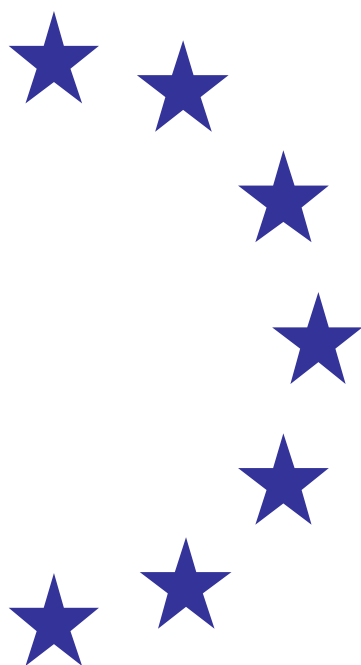


# EUROPEAN COMMISSION

DIRECTORATE-GENERAL FOR  
ECONOMIC AND FINANCIAL AFFAIRS



**February 2008**  
**Interim forecast**

**Press conference of 21 February 2008**

## **The current headwinds start to take their toll in the EU**

*The global economic situation and outlook remain unusually uncertain at the start of 2008, in view of continuous distress in financial markets, a more marked US slowdown and soaring commodity prices. So far, the European economy has weathered these headwinds relatively well, but EU economic activity is set to moderate.*

*The initial resilience of the EU and euro-area economies follows from their sound starting position when the turmoil broke out. Household and enterprise balance sheets have improved markedly in recent years and both the internal and external balances are sound. However, confidence indicators peaked and have been on a steady declining path since last summer. Against this background, a certain easing of real GDP growth in the fourth quarter of 2007, to 0.5% from 0.8% quarter-on-quarter (QoQ) in the EU (and to 0.4% QoQ in the euro area), did not come as a surprise.*

*GDP growth has now been revised down by 0.4 percentage point (pp.) in both the EU and the euro area this year. The update of the outlook for the seven largest EU economies results in a GDP projection of 2.0% for the EU and 1.8% for the euro area. The revision is particularly pronounced for Italy, where the sharp contraction in industrial production in the last quarter of 2007, as well as the more marked deterioration in the services sector confidence indicator, weighs on the annual average for 2008. Growth rates remain firm in Poland and the Netherlands.*

*Consumer price inflation has picked up in recent months, fuelled by high commodity prices. The outlook for inflation has been revised up by ½ pp. in both areas to 2.9% in the EU and 2.6% in the euro area. Inflation expectations have also increased somewhat lately and currently stand close to the high levels reached in 2001. But so far, however, second-round effects have been contained.*

### ***A bleaker global outlook***

The global economic situation and outlook remain unusually uncertain at the start of 2008. This follows from the ongoing turmoil in financial markets, a sizeable deceleration of growth in the US economy, where the slowdown has spread beyond the housing market, and soaring commodity prices.

First, the hopes that the financial turmoil might be relatively short-lived and that it would gradually peter out – which was a crucial assumption in the Commission's autumn 2007 forecast – have now given way to a realisation that further problems may still be ahead.

Second, following a sharper downturn in the US economy, global growth is expected to slow to below 4% this year. This represents a more marked easing than expected in the autumn forecast. However, the difference also reflects the impact of revised purchasing power parities on the starting position. This revision trimmed global growth by about ½ pp. during 2005-2007.

Third, a weaker outlook for growth in the developed world has allowed oil prices to ease back from record highs at the turn of the year. However, oil prices remain high and volatile, driven by limited spare capacity and geopolitical tensions in oil-producing countries. Based on futures, the oil-price assumption is revised up by 15% in USD-terms compared to the autumn outlook.

### ***International financial system remains fragile***

The functioning of several key credit markets has been severely impaired since last summer. The current distress was triggered by a rapid increase in defaults in the US subprime mortgage market. Exposure to these losses spread to financial institutions around the world, as sub-prime loans were mixed with different types of loans or receivables into complex financial products, such as collateralised debt obligations (CDO) and passed on to other financial institutions. Investor confidence has been seriously undermined by the uncertainty regarding the ultimate scale and location of these losses.

Central banks have responded effectively to the turmoil by ensuring adequate liquidity in the banking system in a series of interventions in the second half of 2007. These actions have stabilised liquidity since the start of 2008 and allowed the short-term interest rates to come down markedly (together with the impact of a sizeable monetary easing in the US). However, markets are not yet functioning properly. This is reflected, for example, in inter-bank spreads remaining at elevated levels, at about 35 basis points (bp) compared to a long-term average of 20 bp.

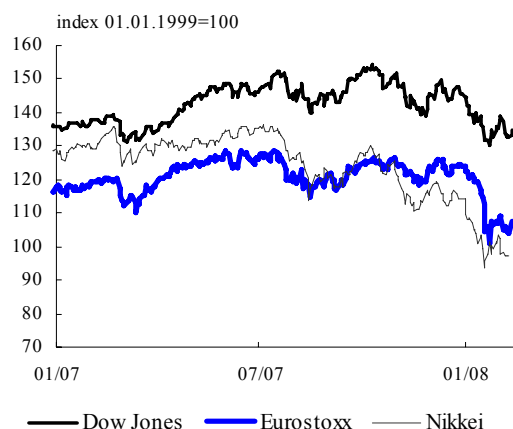
The Ecofin Council has also responded by endorsing a roadmap for action to follow-up on the turmoil (October 2007), where work is now well in progress. These actions are structured around the following four main objectives:

- (i) *Improving transparency in the market*, notably with respect to banks' exposures relating to securitisation and off-balance sheet items;
- (ii) *Upgrading valuation standards* to respond in particular to the problems arising from the valuation of illiquid assets;
- (iii) *Strengthening the EU's prudential framework* for the banking sector, e.g. with respect to the treatment of large exposures, banks' exposures to securitisation and liquidity risk management; and
- (iv) *Investigating structural market issues*, such as the role played by credit rating agencies or the "originate and distribute" model.

At the international level, work has also been initiated by e.g. the G7 Finance Ministers to diagnose the causes of the financial turmoil and to make appropriate recommendations. In response, the Financial Stability Forum (FSF) has set up a Working Group on Market and Institutional Resilience with a view to (a) developing a diagnosis of the causes of recent events; (b) identifying the weaknesses that merit attention from policymakers; and (c) recommending actions needed to enhance market discipline and institutional resilience.

The working group's initial findings, presented earlier in February, are consistent with those identified in the ECOFIN roadmap. The IMF has also been invited to report on the threats to the global economy from financial-sector developments, in parallel to the report by the FSF, at the IMF/World Bank meetings in April 2008.

Graph 1: Stock-market indices: Dow Jones, Eurostoxx and Nikkei



Meanwhile, problems in other parts of the financial markets have intensified. Credit ratings for CDOs have come under renewed pressure as defaults spread to higher-quality segments of the US mortgage market as well as to credit-card debt and automobile loans. A growing concern about the financial health of bond insurers (so-called monolines), which underwrote much of the credit risk linked to CDOs, now adds to the pressure.

Financial losses incurred by banks, which so far amount to around € 100 bn., have triggered a generalised tightening in lending standards. While some of the larger banks have been able to recapitalise, often from sovereign wealth funds, their balance sheets remain vulnerable to a further deterioration in the quality of assets or in securitising outstanding loans to the private equity sector.

A tightening in lending conditions, together with a reduction in investor's risk appetite, implies a reduced availability of credit for businesses and households going forward. This has reinforced the expectations of a more marked slowdown in the US, and, to a large extent, also in the EU economies, reflected in both a marked fall in long-term interest rates and a sharp correction in equity prices since the beginning of this year (Graph 1). A certain spill-over of the financial turmoil (and its impact on the US economy) is now noticeable also in emerging markets, albeit to a lesser extent.

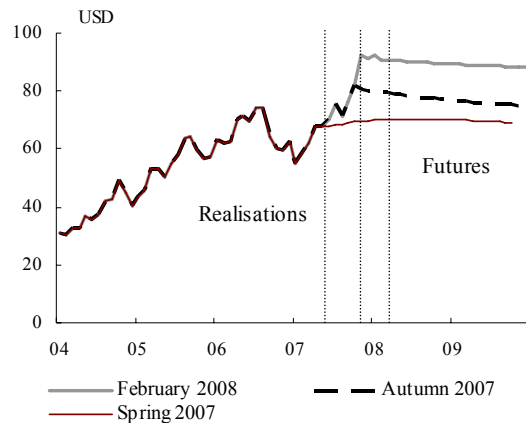
*Diverging growth trends with developed economies more affected*

The financial turmoil was initially contained to the financial markets themselves. The impact on hard (essentially backward looking) data has, so far, been limited. However, soft data such as consumer and investor confidence have been on a declining trend since last summer, albeit with marked differences across sectors and countries (see also the section on survey indicators). The deterioration of confidence has now started to affect the real economy.

In the *US*, recent data not only point to a more severe contraction of the housing sector, but also to a larger spill-over into the rest of the economy. The financial distress has caused a sharp tightening in lending conditions for many borrowers, which reinforces this process. Quarterly GDP growth dropped to 0.2% in the last quarter of 2007. According to some analysts the US economy is already in, or at the brink of, a recession. However, net exports are providing considerable offset to weakness in domestic demand and the US may still avoid a recession.

Looking ahead, it is crucial to assess the impact of the recent monetary and fiscal easing in the US. The Federal funds rate has been lowered sharply to 3% in January and an 'economic stimulus act' has been adopted that provides households with significant additional spending power, mainly in the form of tax rebates. Together with the investment incentives for business, the fiscal easing amount to some 1.2% of GDP. These measures will provide a certain stimulus to activity, especially in the second half of 2008, but the question is to which degree. Household finances are stretched during the current housing downturn and the propensity to spend may well be lower than during previous periods with tax cuts. Taking this into account, the forecast for US GDP growth in 2008 is revised down by almost ½ pp. to some 1¼% in 2008.

Graph 2: Oil price assumptions



The outlook for *Japan* is also bleaker this year. Despite a surprisingly good last quarter of 2007, where net exports and investment boosted the economy, Japan's GDP growth is expected to decelerate in 2008 amid weak personal consumption (consumer's confidence deteriorated sharply in recent months) and the drag that a deteriorating international economic environment will exert on net exports. On the positive side, construction investment, which plummeted in the second half of last year because of the introduction of new safety regulations, should rebound in 2008.

In *China*, economic growth has, yet again, surprised on the upside at 11.4% in 2007. However, growth rates have probably moderated somewhat in the course of last year. Reflecting a stronger-than-expected slowdown in developed countries, real GDP growth is expected to decline to around 9½% in 2008.

Overall, the global economy is expected to slow by 0.8 pp. in 2008 compared to 2007, markedly more than expected in the autumn forecast (excluding the impact of revised purchasing power parities, which lowered growth by about ½ pp. during 2005-2007).

However, it is important to recall that growth has been exceptionally strong in recent years. In a historical perspective, the projected global GDP growth remains about ½ pp. above the long-term average.

*Oil prices expected to stay high*

A weaker outlook for growth in the developed world has allowed oil prices to decline somewhat in the most recent weeks. Prices have come down from a level of close to 100 USD/bl. at the turn of the year. However, oil prices remain high and volatile, driven by limited spare capacity and geopolitical tensions in oil-producing countries.

For the year 2008 as a whole, oil prices are assumed to average 90 USD/bl. according to the futures market (i.e. up by 15% compared to the autumn outlook, see Graph 2). For the euro area, the impact of higher oil prices is partly cushioned by the recent appreciation of the euro. Measured in EUR, the change is limited to 11%.

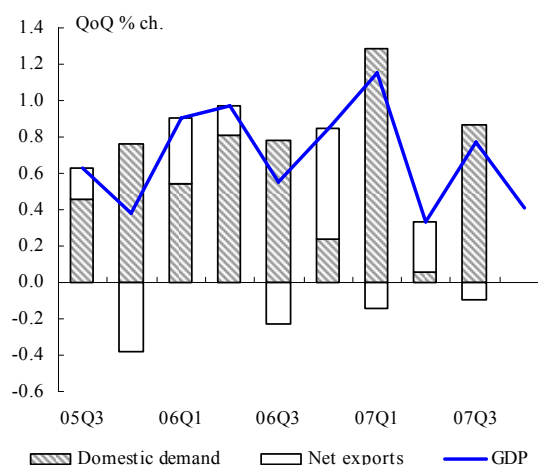
In the last three years, oil prices have almost doubled when measured in EUR and more than doubled in USD-terms. While the past increase in oil prices has contributed to a higher inflation and has dampened real activity, it is noteworthy how relatively resilient the global economy remained – ahead of the outburst of the financial turmoil last summer.<sup>1</sup>

***Growth in Europe also moderating towards the end of 2007...***

The year 2007 started on a strong note in the EU and the euro area, on the back of solid fundamentals. GDP growth was driven by strong job creation that supported private consumption together with robust investment growth. In addition, the absence of external imbalances and, comparatively low public deficits placed the European economies in a good position to weather the headwinds from a gradually deteriorating global outlook in the course of 2007.

<sup>1</sup> Estimates from the Commission's QUEST III model, which is a dynamic stochastic general equilibrium (DSGE) model, point to a lower impact on real activity than earlier model simulations have suggested, but also to a higher pass-through to inflation. A more detailed description of the model and its simulation results will be presented in the upcoming spring 2008 forecast.

Graph 3: GDP growth and components, euro area



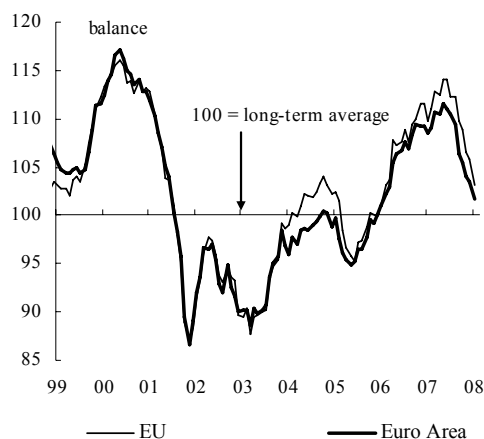
GDP growth came in at 0.8% in both regions in the third quarter, thus above potential and higher than projected last autumn. The pick-up was broad-based across the largest EU economies covered by this update.

Growth in the third quarter was exclusively driven by domestic demand. Gross fixed capital formation rebounded strongly as activity in the construction sector recovered and investment in equipment continued to expand rapidly. Private consumption confirmed the positive indications observed in the previous quarter, while net external trade was a drag on growth, particularly in the EU.

As anticipated by most short-term indicators of hard and soft data, Eurostat's flash estimate of GDP growth confirmed the deceleration of economic activity in Q4, with QoQ GDP growth slowing down to 0.5% in the EU and 0.4% in the euro area.

According to available data, economic activity weakened particularly in Italy, Germany and France. Growth decelerated but remained healthy in the Netherlands, the UK and Poland while, contrary to expectations, GDP growth rose in Spain. As a result, the divergence of QoQ growth rates in the EU increased to 0.6 pp. in the fourth quarter (from 0.2 pp. in the previous quarter).

Graph 4: The European Commission's economic sentiment indicator (s.a.)



Information made available by some Member States suggests that domestic demand may have slowed, possibly dragged down by private consumption in the fourth quarter. Information about the external side seems to confirm the impact of a certain cooling of global growth, reinforced by a euro appreciation.

For the whole of 2007, GDP growth is estimated at 2.9% in the EU and 2.7% in the euro area. The carry-over for GDP growth in 2008 is currently estimated at 0.9% in the EU and 0.8% for the euro area.

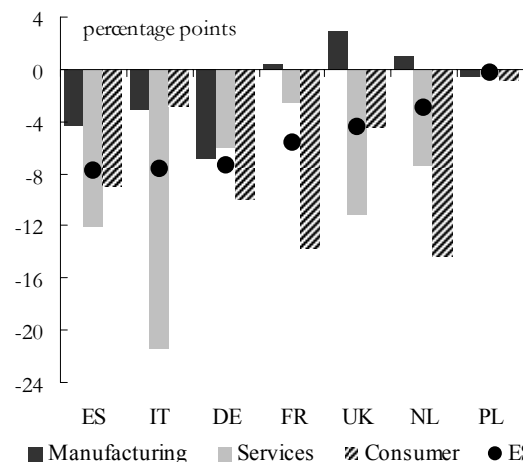
#### *...in line with weaker survey indicators*

Looking ahead, on top of the slowdown in Q4, the recent distress in the financial markets appears to have had a certain, but also differentiated impact across Member States. Confidence indicators offer some indication as to the impact of the financial turmoil and the cooling of global growth across sectors and countries.

The European Commission's economic sentiment indicator peaked in July 2007 and has been on a steady declining path since then, indicating growth moderation (Graph 4). Despite this deterioration, the indicator remains above the long-term average in both the EU and the euro area.

Sentiment deteriorated in all sectors in the past few months in both the EU and the euro area.

Graph 5: Change in key confidence indicators between July 2007 and January 2008



Nonetheless, the sectoral confidence indicator for industry remains above the long-term average. Capacity utilisation rates remain high in both areas (at just below 84%). On the contrary, confidence in the services sector dropped below its long-term average in both the EU and the euro area.

The composite Purchasing Managers' Index (PMI), which combines the indices for manufacturing and services, declined further to 51.8 in January from 53.3 in December, and is now below its long-term average value.

The index was dragged down by a decline in the services sub-component, which is far below its long-term average, while the manufacturing sub-component is broadly unchanged, close to its long-term value.

In the past seven months, since the outburst of the financial turmoil, the change in confidence indicators points to mixed developments across Member States (Graph 5). The overall economic sentiment indicator significantly deteriorated in Spain, Italy and Germany, while it remained robust in Poland.

At the sectoral level, confidence in the services sector has deteriorated significantly in most Member States, and especially in Italy, but also in the United Kingdom, while confidence in the manufacturing sector has clearly held up well.



Consumer confidence, on the other hand, has declined particularly in the Netherlands and France.

### ***Growth outlook revised down for 2008***

Based on the individual updates for Germany, Spain, France, Italy, the Netherlands, Poland and the United Kingdom (which are presented in greater detail in the country-specific sections below), and taking into account the flash estimate for Q4, the update for the euro-area aggregate for 2008 points to a growth rate of 0.3% QoQ in Q1 and Q2, and 0.4 % in Q3 and Q4. Compared to the fully-fledged autumn forecast, it represents a more pronounced slowdown in the first half of 2008. This reflects in part the slowdown of global growth driven by the US through the trade channel, and also a certain effect on domestic demand via reduced confidence and tighter credit conditions.

At the level of Member States, the slowdown is reflected in a revision of annual GDP growth by -0.7 pp. in Italy and by -0.5 pp in both Germany and the UK. At the same time, the Dutch economy grew surprisingly fast in both the third and fourth quarters on the back of higher gas production, implying a markedly higher carry-over into 2008 contributing to an upward revision of annual growth in 2008. Nevertheless, the Netherlands are expected to decelerate strongly in 2008 on a quarterly basis compared with the autumn projection following the impact of the easing of global growth on this very open economy. Some Member States appear relatively more isolated from the effects of the financial turmoil, with robust domestic demand, notably Poland.

As a result, annual GDP growth is revised downwards by 0.4 pp. in both areas as compared to the autumn forecast, to 2.0% in the EU and 1.8% in the euro area. Risks to the growth forecast remain sizeable (see also the section on downside risks to the growth outlook).

Looking further ahead, this updated outlook for 2008 points to a reduced growth momentum at the turn of 2009. The impact of the lower carry-over from 2008, the more pronounced and protracted slowdown in the US and the re-pricing of risks would need to be carefully assessed against other

information. The next fully-fledged forecast by the Commission, planned for 28 April, will provide a more detailed assessment of these issues.

### ***Inflation up on soaring food and oil prices***

After recording moderate rates of growth in the first half of 2007 (around 1.8%), HICP inflation in the EU rose to above 3% in November-December 2007. The flash estimate by Eurostat continues to indicate an increase to 3.2% in January 2008 in the euro area. The recent increase in *headline inflation* has been driven by soaring oil and food prices, combined with unfavourable base-effects.

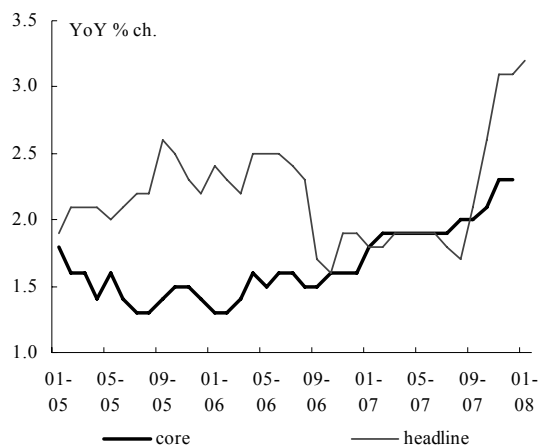
The strong rise in oil prices in 2007 has inflated the contribution from the energy sector significantly to 0.8-0.9 pp. in November-December. Likewise, the contribution of food has increased to 0.9 pp. in December, reflecting the transmission to consumer prices of surging international agricultural prices (e.g. cereals, dairy products and meat). The pass-through from oil and international agricultural prices to consumer prices varies from one Member State to the other, resulting in an increased dispersion in headline inflation across European economies.

Within headline inflation, the favourable base-effects from energy-price developments faded away at the end of 2007, on account of a surge in oil prices, while inflation in unprocessed food was relatively high in 2007.

*Core inflation* (HICP excluding energy and unprocessed food) remained stable in the first half of 2007, but it increased gradually to 2.3% in December after a 0.2 pp. rise in November.

The increase in core inflation can be attributed to services, non-energy industrial goods and processed food altogether. Some additional upward pressure continued to develop in the price of services in 2007, and inflation in processed food picked up markedly in the second half of 2007. Moreover, industrial price pressures at the producer level had remained moderate in the first half of 2007 (rising by around 2½% on average) but increased in the second half of the year to around 3%, suggesting that expected price pressures referred to in the autumn forecast have now materialised.

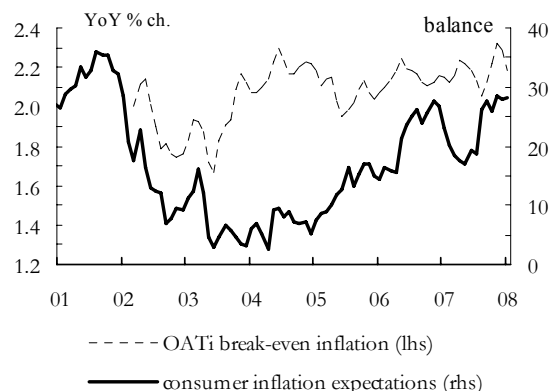
Graph 6: Headline and core inflation, euro area



Turning to *wage indicators*, the growth of nominal compensation per employee remained subdued in 2007, increasing by 2.0% YoY in Q3 (up from 1.9% in Q2), while total hourly labour costs edged up to an annual rate of 2.5% in the third quarter of 2007. Nevertheless, unit labour costs increased by 1.2% in Q2 and Q3 on the back of a moderation in productivity growth. Considering the relatively strong improvement in the labour market in 2007, wage growth has been contained. Some Member States have seen increased wage claims, which so far have not resulted in higher wage settlements. Furthermore, the current weakening in confidence indicators and the general uncertainty surrounding economic activity might put a lid on wage claims.

At this juncture, the key concern is whether inflation *expectations* will remain well-anchored. In January 2008 future price developments showed diverging developments. Compared to December, managers' selling-price expectations slightly increased in industry, while they decreased in the construction sector. Consumers' price expectations increased, and currently stand close to the high levels reached in 2001. Moreover, long-term inflation expectations, derived from French inflation-indexed bonds have continued to pick up (since the beginning of September). In both November and December they averaged 2.3%, 10 bp higher than the first ten months of 2007.

Graph 7: Inflation expectations, euro area



Looking ahead, the aggregated outlook for inflation in 2008 has been revised upwards significantly, based on upward revisions in most of the largest Member States, except for the Netherlands. HICP inflation is now expected to average 2.9% in the EU and 2.6% in the euro area this year. This adds about half a pp. to consumer price inflation in both areas compared to the autumn 2007 forecast.

This upward revision takes into account the higher oil and food-price assumptions and a risk of possible second-round effects on price and wage-setting resulting from the observed increase in inflation expectations. High capacity utilisation and fairly tight labour markets may further fuel wage demands, which could drive up unit labour costs.

In terms of *quarterly developments*, inflation in the EU is now expected to peak in the first quarter at just above 3% and moderate gradually thereafter reaching close to 2% in the fourth quarter, on account of reduced inflationary impulses from commodity prices.

#### ***Employment and public finances react with a lag***

In the second half of 2007, employment growth moderated somewhat to 0.3% QoQ in the third quarter in both the EU and the euro area (down from a robust 0.5% in the EU and 0.6% in the euro area in Q2). Compared to one year ago, the increase in 07Q3 was 1.7% in the EU and 1.9% in the euro area, representing widespread employment gains across Member States. The unemployment rate



declined to 6.8% in December 2007 in the EU and was 7.2% in the euro area. Overall, the annual average unemployment rate was 7.1% in 2007 in the EU, as expected in the autumn forecast. In the euro area, it was 7.4% in 2007, compared with an autumn forecast of 7.3%.

However, given that employment growth lags output growth, employment growth will not remain unscathed from the downward revision to GDP growth forecasts. In the autumn forecast, the Commission projected a deceleration of employment growth to around 1% a year in 2008 and 2009. This forecast is likely to be taken further down in coming months, thereby worsening labour market developments in the coming years.

This is in line with survey data being still above long-term averages, although they appear to have peaked. Hiring intentions in the services sector, which is the largest employer, continued to deteriorate in January. A similar observation can be made in the manufacturing sector. In addition, consumers' unemployment expectations have worsened in January.

Turning to public finances, the information available suggests that, given the marked downward revision to economic activity, the 2008 budgetary position in the EU and the euro area could be worse than expected in the autumn forecast (after reaching its best outcome in 2007, in structural terms, since at least the start of monetary union.). In particular, the slowdown heightens the risk that, following years of tax buoyancy, revenues may surprise on the downside. However, for some countries this may be partly compensated by a better-than-expected outcome for 2007. A full assessment of the prospects for public finances will be carried out in the Commission's spring forecast.

#### ***Downside risks to GDP outlook continue to prevail***

The autumn forecast identified the risks to the growth outlook as being clearly tilted to the downside in 2008, while being tilted to the upside for consumer price inflation.

As regards the *risks to the growth outlook*, developments since the autumn forecast have

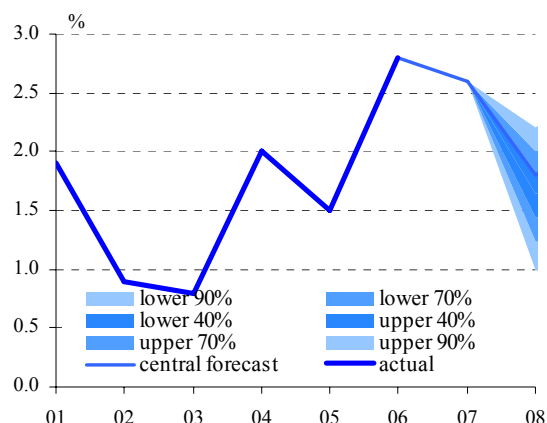
confirmed a number of them, not least the one related to the slowdown in the US economy, which now appears both to be more pronounced and more protracted while the impact of the monetary and fiscal easing is surrounded by a sizeable degree of uncertainty.

The turmoil in the financial markets has also proven more persistent than assumed last autumn, with problems spreading to or intensifying in other credit markets. Spreads also remain at higher levels (not only compared to the level of last summer, when risks were compressed to an unsustainable level, but also above long-term averages). This signals a continued lack of confidence affecting liquidity and credit provisions.

It cannot be excluded that credit conditions and credit availability may be more seriously affected than assumed in this update of the outlook. This could affect, *inter alia*, the housing markets adversely, not only in the US, but also in the EU. Indeed, it should be noted that the exposure to and impact from the current distress in the financial markets differ across Member States. Countries having had a housing boom in the recent past, with high external debt or a high share of debt at variable interest rates are likely to be more exposed than others. From this follows that, although the downward revision is relatively limited, the outlook for Spain remains uncertain. In the case of the UK, the above-average importance of the financial services sector adds to the (downside) risks at the current juncture. As regards the French economy, the housing market remains relatively resilient, although slowing down, and the impact of the additional measures taken to support household disposable income is difficult to predict.

Other risks relate to the effect of e.g. higher oil prices, changes in exchange rates and, not least, adverse shifts in consumer and investor confidence. On the other hand, commodity prices could decline faster than futures currently suggest or the growth momentum in emerging markets could surprise on the upside. The importance of the still positive employment growth in the regular labour market on consumption propensity may also have been underestimated.

Graph 8: Risks to the euro-area growth outlook



Graph 8 provides a quantification of these risks in terms of possible deviation of output growth from the main scenario. More specifically, the graph shows the impact various combinations of risks could have on euro-area GDP growth, the outcomes being weighted by the probability of their occurrence.

At a 90% confidence interval, GDP growth in the euro area could be 0.8 pp. lower in 2008 compared to the central scenario if all negative factors materialise. But growth could also be up to 0.4 pp. higher if the positive risks to the outlook were to materialise.

As regards *the inflation outlook*, the risks identified in the autumn forecast of a further up-tick in commodity prices have already materialised and have had a direct impact on consumer price inflation.

Second-round effects have been relatively limited so far. However, a certain impact from soaring oil- and food prices on inflation expectations and subsequently on wage claims has been noted in some Member States. While competitive pressures from globalisation are expected to limit the acceleration in wage growth at the aggregated level, a relatively tight labour market in some sectors and/or Member States could imply a higher wage growth than assumed.

On the other hand, in view of a general moderation of growth, domestic inflationary pressures should

ease. In particular if commodity prices were to decline faster than futures suggest.

Overall, whilst the risks to the inflation outlook now appear more balanced, they are still on the upside with the increase in inflation expectations (and its possible impact on wage formation) being a particular source of concern.

## ***Growth and inflation prospects in the seven largest Member States***

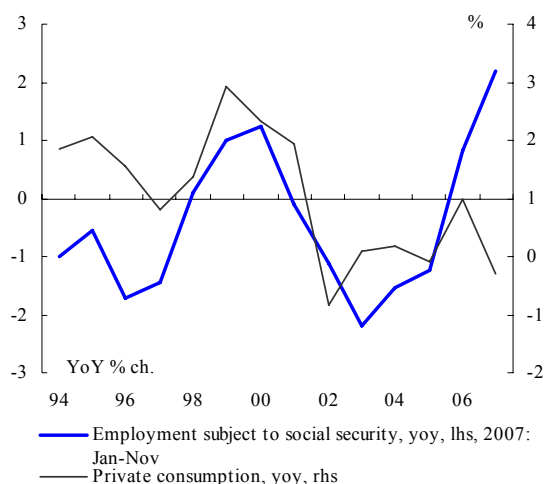
### ***1. Germany – slower growth despite strong fundamentals***

Despite overall sound fundamentals, growth in Germany is set to slow down to slightly above 1½% in 2008. This revision by half a pp. compared with the autumn forecast is a direct consequence of both a weakening of growth towards the end of 2007 and a more cautious outlook for 2008.

Contributing factors to the growth moderation are the continuing financial turmoil and a more subdued international environment, which have led to a drop in consumer and producer confidence. Exports are further dampened by the euro appreciation since early 2006. Additionally, stronger-than-expected increases in oil and food prices have dampened real disposable income growth and thus private consumption. In addition to reducing the carry-over by a quarter of a pp. from 2007 to 2008, these effects will weigh on growth in 2008.

At the current juncture, Germany's economy is expected to remain on a positive growth path. Given the sound financial position of private households and enterprises as well as a subdued housing market, Germany is only to a limited extent vulnerable to shocks from the financial turmoil. In addition, price competitiveness of German exports and their composition remain relatively favourable. Private consumption, which was dampened in 2007 by VAT-induced purchases brought forward to 2006 as well as price increases, should benefit from healthy employment growth already seen over the last two years (Graph 9). Accelerating wage growth should also add to rising disposable income compensating for higher inflation. However, the so far buoyant labour market performance could be jeopardised by higher inflation and low consumer confidence weighing on private consumption.

Graph 9: Germany – Employment and private consumption growth



In December 2007 inflation reached a 14-year high. Oil and food prices are predicted to remain high but no longer rising. Therefore, base effects after price increases in the context of the VAT hike and the introduction of tuition fees in some *Länder* should help to gradually bring inflation down in the course of the year.

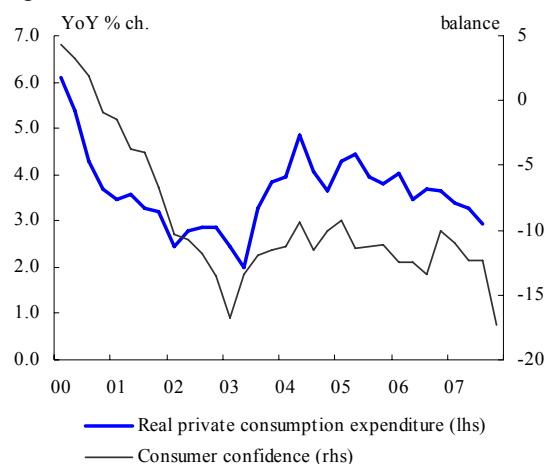
### ***2. Spain – still in for a soft landing***

GDP grew in Spain by 0.8% in quarterly terms in the fourth quarter of 2007, up from 0.7% in the third quarter. For the year as a whole, economic activity is estimated to have expanded by 3.8%, unchanged from the autumn forecast and, as in previous years, exclusively based on domestic demand. In 2008, and in spite of the robust growth in the last quarter of 2007, GDP growth is projected to slow down to 2.7%. This would be fully explained by a decelerating domestic demand on the back of a drop of consumer confidence, a cooling down of the housing sector and tighter credit conditions due to the financial turmoil.

Concerning the external sector, the most recent available information would suggest that exports might be on an accelerating path and growing well above imports, which should lose momentum as a result of a weaker domestic demand. All in all, and

in spite of expected lower activity in the euro area, the traditional negative contribution of net exports to GDP growth observed in previous years should almost vanish in 2008. Finally, the rebalancing of the economic growth pattern might still be insufficient to improve the current account deficit, which should still remain close to two-digit territory.

Graph 10: Spain - Real private consumption expenditure and consumer confidence



Inflation rose sharply to 4% in the last quarter of 2007 compared with 2.4% in the previous one. The inflationary rebound is mainly explained by the increase in energy and food prices. The inflation differential vis-à-vis the euro area has widened during the last quarters and, from about ½ pp. last summer, it has widened to above one pps. recently and is projected to remain around that level. While price increase for the year as a whole would not depart substantially from 3¼%, it is projected to decline at the end of the year to below 3%.

### ***3. France – slower growth in a cooling global environment***

After 2% real GDP growth in 2006, the French economy is estimated to have expanded by 1.9% in 2007, as in the Commission services' autumn 2007 forecast (albeit with a slightly lower carry-over) and below current estimates of potential growth. In 2007, GDP growth was driven by domestic demand, in particular by strong private consumption in line with the improvement of

households' disposable income, while the external sector once more provided a negative contribution.

In 2008, economic activity is projected to slow down, growing at 1.7% (against 2.0% in the autumn forecast). Although most sentiment and activity indicators are still posting comparatively positive readings (with the notable exception of consumer confidence), they are likely to turn more negative in the course of the year. The downward revision with respect to the autumn forecast results from the lower carry-over from 2007, higher-than-expected inflation and the weakening of the global environment.

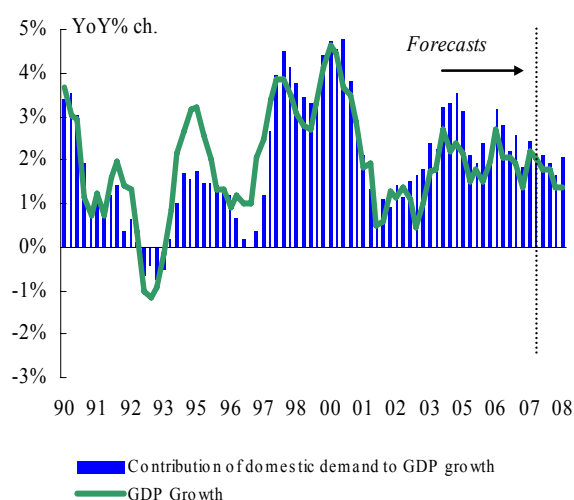
Slower economic growth in France's main trading partners will entail a stronger drag on growth from net trade. Nevertheless, domestic demand and in particular private consumption is expected to remain comparatively resilient (Graph 11). Still favourable employment developments and tax and social contribution cuts introduced with the TEPA package in August 2007, as well as additional measures on purchasing power adopted in February 2008, will partly limit the negative impact of considerably higher inflation on households' disposable income. Business investment is expected to grow more slowly than in 2007 due to a slackening demand and tighter financial conditions.

Risks to this scenario are tilted to the downside, notably since the French economy could be affected more than projected by the global slowdown and measures to support households disposable income may be less effective than assumed in the forecast.

For 2007 as a whole, headline inflation turned out at 1.5% in line with the autumn forecast. In the fourth quarter, inflation however has risen more quickly than expected peaking at 2.8% in December, the highest monthly year-on-year (YoY) change since May 2004, due chiefly to higher oil and food prices. In 2008, headline HICP inflation is forecast to average close to 2.4%, 0.7 pp. higher than expected last autumn. In view of broadly stable oil prices following a peak at the turn of the year and of a base effect after the high level of inflation recorded in the last quarter of 2007, headline HICP should gradually decrease during the year. Core inflation as measured by the HICP excluding food and energy prices, should increase

to close to 1.8% for 2008 as a whole, from an estimated 1.5% in 2007.

Graph 11: France – Growth of GDP and domestic demand



#### 4. Italy - weaker prospects for GDP growth

Economic activity in Italy slowed down more than in the rest of the euro area in the latter part of last year. Real GDP is expected to have contracted relative to the previous quarter. The resulting annual growth rate for real GDP in 2007 is estimated at 1.8%, 0.1 pp. lower than projected in the autumn forecast.<sup>2</sup>

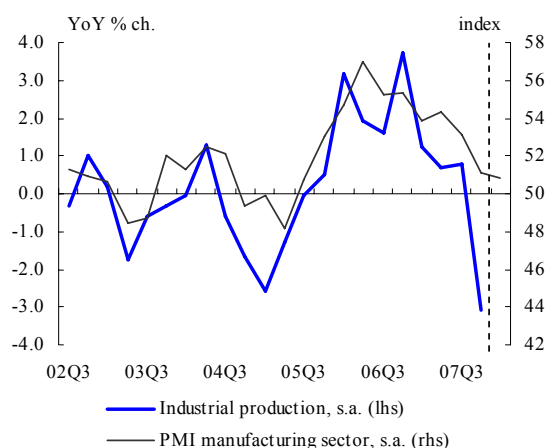
The expected contraction in the fourth quarter of 2007 also implies a substantial weakening of the growth impulse into 2008. The carry-over effect is now a mere 0.1%, well below the 0.5% expected in autumn. The available indications for economic activity in the first quarter of 2008 are rather negative. Business surveys reflect expectations of a further slowdown. But while in the services sector the PMI indicator has fallen well below the critical threshold of stagnating activity, it remains slightly above that threshold in the manufacturing sector.

<sup>2</sup> On 29 February, the Italian statistical office (ISTAT) will release new annual National Accounts incorporating a revised methodology for computing exports and imports deflators. This could lead to a different real GDP growth.

Moreover, since part of the contraction in industrial production in the fourth quarter of 2007 appears to be due to exceptional factors, namely, strikes in the transportation sector in December, a small recovery in 2008 Q1 is expected. On the demand side, the deceleration in foreign demand associated with the appreciation of the euro affects export growth. Also the expansion of private consumption is expected to have lost momentum, under the impact of higher prices and lower confidence. After having rebounded in the third quarter of 2007, investment is expected to ease on the back of decreasing capital utilization. Quarterly real GDP growth in the first quarter of 2008 is thus forecast to remain almost flat.

For the remaining quarters of the current year, a gradual but mild recovery is expected, under the assumption of weaker inflationary pressures on households' disposable income and accelerating external demand. Overall, real GDP growth in 2008 is now expected at 0.7%, half that of the autumn forecast.

Graph 12: Italy - Industrial production and confidence in the manufacturing sector



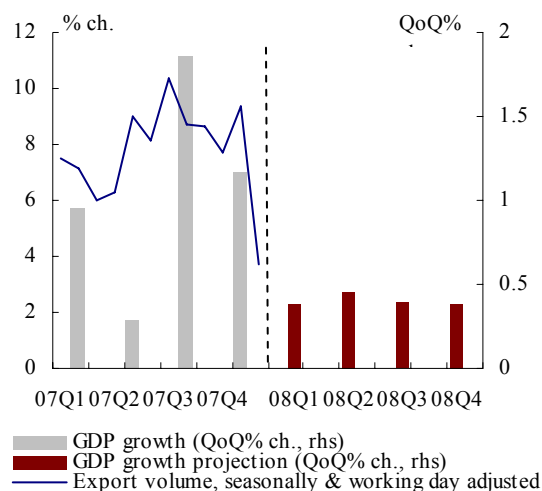
Annual HICP inflation in 2007, at 2%, turned out slightly higher than projected in the autumn forecast, due to the acceleration recorded in the last quarter of the year (2.6% YoY). In the fourth quarter of 2007, core inflation also peaked at around 2%. In January, HICP inflation surged further to 3.1%. The main sources for the sustained

high level of headline inflation were the increases in oil and food prices, but also the increases in tariffs and the rising prices of house services and tobacco. On the assumption of broadly stable oil prices over the forecast horizon, inflation should remain at around 3.0% in the first quarter of 2008 and progressively ease thereafter to reach 2.2% in 2008 Q4, due to a gradually smaller base effect. Overall, HICP inflation is expected to average 2.7% in 2008.

#### **5. The Netherlands - strong growth in 2008 masks deceleration**

Economic growth was 3.5% in 2007, the highest level since the start of the century and significantly above the autumn forecast. Sluggish growth in the second quarter of 2007 turned buoyant in the second half of the year (Graph 13), supported by dynamic employment growth, which brought the unemployment rate below 3% at the end of 2007. Strong intra-year dynamics were related to high variability in the volume of gas production, as production normalised in the second half of the year following the relatively high temperatures in the winter of 2007. On balance, however, economic growth over the year 2007 was unaffected by volatile gas production and was primarily driven by strong domestic demand, supported by the, at the time, still favorable international environment.

Graph 13: The Netherlands - Export volume and quarterly GDP growth



Furthermore, private consumption expenditure growth is expected to be held back by rising inflation that reduces households' purchasing power. Despite the slowdown, economic growth in 2008 is likely to come out better than anticipated in the autumn forecast, at 2.9%. This is linked to the exceptionally high growth in the second half of 2007, which raised the carry-over to 1.9% from 1% projected in the autumn 2007 forecast.

Consumer price inflation is forecast to increase from 1.6% in 2007 to 2.3% in 2008, in line with the autumn 2007 forecast. Factors that act to increase inflation include higher food and energy prices and - from mid-2008 onwards - increased fuel levies, the introduction of the aviation tax and an expected increase in housing rental prices.

#### **6. Poland – moving towards more sustainable levels**

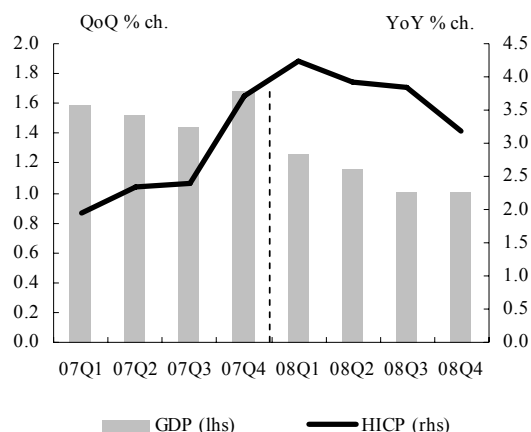
Economic activity continued to be robust at the end of 2007. GDP growth is estimated to have surged to 1.7% QoQ in the last quarter of 2007. This is a preliminary estimate subject to revision. Firm growth in the fourth quarter, supported by continued strong investments and private consumption fuelled by wage increases, contributed to an annual growth rate of 6.5% (the highest in ten years), which is in line with the autumn forecast.

For 2008, GDP growth is expected to lose some momentum and reach 5¼%, which is ¼ pp. lower than in the autumn forecast. This follows from the expected slower growth in the EU, the main trading partner of Poland. Lower external demand will increase the trade deficit and thus hamper GDP growth despite solid domestic fundamentals.

GDP is expected to grow at around 1 – 1¼% QoQ in each quarter in 2008. Domestic demand will continue to be the main driver of growth, particularly on robust gross fixed capital formation and strong consumption growth. Lower external demand due to slower growth in the EU and rising investment- and consumption-driven imports will, however, slow down the Polish economy.



Graph 14: Poland – GDP growth and consumer price inflation



Consumption growth is being supported by a continued recovery in the labour market and increasing nominal wages. In 2007 until the third quarter, the employment rate increased by ca. 2.4 pps. to 57.8% (yet it is still far behind the EU average), while the unemployment rate declined from 11.8% to 8.1% at the end of the year, which was, by far, the largest drop in the EU. The improvement is expected to continue, albeit at a slower pace due to emerging skill mismatches.

HICP inflation reached 2.6% YoY in 2007, a notch higher than in the autumn forecast. Planned increases in administrative prices, soaring food and oil prices together with high wage demands in the public sector and labour shortages in certain segments of the market, will put upward pressure on inflation in 2008. The appreciation of the Zloty and a tightening monetary policy are expected to mitigate the impact somewhat. Overall inflation for 2008 has been revised upwards compared to the autumn forecast from 2.8% to 3.8% with the peak in the first quarter at 4¼% and afterwards a decline to 3¼% in the last quarter, back within the Polish central bank's inflation band.

## ***7. The United Kingdom – weakening growth driven by private consumption slowdown***

In the second half of 2007 economic activity in the UK remained relatively strong but showed some signs of moderation relative to the first half of the year amidst ongoing financial market turmoil. In the third and fourth quarters of 2007 real GDP grew by 0.7% and 0.6% QoQ respectively. If confirmed in final GDP data, this brings annual growth in 2007 to 3.1%, in line with the autumn forecast.

In the third quarter (for which detailed national accounts exist), domestic demand growth proved robust and more than compensated for a sharp fall in net exports, which subtracted 0.5% points from quarterly growth. Consumer spending remained vigorous, supported by relatively strong housing market activity. However, household sector data continued to show very low saving. Fixed investment rebounded sharply and made a positive contribution to growth, as did changes in inventories. The overall employment rate grew and the unemployment rate fell slightly in the final quarter.

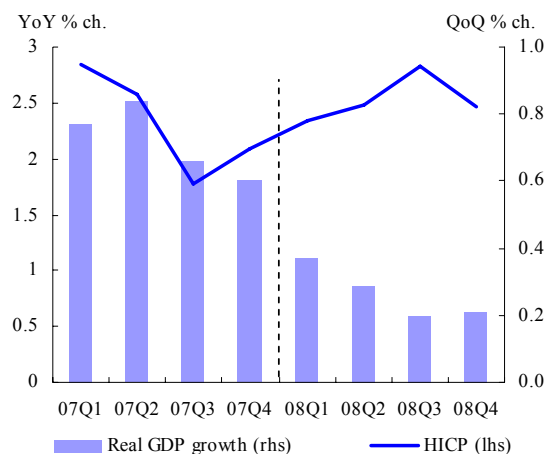
Perceptions of the UK's relatively greater exposure to changed credit market conditions contributed to a depreciation of the pound sterling between October and mid-February of around 6% in nominal effective terms, and UK policy rates were cut by a cumulative 50 bp in December and February.

GDP growth in 2008 is expected to slow markedly from 0.4% in the first quarter to 0.2% QoQ in the final two quarters, driven by a substantial weakening of domestic demand growth. Private consumption is likely to moderate due to the combined impact of tighter credit conditions for household borrowing and a weakening housing market. Furthermore, heightened uncertainty over households' real income growth prospects is likely to encourage precautionary saving. Investment growth is expected to moderate on account of tighter credit conditions and a less supportive business environment, both domestic and external, over the medium term. External demand is set to weaken in 2008 due to the deterioration in global growth prospects, but the weaker exchange rate is likely to support export growth in the medium term.

Overall, GDP growth for the entire year is forecast to reach 1.7%, significantly lower than in the preceding year and  $\frac{1}{2}\%$  weaker than in the Commission services' 2007 autumn forecast.

The YoY HICP inflation rate in January 2008 rose slightly to 2.2% from 2.1% in the previous month. However, the rate of inflation is expected to increase significantly during the rest of 2008 due to higher energy and food prices and the gradual pass-through of higher import prices. These inflationary pressures are also evident in rising producer price inflation, which reached 5.7% in January 2008, the highest rate in over 16 years. Therefore, average HICP inflation in 2008 is expected to be 2.5%, somewhat higher than forecast in the autumn, with full-pass through of inflationary pressures expected to be progressively mitigated by demand weakness.

Graph 15: The United Kingdom – GDP growth and consumer price inflation



**Table 1: Real GDP growth**

	Quarterly GDP forecast (%, quarter-on-quarter) 2008				Annual GDP forecast (%, year-on-year) 2008	
	2008/1	2008/2	2008/3	2008/4	<i>Autumn forecast</i> <i>Nov. 2007</i>	<i>Interim forecast</i> <i>Feb. 2008</i>
Germany	0.1	0.3	0.4	0.4	2.1	1.6
Spain	0.6	0.6	0.5	0.5	3.0	2.7
France	0.3	0.4	0.3	0.3	2.0	1.7
Italy	0.1	0.2	0.3	0.3	1.4	0.7
Netherlands	0.4	0.5	0.4	0.4	2.6	2.9
<b>Euro area</b>	<b>0.3</b>	<b>0.3</b>	<b>0.4</b>	<b>0.4</b>	<b>2.2</b>	<b>1.8</b>
Poland	1.3	1.2	1.0	1.0	5.6	5.3
United Kingdom	0.4	0.3	0.2	0.2	2.2	1.7
<b>EU27</b>	<b>0.4</b>	<b>0.4</b>	<b>0.4</b>	<b>0.4</b>	<b>2.4</b>	<b>2.0</b>

*Notes: Where possible, the quarterly growth rates are working-day and seasonally-adjusted, whereas the annual projections are unadjusted.*

**Table 2: Consumer price inflation**

	Quarterly HICP forecast (%, year-on-year) 2008				Annual HICP forecast (%, year-on-year) 2008	
	2008/1	2008/2	2008/3	2008/4	<i>Autumn forecast</i> <i>Nov. 2007</i>	<i>Interim forecast</i> <i>Feb. 2008</i>
Germany	2.9	2.4	2.2	1.7	2.0	2.3
Spain	4.4	4.0	3.6	2.9	2.9	3.7
France	2.9	2.6	2.3	1.8	1.7	2.4
Italy	3.0	2.8	2.7	2.2	2.0	2.7
Netherlands	1.8	1.8	2.6	2.8	2.3	2.3
<b>Euro area</b>	<b>3.1</b>	<b>2.8</b>	<b>2.6</b>	<b>2.1</b>	<b>2.1</b>	<b>2.6</b>
Poland	4.2	3.9	3.8	3.2	2.8	3.8
United Kingdom	2.3	2.5	2.8	2.5	2.2	2.5
<b>EU27</b>	<b>3.3</b>	<b>3.0</b>	<b>2.9</b>	<b>2.5</b>	<b>2.4</b>	<b>2.9</b>

*Box: Technical background to the interim forecast*

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 28 April 2008). This interim forecast updates the outlook of the autumn 2007 economic forecast of 9 November ([http://ec.europa.eu/economy\\_finance/thematic\\_articles/article12054\\_en.htm](http://ec.europa.eu/economy_finance/thematic_articles/article12054_en.htm)). The cut-off date for this interim forecast to take new information on board was 15 February 2008.

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

Estimates for the European Union and the euro area are prepared using the nominal GDP-weighted updates for the largest Member States. These countries account for 80% of the European Union and almost 85% of the euro area in terms of nominal GDP. The outlook for the smaller Member States, which have tended to grow faster than the larger ones, have 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 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. As 2008 is a leap year, the working day adjustment is likely to be positive, estimated at 0.1 pp. for the euro area.

**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 31 January to 13 February, implying an annual average of USD/EUR of 1.47.

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 3.8% and the long-term interest rates at 3.9% in 2008 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 90.3 USD/barrel in 2008 (corresponding to 61.4 EUR/barrel). This would be 11.5 USD/barrel (or 5.9 EUR/barrel) higher than assumed in the autumn 2007 forecast, reflecting maintained strong demand from e.g. emerging markets and geopolitical uncertainties.

Global demand in 2008 is revised downwards, following the recent distress in the financial markets and a weaker outlook for the US. However, a still relatively strong growth in emerging markets, especially China, limits the overall easing of global growth. Global GDP growth is thus forecast to slow to 3.8% in 2008 (down from 4.8% in 2007). This update uses the revised purchasing power parities from the international comparison programme (ICP) for 146 countries, which lower global growth by around ½ pp. a year in 2005-2007.

World trade is also set to slow somewhat in 2008, with growth in export and import volumes of goods estimated at just below 7%.

