Interim forecast February 2010

Fragile recovery in progress in the EU

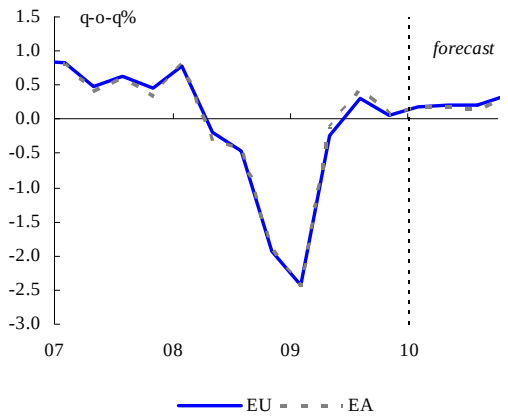
The EU economy is gradually recovering, whilst still facing headwinds. Real GDP started to grow again in the third quarter of 2009, ending the longest and deepest recession in the EU's history. As projected in the autumn, growth eased in the fourth quarter as the impact of temporary factors, such as the car-scrapping scheme in Germany that ended in September, started to fade. The exceptional crisis measures put in place in the EU and its major trading partners played a key role in turning the economy around, with inventory adjustment shaping the short-run dynamics.

Looking ahead, recent data give a mixed picture. The global economy, most notably emerging Asia, appears stronger than expected earlier, although it remains to be seen to what extent this will help the EU this year. Financial-market conditions have recovered since early 2009, but balance-sheet adjustment is not complete and uncertainty remains abundant. Improved sentiment indicators for the EU point to an expansion of activity going forward, but hard data, especially industrial production and retail sales, have been less encouraging recently. A sizeable slack in the economy continues to keep inflation in check. With the main driving forces being still temporary in the EU and globally, the robustness of the recovery is yet to be tested, and a soft patch later this year is accordingly to be expected in the EU as well as in most developed economies.

Based on an update for the seven largest EU Member States focusing on growth and inflation this year, the economic outlook for the EU remains broadly unchanged from the Commission's autumn 2009 forecast. GDP growth is projected at 0.7% in both the EU and the euro area in 2010, with only marginal revisions for most individual Member States. Notwithstanding increased volatility in commodity and exchange rate markets, the inflation forecast also remains largely unchanged for 2010, with HICP inflation projected at 1.4% and 1.1% in the EU and the euro area respectively.

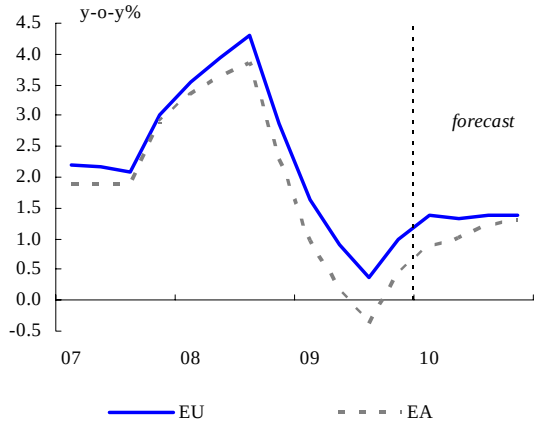
The recent turbulence in financial markets illustrates well the high uncertainty that continues to surround economic projections. Risks to these projections thus remain high, but broadly balanced, with some risk factors, such as heightened turbulence in sovereign bond markets on the one hand and a more vigorous recovery of the world economy on the other, gaining importance since the autumn forecast.

Graph 1: Sluggish GDP recovery ahead



Source: European Commission

Graph 2: HICP inflation set to remain subdued



Source: European Commission

EUROPEAN COMMISSION
Directorate-General
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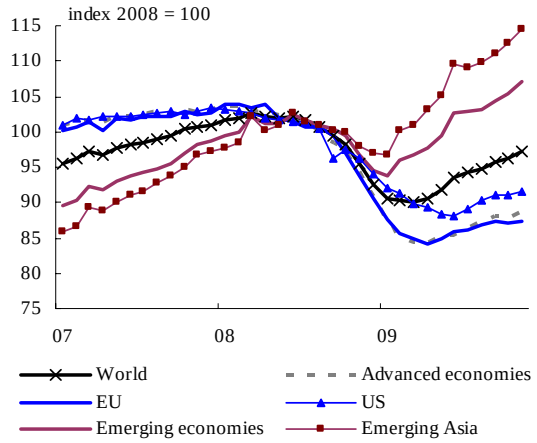
Financial Affairs

Temporary factors spur global recovery

Global economic activity proved more robust in the second half of 2009 than previously expected. The recovery was particularly fast in emerging Asia, but it was also strong in the US, where most of the growth in the second half of the year was driven by inventories. World real GDP (excluding the EU) could thus escape an outright fall last year, and is now expected to grow by some 4½% in 2010. For 2010, this reflects an upward revision of about ½ percentage point (pp.) relative to the Commission's autumn forecast. Nevertheless, the global recovery is still expected to be uneven and surrounded by major uncertainties.

Regarding the near term, global indicators are encouraging, partly reflecting the inventory cycle in manufacturing. The global PMI for manufacturing reached its highest level for 5½ years in January 2010, while for services it was much more subdued. The CPB world trade indicator also points to a strong momentum at the turn of the year: in the three months up to November 2009 (the latest available data), world trade was up by 5.7% from the preceding three months. Based on the revised global outlook, world trade (excluding the EU) is now expected to grow at around 7% in 2010.

Graph 3: Strong industrial production rebound in emerging economies



Source: CPB Netherlands Bureau for Economic Policy Analysis

The upward revisions to global output and trade this year are mainly due to a higher carry-over from the stronger-than-expected outcomes in the second half of 2009. Further out, world growth is set to hit a soft patch, due to the gradually fading effect of the stimulus measures and because of the inventory cycle. Differences across countries remain sizeable, with a markedly more solid recovery in emerging economies, on the back of resuming capital inflows and the return of investors' risk appetite.

Financial markets sending mixed signals

The mood deteriorated quite significantly in some segments of *financial markets* at the start of 2010 following growing concerns about the fiscal situation in developed economies, particularly in some euro-area countries. This has led to sharp increases in sovereign bond spreads in the euro area and a flight to quality, accompanied by a substantial pick-up in volatility. Developments have been, overall, more stable for equity and corporate bonds, reflecting encouraging corporate results. Money-market rates have remained low by historical standards, as major central banks have not signalled imminent large increases in policy interest rates.

EU banks have continued to repair their balance sheets on the back of improved earnings and more favourable funding conditions. However, bank refinancing conditions remain far from normal, in particular as regards the availability of medium to long-term financing. The recovery of the banking sector still appears fragile, as further loan losses cannot be ruled out due to a weak economy and deteriorating labour markets. Bank lending to non-financial corporations has continued to decline in the euro area, while lending to households has recently turned positive. The latest ECB Bank Lending Survey points to a further, albeit slight, tightening of credit standards by euro-area banks. Overall, the state of the banking sector could limit lending to firms and households later in the recovery.

A modest EU recovery so far

Regarding the real side, the EU economy ended 2009 on a subdued note. In the final quarter of 2009, *GDP* expanded by a mere 0.1% from the previous quarter in both the EU and the euro area. As predicted earlier, growth eased after a relatively strong third quarter (0.3% and 0.4% in the EU and

the euro area respectively), as the impact of temporary factors, such as the car-scrapping scheme in Germany, petered out. In 2009 as a whole, GDP contracted by 4.1% in the EU and 4.0% in the euro area, in line with the Commission's autumn forecast. The carry-over for 2010 GDP growth is also as expected.

The weakness evident from hard data towards the end of 2009 was not limited to GDP data. Industrial production posted a substantial slowdown in the fourth quarter of last year. Construction activities also perform weakly, partly due to an unusually cold winter. Based on demand prospects that are subdued according to survey data, industrial output (including construction) is therefore set to remain sluggish throughout this year. Moreover, the important temporary factors that supported the rebound in GDP in the second half of last year should continue to wane, further dampening the momentum for economic activity.

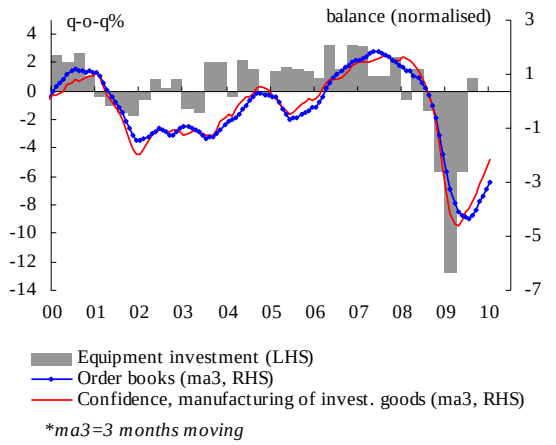
Recent data send mixed signals about the pace of the recovery. While a better-than-expected external environment could spur exports further, investment remains very weak and the labour market continues to deteriorate.

As regards *foreign demand*, extra-euro-area exports were on track for a further expansion in the fourth quarter according to monthly data up to November 2009. Moreover, survey data from both the Commission surveys and PMI signalled robust export growth at the beginning of 2010. The question is how robust the global cycle will prove to be and how much EU economies will benefit from it. Lagged adverse effects from the past euro appreciation cannot be excluded either. A rather cautious export outlook is therefore warranted, and the more muted the export recovery, the weaker the impetus for equipment investment.

Equipment investment is expected to remain subdued this year for structural and cyclical reasons. Deleveraging takes time and the exceptionally low capacity utilisation rate in manufacturing (73% in the first quarter of 2010) suggests that firms have room to expand production with the available capital stock. Moreover, despite improving demand, companies still tend to keep a low level of inventories. Given relatively strong new orders (and record-high level of new-orders-to-inventory ratio), this suggests a high level of risk aversion by firms, which is likely to weigh on capital spending in the near term.

Residential investment is also likely to be weak in 2010. Given past experience, an undershooting following the pre-crisis construction bubble cannot be excluded in certain Member States. Leading supply indicators also continue to depict a weak outlook. For instance, while building permits have started to recover in the third quarter of 2009, they were still down by almost 17% from a year earlier. In contrast, *non-residential construction investment* is likely to expand over the forecast horizon, mostly on the back of government-financed infrastructure projects, partly offsetting the weakness of residential investment.

Graph 4: Outlook for equipment investment remains weak in the EU

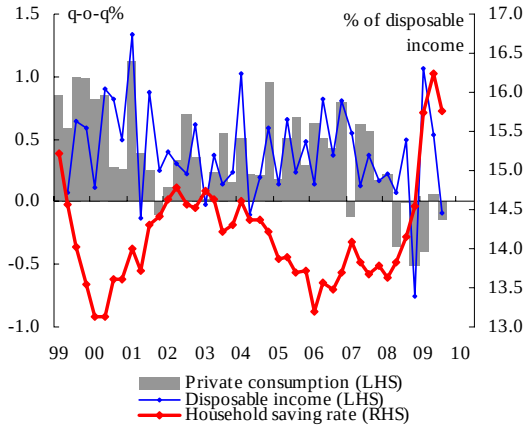


Source: European Commission

A muted outlook for investment typically implies a weak labour market ahead, which in turn is likely to dampen *private consumption*. Indeed, retail sales remain bleak and car registrations are flattening as the generous scrapping schemes are coming to an end in several countries. Although consumer confidence has shown a trend increase since March 2009, its current level remains below the long-term average. On the other hand, the household saving rate may have peaked. After having risen by almost 3 pps. during the previous four quarters, it declined in the third quarter of 2009, reflecting improved confidence. Moreover, demand for housing loans has turned positive in recent months, and still

subdued inflation supports real disposable income and consumer spending.

Graph 5: Private consumption in the EU remains depressed but the household saving rate may have peaked



Source: European Commission

Growth forecast for the EU remains on track

Overall, recent developments broadly confirm the near-term outlook of last autumn. Based on an update of the outlook for 2010 for the seven largest Member States, the forecast for GDP growth remains unchanged at 0.7% this year in both the EU and the euro area, with a broadly unchanged time profile of the recovery. The upswing remains muted for most of 2010, gaining some momentum only towards the end of the year.

Subdued outlook for inflation in the EU

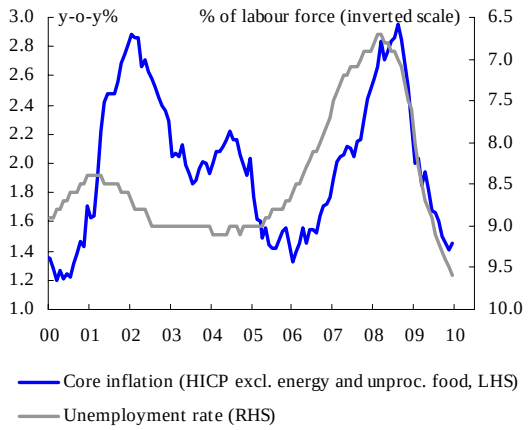
Consumer price inflation turned positive again in the euro area during last autumn, following a temporary dip into negative territory over the summer. The strong disinflation process over most of 2009 was mainly explained by downward base effects from the energy and food components and by a growing slack in the economy.

Euro-area HICP inflation rose to 0.4% in the fourth quarter of 2009, slightly below the autumn projection (0.5%), while the full-year rate was in line with the forecast (0.3%). Core inflation (i.e. HICP inflation excluding energy and unprocessed food) also declined in the course of 2009, to 1.0% in the fourth quarter, down from 2.2% one year earlier. For the EU as a whole, both the fourth-quarter and the full-year headline inflation estimates (1.0%) were in line with the autumn forecast.

Reflecting the significant slowdown in economic activity, a sharp decline in inflation and deteriorating labour market conditions, *wage growth* in the euro area dropped appreciably in the third quarter of 2009. Nevertheless, compared with historical averages, unit labour cost growth remains high, reflecting mostly productivity developments.

The *projected rate of inflation* remains unchanged for the euro area this year (1.1%), while it is marginally revised up in the EU (by 0.1 pp. to 1.4%). However, the headline euro-area figure masks divergent developments across countries, with Germany, Italy and the Netherlands being revised slightly down, while inflation in France and Spain is now projected to be somewhat higher than in the autumn. Outside the euro area, inflation has been revised up more substantially, mainly due to a higher-than-expected pass-through from exchange-rate developments to the headline inflation rate.

Graph 6: EU core inflation subdued amidst high unemployment



Source: European Commission

Notwithstanding increased volatility in commodity and foreign exchange markets, underlying inflation trends remain largely unchanged: the projected sluggish recovery and a large slack in the economy are expected to offset price pressures from slightly higher oil and commodity prices (in euro terms) and a lower euro exchange rate vis-à-vis the US dollar.

Full impact on labour market and public finances is still to come

The *labour market* situation has continued to worsen in the past months, albeit the pace of deterioration has eased somewhat. Overall, the outcome appears to be in line with the autumn forecast. While GDP growth turned positive again in the third quarter of 2009, the number of persons employed continued to decrease, falling by 0.5% q-o-q in both the EU and in the euro area. This reflects the usual lag with which the labour markets tend to follow changes in GDP. The unemployment rate also continued to increase, reaching 10.0% in the euro area and 9.6% in the EU in December 2009, almost 3 pps. above the lows of early 2008.

Looking ahead, survey indicators of firms' employment expectations have improved in recent months, suggesting that the deterioration in the labour-market situation could level off in the course of 2010. As developments in the labour market have turned out broadly as expected in the autumn forecast, no significant changes in the outlook for the near future appear warranted, conditional on economic growth in 2010 also being in line with the autumn forecast, as it is now expected. According to the autumn forecast, the unemployment rate in the EU was expected to already be lower in 2011 compared to the previous year, whereas in the euro area unemployment was still expected to increase in 2011.

Turning to *public finances*, available information suggests that, in line with the broadly unchanged outlook for economic activity, the 2010 budgetary position in the EU and the euro area should be broadly as expected in the autumn forecast.

A full assessment of the prospects for public finances and labour markets will be carried out in the Commission's upcoming spring forecast.

Continued high uncertainty, but broadly balanced risks

Amid continued high uncertainty, risks to the EU *growth outlook* for 2010 still appear broadly balanced. Recent economic developments have generally confirmed the baseline picture presented in the autumn, with most of the driving forces behind the recovery being of a temporary nature. The underlying momentum and robustness of the nascent EU recovery are not yet fully established. Moreover, in these early stages of the post-crisis recovery, economic growth is still facing a number of significant and unusual impediments, discussed in detail in the autumn forecast. Indeed, nearly all risk factors remain relevant, although recent developments suggest that some of them may carry a larger weight than previously thought.

On the *downside*, recent developments in financial markets have shown that while the conditions are overall significantly better than a year ago, the situation remains highly uncertain and subject to serious downside risks. Most recently, for instance, developments in sovereign bond markets indicate that mounting concerns about the sustainability of public finances in some Member States could have a stronger adverse impact than currently assumed. This could lead to higher-than-earlier-anticipated financing costs for firms and households, with adverse consequences on real activity, in the Member States where such concerns arise. In addition, there is a possibility that the effect could be broader, weighing further on the recovery.

On the *upside*, a more pronounced upturn in global demand has already materialised since the autumn forecast. The vigour of the global recovery, particularly in Asian emerging markets, may continue to surprise, posing an upside risk for EU export growth. Moreover, the turning of the inventory cycle in the EU could have a greater impact on domestic demand than currently anticipated, as could further improvements in sentiment.

Turning to the *inflation outlook*, risks also appear to remain broadly balanced for 2010. While the recent rebound in oil and other commodity prices and a weaker-than-previously-assumed exchange rate constitute upside risks to the inflation projection, large excess capacity, weak labour-market conditions and well-anchored inflation expectations are likely to prevail, containing inflationary pressures in the near term.

Growth and inflation prospects in the seven largest Member States

1. Germany – exports sustaining the recovery

German real GDP is estimated to have contracted by 5.0% in 2009, in line with the autumn forecast. After the economy was severely hit by the collapse in world trade around the turn of 2008-09, it rebounded briskly in the second and third quarters by 0.4 and 0.7% respectively. This rebound was driven by expansionary monetary and fiscal policy, a sharp turnaround in the inventory cycle, and a recovery of world trade. Low inflation, stable employment levels and the car-scrapping scheme also underpinned relatively buoyant private consumption in the first half of the year. The recovery lost momentum in the final quarter of 2009, however, when real GDP stagnated. While exports continued to expand strongly, the impetus from stock-building and the introduction of stimulus measures petered out and private consumption suffered a marked backlash from the expiry of the car-scrapping scheme.

Despite steadily improving business climate indicators since early 2009, the recovery of industry stalled towards the end of the year. Industrial production dropped in December and new industrial orders remained flat in the final quarter. Due to this temporary halt in the recovery of industry and harsh weather conditions in the first two months of the year real GDP growth is set to remain flat in the first quarter of 2010. However, boosted by a technical, weather-related rebound, economic growth is projected to gather pace again from the second quarter onwards, largely owing to the improved outlook for world trade. While growth in the first half of the year is likely to remain largely export-driven, it is expected to become more broadly based in the second half as investment picks up and private consumption stabilises aided by additional fiscal stimulus measures introduced in 2010. Despite a weaker start to the year than assumed in the autumn and a lower statistical carry-over from 2009, real GDP is projected to grow by 1.2% in the year as a whole – in line with the autumn forecast.

HICP inflation turned out lower than expected in the last quarter of 2009 and January 2010, and given the considerable slack in the economy it should remain subdued. Therefore, despite an assumed increase in oil prices, the outlook for inflation in 2010 is slightly lower than in the autumn forecast.

2. Spain – lower fall in economic activity

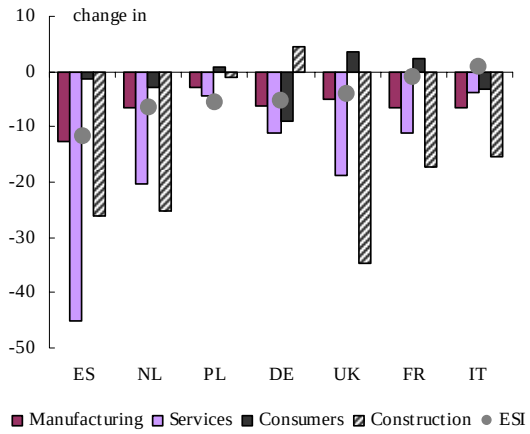
Record high unemployment, a long structural adjustment of the residential construction sector and the on-going deleveraging process of households and firms are hampering a recovery of the Spanish economy. In quarterly terms, real GDP in Spain fell by 0.1% in the fourth quarter of 2009 from -0.3% in the third quarter. For the year as a whole, economic activity is estimated to have contracted by 3.6%, in line with the autumn forecast. Car-scrapping schemes and improved confidence in the second half of the year, in parallel with a favourable evolution in external demand, have contributed positively to this outcome. Domestic demand lowered GDP growth by 6¼ pps., while net external demand contributed positively by 2¾ pps.

The outlook features a further, albeit much smaller, contraction of the economy in 2010. Real GDP is projected to fall by 0.6%, following a smaller contraction in domestic demand. Indeed, recent improvements in consumer and industry confidence suggest a faster recovery of domestic demand in 2010 than previously anticipated. Still, a restrain of public consumption, tight credit conditions and a fading out of the positive effects of car-scrapping schemes are expected to partially hamper the recovery. The VAT-rate increase scheduled for mid-2010 is likely to bring forward consumption impacting on the quarterly GDP growth pattern. Exports are forecast to grow over the next quarters faster than projected in autumn, reflecting some improvement in world demand. However, a more muted fall in imports, consistent with stronger domestic demand, would lead to a smaller positive contribution of the external sector to GDP growth.

Inflation turned positive to 0.2% in the last quarter of 2009, compared with negative outcomes in earlier quarters. This inflationary rebound is mainly explained by energy price developments in 2009

and by fading base effects of the 2008 oil price increases. Inflation is expected to rise in 2010 to 1.1% on average, and to 1½% at the end of the year, on the back of higher oil prices and the VAT hike. After a significant increase in 2009, real wages are expected to moderate in 2010, following higher inflation and lower nominal increases included in recent wage agreements.

Graph 7: Change in Commission's key confidence indicators: differences from the long-term averages (last obs. Jan 2010)



Source: European Commission

3. France – strong growth at the end of 2009 masks risks ahead

The global financial crisis cast the French economy into recession, with quarter-on-quarter GDP growth rates of -1.5% and -1.4% in the last quarter of 2008 and the first of 2009. However, with a contraction of economic activity of -2.2% in 2009, France was less affected by the crisis than its neighbours. GDP growth turned positive in the second quarter of 2009, registering quarterly growth of 0.3%, 0.2% and 0.6% in the last three quarters of the year. A resilient private consumption contributed positively to GDP growth throughout 2009, supported by households' income growth and stimulus measures, especially by the car-scrapping premium, the effect of which peaked in the fourth quarter. In the second quarter, the growth contribution of net trade was surprisingly positive owing to automotive production, which benefited strongly from car-scrapping schemes in neighbouring countries. But this proved short-lived, with the net trade contribution to growth turning negative again in the fourth quarter. The inventory cycle turned around in the third quarter, and was the strongest contributor to GDP growth in the fourth quarter.

For 2010 as a whole, GDP growth is projected to return to positive territory, with an annual rate of 1.2%. Temporary factors, such as the inventory cycle and the effects of stimulus measures, at play at the end of 2009 are set to last in the first quarter. From the second quarter onwards, activity is projected to slow down. Private consumption will suffer from muted increases in purchasing power and the expiry of the car-scrapping premium. In addition, the uncertain demand outlook, the underutilisation of production capacities, the widespread declines in profits and the need for firms to strengthen their balance sheets, do not bode well for corporate investment. With the export market share of France in global trade declining, the growth impetus from exports is expected to remain lacklustre.

The HICP inflation rate turned out very low in 2009 (0.1%), reflecting base effects associated with high food and energy prices in 2008. Year-on-year inflation bottomed out in the third quarter of 2009, however, and turned positive again in the fourth. In 2010, HICP inflation is expected to remain relatively subdued, at 1.2%.

4. Italy – mild growth ahead

Real GDP recorded a steep fall in 2009, dragged down by plummeting exports and a sharp decline in investment, especially in the first half of the year, while private consumption fell more moderately. However, following a quarterly contraction by 2.7% and 0.5% in the first two quarters, GDP growth rebounded to 0.6% in the third quarter. The fourth quarter posted a renewed GDP contraction, by 0.2%, but business and consumer confidence indicators point to stronger economic activity in the current quarter. Real GDP is therefore set to expand again in the first quarter of 2010.

Broadly confirming the Commission's autumn 2009 forecast, a moderate recovery is expected in 2010. Real GDP is projected to grow by 0.7% in the year as a whole, driven by relatively buoyant private consumption and exports. The former is set to

benefit from lower precautionary household savings, owing to the improved conditions in the financial markets, along with moderate inflation prospects. Exports are expected to receive a positive impulse from the strengthening of global demand. Low capacity utilisation in industry, on the other hand, is set to keep firms' investment plans subdued.

The risks around this projection are broadly balanced. An upside risk to the GDP growth scenario is the possibility of a faster rise in world trade, which could further boost exports and subsequently investment. On the downside, lagged effects of the economic crisis on employment could negatively affect private consumption.

As anticipated in the Commission's autumn 2009 forecast, HICP inflation declined markedly in 2009 to 0.8% on average, due to the fall in energy prices and weak demand. It picked up in the last quarter of 2009, as the favourable base effects from energy prices started to fade out. In 2010, under the assumption of higher oil prices and recovering demand, it is projected to increase to 1.7% on average.

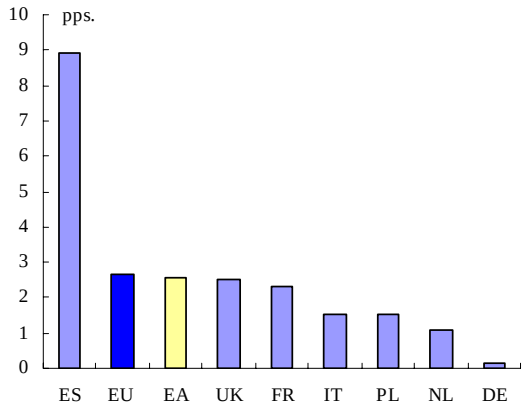
5. The Netherlands – trade to turn tables again

In 2009, economic activity experienced a severe contraction of 4%. The contraction was concentrated in the first half of the year, with the first and second quarter showing negative quarter-on-quarter growth of 2.3% and 1.1% respectively. The economy rebounded in the third and fourth quarter with positive growth of 0.5% and 0.3% respectively. This growth profile during the year reflected in large part external developments, with net exports contributing negatively to growth in the first half and positively in the second, as expected, in view of the sensitivity of the Dutch economy to world trade. Domestic demand was a drag on growth throughout the year as private consumption contracted due to important negative wealth and confidence effects stemming from the financial crisis. Investment suffered from decreasing demand, lower profitability and tightening credit conditions. Government consumption was the only factor supporting domestic demand growth, mainly owing to the fiscal stimulus package amounting to 1% of GDP.

For 2010, GDP growth is expected to turn positive again at 0.9%. Net trade is most likely to be the main driver as exports are likely to benefit from a further recovery of world trade and to outpace import growth. As firms are grappling with a very low capacity utilisation rate, decreased profitability and tighter credit conditions, investment will continue to suffer. Despite a tendency of confidence to improve, private consumption is set to remain subdued, as real disposable income is negatively affected by lower wage growth and increasing unemployment. The latter is likely to increase strongly in 2010 after a relatively favourable development in 2009. Most importantly, some mitigating effects that played an important role in 2009, such as labour hoarding and part-time unemployment measures, are expected to gradually disappear.

The inflation rate is likely to remain subdued in the first half, mainly because of a negative contribution of energy prices, which are related to a decrease in prices for gas and electricity. Energy prices should contribute positively again to inflation in the second half of 2010, resulting from a base effect. Overall for 2010, inflation is expected to come out at 0.8%.

Graph 8: Change in unemployment rates (last 3 months average compared to 08Q2 average)



Source: European Commission

6. Poland – A front-runner in the recovery phase

Economic activity accelerated substantially towards the end of 2009, with real GDP increasing by an estimated 1.7% in the fourth quarter from 0.1%,

0.5% and 0.5% respectively, in the preceding three quarters. The upswing was driven by a sharp increase in public investment (partly co-financed by EU funds) and a rebound of exports. Private consumption continued to increase, supported by better-than-expected employment performance and cuts in the personal income tax rates. Overall, real GDP growth reached 1.7% in 2009, the highest and only positive growth rate in the EU and ½ pp. more than projected by the Commission last autumn.

In 2010, real GDP growth is expected to accelerate to 2½%, i.e. ¾ pp. higher than predicted in the autumn forecast. Real GDP is projected to remain stable in the first quarter of 2010 – as high frequency indicators point to a technical correction after the strong increase in the fourth quarter of 2009 – and to accelerate gradually over the year. The recovery would continue to be driven by exports, which will benefit from the rebound in external demand and the lagging positive effects of the past exchange rate depreciation. The latter effect will however gradually fade away and domestic demand will become the main driver of growth in 2010. Investment is projected to recover slowly after the drop recorded in 2009. This will reflect robust public spending in capital expenditure, firming-up production expectations and improved perception of the Polish economy among foreign investors (attracting FDI inflows). Private consumption is expected to contribute moderately positively to growth. It will be supported by a marked increase in social transfers and better-than-expected developments in the labour market, where the sharper-than-anticipated adjustment of real wages is cushioning the effects of the downturn on employment.

HICP inflation reached 4% y-o-y in 2009, marginally higher than in the autumn forecast. It is expected to remain close to the central bank's inflation target of 2.5% over the forecast horizon, reflecting the large negative output gap caused by the crisis.

7. The United Kingdom – emerging from the recession with little momentum

After having posted 2.5% and 0.7% contractions in the first two quarters of 2009, UK GDP fell further in the third quarter of 2009 (-0.2%), in line with the Commission's autumn forecast, making it the seventh successive fall in quarterly output. Overall, the strength of domestic demand surprised somewhat in the third quarter, as private consumption levels stabilised, and fixed investment rebounded noticeably, although stock building partly offset the resulting lift to GDP. Due in part to the resilience of disposable income growth throughout the recession (helped by lower interest rates, tax reductions and higher benefit payments), the aggregate household saving rate rose to around 8% in the third quarter, up from zero in early 2008. Preliminary GDP and other data suggest that the UK economy expanded only marginally (0.1%) in the fourth quarter of 2009, apparently driven by domestic demand growth. By contrast, net external demand exerted a drag on growth in both the third and – according to monthly trade data – fourth quarters, thus indicating that the economy was still failing to rebalance towards external demand following sterling's depreciation over the past two years. Unemployment levels broadly stabilised in late 2009. In 2009 as a whole GDP is now estimated to have contracted by 4.8%.

Sentiment indicators suggest that positive output growth in the fourth quarter carried over into 2010, particularly in manufacturing. However, the impact of the January 2010 reversal of the VAT cut and poor January weather are likely to depress private consumption in the first quarter. In view of the lower-than-expected momentum evident in the fourth quarter, this suggests a slightly weaker GDP growth profile in the first half of 2010. On an annual basis, growth of 0.6% is expected in 2010, marked by a continued domestic demand weakness driven by the household and government sectors.

HICP inflation rose in the final quarter of 2009, due to a base effect from December 2008's VAT reduction, a higher pass-through from import prices to consumer goods and sharp falls in the price of oil in late 2008. Inflation is expected to increase further in the first quarter, due to VAT-linked prices rises, but in view of the large amount of spare capacity these temporary factors should gradually soon give way to a renewed moderation of inflation.

Table 1: Real GDP growth

	Quarterly GDP (%, quarter-on-quarter)					Annual GDP (%, year-on-year)	
	Outturn	2010 (forecast)				2010 (forecast)	
	2009/4	2010/1	2010/2	2010/3	2010/4	*Autumn forecast Nov. 2009*	Interim forecast Feb. 2010
Germany	0.0	0.0	0.3	0.3	0.4	*1.2*	1.2
Spain	-0.1	-0.1	0.1	-0.2	0.1	*-0.8*	-0.6
France	0.6	0.4	0.0	0.1	0.3	*1.2*	1.2
Italy	-0.2	0.4	0.1	0.2	0.3	*0.7*	0.7
Netherlands	0.3	0.3	0.3	0.3	0.3	*0.3*	0.9
Euro area	**0.1**	**0.2**	**0.2**	**0.2**	**0.3**	***0.7***	**0.7**
Poland	1.7 *	0.1	0.5	0.8	0.9	*1.8*	2.6
United Kingdom	0.1	0.2	0.2	0.3	0.4	*0.9*	0.6
EU27	**0.1**	**0.2**	**0.2**	**0.2**	**0.3**	***0.7***	**0.7**

* 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	2010 (forecast)				2010 (forecast)	
	2009/4	2010/1	2010/2	2010/3	2010/4	*Autumn forecast Nov. 2009*	Interim forecast Feb. 2010
Germany	0.3	0.5	0.7	0.9	0.8	*0.8*	0.7
Spain	0.2	0.8	1.0	1.2	1.5	*0.8*	1.1
France	0.4	1.1	1.2	1.2	1.3	*1.1*	1.2
Italy	0.7	1.5	1.6	1.7	1.9	*1.8*	1.7
Netherlands	0.6	0.0	0.0	1.5	1.5	*0.9*	0.8
Euro area	**0.4**	**0.9**	**1.0**	**1.3**	**1.3**	***1.1***	**1.1**
Poland	3.8	3.1	2.2	2.0	2.1	*1.9*	2.3
United Kingdom	2.1	3.3	2.6	2.1	1.5	*1.4*	2.4
EU27	**1.0**	**1.4**	**1.3**	**1.4**	**1.4**	***1.3***	**1.4**

Source: European Commission

Questions and comments on the February 2010 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 6 May 2010). This interim forecast updates the outlook of the autumn 2009 economic forecast of 3 November 2009. The cut-off date for this interim forecast to take new information on board was 15 February 2010.

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 or judgemental forecasting techniques.

Estimates for the European Union and the euro area are prepared using the nominal GDP-weighted updates for the largest Member States. These countries account for 79% of the European Union and 83% of the euro area in terms of nominal GDP. The outlook for the smaller Member States has not been updated. The Commission has made projections for the euro area and the EU using the updates for the five and seven largest Member States respectively, and assuming that the revision for quarter-on-quarter growth rates for the smaller Member States is equal to that of the larger ones.

Quarterly data are updated with the latest available information. When comparing quarterly with annual GDP growth it must be kept in mind that, whenever possible, quarterly data are adjusted for both seasonal influences and the number of working days while annual data is presented in unadjusted form. Calendar factors are, however, relatively small in 2010.

External conditions

This forecast is based on a set of external assumptions. These assumptions are based on market expectations at the time of the forecast. To shield the assumptions from possible volatility during one specific trading day, averages from a 10-day reference period have been used for all technical assumptions.

The technical assumption as regards exchange rates has been standardised using fixed nominal exchange rates for all currencies. They are kept constant based on the averages from 10 days up to 15 February, implying e.g. an annual average of USD/EUR of 1.38.

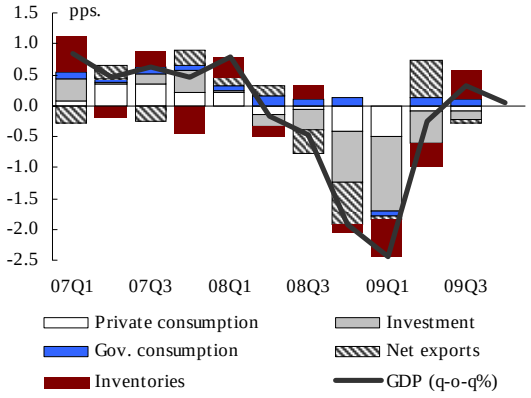
Interest rates assumptions are, since spring 2007, market-based instead of expert-based. These assumptions should be interpreted with caution, as market-based assumptions do not only reflect policy rate expectations, but also liquidity conditions in this period of market uncertainty. Short-term interest rates for the euro area are derived from future contracts. Long-term interest rates for the euro area, as well as short- and long-term interest rates for Poland and the UK are calculated using implicit forward swap rates, corrected for the spread between the 3-month interbank interest rate and the 3-month swap-rate. As a result, the short-term rate is at 0.9% and the long-term interest rates at 3.3% in 2010 for the euro area.

The outlook for oil prices is based on futures prices. The price for a barrel of Brent crude oil is projected at 75.7 USD/barrel in 2010 (corresponding to 54.7 EUR/barrel). This would be 0.8 USD/barrel lower (or 3.0 EUR/barrel higher) than assumed in the autumn 2009 forecast, reflecting an improved global outlook and demand expectations from e.g. emerging markets (as well as exchange rate movements).

Global demand in 2010 is revised upwards, following the stronger-than-expected growth in the second half of 2009 in emerging economies, United States (where it has been led by inventories), and a rebound in world trade and industrial production. Global GDP growth, excluding the EU, is now forecast to accelerate to 4.4% in 2010 (up from 0.1% in 2009), about ½ pp. higher than expected in the autumn forecast (3.8%). World trade is set to rise substantially in 2010, with growth in export and import volumes (excluding the EU) estimated at around 7% (compared with an average 12% fall in 2009).

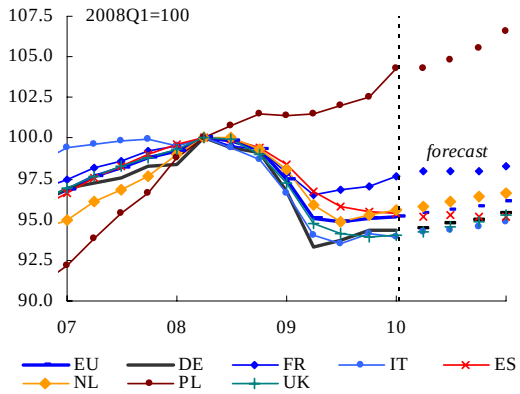
Annex: Selected graphs

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



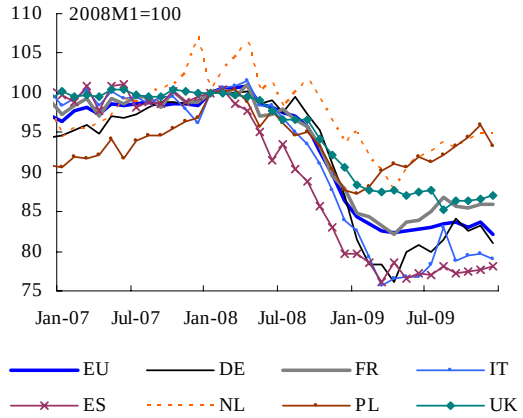
Source: European Commission

Graph A.2: GDP levels in the EU and selected Member States



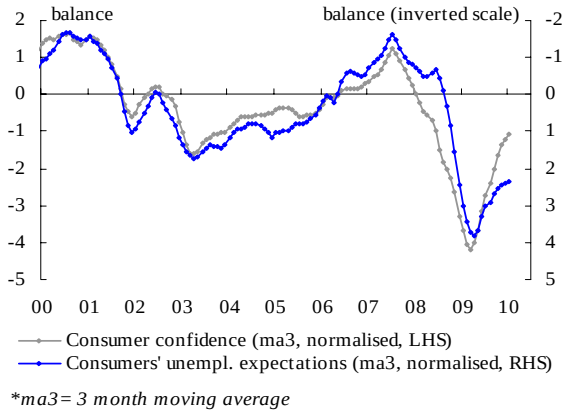
Source: European Commission

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



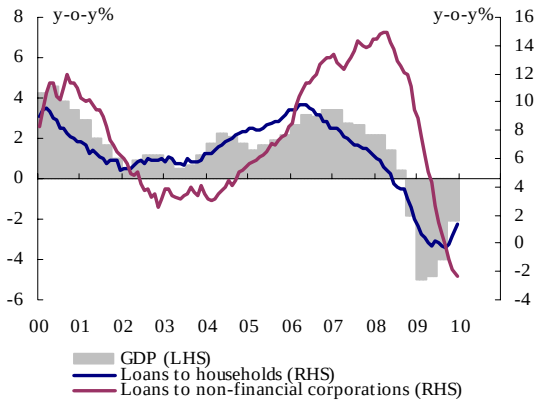
Source: European Commission

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



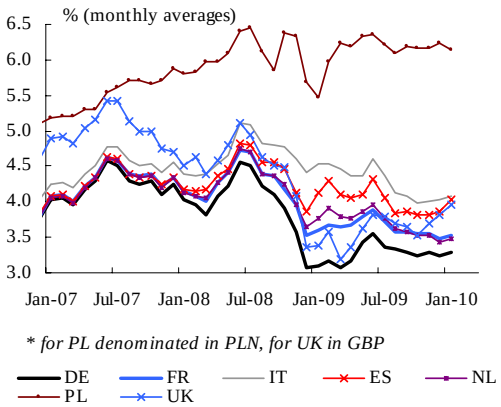
Source: European Commission

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



Source: European Commission

Graph A.6: Sovereign bond yields in selected Member States



Source: European Commission