EUROPEAN COMMISSION

DIRECTORATE-GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

February 2007 Interim forecast

Press conference of 16 February 2007

Continued brisk growth, while inflation is currently easing

In February 2006, the Commission presented the first of what are now regular twice-yearly interim forecasts. They update the comprehensive bi-annual forecasts, the purpose being to improve economic surveillance in the European Union and the euro area. Interim forecasts assess real GDP growth and HICP inflation for both areas based on updates for the seven largest Member States. This note presents the third interim forecast and includes, for the first time, an update of the Dutch outlook (see also the technical Box). It updates the Commission's fully-fledged autumn forecast of 6 November 2006.

The European economies performed better than expected in 2006 despite headwinds from high oil prices, tighter monetary conditions and a slowdown of the US economy. Following a deceleration in the third quarter of 2006, real GDP growth rebounded to 0.9% quarter-on-quarter (QoQ) in the fourth quarter in both the euro area and the EU. For the year as a whole, economic activity expanded by 2.7% in the euro area and 2.9% in the EU.

This is slightly above the projections of the autumn forecast. In addition to a milder-than-expected downturn in the US, this robust performance reflects an increase in the resilience of the European economies, with a significant improvement in the labour market helping to bolster domestic demand.

Although moderating somewhat, output growth is projected to remain robust in 2007, at 2.4% in the euro area and 2.7% in the EU (+0.3 pp. compared to the autumn forecast), reflecting a marginally higher carry-over from 2006.

Higher energy prices kept consumer price inflation above 2% in 2006 (2.2% in both the euro area and the EU). But core inflation, excluding energy and unprocessed food, remained subdued, suggesting limited indirect effects of higher energy prices. Reflecting lower oil prices and a moderate initial impact of the German VAT hike, the projections for HICP inflation in 2007 have been revised downwards, to 1.8% in the euro area and 2.0% in the EU.

Global economic and financial environment remains growth-supportive

Global economy activity has moderated somewhat since mid-2006, although remaining overall at a very high level. The deceleration is mainly observed in the industrial sector, while the solid momentum in the services sector continues unabated. Regionally, the slowdown has been concentrated in the US and Japan, whereas growth in other regions remained vigorous, notably in the emerging markets of Asia, many of which posted higher growth rates than expected.

Despite a rebound of consumer spending in the last quarter of 2006 in the US – fuelled by lower oil prices and rapid employment growth – indicators point to softer growth continuing through the early parts of the current year. This follows from an ongoing inventory correction in both manufacturing and construction that is dampening production. However, as the sharp downturn in the housing sector in the US has not spread to other parts of the economy so far, the probability of a hard landing seems to have diminished.

In Japan, GDP growth slowed down in the course of 2006, particularly in the third quarter and for private consumption. Economic activity is however expected to rebound, and growth is forecast to lie around potential in 2007.

The somewhat stronger-than-expected performance of the US economy in recent months combined with some upward adjustment of growth rates for emerging Asia, particularly China, leads to a more positive assessment of the global economic environment. Compared to the autumn forecast, world GDP growth (excluding the EU-25) has been revised upwards by 0.2 percentage point (pp.) for both 2006 and 2007 (to 6% and 5½%, respectively).

Thanks to brisk output growth, world trade will keep expanding at a rapid pace. However, in view of the easing in the global manufacturing sector, trade in goods is expected to grow at a slightly lower rate than assumed in the autumn forecast. Total world imports of goods excluding the EU are thus projected to reach 9.2% in 2006 and 8.4% in 2007, 0.2 pp. below the autumn forecast.

On the back of an initially mild winter, oil prices eased significantly in the early weeks of 2007.

Thereafter, prices have risen again, reflecting harsher winter weather in parts of the Northern hemisphere and the decision of the US authorities to double the size of the Strategic Petroleum Reserves. They remain, however, below the level observed at the time of the autumn forecast and, based on futures prices, the average price for Brent crude in 2007 is estimated at 59.9 USD per barrel, some 6½ USD below the assumption in the autumn.

The euro has appreciated in recent months and, for example, now stands at 1.30 vis-à-vis the USD (compared to 1.27 USD/EUR for 2007 assumed in the autumn 2006 forecast). However, the appreciation of the nominal effective exchange rate is much more limited.

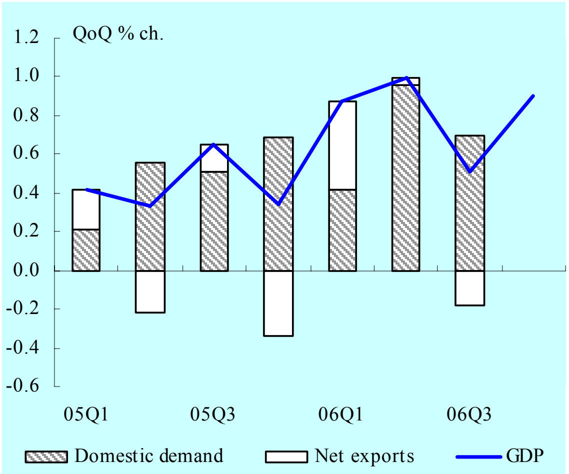
Financing conditions have remained favourable in the EU as suggested by several indicators. In particular, credit growth continues to rise at a brisk pace. Despite policy interest rates having moved up since the autumn, the cost of external financing has remained broadly stable as (already low) corporate bond spreads have narrowed further and a rise in stock prices has lowered the cost of equity financing. Although policy interest rates are assumed, following market expectations, to rise further in the near term (see Box), financing conditions are expected to remain broadly benign.

Growth was well above potential throughout 2006

The very strong growth recorded in the euro-area and EU economies in the first half of 2006 moderated somewhat, although remaining well above potential in the second half of the year. Real GDP rose by 0.9% quarter-on-quarter (QoQ) in both the euro area and the EU in the fourth quarter according to Eurostat. This outcome is better than expected in the autumn forecast, suggesting an upward revision of annual GDP growth to 2.7% in the euro area and 2.9% in the EU (up from 2.6% and 2.8% respectively).

The economic pick-up apparently became more broad-based in the course of 2006 (although the break-down of GDP into its components is not yet available for the fourth quarter). Domestic demand remained the main contributor to growth, but net trade improved after the relatively weak performance in 2005 (Graph 1). However, despite a robust growth of exports, an even stronger growth of imports limited the contribution of net exports. The recovery of domestic demand (excluding inventories) was initially driven by a surge in investment spending. Although private consumption increased more moderately, its contribution to real GDP growth was equal to that of investment for the first three quarters of 2006. The strengthening of private consumption in the euro area owes much to the improved performance on the labour market, with employment growth picking up to 0.4% QoQ on average since late 2005.

Graph 1: GDP growth and contributions, euro area



Furthermore, growth differentials among the largest economies narrowed towards the end of 2006. They amounted to more than 1 pp. in the first half of 2005, but declined to ½ pp. in the fourth quarter of 2006. Three out of the five largest euro-area economies even recorded a growth rate between 0.9 and 1.1% QoQ in the fourth quarter of 2006.

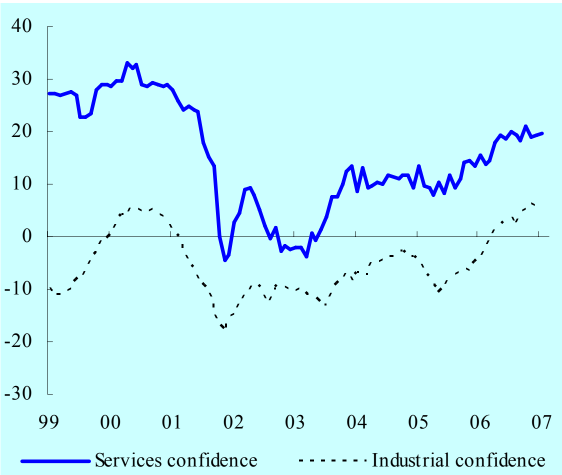
Survey indicators point to continued robust growth

Looking ahead, survey data indicate continued vigorous real GDP growth in the coming quarters, although at a somewhat lower pace than the record highs attained in 2006.

The European Commission's economic confidence indicators still appear to be on an upward trend (Graph 2). Despite a certain weakening in January, all sectoral confidence indicators remain well above their long-term averages in both the euro area and the EU.

Although the Purchasing Managers' Indexes (PMI) for manufacturing and services peaked already during the summer of 2006, they remain firmly in the zone indicating expansion. Moreover, a certain rebound has been observed for PMI services in the most recent months. In addition, the surge of the employment component of the PMI manufacturing to the highest level since November 2000 suggests that manufacturing companies also remain optimistic about their outlook.

Graph 2: Economic confidence indicators, euro area



Several national survey indicators have declined somewhat in early 2007, but remain well above their historical averages, suggesting GDP growth above potential (such as the German IFO and Belgian NBB indexes).

A certain divergence in the outlook at the sectoral level is not necessarily surprising. The recent rebound noted in the PMI services is likely to reflect the increased importance of domestic demand in the EU. The decline recorded in PMI manufacturing in the EU, on the other hand, mirrors a moderation in the industrial sector globally, which is likely to be more noticeable for some Member States in view of their competitive position.

The slight moderation in economic growth suggested by some survey data may reflect the impact of the strengthened euro together with a deceleration of the industrial cycle. It could also be caused by a lagged effect of high oil prices in 2006, which may gradually weigh on the growth momentum. In the case of Germany, it also mirrors the expected impact on demand in the first half of 2007 of the increase in the standard VAT rate by 3 percentage points in January 2007. However, the still relatively favourable assessment of the current situation in the IFO index suggests that the impact may be less pronounced than expected in the autumn forecast and partly offset by the effect of a stronger-than-expected labour market on consumer spending.

2007: another year with growth above potential

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), GDP growth is set to temporarily slow in the first quarter of 2007, mainly reflecting developments in Germany, before rebounding to around 0.6% QoQ for the rest of the year. This is broadly in line with the outcome of DG ECFIN's Dynamic Factor Model which projects euro-area GDP growth of 0.6% QoQ on average in 2007.

As a consequence of a stronger carry-over from 2006 coupled with a slightly higher growth profile in 2007, GDP growth is revised upwards for the year as a whole by 0.3 pp. in both areas as compared to the autumn forecast, to 2.4% for the euro area and 2.7% for the EU.

Domestic demand is expected to continue to be the main contributor to GDP growth in both the euro area and the EU, with output set to be driven by private consumption and investment.

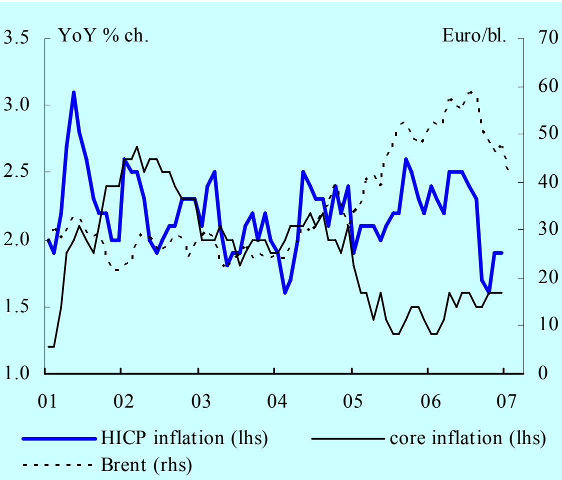
Private consumption will be supported by an improved outlook for real disposable income, reflecting the better-than-expected inflation outlook and favourable labour market developments. Moreover, consumer confidence remains on an upward trend since mid-2005 and is above its long-term average since the beginning of 2006.

Judging from the European Commission's investment survey of October-November 2006, investment volumes in the manufacturing sector are expected to rise at their fastest pace since 2001 – albeit with sizeable differences noted across the largest Member States. The pick-up in investment intentions may mirror the further increase recorded in capacity utilisation - which rose above its long-term average to more than 84% in both the euro area and the EU in January - continued favourable financing conditions and generally optimistic demand expectations.

Inflation remained contained in 2006 despite high oil prices

Consumer price inflation was 2.2% in 2006 in both the euro area and the EU, broadly in line with the autumn forecast for 2006 and unchanged from the previous year. The hike in energy prices kept headline HICP inflation above 2% until August. Thereafter, the drop in oil and energy prices helped to bring inflation down below 2%. In contrast, core inflation (HICP excluding energy and unprocessed food prices) remained fairly steady at 1.5% on average in 2006, suggesting the absence of second-round effects from the energy price hikes. This is highly significant as it took place in a situation of cyclical acceleration and strong labour demand. Overall, it was developments in energy prices that shaped the pattern of HICP inflation during 2006.

Graph 3: Headline and core inflation; oil prices



In 2006, some upward price pressures were compensated for by favourable cost developments in the labour market. In particular, industrial price pressures at the producer level crept up in the first half of 2006, and decelerated in the second half, while remaining relatively high (rising by 5.1% on average). Moreover, money and credit growth kept rising at a swift pace (around 9% YoY in the last quarter of 2006), the fastest pace since the introduction of the euro in 1999. On the other hand, strong international price competition limited the full pass-through of relatively high input prices to core and headline inflation. Wage developments remained subdued, with total hourly labour costs rising at an annual rate of 2% in the third quarter of 2006 (down from 2.3% in the first half of 2006). Compensation per employee increased only moderately, at an annual rate of 2.3% up to the third quarter of 2006.

Inflation to ease in 2007, with upside risks

Looking ahead, the outlook for inflation in 2007 has been revised downwards, based on the individual updates for Germany, France, Italy, the Netherlands, Poland, Spain and the United Kingdom. HICP inflation is now expected to average 1.8% in the euro area and 2.0% in the EU this year. This is a downward revision of 0.3 pp. for both areas compared to the autumn 2006 forecast.

The expected easing of oil prices and the rather moderate impact of the German VAT hike play a key role in making the inflation outlook more optimistic in the short term. Indeed, the VAT effect might be more spread out than initially expected in autumn 2006. The quarterly pattern projected for 2007 will be affected by base effects reducing inflation in the first two quarters and increasing it towards the end of the year. On top of this, the increase in productivity witnessed in 2006 has resulted in low unit labour cost growth. Should growth prospects materialise as foreseen in 2007, this dampening effect should continue to keep a lid on price pressures from the input side. However, as the cycle matures and productivity growth goes beyond its peak, unit labour costs may start to pick up again in the course of 2007. The improvement noted in the labour market could eventually prompt higher wage settlements.

Improved outlook for the labour market and public finances

In 2006, the labour market has improved considerably. For the euro area, after four years of subdued growth at around 0.7% per year, employment growth accelerated to around 1.5% in 2006, representing around 2 million new jobs (3 million in the EU). Meanwhile, the euro-area unemployment rate reached 7.5% in December 2006 (an annual average of 7.8%), the lowest level in more than a decade. While the fall in the unemployment rate is attributable to a large extent to the strong cyclical upswing, available estimates also point to a clear fall in the structural rate of unemployment, currently estimated at around 7.8%, indicating that earlier labour market reforms have had some effect. The chances are then, that the improvement is not just quantitative but also qualitative, e.g. by creating more jobs in the regular labour market.

In line with the revisions made to the growth and inflation projections for 2007, the labour markets are expected to continue to improve, somewhat more strongly than suggested in the autumn forecast.

The information available suggests that the outlook for public finances is also brighter. The budgetary results in several Member States, in particular in Germany, proved better than forecast in 2006. This better-than-expected development should, to some extent, be carried over to 2007. Higher growth should support public finance adjustment also this year.

Risks to the forecast remain fairly balanced

The autumn forecast identified the risks to the outlook as being tilted to the upside for 2006, but skewed to the downside further ahead. Developments since then have confirmed a number of upside risks for 2006 (higher growth in emerging Asia, lower oil prices, higher employment and productivity growth in the EU), with important knock-on effects for 2007. The downside risks have not materialised to the same extent. The single most important downside risk at the time, i.e. the possibility of a hard landing for the US economy, has clearly diminished since the publication of the autumn forecast.

This does not mean that there area no longer any downside risks at all. Indeed, while there is a higher likelihood of a soft landing of the US economy, the issue of global imbalances remains unsolved. Whilst the probability of a disorderly unwinding of these imbalances remains low, if it did happen it would have far-reaching consequences. Similarly, the yen seems to trade significantly below its longer-term equilibrium. This tends to erode the competitiveness of euro-area exports and carries the risk of abrupt exchange rate adjustments in the event of a rapid unwinding of carry-trade positions. Finally, oil prices may remain volatile during 2007, amid continued risks of geopolitical tensions.

The EU economy proved remarkably resilient in 2006 in the face of headwinds from higher oil prices, a tighter monetary policy stance, an appreciating euro and the slowdown of the US economy. The fact that growth was driven by a marked pick-up of domestic demand bodes well for the outlook in 2007. In particular, the turnaround in the labour market will boost labour incomes and consumer confidence, and could turn this upswing into a durable, domestically-led recovery. However, a precondition for this to materialise is that price and wage pressures remain contained. While the recent rebound in productivity growth provides some leeway in a number of countries, an unwarranted acceleration of wages could choke off the expansion by prompting a faster-than-expected monetary policy tightening.

Overall, the risks to this forecast appear broadly balanced. Uncertainties remain high regarding the impact of the VAT increase in Germany, as the better-than-expected growth in the second half of 2006 could also imply a correspondingly larger payback in the first half of 2007. On the other hand, the strong performance of the German economy in 2006 could also mean that growth in Germany is being lifted onto a higher longer-term trajectory, following an extended period of adjustment and structural reforms.

Growth and inflation prospects in the seven largest Member States

1. Germany - the economy continues its buoyant recovery

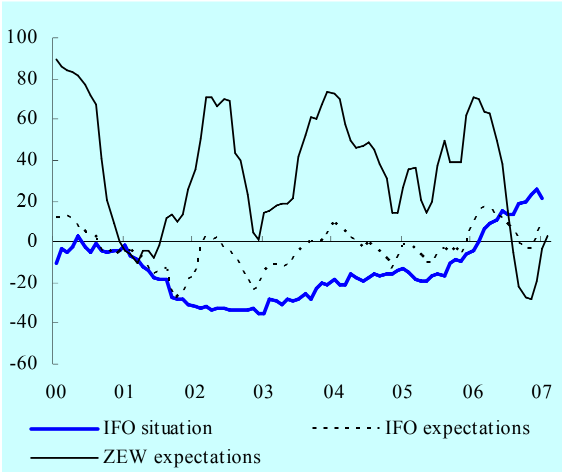
On 13 February 2007, the German statistical office (Destatis) announced that real GDP had grown by 0.9% QoQ in the fourth quarter of 2006. It also revised growth in the preceding three quarters upwards. As a consequence, real annual GDP grew by 2.7% in 2006, which is 0.3 pp. above the Commission services autumn forecast. At the same time, the growth carry-over to 2007 amounts to 1.3 pps., 0.3 pp. higher than in the autumn projection.

The revised growth figures suggest that, on the back of booming exports, a solid increase in capital formation (both equipment and construction) and a better functioning labour market, the underlying expansion in economic activity has been more robust than was expected in autumn. Private consumption contributed to growth in 2006, after several years of stagnation. This was partly driven by substantial anticipation effects ahead of the VAT increase on January, 1st. While the corresponding mirror-effect is expected to weigh on private consumption expenditure in 2007, the underlying recovery in private consumption is corroborated by a further brightening of the labour market. In addition, the swing effects in domestic demand related to fiscal measures may have been muted, as the pass-through of the VAT hike to consumer prices is apparently spread over several months.

Furthermore, recent indicators suggest that, after a growth dip in 2007-Q1, the German economy will resume its cyclical upswing. Consumer confidence is benefiting from a more favourable labour market outlook and business expectations have been steadily increasing since October. Real GDP is therefore expected to grow by 1.8% this year, which is 0.6 pp. higher than projected in autumn.

With an average annual rate of 1.8%, HICP inflation in 2006 turned out as predicted in the autumn forecast. The VAT increase from 1 January 2007 caused prices to rise at the beginning of this year, albeit by much less than implied by a full pass-through to consumer prices. Although further VAT-induced price increases cannot be excluded for the remainder of the year, lower energy prices will dampen HICP inflation to 1.7% in 2007, which is 0.5 pp. below the autumn forecast.

Graph 4: Germany - Survey indicators



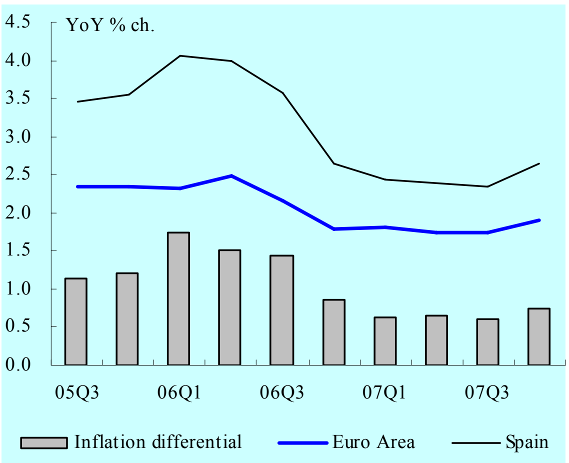
2. Spain - higher growth, lower inflation

In 2006, the Spanish economy's long upswing continued and, in fact, gathered pace. GDP growth, according to the most recent estimates, may have risen to 3.8% in 2006, from 3.5% the previous year. GDP growth in the fourth quarter of 2006 attained 1.1% QoQ (0.9% in the previous quarter). Strong economic activity continued to be underpinned exclusively by domestic demand, mainly by the high dynamism of private consumption and investment in dwellings, which was partially offset by the draining effect of a negative net external demand. However, the growth composition was more balanced than in 2005. This might be partly the result of tightening of monetary conditions, having been one of the main drivers behind the strong and sustained domestic demand growth during the last decade.

In 2007, GDP growth is projected to slow down marginally to 3.7%. Both annual average and quarterly profiles reflect developments in the euro-area economy, namely a downturn in the first quarter followed by an upswing in the second. However, activity expansion will still be based on domestic demand. In spite of prospects of a certain rebalancing of the growth pattern, a still negative contribution of net exports to growth should keep on feeding an increasing current account deficit, which might attain 9½% of GDP at the end of the year.

Inflation reached an annual average rate of 3.6% in 2006, 0.2 pp. higher than in 2005. However, price pressures eased to 2.6% YoY in the last quarter of 2006, driven by lower-than-projected oil prices, and should continue to moderate to 2.5% in 2007. In 2006, the inflation differential with the euro area peaked at 1½ pps. for the year as a whole, but it should decline to about ¾ of one pp. in 2007. Apart from the effect associated with energy prices, the sharp decline in Spanish inflation may also be due to moderate wage developments. Specifically, indexation clauses (associated with labour market agreements) are based on year-on-year inflation at the end of the year, which was relatively low.

Graph 5: Spain - HICP growth in Spain and the euro area

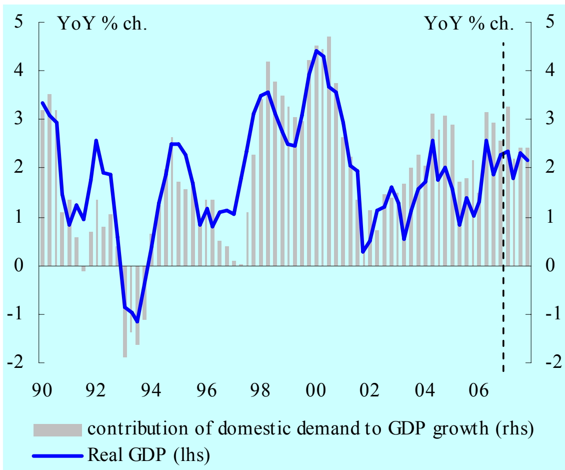


3. France – growth to pick up

The French economy lost momentum in the second half of 2006, when GDP stagnated in the third quarter. Nevertheless, for the year as a whole, GDP growth is estimated to have reached 1.9% in 2006, after 1.2% in 2005. This is 0.3 pp. below the projections in the Commission services' autumn forecasts. The main factor behind this downward revision is the unexpected decrease in exports in the third quarter, which has highlighted the weaknesses of the French external sector. In 2006, net trade once again made a negative contribution to GDP growth of around 0.5 pp. Preliminary data for the last quarter (GDP growth of 0.6%-0.7% QoQ) and the last macroeconomic indicators suggest that GDP growth should remain robust in the coming months.

In 2007, economy activity is projected to increase by 2.2%. GDP growth is expected to be still largely driven by domestic demand and especially by private consumption. Consumption is likely to increase in line with households' disposable income. Employment growth has shown encouraging signs and the benign inflation outlook should also support households' purchasing power. Thanks to improved prospects in France's main trading partners, exports could somewhat rebound in the course of 2007. Nevertheless, the external sector should again dampen GDP growth, as imports are projected to grow in line with robust domestic demand, outpacing the growth in exports.

Graph 6: France - GDP and domestic demand growth



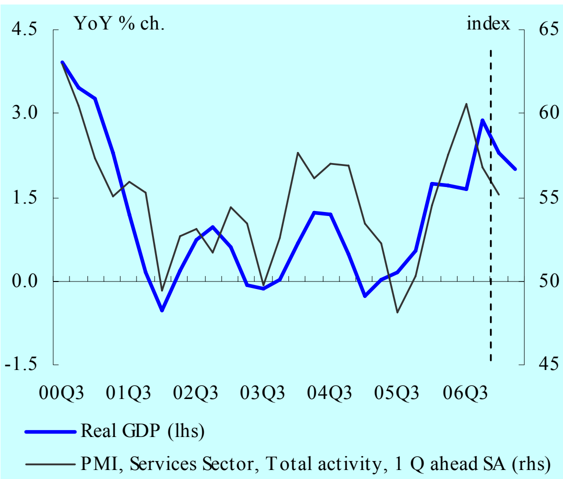
Inflation in 2006 turned out at 1.9%, in line with the autumn forecast. In view of the expected decrease in oil prices in the course of 2007, headline HICP inflation should be close to 1.5% this year, lower than expected last autumn. Second-round effects from high prices of raw materials have been contained up to now. Unit labour costs are forecast to gradually increase since the cyclical rise in labour productivity should wane. Thus, core inflation, as measured by HICP excluding food and energy prices, should be close to 1¾%.

4. Italy - a good start for economic growth in 2007

Italy ended 2006 on a strong note. Quarterly GDP is reported to have accelerated to 1.1% in the fourth quarter of 2006. The resulting annual growth rate for real GDP in 2006 is estimated at 1.9%, the highest since 2000 and 0.2 pp. higher than projected in the autumn forecast.

The acceleration of GDP growth in the latter part of the year was foreshadowed by a surge in industrial production in the last quarter of the year, and especially in December (+2% relative to the previous month). Italian manufacturers seem to have benefited from increased external demand, which within the EU was particularly driven by German orders. At the same time, the component breakdown of industrial production, as well as still positive indications for the services sector, suggest that private consumption and gross fixed capital formation are continuing to contribute positively to growth.

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



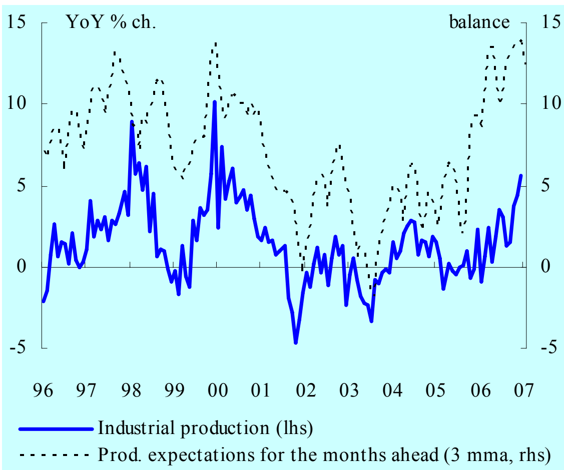
The acceleration in the fourth quarter of 2006 also implies a favourable impact on real GDP growth in 2007: the carryover effect into 2007 is now at +1.2%, well above the +0.6% expected in the autumn. However, the decrease in industrial and consumer confidence recorded in January, as well as the expected contraction of German growth in the first quarter of the year, suggest that economic activity in Italy will slow down in the first part of the year. In 2007 as a whole, economic growth is expected to be 2% (1.9% if adjusted for the 3 additional working days), 0.6 pp. higher than in the autumn forecast.

Annual HICP inflation in 2006, at 2.2%, turned out slightly lower than projected in the autumn forecast, partly thanks to the falling energy prices in the last part of the year. The forecast for annual HICP inflation in 2007 has also been revised marginally downwards relative to the autumn forecast, from 2.0% to 1.9%. Besides lower energy prices, the liberalisation measures adopted or planned so far should contribute to a deceleration in prices.

5. The Netherlands – recovery continues

Real GDP growth continued to be quite vigorous in the fourth quarter of 2006, posting a 0.6% QoQ growth and thereby contributing to annual growth of 2.9%. International trade flows, in particular, continued to be buoyant in the fourth quarter, while domestic demand components eased slightly. Employment growth firmed in the course of the year and reached 1.7% measured in full-time equivalents. For 2007, employment growth is likely to remain strong and domestic sources of growth, including private consumption expenditure, are expected to once again contribute significantly to GDP growth.

Chart 8: The Netherlands - Industrial production and business climate



In the course of 2006, both consumer and business confidence indicators improved strongly. The production expectations in the industry seem to have stabilised at a high level, supporting an outlook of steady underlying growth well into 2007. In all, real GDP growth is likely to remain strong throughout 2007 and post quarterly growth rates of 0.6%. On an annual basis, this will result in GDP growth of 2.8%.

The labour market is expected to tighten further in the course of 2007 and with the unemployment rate falling to around 3% it will show its first signs of overheating in the form of labour shortages in some sectors including construction and business services. At the start of 2007, evidence is mounting that contractual wages are accelerating and this should lead to upward price pressures over the course of 2007. However, this effect is expected to be fully compensated by the impact of the recent decline in oil prices. All in all, HICP inflation is expected remain modest in 2007 and come out at 1.7%.

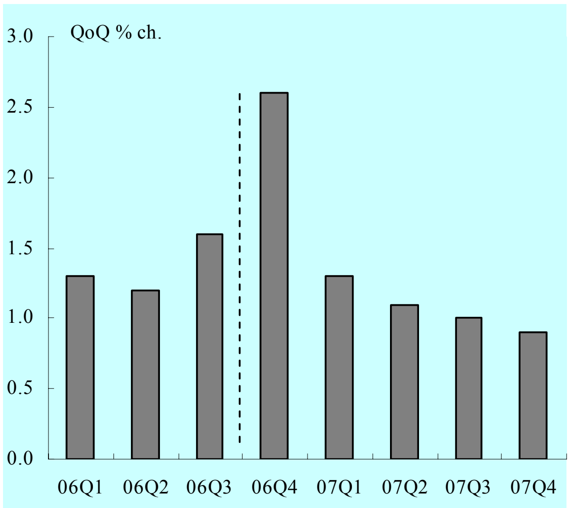
6. Poland – the economy surprises on the positive side

Economic activity continued to be strong at the end of 2006. GDP growth is estimated to have surged to 2.6% QoQ in the last quarter of 2006. This is a preliminary estimate subject to revision. Very strong growth in the fourth quarter contributed to an annual growth rate of 5.8%, 0.6 pp. higher than in the autumn forecast. The positive growth surprise was due to continued strong investments in construction activity in particular, thanks to the mild winter.

For 2007, GDP is expected to grow by 6%, which is 1¼ pps. higher than in the autumn forecast. This follows from the much better-than-expected result in the second half of 2006 and a positive outlook for 2007 as indicated by hard and soft indicators.

GDP is expected to grow at around 1¼% QoQ in the first half of 2007 and to decelerate slightly to 1% in the second half of the year. Domestic demand will continue to be the main driver of growth, with a key role for robust gross fixed capital formation and strong consumption. Lower external demand due to a slower world GDP growth and rising investment- and consumption-driven imports will slow down the growth rate of the Polish economy in the second half of the year. Consumption growth is being supported by a recovery in the labour market. In 2006, the employment rate increased by ca. 1.8 pps., while the unemployment rate was reduced by 3 pps. to 14.9% at the end of the year, which means 550 thousand people found a job. The improvement is expected to continue, albeit at a slower pace due to emerging skill mismatches.

Graph 9: Poland - Quarterly GDP growth



HICP inflation reached 1.3% year-on-year in 2006, slightly lower than in the autumn forecast. Planned excise duty hikes and higher wage demands, fuelled partly by labour shortages in certain segments of the market, will put upward pressure on inflation in 2007, but a stronger zloty, falling import prices and lower fuel prices will mitigate the impact. Thus, inflation for 2007 has been revised downwards compared to the autumn forecast, from 2.5% to 2.0%.

7. The United Kingdom - firm growth continues

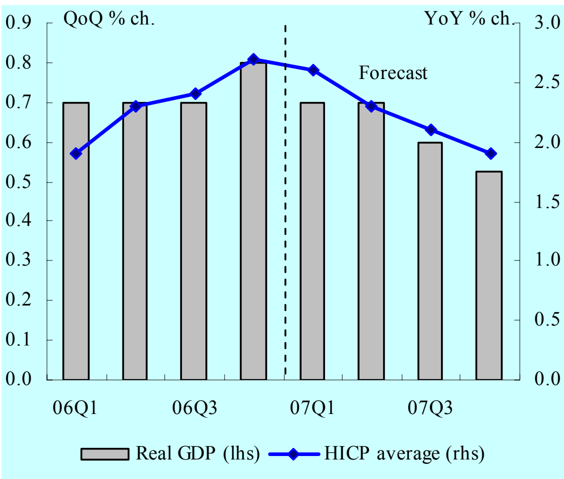
Estimated GDP growth of 0.8% QoQ in the fourth quarter of 2006 confirms that the UK economy continues to expand at a robust pace.

During the first three quarters of 2006 GDP growth was mainly driven by domestic demand. Consumption grew steadily, although below its historical average, and business investment maintained a sound footing. Trade volumes showed a buoyant evolution during the first half of the year, decreasing afterwards. However, except in the second quarter of 2006, the external sector recorded a negative net contribution to economic growth.

In the fourth quarter of 2006, services proved to be the main contributor to growth while total production fell slightly. Although an expenditure breakdown is not yet available, retail sales volumes showing a strong increase in the quarter suggest firm consumer spending.

January survey indicators confirm that retail trade confidence remained robust at the start of 2007. GDP is expected to maintain its steady growth early in the year before gradually decelerating, mainly due to the effects of higher interest rates, to reach an annual growth rate of 2¾% for the year as a whole. This is a slight upward revision from the autumn forecast.

Graph 10: United Kingdom – Real GDP growth and HICP inflation rate



The year-on-year HICP inflation rate reached 2.7% in the fourth quarter of 2006, including a spike to 3.0% in December mainly driven by a strong increase in transport costs. The Bank of England increased its policy rate by 25 basis points (bp) in January 2007. This rise followed two 25 bp increases in August and November 2006. In the remainder of the year inflationary pressures from energy prices are expected to fade away as the fall already evident in wholesale prices is reflected with a lag in retail prices. In addition, wage growth is assumed to remain stable or rise only moderately compared to the subdued levels in 2006, thus dampening second-round inflationary effects. Inflation is thus expected to fall slightly below the Bank of England target of 2% by the end of 2007. The forecast for average HICP inflation in 2007 remains as in the autumn 2006 forecast, 2.2%.

Table 1: Real GDP growth

	Quarterly GDP forecast (%, quarter-on-quarter)					Annual GDP forecast (%, year-on-year) 2006		Annual GDP forecast (%, year-on-year) 2007	
	2006/4 (a)	2007/1	2007/2	2007/3	2007/4	Interim forecast February 2007	*Autumn forecast November 2006*	Interim forecast February 2007	*Autumn forecast November 2006*
Germany	0.9	-0.5	0.8	0.7	0.6	2.7	*2.4*	1.8	*1.2*
Spain	1.1	0.9	1.0	0.9	0.8	3.8	*3.8*	3.7	*3.4*
France	0.7	0.5	0.6	0.5	0.5	1.9	*2.2*	2.2	*2.3*
Italy	1.1	0.3	0.3	0.3	0.3	1.9	*1.7*	2.0	*1.4*
Netherlands	0.6	0.6	0.6	0.6	0.6	2.9	*3.0*	2.8	*2.9*
Euro area	**0.9**	**0.3**	**0.7**	**0.6**	**0.6**	**2.7**	***2.6***	**2.4**	***2.1***
Poland	2.6	1.3	1.1	1.0	0.9	5.8	*5.2*	6.0	*4.7*
United Kingdom	0.8	0.7	0.7	0.6	0.5	2.7	*2.7*	2.7	*2.6*
EU27	**0.9**	**0.6**	**0.7**	**0.6**	**0.6**	**2.9**	***2.8***	**2.7**	***2.4***

Notes: (a) Data for 2006/4 are estimates released by Eurostat. Where possible, the quarterly growth rates are working-day and seasonally-adjusted, whereas the annual projections are unadjusted.

Table 2: Consumer price inflation

	Quarterly HICP forecast (%, year-on-year)					Annual HICP forecast (%, year-on-year) 2006		Annual HICP forecast (%, year-on-year) 2007	
	2006/4	2007/1	2007/2	2007/3	2007/4	Interim forecast February 2007	*Autumn forecast November 2006*	Interim forecast February 2007	*Autumn forecast November 2006*
Germany	1.3	1.8	1.7	1.6	1.8	1.8	*1.8*	1.7	*2.2*
Spain	2.6	2.4	2.4	2.3	2.7	3.6	*3.6*	2.5	*2.8*
France	1.5	1.4	1.4	1.5	1.7	1.9	*2.0*	1.5	*1.8*
Italy	2.0	2.0	1.9	1.8	1.8	2.2	*2.3*	1.9	*2.0*
Netherlands	1.5	1.7	1.5	1.7	1.8	1.7	*1.6*	1.7	*1.8*
Euro area	**1.8**	**1.8**	**1.8**	**1.8**	**1.9**	**2.2**	***2.2***	**1.8**	***2.1***
Poland	1.3	2.1	1.9	1.8	2.2	1.3	*1.4*	2.0	*2.5*
United Kingdom	2.7	2.6	2.3	2.1	1.9	2.3	*2.4*	2.2	*2.2*
EU27	**2.0**	**2.0**	**1.9**	**1.9**	**2.0**	**2.2**	***2.3***	**2.0**	***2.3***

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 7 May 2007). This interim forecast updates the outlook of the autumn 2006 economic forecast of 6 November (http://ec.europa.eu/economy_finance/publications/european_economy/forecasts_en.htm). The cut-off date for this interim forecast to take new information on board was 13 February 2007.

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

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 exchange and interest rates as well as for oil prices.

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.

Interest rates assumptions are, for the first time, market-based instead of expert-based. 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, both the short- and long-term interest rates are at 4.1% on average in 2007 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 59.9 USD/barrel in 2007. This would be 6.4 USD/barrel lower than assumed in the autumn 2006 forecast, reflecting inter alia the exceptionally mild winter.

Global demand in 2007 is revised slightly upwards, mirroring an improved outlook in Asia (excluding Japan) and somewhat stronger-than-expected growth in the United States in recent months. Real GDP growth for the world (excluding the EU-25) is thus forecast to ease from 6% in 2006 to 5½% in 2007. At the same time, world trade has been revised marginally downwards for 2007, with growth in export and import volumes of goods estimated at 9% and 8½%, respectively (excluding the EU-25), reflecting a certain moderation in the global manufacturing sector.