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European Economic Forecast

Summer 2023

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EUROPEAN ECONOMY

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European Commission
Directorate-General for Economic and Financial Affairs

European Economic Forecast

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Institutional Paper 255

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EASING GROWTH MOMENTUM AMID DECLINING INFLATION AND ROBUST LABOUR MARKET

The EU economy continues to show resilience in the face of the formidable shocks it has endured in recent years, but it has lost momentum. Economic activity in the EU was very subdued in the first half of 2023. Weakness in domestic demand, in particular consumption, shows that high, and still increasing consumer prices for most goods and services, are taking a heavy toll, more than expected in the Spring Forecast. This is despite declining energy prices and an exceptionally strong labour market, which has seen record low unemployment rates, continued expansion of employment and rising wages. Meanwhile, the sharp slowdown in the provision of bank credit to the economy shows that monetary policy tightening is working its way through the economy. Survey indicators point to slowing economic activity in the summer and months ahead, with continued weakness in industry and fading momentum in services, despite a strong tourism season in many parts of Europe.

The weaker growth momentum in the EU is expected to extend to 2024, and the impact of tight monetary policy is set to continue restraining economic activity. As the outlook for global growth and trade remains broadly unchanged compared to spring, the EU economy cannot count on strong support from external demand. However, a mild rebound in growth is still projected next year, as inflation keeps easing, the labour market remains robust and real incomes gradually recover.

Retail energy prices are set to continue declining for the remainder of 2023, but at a slowing pace. They are projected to increase slightly again in 2024, driven by higher oil prices. Inflation in services is set to continue moderating as demand softens, under the impact of monetary policy tightening and a fading post-COVID boost. The other non-energy components of the consumption basket will continue contributing to easing inflation over the forecast horizon, also reflecting lower input prices and normalising supply chains.

Overall, this forecast revises growth down for the EU and the euro area in both 2023 and 2024. HICP inflation is expected to continue declining, broadly in line with the spring projections.

Russia's ongoing war of aggression against Ukraine and wider geopolitical tensions continue to pose risks and remain a source of uncertainty. Furthermore, monetary tightening may weigh on economic activity more heavily than expected, but could also lead to a faster decline in inflation that would accelerate the restoration of real incomes. By contrast, price pressures could turn out more persistent, prompting a stronger response of monetary policy. Mounting climate risks also weigh on the outlook.

Table 1:
Overview - the Summer 2023 interim Forecast

	Real GDP growth						Inflation					
	Summer 2023 interim Forecast			*Spring 2023 Forecast*			Summer 2023 interim Forecast			*Spring 2023 Forecast*		
	2022	2023	2024	2022	2023	2024	2022	2023	2024	2022	2023	2024
Euro area	3.3	0.8	1.3	*3.5*	*1.1*	*1.6*	8.4	5.6	2.9	*8.4*	*5.8*	*2.8*
European Union	3.4	0.8	1.4	*3.5*	*1.0*	*1.7*	9.2	6.5	3.2	*9.2*	*6.7*	*3.1*
Germany	1.8	-0.4	1.1	*1.8*	*0.2*	*1.4*	8.7	6.4	2.8	*8.7*	*6.8*	*2.7*
Spain	5.5	2.2	1.9	*5.5*	*1.9*	*2.0*	8.3	3.6	2.9	*8.3*	*4.0*	*2.7*
France	2.5	1.0	1.2	*2.6*	*0.7*	*1.4*	5.9	5.6	2.7	*5.9*	*5.5*	*2.5*
Italy	3.7	0.9	0.8	*3.7*	*1.2*	*1.1*	8.7	5.9	2.9	*8.7*	*6.1*	*2.9*
Netherlands	4.3	0.5	1.0	*4.5*	*1.8*	*1.2*	11.6	4.7	3.0	*11.6*	*4.9*	*3.3*
Poland	5.1	0.5	2.7	*5.1*	*0.7*	*2.7*	13.2	11.4	6.1	*13.2*	*11.7*	*6.0*

1. EA AND EU OUTLOOK

1.1. SETTING THE SCENE

This Summer interim Forecast updates the GDP and inflation projections of the previous, full-fledged European Economic Spring 2023 Forecast, with focus on the economies of the six largest EU Member States, as well as the euro area and the EU aggregates. Country-specific projections for real GDP growth and HICP inflation in 2023 and 2024 are presented for Germany, Spain, France, Italy, the Netherlands and Poland. For the remaining 21 Member States, latest economic developments are factored into the calculation of the EU and euro area aggregates. Thanks to the later timing for its publication – in September instead of July as per past practice –, it factors in key data released over the summer, including information on real GDP growth in the third quarter and inflation in August.

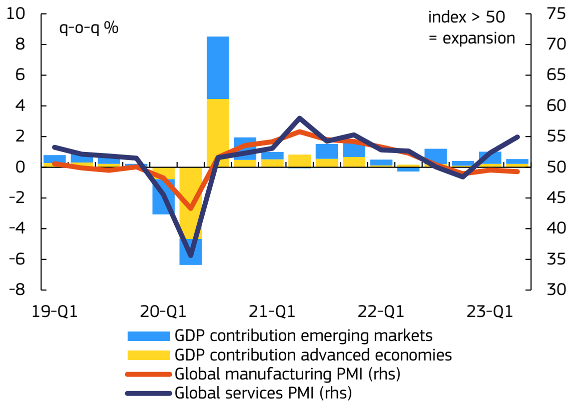
The factors shaping this forecast are not significantly different from those underpinning the Spring Forecast. The global economy fared somewhat better than anticipated in the first half of the year, despite the weak performance in China. However, the outlook for global growth and trade remains broadly unchanged compared to spring, implying that the EU economy cannot count on strong support from external demand. The tightening of monetary conditions is assumed to continue in line with markets' expectations for short and long term rates, without producing any disorderly adjustment in financial markets. As for energy commodity prices, spot and futures prices for oil have moved up compared to the prices assumed in spring, but gas and average electricity prices are lower. Risks of energy supply shortages have receded, and it is still assumed that (limited, but adjusting) supply will match (restrained) demand throughout the forecast horizon. Last but not least, geopolitical tensions caused by Russia's war of aggression against Ukraine have not eased and the working assumption underpinning this forecast is again that they will not be resolved within the forecast horizon.

1.2. THE GLOBAL ECONOMY: RECENT DEVELOPMENTS AND OUTLOOK

Global economic activity moderated in the second quarter of 2023. Global growth is estimated to have slowed to 0.5% q-o-q in the second quarter of 2023, after a strong (1% q-o-q) beginning of the year (see Graph 1.1). Growth in 2023-Q2 was driven mainly by robust activity in the US, where domestic demand continued to expand, and in other advanced economies. At the same time, growth in China slowed, as the initial reopening surge fizzled out.

The US economy has held up better than expected since the start of the year. Output increased by 0.5% q-o-q in both 2023-Q1 and 2023-Q2 on the back of robust consumption growth and positive surprises in investment, possibly spurred by subsidies under the CHIPS and Science Act and the Inflation Reduction Act. With the unemployment rate at 3.8% in August, still near the trough of 3.4%, and continued employment growth, the labour market remains tight. However, the vacancy rate started to subside, and unemployment claims are creeping up. July monthly data point to a continued expansion of the economy in the third quarter, with industrial production up sharply (1% m-o-m) and retail sales also up (0.6% m-o-m). Stronger-than-expected growth in the first half of the year and sustained momentum into 2023-Q3 results in an upward revision of the projection for real GDP growth for 2023 as a whole, compared to the Spring Forecast. Some slowdown is still expected in 2024 in the face of gradually deteriorating consumer finances in a high interest rate environment.

Graph 1.1: **Growth in global GDP and global PMIs**



Sources: OECD, IMF and national sources for GDP, S&P Global for PMI.

Table 1.1:
International environment

(Annual percentage change)				Summer 2023 interim Forecast			Spring 2023 Forecast		
	2019	2020	2021	2022	2023	2024	2022	2023	2024
				Real GDP growth					
World (excl.EU)	2.9	-2.6	6.3	**3.2**	**3.2**	**3.2**	*3.2*	*3.1*	*3.3*
				Trade volumes					
World (excl.EU) exports of goods and services	0.2	-7.0	10.4	**4.0**	**1.4**	**3.2**	*3.9*	*2.2*	*3.2*
World (excl.EU) imports of goods and services	-0.6	-8.3	11.3	**4.8**	**1.5**	**3.4**	*4.8*	*1.4*	*3.0*

The outlook for the other advanced economies for 2023 has brightened as well. Activity in the UK has held up better than previously expected, despite energy prices and inflation being high. Real GDP grew by 0.1% in 2023-Q1 and 0.2% in 2023-Q2, leading to an upward revision to the growth outlook for 2023 compared to the Spring Forecast ([1]). However, as monetary policy continues to tighten amid persistent inflationary pressures and the outlook for trade, investment and productivity remains weak, the growth projection for 2024 is now lower. In Japan, GDP growth was a robust 1.5% q-o-q in 2023-Q2, driven by rapid expansion of exports on receding supply bottlenecks and booming tourism. The outlook for 2023 is marked up compared to the spring on account of the strong outcome in the first half of the year, while for 2024 it has been slightly lowered as elevated inflation is expected to dent private demand.

China's reopening rebound following its strict COVID-19 policies proved short-lived. China's GDP growth slowed considerably to 0.8% q-o-q in 2023-Q2, from 2.2% in the first quarter. Household spending remained subdued due to relatively poor labour market outcomes, especially for youth, and still high precautionary savings. Investment growth weakened, on the back of poor investor confidence and low private sector investment, especially in real estate. July data point to further softening in activity, adding to unfavourable developments (e.g., consumer and producer price deflation, the rising default risk of a major property developer, and missed payments on high-yield investment products by a large private wealth manager). The economy is struggling with a confidence crisis, with both households and private enterprises focusing on saving or reducing debt. External demand is also weakening, leaving only the state-run sectors to drive growth. Without further more decisive policy support to boost demand in the second half of 2023, the outlook is revised downwards compared to the spring. The direct impact of the downward revision on the EU economy is likely to be marginal ([2]).

Recent PMI readings point to moderation in global growth over the summer. Global composite manufacturing and services PMIs have fallen from their April readings (which were taken into account in the Spring Forecast). The global manufacturing PMI was at 48.7 in July (49.6 in April), while the services PMI was 52.7 in July (55.4 in April), with PMIs in emerging market economies higher than in the advanced economies.

Overall, global growth is now projected slightly higher than in spring for 2023, but slightly lower for 2024. With higher-than-projected growth in the second quarter of 2023 in major advanced economies (e.g. US, Japan, UK), but softer momentum in China, on balance, real global GDP growth is forecast to reach 3.2% (+0.1 pps.) in 2023 and 3.2% (-0.1 pps.) in 2024.

Global trade growth deteriorated during the summer amid weak demand. Global trade volumes momentum (latest three months on the three months before) declined to -0.3% in June, down from +0.7% in May. More recent data signal a marked deterioration of global trade during the summer, with the Kiel trade indicator falling by 1.6% m-o-m in July and 0.3% in August. In addition, new export orders in global PMIs declined further (47.8 in July vs. 48.3 in June) and still point to a divergence between goods, registering a deeper downturn in export performance amidst weak global demand, and services. Growth in global trade is

([1]) Moreover, taking account of significant revisions to national accounts data for 2020 and 2021, the volume of UK GDP is now estimated to be 1.8% above pre-pandemic level, instead of being just below in previous estimates.

([2]) China is the destination of less than 2.5% of GDP worth of exports of goods and services by the EU or the euro area, whereas it is the origin of almost 4% of GDP worth of imports.

forecast to slow significantly (to 1.5%) in 2023, despite a better-than-previously-expected outlook for Chinese imports, driven by a higher import share in domestic demand and stockpiling of oil and raw materials. World trade is forecast to pick up moderately (+3.4%) in 2024, though growth is projected to remain much below long-term averages. This implies minor upward revisions for global imports relative to the Spring Forecast for both 2023 and 2024 (see Table 1.1), which may be of limited relevance for EU exports.

Supply chain pressures increased marginally but remain relatively low after steady improvement since late 2021. In July, the Federal Reserve Supply Chain Pressure Index rose to -0.9, ([3]) from -1.14 in June and a historical low of -1.56 in May. The supplier's delivery times index reported in global PMIs deteriorated slightly (51.9 in July vs. 52.3 in June) but continues to indicate an improvement in delivery times. Container ship waiting time at major ports continued decreasing or remains at low levels, with the low water levels at the Panama Canal not having a noticeable impact on global maritime traffic. Shipping rates remain contained, albeit the start of the peak shipping season came with an incipient increase in rates since late July.

Global headline inflation continued to decline in 2023, but core inflation remains high. Inflationary pressures moderated on lower commodity prices and softening global goods demand. Global (ex-US) headline inflation retreated to 4.2% ([4]) in June 2023, from a peak of 7.4% in October 2022. However, underlying inflationary pressures remain more elevated (inflation excluding energy and food stood at 4.9% in June), reflecting tight labour markets and high service price inflation, both in advanced and emerging market economies (except for China).

Global monetary policy was tightened over the summer. Having paused in June for the first time since the hiking cycle started in the US in March 2022, the Federal Open Market Committee increased its policy rate by 25 bps. at its meeting in July (to a range of 5.25% to 5.5%). Markets now expect at most one more policy rate hike, possibly in November (with another pause at the September meeting). The expected timing of the first rate cut now pushed further out, as elevated core inflation, notably due to services, and high wage growth remain a source of concern for the FED. Central banks in the other advanced economies (e.g. UK, Australia, Canada) hiked interest rates as well (by 75-50 bps. since April 2023) amid persistent high core inflation, while in the emerging market economies monetary policy tightening seems to have broadly come to an end. At the same time, the Chinese central bank cut its policy rates in August for the second time in three months to boost borrowing.

1.3. COMMODITIES

The outlook for oil prices is for a slight decline, but to higher levels than assumed in the spring, and upside risks have been building up. After a two-year low of 74 USD per barrel at the beginning of summer, the Brent oil price recovered to 88 USD in early August on higher consumption, and a decrease of stocks and production cuts. It then retreated to 84 USD on evidence of a deepening property sector crisis in China. Futures prices have moved up on signs of possible OPEC+ supply cuts and point to slightly higher prices than assumed in the Spring Forecast for both the remainder of 2023 and 2024 ([5]). The oil market remains tight, with the International Energy Agency predicting global supply to run short of demand this year and some countries already striving to replenish low stocks. Potential sources of volatility of crude oil prices over the forecast horizon include the uncertain outlook for supply from Russia, due to the implementation of oil sanctions, and from Saudi Arabia and OPEC+, as well as the pace of China's recovery and corresponding oil demand.

The outturn and outlook for European gas and electricity prices have improved relative to spring. Spot prices turned out lower than previously expected in 2023-Q2 (by 11% for electricity and by 15% for TTF gas). For 2023-Q3 markets now seem to suggest levels that are lower by 21% for gas and 25% for electricity relative to what was expected in spring. This was made possible by the rapid expansion of the liquefied natural gas infrastructure and the diversification of supplies. Gas storage facilities across the EU are reported

([3]) Values are reported in standard deviations from the series average. Supply pressures peaked at 4.3 in Dec 2021.
([4]) Calculated by the Federal Reserve Bank of Dallas
([5]) The revision is above all due to the movements in the USD price and to a far lesser extent to the evolution of the exchange rate.

to be near-full, implying limited pressure from stock replenishment going forward. Gas futures suggest prices staying marginally below the levels expected in spring in the outer quarters of 2024. Against this background, a similar evolution is expected for electricity prices. With energy-intensive industries and households having adjusted their energy consumption patterns, and assuming normal temperatures throughout winter, upside risks to gas and electricity prices appear contained.

Metal prices have remained broadly flat since spring. Signals to markets have been mixed, considering the more subdued Chinese recovery. Metal price evolution over the forecast horizon will remain influenced by developments in China's construction and manufacturing, the pass-through of monetary policy tightening in advanced economies and continued supply-side constraints for metals crucial to the transition to clean energy (e.g. lithium, cobalt).

Agricultural commodity prices continued declining, but the outlook is increasingly uncertain. The FAO Food Price Index edged up in July, following three consecutive monthly declines in a row. As a result, in July, the index was about 12% lower compared to a year ago, at levels seen in the same month of 2021. Price developments since the Spring Forecast have been mostly driven by large falls in prices for cereals and to a lesser degree for dairy products and vegetable oils. Uncertainty on the price outlook remains elevated ([6]), especially for cereals (notably wheat, despite positive news about this year's crop in some regions), given Russia's withdrawal from the Black Sea Grain Initiative, changes in global demand, export restrictions (rice) and weather-related anomalies such as El Niño affecting yields.

1.4. FINANCIAL MARKETS

Tight financial conditions continue to put a brake on economic activity. While the increase in expected policy rates since spring has been moderate, there is mounting evidence of its impact on financing costs and credit volumes. Investments and overall activity in economic sectors most reliant on external funding, such as real estate, are most affected.

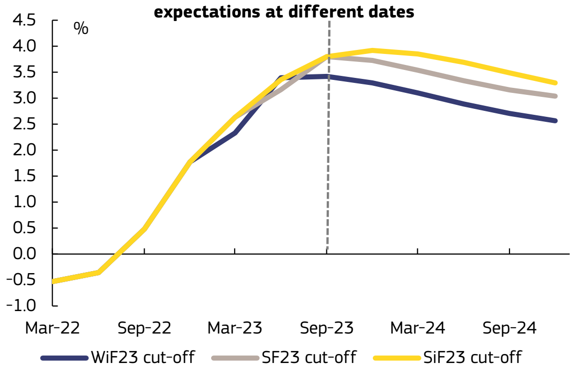
The European Central Bank has continued normalising its main monetary policy instruments. The ECB Governing Council raised its policy rates further by 25 bps. on 15 June and by an additional 25 bps. at its latest meeting on 27 July, bringing the overall increase in its policy rates to 425 bps. since July 2022. At the cut-off date of this forecast, the interest rates on the main refinancing operations, marginal lending facility and deposit facility stood at 4.25%, 4.50% and 3.75%, respectively. The size of the Eurosystem's balance sheet has continued to shrink over the past months, mainly driven by banks' repayment of maturing TLTRO III loans. Furthermore, following its previous guidance, in July the ECB stopped reinvesting the proceedings of securities maturing under its Asset Purchase Programme. However, it has remained committed to continue reinvesting the principal payments from maturing securities purchased under the Pandemic Emergency Purchase Programme, until at least the end of 2024.

It also reaffirmed its commitment to address fragmentation risks and risks for financial stability. The flexibility in the reinvestments of redemptions under the Pandemic Emergency Purchase Programme and the Transmission Protection Instrument is intended to ensure a smooth transmission of monetary policy. Following market tensions generated by the failure of several bank in the US, the ECB has stressed that it could provide liquidity if necessary for financial stability purposes.

([6]) A commodity food futures index of eleven agricultural commodities calculated with averaged weights used by various international institutions (ECB, HWWI, S&P and WB) went up by 3.5 % for 2023-H2 and 4.6 % for 2024 compared to the Spring Forecast.

Compared to the Spring Forecast, market expectations now point to policy rates peaking later and remaining slightly higher throughout next year. Markets expect the ECB main policy rate to be close to peak and see a further 25 bps. increase as very likely before the end of 2023 (see Graph 1.2). They then expect the ECB main policy rate to remain at its peak level until 2024-Q2, after which ECB would start cutting it. Some market analysts expect the ECB to start cutting interest rates later, in 2024-Q3.

Graph 1.2: **Short-term euro area interest rate expectations at different dates**

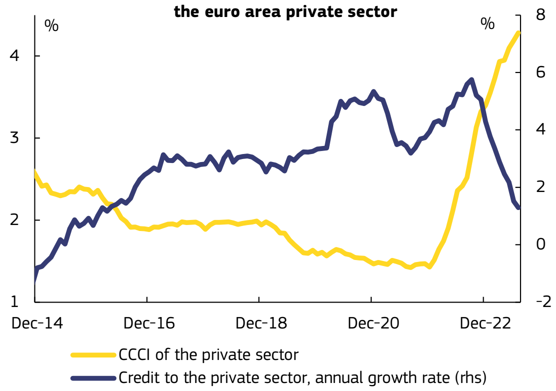


Source: IHS Markit, Refinitiv, Bloomberg.
Note: 3 months Euribor, expectations based on future contracts.

In central and eastern Europe, some central banks have started to decrease their interest rates from peak level. Policy rates have been kept unchanged since the Spring Forecast in Czechia and Romania, both at 7%. At the same time, in Hungary and Poland, central banks have started to cut policy rates, which translated into slightly lower expected rates throughout next year. In Sweden and Denmark, central banks have increased their policy rates further, tracking the process of monetary policy normalisation of the ECB.

The provision of bank credit to the private sector continued to slow down, signalling an effective transmission of monetary policy. As the credit cost has risen further since spring, the provision of credit to the private sector continued to soften. The annual growth rate of adjusted loans to the private sector stood at 1.6% in July, down from 3.3% in April (see Graph 1.3). Both households and corporations have seen falling annual growth rates in loans (1.3% for households in July, down from 2.5% in April; 2.2% for non-financial corporations in July, down from 4.6% in April). This slowdown finds its roots in both tighter supply conditions and lower demand. According to the latest ECB bank lending survey for the second quarter, euro area banks tightened further their credit standards for loans or credit lines to both enterprises and households in the second quarter of 2023. For corporates, credit standards tightened slightly more for SMEs than for large firms and for long-term loans than for short-term loans. Banks' risk perceptions and lower risk tolerance continued to be the most significant factors contributing to the tightening. Banks' cost of funds and balance sheet situation also played a role, mainly owing to higher capital costs and banks' lower liquidity position. Demand for loans also continued to decline for both firms and households in the second quarter of 2023. For firms it reached an all-time low since the start of the survey in 2003, mainly driven by rising interest rates and declining demand for financing fixed investment. For households, higher interest rates, weakening housing market prospects and low consumer confidence all contributed to the lower demand for loans for house purchases. Looking forward to the third quarter of 2023, euro area banks expect a further net tightening of credit standards for loans to firms and households, but at a slower pace than in the second quarter. They also expect a further net decrease in demand for loans by firms and households, but to a lesser degree than during the previous quarters.

Graph 1.3: **Composite Credit Cost Indicator and credit to the euro area private sector**



Source: ECB, Bloomberg, Datastream.

The banking sector remains robust. The results of the 2023 EU-wide stress tests published by the European Banking Authority (7) (EBA) and the ECB in July indicated that banks would remain resilient under an adverse scenario combining a severe recession and higher interest rates and credit spreads. Resilience reflects

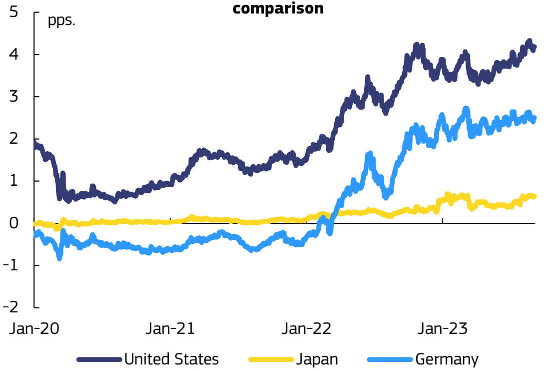
(7) The EU-wide stress test has been conducted on a sample of 57 banks from Euro area countries and 13 banks from Denmark, Hungary, Norway, Poland, and Sweden, overall representing about 75% of EU banks' total assets. https://www.eba.europa.eu/eba-publishes-results-its-2023-eu-wide-stress-test

banks' robust capital position, as well as the positive impact of increasing interest rates on banks' profits so far. At the same time, after a prolonged period of reduction in non-performing loans, early signs of deterioration of banks' asset quality are emerging. The increasing interest rates are expected to have an impact on the debt servicing capacity of households and firms, which could in turn affect the banks' loan portfolio quality. The EBA therefore stressed the importance of remaining vigilant and called for both supervisors and banks to be prepared for a possible worsening of economic conditions.

Higher mortgage rates and overall tightening credit conditions continued to impact EU's housing markets. Euro area house price growth decelerated to an annual rate of 0.4% in 2023-Q1, down from 9.8% in the same quarter last year. The majority of Member States saw continued moderation of house prices in the last quarters, with an outright decline in Czechia, Denmark, Germany, Finland, Luxembourg, the Netherlands, and Sweden. Looking forward, house prices in the EU are expected to mildly decline in nominal terms this year amidst persistent cross-country variations. While the high mortgage rates are set to weigh further on housing demand, housing supply is expected to remain constrained in most EU countries, which limits the potential for a generalised house price slump. Residential construction has fallen in recent months in most EU countries and is expected to further decline as suggested by declining building permits.

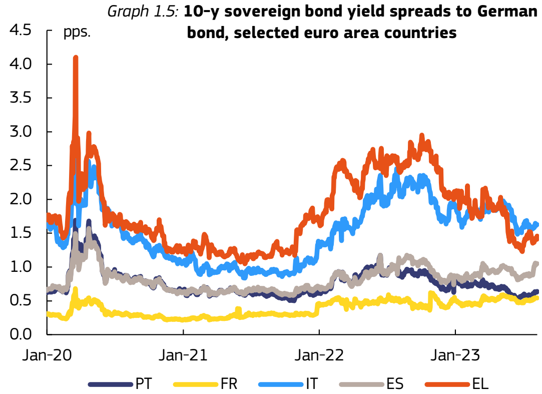
Long term sovereign bond yields have continued to move slowly up since the Spring Forecast, tracking expectations for higher policy rates. The increase is marginal in the euro area, less than 10 bps., while the US treasury yield increased by slightly more (see Graph 1.4). At the same time, euro area sovereign spreads remained constant for most countries and narrowed for the lowest rated Member States such as Italy and Greece (see Graph 1.5).

Graph 1.4: **10-year sovereign bond yields, international comparison**



Source: S&P Global Market Intelligence.

Graph 1.5: **10-y sovereign bond yield spreads to German bond, selected euro area countries**



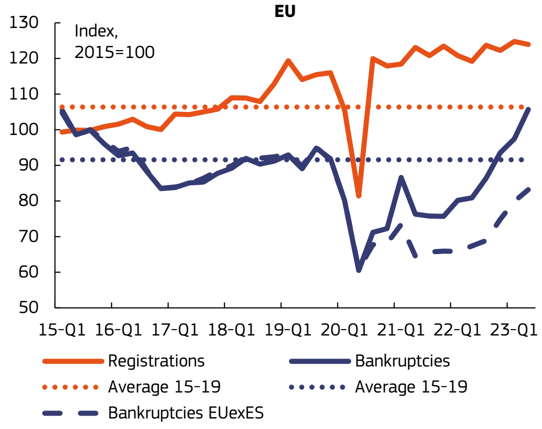
Source: iBoxx by IHS Markit.

Private sector asset valuations have only marginally changed since Spring. European equity markets stood at roughly the same level as at the Spring Forecast cut-off date, while corporate bond spreads increased marginally. This reflects both the prospects of slightly higher interest rates and the rising trend in corporate defaults, compounded by lower economic growth prospects.

EU bankruptcies are on the rise after a prolonged period at low levels. While business registrations remained constant at high levels, the number of bankruptcy declarations in the EU continued to increase in 2023-Q2 for the sixth consecutive quarter (see Graph 1.6). The EU average continues to be heavily impacted by the high and rising number of bankruptcy declarations in Spain, due to the new insolvency framework facilitating restructuring and creditor requests. Excluding Spain, the EU aggregate was still trending up from its 2022 levels, but at a much slower pace. The sectors that received financial support during the pandemic crisis, such as food and accommodation and transportation, show particularly high increases in bankruptcy registrations. What is more, as loans under the various national COVID-19 guarantee schemes mature over the coming months/years, bankruptcy declarations may increase further.

The euro has continued to strengthen since the Spring Forecast, appreciating by 2% in nominal effective terms. The euro appreciated against the Chinese renminbi and the Japanese yen, reflecting the widening difference in monetary conditions between these jurisdictions and the euro area. The euro also benefited from the broad depreciation of the Russian ruble, amid foreign investment outflows from Russia, and the Turkish lira. At the same time, the euro depreciated against the British pound and the Swiss franc, reflecting expectations of tighter monetary conditions in these jurisdictions in response to inflationary pressures. The euro also depreciated slightly against the US dollar.

Graph 1.6: **Business registrations and bankruptcies, EU**



1.5. RECENT ECONOMIC DEVELOPMENTS IN THE EU

1.5.1. Economic activity

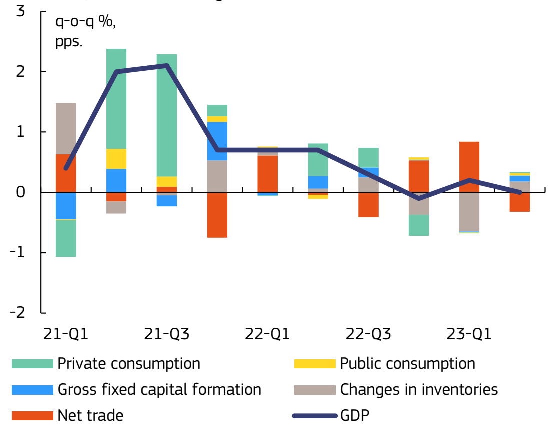
The EU economy has lost momentum. Following a mild contraction in the fourth quarter of 2022, EU real GDP grew by 0.2% q-o-q in the first quarter of 2023 and remained flat in the second quarter (see Graph 1.7). This means that the EU economy grew by only 0.2% in the first half of 2023, compared to the last quarter of 2022, 0.2 pps. lower than projected in spring. ([8]) In the euro area, growth was at 0.1% in both quarters (the second quarter was 0.1 pps. lower than projected in spring). Taking into account revisions to past data and growth up to the second quarter, acquired growth for 2023 stands at 0.4% in the EU and 0.5% in the euro area. As compared to the Spring Forecast, this implies 0.3 pps. lower annual growth in 2023 for the EU and 0.1 pps. for the euro area.

The loss of momentum over the first half of the year was underpinned by the lack of a solid growth driver, with weakness both on the external side and among consumers. Accumulating growth over the first two quarters of 2023 and comparing against the levels of the fourth quarter of 2022, only gross fixed capital formation – mainly equipment investment - and government consumption registered positive, albeit weak, growth in the EU (+0.2% and +0.1%, respectively). Investment dynamics were very volatile across Member States in the first half of the year, with sharp declines in Ireland and Denmark and strong gains in Spain, the Netherlands and Poland. Private consumption was stagnant, showing that high and still increasing consumer prices for most goods and services of the consumption basket – with the notable exception of energy prices - took a heavier toll than expected in the Spring Forecast. Based on available data for the first quarter, consumption of goods continued to decline, whereas consumption of services held up (see Graph 1.8). As consumption fell, the saving rate in the EU edged up to 13.3% in the first quarter (latest available), which is around 1 percentage point higher than 2019 levels. Mirroring the decline in consumption, imports fell by 1.5% over the first half of the year. The external side did not provide support to exports, which fell by 0.3% in total this year.

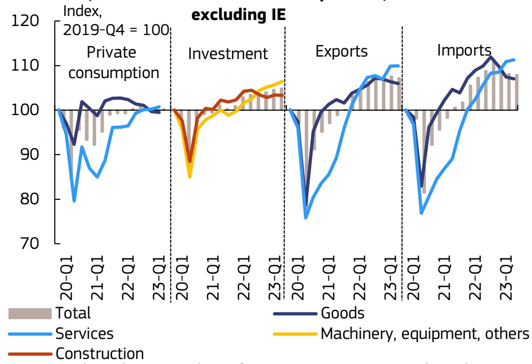
Weaker growth in the EU compared to the euro area in the second quarter was driven by a significant decline in Poland and Sweden. In these two countries, real GDP contracted by 2.2% and 0.8%, respectively. GDP also contracted in Hungary, Latvia, Austria, Cyprus, Estonia, Italy and the Netherlands, and stalled in Germany and Portugal, overall pointing to broad weakness across the EU. Among the remaining largest Member States, economic activity increased by 0.5% in France and 0.4% in Spain.

([8]) Ireland's outsized negative growth of -2.6% in the first quarter, again driven by the multinational enterprise sector, followed by a small rebound of 0.5% in the second quarter, affected the aggregate growth outturn. Excluding Ireland, growth for the EU in the first half of the year would have been 0.3%.

Graph 1.7: **Real GDP growth and its contributions, EU**

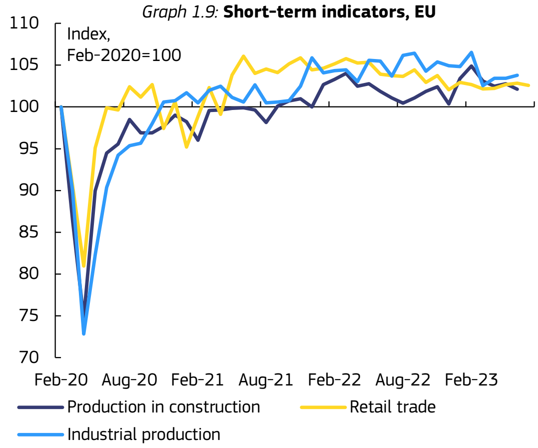


Graph 1.8: **GDP demand-side components, EU excluding IE**



Note: Goods and services data of private consumption are based on Member States' data where available, accounting for 77% of total private consumption in the EU excluding Ireland.

Graph 1.9: **Short-term indicators, EU**



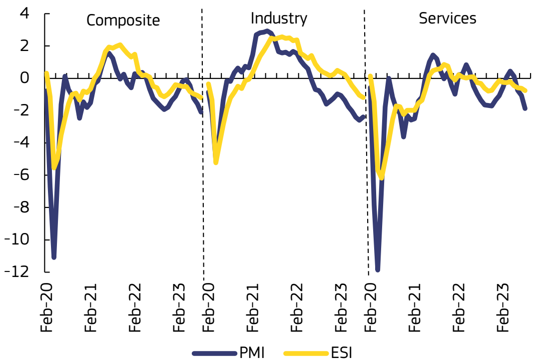
Business statistics signal a downturn in industry, construction and retail trade, but new car registrations and tourism point to normalisation in the sectors most impacted by the pandemic. Industrial production in the EU fell by 1.1% q-o-q in the second quarter, especially due to strong contractions in the production of consumer goods and energy (see Graph 1.9). Output in construction also fell by 1.4%, after a strong increase in the first quarter (2.4%). Likewise weak, retail trade volumes decreased by 0.2% in the second quarter, held back by price increases. Seasonally and calendar-adjusted extra-EU exports and imports of goods declined by 2% and 3.5%, respectively. On the positive side, new car registrations in the EU in July expanded by 15.2% year-on-year, with most markets posting solid growth. From January to July 2023, new EU car registrations grew significantly (+17.6%) on the back of lower supply chain disruptions.

More upbeat, latest figures point to a brisk rebound in tourism in the EU in the second quarter and, tentatively, also in the summer months, with levels of activity higher than in the same periods of 2022. According to Airports Council International Europe, passenger traffic across the European airport network increased by 28.3% in 2023-H1 (16.3% in 2023-Q2), compared to the same period last year. When compared to pre-pandemic (2019) levels, passenger volumes stood at -7.7% in 2023-H1, steadily improving over the period from -11% in January to -5.9% in June. Latest Eurostat data for May on total nights spent at tourist accommodation establishments (1.8% higher than May 2022) and August Eurocontrol data on flights across the European network (6.9% higher than August 2022) also offer an upbeat picture.

Survey indicators point to worsening economic activity in the third quarter, with continued weakness in industry and fading momentum in services. In August, the Economic Sentiment Indicator (ESI) continued to decline in both the EU and the euro area (see Graph 1.10). The decline was due to lower confidence among consumers (see Box 1.1), as well as services, retail trade and construction managers. Confidence in industry recorded only a minor slippage. However, of all surveyed business sectors, industry is the furthest below its long-term average. The HCOB Eurozone Composite PMI Output Index dropped further into contractionary territory in July and especially in August. At 47, the flash August reading was the lowest for business activity in the euro area since November 2020. The manufacturing PMI indicates that the sector is undergoing a deep downturn, though it recovered slightly in August. Importantly, weakness extended to the services sector, with the services PMI falling into contractionary territory in August. Amongst the largest EU economies, both sources point to a big deterioration in conditions in Germany and France. More forward-looking, both the manufacturing and services sectors reported falling new orders, suggesting that economic activity in the euro area will remain subdued also in the third quarter (see Graph 1.12). This trend was observed also in the Commission's July quarterly manufacturing survey, where managers' export volume expectations worsened strongly. More upbeat, in its August release, the ZEW indicator of economic sentiment showed an improvement for the euro area.

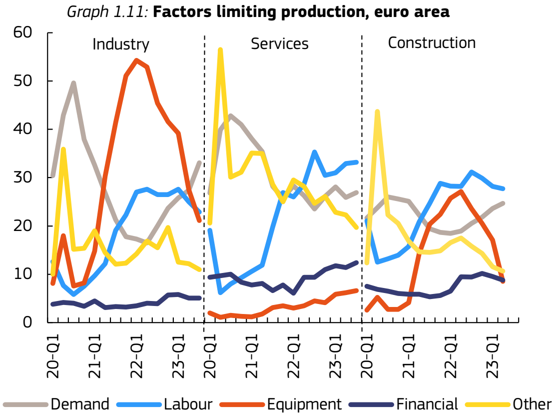
Insufficient demand gained prominence in managers' assessments of constraining factors for business activity. The share of industry managers pointing to shortages of material and/or equipment as a factor limiting production decreased further (to 20.7% in the EU) from the record-high level of early 2022 (see Graph 1.11). Also the share of managers indicating labour force shortages decreased in the EU, but remained relatively high, at 24.5%. Such shortage appears most pressing in Germany, the Netherlands and Poland. The prevalence of financial constraints remained broadly stable and, at 5.4%, stayed low compared to the other limiting factors. Insufficient demand was the only constraining factor that gained further prominence in July, increasing for the fifth month in a row to 33.2% in the EU. Poland and Spain seem to be the most affected countries.

Graph 1.10: **ESI and PMI, euro area**

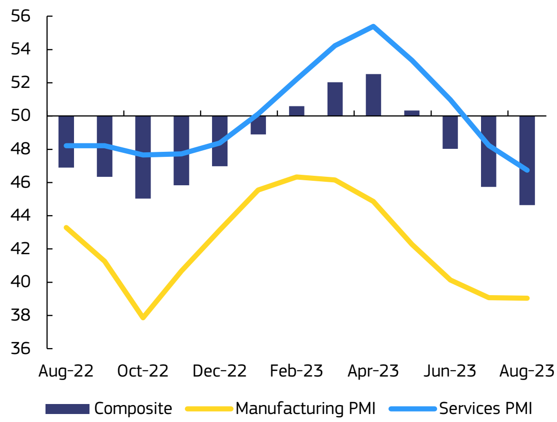


Source: S&P Global, European Commission.
Note: Standardised data based on 2000-'07 sample.

Graph 1.11: **Factors limiting production, euro area**



Graph 1.12: **New orders or incoming new business, euro area**

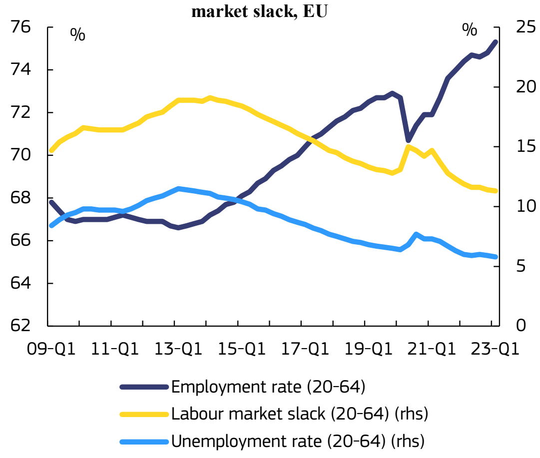


1.5.2. Labour market developments

The EU labour market remained strong in the first half of 2023. According to national accounts, employment in the EU grew by a further 0.4% q-o-q (0.5% q-o-q in the euro area) in 2023-Q1. It remained flat in industry, while it was buoyant in some segments of contact-intensive services (G-I) and in the construction sector (+1.1% and 0.8% q-o-q, respectively). Quarterly national accounts for 2023-Q2 show that employment continued to grow on aggregate in the EU, though at the slower pace of 0.1% (0.2% in the euro area). Across Member States for which Q2 data are available, outturns ranged from -1.5% q-o-q in Estonia to 1.3% in Lithuania, Malta and Portugal. In the largest countries, employment grew by 0.3% in France and by 0.1% in Germany and the Netherlands, stagnated in Spain, and contracted marginally in Italy and Poland. Looking at metrics from the Labour Force Survey for 2023-Q1, in the EU the employment rate of people aged 20-64 stood at 75.3% (from 74.8% in 2022-Q4), which is a new record high in the series (see Graph 1.13). Labour market slack, which comprises all people who have an unmet need for employment, including the unemployed, was at a new record low of 11.3% of the extended labour force aged 20-64.

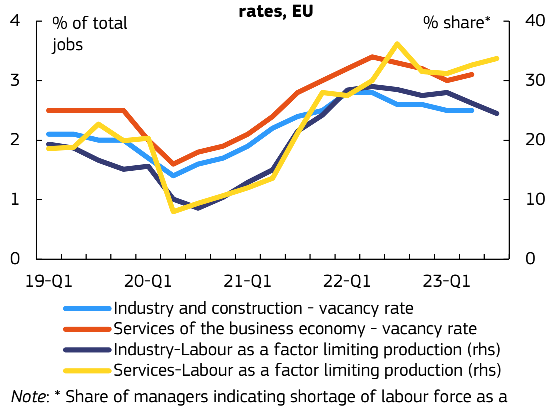
The unemployment rate remained at a record low. In July 2023, the unemployment rate in the EU was unchanged at 5.9% in the EU and 6.4% in the euro area, stable for the third and second month in a row, respectively. These were the lowest readings in the history of the series (since 2000 in the EU, since 1998 in the euro area). In July the unemployment rate ranged from 2.5% in Malta to 11.6% in Spain. Among the remaining large Member States, it stood at 2.8% in Poland, 2.9% in Germany, 3.6% in the Netherlands, 7.4% in France and 7.6% in Italy.

Graph 1.13: **Employment, unemployment and labour market slack, EU**



Survey data signal a moderate cooling of the labour market. In August, the Employment Expectations Indicator declined further in the EU and the euro area, due to less optimistic employment plans among services and construction managers, while those in industry edged slightly up. Employment expectations dropped in 13 Member States, with the steepest falls recorded in Denmark and France. Among the largest countries, expectations deteriorated markedly also in Spain, and slightly less in Poland and the Netherlands. They remained unchanged in Germany and improved in Italy. The August HCOB Eurozone PMIs point to slowing expectations for employment for the whole economy, and especially in the manufacturing sector. According to quarterly results from the Commission's survey, the share of industry managers indicating shortage of labour force as a factor limiting production decreased further in July (-1.7 pps. compared to April, to 24.5%), but remained close to the all-time high registered in April 2022 (see Graph 1.14). In services, the share of managers reporting labour shortages increased (to 34%), very close to the highest value recorded last year. Data on job vacancies provide a consistent picture: the job vacancy rate edged down to 2.8% in 2023-Q1 (from 2.9% in the previous quarter) and 2.7% in Q2, driven by declines in industry and construction.

Graph 1.14: **Labour limiting production and vacancy rates, EU**



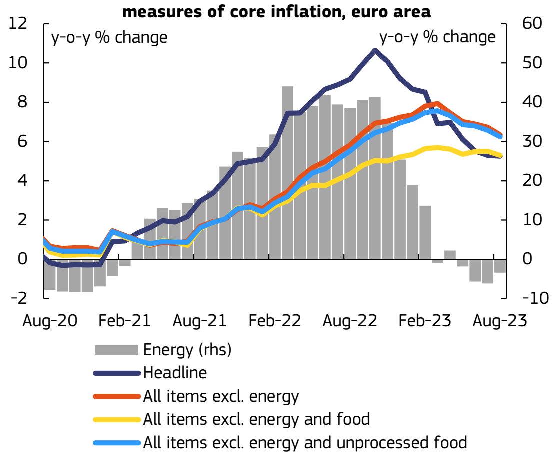
Note: * Share of managers indicating shortage of labour force as a factor limiting production.

Wage growth continued, with real wages still falling but at a decelerating rate. Based on quarterly national accounts data, in 2023-Q1 nominal compensation per employee in the EU was 5.7% higher than in the same quarter of last year (5.5% in the euro area). Given the high inflation prints during the period, these relatively high nominal growth rates still resulted in purchasing power losses, although at a slowing annual rate as annual inflation decelerated. The strongest compensation increase was reported in industry, followed by services and construction. The ECB indicator of negotiated wages in the euro area, which is not sensitive to the number of hours worked, increased in the first quarter of 2023 at an annual rate of 4.4% (up from 3.1% in the previous quarter). This was the highest reading since the beginning of the series in 1991-Q1. In the same period, hourly labour costs rose by 5.3 % in the EU (after +5.7% in the previous quarter) and by 5.0% in the euro area (from 5.6%), compared with the same quarter of last year. The increase was strongest in services (5.8%), followed by industry (5.5%) and construction (4.4%). In the second quarter, negotiated wages increased again strongly in the euro area, by 4.3% y-o-y, according to ECB data. According to QNA, nominal compensation per employee in the EU accelerated further (6.0% y-o-y), mainly due to stronger developments in construction and some sectors in services, while industry and contact-intensive sectors saw some moderation.

Going forward, labour markets' reaction to the observed and expected slowdown in economic growth is set to be mild. Continued labour market tightness, despite signs of cooling, and labour hoarding due to skill shortages, are expected to limit the labour market's lagged response to the economic slowdown. A significant increase in unemployment is not expected either. Still, employment growth is expected to ease, while nominal wage growth would accelerate further, but without fully offsetting the recorded past losses in real incomes.

1.5.3. Inflation developments

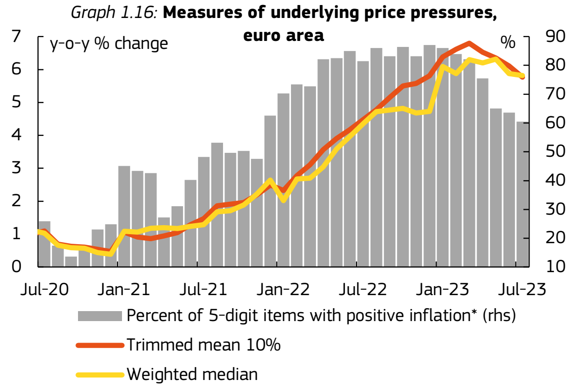
Graph 1.15: **Headline inflation and various alternative measures of core inflation, euro area**



Decelerating goods prices pushed headline inflation down, despite persistent strong services price pressures. Euro area headline inflation continued to decline in June and July, to 5.5% and 5.3%, respectively (see Graph 1.15). It is estimated to have remained unchanged in August according to Eurostat's flash estimate, at exactly half the peak level reached in October 2022. The recent decline was driven by falling goods inflation: primarily energy, but also food and industrial goods. In particular, energy prices declined further until July, as lower wholesale gas and electricity prices were passed through to consumers, but rebounded somewhat in August, reflecting the increase in oil prices and the ensuing pick up in prices of fuel for transport. Food inflation eased on the back of lower agricultural and energy commodity prices. Non-energy industrial goods inflation continued to trend down across the board, as deflation in producer prices deepened (to -7.6% y-o-y in July) amid dissipating supply-side bottlenecks. By contrast, services inflation continued to increase, hitting an all-time high of 5.6% y-o-y in July, to ease only marginally in August (5.5%). Driven by firming wage growth and persistently strong demand pressures, prices of contact-intensive services continued to dominate services inflation, but they started to decelerate (on a year-on-year basis) in July (one month ahead of all services).

Underlying price pressures are moderating but remain elevated. Most exclusion-based measures of underlying inflation – that is, measures that permanently exclude items with highly volatile prices - point to moderating, albeit still strong price pressures (see Graph 1.16). HICP inflation excluding (i) energy, and (ii) energy and unprocessed food continued to fall through August. Excluding energy and all food, inflation has remained broadly stable since May. The difference of the latter indicator compared to the prior two is largely due the fact that it excludes the HICP component (processed food) that showed the sharpest fall in inflation between May and August. Other measures of underlying inflation, including the trimmed mean and the weighted median ([9]), have all trended down in May, June and July (see graph). Finally, the share of HICP items, seasonally adjusted, showing positive month-on-month change on average in the last three months declined further in the second quarter and in July, suggesting that inflationary pressures continue to narrow.

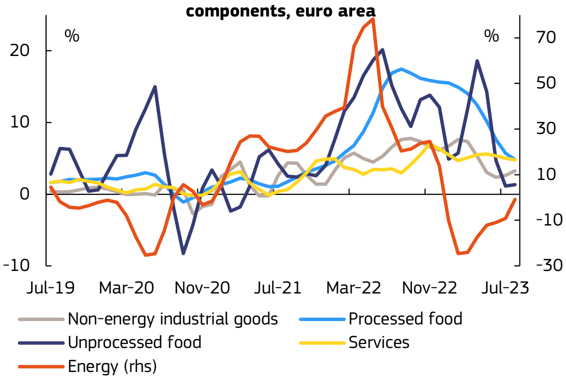
Graph 1.16: **Measures of underlying price pressures, euro area**



Note: * Percent of 286 COICOP items (5-digit level) that registered positive inflation on average in the last three months (seasonally adjusted).

([9]) Trimmed means are weighted averages of the inner core of prices changes, after *trimming* away the items with the most extreme price changes (both positive and negative). The weighted median is the inflation rate of the item at the middle of the price change distribution in the CPI basket (the 50th percentile by weight).

Graph 1.17: **Annualised momentum of major HICP components, euro area**



Note: Annualised, 3m-on-3m % change of the seasonally adjusted series,adjustment with ARIMA X13 over the sample 01/96-08/23.

The momentum of price changes is weakening across major aggregates except energy. Price pressures suggested by annual inflation rates are broadly confirmed by the price change momentum (see Graph 1.17). The measure – reflecting the current inflationary momentum free from the impact of base effects - points to gradually weakening price pressures in food and industrial goods prices into the third quarter. Price pressures in services have built up through May, but began to weaken very gradually over the summer months, and appear to have peaked. The momentum of energy prices remained negative through July, but turned positive in August in view of recent monthly gains in energy prices.

1.6. THE OUTLOOK

1.6.1. Economic activity outlook

Latest data point to continued weakness through the summer and the months ahead, justifying a downward revision of EU and euro area growth for the remainder of the year. Following the stagnation of private consumption recorded in the first half of the year, rising wages and continued moderation in inflation should lift real disposable incomes, in turn supporting a mild rebound of consumer spending. Meanwhile, the sharp slowdown in the provision of bank credit to the economy shows that monetary policy tightening is working its way through the economy. Investment growth, already subdued in the first two quarters of the year, is not expected to regain much strength. The muted global outlook and declining new (export) orders do not augur well for exports. Overall, real GDP growth in the second half of the year is expected to remain very subdued.

In 2024, a mild rebound in growth is still projected, as inflation keeps easing, the labour market remains robust, and real incomes gradually recover. The weaker growth momentum in the EU economy throughout this year is expected to extend to 2024, when the impact of tight monetary policy is set to continue restraining economic activity. Compared to the Spring Forecast, a lower carry-over for real GDP growth from 2023 combines with weaker economic activity within the year, resulting in the projected lower annual growth rate for 2024. Private consumption growth is still expected to be the main driver of growth in 2024 as inflation keeps easing, the labour market remains robust and real incomes gradually recover.

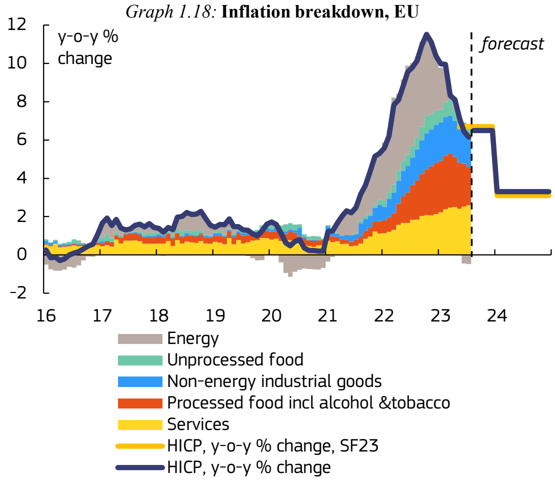
EU growth is projected at 0.8% in 2023 and 1.4% in 2024, respectively 0.2 and 0.3 pps. lower than in the Spring Forecast. Euro area growth is forecast at 0.8% in 2023 and 1.3% in 2024 (0.3 pps. lower in both years).

1.6.2. Inflation outlook

Headline inflation is projected to continue trending down. Inflation outturns from May to August are broadly consistent with the Spring Forecast. Headline inflation is expected to continue its decline throughout the forecast horizon, reflecting gradually easing underlying price pressures, compounded in 2023 by the fall in energy prices (see Graph 1.18). Moderation in inflation is set to be underpinned by shrinking corporate profit margins, providing a buffer for the strong growth in labour cost. All in all, headline inflation is projected to decline in the euro area/EU from 8.4% and 9.2%, respectively, in 2022 to 5.6% and 6.5% in 2023, and then further down to 2.9% and 3.2% in 2024. Revisions compared to the Spring Forecast are marginal. For 2023, inflation in both areas is expected to be 0.2 pps. lower, as the stronger disinflationary impulse from retail energy prices more than offsets firmer underlying price pressures. In 2024, headline inflation is revised marginally up (by 0.1pps.) reflecting the impact of higher oil prices.

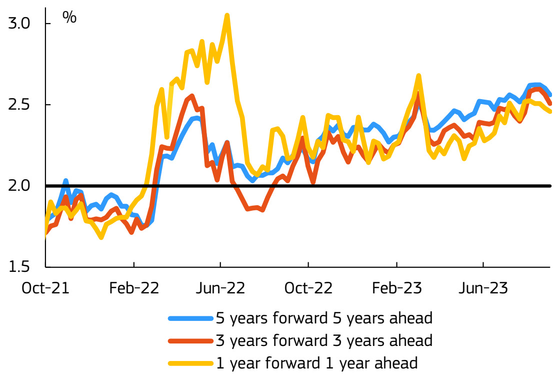
The contribution from energy prices is set to be negative in 2023, but should turn positive in 2024. The combination of an upward shift in oil future curves and lower TTF gas and electricity futures prices have, on balance, pushed the assumptions for wholesale energy prices that underpin this forecast lower in 2023, but higher in 2024, compared to the Spring Forecast. Moreover, as lower wholesale gas prices appear to have passed through to consumers somewhat faster than previously expected in recent months, the disinflationary impulse from falling retail gas and electricity prices is now set to be stronger also in the remainder of 2023 (compared to the Spring Forecast). In 2024, however, the opposite is expected, as the usually fast pass-through of (higher) oil prices to fuel prices ([10]) should dominate the dynamics of retail energy prices, while the expiration of price-mitigating policy measures is set to add to gas and electricity inflation. The contribution of energy to headline inflation is therefore expected to turn positive over the course of 2024, also boosted by sizeable base effects.

Graph 1.18: **Inflation breakdown, EU**



Services inflation is set to be more persistent in the near term but to subside subsequently as demand pressures weaken under the impact of monetary policy tightening. It is expected to moderate only gradually in the near term, as rising labour costs interact with demand pressures, especially on contact-intensive services and tourism. However, tightening financial conditions are set to play an increasingly important role in cooling these pressures, accelerating the disinflation in services over the course of 2024. Inflation of food and non-energy industrial goods should continue moderating over the forecast horizon reflecting receding pipeline pressures, lower commodity prices and normalising supply chains.

Graph 1.19: **Inflation expectations derived from implied forward inflation-linked swap rates**



Source: Bloomberg

Inflation expectations of financial markets continued to move up over the summer months, but remain anchored overall. Market-based measures of inflation expectations at different horizons (inflation-linked swaps, which include various risk premia) continued to trend up since the Spring Forecast but remain close to the medium-term objective of the ECB (see Graph 1.19).

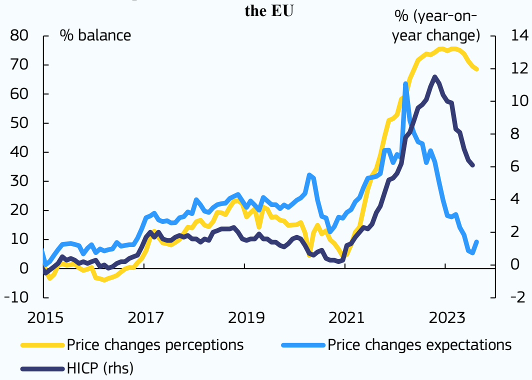
([10]) In comparison to the drawn-out transmission of lower wholesale gas prices to retail gas and electricity prices.

Box 1.1: **Insights from the Commission's consumer survey: how inflation is shaping consumer confidence and spending.**

The analysis presented in this box takes a close look at the results of the European Commission's harmonised consumer survey up to August 2023 to explore the impact of recent price developments on consumers' sentiment, savings and consumption intentions. The understanding of these dynamics helps inform expectations for consumer spending over the forecast horizon.

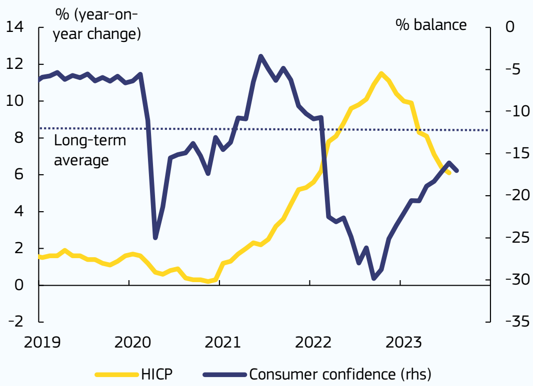
Reflecting developments in HICP inflation, an increasing share of consumers in the EU reported rising prices from early 2021 until autumn 2022. After a period of stabilisation at record-high level, (1) the balance of replies reporting fast increasing prices started to decline in April 2023, while remaining high (see Graph 1). From October 2020 to March 2022, consumers' expectations of future prices soared as well. Thereafter, an increasing share of consumers expected future prices to increase at a slower rate or stabilise. In August 2023, the latest available data point, consumers once again revised their expectations of future prices upwards. (2)

Graph 1: **Consumers' perceptions of price developments over the past and next 12 months, and HICP inflation in the EU**

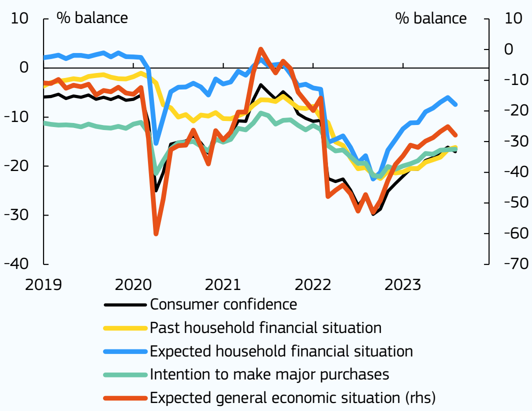


Consumer confidence in the EU reached an all-time low in September 2022, as HICP inflation was about to peak at 11.5% the following month. Since then, consumer confidence has steadily increased towards its long-term average (see Graph 2), while inflation has gradually eased. This suggests that moderating inflation has had a positive influence on consumer confidence. As consumer sentiment remains well below its long-term average, inflation (and prices) remains high. Moreover, in August, consumer confidence decreased once again. This coincided with consumers' inflation expectations moving up for the first time in several months.

Graph 2: **Consumer confidence and HICP inflation**



Graph 3: **Consumer confidence and its components**



The consumer confidence indicator is composed of four variables: past and expected household financial situation (3), intentions to make major purchases (4) and the general economic situation in their country (5). Graph 3 shows that all components improved as inflation eased between autumn 2022 and July 2023, but remained below both their pre-COVID-19 levels and their long-term averages. This suggests that an important share of

(1) For the formulation of question 5 and question 6 of the consumer survey, see the User Guide: [bcs_user_guide.pdf (europa.eu)](bcs_user_guide.pdf)
(2) See question 61 in the User Guide. These "quantitative" inflation expectations continued to increase up to October 2022, reaching an all-time high of 17.5%. Since then, they have decreased but remain relatively high, at around 12%.
(3) See questions 1 and 2 in the User Guide
(4) See question 9 in the User Guide.
(5) See question 4 in the User Guide.

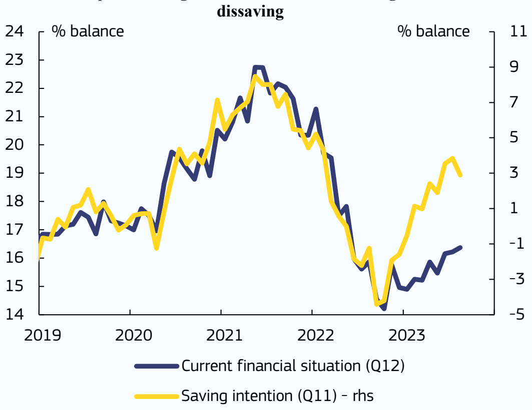
(Continued on the next page)

Box (continued)

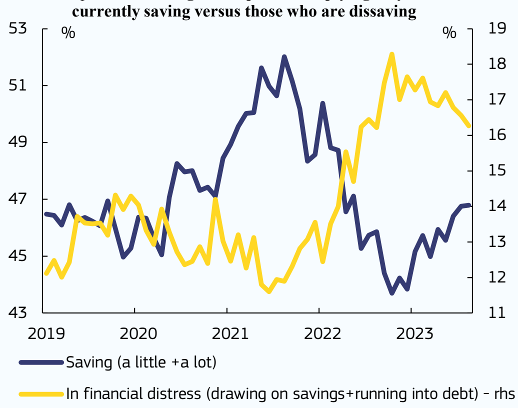
consumers have not yet shrugged off the negative confidence shocks incurred over the past three years (COVID-19, war in Ukraine, steep increase in energy costs and high inflation).

A gap opened between consumers' forward-looking and backward-looking assessments of their household's financial situation, with the former rebounding more strongly. The recovery in consumers' intentions to make major purchases was also slow compared to the expectations of an improved financial situation. In August 2023, however, the gap shrank as consumers' expectations of their household's future financial situation slipped back down again. A similar pattern is apparent when looking at consumers' assessment of their household's current financial situation, expressed as the balance of saving and dissaving status ([6]), and their savings' intentions over the 12 months following the survey ([7]). Between early 2020 and autumn 2022, developments in the two variables had been very similar: after increasing steeply until the summer of 2021, they both fell rapidly to a trough in October 2022, when inflation peaked. When inflation started to decline, consumers' intentions to save started soaring, beyond their pre-COVID-19 level, before tipping down again in August (see Graph 4). Savings intentions increased mainly among consumers with the highest incomes, the group with the largest saving potential. By contrast, the balance of households' current savings/dissaving situation improved much more slowly. It is worth noting that the share of respondents reporting to be drawing on their savings or running into debt – an indicator of financial distress - increased rapidly between August 2021 and October 2022, when it reached an all-time high (see Graph 5). The percentage of respondents reporting to be saving (a lot or a little) decreased to a similar extent. Since inflation started to ease, both series have been showing some improvement, but the share of consumers reporting to be in financial distress remains very high.

Graph 4: **Saving intentions vs Current saving and dissaving**



Graph 5: **Percentage of respondent replying they are currently saving versus those who are dissaving**



Overall, the ongoing moderation in inflation and the associated partial recovery in consumer confidence have not yet translated into clear improvements in the assessments of households' balance sheet positions. This, compounded with increasing intentions to save by the most affluent consumers, suggests subdued growth in private consumption ahead. The recent deterioration in many of the observed variables in August - if confirmed in the months ahead - could further dampen the prospects for household spending.

([6]) See question 12 in the User Guide.
([7]) See question 11 in the User Guide.

1.7. RISKS TO THE OUTLOOK

This Summer interim Forecast is surrounded by formidable uncertainty and both upside and downside risks. Russia's ongoing war of aggression against Ukraine, wider global geopolitical and economic concerns as well as the ongoing, internationally synchronous monetary tightening all have the potential to push the European economy's growth and inflation paths higher or lower than projected in this forecast.

The outlook for the EU's external environment remains challenging. In the US, the balance of risks has improved on account of stronger productivity gains, which could turn out more long-lasting. The risks in China, on the other hand, are on the downside, related to the downturn in the property sector, high debt imbalances, and depressed confidence, with potentially negative repercussions on Europe's trade performance. Globally, persistently high core inflation could lead to higher-for-longer policy rates. Tight financial conditions could especially affect countries with public debt vulnerabilities, with spillovers on financial stability. Fragmentation of global trade, also related to increasing geopolitical tensions, could intensify, entailing significant economic costs for the EU.

Monetary tightening may weigh more heavily on economic activity. Monetary policy transmission is working as intended, as evidenced by the continued marked slowdown of the flow of credit to the private sector. Its adverse impact on domestic demand would be magnified if it comes along with a deterioration of households' and firms' balance sheets, in turn affecting economic sentiment and banks' capacity to finance growth. At the same time, monetary tightening could lead to a faster-than-expected fall in inflation that would accelerate the restoration of real income.

The evolution of inflation could surprise on both the downside and the upside. As domestic demand weakens, inflation may prove less persistent than projected. This could set in motion a virtuous circle of faster recovery in households' purchasing power, improving sentiment and restoring consumer spending. By contrast, price pressures could turn out more persistent, for instance if wages accelerate more than projected, and without the expected adjustment in profit margins. Persistent inflation would prompt a stronger response of monetary policy, with negative repercussions on growth. Meanwhile, the evolution of food and energy prices, assumed to be on a downward trend in this forecast, remains subject to risks and exposes the inflation outlook to some uncertainty.

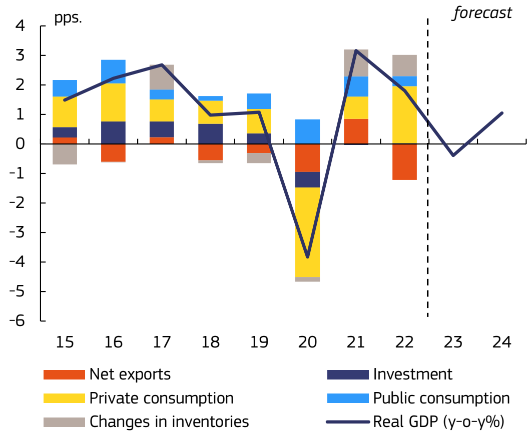
Finally, mounting climate risks, illustrated by the extreme weather conditions and unprecedented wildfires and floods in the summer, also weigh on the outlook. The materialisation of these risks bears severe costs for the EU economy, in terms of losses in natural capital and deterioration of economic activity, including tourism.

2. PROSPECTS BY MEMBER STATES

2.1. GERMANY

The German economy stagnated in the second quarter of 2023, following a decrease in real GDP of 0.1% in the first quarter. For both quarters, growth was significantly weaker than previously expected. Real wage losses continued to weigh on private consumption during the first half of 2023. Additionally, weak dynamics in external demand led to subdued exports. Public consumption declined in the first quarter, reflecting the progressive phasing out of COVID-19-related spending. By contrast, a rebound in investment from a weak last quarter of 2022 supported growth.

Graph 2.1: **Germany - Real GDP growth and contributions**



Since January 2023, confidence indicators for manufacturing have been on a downward trend. This was particularly pronounced in the energy-intensive industries. There, the energy price shock following Russia's war of aggression against Ukraine hit particularly hard. Even after this shock subsided, energy price levels remained elevated in comparison to production locations elsewhere, especially outside of Europe, which negatively impacts competitiveness. More recently, in May, indicators for the services sector also started to decline, reflecting a weakness in manufacturing-related services as well as in transport and logistics. Despite the negative sentiment, a turnaround to positive real wage growth is expected to lead to a subdued recovery in the third and fourth quarters, driven by private consumption.

On an annual basis, the economy is now projected to shrink by 0.4% in 2023. This is a downward revision compared to the 0.2% growth projected in the Spring Forecast. A weak overall outturn for consumption and a decline in construction investment are forecast to negatively impact growth, despite support from an uptick in equipment investment. While weak external demand depresses exports, net exports are expected to contribute positively to growth due to falling imports.

In 2024, real GDP is forecast to rebound by 1.1% driven by a recovery in consumption. This is less than projected in the spring due to a slowdown in the construction sector, as well as to less dynamic exports growth.

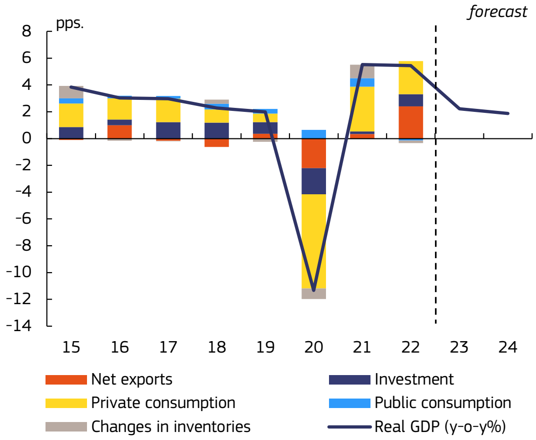
Headline inflation in 2023 is expected to come down to 6.4%, implying a downward revision from the Spring Forecast, and to 2.8% in 2024, slightly higher than projected in the spring. In the first half of 2023, energy and service price inflation fell more than expected. Nonetheless, service inflation is set to remain elevated as wages rise. This, in combination with high food prices and core inflation, is expected to make headline inflation remain high in 2023. In 2024, a gradual slowdown in goods prices is set to lead to a decrease in headline inflation. Falling energy price inflation is also expected to contribute to this slowdown, albeit less than previously forecast.

2.2. SPAIN

The economic expansion is set to be more subdued in the second half of 2023 due to the fading impetus of the tourism sector, weaker economic activity in main trading partners, the impact of tighter financing conditions on aggregate demand, and softer labour market dynamics. Households' purchasing power, which is expected to benefit from the maintained easing of price pressures coupled with rising nominal wages, partially mitigates headwinds on private consumption. In addition, the lower leverage of the private sector achieved in recent years and the resilience of the banking sector is set to contribute to the mitigation of financial risks, while the implementation of the RRP is expected to continue supporting investment growth over the forecast horizon.

Overall, GDP growth is expected to reach 2.2% in 2023. This represents an upward revision, by 0.3 pps., compared to the Spring Forecast, reflecting a higher-than-projected carry-over from 2022 and the robust outturn in the first half of 2023. In 2024, real GDP growth is forecast to moderate to 1.9%, 0.1 pps. less than projected in the spring, as the softening of economic activity expected towards the end of the year is set to extend at least into the first half of 2024.

Graph 2.2: **Spain - Real GDP growth and contributions**



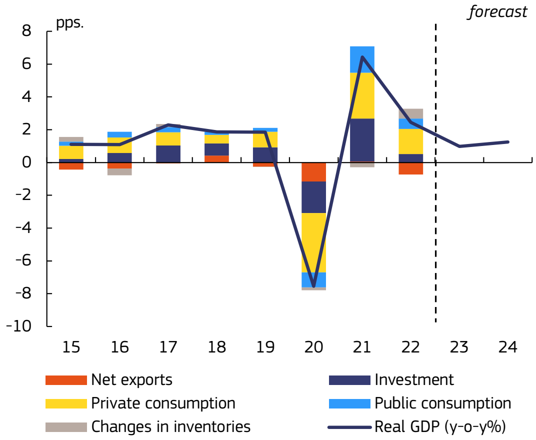
Annual HICP inflation is forecast to moderate to 3.6% in 2023, on the back of the continued deceleration of energy inflation since the third quarter of 2022. A further slowdown to 2.9% is projected for next year despite the upward pressure from the expected phasing out of government measures implemented to mitigate the impact of high energy prices. HICP inflation excluding energy and unprocessed food is set to decline more gradually as the pass-through of high energy prices to other items, especially food and services, lingered throughout the first half of 2023. Second-round effects on wages have been limited so far, despite the moderate pick-up in both nominal and real terms observed in the first half of this year.

2.3. FRANCE

Thanks to a strong rebound in the second quarter of this year, economic growth is expected to reach +1.0% in 2023 and increase to 1.2% in 2024. After having slowed down significantly in the second half of 2022 and in the first quarter of 2023, on the back of supply bottlenecks and higher energy and commodity prices, GDP growth accelerated to 0.5% in the second quarter of the year. This was significantly more than previously expected (0.1%). The rebound was driven by net exports, while domestic demand remained sluggish. GDP is forecast to grow moderately over the rest of the forecast horizon, as domestic demand starts to recover.

While households' purchasing power has been preserved thanks to government measures, dynamic wages and a very favourable labour market, private consumption remains weak as households maintained an exceptionally high saving rate. Over the next quarters, consumption is expected to pick up as inflationary pressures progressively dissipate, and as the households' saving rate returns gradually to its historical average. Investment from both households and corporations is projected to recover progressively. Over the forecast horizon, net exports are set to have a limited contribution to growth. Exports growth, which traditionally relies on a few specialised sectors such as aeronautics and other transport equipment, is expected to be offset by rising imports mirroring the expansion of household consumption.

Graph 2.3: **France - Real GDP growth and contributions**



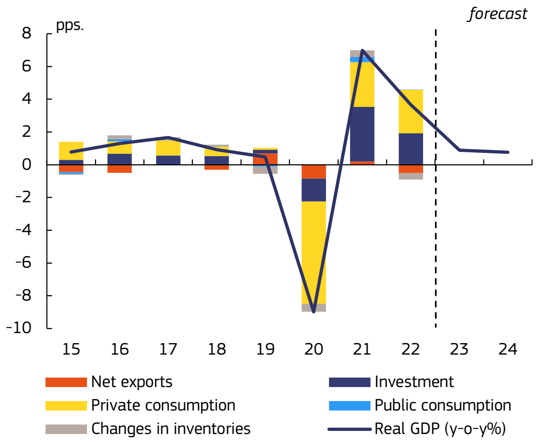
Inflation increased to 5.9% in 2022, driven by energy and commodity prices, but remained the lowest in the EU thanks to government support measures. In 2023-Q1, higher regulated electricity and gas prices and the end of the fuel rebate pushed energy inflation up. Food products inflation soared as well, as the increase in energy and commodity prices eventually passed through to consumer prices. Similarly, the delayed pass through of energy prices to other products led to a significant increase in the underlying inflation. Overall, this resulted in headline inflation peaking in 2023-Q1, followed by a decline in 2023-Q2. Headline inflation is projected to decrease further throughout the forecast horizon but only gradually, as wage increases feed into core inflation while lower energy prices translate into non-energy industrial goods with a delay. Thus, headline inflation is expected to stand at 5.6% in 2023 as a whole, before slowing down to 2.7% in 2024, a slight upward revision from the Spring Forecast (5.5% in 2023 and 2.5% in 2024).

2.4. ITALY

Italy's economic growth started slowing down last year, halting the post-pandemic rebound which had lifted growth to 7.0% in 2021 and 3.7% in 2022. After a pick-up in the first quarter of 2023, GDP decreased by 0.4% q-o-q in the second quarter, driven by falling domestic demand, particularly investment in construction. The phasing out of the extraordinary and temporary incentives for building improvements decided during the pandemic, which pushed construction activity up sharply in the past two years, contributed to this development. Some short-term indicators, including industrial production, that had been worsening for several months levelled off during the summer, suggesting a marginal rebound in the second half of the year. Overall, GDP is forecast to grow by 0.9% in 2023 and 0.8% in 2024, entailing a 0.3 pps. downward revision in each year.

Consumer spending was held back by households' lower real disposable income during the past year's high inflation, as previously accumulated savings dwindled. A very gradual increase in wages, together with still favourable employment conditions, is expected to underpin a modest uptick in private consumption throughout 2024, despite the planned expiry of all temporary income-support measures. Labour participation rates are expected to stabilise after the robust growth recorded until mid-2023. Investment activity is set to contract in the remainder of 2023 and then pick up moderately in 2024, as the fall in housing construction is offset by RRF-supported increases in investment in infrastructure and equipment. Net exports are projected to provide a smaller support to growth in 2024, following a positive contribution in 2023.

Graph 2.4: **Italy - Real GDP growth and contributions**



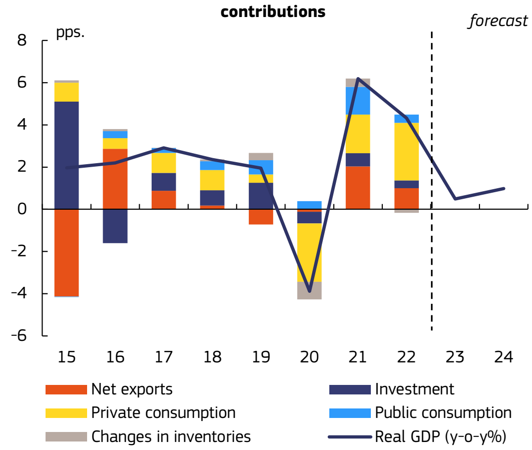
HICP inflation is projected to moderate to 5.9% in 2023 and 2.9% in 2024. While energy prices eased during the first months of 2023, they are not expected to continue exerting downward pressure on inflation in 2024, also due to the planned phasing out of temporary measures adopted to mitigate the impact of high energy prices. Higher average consumer prices are expected to pass through into labour costs only partially and with a substantial lag. This is due, on the one hand, to the long duration of wage agreements and negotiations, and, on the other hand, to the indexation of contractual wages to a measure of domestic inflation that excludes the impact of imported energy inflation. As a result, HICP inflation excluding energy and unprocessed food is projected to exceed headline inflation in the next few quarters, as the prices of domestic goods and services are set to abate more gradually.

2.5. THE NETHERLANDS

Following strong GDP growth in 2022, the Dutch economy cooled down in the first half of 2023, with real GDP decreasing by 0.4% q-o-q in the first quarter and 0.3% q-o-q in the second quarter. High inflation rates eroded households' purchasing power, leading to a decrease in consumer spending. At the same time, a weakening external environment has resulted in a contraction of exports in the first half of 2023. Despite the decrease in economic activity, the labour market remains tight – unemployment is low in historical perspective and wage growth has picked up significantly. The increase in wage growth and a gradual decline in the inflation rate from high levels are expected to lead to a modest recovery in real wages and prevent a further drop in consumer spending in the second half of the year. Annual growth in 2023 is projected at 0.5%, a downward revision of 1.3 pps. from the Spring Forecast mainly due to the worse-than-expected outcome of GDP growth in the first half of the year.

Growth is forecast to pick up slightly to 1.0% in 2024 on the back of a partial recovery in households' purchasing power and an expected increase in demand from the Netherlands' main trading partners. In addition, GDP growth is projected to be supported by government investments related to inter alia the green transition and defence.

Graph 2.5: **The Netherlands - Real GDP growth and contributions**

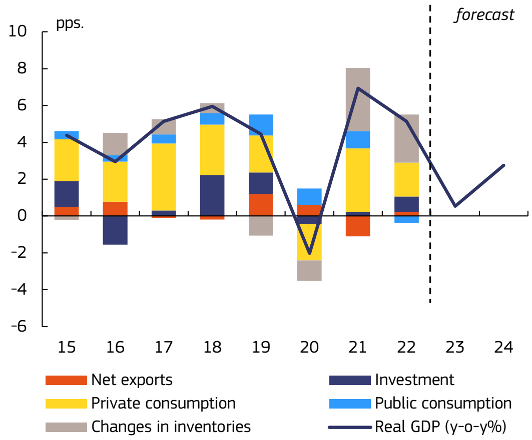


Energy prices surged in 2022, driving up annual HICP inflation to 11.6%. Since the peak in the third quarter of 2022, energy prices started to come down and headline HICP inflation decreased to 6.3% y-o-y in the second quarter of 2023. The authorities put in place a price cap for gas and electricity in 2023 to protect consumers from any further price spikes. HICP inflation excluding energy and unprocessed food continued to increase in early 2023, reaching 8.8% in the first quarter and remaining at the same level in the second quarter. It is forecast to come down gradually in the second half of 2023 as the weakened domestic demand and lower energy prices relieve the pressure on price growth across the board. Headline inflation is forecast at 4.7% in 2023 and is expected to further slow down to 3.0% in 2024.

2.6. POLAND

The Polish economy is expected to decelerate sharply and grow by 0.5% in 2023 with a negative contribution from inventories and falling real private consumption while net exports and investment are set to grow. Real GDP contracted in 2023-Q2 by 2.2% quarter-on-quarter, but is set to resume in the second half of 2023. While household disposable income is benefiting from significant fiscal support, in particular through energy-support measures, private consumption in 2023 is set to be negatively impacted by falling real wages, weak consumer confidence and high borrowing costs given the high share of mortgages with variable interest rates. On the upside, investment growth accelerated in the first half of 2023 due to more resilient private investment and stronger public investment, including from EU funds.

Graph 2.6: **Poland - Real GDP growth and contributions**



In 2024, GDP growth is expected to reach 2.7%, remaining below historical averages. Private consumption is set to be the main growth driver as inflation pressures abate and additional government fiscal measures increase disposable income of households, including additional social support for families with children and pensioners. Investment is projected to positively contribute to growth in 2024 to a lesser extent, while the contributions of net exports and inventories are expected to be broadly neutral. HICP inflation decelerated rapidly from the peak of 17.2% in February 2023 to 10.3% in July 2023. Energy and unprocessed food inflation declined sharply in 2023-Q2, supported by strong base effects and declining commodity prices. Inflation excluding energy and unprocessed food is slowing down since March 2023 in a context of weakening domestic demand and high interest rates. Headline inflation is set to reach 11.4% in 2023, lower than projected in the Spring Forecast. Throughout 2024, headline inflation is forecast to remain above the central bank target of 2.5% and reach 6.1% for the whole year. Energy prices are expected to increase in 2024-Q1 as government energy measures related to prices of electricity, gas, coal and heating are set to expire. The new fiscal measures and a sizeable increase of the minimum wage in 2024 are expected to increase core inflation pressures.

Box 2.1: **Some technical elements behind the forecast**

The Summer 2023 interim Forecast provides an update of the Spring 2023 Forecast of 15 May 2023, focusing on GDP and inflation developments in the largest EU Member States. For the remaining 21 Member States, latest economic developments are factored into the calculation of the EU and euro area aggregates. The cut-off date for taking new information into account was 7 September 2023.

ESA 2010

The source for all tables is the European Commission, unless otherwise stated. Historical data for the Member States are based on the European System of Accounts (ESA 2010). 2023 and 2024 are forecast years.

Technical assumptions

To shield the assumptions from possible volatility on any given trading day, averages from a 10-day reference period (between 17 and 30 August) were used for exchange and interest rates, and for commodity prices. Assumptions for Brent oil, natural gas and electricity prices are based on futures markets.

Nominal exchange rates are kept constant over the forecast horizon at the level recorded during the reference period (see Table 1). Interest rate assumptions are market-based. Short-term interest rates for the euro area are derived from futures contracts. Long-term interest rates for the euro area, as well as short- and long-term interest rates for other Member States are calculated using implicit forward swap rates, corrected for the spread between the interest rate and swap rate during the reference period. In cases where no market instrument is available, a fixed spread vis-à-vis the euro area interest rate is taken for both short- and long-term rates.

Trade policies

Compared to the Spring 2023 Forecast, there are no significant changes in the pencilled in trade policy measures.

Geographical zones

Euro area: EA20 (BE, DE, EE, IE, EL, ES, FR, HR, IT, CY, LV, LT, LU, MT, NL, AT, PT, SI, SK and FI).

European Union: EU (EA20, BG, CZ, DK, HU, PL, RO and SE).

Table 1:

		Summer 2023 interim Forecast		***Spring 2023 Forecast***	
	2022	**2023**	**2024**	***2023***	***2024***
3-month EURIBOR (percentage per annum)	0.3	**3.4**	**3.6**	*3.3*	*3.3*
10-year government bond yields (percentage per annum) (a)	1.1	**2.4**	**2.5**	*2.4*	*2.4*
USD/EUR exchange rate	1.05	**1.09**	**1.09**	*1.09*	*1.10*
GBP/EUR exchange rate	0.85	**0.87**	**0.86**	*0.88*	*0.88*
RMB/EUR exchange rate	7.08	**7.70**	**7.91**	*7.50*	*7.56*
JPY/EUR exchange rate	138.03	**151.92**	**158.43**	*145.76*	*147.11*
EUR nominal effective exchange rate (annual percentage change) (b)	-3.2	**5.9**	**1.6**	5.8	0.7
Natural gas (EUR/Mwh) (c)	131.9	**42.8**	**54.4**	*48.0*	*55.4*
Electricity (EUR/Mwh) (d)	260.3	**108.9**	**140.2**	130.7	161.4
Oil price (USD per barrel)	100.7	**81.8**	**81.2**	*76.3*	*72.1*

(a) 10-year government bond yields for the euro area equal the German government bond yields.
(b) 42 industrial countries EU TR CH NR UK US CA JP AU MX NZ KO CN HK RU BR. (c) ICE Dutch TTF. (d) GDP - weighted average of electricity prices in DE, FR, IT, ES, NL, BE, AT.

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