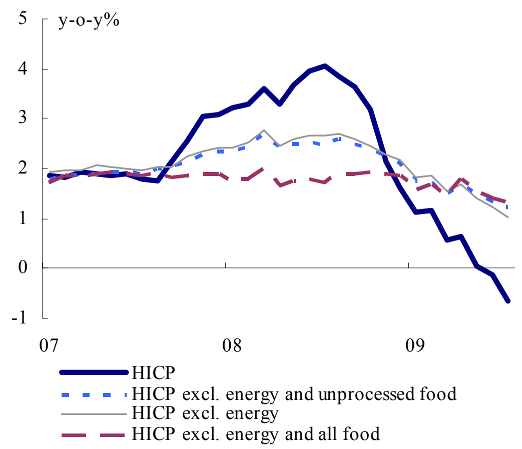
Consumer-price inflation continued to decline substantially in the course of 2009 - reaching a trough of -0.7% in July in the euro area and 0.2% in the EU - and providing noticeable support to household real disposable income. The decline in the headline inflation rate has been driven mostly by energy and food prices, although inflation has subsided across all products and services as the macroeconomic environment has weakened.

Regarding the measures of underlying inflation, HICP inflation excluding energy and unprocessed food (core inflation) decreased from over 2% in the euro area at the end of last year to 1.2% in July 2009, mainly as a result of an easing in services' prices and, to a lesser extent, a moderation in processed food prices.

The effect of the sharp weakening in activity is particularly visible in *producer-price inflation*. It fell in the euro area from 9.1% to -8.5% between July 2008 and July 2009, on the back of decelerating prices for energy and food input products and base effects. However, the speed of the decline in industrial price inflation and its main components seems to have slowed in the last few months, suggesting an easing of downward pressures.

Turning to *wage indicators* in the euro area, the annual growth rate of hourly labour costs remained relatively high at 3.7% in the first quarter of 2009 (down from 4.0% in the fourth quarter of last year). On the other hand, reflecting shorter working hours, the growth of nominal compensation per employee slowed significantly, from 3.1% in 2008 to 1.8% in the first quarter of 2009. However, combined with a sizeable decline in labour productivity, unit labour costs rose markedly. At 5.6% in the first quarter of 2009, the growth in unit labour costs was the highest in almost six years.

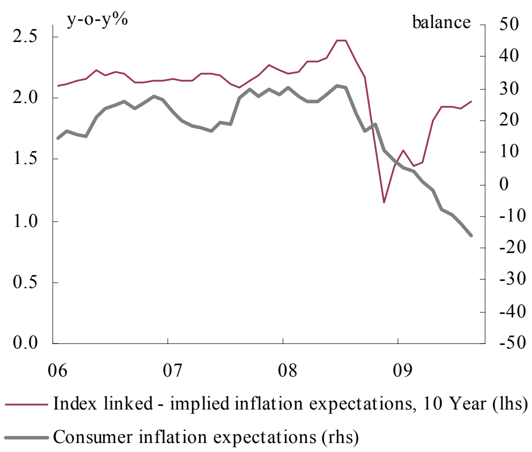
Graph 10: Headline and underlying inflation, euro area



Source: Commission services.

Looking ahead, given that labour markets react with a lag to economic activity and capacity utilisation is at a record-low level, a moderation of inflationary pressures from labour markets appears likely.

Graph 11: Inflation expectations, euro area



Source: Ecowin and Commission services.

Consumers' and producers' inflationary expectations also continued to ease in August, in response to the subdued economic outlook and the continued drops in actual inflation.

Based on an update of the inflation outlook for the seven largest Member States, the *outlook for inflation* in 2009 has been left unchanged at the aggregated level. Relatively moderate revisions across countries, except Germany, have offset each other. Thus HICP inflation is expected to average 0.4% in the euro area and 0.9% in the EU this year.

The stability of the inflation annual average, however, masks some significant shifts in the quarterly profiles across countries, due to the sometimes surprising outcomes in the second quarter. The pass-through from currency depreciation was stronger than expected in Poland and the UK, oil prices in Italy and the Netherlands were higher than anticipated, while services inflation decelerated faster than expected in Spain. Nonetheless, inflation is still expected to reach a trough of 0.3% in the EU and -0.3% in the euro area in the third quarter of 2009, and increase gradually thereafter.

The projected profile for inflation is shaped by two factors. On the one hand, the assumed softening of inflationary pressures on all HICP components, due to the weakening macroeconomic environment and the expected deceleration in unit labour costs, is likely to continue to depress underlying inflation. This is consistent with substantial slack in the economy, as reflected by the large output gap. On the other hand, the large energy and food-related base effects of last year are set to reverse this autumn, thus adding to the headline inflation rate towards the end of 2009. Commodity prices also pose an upside risk to the inflation outlook.

Impact on labour market and public finances partly ahead

The *labour market* situation deteriorated further this year. Employment in both the euro area and the EU fell by 0.9% in the first quarter, exceeding the quarterly declines recorded in the second half of 2008. In July, the unemployment rate stood at 9.5% in the euro area and 9.0% in the EU, more than 2 pps. above the lows of early 2008.

However, the pace of the deterioration in labour market conditions appears to have moderated somewhat since late spring. For instance, the average monthly change in the unemployment rate between May and July was 0.1 pp., compared with 0.3 pp. for the first four months of the year. This easing reflects in particular the short-term policy measures put in place to support employment.

Nonetheless, the labour market situation is expected to deteriorate further in the second half of 2009. This is in line with the usual lag of around 2-3 quarters between cyclical developments in economic activity and the labour market. Moreover, despite an improvement in firms' employment expectations in recent months, survey data is still pointing to job reductions going forward. Likewise, while the positive impact of the various labour market policies implemented in response to the recession is set to continue, the effects of some may weaken in the latter part of the year. Specifically, if the economic outlook does not improve rapidly, firms in countries where publicly supported short-term working schemes are in place (such as Germany whose short-term work programme covered around 1.4 million people at the end of June, compared to 270,000 at end-2008), may reduce the use of such schemes and increase layoffs.

Public finances in 2009 are expected to be strongly affected by the downturn, due to the working of automatic stabilisers (e.g. shrinking tax bases and rising social expenditure), but also because of the discretionary fiscal stimulus measures taken by many EU governments with the aim of stabilising the economy within the framework of the Recovery Plan. While the interim forecast does not reassess the budgetary outlook for EU Member States, preliminary information suggests that government deficits in the EU and the euro area in 2009 could be even higher than expected at the time of the spring forecast. This appears to be mainly caused by stronger-than-expected revenue shortfalls in a number of countries, as output growth and the size of discretionary stimulus measures are broadly in line with the spring forecast.

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

Continuing uncertainty but risks more balanced

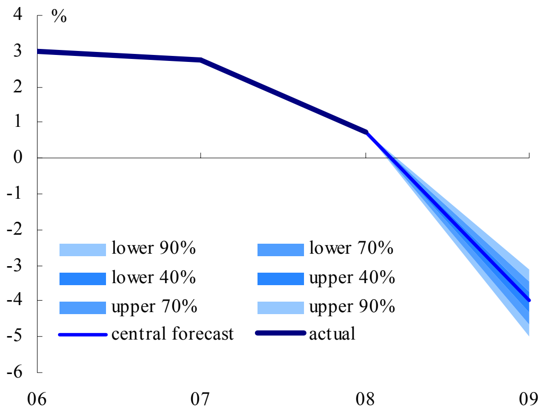
At the current juncture, risks to the EU *growth outlook* for 2009 appear broadly balanced. While data for the early part of the year confirmed the materialisation of some of the downside risks identified in the spring forecast it is, above all, surprises on the upside that have characterised the situation as of late. The positive nature of recent data points to a pick-up in economic activity, albeit modest, in the second half of 2009. However, the sustainability of any recovery is far from clear and uncertainty remains high.

Beginning with the *downside risks* to the outlook, the possible intensification of the negative feedback loop between the real economy and the still relatively fragile financial sector remains a key concern. In addition, headwinds on the domestic front - such as deteriorating labour-market conditions (unemployment has yet to peak), ongoing housing-market corrections in several Member States, spare capacity and the ending of some stimulus measures - could weigh on domestic demand more than envisaged at present, posing a second downside risk. At the same time, the relative strength of the euro may restrain export growth somewhat. In terms of the external environment, rising oil and other commodity prices could mitigate the global recovery, as could an increase in protectionist pressures (following a further increase in unemployment) or a loss of confidence due to e.g. uncertainty about the composition and robustness of the rebound and the nature of exit strategies.

On the *upside*, policy measures in the EU (and abroad) may prove more effective than assumed to date in restoring the financial sector to health, and in supporting economic activity. Similarly, the imminent turning of the inventory cycle could have a greater impact on domestic demand than currently anticipated, as could further improvements in business sentiment. Moreover, to the extent that policies aimed at the labour market have a better than expected outcome, consumer confidence and spending might also be stronger. Finally, a more pronounced upturn in global demand poses an upside risk for export growth.

Graph 12 quantifies these various risks in terms of the possible deviation of output growth from the updated central forecast. It shows the impact that different 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 and with data for the first half of the year already available, GDP growth in the euro area in 2009 could be about 1 pp. lower than the central scenario if all negative factors were to materialise, but could also be up to 1 pp. higher if the positive risks to the outlook were to come about.

Graph 12: Risks to the growth outlook, euro area



Source: Commission services.

Turning to the *inflation outlook*, risks also appear to be broadly balanced for 2009. While the recent pick-up in commodity prices and improving economic conditions represent upside risks further out, excess capacity (as reflected by the large output gap), is likely to continue exerting downward pressure on inflation in the near future.

As regards the risk of a deflation scenario, i.e. a persistent decline in a very broad set of prices, propagated by a self-reinforcing expectation of further price declines, the spring forecast noted that this 'appeared limited at the current juncture, at least at the aggregate level'. Given the present rebound in oil and other commodity prices, and with base effects set to reverse shortly, this risk seems to have subsided further thereafter.

Overall, it would appear that, amid continuing sizeable uncertainty, risks to the EU growth outlook for 2009 are broadly balanced. Likewise, risks to the inflation outlook appear largely balanced at this time.

*L*ooking towards the *medium-term horizon,* it remains to be seen whether the current rebound will translate into a sustained recovery once the effect of stimulus measures fade, and the full implications of the crisis for labour markets, public finances and potential growth rates come to the fore. A full assessment of these risks will be carried out in the upcoming autumn forecast.

Growth and inflation prospects in the seven largest Member States

1. Germany – private consumption stabilises the economy

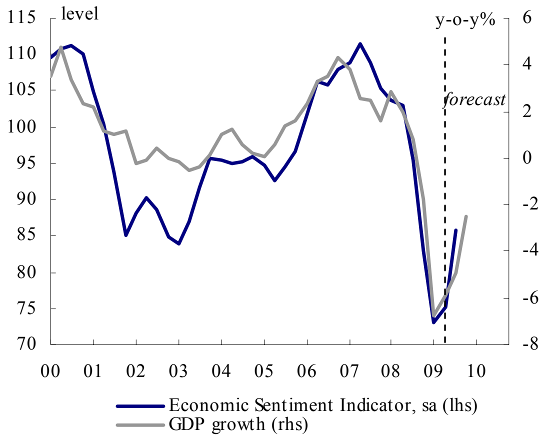
Dragged down by a massive slump in exports and investment, real GDP in Germany contracted by 3.5% q-o-q in the first quarter, slightly worse than projected in the spring forecast. However, on the back of robust private and public consumption, the economy staged a faster-than-expected recovery in the second quarter, growing by around ¼% q-o-q. Private consumption was aided by very low inflation, the legacy of relatively high wage growth in 2008 and the fact that unemployment has remained well contained so far, mainly thanks to the increased use of short-time work. Moreover, relief measures included in the fiscal stimulus packages and higher social transfers limited the impact of the crisis on disposable incomes, while the car scrappage premium offered additional incentives to advance car purchases. The rebound in the second quarter was further supported by a gradual recovery of exports and a certain stabilisation of investment demand.

Most leading indicators point to the recovery taking further hold in the second half of the year. Economic sentiment, business climate and consumer confidence indicators have improved noticeably in recent months. Industrial orders, including export orders, have recovered from record-low levels and industrial production started growing again in May, having fallen almost uninterruptedly for eight months in a row.

In line with these improving leading indicators, real GDP growth is set to gather pace in the third quarter. This is due to a number of factors. First, judging from monthly data, the economic recovery in the second quarter only took off in May and June. This implies a large positive carry-over into the third quarter, which increases the quarterly growth rate for purely statistical reasons. Second, the public infrastructure projects adopted as part of the German stimulus package started being implemented mainly from the third quarter, providing an additional boost to growth. Third, the inventory cycle has turned with massive de-stocking already taking place in the second quarter. Consequently, positive growth contributions can be expected in the third quarter (and beyond) as companies gradually start to replenish their inventories. Finally, private consumption will again be supported by still relatively low unemployment as well as pension hikes taking effect in July.

While the recovery is expected to continue in the fourth quarter, it is, however, set to lose some momentum. The anticipated increase in unemployment and higher inflation in the second half of the year will increasingly weigh on private consumption. Furthermore, the de facto expiry of the car scrappage scheme in September is likely to trigger some backlash, leading to a short-fall in demand later in the year. Also, statistical factors will no longer provide an additional boost to growth rates as they do in the third quarter. Real GDP growth is therefore projected to decelerate from ¾% in the third quarter to 0.1% in the fourth quarter.

Graph 13: Germany – economic sentiment and GDP growth



Source: Commission services.

Thanks to favourable base effects associated with lower oil and energy prices, annual HICP inflation has steadily decelerated since the start of 2009 and turned briefly negative in July. Inflation is expected to pick up moderately until the end of the year, as these base effects gradually peter out, and to reach around 0.3% on average for the year.

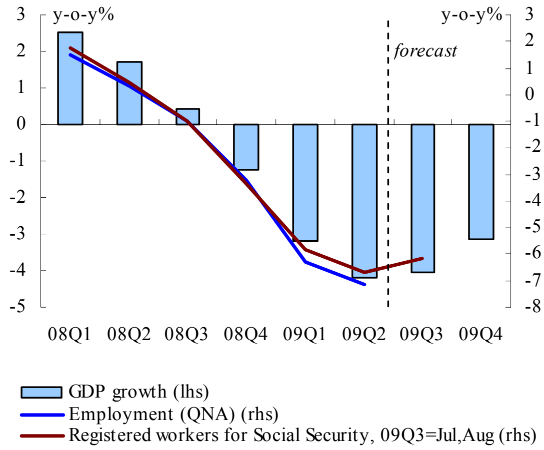
2. Spain – slower pace of adjustment due to structural imbalances

Economic activity in 2009 is forecast to decline by around 3¾%, reflecting the structural correction of internal and external imbalances accumulated over the last ten years, together with the impact of the financial crisis.

The deeper GDP contraction projected for 2009, which represents a downward revision of ½ pp. compared with the spring forecast, stems from the materialisation of some of the identified downside risks. Specifically, the strong acceleration of job destruction in the first half of 2009 has accentuated the fall in private consumption. In addition, the latest revision of the national accounts has revealed a more negative contribution from domestic demand in 2008, as well as in the first half of 2009, driven by a sharper fall in gross fixed capital formation and a more negative behaviour in private consumption. However, the lower cost of credit, the recent improvements in the consumer confidence indicator, and positive developments in the number of registered workers in July and August suggest a slower fall in the coming quarters. For investment, the on-going adjustment in the housing sector is projected to continue at a similar pace. Nevertheless, less tight credit conditions and the easing observed in the deterioration of the economic situation, which could lead to an improvement in profit expectations, should favour the realisation of some of the corporate investment plans that were initially delayed. As a result, the fall in investment in equipment is set to be less pronounced in the second half of the year. Overall, domestic demand is projected to reduce GDP growth in 2009 by more than 6.5 pps.

In the external sector, the revision of the national accounts has also revealed a more positive contribution of net external demand in 2008 and in the first half of 2009, mainly driven by a significant contraction in imports of goods and services. However, the fall in imports might be less marked in the coming quarters, more in line with developments in domestic demand. Exports growth turned positive in the second quarter of 2009, consistent with the incipient recovery of world demand. All in all, the growth contribution of net exports is expected to increase to 2.9 pps. compared to 1.4 pps. in 2008.

Graph 14: Spain – employment and GDP growth



Source: INE and Social Security Institute.

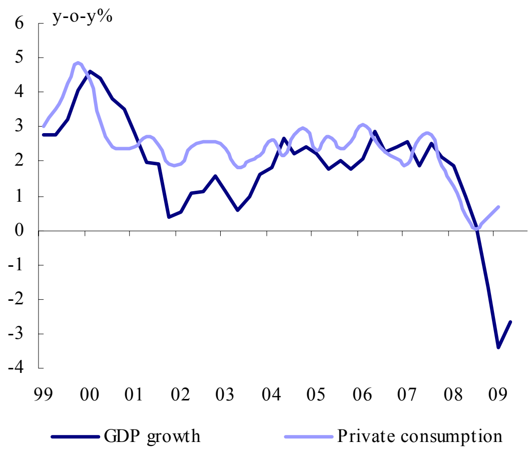
Prices are expected to stagnate in 2009. Although inflation fell to -0.7% in the second quarter of the year and might still fall slightly further in the third quarter, it should return to positive territory in the fourth quarter, around ¼ pp. above the average in the euro area, mirroring the projected increase in oil prices. The recent slowdown in unit labour cost in the first half of 2009 merely reflects large productivity increases resulting from the significant number of lay-offs recorded in the construction sector.

3. France – back in positive territory from the second quarter

GDP surprisingly started to expand again and grew by 0.3% in the second quarter of 2009 after having contracted sharply by 1.4% in the last quarter of 2008 and 1.3% in the first of 2009. Growth was mainly supported by a surge in exports, thanks most notably to the good performance of the automotive industry. Thus, the contribution of net trade to GDP growth came out significantly positive (0.9 pp.) after having been a drag for the four previous quarters. Private consumption maintained a relative resilience and posted positive growth despite the ongoing marked deterioration of the labour market. Fixed investment continued to adjust to the downturn, but at a slower pace (-1.0% q-o-q after -2.6% in the first quarter). Inventories were the main hindrance to economic activity; after having subtracted 0.7 pp.

from GDP in the first quarter, they shaved off an additional 0.6 pp. in the second quarter.

Graph 15: France – GDP and private consumption



Source: Ecowin.

In the second half of 2009, activity is expected to continue to expand moderately, with quarterly growth of 0.4% and 0.3% in the third and fourth quarters respectively. Indicators point to a recovery in production: the manufacturing Purchasing Managers' Index (PMI) rose above 50 in August for the first time since mid-2008 and the services PMI is recovering rapidly as well. With inventories back at normal levels, stock building could have a positive impact on growth in the second semester of 2009 for the first time since the first half of 2008. In an improved international context, exports are set to keep on rising. Private consumption, which continues to be supported by the various stimulus measures in favour of households, is expected to remain positive but weak, in view of the rapidly worsening labour market: unemployment reached 9.8% in July and might even cross the two-digit barrier in 2009. In addition, consumer confidence is slowly recovering, but from a low level. The end of the decline in consumer prices is also expected to weigh on household consumption from the fourth quarter onwards. As for investments, they are likely to suffer in the short term from low capacity utilisation rates, as well as from a lacklustre housing market. However, the stimulus package will kick in, mainly from the third quarter, and public investment is expected to provide a significant relief to activity notably in the construction sector.

Over the entire year, GDP is forecast to grow by -2.1%, compared with -3% in the Commission services' spring 2009 forecast.

The year-on-year HICP inflation rate, which continued to fall in July, to -0.8% from -0.6% in June, is expected to bottom out in the third quarter and to become positive in the fourth. The main reason for these developments is the base effects associated to last year's sharp price increases caused by food and energy inflation, in a context of clearly positive underlying inflation.

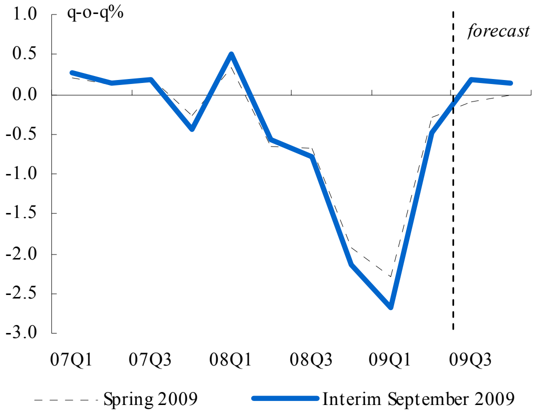
4. Italy – gradual improvement after a deep recession

The slump in global demand and confidence linked to the financial crisis has hit hard the Italian economy. Having already been on a recessionary path since the second quarter of 2008, real GDP contracted sharply over the final quarter of 2008 and the first quarter of 2009 (-2.1% and -2.7% q-o-q respectively). It is reported to have contracted again in the second quarter of 2009, although more moderately (-0.5% q-o-q). These outcomes were worse than those projected in the Commission services' spring 2009 forecast.

In recent months, confidence in both services and manufacturing rebounded significantly from the trough reached in February/March 2009, even though the level remains relatively subdued. Industrial production is expected to recover somewhat in the third quarter of 2009, after contracting by around 25% since the peak recorded at the beginning of 2008. Real GDP is thus projected to grow moderately in both the third and the fourth quarters of 2009. For the year as a whole, economic activity is projected to shrink by 5%, the strongest annual fall in several decades.

Final consumption is expected to be the main driver of the very mild expansion in the final quarters of 2009, as anticipated by the recent rebound in consumer confidence. The factors behind this improvement are likely to be lower inflation and the government recovery schemes providing relief to most vulnerable households and sustaining purchases of durable goods. At the same time, tax incentives recently put in place by the government will help to limit the contraction in investment in the remainder of the year.

Graph 16: Italy – GDP growth



Source: Commission services.

Exports are assumed to benefit from the nascent recovery in global demand, in particular in Italy's main trading partners of the euro area. Imports are expected to return to modest growth, driven by domestic demand for durable goods. Overall, the contribution of net exports to real GDP growth in the second half of the year is anticipated to be broadly neutral. Finally, following the recovery in activity, a re-stocking of inventories above the current low levels is also expected to support demand in the second half of 2009.

The expected weak recovery in the second half of 2009 implies a small positive growth impulse into 2010.

HICP inflation is expected to decline to an historical low in the third quarter of 2009 given the still positive base effect for energy prices. Under the assumption of a moderate increase in oil prices, inflation is set to pick up in the fourth quarter. Overall, annual HICP inflation is expected to average 0.9% in 2009.

5. The Netherlands – end of recession this year?

In the first half of 2009, economic activity experienced a severe contraction. After a sharp q-o-q drop of GDP by 2.7% in the first quarter, there was another decline of 0.9% in the second quarter, the fifth in a row. Exports contracted rapidly in the first half of 2009, reflecting the sensitivity of the Dutch economy to world trade. However, as imports also decreased sharply, the contribution of net exports to the negative growth (1.1%) remained relatively limited in the first half of 2009 compared to the 2.5% negative contribution of domestic demand. Most striking was the fall in private consumption, which decreased by 1.8% and 0.6% q-o-q in the first two quarters respectively, despite a rise in real disposable income. This was probably due to significant confidence and wealth effects.

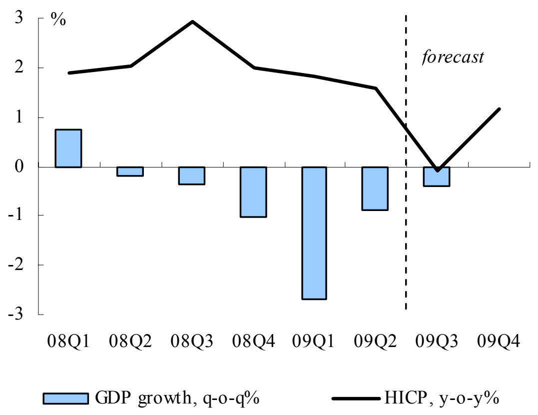
GDP growth is expected to escape negative territory at the end of this year, with flat growth in the fourth quarter, whereas the preceding third quarter should still show a decline in economic activity of 0.4%. Private consumption growth is expected to remain subdued for the rest of the year, as consumer confidence, although on an increasing trend in the past months, continues to be negative and will therefore most likely put downward pressure on spending. Also, households have experienced important wealth losses over the past year, mainly through a fall in the stock markets and decreasing pension fund assets. These wealth losses are foreseen to have a prolonged upward effect on the households' saving rate. Finally, unemployment might increase, having a negative impact on real disposable income. Government expenditure and the stimulus package are expected to have a positive effect on economic growth. As for investment, the negative growth of the first half of 2009 is likely to be continued in view of still weak demand and a very low capacity utilisation rate, as well as difficult credit conditions. GDP growth is projected to benefit also from a positive contribution from net exports, as it is expected that exports stabilise in the remainder of 2009 and imports decrease due to falling domestic demand.

After having been very tight for several years, the labour market has been loosening this year, reflected by the sharp fall in the vacancy rate. Although the unemployment rate is still at a very low level and until now rising at a rather modest pace it is expected that it will increase rapidly.

The year-on-year HICP inflation rate should bottom out in Q3. Its drop is mainly the result of the lower energy prices, in particular gas and electricity.

Overall for 2009, inflation is expected to come out at 1.1%.

Graph 17: The Netherlands – GDP growth and inflation



Source: Commission services.

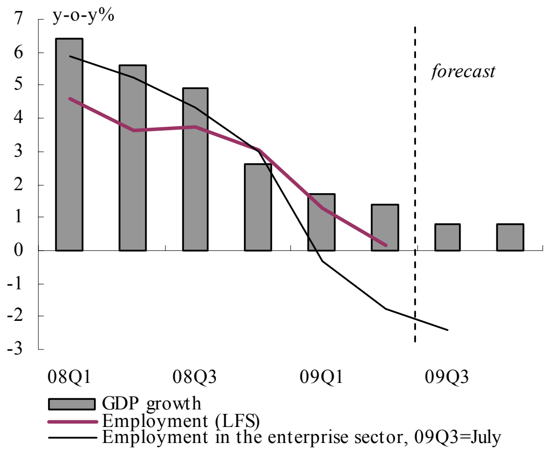
6. Poland – strong resilience in a difficult environment

Economic activity continued to be strong in the second quarter of 2009 reaching ½% q-o-q. The positive growth surprise was due to a highly positive contribution of net exports, driven by the collapse of imports as the sustained depreciation of the Polish currency undermined their price-competitiveness to the benefit of domestic production. However, domestic demand fell on the back of a significant drop in inventories and shrinking investments, while private consumption continued growing, fuelled by personal income tax cuts, indexation of pensions, the relatively resilient labour market and still positive credit growth to households.

For 2009 as a whole, GDP is expected to grow by 1%, Poland being probably the only country in the EU to post positive growth. This follows from the better-than-expected result in the first half of 2009.

GDP quarter-on-quarter growth is expected to stabilise during the remainder of the year. Domestic demand will continue to fall, with a decreasingly positive contribution of consumption and negative contribution of investments. Improving external demand and imminent restocking will, however, support the Polish economy in the second half of the year.

Graph 18: Poland – employment and GDP growth



Source: Polish statistical office and Commission services.

Consumption growth will decline as the situation in the labour market is set to deteriorate on the back of increasing unemployment and sluggish growth in nominal wages. The unemployment rate is expected to grow, after a temporary improvement during the summer, as the effects of the recent lay-offs and restructuring in the enterprise sector become visible. Investment levels are expected to weaken further on account of uncertain business environment and sluggish FDI inflows, despite relatively sound profit situation of the corporate sector in the first half of the year and increased infrastructure spending.

The appreciation of the currency in recent months is expected to improve the price-competitiveness of imports towards the end of the year and into 2010, while rebounding external demand is set to improve the outlook for exports. All in all, the contribution of net exports should remain positive, albeit in a declining trend.

HICP inflation in the second quarter of 2009 reached 4¼% year-on-year on the back of exchange rate developments, almost a full percentage point higher than in the spring 2009 Commission services' forecast. The effects of the depreciation during the turn of 2008 / early 2009 will still be felt throughout 2009, though should be progressively mitigated by the deteriorating domestic demand.

All in all, inflation for 2009 has been revised upwards compared to the spring forecast, from 2.6% to 3¾%.

7. The United Kingdom – return to positive territory before year-end

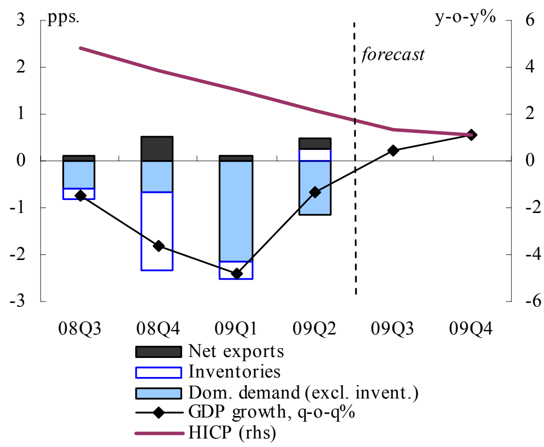
Following declines in UK output in the second half of 2008, the pace of GDP contraction increased further in the first quarter of 2009 to reach a quarterly rate of -2.4%. The second quarter saw a smaller reduction in output of 0.7% (q-o-q), marking it as a probable inflection point in the recession. Growth in both quarters was dominated by domestic demand falls, led by large reductions in fixed investment as credit conditions remained restrictive, spare capacity rose and new industrial orders fell. Private consumption contracted by 1¼% and 1% respectively in the corresponding quarters, exerting a negative drag on growth and continuing the falls in household spending that set in during the second quarter of 2008. Government expenditure grew moderately throughout the first half of 2009, but gave only a minor impetus to growth. Inventories were reduced in the first and second quarters by the largest amounts on record, although a smaller fall in the second implied a minor GDP stimulus for the quarter. Imports and exports contracted sharply over the same period as domestic demand in the UK and its main trade partners fell. Imports shrank somewhat more sharply, thus improving net exports, which supported growth by 0.1 pp. and 0.2 pp. respectively. The labour market weakened considerably, with the unemployment rate rising from 6.3% in Q4 2008 to 7.8% in Q2 and the employment rate declining by 2 p.p. on the year to 72.7% in the second quarter. The Bank of England maintained its accommodative stance, leaving Bank Rate at 0.5% since its last change in March, when it commenced a programme of asset purchases currently expected to total £175bn (~12.5% GDP).

GDP in the third and fourth quarters of the year is expected to return to slight positive growth as both industrial and services output recover from the lows of the second quarter. Domestic demand will continue to prove lacklustre, however, with continued falls in fixed investment likely. In view of a projected further weakening of the labour market, a return to minimal positive growth in private consumption is likely to occur only in the final quarter, partly supported by the announced reversal of the 2.5 p.p. reduction in VAT at the beginning of 2010. Slower falls in inventories are likely to temporarily exert upward pressure on growth in the remaining quarters, with inventories stabilising at the turn of the year. Government consumption will be buoyed in the second half if Budget spending targets are adhered to, while net foreign demand will provide a minor lift to activity, supported by a gradual stabilisation of exports and further falls in imports.

Overall, GDP growth for the entire year is forecast to reach -4.3%, which constitutes a downward revision of ½ p.p. from the Commission services' spring 2009 forecast.

The year-on-year HICP inflation rate in July remained unchanged from the previous month at 1.8%, only slightly below the Bank of England's target. Inflation is expected to fall throughout the rest of the year on account of easing capacity pressures and continued demand weakness, as indicated by negative producer price inflation rates. Base effects from the previous year are also likely to depress inflation rates. Average HICP inflation in 2009 is expected to be 1.9%, with the upward revision from spring being primarily due to the larger-than-expected pass-through of sterling's depreciation.

Graph 19: The United Kingdom –contributions to quarterly GDP growth and inflation



Source: Commission services.

Table 2: Real GDP growth

	Quarterly GDP forecast (%, quarter-on-quarter) 2009				Annual GDP forecast (%, year-on-year) 2009	
	2009/1	2009/2	2009/3	2009/4	*Spring forecast May 2009*	Interim forecast Sep. 2009
Germany	-3.5	0.3	0.7	0.1	*-5.4*	-5.1
Spain	-1.6	-1.1	-0.4	-0.2	*-3.2*	-3.7
France	-1.3	0.3	0.4	0.3	*-3.0*	-2.1
Italy	-2.7	-0.5	0.2	0.1	*-4.4*	-5.0
Netherlands	-2.7	-0.9	-0.4	0.0	*-3.5*	-4.5
Euro area	**-2.5**	**-0.1**	**0.2**	**0.1**	***-4.0***	**-4.0**
Poland	0.3	0.5	0.1	0.0	*-1.4*	1.0
United Kingdom	-2.4	-0.7	0.2	0.5	*-3.8*	-4.3
EU27	**-2.4**	**-0.2**	**0.2**	**0.1**	***-4.0***	**-4.0**

Source: Commission services.

Table 3: Consumer price inflation

	Quarterly HICP forecast (%, year-on-year) 2009				Annual HICP forecast (%, year-on-year) 2009	
	2009/1	2009/2	2009/3	2009/4	*Spring forecast May 2009*	Interim forecast Sept. 2009
Germany	0.8	0.2	-0.2	0.6	*0.3*	0.3
Spain	0.5	-0.7	-0.8	0.9	*-0.1*	0.0
France	0.7	-0.2	-0.6	0.2	*0.2*	0.0
Italy	1.4	0.9	0.1	1.1	*0.8*	0.9
Netherlands	1.8	1.6	-0.1	1.2	*1.4*	1.1
Euro area	**1.0**	**0.2**	**-0.3**	**0.7**	***0.4***	**0.4**
Poland	3.6	4.3	4.2	3.3	*2.6*	3.8
United Kingdom	3.0	2.1	1.3	1.1	*1.0*	1.9
EU27	**1.6**	**0.9**	**0.3**	**0.9**	***0.9***	**0.9**

Source: Commission services.

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

Technical background

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 2009). This interim forecast updates the outlook of the spring 2009 economic forecast of 4 May 2009. The cut-off date for this interim forecast to take new information on board was 7 September 2009.

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 has 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 quarter-on-quarter growth rates 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. Calendar factors are, however, relatively small in 2009.

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 4 September, implying e.g. an annual average of USD/EUR of 1.38.

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 1.3% and the long-term interest rates at 3.3% in 2009 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 61.9 USD/barrel in 2009 (corresponding to 45.4 EUR/barrel). This would be 17.1 USD/barrel (or 12.8 EUR/barrel) higher than assumed in the spring 2009 forecast, reflecting an improved global outlook and demand expectations from e.g. emerging markets.

Global demand in 2009 is revised upwards, following the recent improved indicator for the US and particularly Asia. Global GDP growth excluding the EU is now forecast to slow to 0.2% only in 2009 (down from 3.8% in 2008), nearly 1 pp. higher than expected in the spring forecast (-0.7%). World trade is also set to fall sharply in 2009, with growth in export and import volumes (excluding the EU) estimated at below -12%.