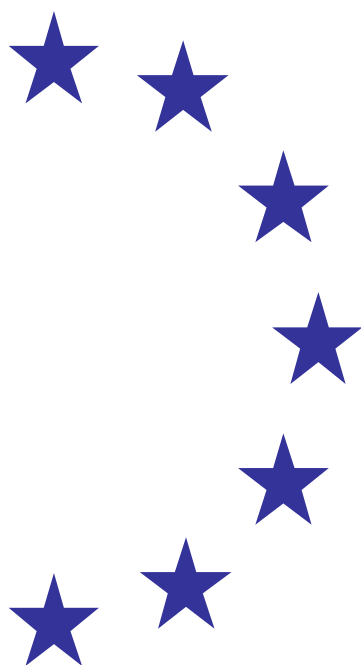


# EUROPEAN COMMISSION

DIRECTORATE-GENERAL FOR  
ECONOMIC AND FINANCIAL AFFAIRS



**September 2006**  
**Interim forecast**

**Press conference of 6 September 2006**

## **European economic growth speeding up, boosted by buoyant domestic demand**

*In February this year, the Commission presented the first of what will now become regular twice yearly interim forecasts. These forecasts update the comprehensive bi-annual forecasts, the purpose being to improve economic surveillance in the European Union and the euro area. The interim forecasts make an assessment of real GDP growth and HICP inflation for the current year for the European Union and the euro area based on updates for six of the larger Member States. This note presents the second interim forecast and includes, for the first time, an update of the Polish outlook (see box for further details). It updates the Commission's fully-fledged spring forecast presented on 8 May 2006.*

***The European economies have performed markedly better than expected so far in 2006, despite oil prices rising by 80% since the beginning of 2005. Real GDP growth accelerated to 0.8% quarter-on-quarter in the first quarter and 0.9% in the second quarter of 2006 in both the euro area and the EU, bringing the pace of growth well above potential.***

***This robust acceleration reflects an increase in the resilience of the European economies and a greater ability to rely on domestic demand.***

***The update of the outlook for six of the larger EU economies indicates that economic growth is set to remain above potential throughout 2006. For the year as a whole, GDP growth has been revised upwards by 0.4 percentage points from 2.1% to 2.5% in the euro area and from 2.3% to 2.7% in the EU.***

***Consumer prices continue to be pushed up by higher energy prices. However, excluding the impact of energy and unprocessed food, core inflation has remained subdued, suggesting that indirect effects of the high oil prices on consumer price inflation have been minor so far. Based on the new update, HICP inflation for the year as a whole has been revised upwards slightly to 2.3% in both the euro area and the EU.***

### ***Conditions for growth remain favourable***

Overall, the external conditions remain supportive to economic growth in the euro area and the EU.

External demand will be helped by a continued strong expansion of the global economy. Following a better-than-expected outcome in e.g. the US and China in the beginning of 2006, world GDP growth (excluding the EU-25) has been revised upwards since the spring forecast to 5½% in 2006. Whilst the growth momentum is expected to be sustained in much of Asia, economic activity is set to moderate in the US, owing to the earlier monetary tightening and the surge in oil prices as well as the impact of the slowdown in the housing market on domestic demand.

Oil and other commodity prices have increased significantly in recent years. Oil prices reached a new record high at the beginning of August, when the price of a barrel of Brent crude rose to almost 80 USD, but eased somewhat thereafter when the risk of an extended conflict in the Middle East diminished. However, a low level of excess oil supply capacity, stretched refinery capacity and ongoing geopolitical risks suggest that oil prices will stay high in the near term. Based on current futures prices, oil prices are assumed to remain around 73 USD/barrel in the second half of 2006, which would be marginally higher than assumed in the spring forecast.

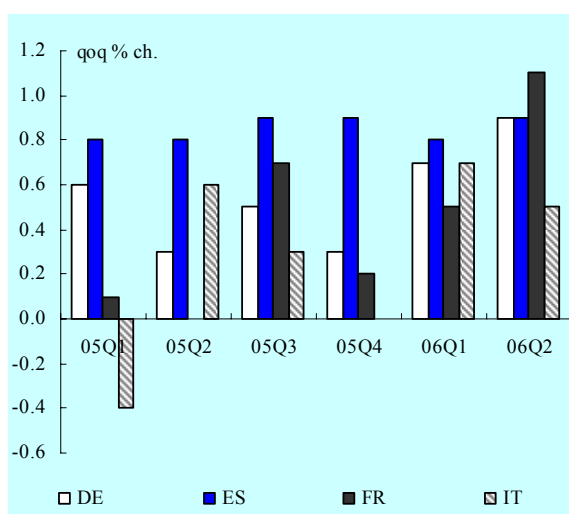
Furthermore, the stance of the macro-economic policy mix remains supportive to growth. Despite the recent interest rate hikes, credit growth remains robust suggesting that financing conditions continue to be favourable.

### ***Strong pick-up in EU growth so far in 2006...***

Against this background, the euro-area and the EU economies have performed even better than expected, with a marked acceleration in economic activity in the first half of 2006. According to Eurostat's first estimate of quarterly National Accounts, real GDP rose by an impressive 0.9% quarter-on-quarter in both the euro area and the EU in the second quarter. At the same time, real GDP growth in the first quarter was revised upwards to 0.8% for both areas. The outcome for the first half of this year is significantly above the

spring forecast and the strongest pace of growth recorded since 2000.

Graph 1: Growth dispersion across the largest euro-area Member States



The economic recovery now appears more broad-based, with domestic demand gaining momentum. The recovery is underpinned by an acceleration of investment (2.1% quarter-on-quarter in the second quarter), while private consumption rose more moderately (0.3%). Furthermore, growth differentials among the larger economies have narrowed (Graph 1). They amounted to around 1 percentage point in the first half of 2005, but thereafter fell to less than ½ a percentage point in the first half of 2006. Four of the five largest economies in the EU recorded a growth rate between 0.8-1.1% quarter-on-quarter in the second quarter of 2006.

**...but survey indicators point to an easing ahead**

Looking ahead, survey data indicate a moderation of economic activity in the second half of 2006, since several indicators appear to have peaked during the summer. For instance, the euro-area PMI composite indicator and the Commission's Economic Sentiment Indicator started to fall in July and August, respectively (Graph 2). Several national survey indicators also point to an easing in the pace of economic activity after the summer. The available information suggests that the softening of survey indicators would, to a varying degree, not only affect the manufacturing sector, but also the construction and services sectors.

The moderation suggested by the survey data may reflect a lagged effect of the strengthening of the euro and high oil prices, which are expected to gradually weigh on the growth momentum. In the case of Germany, it also mirrors the anticipated impact on demand in the first half of 2007 of the planned increase in the standard VAT rate by 3 percentage points in January 2007.

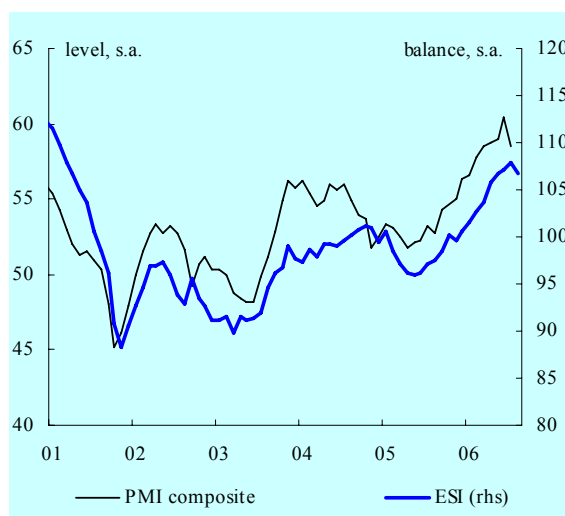
However, it should be noted that despite the recent slowdown, many indicators are still well above their long-term averages, suggesting a healthy pace of economic activity also in the second half of the year, even if somewhat below the growth performance in the first half of 2006.

**Growth outlook revised upwards for 2006**

Based on the individual updates for Germany, France, Italy, Poland, Spain and the United Kingdom (which are presented in greater detail in the country-specific sections below), GDP growth is set to ease somewhat, to 0.7% quarter-on-quarter, in the third and fourth quarter for both the euro area and the EU.

As a benchmark, when using the most recent information from both hard and soft data in DG ECFIN's Dynamic Factor Model, GDP growth is also projected to ease to 0.6-0.7% quarter-on-quarter in the euro area in the second half of 2006.

Graph 2: Business sentiment indicators in the euro area



Domestic demand is foreseen to continue to be the main contributor to the expansion in the euro area. Investment in equipment and construction is set to increase at a robust pace. However, the evolution of construction investment is partly explained by the increase in the German VAT rate in 2007, which is expected to shift part of the German housing investment as well as private consumption from 2007 to 2006. Other Member States expect a certain cooling of their housing markets. The gradual recovery of consumer confidence since the summer of 2005 and, above all, an improved labour market situation should stimulate an expansion of private consumption in the euro area. The impact of the planned budgetary measures in Germany on the underlying euro-area growth should not be exaggerated. While this has a marked impact on the projected profile, as assumed in the Commission's spring forecast, the overall growth effect for Germany of the budgetary policy measures is assessed to be broadly neutral over a time horizon of two years and does therefore not imply a weakening of the underlying growth momentum in 2007.

Overall, economic growth is expected to accelerate from 1.4% in 2005 to 2.5% in the euro area in 2006<sup>1</sup> and from 1.7% in 2005 to 2.7% in 2006 in the EU. In both cases, this represents an upward revision of 0.4 percentage point compared to the spring forecast. The revisions are principally the result of the stronger-than-expected outcome for the first half of 2006.

Looking further ahead, the updated outlook for 2006 (i.e. the upward revision by 0.4 percentage points for both areas) and the projected higher growth momentum at the end of the year should translate, in both the euro area and the EU, into upward revisions for 2007. However, the impact of a higher carry-over into 2007 will have to be carefully assessed against changes in the international environment, such as a possible faster deceleration of world economic growth. While, on current expectations, the scenario of a sharper deceleration than expected in the spring 2006 forecast does not have a high probability, it cannot be excluded either. The next fully-fledged Commission economic forecast, due in early

<sup>1</sup> Whilst quarterly growth data are working-day and seasonally-adjusted, to best obtain an underlying growth profile, the annual GDP data are unadjusted, in view of their use in the Commission's budgetary surveillance.

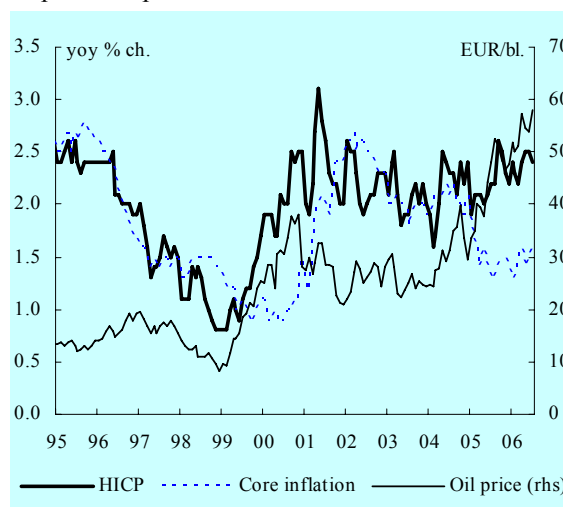
November, will provide a more detailed analysis of these issues.

***Headline inflation pushed up by higher energy prices – but core inflation remains well below 2%***

Turning to inflation, headline HICP inflation has remained above 2% so far this year in the euro area and the EU. This is largely the result of higher energy prices driven by the continued sharp increases in oil prices. However, excluding the impact of energy prices and unprocessed food, core inflation has remained subdued (1.6% in July).

The substantial gap between headline and core inflation (amounting to 0.8 of a percentage point in July) suggests that the oil price hike has not had significant indirect effects on the non-energy part of the HICP so far. However, price pressures at the producer level have kept increasing in recent months, with e.g. industrial producer prices (excl. construction) rising by 5.9% in July in the euro area. Excluding also the energy component, they accelerated from an annual rate of change of 1.6% in January to 3.4% in July in the euro area (with a similar acceleration in the EU). While the rising trend in input prices is likely to continue in the remainder of the year, strong price competition limits a full pass-through to core and headline inflation.

Graph 3: Oil prices and inflation in the euro area



In addition, inflation expectations, whilst accelerating somewhat, remain relatively subdued. Moderate wage increases and the recent increase in productivity

have resulted in sustained low unit labour costs growth. Second-round effects stemming from the surge in oil prices on wages continue to be largely absent. The improvement noted in the labour market could eventually prompt higher wage expectations as reflected by recent wage claims of 7% by German metal workers.

Based on the individual updates for Germany, France, Italy, Poland, Spain and the United Kingdom, HICP inflation in both EU and the euro area is now expected to average 2.3% this year. This corresponds to an upward revision of 0.2 percentage point for the EU and 0.1 percentage point for the euro area, compared to the spring 2006 forecasts.

***Positive impact on labour market and public finances***

In line with the upward revisions made to the projected growth scenario, labour markets have shown a somewhat more marked improvement in 2006 than expected earlier. The unemployment rate stood at 7.8% in the euro area in July 2006, compared to 8.6% one year earlier. Similarly, employment growth accelerated to 1.2% year-on-year (y-o-y) in the first quarter of 2006 in both the euro area and the EU, the strongest increases noted since 2000. The even stronger pick-up in economic activity has led to a sharp increase in labour productivity in the first half of 2006 (estimated at around an annualised 2%).

As regards public finances, currently available information suggests that in most of the larger Member States the budgetary results in 2006 may turn out somewhat better than expected in the spring 2006 forecast, thanks to the improved outlook for economic activity and a higher tax content of growth. A full assessment of the prospects for the public finances will be carried out in the Commission's autumn forecast.

***Risks to the forecast remain fairly balanced***

In the short term, the balance of risks may be slightly tilted to the upside as, mechanically and barring major data revisions, the carry-over from the first half of the year is sufficiently high to prevent any large downward deviations for annual growth in 2006. Moreover, the current strong momentum may, if the favourable conditions continue, be maintained for some time, which could lead to higher growth rates

than expected in the second half of the year. Finally, the improved labour market situation may impact on private sector spending more strongly than assumed.

Going forward, the balance of risks become tilted to the downside in 2007. First, further oil price hikes cannot be excluded in view of continued tensions in the Middle East and the approaching American hurricane season. Second, there is a non-negligible risk that the expected slowdown in world economic growth, particularly in the US, might be more significant than assumed by the forecast. Third, a disorderly unwinding of global imbalances continues to be a threat to the world growth outlook.

**Growth and inflation prospects in the six large Member States**

**1. Germany**

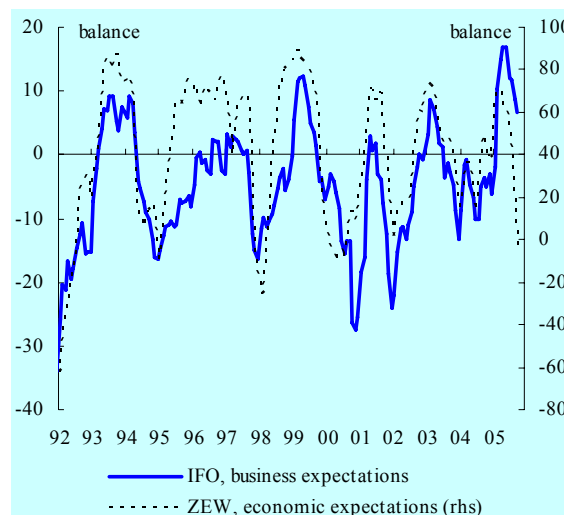
After an already robust first quarter, in the second quarter of 2006 the growth rate of real GDP reached its highest level in five years at 0.9%. For the year as a whole real GDP growth is expected to average 2.2%, 0.5 percentage point higher than in the spring forecast.

While in 2005 net exports were the main driver of growth, domestic demand also recently picked up, particularly machinery and equipment investment. In addition, after more than a decade of a continuous decline, construction investment has been staging a recovery, only interrupted by the cold weather in the first quarter. The particularly strong contribution of inventories to growth in the second quarter has to be seen in the light of an expected surge in domestic demand in the second half of the year, in anticipation of the increase in the standard VAT rate from 1 January 2007. Although private consumption figures have been volatile, the underlying trend appears solid.

Notwithstanding an expected easing in the third quarter, mainly on the back of inventory decumulation and lower exports of services, growth will remain strong in the second half of the year. Private consumption will be the main driver, particularly in the first quarter, reflecting anticipation effects but also recent positive labour market developments. The recent drop in survey data (Graph 4) should not be read as increasing the downside risks for 2006, as it essentially reflects the realisation of a particularly difficult first quarter in 2007.

Inflation in Germany is currently mainly driven by energy prices, with non-processed food prices also a factor in recent months. In addition, some enterprises may have already started to put up prices in anticipation of the increase in VAT. Therefore, although the escalation in energy prices should have come to an end, inflation is expected to fall only slightly in the third and fourth quarter, resulting in an average inflation rate of 2.0% in 2006.

Graph 4: Business expectations in Germany: ifo-Index versus ZEW-Index

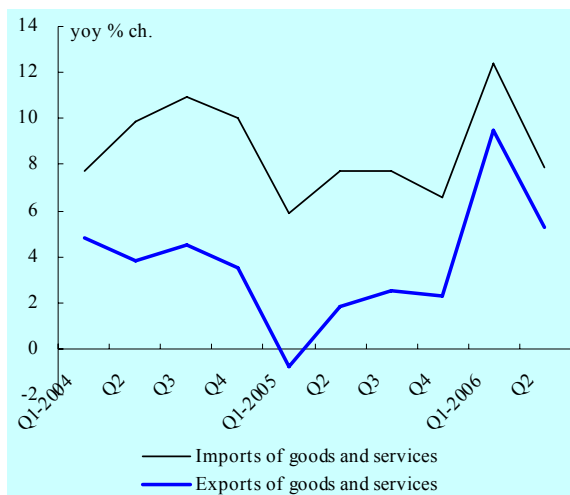


**2. Spain**

In the second quarter of 2006 real GDP grew by 0.9% (quarter-on-quarter), the same rate as in the first quarter. For the year as a whole, GDP growth is expected to average 3.5%, the same rate as in 2005. This represents a 0.4 percentage point upward revision with respect to the spring forecast.

Domestic demand is expected again to be the sole driver of growth. The dynamism of investment in dwellings explains the higher-than-expected outcome. Concerning the external sector, Spain seems to have benefited from the recovery of its traditional trade partners within the euro area and, as a consequence, a strong rebound of exports has taken place since the beginning of the year. However, a concomitant rebound of imports is likely to partly offset the beneficial effects of higher exports on growth.

Graph 5: Real growth of exports and imports of goods and services in Spain



Annual inflation rose by 4% in the second quarter of 2006. This is 0.3 percentage point above the spring forecast. The inflation differential vis-à-vis the euro area remains at around 1½ percentage points. The upward revision of the inflation forecast reflects not only the relatively stronger real GDP growth, but also the fact that the effect of the energy bill is still passing through to HICP. Moreover, structural rigidities, such as the lack of competition in certain sectors coupled with remaining rigidities in the labour market, continue to weigh on price developments.

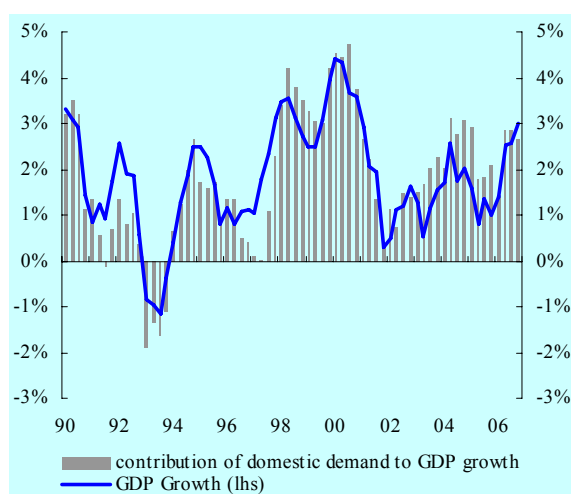
### 3. France

The expansion of economic activity in France continued in the first half of 2006, and in particular in the second quarter, when GDP growth rebounded by 1.1% on a quarterly basis. Although this performance is unlikely to be repeated in the coming quarters, economic activity should remain buoyant. Real GDP growth is projected to reach 2.3% for the year as a whole. This compares with 1.2% growth in 2005 and a forecast of 1.9% in the spring.

The latest macroeconomic indicators reveal positive prospects, with employment growth in particular showing encouraging signs in the second quarter of 2006. This should increasingly support private consumption, which is expected to remain the main driving force of economic growth. Exports are on an

upward trend as a result of the economic recovery in Europe, but considering that imports are expected to grow in line with robust domestic demand, the contribution of net exports to GDP growth should still be slightly negative.

Graph 6: Real GDP and domestic demand growth in France



In 2006, second-round effects from high raw material prices have been contained. Headline HICP inflation should be close to 2.0%, broadly in line with the spring forecast, in spite of the upwards revision in the assumptions about energy prices. Strong competition from low cost countries is preventing companies from fully passing the commodity price increases on to final customers. In addition, although the situation of the labour market is gradually improving, wage moderation still continues to prevail. Thus, core inflation, as measured by the HICP excluding food and energy prices, should be close to 1%, while energy inflation could exceed 8%, contributing half a percentage point to overall HICP inflation.

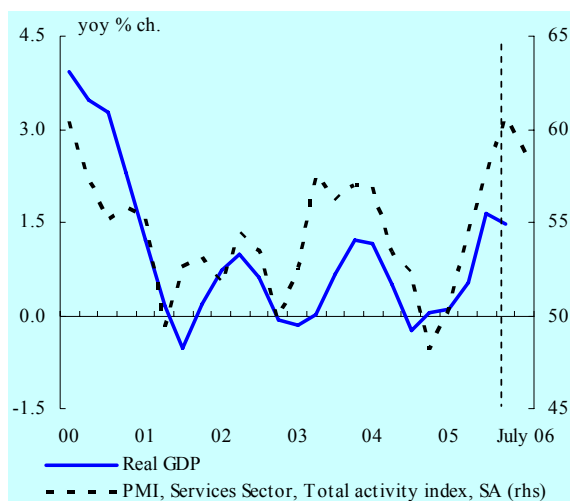
### 4. Italy

Following more dynamic than expected economic activity in the first two quarters of the year, business confidence indicators for both the manufacturing and services sectors suggest that economic activity is likely to expand further in the second half of the year. As confidence indicators appear to have peaked in May-June, quarterly GDP growth is expected to

moderate in the next quarter and to slow down slightly in the fourth quarter to just above the current estimate of potential growth. For 2006 as a whole economic growth is expected to be 1.7%, 0.4 percentage point higher than in the spring forecast.

The significant contribution of private consumption and gross fixed capital formation to real GDP growth in the first quarter and the positive indications for the services sector in the second quarter suggest that domestic demand will be the main driver of growth. Given also the stronger demand from the euro area, the contribution to economic growth from net exports could finally turn slightly positive. However, the recovery in exports is not expected to be sufficient to keep up with the pace of expansion in the corresponding export markets, resulting in further losses in market share.

Graph 7: Real GDP growth and confidence in the services sector in Italy



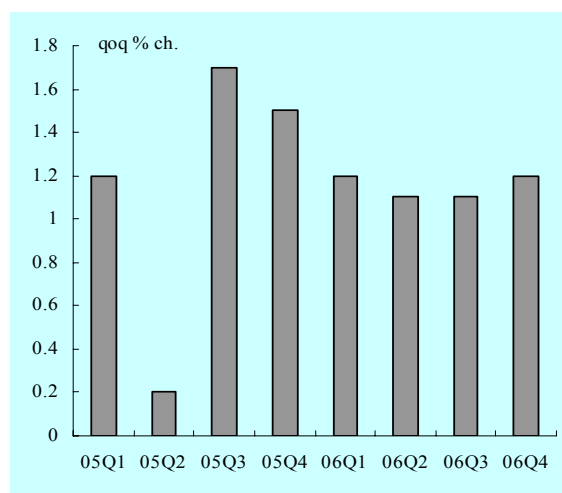
The forecast for annual HICP inflation has been revised marginally upwards relative to the spring forecast, to 2.3% in 2006. Industrial producer prices of final consumption goods have been accelerating over recent months providing evidence of some pass-through of high oil prices, even if core inflation is still well below 2%. On the back of more favourable cyclical conditions, labour productivity is expected to recover moderately, which should have a positive impact on the competitive position of the Italian economy.

**5. Poland**

Real GDP grew by a better-than-expected 1.1% quarter-on-quarter in the second quarter of 2006, contributing to an annual growth rate of 5.4% in the first half of the year. GDP is expected to continue to grow at similar levels until the end of 2006. For the year as a whole, real GDP is expected to grow by 5.0%, which is 0.5 percentage point higher than in the spring forecast.

The ongoing recovery is based on robust gross fixed capital formation, supported by healthy corporate profits and solid external demand. In particular, construction activity is strong and a recovery in the labour market is supporting growth. In the first half of 2006 the unemployment rate declined by 2 percentage points to 16%. The improvement is expected to continue in the second half of the year, albeit at a somewhat slower pace due to emerging skill mismatches.

Graph 8: Quarterly real GDP growth in Poland



HICP inflation reached 1.4% year-on-year in the second quarter of 2006, rising from 0.9% in the first quarter. Higher wage demands, fuelled also by emigration, which created bottlenecks in certain segments of the labour market, will put upward pressure on inflation in the second half of 2006. Thus, inflation for 2006 has been revised to 1.3%, up from 1.0% in the spring forecast.

**6. The United Kingdom**

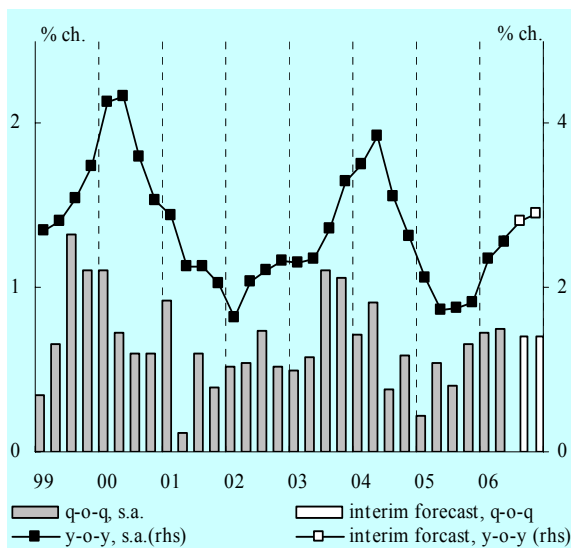
UK real GDP growth has regained momentum and reached a slightly better-than-expected 0.8% in the second quarter, after 0.7% in the first. Economic growth is now expected to continue at similar levels in the second half, with annual growth for 2006 reaching 2.7%. This is an upward revision of 0.3 percentage point from the spring forecast.

Second quarter growth was buoyed by robust consumers' expenditure. Retail sales volumes increased strongly, although the unusually hot weather may have affected the pattern of retail spending. Business investment maintained a sound footing during the first half of the year. Trade volumes have been buoyant, though the external sector is recorded as making a negative net contribution to economic growth.

Survey indicators support an outlook of continuing underlying steady economic growth. In particular industrial and retail trade confidence have improved considerably since the end of 2005.

wage settlements have so far remained subdued, thanks also to the softening of the labour market seen in the first half.

Graph 9: Real GDP growth in the United Kingdom



HICP inflation is projected at 2.3% in 2006, 0.3 percentage point higher than the spring forecast. Persistently high oil prices and the forthcoming increases in higher education costs (to be implemented in the autumn) may herald higher inflation. Nevertheless, inflationary pressures from

**Table 1: Real GDP growth**

	Quarterly GDP forecast (%, quarter-on-quarter)				Annual GDP forecast (%, year-on-year) <b>2006</b>	
	2006/1 (a)	2006/2 (a)	2006/3	2006/4	Interim forecast September 2006	Spring forecast May 2006
Germany	0.7	0.9	0.5	0.7	2.2	1.7
Spain	0.9	0.9	0.8	0.8	3.5	3.1
France	0.5	1.1	0.7	0.7	2.3	1.9
Italy	0.7	0.5	0.6	0.4	1.7	1.3
<b>Euro area</b>	<b>0.8</b>	<b>0.9</b>	<b>0.7</b>	<b>0.7</b>	<b>2.5</b>	<b>2.1</b>
Poland	1.2	1.1	1.1	1.2	5.0	4.5
United Kingdom	0.7	0.8	0.7	0.7	2.7	2.4
<b>EU25</b>	<b>0.8</b>	<b>0.9</b>	<b>0.7</b>	<b>0.7</b>	<b>2.7</b>	<b>2.3</b>

Notes: (a) Data for 2006/1 and 2006/2 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) <b>2006</b>	
	2006/1 (a)	2006/2 (a)	2006/3	2006/4	Interim forecast September 2006	Spring forecast May 2006
Germany	2.1	2.1	1.9	1.8	2.0	1.7
Spain	4.1	4.0	3.8	3.7	3.9	3.6
France	2.0	2.2	2.0	2.0	2.0	1.9
Italy	2.2	2.3	2.3	2.3	2.3	2.2
<b>Euro area</b>	<b>2.3</b>	<b>2.5</b>	<b>2.3</b>	<b>2.3</b>	<b>2.3</b>	<b>2.2</b>
Poland	0.9	1.4	1.4	1.6	1.3	1.0
United Kingdom	1.9	2.2	2.4	2.4	2.3	2.0
<b>EU25</b>	<b>2.2</b>	<b>2.4</b>	<b>2.3</b>	<b>2.3</b>	<b>2.3</b>	<b>2.1</b>

*Box: Technical background to the interim forecast*

In February 2006, the Commission presented the first of what will now be twice-yearly interim forecasts with the objective of updating its comprehensive spring and autumn economic forecasts (with the next fully-fledged forecast scheduled for 6 November 2006). This interim forecast updates the outlook of the spring 2006 economic forecast presented on 8 May 2006, ([http://ec.europa.eu/economy\\_finance/publications/european\\_economy/forecasts\\_en.htm](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 1 September 2006.

The interim forecast updates the outlook for the six larger Member States, i.e. Germany, Spain, France, Italy, Poland 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, the results of which may be adapted using judgemental forecasting techniques.

Estimates for the European Union and the euro area are prepared using the (nominal) GDP-weighted updates for the larger Member States. These countries account for more than 75% of the European Union and almost 80% of the euro area in terms of nominal GDP. Smaller Member States have tended to grow faster than the larger ones and their outlooks have not been updated. The Commission has made projections for the euro area (and the EU) using the updates for the four and six larger Member States, respectively, and assuming that the revision for the smaller Member States is equal to that of the larger ones.

When comparing quarterly with annual GDP growth rates it must be kept in mind that, whenever possible, quarterly data are adjusted for seasonal influences and the number of working days while annual data is presented in unadjusted form.

***External conditions remain broadly unchanged***

This forecast is based on a set of external assumptions.

As usual, a technical assumption is made as regards the exchange rates. It is kept constant based on an average of the historic exchange rates from 11 to 25 August 2006. The estimated average for the USD/EUR rate was 1.26 for 2006 (compared to 1.22 USD/EUR used in the spring 2006 forecast).

Short-term interest rates are set in order to reflect the price stability objective of monetary policy. Long-term interest rate assumptions are based on developments in short-term rates and an assessment of economic conditions, taking into account international financial linkages and market expectations.

The outlook for oil prices is based on futures prices. The price for a barrel of Brent crude oil is projected to remain at around 73 US\$/barrel in the second half of 2006. This would yield an expected average price of 69.3 US\$/barrel in 2006, which is only 0.4 US\$/barrel higher than assumed in the spring 2006 forecast.

Global demand in 2006 is revised slightly upwards reflecting, in particular, stronger-than-expected growth in the US and China in the first half of this year. Real GDP growth for the world (excluding the EU-25) is thus forecast at around 5½% in 2006. Similarly, world trade has been revised slightly upwards for 2006, with growth in both export and import volumes of goods estimated at around 9% (excluding the EU-25).