Interim forecast
February 2011

EU recovery gaining ground

The economic recovery in the EU continues to make headway. After a strong performance in the first half of 2010, real GDP growth for both the EU and the euro area slowed down in the second half of last year. The deceleration was expected and in line with a soft patch in global growth and trade, which reflected the withdrawal of stimulus measures and the fading away of positive impulses from the inventory cycle. Nonetheless, the global economy, particularly the US and emerging markets, proved more dynamic in the fourth quarter than expected in the autumn. This is likely to have supported EU exports, providing a countervailing impulse to the adverse weather effects observed in the final part of the year in some Member States.

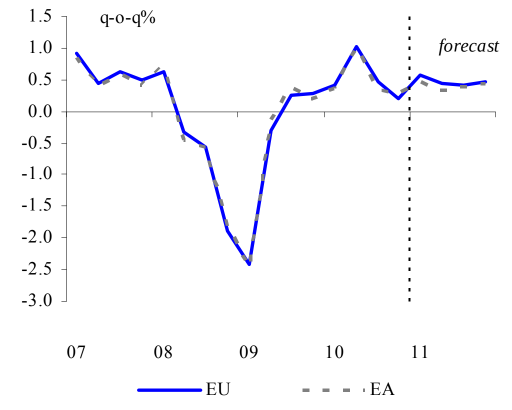
Looking ahead, EU GDP growth in 2011 is set to be somewhat stronger than expected in the Commission's autumn 2010 forecast, despite lingering vulnerabilities in financial markets. This improved outlook is supported, inter alia, by better prospects for the global economy and upbeat EU business sentiment. The latter generally points to economic activity gathering pace going forward and shows signs that the recovery is also broadening across sectors. Moreover, developments in profitability, order books, lending to households, saving ratio also point to a gradually firming pace of domestic activity. The encouraging progress in economic sentiment stands in contrast with the tensions observed in some sovereign-bond markets in the EU since autumn.

Based on an update for the seven largest EU Member States, growth prospects for this year have been revised slightly up in the Commission's February 2011 interim forecast. GDP growth in 2011 is now projected at 1.8% in the EU and 1.6% in the euro area, both 0.1 pp. higher than in the autumn. While upward revisions are reported for most countries considered here, the expected pace of recovery remains uneven across Member States. Germany continues to benefit from the robust external environment and strong domestic demand dynamics, whereas significant adjustment challenges still weigh on activity in several other countries.

The inflation projection has been revised up more markedly. A surge in energy and commodity prices in the last few months has led to an uptick in headline HICP inflation. The inflation forecasts for 2011 are thus revised up, with HICP inflation now projected at 2.5% and 2.2% in the EU and the euro area respectively. Nevertheless, the remaining economic slack, subdued wage growth and overall well-anchored inflation expectations should keep underlying inflationary pressures in check, with inflation expected to end the year at close to 2% in both regions.

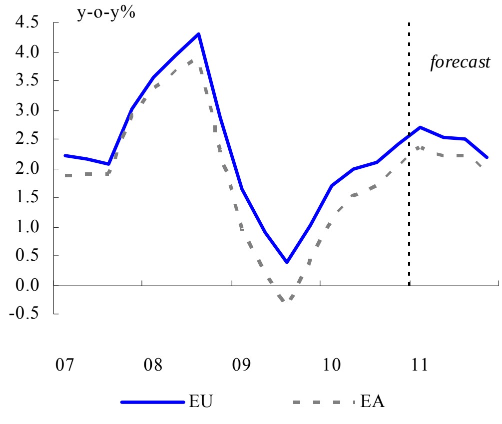
Amid still high uncertainty, risks to the EU growth outlook at the current juncture appear broadly balanced for 2011. Risks to inflation seem somewhat tilted to the upside, on account of ongoing geopolitical tensions in the MENA region.

Graph 1: GDP growth making headway



Source: European Commission

Graph 2: HICP inflation returning to average rates



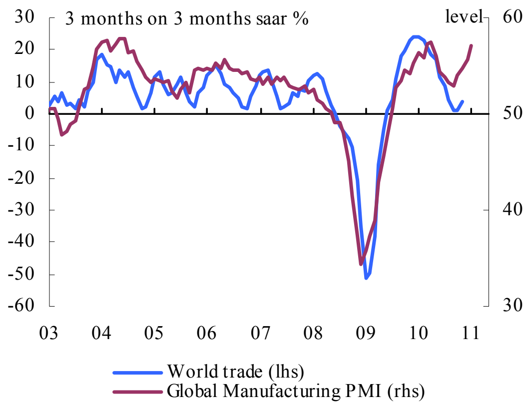
Source: European Commission

EUROPEAN COMMISSION
Economic and Financial Affairs

Global outlook improves again

After a buoyant recovery in the first half of 2010, the world economy went through a soft patch in the third quarter of 2010. Global activity rebounded in the fourth quarter and leading indicators suggest a further acceleration. The recovery continued to be uneven, with advanced economies lagging behind emerging ones in the business cycle. The rise in commodity prices has contributed significantly to the hike in headline inflation, especially in emerging market economies, where commodities (in particular food) account for a larger share of consumer baskets. In advanced economies, core inflation and inflation expectations remain contained, which has so far allowed monetary policy to remain accommodative. In global financial markets, conditions have improved gradually since the autumn 2010 forecast, despite nervousness and episodes of heightened risk aversion. Stock markets have continued to recover.

Graph 3: Re-acceleration in global trade



Source: CPB, Markit Economics

In this interim forecast, global growth in 2011 is being revised upwards, mainly on the back of the additional fiscal stimulus adopted in the US in December 2010, while growth in major emerging market economies continues to be buoyant. Global GDP (excl. EU) is projected to grow by some 4¾% in 2011, up by ¼ pp. compared to the autumn forecast. The global recovery is still expected to be uneven between emerging and advanced economies.

While the global outlook has been revised upwards, concerns about global growth remain in place. Rising headline inflation and possibly excessive capital inflows can lead to overheating in emerging markets. Reversal of capital flows in countries where current-account deficits are widening or where there is heightened geopolitical uncertainty creates an additional concern at the global scene.

Financial markets recovering from sovereign-debt crisis but important vulnerabilities remain

Whilst remaining relatively fragile, the overall financial-market situation in the EU has improved since the autumn forecast. Sovereign-bond spreads have trended down in the beginning of the year, though they remain at elevated levels. Money market activity is more favourable and real financing conditions remain supportive. Nevertheless, important vulnerabilities remain in place, especially with regard to banks' funding and the assessment of the sustainability of public finances in some euro-area Member States. Looking ahead, notwithstanding the risk of disruptions, overall monetary and financial conditions are expected to provide further support to the recovery in 2011.

More specifically on sovereign-bond markets, some positive factors have led to an easing of tensions. In addition to positive news from the real economy, policy reforms in some Member States have raised confidence. Also expectations of further EU measures to harness financial-market stability going forward have probably contributed to the improved market sentiment. The successful auctions by some euro-area sovereigns and the successful bond issuance by the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF) bear witness to the overall improved conditions. Nevertheless, bond spreads of peripheral euro-area sovereigns remain at elevated levels. The benchmark sovereign-bond yields are significantly up since mid-2010, mainly driven by higher inflation expectations and an improved growth outlook.

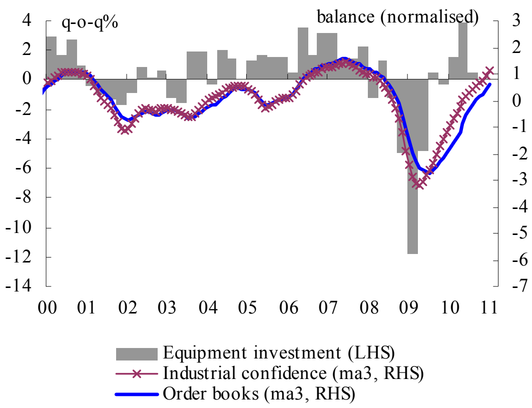
Spreads between yields of corporate and government bond have narrowed substantially, reflecting declining default perceptions. In money markets, conditions have continued to improve since the beginning of this year. For the majority of banks in the euro area, the access to market-based financing continues to normalise. Bank credit provision to the economy has improved further.

Bank lending to households has continued to increase, whilst remaining subdued. The volume of bank loans to the non-financial corporate sector continued falling, but at lower rates. The latest ECB Bank Lending Survey points to slightly tightening (house purchases) or stable (non-financial corporate sector) credit standards in parallel with stronger demand for lending, amid continued constraints on banks' balance sheets.

EU recovery making headway

As expected in autumn, the pace of EU economic activity moderated in the second half of 2010. This reflected the phasing out of temporary support measures and the slowdown in global activity, which dampened EU export growth. In the third quarter of 2010, GDP growth in the euro area and the EU softened to 0.3% and 0.5% respectively, compared to the previous quarter. In the final quarter, according to Eurostat's Flash estimate, GDP expanded by 0.3% from the previous quarter in the euro area and by 0.2% in the EU. In a few countries, GDP growth in the fourth quarter was negatively affected by the exceptionally harsh winter weather. Activity in these countries is expected to bounce back in the first quarter of 2011. In 2010 as a whole, GDP is estimated to have grown by 1.8% in the EU and 1.7% in the euro area, in line with the autumn forecast.

Graph 4: Improving prospects for EU equipment investment



*ma3=3 months moving average

Source: European Commission

The economic *outlook* for the EU in 2011 has slightly improved compared to the autumn forecast. The upward revision to EU GDP growth is supported by slightly better prospects for the global economy, in particular in the US, as well as by stronger sentiment. Indeed, the elevated levels of the Economic Sentiment Indicator as well as of the composite PMI suggest solid growth going forward.

The improved outlook for the external environment will provide a boost to EU exports, particularly in the more export-oriented economies. In line with this view, managers' assessment of export order books has improved strongly over the last three months.

While *exports* should continue supporting the recovery going forward, rebalancing of growth towards domestic demand is expected for 2011, driven by growth in private investment. A better export outlook should translate into a stronger impetus for *equipment investment*, which will increasingly contribute to growth. In addition to this impetus from the export-led industrial rebound, equipment investment should benefit from the continued improvement in corporate profits, stronger order inflows and the low level of stocks, as well as from higher capacity utilisation rates, now close to their long-term averages. This view is supported by the strong business confidence and the latest Commission's investment survey, which suggests robust investment plans for 2011. Construction investment is, however, projected to remain relatively subdued this year due to ongoing adjustment in this sector.

Private consumption remained subdued in the second half of 2010. Looking ahead, a gradual firming is expected this year. The ongoing stabilisation in the labour market, the recovery of lending to households as well as the continued decline of the household saving rate, bode well for consumer spending in the near term. In contrast, weak real disposable income (dented by higher inflation), ongoing deleveraging and still muted consumer confidence are expected to weigh on private consumption over the forecast horizon.

Growth forecast for the EU economy slightly revised up

For 2011, GDP growth is now forecast at 1.8% in the EU and 1.6% in the euro area. This represents a 0.1 pp. upward revision compared to the autumn forecast in both the EU and the euro area, reflecting the improved external environment and stronger confidence. However, this aggregate picture masks uneven developments across Member States. In the euro area, Germany is expected to lead the ongoing recovery, with GDP growth projected at 2.4%, followed by France (1.7%) while Spain's recovery remains muted (0.8%). Outside the euro area, growth in Poland and the UK is respectively projected at 4.1% and 2.0%. All these developments confirm the Commission's expectation of a multi-speed recovery within the EU. As argued in previous forecast documents, this is not surprising given differences in the scale of adjustment challenges and ongoing rebalancing within the EU and euro area.

Headline inflation up while core remains low

In line with expectations, *consumer price inflation* increased moderately in the course of 2010, reflecting a rise in global commodity prices, changes in taxation and administered prices, as well as the impact of upward base effects from the food and energy components.

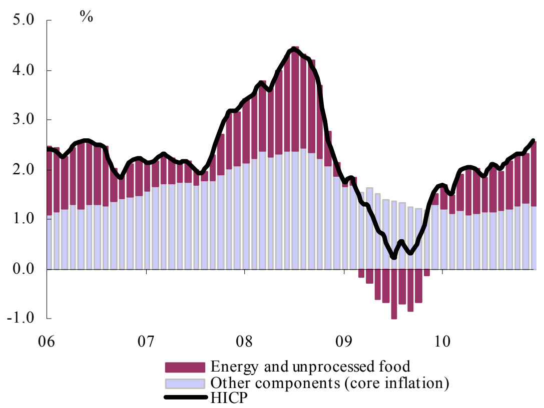
In the last quarter of 2010, headline HICP inflation in the EU (at 2.4%) and euro area (at 2.0%) was higher than expected in the autumn forecast. To a large extent this can be attributed to the surge in commodity prices towards the end of the year. Upstream pressures have also been building up gradually from producer prices. Nevertheless, *core inflation* (i.e. all items excluding energy and unprocessed food) has remained low (1.0% on average in 2010), and the underlying inflation pressure has been contained, supported by moderate wage developments across EU Member States.

The generally feeble labour-market conditions kept *wage growth* subdued in the euro area in the third quarter of 2010. At the same time, annual unit-labour-cost growth remained negative for the third consecutive quarter, reflecting a cyclical improvement in productivity and only moderate growth in compensation per employee. The situation varied largely, however, across Member States.

Looking ahead, compared to the autumn forecast headline inflation for 2011 has been revised up by 0.4 pp. both in the EU and the euro area and is now expected to reach 2.5% and 2.2%, respectively. On a quarterly basis, the outlook is for a peak in headline inflation in the first quarter of 2011 at 2¾% in the EU (2¼% in the euro area) and a gradual decrease towards 2% in both zones by the end of the year. This profile reflects the diminishing effects of pass-through from both the surge in commodity prices at the turn of the year and statistical base effects exerting a downward pressure on inflation for most of 2011.

Within the euro area, the projected 1 pp. annual revision for Spain stands out. Unlike in other Member States covered by the interim forecast, inflation in Spain is driven not only by commodity prices but even more so by the impact of the planned increases in indirect taxes and administered prices. Outside the euro area, inflation has been revised up on account of changes in indirect taxation and commodity prices, as well as due to a stronger-than-expected pass-through of exchange-rate changes to headline inflation (in the case of the UK).

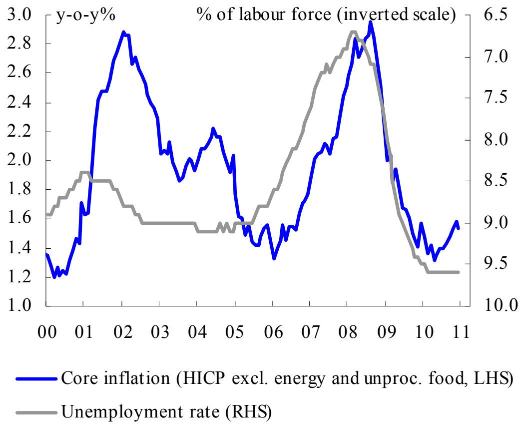
Graph 5: Growing contribution of energy and unprocessed food to headline HICP inflation in the EU



Source: European Commission

Despite the upward revisions to headline inflation mentioned above, the underlying inflation trends identified in the autumn forecast remain valid. The lingering slack in the economy and weak labour-market conditions are expected to keep the underlying inflationary pressures contained. Nevertheless, core inflation is expected to rise slowly in line with the pick-up in activity and possibly due to higher imported inflation from emerging-market economies. The headline rate may prove to be volatile in the course of 2011, driven by changes in commodity prices related to the outlook for advanced economies, geopolitical tensions and base effects.

Graph 6: EU underlying inflation pressures remain contained



Source: European Commission

Ongoing recovery prepares ground for labour market improvements

With the recovery in its third year, *labour-market* conditions in the EU and the euro area are showing signs of improvement, thereby following the usual and expected pattern of lagging response to developments in GDP. Already since mid-2009 the labour input in terms of hours worked in the euro area has moved up and since the beginning of last year also the number of employed persons has stabilised, having recorded a moderate increase in the first three quarters.

Mirroring these developments, the unemployment rate has been almost stable since mid-2010, staying at around 9½ percent in the EU and at around 10% in the euro area. With the recovery continuing on a solid footing, improvements are expected for the period ahead. Both survey indicators of firms' employment expectations as well as the PMI employment index support this positive outlook for the euro area and the EU. But improvements will be moderate and unevenly distributed, in particular with gains in Germany and a continuation of the difficult situation in Spain.

Turning to *public finances,* the bulk of consolidation measures affecting 2011 had already been taken into account in the autumn forecast. Only a few Member States announced or implemented additional consolidation measures since then. The limited size of these measures, combined with the slightly improved growth outlook should not lead to any major revision of the public finances this year. A full assessment of prospects for public finances and the labour market will be carried out in the Commission's upcoming spring forecast.

Elevated uncertainly, but risks still broadly balanced

Amid still high uncertainty, risks to the EU growth outlook at the current juncture appear broadly balanced for 2011.

On the *upside*, stronger global growth – beyond that allowed for in the baseline – would further benefit EU export growth. Also, the impetus from export-led industrial rebound to domestic demand could prove stronger than assumed. Moreover, the strong business confidence could translate into stronger domestic demand than currently projected. A further upside risk relates to the spill-over from stronger activity in Germany to other Member States, which could materialise to a greater extent than expected at present.

On the *downside*, the still relatively fragile financial-market situation remains a concern. Tensions in some segments of the financial markets, though easing, remain, and potential spill-over to other market segments and to the real economy cannot be ruled out. These concerns would be aggravated in case of further increases in long-term government bond yields. Significant fiscal sustainability issues are yet to be tackled in key countries outside the EU. Another downside risk relates to renewed increases in commodity prices, negatively affecting disposable incomes and thereby private consumption. Finally, the fiscal consolidation in a number of Member States may weigh more on domestic demand than currently envisaged.

Risks to the *inflation outlook* in 2011 seem somewhat tilted to the upside, on account of ongoing geopolitical tensions in the MENA region. While the considerable slack remaining in the economy and well-anchored inflation expectations should keep underlying inflation in check, the upward pressures on non-core HICP components, stemming from the developments in commodity prices could come to the fore more than currently projected. Should geopolitical tensions spread further in the MENA region, disruptions to oil supply could not be excluded, fuelling oil-price increases beyond what is assumed in this forecast.

Growth and inflation prospects in the seven largest Member States

1. Germany – robust and broad-based recovery continues

The German economy rebounded strongly from the recession, with real GDP estimated to have increased by 3.6% in 2010, the highest growth rate since the early 1990s. Exports expanded buoyantly, largely reversing the massive decline recorded in 2009 and paving the way for a broader-based recovery of the German economy. Indeed, the highest growth contribution came from domestic demand (2.5 pps., including inventories). Catching-up effects after the crisis, increased public spending on infrastructure and rapidly increasing capacity utilisation led to a rebound in investment, while private consumption was supported by the robust performance of the labour market as evidenced by rising employment and hours worked. As expected in the autumn, the pace of economic expansion slowed somewhat in the second half of the year, with real GDP expanding by 0.7% in the third and 0.4% q-o-q in the fourth quarter. The slightly stronger-than-expected slowdown in the final quarter reflected the exceptionally harsh weather conditions. These hit investment most severely, notably activity in the construction sector.

A marked technical rebound in the first quarter of 2011 is expected to reverse the latest development. In the following quarters, economic activity should continue to expand steadily, confirming the outlook for a broad-based recovery. Further gradual employment gains and a pick-up in wage growth should underpin the momentum of private consumption. Likewise, full order books, favourable real interest rates and lower capital exports after the end of asset booms abroad contributing to the absence of credit supply bottlenecks, should further sustain domestic investment. While slowing somewhat compared to 2010, exports should continue to benefit from expanding world trade.

The improved outlook for trading partners compared to the autumn forecast, record-high business confidence and the technical rebound at the beginning of the year, imply that real GDP is now projected to expand by 2.4% in 2011, despite the statistical carry-over from 2010 being slightly lower than previously forecast.

HICP inflation surprised on the upside in the last quarter of 2010 and in January 2011, essentially reflecting higher-than-expected energy prices. High oil prices should continue to exert upward pressure in 2011, with headline inflation now expected at 2.2% for the year as a whole. However, core inflation should remain contained and, although wages are expected to grow more buoyantly, the impact on unit labour costs should remain limited, given sound productivity growth.

2. Spain – external demand sustains economic activity

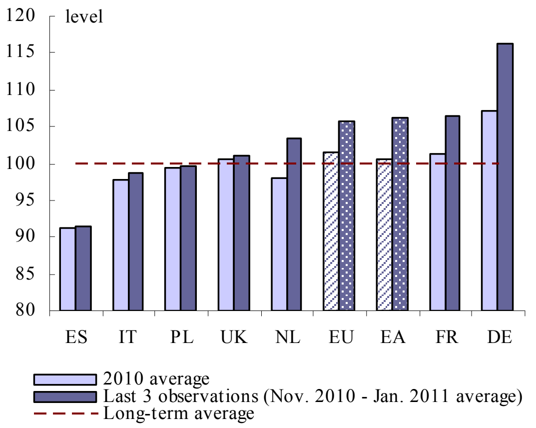
Quarterly real GDP in Spain increased by 0.2% in the fourth quarter of 2010, after having remained flat in the third quarter. For the year as a whole, economic activity is estimated to have contracted by 0.1%, slightly less than expected in the autumn forecast. Domestic demand is set to have dragged down GDP growth by 1¼ pps., while net external demand contributed positively by around 1 pp.

Annual real GDP growth is projected at 0.8% in 2011. Net exports will continue to provide a significant positive contribution to growth, while the drag from domestic demand will be smaller than in 2010. Domestic demand is expected to remain weak this year as unemployment remains at a record high, residential construction adjusts further, the deleveraging of households and firms continues, and the public sector restraints consumption and investment expenditures. Progress in fiscal consolidation and structural reforms in the labour market, pension system and banking sector has had a positive impact on sentiment in the Spanish sovereign bond market. Nevertheless, overall credit conditions in the private sector have become tighter. A further moderate decline in the household savings ratio from the 2009 peak will nevertheless allow modest growth of private consumption. Improvements in industry confidence and, more specifically, in export order books, suggest that the recovery of external demand at the end of 2010 will continue in 2011. This will provide some support to private investment.

Exports in 2011 are expected to grow faster than previously forecast, in line with the improved outlook for global demand and some improvement in cost competitiveness. With import growth projected to remain subdued amidst weak domestic demand, the current-account deficit is set to narrow further.

Inflation increased significantly in the last quarter of 2010 and was above 3% in January 2011. This is partly explained by the surge in energy prices. However, the hike in VAT in July 2010, higher taxes on tobacco introduced in December and a rise in administered electricity prices also played an important role. Headline HICP inflation is projected to be just below 2½% on average in 2011. Core inflation is set to remain subdued, on the back of expected weak demand and still moderate unit-labour-cost developments.

Graph 7: Improving Commission's Economic Sentiment Indicators



Source: European Commission

3. France – recovery taking hold, domestic demand getting firmer

Throughout 2010, support to activity from temporary factors, which kick-started the economic recovery, gradually disappeared: the destocking cycle ended and stimulus packages – especially car scrapping schemes – in France and in neighbouring countries were mostly phased out. Domestic demand, France's traditional growth engine, contributed 1 pp. to 2010 growth. In particular, investment finally picked up in the second quarter of 2010, after having decreased for eight consecutive quarters. Net trade (0.4 pp.) and stocks (0.1 pp.) contributed positively to growth in 2010. Overall, GDP growth came out at 1.6% in 2010.

The short-run prospects for activity appear favourable. Business climate indicators have shown a strong acceleration for the latest months, in particular as regards industrial activity but also services (notably wholesale and retail trade sectors). All business climate indicators stand now above their historical average, and point to an acceleration, except in the construction sector. The capacity utilisation rate is back to the levels recorded in summer 2008 and closer to its long-term average. In this context, investment is set to strengthen, benefitting from low interest rates and the fact that firms should realise investment projects put on hold during the crisis. Exports are also set to benefit from strong growth in neighbouring countries, especially in Germany. Regarding more specifically the first quarter, the end of the car-scrapping premium still had a short-term positive impact in the first weeks, due to the delay between orders passed and production in plants. GDP is thus expected to grow by 0.6% q-o-q in the first quarter, before returning to more subdued growth rates in the subsequent quarters (0.3%, 0.3% and 0.4% respectively). This easing is expected against the background of low household confidence, still high unemployment and fiscal consolidation (in particular measures related to reductions in tax expenditure and the slowdown of the public wage bill). All in all, growth is projected at 1.7% for 2011 as a whole.

While core inflation is expected to stay close to 1½% in 2011, headline HICP will be sizeably higher since oil and agricultural commodity prices have gone up significantly (the latter having a smaller impact). This translates into an annual rate of 2.0%.

4. Italy – the moderate recovery continues to be export-led

The Italian economy is experiencing a moderate recovery after the severe output losses recorded during the 2008-09 crisis. In 2010 as a whole, real GDP expanded by 1.1% according to preliminary estimates. Quarter-on-quarter GDP growth reached around ½% in each of the first two quarters, then eased to 0.3% in the third and decelerated further to 0.1% in the fourth quarter due to less buoyant external demand and the expiry of tax incentives for investment in equipment at the end of June.

Supported by sustained global demand, exports are expected to continue driving the recovery also in 2011. This is in line with business confidence indicators that point to healthy expansion in the manufacturing sector. By contrast, still weak labour- market conditions and higher imported inflation are set to dampen private consumption dynamics. Investment is expected to grow moderately. On the one hand, it is set to benefit from improved profitability and credit conditions. On the other hand, still low levels of capacity utilisation leave little scope for new investment plans. Overall, GDP growth in 2011 is projected at the same rate as in 2010 (1.1%), confirming the autumn 2010 forecast, with quarter-on-quarter growth at around 0.3-0.4% throughout the year.

After a sizeable decline in 2009, HICP inflation increased to 1.6% on average in 2010. The acceleration of prices in the last quarter of 2010 was mainly due to the dynamics of the energy component, amplified by a base effect from 2009. In 2011, HICP inflation is expected to reach 2.2% on average. This is a 0.4 pp. upward revision compared to the autumn 2010 forecast attributable to the assumption of higher oil prices, while no major second-round effects are expected, mainly thanks to the reformed wage bargaining framework that uses forecast HICP inflation excluding prices of imported energy as a benchmark.

5. The Netherlands – consumption crucial for continued recovery

The economic recovery that started in the second half of 2009 came to a sudden halt in the third quarter of 2010, largely due to a significant negative contribution from stocks to real GDP growth. In the fourth quarter, the economy started to grow again, with real GDP increasing by 0.6% q-o-q. In 2010 as a whole, economic growth is expected to have reached 1.7%, with domestic demand and net exports contributing by 0.7% and 1.0% respectively.

For 2011, economic activity is forecast to continue growing at the modest pace of 1.7%. Exports, the traditional driver of the Dutch economy, are likely to contribute only moderately to growth in 2011. Furthermore, domestic demand growth, despite returning to positive territory in 2011, is set to be slowed down by several factors. Firstly, from 2011 on, the fiscal stimulus measures will be phased out. In addition, the government has embarked on an ambitious consolidation strategy. For investment, the outlook remains rather weak. Despite strong improvements in industrial sentiment, the capacity utilisation rate stabilised in recent quarters at around 78%, still significantly below the pre-crisis level of around 82%. This suggests that growth in private investment could be limited to replacement investments, as there is no need yet to increase total capacity. Furthermore, the recent tightening of criteria for credit approval by banks to corporations and the rise in long-term interest rates also do not support the outlook for private investment. In this context, the continuation of the recovery will crucially depend on developments in private consumption. As modest wage increases and higher inflation put real disposable income under pressure, it is unlikely that consumption will be able to play a pivotal role in this respect. However, a positive impact could come from the labour market, where developments, in particular in unemployment, continue to outperform expectations.

The annual HICP inflation rate came in at 0.9% in 2010 and is expected to rise to 1.7% in 2011. The projected increase mainly results from the recent rise in oil and food prices, which are expected to mostly feed through in the HICP in the first half of 2011 as they tend to have lagged effects on inflation in the Netherlands.

6. Poland – accelerating domestic demand supports rebound

Economic activity accelerated in the third quarter of 2010, with real GDP growth reaching 1.3% q-o-q, while in the last quarter of 2010 it is estimated to have increased by 0.9% q-o-q. Continued robust performance in the second half of the year can be attributed to strong consumer spending, as households brought forward some of their spending from 2011 in fear of tax and price hikes.

For 2010 as a whole, real GDP grew by 3.8%, one of the highest growth rates in the EU. This was mainly due to a sharp rebound in world trade in the first half of the year, fuelling manufacturing activity and resilient consumer spending, resulting from improving confidence as the labour market survived the crisis broadly unscathed. However, private investment continued to suffer from uncertainties regarding the global recovery, despite the strong financial position of the corporate sector and increasing capacity utilisation levels. All in all, real GDP growth in 2010 was driven by domestic demand, predominantly private consumption and inventories, while the contribution of net exports remained broadly neutral throughout the year.

Quarterly real GDP growth is projected to ease further to 0.8% q-o-q in the first quarter of 2011, as VAT increases and inflation pick-up are expected to hamper temporarily private consumption. Real GDP growth is likely to remain stable at around 1% q-o-q thereafter, driven by improving domestic demand. In particular, business climate indicators, rising above their historical recovery levels, suggest improved outlook in the private sector. In addition to the impact of strong public spending in infrastructure, investment growth will also be pushed up by accelerating private investment. Moreover, moderate employment growth and the stronger-than-expected pick-up in wages are likely to support consumer spending, despite levelling-off consumer confidence and higher inflation rates. However, the inventory build-up is set to become less supportive after its strong contribution to growth in 2010. For 2011 as a whole, GDP is projected to grow by 4.1%.

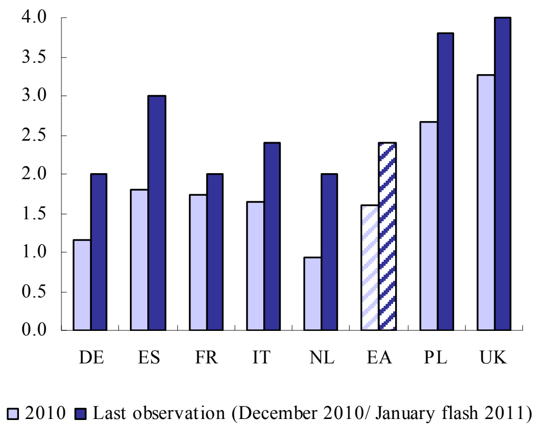
HICP inflation reached 2.6% y-o-y in 2010, on the back of rising commodity prices. It is expected to hover around the upper bound of central bank's inflation target of 3.5% in the first half of 2011, reflecting rising commodity prices and improving domestic demand, and gradually ease thereafter.

7. United Kingdom – negative shock in the last quarter of 2010 but economy should recover

In the fourth quarter of 2010, UK GDP fell by 0.5% q-o-q, following rapid growth earlier in the year of 1.1% in the second and 0.7% in the third quarter. The autumn forecast had predicted growth of 0.6% in the fourth quarter. December's bad weather was a factor in curtailing the small construction boom and likely forced the contraction in distribution, hotels and restaurants, and transport. However, business services and finance – less obviously weather-linked – also declined (-0.7%). The UK Office for National Statistics estimated that GDP would have been "flattish" without the snow-effect. 2010 annual growth is estimated at 1.4%, with 1 pp. negative contribution of net exports.

While the fourth quarter's poor performance reduces the expected level of 2011 output slightly, it improves growth prospects for the first half of 2011 as snow-hit sectors return to normal and postponed construction activity catches up. The growth forecasts for the first and second quarter have therefore been revised up to 1.0% and 0.6% respectively. Otherwise the quarterly profile remains unchanged, yielding 2011 annual growth of 2.0%, only slightly below the autumn forecast reflecting a lower carry-over from 2010. Growth in 2011 should be driven by net exports and corporate investment, offsetting falling government consumption. Private consumption growth is likely to be weak but still positive, in spite of contracting real wages, as consumers prop up spending by reducing savings. Exports should improve given sterling's stability well below pre-crisis levels and strength in some major export markets, particularly the US. Stronger exports, a credible policy environment and investment levels well below pre-crisis peaks should support corporate investment, expected to gather pace in 2011, financed by the high savings accumulated in the corporate sector.

Graph 8: Inflation accelerated at the turn of the year



Source: European Commission

Annual HICP inflation has continued to surprise on the upside, reaching 3.4% in the fourth quarter of 2010, above the 2.9% projected in the autumn forecast. Transport costs, housing and household services were the main contributors to the December increase. Retailers may also have increased prices before the January VAT rise. However, there is still little evidence of second-round effects as wage growth remains low and inflation expectations stay below crisis peaks. Inflation may increase further in early 2011, but should fall later in the year as spare capacity holds down domestic prices, and the sterling depreciation and commodity price rises no longer affect the annual comparison.

Table 1: Real GDP growth

	Quarterly GDP (%, quarter-on-quarter)					Annual GDP (%, year-on-year)		
	Outturn	2011 (forecast)				Outturn	2011 (forecast)	
	2010/4	2011/1	2011/2	2011/3	2011/4	2010*	*Autumn forecast Nov 2010*	Interim forecast Feb. 2011
Germany	0.4	0.6	0.4	0.5	0.5	3.6	*2.2*	2.4
Spain	0.2	0.2	0.2	0.3	0.4	-0.1	*0.7*	0.8
France	0.3	0.6	0.3	0.3	0.4	1.6	*1.6*	1.7
Italy	0.1	0.3	0.3	0.4	0.4	1.1	*1.1*	1.1
Netherlands	0.6	0.4	0.4	0.4	0.4	1.7	*1.5*	1.7
Euro area	**0.3**	**0.5**	**0.3**	**0.4**	**0.4**	**1.7**	***1.5***	**1.6**
Poland	0.9**	0.8	1.1	1.1	1.0	3.8	*3.9*	4.1
United Kingdom	-0.5	1.0	0.6	0.4	0.4	1.4	*2.2*	2.0
EU27	**0.2**	**0.6**	**0.4**	**0.4**	**0.5**	**1.8**	***1.7***	**1.8**

* DG ECFIN estimate

** estimate based on the annual growth rate

Source: European Commission

Table 2: Consumer-price inflation

	Quarterly HICP (%, year-on-year)					Annual HICP (%, year-on-year)		
	Outturn	2011 (Forecast)				Outturn	2011 (forecast)	
	2010/4	2011/1	2011/2	2011/3	2011/4	2010	*Autumn forecast Nov 2010*	Interim forecast Feb. 2011
Germany	1.6	2.1	2.3	2.4	1.9	1.2	*1.8*	2.2
Spain	2.5	3.0	2.7	2.2	1.8	1.8	*1.5*	2.4
France	1.9	2.0	1.9	2.1	2.0	1.7	*1.6*	2.0
Italy	2.0	2.3	2.1	2.1	2.1	1.6	*1.8*	2.2
Netherlands	1.5	1.8	1.5	1.9	1.8	0.9	*1.5*	1.7
Euro area	**2.0**	**2.3**	**2.2**	**2.2**	**1.9**	**1.6**	***1.8***	**2.2**
Poland	2.7	3.4	3.4	3.3	3.3	2.7	*2.9*	3.3
United Kingdom	3.4	4.0	3.4	3.6	2.8	3.3	*2.6*	3.4
EU27	**2.4**	**2.7**	**2.5**	**2.5**	**2.2**	**2.1**	***2.1***	**2.5**

Source: European Commission

Questions and comments on the February 2011 Interim forecast should be directed to:
ECFIN-INTERIM-FORECAST@ec.europa.eu

BOX: TECHNICAL BACKGROUND TO THE INTERIM FORECAST

Technical background

In February 2006, the Commission presented the first of what are now twice-yearly interim forecasts with the objective of updating its comprehensive spring and autumn economic forecasts (with the next fully-fledged forecast scheduled for 13 May 2011). This interim forecast updates the outlook of the autumn 2010 economic forecast of 29 November 2010. The cut-off date for this interim forecast to take new information on board was 15 February 2011.

The interim forecast updates the outlook for the largest seven EU Member States, i.e. Germany, Spain, France, Italy, the Netherlands, Poland and the United Kingdom (which are the largest in the EU based on an average of the ranking in terms of both population and nominal GDP). The update covers real GDP growth and HICP inflation for the current year. These updates are prepared using indicator-based forecasting models and/or judgemental forecasting techniques.

Estimates for the European Union and the euro area are prepared using the nominal GDP-weighted updates for the largest Member States. In terms of nominal GDP, these countries account for 79% of the European Union, while the five euro-area Member States account for 83% of the euro-area aggregate. The outlook for the smaller Member States has not been individually updated. The Commission has made projections for the euro area and the EU using the updates for the five and seven largest Member States respectively, and assuming that the revisions to GDP and inflation for the smaller Member States are proportionate to those of the larger ones.

Quarterly data are updated with the latest available information. When comparing quarterly with annual GDP growth it must be kept in mind that, whenever possible, quarterly data are adjusted for both seasonal influences and the number of working days while annual data is presented in unadjusted form. Calendar factors are, however, relatively small in 2011 and amount to -0.1 pp.

External conditions

This forecast is based on a set of external assumptions. Technical assumptions are used for interest rates, oil prices and exchange rates. Except for the latter, these assumptions are based on market expectations at the time of the forecast. To shield these assumptions from possible volatility during one specific trading day, averages from a 10-day reference period have been used.

The technical assumption as regards exchange rates has been standardised using fixed nominal exchange rates for all currencies. They are kept constant based on the averages from 10 working days up to 11 February, implying e.g. an annual average of USD/EUR of 1.36.

Interest-rate assumptions are, since spring 2007, market-based instead of expert-based. These assumptions should be interpreted with caution, as market-based assumptions do not only reflect policy rate expectations, but also liquidity conditions in a period of market uncertainty. 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 Poland and the UK are calculated using implicit forward swap rates, corrected for the spread between the 3-month interbank interest rate and the 3-month swap-rate. In this forecast, the euro-area short-term rate is assumed to be at 1.5% and the long-term interest rates at 3.4% in 2011.

The outlook for oil prices is based on futures prices. The price per barrel of Brent crude oil is projected at 101.6 USD/barrel in 2011 (corresponding to 74.7 EUR/barrel). This would be 12.7 USD/barrel higher (or 10.7 EUR/barrel higher) than assumed in the autumn 2010 forecast.

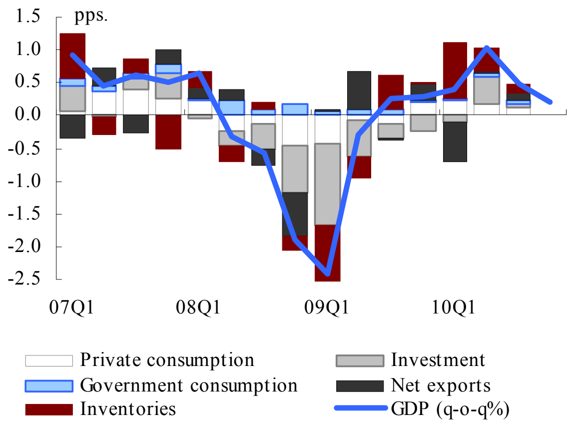
Global demand in 2011 is revised upwards, following the improved outlook for US growth and a rebound in world trade and industrial production. Global GDP growth, excluding the EU, is now forecast to reach 4.8% in 2011, about ¼ pp. more than expected in the autumn forecast. World trade is set to rise moderately in 2011, with growth in export and import volumes (excluding the EU) estimated at around 7½% (down from about 8% in the autumn forecast).

Acknowledgements

This report was prepared in the Directorate-General for Economic and Financial Affairs under the direction of Marco Buti, Director-General, and Elena Flores Gual, Director of the "Policy strategy and coordination". Executive responsibilities were attached to Reinhard Felke, Head of Unit for "Forecasts and economic situation", Moisés Orellana, Head of Sector for "Macro-economic forecasts & short-term economic developments" and the forecast coordinators, Michał Narożny and Laura González Cabanillas.
The report benefited from contributions by Piotr Bogumił, Chris Bosma, Mateo Capó Servera, Oliver Dieckmann, Pierre Ecochard, Małgorzata Galar, Julien Genet, Laura González Cabanillas, Javier Jareño Morago, Bettina Kromen, Karolina Leib, Guy Lejeune, Olivia Mollen, Marco Montanari, Michał Narożny, Moisés Orellana, Manuel Palazuelos Martínez, Vito Ernesto Reitano, Adriana Reut, Julien Rousselon, Thomas Springbett, Jonathan van der Heijden and Norbert Wunner.
Statistical and layout assistance was provided by Daniela Porubská.

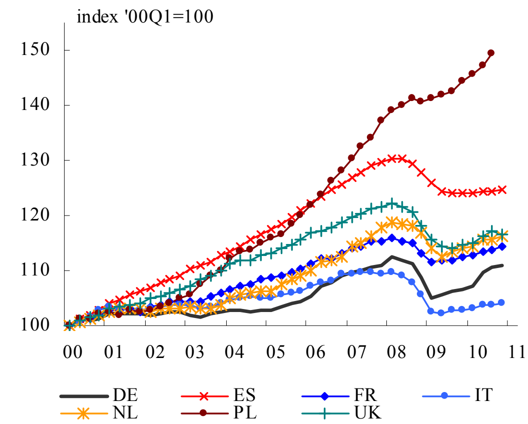
Annex: Selected graphs

Graph A.1: Contributions to GDP growth in the EU



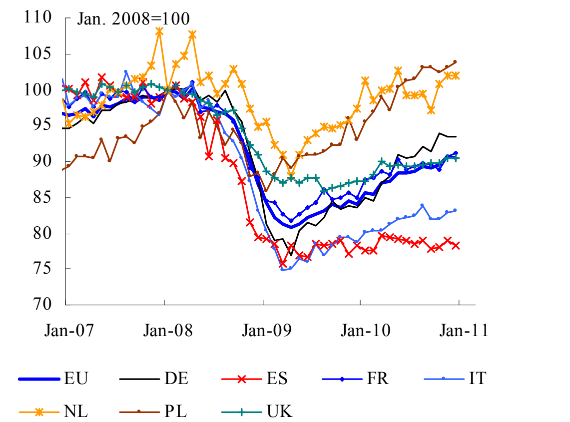
Source: European Commission

Graph A.2: GDP levels in selected Member States



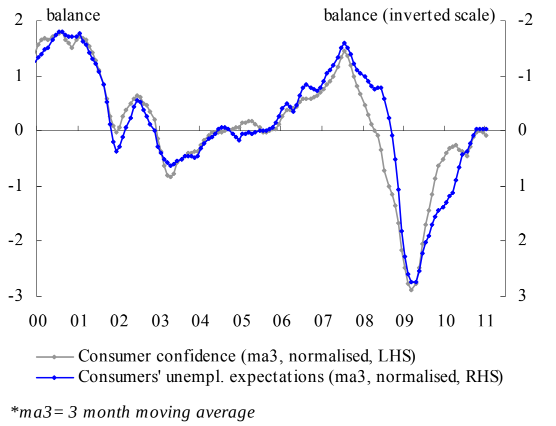
Source: European Commission

Graph A.3: Industrial production levels in the EU and selected Member States



Source: European Commission

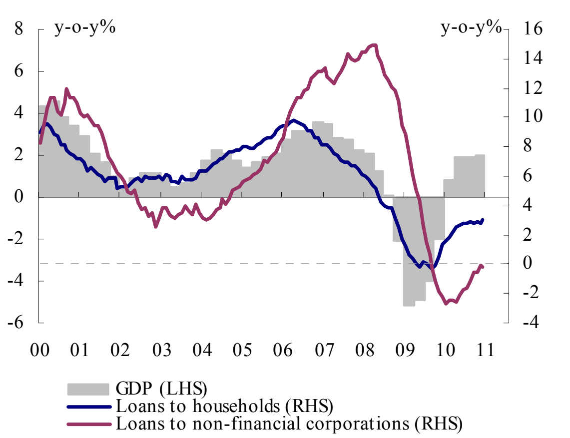
Graph A.4: Consumer confidence and unemployment expectations in the EU



**ma3= 3 month moving average*

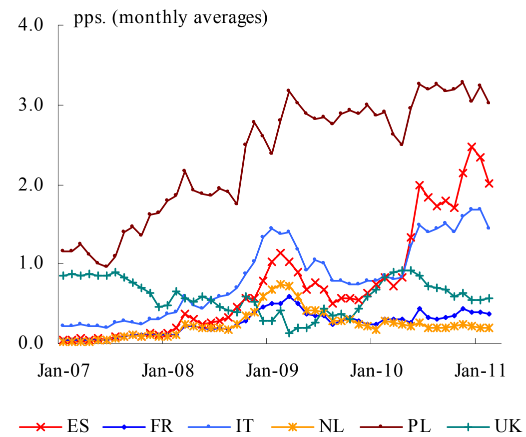
Source: European Commission

Graph A.5: Bank lending to households and non-financial corporations in the euro area



Source: European Commission and European Central Bank

Graph A.6: Sovereign-bond spreads in selected Member States



Source: Reuters and European Commission