European
Commission

Interim Forecast
February 2012

Economic and
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European Commission
Directorate-General for Economic and Financial Affairs

Interim Forecast

February 2012

Press conference of 23 February 2012

OVERVIEW

The economic situation has further deteriorated around the turn of the year, but some signs of stabilisation have appeared lately.

The EU is set to experience stagnating GDP this year, and the euro area will undergo a mild recession. Several factors weigh on the outlook for the EU economy more heavily than forecast last autumn. In particular, the growth momentum seen at the end of 2011 has weakened more than previously expected, while the global economy has softened. Moreover, negative feedback loops between weak sovereign debtors, fragile financial markets and a slowing real economy do not yet appear to have been broken. Financial markets, however, are displaying signs of stabilisation, and some soft and hard indicators point to a more positive outlook. Member States have adopted additional measures to pursue necessary fiscal consolidation as the sovereign-debt crisis in some euro-area Member States lingers on, although this is likely to weigh on growth perspectives in the short run.

Support from the global economy has waned as expected in autumn.

The temporary weakening of global demand expected in the autumn forecast is ongoing, though with substantial differences across regions. Among the advanced economies, the US has recently shown signs of moderately stronger growth than forecast in the autumn, as the labour market improved and consumption rebounded. In Japan, by contrast, the economy has ended 2011 on a weak note, although the perspective of moderate growth in 2012 remains intact. Many emerging market economies have been affected by the crisis in Europe through weaker exports and reduced capital inflows. Moreover, oil prices have not continued the measured decline expected in the autumn, but have rebounded by 13% in euro terms since the autumn forecast. Overall, and broadly in line with the autumn forecast, global GDP and world trade growth, having weakened since spring 2011, are expected to recover only gradually in 2012.

Financial markets have stabilised, but the situation remains vulnerable.

Financial market indicators have shown signs of stabilisation since the autumn, with some easing of pressures on sovereign yields, although spreads remain at high levels for some Member States. While credit conditions for the private sector have been tightening, the latest measures taken by the ECB, in particular the provision of ample liquidity with a maturity of three years and the broadening of eligible collateral, have eased banks' funding stress and appear to have improved risk sentiment in financial markets more broadly. Looking at the euro area and the EU as a whole, evidence of a continued credit deceleration is building up, but the risk of an outright credit crunch in the euro area as a whole has decreased. Despite the recent tightening of credit conditions, credit supply is not expected to be a major constraint on investment and consumption as long as credit demand also remains weak. However, credit supply conditions and credit growth differ strongly across Member States. Finally, despite initial concerns, bank recapitalisation is progressing. The European Banking Authority expects that banks will reach the target capital ratio set for end-June 2012 with only limited recourse to deleveraging.

The EU economy is expected to have started the year in technical recession, with a return to recovery in the second half of 2012.

The loss of economic momentum towards the end of 2011 was stronger than anticipated. After a weak third quarter, the economy contracted in the fourth quarter – by 0.3% in the EU and the euro area according to Eurostat's flash estimate. Domestic demand was lacklustre in the third quarter of 2011 and – as shown by the continued fall in confidence in the autumn and available hard indicators – probably contributed substantially to the contraction in the fourth. Most recent readings of confidence indicators, however, have stabilised or even rebounded. Together with the improvement in financial markets, and significant recent policy action at both EU and Member-State level, this suggests that the drag on private investment and consumption from the uncertainty related to the sovereign-debt crisis should fade little by little. Global trade is also expected to recover gradually. Overall, some further contraction is forecast for early 2012 in both the EU and the euro area, and a return to the kind of modest recovery that is typical for the aftermath of financial crises is expected only from the second half of the year.

The 2012 GDP forecast for the EU and the euro area is revised down.

GDP growth for 2012 is now expected to be zero for the EU and -0.3% for the euro area. This is a downward revision compared to the autumn 2011 forecast of 0.6 percentage point and 0.8 percentage point, respectively. The quarterly profile has been lowered for all quarters, most strongly around the turn of the year, in view of the weaker-than-expected flash estimate by Eurostat for the fourth quarter of 2011. A recovery is still forecast for the second half of the year, but is expected to be more modest and to occur later than forecast in the autumn. This reflects a more gradual return of business and consumer confidence, and therefore investment and consumption, as well as additional fiscal consolidation in a number of Member States.

Growth differentials across Member States remain pronounced.

Although growth differentials remain accentuated, the broad basis of downward revisions suggests that there is no clear core/periphery pattern in the euro area. While the autumn forecast foresaw negative annual GDP growth in 2012 only for Greece and Portugal, this is now forecast also for Belgium, Spain, Italy, Cyprus, the Netherlands, Slovenia and Hungary. However, growth differentials are set to remain substantial. The largest downward revisions to annual growth (of one percentage point or more) were made for Estonia, Spain, Greece, Italy, and the Netherlands. By contrast, the forecasts were kept unchanged or revised only by little (less than ¼ percentage point) for Germany, France, Austria, Slovakia, Denmark, Poland and the UK.

Inflation has remained more persistent than forecast, but is expected to ease gradually.

Energy inflation has started to decrease only recently, but crude oil prices expressed in euro have actually increased since the autumn. At the same time, core inflation has stabilised at about 2¼ % in the EU and 2% in the euro area. Indirect tax increases have further contributed to headline inflation, by up to ½ percentage point in the EU and ¼ percentage point in the euro area in recent months. As a result, headline HICP inflation has decreased more gradually than earlier forecast. It stood at 3% in the EU in December 2011 and, according to Eurostat's flash estimate, at 2.7% in January 2012 in the euro area. In view of trends in commodity futures and the expected weakening of GDP, inflation is expected to continue its slow decline over the coming quarters. For 2012 as a whole, HICP inflation is now forecast to fall to 2.3% in the EU and 2.1% in the euro area.

Risks while remaining tilted to the downside, have become more balanced lately.

Some of the risks identified in the autumn forecast have materialised. Nonetheless the balance of risks to GDP growth remains tilted to the downside amid still-high uncertainty. This interim forecast continues to rely on the assumption that adequate policy measures are decided and implemented at the EU and Member-State level to overcome the sovereign-debt crisis. This assumption underpins the forecast of a gradual return of confidence and a recovery in investment and consumption in the second half of 2012, which is however set to occur later and be more modest than assumed in the autumn. Moreover, the financial market situation remains fragile. If the sovereign-debt crisis were to rebound massively, with a broad surge in risk premia and spillovers across countries, severe credit rationing and a collapse of domestic demand could ensue. Such an outcome would most likely trigger a deep and prolonged recession, not sparing even those countries which have shown more resilience so far.

As usual, this forecast assumes no change in fiscal policy beyond measures that are at present known with sufficient certainty. If additional fiscal tightening is decided – which appears to be needed in some Member States which still do not have a 2012 budget or need to correct the excessive deficit in 2012 – this could raise confidence and ease financial market pressure. Nonetheless, in the short run, GDP growth would probably be negatively affected. Upside risks to GDP include a stronger-than-expected rebound of confidence following decisive EU level decisions to tackle the sovereign-debt crisis, building on the recent agreement on the Greek adjustment programme. Another upside risk is a more resilient global demand, which could, for instance, stem from the decreased dependency of emerging markets on advanced economies or a stabilisation in US housing markets.

Risks to inflation appear broadly balanced.

The main risk for markedly lower inflation relates to a sharper-than-expected contraction of GDP, which would also depress underlying price dynamics. On the upside, oil prices could surge in the case of supply disruptions, in particular in the case of an intensification of geopolitical tensions; stronger demand from emerging markets could also drive commodity prices higher. Similarly, inflation could increase on the back of unanticipated increases in indirect taxes.

1. EU ECONOMY: A MILD RECESSION WITH SIGNS OF STABILISATION

The global economy has decelerated...

The overall picture of the global economy has been mixed in 2011 and economic growth has been uneven across regions. The fragile recovery from the global crisis that had started in 2009 has been negatively affected by sharp commodity price increases, natural disasters in Asia, and increased uncertainties about the resolution of the sovereign-debt crisis in the euro area. Elevated inflation pressures in emerging economies led to tightening of domestic policies, and this weighed further on global growth dynamics.

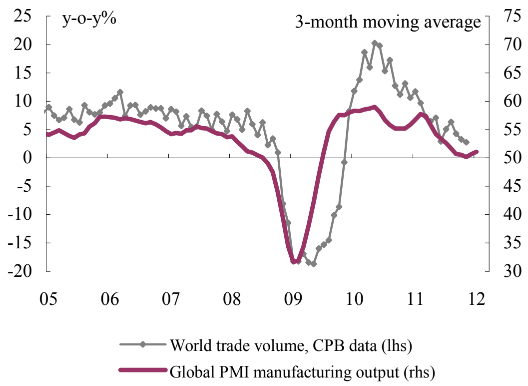
In the third quarter of 2011, global growth accelerated, led by Japan's post-disaster recovery and an improvement in the US economic activity. The advanced estimate for the fourth quarter points to a continuing growth momentum in the US driven to a large extent by inventory rebuilding and consumption financed from savings. Nevertheless, world growth is expected to have slowed down again towards the end of the year, despite the better-than-expected performance of the US economy. Preliminary estimates of GDP growth in Japan in the last quarter of 2011 surprised on the downside on the back of weak public investment and negative trade repercussions following floods in Thailand. While so far China has proved to be resilient to the slackening global economy, growing at a robust 8.9% in the last quarter of 2011, most emerging market economies continue to be affected, notably through the trade and financial channels.

... and is expected to move out of the soft patch only gradually.

Looking ahead, leading indicators of global activity, such as the global manufacturing PMI, point to a moderate expansion in the short term.

Against this background, the global economy (excl. EU) is expected to grow by 4¼% in 2012, almost the same rate as forecast in autumn. However, the overall figure masks large regional differences. Compared to autumn, a more upbeat US outlook combined with an unchanged forecast for China, counterbalances downward revisions elsewhere, particularly in Japan, Latin America and the MENA region.

Graph 1.1: **World trade and Global PMI manufacturing output**



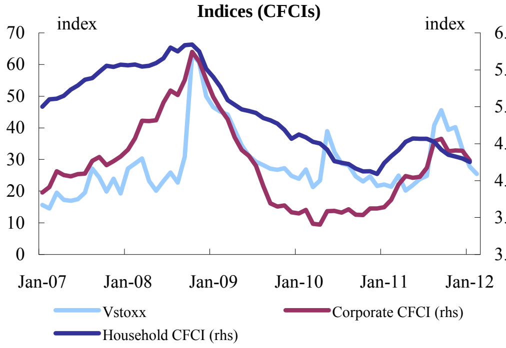
Commodity prices are trending down but still remain high from a historical perspective. Energy prices, most notably crude oil, have held up in recent months, despite a global slowdown in demand growth, reflecting geopolitical tensions and the risk of supply disruptions. Nevertheless global inflation concerns have receded recently. Across both, advanced and emerging economies, inflation is set to decelerate on the back of moderating commodity prices, subdued economic growth and base effects from commodity price increases in early 2011.

Risks to the global growth outlook remain elevated. More pronounced contagion from the sovereign-debt crisis in the euro area to the rest of the global economy and stronger spillovers between the financial and real sector remain the largest downside risks. Moreover, an aggravation of geopolitical tensions in oil-exporting regions could lead to higher oil prices. On the upside, global growth dynamics may prove to be stronger than currently envisaged in the forecast, in particular if the US economy were to rebound sooner (on account of a faster recovery in the housing market, stronger job creation and corporate investment).

Financial markets have calmed but remain vulnerable

Financial market stress has ebbed off in recent months. Financing cost indicators point to a gradual improvement, while volatility indicators suggest a return of risk appetite among market participants. Improvements have been widespread across financial market segments. Nonetheless, the financial market situation remains fragile. Yields on many euro-area sovereigns remain too high for comfort, and the risk of a sudden aggravation of the sovereign-debt crisis, with spillovers across the euro area, but also to global financial markets is still very present. The sovereign-debt crisis in the euro area continues to be the main source of instability in the global financial system. Adverse feedback loops between vulnerable sovereign debtors and weak banking systems are still active, and there is evidence of tightening credit conditions for the private non-financial sector. Breaking such negative feedback loops requires consistent policy decisions in the coming weeks.

Graph 1.2: **Volatility and Composite Financing Cost Indices (CFCIs)**



Note: The CFCI is a synthetic measure of the nomial external financing cost for the euro-area corporate sector and households.

Stabilisation in sovereign-debt markets but further measures are required

Although decreasing in several countries, sovereign yield spreads remain high by historical standards. Shortly after the autumn 2011 forecast, the euro-area sovereign-debt crisis intensified on concerns that slowing economic growth would undermine public debt sustainability, that the benefits of the fiscal consolidation efforts risked being wiped out by the further rising debt-servicing costs, and that some sovereigns (and banks) would struggle to refinance the challenging volume of maturing debt. However, since mid-November sovereign-debt spreads have come down somewhat, supported by policy measures as well as successful sovereign-bond auctions. Stronger credibility of policy in vulnerable countries and the increasing perception that a consistent strategy to tackle the sovereign-debt crisis was emerging at the EU level helped to stabilise the markets. Consequently, the market reaction to sovereign credit-rating downgrades since December has been muted.

Despite banking sector weakness...

Tensions in sovereign-debt markets have strong contagion effects into the EU banking system. Banks' funding costs and debt spreads in secondary markets remain high. Difficult bank funding conditions have been a key driver behind credit supply tightening in recent months (see Box 1.1). New liquidity measures introduced by the ECB in December 2011 and February 2012 have provided a relief, as banks now have access to longer maturity funding from the ECB and can use a wider range of eligible collateral. Euro-area interbank markets continue to be dysfunctional, though market conditions have started to ease gradually after the announcement of the ECB's additional liquidity measures in early December. The Euribor-OIS spread, an indicator of the willingness of banks to lend to each other, has decreased from a peak of 100 basis points early December, but at around 75 basis points it remains high.

... a credit crunch has been avoided

Looking forward, the risk of a full-blown credit crunch has decreased. The process of deleveraging is ongoing in the banking sector, but there is no clear-cut evidence that it has become excessive or disorderly. The transmission from central bank liquidity to additional loans to the private sector remains impaired, and credit supply conditions have tightened. However, demand for credit has also fallen, so that credit supply conditions are – at the current juncture and considering the EU and euro-area aggregates – unlikely to constrain credit growth until demand picks up more strongly. Moreover, premiums on corporate bonds have come down somewhat, and the strong liquidity of the non-financial corporate sector should sustain it through a period of more difficult financing conditions. Differences in credit conditions across countries have, however, increased, with far more severe credit supply constraints in some Member States where bank balance sheets are under particular stress.

Box 1.1: Substantial slowdown in credit growth amid very large cross-country divergences

Credit expansion in the EU and the euro area is bound to remain anaemic in 2012, despite – inter alia – the substantial relief provided by the ECB longer-term refinancing operations. However, currently decelerating bank lending growth is not expected to turn into a fully-fledged credit crunch in the EU or the euro area.

Towards the end of 2011, private sector credit growth decelerated noticeably, but was subject to large cross-country differences. Credit growth has been declining strongly in Italy, and to a smaller but still noticeable extent in France. In Ireland, the extensive credit contraction seems to be receding, while a milder credit contraction has continued in Greece and is intensifying in Spain and Portugal. In the Netherlands and Germany, credit growth turned positive in the course of 2012, but has recently shown signs of decelerating again. But credit growth in Belgium, after having turned positive in the summer of 2011, turned negative again in December 2011. Recent trends in Central and Eastern Europe do not follow a single pattern either. Credit growth has been accelerating in Romania in recent quarters, but receding in Poland and the Czech Republic, while in Hungary, the credit contraction is deepening. Annual credit growth in Bulgaria remains at low but stable levels (Table 1).

The overall slowdown in credit growth resulted both from weakening demand and tightening credit conditions, as highlighted by the ECB Bank Lending Surveys of October 2011 and January 2012. In particular, the sovereign-debt crisis has reduced banks' access to funding markets. Financial institutions are under unabated pressure to adjust balance sheets and secure liquidity provision, while funding costs remain at elevated levels (see page 5 in section 1). In the euro area, funding stress appears to be most severe in Italy, Spain and France, as indicated by the large take-up of the 3-year longer-term refinancing operations by Italian, Spanish and French banks in December 2011. Reflecting the spillover from tensions in the euro area, bank lending conditions in Emerging Europe substantially weakened in the last quarter of 2011, with deteriorating refinancing conditions reported as the most important factor behind the worsening situation.[1]

Table 1:
Bank lending to the non-financial private sector (y-o-y %)

	Dec-10	Jun-11	Nov-11	Dec-11
EA	2.2	2.1	1.7	1.2
BE	-2.0	-2.5	0.6	-1.7
DE	-0.1	-0.2	2.3	2.3
EE	-5.4	-4.8	-5.6	-4.3
IE	-20.2	-13.2	-11.0	-7.5
EL	3.0	-3.7	-4.5	-3.4
ES	0.8	-1.1	-2.8	-3.0
FR	6.0	6.9	4.5	3.7
IT	8.1	4.7	2.6	1.4
CY	6.7	6.3	7.0	7.6
LU	3.3	6.3	1.3	2.0
MT	4.3	1.0	3.1	3.1
NL	-2.9	6.6	5.8	3.8
AT	2.7	1.9	2.3	2.4
PT	0.2	-1.8	-2.8	-3.5
SI	2.5	0.3	-0.9	-2.5
SK	5.0	9.5	7.2	8.5
FI	5.4	6.3	7.9	8.3
BG	1.1	2.3	2.3	:
CZ	9.2	11.3	3.8	:
DK	1.3	-2.0	-1.7	:
LV	-8.4	-9.3	-6.2	:
LT	-6.5	-5.6	-3.4	:
HU	0.5	0.3	-6.3	:
PL	11.9	12.9	3.0	:
RO	4.2	4.6	6.2	:
SE	21.9	10.2	6.0	:
UK	4.6	-12.6	-7.2	:

Source: ECB

While the stress in bank funding markets may have prompted banks to cut back lending to the real economy, the additional liquidity injected by the ECB in December, the expected additional liquidity at the end of February, as well as some other policy measures (e.g. the broadened collateral base) should provide sufficient resources for banks to expand lending. Meanwhile, the European Banking Authority (EBA) assessed earlier this month that the imposed and ongoing strengthening of the capital ratios of banks would be met primarily through direct capital measures (capital raising, retained earnings and conversion of hybrids to common equity) while deleveraging actions would only count for a quarter of the amount of measures.[2] Nevertheless, the transformation of central bank liquidity into loans to the private sector via the bank lending or balance-sheet channel is not straightforward in the current environment, as possible bank capital shortages and high sovereign refinancing needs superimpose the expansionary monetary impulse. Moreover, cross-

[1] Institute of International Finance (IIF), Emerging Markets Bank Lending Conditions Survey – 2011Q4, January 2012

[2] See the EBA's press release: "The EBA's Board of Supervisors makes its first aggregate assessment of banks' capital plans, 9 February 2012."

(Continued on the next page)

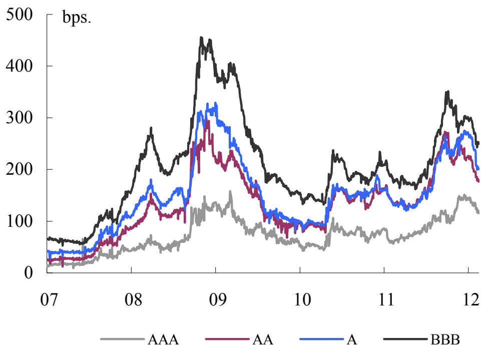
Box (continued)

border retrenchment is likely to continue, adding to possible credit constraints in some Member States. Finally, the much tighter credit conditions applied by banks to long-term loans are an immediate reflex of the particular stress on funding markets for longer maturities, but are also driven by regulatory requirements. This implies that non-financial corporations face a higher interest-rate risk for the financing of long-term investments.

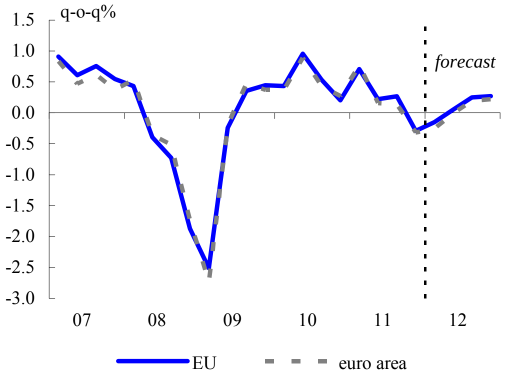
Looking forward, a number of factors suggest that weakening credit growth will not develop into a fully-fledged credit crunch despite the ongoing moderate credit deceleration. (i) Credit growth is still positive or even accelerating in most countries. (ii) The contraction of credit volumes in other Member States corresponds to declining credit demand following slowing economic activity in the last months of 2011, resulting from high uncertainty about future business projects and deleveraging of the corporate and household sector. Warned by the 2008-09 experience of tight liquidity conditions, the corporate sector has been hoarding cash and freezing investment. Fitch[1] estimates that the vast majority of European corporates is well placed to finance themselves out of existing resources in 2012-13, without the need to tap the markets.

(1) Fitch Ratings, EMEA Corporate Credit View, December 2011

Graph 1.3: **Corporate spreads over euro-area sovereign benchmark bonds (5-year maturity)**



Graph 1.4: **Quarterly GDP growth, EU and euro area**



European economic situation has worsened

In 2011 as a whole, real GDP is estimated to have grown by 1.5% in the EU and 1.4% in the euro area, broadly in line with the autumn 2011 forecast. However, the loss of momentum in the EU economy towards the end of 2011 turned out to be stronger than expected in the autumn. Sharply deteriorating confidence, the sovereign-debt crisis and a weaker global economy have all weighed on growth. In the third quarter of 2011, GDP in the EU and the euro area grew by 0.3% and 0.1% respectively, compared to the previous quarter. In the final quarter, according to Eurostat's Flash estimate of 15 February, GDP contracted by 0.3% from the previous quarter in both the EU and euro area. The contraction was particularly strong in Portugal (-1.3% q-o-q), Lithuania (-0.9%), Estonia (-0.8%), Italy (-0.7%) and the Netherlands (-0.7%).

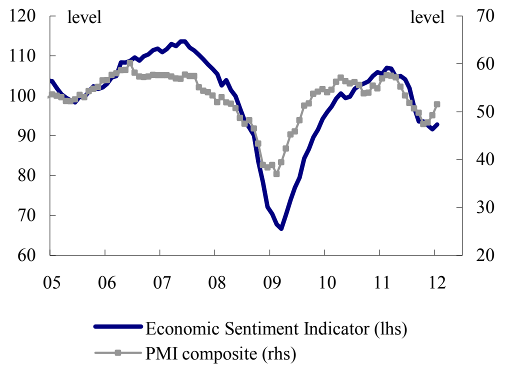
A mild, technical recession

The lower carry-over from 2011 will weigh on the outlook for this year. Growth is expected to stagnate in 2012 in the EU, and the euro-area economy should experience a mild recession: For 2012, GDP growth is now forecast at 0.0% in the EU and -0.3% in the euro area. This is a downward revision of 0.6 pp. and 0.8 pp. respectively compared to the autumn 2011 forecast. The quarterly GDP profile for 2012 has been revised down for all quarters and a technical recession, defined as two consecutive quarters of negative growth, is now expected in both regions in the last quarter of 2011 and the first quarter of 2012. Only after some quarters of zero or negative GDP growth is a gradual and feeble return of growth projected in the second half of 2012. The projection of a sluggish recovery towards the end of the year reflects the pattern of subdued growth that is typical in the aftermath of financial crises.

Still, this growth profile is based on the assumption that the uncertainty related to the sovereign-debt crisis will gradually fade.

The weaker growth prospects for 2012 compared to the autumn 2011 forecast can be explained by several factors. First, the carry-over into 2012 turned out to be lower than expected in the autumn forecast, mainly as a result of lower growth in the last quarter of 2011. Second, the additional fiscal consolidation that has been decided since the autumn forecast in a number of Member States, while necessary, will weigh on growth in 2012. Third, although the policy assumption of the autumn forecast, according to which policy measures to combat the sovereign-debt crisis would prove effective and lead to a gradual return of growth, is still valid, the timing has been delayed. On the upside, compared to the autumn forecast, the ECB's additional liquidity measures have contributed to the stabilisation of market sentiment and reduced pressure on short- and medium-term funding for banks.

Graph 1.5: **Economic Sentiment Indicator and PMI composite index, EU**

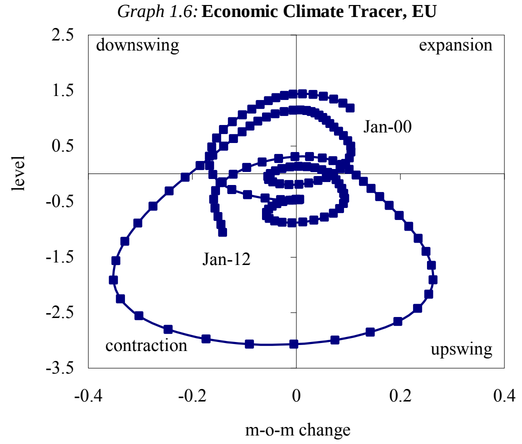


Confidence, while remaining very low, points to some stabilisation

Since the autumn 2011 forecast, survey developments have continued to trend down and began to improve only recently. The Economic Sentiment Indicator (ESI) in the EU and the euro area showed a moderation of the sharp downward trend during the fourth quarter of last year. In January 2012, it rose for the first time since May 2011 for the EU (since February 2011 for the euro area). The indicator remains, however, significantly below its long-term average in both regions. The euro-area composite PMI readings have been slightly more positive, showing a gradual increase in the index since November. In January, the index stood above the threshold of 50 points, signalling a marginal increase in economic activity in the euro area.

Despite this recent improvement, the Commission's business and consumer survey indicators still point to contraction. An Economic Climate Tracer can be constructed depicting the level and change of a (smoothened and standardised) business cycle indicator (Graph 1.6).[1] This tracer displays the position of an economy in the business cycle and its dynamics. For both the EU and the euro area, based on January data, the climate tracer remains in the contraction area. Among the largest Member States, it is now in the contraction area in all countries except Germany which remains in the downswing area and is moving in the direction of expansion.

Graph 1.6: **Economic Climate Tracer, EU**



While recent developments in survey data suggest that the expected slowdown should be mild and temporary, the turnaround of the trend still needs to be confirmed in the coming months.

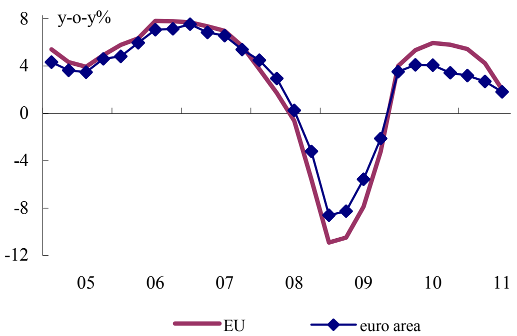
Broad-based downswing

The expected slowdown in 2012 should be broad-based and affect all GDP components. Exports seem to have been the main driver of growth in 2011 in most EU countries and are now back to their pre-crisis levels. However, with global trade expansion slowing down, its contribution to GDP growth will most probably diminish in 2012.

(1) The business cycle indicator is created from the weighted average of the five principle components from the survey series conducted in industry, services, construction and retail trade and among consumers.

The relatively strong EU export recovery in 2010-11 did not translate into a rebound in private investments. Gross fixed capital formation was rather disappointing in 2011. After a strong performance in the first quarter of 2011, investment growth was anaemic in the two following quarters, in line with declining confidence. Looking forward, several factors will contribute to unfavourable developments. The weaker prospects for trade and domestic demand for 2012 will reduce firms' incentives to invest. Furthermore the net tightening of credit standards for loans to enterprises and their declining profit share (Graph 1.7) are set to weigh on the propensity to invest beyond depreciation.

Graph 1.7: **Profit growth, EU and euro area**



Note: Profits defined as gross operating surplus and gross mixed incomes at current prices.

Domestic consumption is set to remain modest, too. After a decline of 0.4% in the EU (-0.5% in the euro area) in the second quarter of 2011, household consumption rebounded slightly in the following quarter. However, weak labour markets, subdued consumer confidence, ongoing private-sector deleveraging in many Member States and the negative impact of fiscal consolidation measures on disposable income are all depressing the outlook for consumption.

Intra-EU divergence persists

The downward revision for GDP growth in 2012 is broad-based across Member States but the magnitude of revision is very different from one country to another. While a slowdown in 2012 is expected in all EU Member States, growth differences are expected to remain pronounced. The sovereign-debt crisis affects in particular those Member States with vulnerable public finances (often compounded by a weak banking sector and low growth), while deleveraging needs stemming from the preceding boom and bust continue to weigh on domestic demand. Differences in openness to international trade and in competitiveness positions will also contribute to growth divergence.

While some countries will suffer significant recessions in 2012, other countries will experience a slowdown with growth remaining in positive territory. In fact, GDP growth rates in 2012 are forecast to range from significant contractions in Greece (-4.3%) and Portugal (-3.3%) to some rapidly growing New Member States, like Poland (2.5%) and Lithuania (2.3%). Divergence in country growth perspectives are also reflected in a number of indicators such as: unemployment rates, credit tightening, financing costs, fiscal consolidation needs and confidence.

Labour markets deteriorating

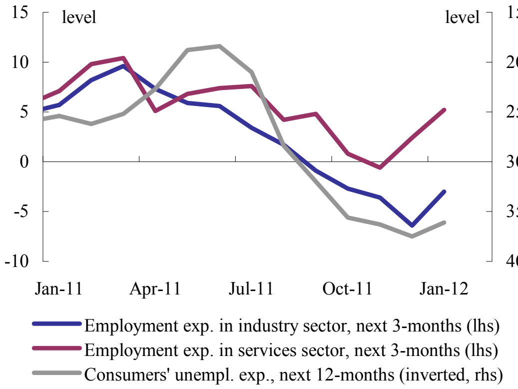
In the third quarter of 2011, employment growth turned negative for the first time since spring 2010, with a decrease of 0.1% in the EU and the euro area respectively. Although this decline was small, it shows that the favourable employment dynamics in some Member States no longer offset the deterioration in countries facing substantial structural adjustments. The unemployment rate stood at 10.4% in the euro area and 9.9% in the EU in December 2011. Labour shedding in the construction sector has continued unabated, whereas employment in the manufacturing sector decreased only slightly in the EU and stagnated in the euro area.

The largest increases in the unemployment rate in December 2011 were recorded in countries with macroeconomic adjustment needs stemming from a burst housing bubble and/or unsustainable public finances coupled with a lack of structural reforms. Greece, Portugal and Spain account for 95% of the rise in unemployment in the EU since late 2010. Additionally, Spain and Greece have seen their youth unemployment rates surge (from already high pre-crisis levels) to close to 50%. But high levels of youth unemployment are also common in several other countries, with the total of eleven Member States significantly exceeding the EU average jobless rate for the 15-24 year olds of 22.1% (as of December 2011). By contrast, the labour market situation still appears to be more benign in countries with less adjustment needs. As a consequence, the large dispersion of unemployment rates among Member States is expected to prevail in 2012.

Looking ahead, the deteriorated economic outlook is expected to leave its mark on the labour market, as the winding-down of imbalances continues, also in response to weak demand. Forward-looking labour market indicators suggest a further worsening of the labour market situation. Readings of Commission surveys of employment expectations in the EU industry and services sectors experienced their trough last autumn, whereas consumers' unemployment fears for the next twelve months have decreased (Graph 1.8). The labour market prospects in the near future are also underpinned by deteriorating PMI composite employment indices for the EU and the euro area.

Given that employment developments tend to follow output fluctuations with a time lag of two to four quarters, the expected weak GDP upturn in the second half of the year is unlikely to lift employment prospects during 2012. With the EU economy set to stagnate and a mild recession unfolding in the euro area at the current juncture, the labour market situation is likely to worsen over the forecast horizon.

Graph 1.8: **Employment expectations, Business and Consumer Surveys, EU**

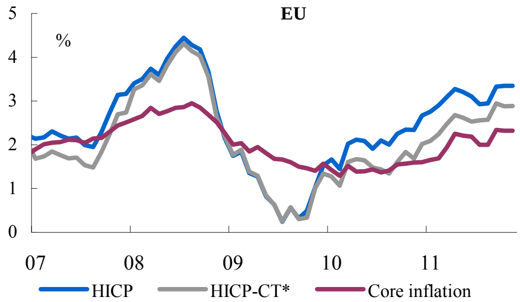


Inflation still high despite weakening economic environment…

In 2011, consumer-price inflation was shaped to a large extent by rising energy prices and changes in indirect taxation in many Member States. While in the second half of last year the oil price started to decrease in USD terms (by 7%), it increased in EUR terms (by 4%). The net effect of the oil-price increase and higher indirect taxes (adding up to ½ pp. to HICP), as well as lagged effects of oil-price increases from the first half of 2011, have resulted in inflation in the EU and the euro area that has been more persistent than expected in the autumn forecast.

Euro-area headline HICP inflation rose to 2.9% in the fourth quarter of 2011, ¼ pp. higher than forecast in autumn, bringing up the 2011 rate to 2.7%. In the EU, headline inflation was 3.2% in the fourth quarter (0.4 pp. higher than in the autumn forecast) and 3.1% for 2011 as a whole (compared with 3.0% in the autumn forecast).

Graph 1.9: **Headline, core and constant-tax* inflation, EU**



** HICP-CT = inflation at constant taxes. The difference between HICP and HICP-CT growth rates points to the theoretical impact of changes in indirect taxes (e.g. VAT and excise duties) on overall HICP inflation, assuming an instantaneous pass-through of tax rate changes on the price paid by the consumer.*

In 2011, core inflation (i.e. all items excluding energy and unprocessed food) reached 2.1% in the EU (1.7% in the euro area), up by about ¾ pp. from the previous year in both areas.

… but with weak labour market conditions …

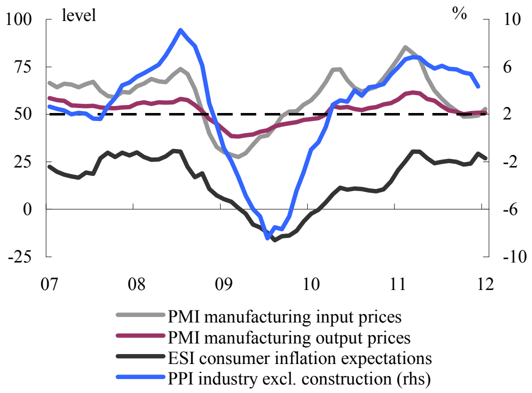
Although the labour market situation is currently highly differentiated across EU Member, conditions generally stayed weak in 2011 and have not exerted any pressures on inflation. Nevertheless, in the course of 2011, the growth of nominal compensation per employee accelerated and outpaced the productivity gains, prompting a moderate increase in nominal unit labour costs.

… and well-anchored expectations …

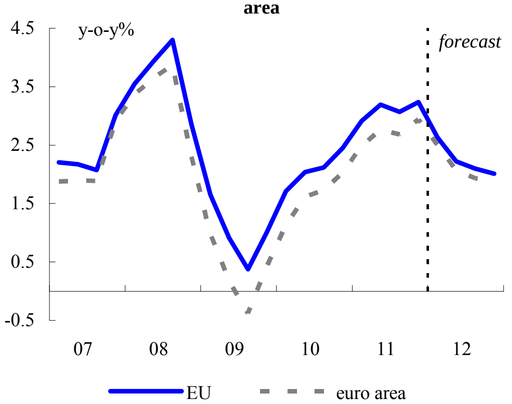
Price pressures on the producers' side have been easing since the spring of 2011, mainly reflecting lower pressures from energy input prices. Industrial producer price inflation fell below 5% in the EU and the euro area at the end of 2011 and the most substantial decrease in the course of the year was observed for intermediary goods, i.e. at the earlier stages of the production chain.

However, survey indicators of price developments (both PMI and ESI components), which signal future producer-price developments, edged up slightly at the turn of the year, suggesting an end to the downward trend. This is in line with manufacturers' expectations of stabilising economic activity in the short term as the PMIs suggest. Consumers' inflation expectations eased slightly in January, though they remain at an elevated level as, on the whole, they tend to be highly correlated with the observed (currently relatively high) inflation rates. By contrast, market-based inflation expectations for the medium- to long term point to a substantial easing of inflation going forward, with inflation rates significantly below the ECB's official target. However, in times of continued financial-market turbulences, these indicators should be interpreted with caution.

Graph 1.10: **Producer-price inflation (PPI) and survey inflation expectations, euro area**



Graph 1.11: **HICP inflation forecast, EU and euro area**



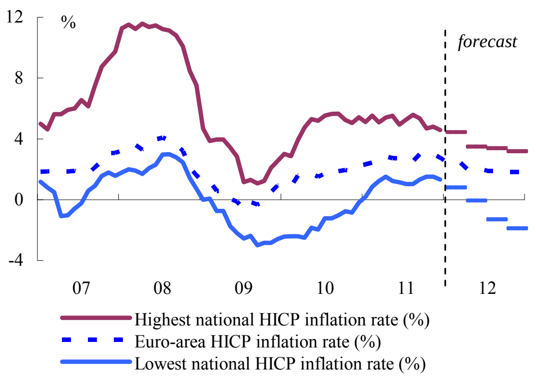
... the outlook is for a gradual decrease ...

Looking ahead, the headline inflation rate for 2012 is revised up both in the EU and the euro area (0.3 pp. and 0.4 pp. respectively compared to the autumn forecast) and is expected to reach 2.3% and 2.1% respectively. On a quarterly basis, inflation at the aggregate level is expected to have peaked in the last quarter of 2011 and is set to gradually return to about 2% towards the end of the year. This profile follows from the interaction of three main elements: the fading pass-through and negative base effects from last year's increases in energy prices combined with increases in indirect taxation and administered prices in many Member States, new tax measures to be introduced in 2012 and the overall feeble economic environment.

... though with increased dispersion among Member States

The revisions to the inflation forecast are equivocal across Member States, in line with divergent patterns in economic activity. For many euro-area countries that are implementing additional fiscal consolidation measures in the form of increasing direct and indirect taxes, inflation for 2012 has been revised up between ½ and 1 pp. Outside the euro area, revisions to the autumn 2011 forecasts have mostly been minor, with the exceptions of Poland, Hungary, Romania and Sweden, mainly on account of exchange rate movements and base effects. On the whole, the dispersion of inflation rates in the euro area is set to increase this year.

Graph 1.12: **Inflation dispersion of EA Member States - HICP inflation rates**



The outlook for public finances broadly unchanged

Turning to public finances, the available information suggests that, despite a downward revision of economic growth in 2012, the budgetary outcome for the EU and the euro area as a whole will be broadly in line with the results of the autumn forecast. The overall unchanged outlook for public finances is mainly due to additional consolidation measures taken in some Member States since the cut-off date of the autumn forecast, which offset the negative budgetary impact from the slower economic activity and fiscal slippage in some countries. A full assessment of prospects for public finances and the labour market will be carried out in the Commission's upcoming spring forecast.

Uncertainty keeps risks at high levels

Against the background of sovereign- and financial-market stress, the growth forecasts for the EU and the euro area remain subject to exceptionally high uncertainty. Despite some favourable developments in recent weeks that made the risks to growth more balanced, the downside risks remain substantial. By contrast the risks to the inflation outlook are broadly balanced.

Downside risks to the growth forecast are closely related to the euro-area sovereign-debt crisis, measures to solve it, adverse feedback loops between the financial and the real sector and the underlying assumptions about the external environment.

– The major downside risk is that the euro-area debt crisis intensifies. This could, for instance, happen if, by contrast to the main policy assumptions, measures are not adopted and/or implemented quickly enough. An intensification of the crisis would trigger an abruptly changing market sentiment, more contagion, and tensions in the financial sector of the EU and beyond. This would endanger financial stability, complicate corporates' financing (credit crunch) and depress confidence of investors and consumers. The fallout would not be restricted to a sharp decline in economic activity in the EU. Economic and financial spillovers beyond Europe could amplify the negative impact.

– Additional fiscal measures, not taken on board due to the no-policy-change assumption (cf. Box 2), may lower economic growth in the short term more than currently envisaged.

– Weaker-than-expected global economic growth would weigh on trade and thus, via merchandise exports, on the growth outlook of EU Member States. Economic growth in non-EU advanced economies is surrounded by risks emanating from the debt crisis in euro-area Member States. The larger the loss in global growth momentum would be, the more protectionist pressures might arise, constituting further downside risks to the growth outlook for the EU.

– An escalation of geopolitical tensions could push oil prices to unprecedented heights, which would weigh heavily on the EU economy. Credible threats to the accessibility of oil supplies from the Middle East could increase risk premia. The growth slowdown following the sharp price increases in the first half of 2011 may give an indication on how substantial the impact could be.

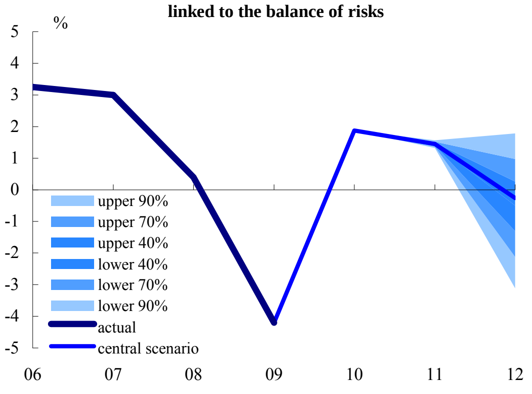
Upside risks to the growth forecast relate to the assessment of measures already taken and the external environment of the EU economy.

– The policy measures already taken and the next moves to solve the euro-area debt crisis may have a faster and more sustained impact than currently expected. A recovery in financial markets, structural reforms and determined fiscal consolidation could lead to an earlier return of confidence than assumed, allowing the EU economy to re-accelerate earlier and stronger than forecast.

– Stronger-than-expected global economic growth, particularly in emerging market economies, may pull economic growth in advanced economies.

Overall, the balance of risks to the economic growth outlook is tilted to the downside. Downside risks to growth will diminish further if decisive policy actions at EU and Member State level reduce uncertainty.

Graph 1.13: **Euro-area GDP forecasts - uncertainty linked to the balance of risks**



The uncertainty surrounding the growth outlook for the euro area is visualised in the fan chart (see

Graph 1.13) that displays the probabilities associated with various outcomes for euro-area economic growth in 2012. While the darkest area indicates the most likely development, the shaded areas represent the different probabilities of future economic growth within the growth ranges depicted on the y-axis. As the balance of risks to economic growth is assessed as tilted to the downside, the fan chart is skewed towards the bottom.

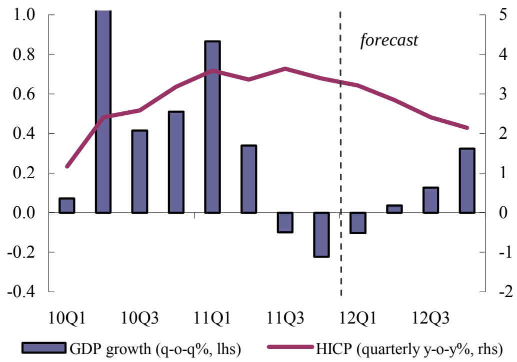
Risks to the inflation outlook are broadly balanced in the EU as a whole and in the euro area.

Downside risks to the inflation outlook are associated with a weaker-than-expected growth performance of the EU economy. In particular, further declining economic activity would reduce cost, wage and price pressures. Upside risks to the inflation outlook are related to policy measures, commodity prices, and monetary factors. More increases in indirect taxes and administered prices may be decided than currently envisaged in the forecast. Supply disruptions, may push commodity prices beyond what is currently assumed. Finally, the long-time build-up of liquidity could eventually result in stronger-than-expected price increases once economic activity re-accelerates.

2. BELGIUM

After the strong recovery in 2010 and the first half of 2011, the Belgian economy slowed down considerably in the second part of 2011. GDP declined by 0.1% and by 0.2% q-o-q in the third and fourth quarters respectively. Together with the downward revision of growth in the second quarter of 2011 (from 0.5% to 0.3%) this led to an estimated GDP growth of 1.9% for the whole year (instead of the 2.2% projected in the autumn forecast) and to a lower carry-over to 2012 (0.2 pp. versus -0.1 pp.).

Graph 2.1: **Belgium - GDP growth and inflation**



In addition to the impact of the global downturn on business and consumer confidence, the collapse of Dexia in October 2011 and the additional amount of guarantees committed by the Belgian government, gave rise to renewed concerns about the health of the banking sector and the impact on lending (conditions) to households and companies. Credit provision by Belgian banks has been slowing down since the second half of 2011, in particular for households.

The factors that led to the contraction of economic activity in the second half of 2011 are expected to remain in place at the beginning of 2012; therefore the outlook for the current year is more negative than expected at the time of the autumn forecast and real GDP is projected to decline by 0.1% over the whole year. A very modest (export-led) recovery should however start in the third quarter and would become more pronounced in the fourth quarter of the year.

After having increased slightly in December, consumer confidence fell back in January. At the start of 2012, consumers expected the general economic situation to get worse over the current year, while fears of an increase in unemployment have also been revived.

Private investment is expected to slow down considerably, with capacity utilisation having fallen back below its long-term average. Demand for mortgages is also expected to decline in the first quarter of 2012, affecting construction investment.

Finally, the consolidation measures included in the budget for 2012 and complemented by additional measures in early January, which were not included in the autumn forecast, are likely to have a limited but negative impact on growth this year.

The contribution of net trade to growth is set to remain weak in 2012 (-0.2 compared to 0.0 in the autumn forecast). While exports were still booming during the first quarter of 2011, they fell in the course of the year due to the deterioration in growth of foreign markets. Exports are expected to resume in the course of 2012, but the unfavourable starting point would limit their increase in 2012 as a whole.

Inflation has been revised upward compared to the autumn forecast, from 2% to 2.7%. The impact of the consolidation measures in the 2012 budget, in particular the increased VAT rates on tobacco, pay-tv and some professional services such as notarial services, is estimated at 0.2%. Other elements contributing to the higher inflation forecast are the increased telecommunication tariffs and the less pronounced slowdown in energy prices compared to the assumption in the autumn. The higher-than-expected level of oil prices for 2012 has an important weight on inflation in Belgium as the economy is rather energy intensive.

3. BULGARIA

The Bulgarian economy has revived relatively slowly over 2010-11, with real GDP in the fourth quarter of 2011 still about 3% below its peak value recorded in 2008. The GDP flash estimate for the fourth quarter of 2011 indicates growth of 0.4% q-o-q and 1.5% y-o-y. For 2011 as a whole, annual growth is expected to reach 1.8%. The growth momentum from 2011 has had a marginally positive carry-over to 2012. As in other EU Member States that are catching up, the growth pattern in the initial recovery has been largely driven by strong exports of both goods and services, while domestic demand has remained stagnant, reflecting a rapid adjustment and an unwinding of imbalances in the private sector.

The strong rebound in exports has been levelling off over 2011, and monthly industrial production indicators, as well as industry confidence readings point to markedly lower export growth going forward. Nevertheless, in spite of the weaker outlook in the euro area, Bulgaria is not expected to fall back into a recession. Annual growth has, however, been revised down (by 0.9 pp. less than projected in the autumn forecast) and is now forecast to reach 1.4% in 2012. GDP growth is expected to remain rather low in the first half of 2012, but to accelerate gradually thereafter in line with economic activity picking up in the EU as a whole.

Following the rapid rebound in exports over the past two years, domestic demand is expected to pick up with a lag and become a main driver of growth in 2012, especially since domestic economic fundamentals have improved amid the rapid adjustment process. Private-sector imbalances have unwound very quickly, as indicated by the current account swinging into a surplus, while the ratio of private sector debt to GDP has started to decline and the dependency of the financial sector on external financing is decreasing. In spite of vulnerabilities, the financial sector has remained stable and has provided for modest growth in private sector credit in 2011. The economy also benefits from relatively strong public finances, which do not face major adjustment needs in the longer term.

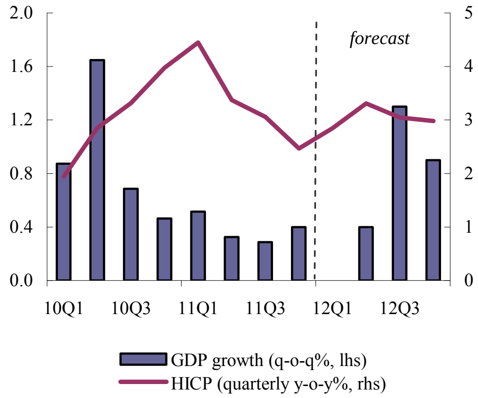
The gradual revival in private consumption is expected to continue. While economic confidence readings declined over the final quarter of 2011, sentiment recovered in January 2012 and is somewhat stronger than the EU average. Following a markedly strong and protracted period of labour shedding, the labour market appears to be stabilising in 2012. Even with weak employment performance, household income has been supported by relatively strong growth in average wages, probably driven by catching-up effects from low levels and structural changes in the labour market.

Investment is expected to be upheld by public sector projects. After a notably slow start in EU structural funds intake over the previous years, it is planned to increase absorption significantly in 2012. However, this is countered by weak private investment activity, given the relatively high debt stock of the corporate sector, which entails further deleveraging of corporate balance sheets.

HICP inflation slowed considerably over the course of 2011 and amounted to 3.4% in 2011 on average, 0.3 pp. less than expected in the autumn forecast. Inflation is expected to moderate to 3% on average in 2012, supporting growth in real purchasing power of consumers.

The forecast baseline scenario is subject to significant risks. A prolonged stress in financial markets could further delay the recovery in consumption and investment. Uncertainty regarding the consumption behaviour of households remains one of the major risks to the outlook, both on the upside and on the downside. Should households lessen their currently high precautionary savings rate, this could underpin stronger consumption growth.

Graph 3.1: **Bulgaria - GDP growth and inflation**



4. CZECH REPUBLIC

The soft patch foreseen in the autumn 2011 forecast materialised when real GDP fell by 0.1% q-o-q in the third quarter of 2011 and 0.3% in the fourth quarter, according to preliminary estimates by the Czech Statistical Office. Industrial production slowed to 2% y-o-y in December 2011 compared to 5.4% in November and 11.9% reported a year ago. The largest decline in manufacturing output was recorded in computers and electronic products (which represent about 4% of total Czech production) while other industries, including motor vehicles, machinery and equipment (about 11% of total production) still showed double-digit growth at the end of the year, although decelerating compared to the first half of 2011.

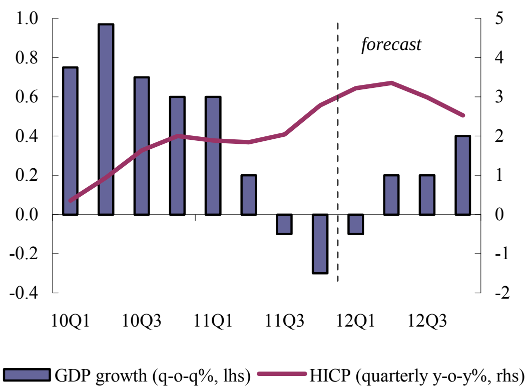
The slowdown affected all components of domestic demand; government consumption expenditure is estimated to have contracted most markedly. By contrast, net exports supported growth, particularly in the second half of the year as the growth rate of exports outpaced that of imports, which were held back by weak domestic demand. The year-end decrease in imports was, however, somewhat cushioned by the effect of pre-stocking on beverages and tobacco due to the anticipated rise in the lower VAT rate and excise taxes in January 2012.

GDP growth is projected to stall during 2012. Consumer confidence survey data suggest an ongoing decrease in household consumption expenditure at the beginning of 2012, which reflects worsening labour market conditions and wage restraint at the level of the central government. Increases in the VAT rate on food and selected services should dampen consumer demand. Investment is expected to recover only in the second half of 2012, reflecting continued uncertainty about export prospects and depressed profit margins. In a setting of generally subdued domestic demand, weak-but-still-growing net exports are likely to be the main factor supporting economic activity.

Against this backdrop, and also owing to a methodological revision to the quarterly profile of GDP components data, the current estimate of flat real GDP in 2012 growth is considerably lower than in the autumn forecast.

The harmonised index of consumer prices increased by 2.1% in 2011 and is projected to pick-up further to 3.0% in 2012. The increase is expected to be driven predominantly by the hike in the lower VAT rate and persistently high oil prices, compounded by a slightly weaker exchange rate than was assumed in the autumn forecast. Domestic demand pressures should remain very limited. The direct effect of the VAT increase on HICP is estimated at 1.1 pps. While the higher rate applies only from the beginning of 2012, part of the adjustment was visible in the price data already in the last quarter of 2011.

Graph 4.1: **Czech Republic - GDP growth and inflation**



5. DENMARK

Following the rebound in 2010, and despite solid exports, the overall performance of the Danish economy was subdued in 2011 owing in particular to low confidence among households and firms in the light of the ongoing sovereign-debt crisis. With lower than initially anticipated domestic demand in the third quarter, annual real GDP growth is not projected to exceed 1% in 2011, i.e. corresponding to a 0.2 pp. downward revision compared with the autumn 2011 forecast. Nevertheless, the improvement of indicators such as industrial production, car sales and exports in the course of the fourth quarter 2011 suggests that Denmark is likely to have avoided a technical recession towards the turn of the year.

In 2012, real GDP is expected to grow slowly at around 1%, driven by domestic demand. The downward revision as compared with the autumn 2011 forecast (1.4%) mainly reflects a weaker external environment. Private consumption is expected to accelerate in the course of 2012 as contributions to the voluntary early retirement pension (VERP) scheme are to be reimbursed following the adoption of the retirement reform by Parliament. However, it is envisaged that a fragile housing market and a stagnating labour market will continue to weigh on consumer spending. Moreover, households are likely to continue with the needed balance sheet deleveraging and to maintain precautionary savings at a relatively high level during the current period of elevated economic uncertainty.

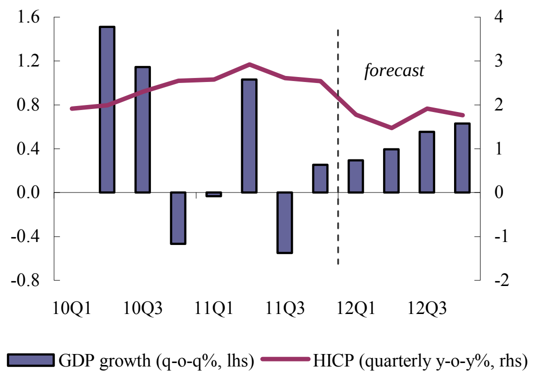
At the current juncture, low interest rates due to the safe-haven status of Danish government and mortgage bonds underpin the Danish housing market. Nevertheless, indicators such as the number of houses for sale and the long selling periods bear witness to a frail market, with house prices expected to continue to fall in 2012.

Overall investment growth is projected to have bottomed out in 2011. However, credit conditions are expected to remain tight and gross fixed capital formation continues to be driven largely by public initiatives in 2012, in line with the government's "kick-start" stimulus package and supported further by large-scale infrastructure projects (e.g. extension of the Copenhagen Metro and the railway network).

Exports proved resilient in 2011, thanks to high growth rates at the beginning of the year, i.e. prior to the slow-down in world trade. Thus in 2012, export growth is projected to be significantly lower due to a less favourable external environment, in particular the subdued growth outlook for Germany and Sweden, Denmark's main trading partners. The large share of non-cyclical goods – such as food and pharmaceuticals – in Danish exports should, on the other hand, sustain export growth.

Furthermore, with an almost steady unemployment rate and private employment not expected to pick up soon, current wage negotiations in the private sector are expected to yield moderate wage increases in the subsequent two-year period and thereby some gains in cost competitiveness. Import growth should remain strong, however, due to the strength of domestic demand.

Graph 5.1: **Denmark - GDP growth and inflation**



While real wages fell in 2011, they may pick up slightly this year as the inflation rate is projected to drop by almost 1 pp. from 2.7% in 2011 to 1.8% in 2012. Due to the oil-price hike at the beginning of 2011, the energy contribution to inflation remained relatively large throughout the year but this effect will peter out in 2012. Services and processed food should be the main contributors to inflation. In addition, a rise in taxes on cigarettes and air pollution, as part of the government's 2012 budget law, will add around ¼ pp. to inflation, just as the earlier introduction of a tax on saturated fat in the fourth quarter of 2011 will continue to contribute to inflation this year.

6. GERMANY

The upswing of the German economy continued in 2011, with real GDP estimated to have increased by 3.0% (after 3.7% in 2010). The expansion was mainly driven by domestic demand, which is expected to have contributed 2.1 pps. to growth. Private consumption saw its largest increase in five years, supported by a benign labour market, as employment reached its highest level in 20 years. Gross fixed capital formation continued to expand markedly, reflecting both continued investment in machinery and equipment and the strongest increase in construction since the mid-1990s. While exports remained dynamic, imports were also robust on the back of strong domestic demand, which is estimated to have resulted in a growth contribution of net exports of 0.8 pp. (after 1.5 pps. in 2010).

However, the growth momentum slowed noticeably in the course of the year as the crisis deepened. Uncertainty took its toll on the sentiment of economic agents, while export prospects weakened and new orders – both for domestic business and from abroad – declined considerably in the second half of 2011. Following a gain of 0.6% q-o-q in the third quarter, real GDP contracted by 0.2% q-o-q in the last quarter of the year. According to preliminary indications, exports declined amid the weak international environment, as did private consumption following the solid expansion of the previous quarter. Gross fixed capital formation increased, with buoyant construction activity likely to have been supported by the mild weather at the end of the year.

Available indicators for the first quarter of 2012 signal an improvement in sentiment among both firms and households. This suggests that the growth momentum has experienced a temporary interruption rather than signalling an entry into recession. A slight edging-up of GDP in the first quarter, followed by an acceleration of growth in the course of the year, thus continues to be the central scenario for the German economy, although risks remain particularly pronounced at the current juncture.

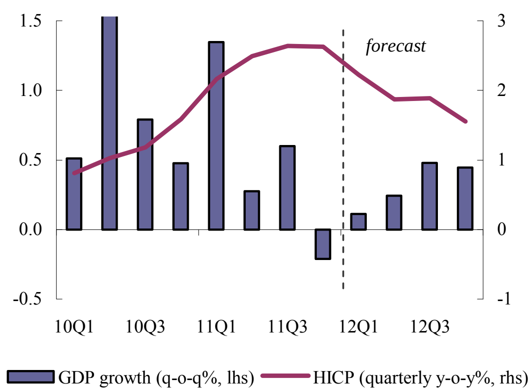
Domestic demand is expected to continue to drive the expansion. Private consumption should be further underpinned by the resilient labour market, where available working-time flexibility is likely to be used to absorb the effects of a temporary slowdown in activity, as well as by healthy wage growth amid slowing inflationary pressures. Gross fixed capital formation is likely to expand considerably more slowly than last year, with some plans for investment in machinery and equipment likely being put on hold amid the current uncertainty. However, this effect should be dampened by the fact that capacity utilisation, although diminishing, remains high, as well as by still-favourable financing conditions. While the end of temporary stimulus measures should lead to downward pressure on public investment, private housing investment should remain relatively dynamic, possibly benefitting from the increase in the perceived risk of investment alternatives.

Export prospects have worsened somewhat compared to the autumn forecast, given the weaker outlook for Germany's trading partners in the EU, which account for around 60% of the country's goods exports. Given still-lively imports on the back of robust domestic demand, net external trade should exert a considerable drag on GDP growth this year.

Overall, real GDP is expected to gain 0.6% this year. The downward revision relative to the autumn forecast is fully explained by the lower carry-over from 2011 following the weaker-than-expected outcome in the last quarter of the year.

HICP inflation was slightly higher than expected in the last quarter of 2011, driven by higher energy prices. The inflation rate is now projected to average 1.9% in 2012, reflecting more elevated oil prices than anticipated in autumn. Core inflation should also remain contained reflecting slower activity than last year.

Graph 6.1: **Germany - GDP growth and inflation**



7. ESTONIA

According to the flash estimate from Statistics Estonia, annual economic growth in Estonia reached 7.5% in 2011, i.e. 0.5 pp. lower than projected in the autumn forecast. Domestic demand was stronger than expected and export performance remarkable. However, in the last months of the year Estonia was not immune to the deteriorating confidence seen in many Member States. As a result, GDP shrank by 0.8% q-o-q in the last quarter of 2011. The contraction, however, was mostly limited to the export-oriented electronics sector, which had been one of the main growth drivers in the initial phase of the recovery. More recently, manufacturing production seems to have stabilised at somewhat below its recent peak level.

The 2012 outlook for the Estonian economy has significantly deteriorated, driven by falling confidence and weaker external demand around the turn of the year. As a result, GDP growth expectations for 2012 have been revised downwards, from 3.2% in autumn to 1.2% in the present forecast.

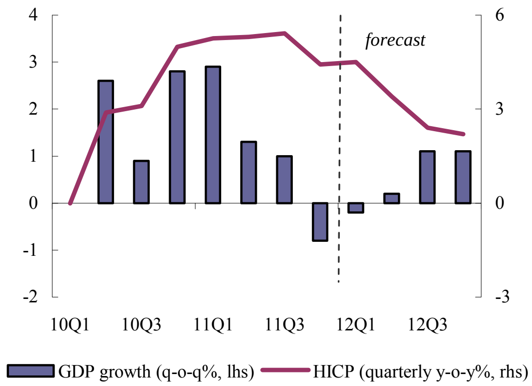
Despite remarkable productivity adjustments in the recent recession, exports are expected to remain weak in the first half of 2012. Export performance and growth will largely depend on the pace of the global recovery.

Domestic demand was mainly driven by strong fixed investment, which rose by 23% in the first three quarters of 2011 compared to first three quarters of previous year, mostly due to corporate spending targeted at increasing productivity. However, public investment surprised positively in the second half of the year. Given the lower utilisation of production capacity in January 2012 compared to the previous October (68% compared to 74%) reflecting the economic deceleration, new corporate investment projects are likely to be put on hold for a while. Nevertheless, strong public investment is expected to largely offset the slowdown in corporate investment. The robust infrastructure investment already planned reflects carbon-credit-trade contracts aimed at increasing energy efficiency, but also higher absorption of EU structural funds.

Reflecting a relatively improved labour market situation and an increased disposable income, private consumption is expected to grow moderately this year.

Average annual HICP inflation reached 5.1% in 2011, spurred by higher international food and oil prices since spring 2010. However, the contribution of non-energy industrial goods to inflation remained low, alleviating the risk of competitiveness losses. The impact of the euro changeover on 1 January 2011 appeared limited. Looking forward, lower commodity prices since mid-2011 should contribute to further inflation moderation in 2012. Given lower output growth and the slower decline in unemployment in 2012, second-round effects from earlier commodity price increases and upward pressure on wages due to skills mismatches should also be moderate.

Graph 7.1: **Estonia - GDP growth and inflation**



8. IRELAND

Ireland's economy is estimated to have returned to modest growth of 0.9% in 2011, after a sharp 10% contraction in output between 2008 and 2010. Following stronger-than-expected growth in the first half of the year (1.8% and 1.4% q-o-q in the first and second quarters respectively), third-quarter data were weaker than anticipated (with GDP contracting by 1.9% q-o-q), especially in terms of domestic demand, while exports held up rather well. [2] Indeed, for 2011 as whole, growth is estimated to have been entirely export-led. Net exports contributed an estimated 3.6 pps. to GDP in 2011, as external demand benefited from competitiveness improvements, while domestic demand continued to contract due to fiscal consolidation, falling employment and household balance sheet repair.

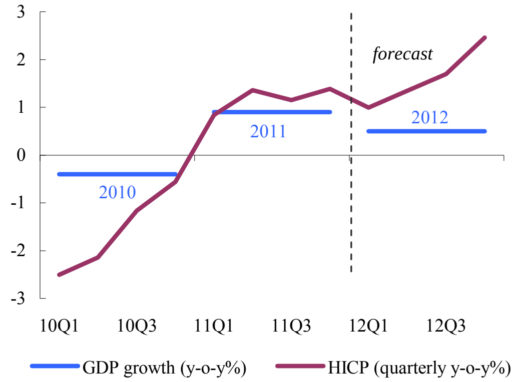
A small current-account surplus of 0.4% of GDP is expected on the basis of net export growth. Employment continued to contract, by 2.2%, although the unemployment rate stabilised through the year at 14.3%, as participation declined and net outward migration continued.

Due to weaker projected outlook for the euro area, Irish export growth is expected to slowdown in 2012, although the unchanged outlook for the UK and US economies (large trading partners for Ireland) will provide some support. Net exports are expected to contribute positively to growth, as domestic demand contracts for a fifth successive year. Overall, GDP is forecast to grow by a modest 0.5% in 2012. Private consumption is set to decline once again as households continue to adjust their balance sheets and the continuing reduction in construction activity will see investment activity decline once again

The current account is expected to move more into surplus as domestic demand continues to contract. Employment is set to fall once again as the public service and financial sector shrink, with the unemployment rate rising, with lowered participation and some further net outward migration mitigating in part the impact of the fall in employment.

Inflation turned positive in 2011, largely on the back of imported energy pressures, but remained low at 1.2%. It is expected to rise slightly to 1.6% in 2012, with upward pressure coming from the depreciation vis-à-vis sterling, and the effect of the 2 pps. increase in VAT as well as a number of administered price increases throughout 2012.

Graph 8.1: **Ireland - GDP growth and inflation**



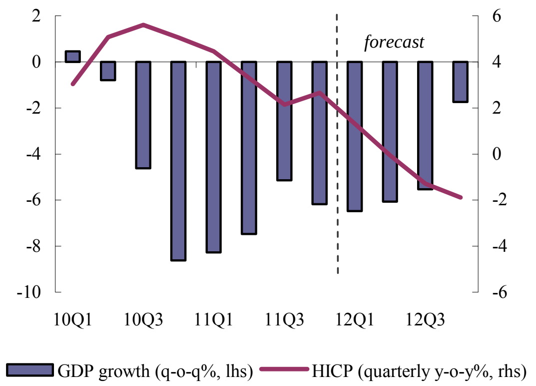
Risks to the growth outlook remain tilted to the downside. If downside risks to the euro area materialise, it could have an impact on demand for Irish exports. The continuing need for household balance sheet repair could weigh on consumption more heavily than projected. The low interest rate environment may, on the other hand, assist the household sector in this regard without impacting unduly on already-low domestic demand.

(2) Given Ireland's small and very open economy, quarterly figures are particularly volatile and subject to revision. Thus they should be interpreted with caution.

9. GREECE

In 2011, economic activity was much weaker than anticipated in the autumn forecast. Recent flash data for the last quarter of 2011 by ELSTAT reveal that real GDP fell by 6.8% for the year as a whole. The fall in domestic demand was driven by income losses, tight access to credit for the private sector and the ongoing adjustment in the labour market. Exports of goods and services rose by an estimated 3.9% in real terms, although from a low base (exports of services and goods represent about 24% of GDP in Greece), and decelerating from 4.2% in 2010.

Graph 9.1: **Greece - GDP growth and inflation**



The labour market is undergoing a painful adjustment process. According to the Labour Force Survey, in January to November 2011 the average unemployment rate was 17.2%; for the year as a whole employment is estimated to have contracted by 4.8%. The increase in unemployment is expected to continue in 2012.

Minimum wages in the private sector, and other wages regulated by the National General Collective Agreement will be reduced by around 22%. Unit labour costs for the business economy are expected to fall by 15% over the next three years. While the decision by the Government to reduce minimum wages and the expected emulation effect on other wages are intended to improve competitiveness and absorb youth and low-skilled workers, they are expected to hamper domestic demand, which in the short term may procure negative feedback loops into employment. In a medium-term perspective, other structural reforms are also expected to create more favourable conditions for employment.

In 2012, real output is expected to shrink further, by 4.3% – markedly lower than forecast in the autumn and with substantial downside risks – mirrored by very low consumer and business confidence. Apart from the weakening external demand, domestic demand is set to contract given the expected acceleration of the labour market adjustment, with wage cuts in the private sector. Overall exports are set to be even less dynamic than in the previous three years, despite the competitiveness-enhancing reductions in labour costs of Greek enterprises. On the other hand, imports will continue to be affected by weak domestic demand, so that the external sector will again make a positive contribution to GDP.

Headline HICP inflation averaged 3.1% in 2011, down from 4.7% in 2010. It rose by 2.2% in January 2012. The slow reduction in prices is mainly attributed to oil prices and tax measures implemented under the adjustment programme. Constant-tax inflation in 2011 was 1.2% in 2011. However, for an economy in deep recession, the inflation rate reveals deep inflexibility in product and services markets. In 2012 the price rise trend is expected to be reversed, resulting in slight deflation of 0.5%. The main driving force stems from anticipated falls in disposable income and consumer spending due to wage cuts in the private sector.

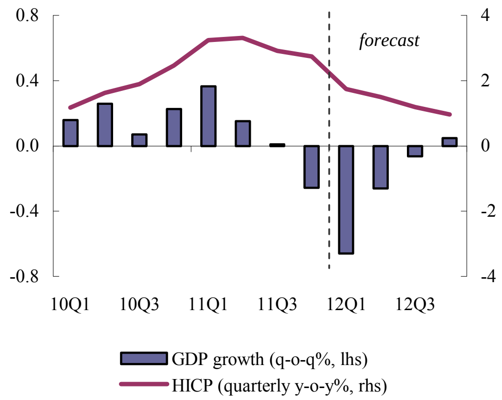
10. SPAIN

The Spanish economy lost momentum in the second half of 2011. Real GDP growth stagnated in the third quarter and declined by 0.3% q-o-q in the last quarter. This deceleration was driven by a weaker external environment, intensification of the sovereign-debt crisis with negative spillovers to the Spanish financial sector and to credit conditions, lower public expenditures, and a larger-than-expected deterioration in the labour market. For 2011, real GDP growth is still expected to have reached 0.7%, in line with the Commission services' autumn forecast.

High private sector imbalances accumulated during the housing boom and record-high unemployment continue to weigh on the outlook for the Spanish economy. The weaker outlook for the euro area and still-high uncertainty, especially in relation to the sovereign-debt crisis, are expected to have an adverse effect on growth in 2012. As a result, real GDP is expected to contract by around 1% this year, not taking into consideration additional fiscal consolidation measures still to be adopted [(3)].Taking into account additional fiscal measures in the forthcoming budget may significantly change the picture both for real GDP growth and for its individual components. Real GDP growth is expected to contract most significantly in the first half of the year, especially in the first quarter, followed by some improvement in the second half with growth rates close to zero in the last quarter.

Private consumption is expected to be significantly weaker this year, driven by persistently high unemployment, large household debt, and a binding credit constraint. Public consumption is also expected to shrink, as Spain continues with its fiscal consolidation programme and implements the additional measures announced at the end of December. Investment is expected to remain subdued in an environment of high corporate indebtedness (especially for construction and real estate companies), excess capacity and difficult access to credit. While domestic demand thus remains a major drag on economic growth, net exports continue to provide some support thanks to relatively resilient exports and the weaker imports implied by the subdued domestic demand.

Graph 10.1: **Spain - GDP growth and inflation**



HICP inflation is forecast to decelerate significantly, from around 3% in 2011 to 1.3% in 2012. This is mostly driven by the fading out of transitory factors that fuelled inflation in 2011 (i.e. electricity price and indirect taxes hikes) and by very weak internal demand. Moderating wage growth has also resulted in lower unit labour costs, contributing to a further easing of inflationary pressures. As a result, the inflation differential with the euro area is expected to be negative, leading to some improvement in Spanish price competitiveness.

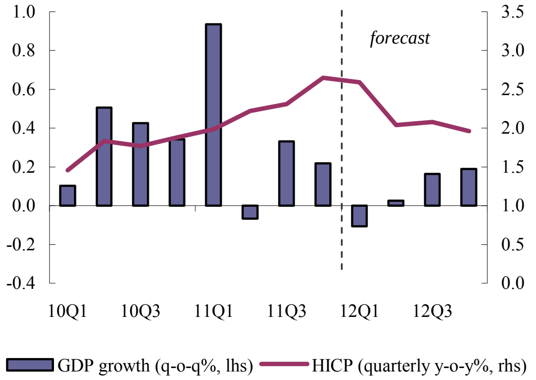
(3) Due to the general elections in November 2011, the adoption of the draft budget for 2012 was postponed until end-March. As this forecast is based on a no-policy-change assumption, it takes into account only the temporary extension of the 2011 budget together with the emergency fiscal measures taken by the Spanish government on 30 December 2011 (including a hike in direct taxes and certain expenditure cuts).

11. FRANCE

At 1.7%, estimated overall GDP growth in France for 2011 is in line with the autumn 2011 forecast, although the growth pattern was very uneven throughout the year.

After strong growth in the first quarter of 2011 (0.9%) and a slight contraction in the second quarter (–0.1%), GDP grew by 0.3% in the third quarter. Household consumption resumed as the influence of some temporary developments (including the aftermath of the phasing out of the car-scrapping premium and low energy consumption due to mild weather) that had affected the second quarter receded. At the same time, investment proved weaker than expected on amid decreasing confidence fuelled in particular by tensions on the financial markets.

Graph 11.1: **France - GDP growth and inflation**



In the last quarter of 2011, GDP growth proved much more resilient than had been forecast in the autumn. While increasing unemployment acted as a drag on household consumption, investment rebounded to 0.9%. This was in particular due to a strong increase in car purchases by companies, possibly in anticipation of the higher taxes on polluting vehicles which comes into force at the beginning of 2012. This acceleration in investment is therefore expected to be temporary. Net exports were strong but were offset by declining inventories.

The stronger-than-expected growth in the last quarter of 2011 translates into a higher carry-over for 2012. Nonetheless, GDP is expected to increase by only 0.4% for 2012 as a whole, below the 0.6% projected in the autumn forecast. Declining confidence throughout the euro area, rising unemployment and the impact of the fiscal consolidation measures included in the November fiscal package, which was announced after the cut-off date of the autumn forecast, and in the supplementary budget for 2012, are expected to bring economic growth to a standstill during the first half of this year. Growth is forecast to resume again in the second half, on the back of a gradual pick-up in domestic demand.

Turning to the components of domestic demand, higher unemployment is expected to weigh on disposable income of households, in particular in a context of increasing inflation. Consumers' assessment of their own financial situation reached a historical low in December suggesting low consumption growth in the first semester. Confidence indicators in both manufacturing industry and services have decreased sharply since the summer. The demand for loans has also receded while credit conditions have tightened somewhat. As one-off effects observed in the last quarter of 2011 dissipate, a temporary contraction of investment is expected in the first quarter. Net trade which contributed positively to growth in the last three quarter of 2011, would slow down due to the weakening of global activity, but would have an overall positive contribution to growth in 2012. Downward risks remain significant, linked in particular to the general economic development in the euro area.

HICP inflation has been revised up, to 2.2%, in 2012, 0.7 pp. above the autumn forecast. Energy prices, which had been expected to slow down markedly, have instead remained on an upward path in 2011, with a strong impact on HICP. The increase in the reduced rate of VAT for specific categories of goods and services in January 2012, together with the announced increase in the general rate from 19.6% to 21.2% in October, is expected to contribute to inflation. The adverse conditions in the labour market, which are expected to weigh on wage negotiations, should by contrast reduce inflationary pressures.

12. ITALY

The Italian economy entered recession again in the second half of 2011. The acute tensions recorded in the Italian and euro-area sovereign-debt markets in the final months of 2011, along with the ensuing tighter credit conditions affecting the private sector, implied a sharp deterioration in economic agents' confidence and a fall in demand. According to the flash estimate of the Italian statistical office (ISTAT), real GDP contracted significantly in the last quarter of 2011, by 0.7% q-o-q after -0.2% in the third quarter. Consequently, estimated real GDP growth for the year 2011 as a whole has been revised downward, from 0.5% in the autumn forecast, to only 0.2% (or 0.4% in calendar adjusted terms).

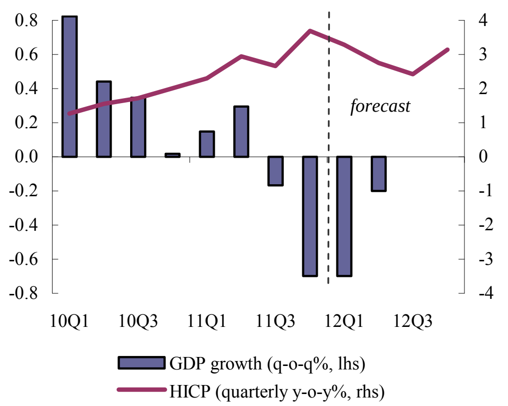
After incorporating the large GDP decline in the fourth quarter of 2011, the negative growth impulse into 2012 is 0.6 pp., much worse than the -0.1 pp. expected in the autumn 2011 forecast. As uncertainty remains elevated and thus major spending plans of consumers and firms are kept on hold, growth prospects for the first half of 2012 have also worsened relative to the autumn forecast. Real GDP is now expected to contract by a further 0.7% in the first quarter of 2012 and by 0.2% in the second quarter. Economic activity is set to stabilise in the second half of the year, under the assumption of no further deterioration in financial market conditions and a stable spread between Italian and German sovereign bonds at around 370 bps for 10-year maturities. As a result, real GDP is expected to contract by 1.3% in 2012 as a whole after the 2010-11 mild recovery. This implies that following the deep recession recorded in 2008-09, the level of real GDP in 2012 is projected to be around 6% lower than in 2007.

Looking at the demand components, very tight financing conditions and relatively low capacity utilisation are expected to hold back gross fixed capital formation. Equipment investment is set to drop substantially in 2012, while construction investment is expected to be scaled down at broadly the same pace as in 2011. Private consumption is set to fall in 2012, after increasing marginally in 2011. This is mainly due to the fall in households' real disposable income, under the impact of declining employment and the large fiscal consolidation measures adopted in 2010-11. The substantial drop in domestic demand is expected to lead to a fall in imports in 2012. By contrast, exports are set to continue to expand in 2012 on the back of sustained demand from extra-EU trade partners. As a result, the positive contribution of net exports to real GDP growth is expected to be substantial in 2012, as in 2011. Thanks to the improved trade balance, the current account deficit is projected to narrow significantly in 2012 relative to the 3¼% of GDP deficit recorded in 2011.

Negative cyclical conditions, along with some labour hoarding, are expected to lead to stagnant labour productivity over 2011-12. As a consequence, unit labour costs are projected to rise despite the moderate wage increases expected in the private sector and the wage freeze in the public sector.

HICP inflation is set to remain at 2.9% in 2012, as in 2011. Core HICP inflation, i.e. excluding energy and unprocessed food, is projected to stabilise in 2012. This relatively high inflation – despite falling domestic demand and moderate pressures from labour costs – is explained by the further rise in oil prices and the effects of fiscal consolidation measures. The standard VAT rate was increased by 1 pp. (to 21%) in September 2011, while excise duties on energy products were raised with the new consolidation package adopted in December 2011. The latter also specified the so-called "safeguard clause": an additional 2 pps. increase in both the 21% standard VAT rate and the 10% reduced rate will be effective as from October 2012, unless equivalent resources are raised through the reform of the tax and social assistance systems. This further VAT increase is incorporated in this forecast.

Graph 12.1: **Italy - GDP growth and inflation**



13. CYPRUS

The Cypriot economy grew by a modest 0.5% in 2011. After a good first half year when GDP rose by 1.5% y-o-y thanks to an exceptionally good tourist season, economic activity was badly affected by the accident in July that destroyed the Vassilikos electricity producing plant, which accounted for half of the total generating capacity of Cyprus. Moreover, a worsening external environment and tightening financial and fiscal conditions compounded the adverse effect on economic activity.

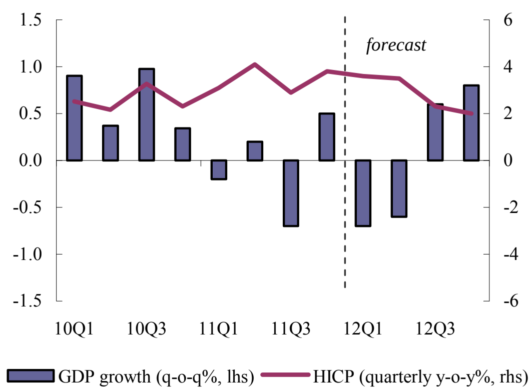
Domestic demand, traditionally the main driver of growth, shrank in 2011. Tightening bank lending conditions along with a worsening labour market outlook and weakening confidence weighed on private consumption. In addition, weak foreign demand for housing and a restructuring of corporate balance sheets kept investment on a correction path for a third year in a row. On the other hand, the external sector made a positive contribution to growth. Tourist arrivals and revenues posted an increase of 10% and 13% respectively. This was due to political instability in competing Mediterranean destinations and an increased flow of arrivals from developing markets such as Russia. Also, import growth decelerated, in line with the contraction in domestic demand.

GDP is projected to contract by 0.5% in 2012 due to weak domestic demand. The downward revision relative to the autumn 2011 forecast is explained by the worsening of the external environment and by the adoption of additional consolidation measures, not accounted for in the autumn 2011 forecast. Furthermore, the deterioration in financial markets and the tightening of credit conditions may raise the cost of financing to the private sector and limit access to it. Leading indicators point to weak albeit improving consumer and business confidence. This suggests that recovery should set in slowly, during the second half of 2012, with the improvement of the external environment, the start of the tourist season and the resumption of investment projects as uncertainty dissipates. Housing investment is expected to remain weak, while other construction investment is likely to benefit from reconstruction work in the destroyed Vassilikos power station and from other infrastructure projects. Moreover, the contribution of the external sector to growth is set to remain positive. While slowing global trade and worsening economic prospects in Cyprus' main trading partners is likely to weigh on exports of goods, this is expected to be partly offset by the healthy performance in business services and tourism. Imports are set to decline, against a backdrop of weak domestic demand.

HICP inflation is projected to decline to 2.8% in 2012 from 3.5% in 2011 on the back of easing commodity prices combined with weakening domestic demand. Furthermore, the base effect of increased electricity prices is set to dissipate in the last quarter of the year. Core inflation is forecast to remain contained at about 1.8%.

Overall, risks appear to be balanced. On the one hand, greater spillovers from potential worsening conditions in Greece, due to the large exposure of the financial sector, are substantial. Also, tightening credit conditions, coupled with already-higher financing costs and the high indebtedness of private agents, could delay the rebound in consumption and investment. On the other hand, external demand may strengthen more than expected if the announced strategic plans by the Cyprus government for attracting more tourists and foreign investors succeed (ex. plans for the introduction of new destinations, for tourist traffic growth, and incentive schemes for winter tourism). Investment, for its part, may be sustained through various announced construction and infrastructure projects.

Graph 13.1: **Cyprus - GDP growth and inflation**



14. LATVIA

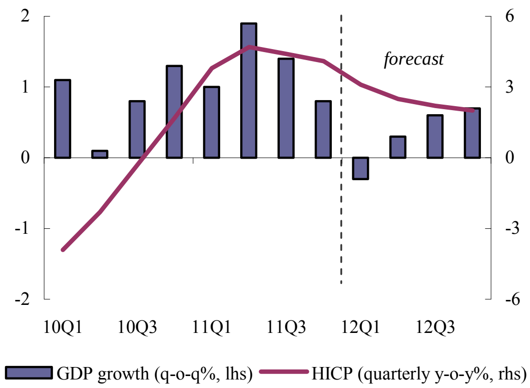
Latvia's economic growth exceeded expectations in 2011 despite a slowdown, driven by weaker external demand, in the last quarter of the year. According to the flash estimate of the national statistical office, GDP rose by 5.3% in 2011, against 4.5% in the autumn forecast. The annualised seasonally unadjusted rate slowed to 5% in the last quarter of the year from 6.6% in the previous quarter. Trends in retail trade and industrial production show a continued slowdown in early 2012, which could translate into a mild contraction in the first quarter of the year compared with the previous quarter.

On the other hand, the Economic Sentiment Indicator rebounded to 105.3 in January from an average of 102.6 in the last quarter of 2011, reaching a new four-year high. Trade volumes and transport services also remained quite resilient to the slowdown in Europe since the summer. Nevertheless, weaker demand from major trading partners, as well as risks of more cautious household consumption and corporate investments, lead to a downward correction to the growth forecast for Latvia to 2.1% in 2012 from 2.5% in the Commission autumn forecast.

The GDP breakdown by demand components confirms the continuous rebalancing of the economy towards export-oriented industries. According to data of the national statistical bureau for January-September 2011, the share of exports in GDP widened to 60% from 53% for the same period of the previous year. Despite some moderation in the last quarter of 2011, the share of exports most probably continued to rise. Balance of payments figures indicate a significant rebound in the service sector that offsets part of the slowdown in the external trade with goods. Tourism services made a substantial contribution to the growth rate in export of services in 2011, along with strong performances in ports and railway cargo services linked to transnational transport channels. However, the rebalancing toward export industries is likely to weaken substantially in 2012, as external demand restraints are expected to result into a balanced growth in the domestic and export components of GDP.

The harmonised index of consumer prices (HICP) was in line with expectations, at 4.2% in 2011 as a whole, including a large contribution from the increase in VAT rates. The constant-tax index is estimated at 2.7% in 2011 reflecting significant price hikes in the energy and food markets. For 2012 as a whole, average inflation is projected to decelerate to 2.5% as the impact of the tax hikes in 2011 weakens substantially. In comparison with the autumn forecast, the figure is revised upwards by 0.1 pp. due to an upward revision of the oil-price assumptions, only partly offset by subdued domestic demand. Uncertainties related to prices of primary energy resources represent a significant risk to the inflation forecast, as the country is strongly dependant on energy imports and the use of energy inputs in relation to GDP is one of the highest in the EU.

Graph 14.1: **Latvia - GDP growth and inflation**



15. LITHUANIA

After a strong economic performance in 2011 with real GDP growing by 5.8%, the worsened global economic outlook and persistent tensions in the world financial markets are now expected to slow Lithuania's economy more markedly than had been expected at the time of the autumn 2011 forecast. Economic output is projected to grow by 2.3% in 2012.

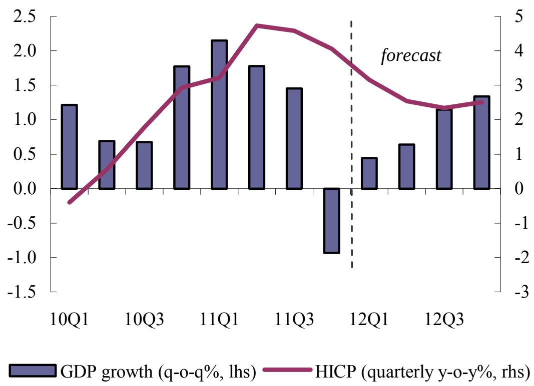
The strong growth in 2011 was initially driven by strong external demand. Substantial nominal wage declines and productivity improvements helped improve competitiveness and Lithuania took full advantage of the growing export markets. Rising exports boosted corporate profitability and contributed to improvements on the labour market. Consequently, private consumption and investment growth gained momentum, and domestic demand took over as the main driver of economic growth. However, at the end of the year, Lithuania started to feel the repercussions of the slowdown in the EU. In the last quarter of 2011, real GDP grew by 4.5% y-o-y, down from 7.3% in the third quarter.

Increased uncertainty, as well as the bankruptcy of the domestic bank Snoras at the end of 2011, have dampened consumer confidence and business expectations. These factors are expected to continue to hold back private consumption and private investment in 2012. Moreover, the on-going fiscal consolidation may further curtail domestic consumption, while public investment will continue to grow due to the frontloading of EU co-financed projects. Against this background, unemployment is likely to remain high, especially among the youth, and skill mismatches have appeared in some sectors.

Lithuania's economic performance in 2012 will depend considerably on developments in its main export markets (Germany, Poland, Russia and the other two Baltic countries) and on prospects for the wider euro area. Robust export performance in 2011 started to wither at the end of the year. Exports are projected to remain weak in the first half of 2012, before picking up in the third quarter in line with the forecast for its trading partners. This, together with a resumption of growth in private consumption, will contribute to accelerating GDP growth in the second half of 2012.

HICP inflation decreased at the end of 2011 to reach an annual average of 4.1%, after accelerating in the middle of the year, driven mainly by the energy and food – although commodity prices declined towards the end of 2011. Inflation is forecast to decelerate to 2.6% in 2012, mainly driven by lower commodity and food prices as well as weakening domestic demand. Some domestic factors, such as rising electricity and heating prices, as well as excise taxes on tobacco products, will provide limited upward pressure on inflation. Due to expected moderate wage growth and still high unemployment, overall domestic price pressures will remain rather weak.

Graph 15.1: **Lithuania - GDP growth and inflation**



16. LUXEMBOURG

GDP growth for 2011 has been revised down to 1.1% from 1.6% projected in the autumn 2011 forecast. A strong downward revision of quarterly growth in the second quarter of 2011 has only partially been compensated by a strong third quarter. As a consequence, the most recent data show an increase in GDP of only 1.1% over the first three quarters of 2011, mainly reflecting developments in domestic demand. The general weakening of global activity and the sovereign-debt crisis in the euro area have weighed on exports, especially on the performance of the important financial sector. Witnessing the further deterioration of indicators in the fourth quarter, a small contraction of 0.1% of the Luxembourg economy in the last quarter of 2011 cannot be excluded.

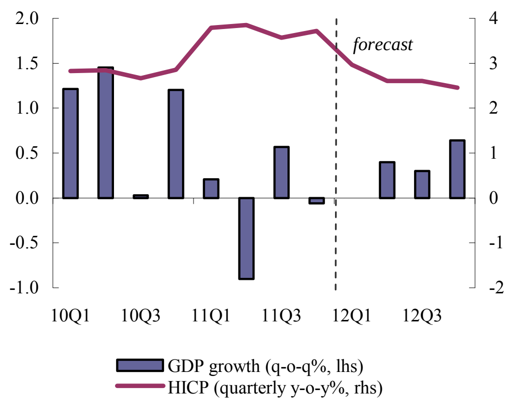
Since December 2011, there have been some signs of stabilisation. Consumer confidence improved after a two-year low had been reached in October. An improving international environment should contribute to a slow return to recovery during 2012. With the carry-over from 2011 expected to be close to zero and manufacturing and financial services contributing little to growth, overall growth in 2012 is now forecast to be around 0.7%. This has been revised down from 1.0% projected in the autumn forecast as the recovery is now only expected to materialise from the second quarter and to be less intense. Private consumption, which is estimated to have been rather weak in 2011, is expected to accelerate only a little in 2012. On the other hand, the number of building permits delivered in 2011 points to a strong performance by the construction sector in 2012, although the winter weather may affect figures for the first quarter of the year.

Job creation in Luxembourg was substantial in the first half of 2011 but slowed down afterwards. As a consequence, unemployment rose rapidly towards the end of the year (it increased from 4.9% in October to 5.2% in December). This trend is expected to continue over 2012, steering unemployment towards a historic high. In 2011, non-resident employment has grown faster than resident employment, but the difference is much smaller than in the ten years preceding the crisis.

On 1 October 2011, all wages in Luxembourg were automatically increased by 2.5% following the postponed application of the wage indexation mechanism, which was originally due in May 2011. At the end of 2011, the government of Luxembourg also decided to postpone the next automatic indexation, normally due in March 2012, to October 2012. As a consequence, wage increases in 2012 induced by the indexation mechanism will only be 2.5% instead of 4% without the postponement. Thus, wages per employee are expected to rise by 3.2%. This would result in an increase in (nominal) unit labour costs in 2012, given the small increase in output and even a negative evolution in terms of added value per employee.

Inflation (measured by the HICP) reached 3.7% in 2011, up from 2.8% in 2010. It has been driven upward by rising oil prices and price increases of other raw materials. Increases in administered prices contributed as well. Inflation is expected to slow to 2.7% in 2012. This figure is higher than in the autumn 2011 forecast due to oil prices remaining at a high level rather than decreasing moderately. The postponement of the automatic indexation of wages will result in a somewhat lower inflation for services compared to the autumn forecast. The National Index of Consumer Prices (NICP), which has a lower weight for oil products, is expected to fall from 3.4% in 2011 to 2.4% in 2012.

Graph 16.1: **Luxembourg - GDP growth and inflation**



17. HUNGARY

Growth in 2011 continued to be driven exclusively by the external balance, with the export sector performing well although losing momentum towards the end of the year against the backdrop of a weakening external environment. Domestic demand remained firmly in negative territory, although the pace of contraction slowed. Household consumption did not take off in light of uncertainties, high unemployment and the impact of the significant exchange rate depreciation against the Swiss franc on private indebtedness. The uncertainty of the policy environment, the weak economic conditions and credit supply constraints also contributed to the continued contraction of gross fixed capital formation.

However, the latest available data indicates that the Hungarian economy proved more resilient in the second half of 2011 than anticipated at the time of the autumn forecast. The implications for economic growth in 2012 are uncertain: the expansion of agricultural output contributed to lifting GDP growth in 2011, but as this was against the background of poor performance in 2010, such a strong rate of growth is unlikely to be repeated in 2012.

The external environment is worse than that expected in the autumn forecast, with Hungary's largest export markets growing at a lower rate. This has appreciable implications for economic growth prospects, since Hungary is a very open economy with exports amounting to 87% of GDP. The recent bankruptcy of the national airline carrier, Malév, will also dampen exports of services and raise imports, although the value the company added to Hungarian GDP was limited. At the same time, the Mercedes automobile factory appears on track to start production in the first half of 2012, helping Hungary gain market share as expected in the autumn forecast.

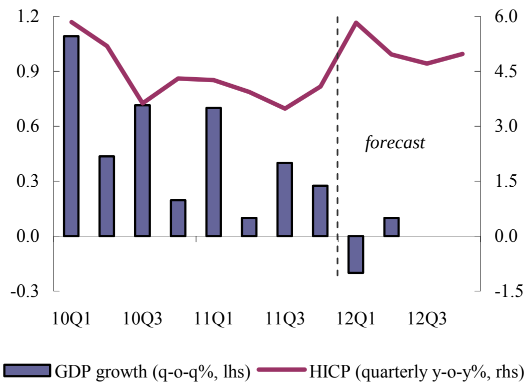
Domestic demand will be affected from the first quarter by fiscal austerity, which results in part from the need to correct for the loss of revenues from the large overall tax cuts, whose impact on the headline deficit in 2011 was obscured by the transfer of private pension fund assets to the state pillar. Employment prospects are also somewhat more negative than expected in the autumn, with consequent implications for household consumption.

On the other hand, on 15 December 2011 the government and the Banking Association signed an agreement that improved on the government's original plan, allowing the early repayment of foreign-currency denominated mortgages at discounted rates. This agreement includes four pillars whose impact is likely to play out over various channels, including a cash-flow effect for FX mortgage holders. The overall effect of the early repayment scheme in combination with the December agreement is still negative for the financial sector and thus for credit supply, although less so than before as the public sector will now share part of the cost. The wage compensation schemes that have meanwhile been specified also imply a smaller-than-expected burden on enterprises.

Overall, GDP growth is now expected to be near standstill in 2012, with some improvement after the first quarter of the year.

The pace of inflation will again rise in 2012 thanks in large part to increases in indirect taxes (including VAT, which at 27% is the highest rate in the EU) and higher-than-assumed oil prices. Other factors include the reduction in road maintenance subsidy, which is expected to raise transport prices due in part to the attendant increase in road toll fees. The inflation rate is now projected to average 5.1% in 2012 as a whole.

Graph 17.1: **Hungary - GDP growth and inflation**



18. MALTA

The Maltese economy rebounded relatively strongly after a mild contraction in real GDP in 2009, and the positive momentum was carried into 2011 as well. Buoyant private consumption, underpinned by healthy job creation and wage growth, as well as a strong performance by the tourist sector, were the main factors behind real GDP growth in the first half of 2011 and more than compensated for the relatively surprising weakness of business investment.

In the second half of 2011, however, the economy gradually lost steam. Private consumption growth slowed considerably in the third quarter, while annual export growth in volume terms turned negative for the first time since late 2009. The downward trend is expected to have continued in the final quarter of 2011, in line with the general slowdown in the euro area. Real GDP growth for 2011 as a whole is estimated at 2.1%, almost exclusively driven by net exports; this is unchanged from the autumn 2011 forecast.

The outlook for 2012 is relatively subdued. The latest consumer confidence indicators suggest that private consumption will remain weak. Households’ disposable income is expected to be squeezed by a significant deterioration in labour market conditions after the very strong employment gains recorded in 2011, while average wage growth is foreseen to remain below HICP inflation. Uncertainties about the domestic and international economic environment, coupled with cautious lending behaviour by banks, are likely to continue to dampen business investment, which is likely to contract for a second consecutive year. Against this background, domestic demand is expected to continue to contribute very modestly towards real GDP growth.

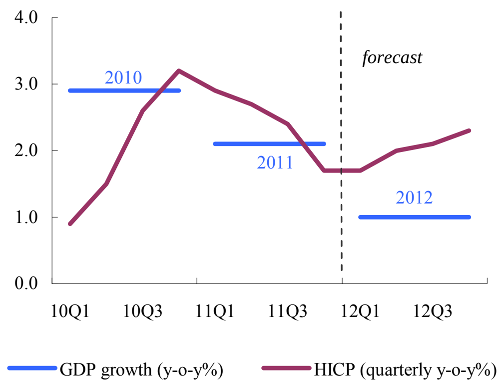
Net exports are again expected to be the main contributor to growth in 2012, but less significantly so than in 2011. Malta’s exports, in particular exports of goods, benefit from a relatively high share of trade with emerging markets but are nonetheless affected by the projected further slowdown of economic activity in the euro area compared to the autumn forecast, which would have a negative impact – especially on tourism exports. Nevertheless, exports are projected to continue to outpace the expansion of imports, which are restrained by the weakness of highly import-intensive domestic demand.

Overall, real GDP growth is forecast to decelerate to 1.0% in 2012, compared to the 1.3% projected in the autumn 2011 forecast. The downward revision primarily reflects the impact of the projected further slowdown in the euro area.

The forecast is subject to downside risks emanating from possible negative feedback loops between the very large banking system and the real economy in case of a further worsening of the quality of the credit portfolio, especially in view of the already elevated share of non-performing loans and high exposure to the real estate sector. In addition, the hit through the trade channel could be larger than anticipated, for instance because of the heavy reliance of the tourist sector on the euro-area market.

Annual HICP inflation moderated gradually in the course of 2011. In 2012, energy inflation is expected to decelerate significantly given the more moderate assumed growth in oil prices compared to 2011, coupled with the government's decision to keep utility tariffs unchanged for a second consecutive year. Overall HICP inflation in 2012 is projected at 2.1%, slightly lower than in 2011 and in line with the euro area average.

Graph 18.1: **Malta - GDP growth and inflation**



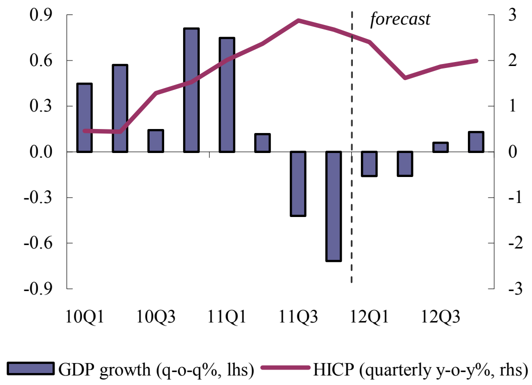
19. THE NETHERLANDS

In the second half of 2011 the Dutch economy experienced a sharp downturn, recording negative q-o-q growth of 0.4% in the third quarter and 0.7% in the fourth quarter, in and implying that the Netherlands is now in a recession. Both quarterly growth rates are significantly lower than the corresponding projections of 0.1% and 0.0% in the autumn 2011 forecast. This reflects a pronounced weakening of both internal and external demand. Consumer confidence, which was already markedly negative in the summer, deteriorated further at the end of 2011 and was at its lowest level since 2003 in January 2012. This was mirrored by a decrease in consumer spending in the second half of the year. House prices have fallen further and the number of transactions, whilst showing some recovery in December, has remained low. Producer confidence also stayed weak. This was reflected in the decrease of 1% (q-o-q) in industrial production in the manufacturing sector (excluding energy) in the fourth quarter of 2011. On the external side, Dutch exports have been adversely affected by the slowdown in global trade. Over 2011 as a whole 2011, GDP grew by at 1.2%, compared to an estimate of 1.8% in the autumn 2011 forecast.

For 2012, the outlook for growth remains subdued. Real GDP is projected to decrease by 0.9%, a marked deterioration compared to the autumn 2011 forecast, which projected modest positive growth of 0.5%. This is predominantly the result of a considerable negative carry-over, but also due to a slight downward revision of the quarterly growth profile projected for 2012. The Dutch economy is expected to record modest negative growth of 0.2% in both the first and second quarters. For the remainder of the year, a fragile and subdued recovery is envisaged, with quarter-on-quarter growth of 0.1% in the third and fourth quarter.

The growth rate of private consumption – already negative for four consecutive quarters in 2011 – is expected to remain negative in 2012, as a result of government consolidation measures, mainly affecting households, and negative wealth effects. The latter mainly emanate from falling prices in the housing market. On top of this, announced pension cuts as of 2013, along with the expectation of additional consolidation measures, may give rise to anticipatory behaviour by households in the form of precautionary savings. Investment is likely to remain weak, on the back of the weak growth outlook. While net exports are expected to remain the only component yielding a positive contribution to growth, they are likely to suffer from weakening external demand, mainly from the rest of the euro area. HICP inflation is expected to decline from 2.5% in 2011 to 2.0% on average in 2012, mainly as a result of subdued domestic demand.

Graph 19.1: **The Netherlands - GDP growth and inflation**



The risks associated with the baseline scenario are predominantly on the downside. These relate mainly to the global outlook, while domestic risks chiefly relate to a sustained and more severe fall in house prices and a worse-than-expected evolution of household disposable income.

20. AUSTRIA

The pace of the economic recovery held up remarkably well in 2011, with GDP expanding by 3.1% according to the Flash estimate. Quarter-on-quarter growth remained robust in the first half of the year, on the back of strong exports, investment and, not least, public consumption. However, the carry-over from 2010 accounted for more than half of the growth for 2011.

Economic activity is set to remain weak in the coming quarters. Corporations and households seem to be adopting an attitude of retrenchment with regard to consumption and investment outlays, setting the stage for only marginal growth throughout most of 2012.

Private consumption is likely to stay sluggish amid collapsing household confidence and stalling employment growth. The decline in unemployment came to a halt in the latter months of 2011 when the rate levelled off at around 4%. The recent wage negotiations have raised negotiated wages by 2.4% year on year on average as of January 2012. This limits the scope for sustaining the pace of employment gains during 2012. The overall impact of these counteracting trends on households' real disposable income is rather uncertain.

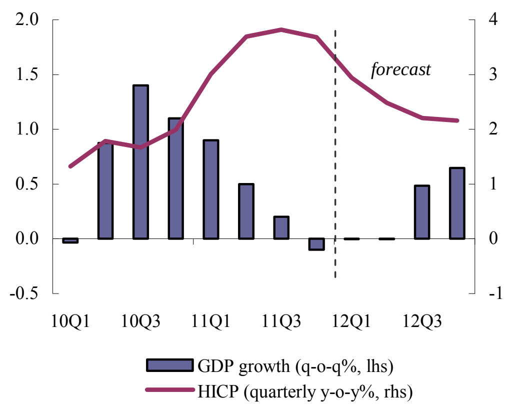
Manufacturers' order inflows and backlogs weakened throughout 2011 as did their expectations for exports. Indeed, firms have boosted their competitiveness by a renewal of capacity and by withholding productivity gains in the course of 2010 and early 2011. Their capacity to accommodate demands for wage increases has strengthened. However the outcomes of recent wage negotiations may put upward pressure on unit labour costs as the growth of output and productivity subside.

Financing conditions may tighten as banks focus on raising capital buffers and a further clean-up of balance sheets. Credit expansion, which had regained momentum since 2010 on the back of the economic recovery, is likely to tail off in the course of 2012. Credit demand from both companies and households has been shrinking of late, due to the uncertainties related to the economic outlook in Europe, while the renewed tightening of credit standards is expected to weigh additionally on credit activity in the coming months.

On the whole, the risk balance seems tilted on the downside. Upside risks are not as pronounced. On the external side, they stem from upbeat domestic demand in neighbouring Germany and possible direct or indirect benefits from still advancing import demand in emerging markets. Domestically, solid sentiment in the construction sector, together with sound corporate and household balance sheets, bode well for investment activity.

Driven by higher motor and heating fuel prices, as well as rising food prices, inflation averaged 3.8% in April-November 2011, but fell to 3.4% in December. Core inflation (HICP excluding energy and unprocessed food) has been affected by spillovers into prices in services, where the annual rate of change accelerated to a peak of 3.9% in August 2011. These effects are projected to disappear gradually, leading to a moderation of inflation in 2012. Wage growth is likely to remain contained, as the pace of economic expansion decelerates, although the translation of wage increases negotiated in various sectors into the effective wage level may well exert upward pressure on producer and consumer prices.

Graph 20.1: **Austria - GDP growth and inflation**



21. POLAND

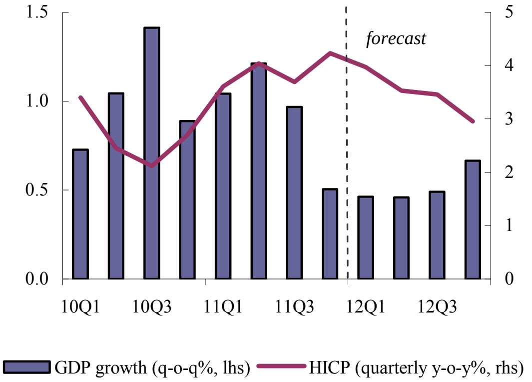
Economic activity decelerated in the last quarter of 2011, with real GDP growth expected at 0.5% q-o-q, down from 1% q-o-q in the previous quarter. The slowdown is attributed to lower private spending as consumer confidence deteriorated and the labour market worsened amid the gloomy external outlook.

For 2011 as a whole, real GDP is estimated by the national authorities to have grown by a healthy 4.3%. Growth was broad-based. Resilient consumer spending in the first half of the year benefited from supportive labour market developments and relatively upbeat consumer confidence. Public spending, as estimated by national authorities, shrank, reflecting the necessary consolidation effort. Better access to credit and increased profitability in the corporate sector, amid growing capacity utilisation levels, resulted in a strong rebound in private investment. Investment growth was further boosted by accelerated EU co-financed infrastructure spending. Moreover, the external trade balance turned positive fuelled by substantial currency depreciation in the second half of the year.

Real GDP is projected to increase by 2.5% in 2012, with quarterly real GDP growth stabilising at around 0.5% q-o-q over the year. Private consumption growth is likely to be muted, as consumer confidence and the labour market situation are set to deteriorate. Moreover, recent changes in non-tax labour costs and frozen nominal wages in public administration are likely to dampen wage growth, with inflation eroding purchasing power. Public spending is set to grow only marginally, on the back of stringent expenditure control.

Investment spending growth is expected to remain robust, supported by accelerating private investment. The corporate sector is likely to continue to increase capacity, financed by intensifying inflows of foreign capital, retained earnings and growing corporate credit. Robust public spending in infrastructure, driven by the completion of major motorway interconnections ahead of the Euro 2012 football championship, is set to support overall growth in gross fixed capital formation. However, inventory build-up is likely to become less supportive after a positive contribution to growth in 2011. The external trade balance is likely to be a major growth driver, as Polish enterprises are set to continue to benefit from a depreciated currency and the favourable sectoral structure of exports, whereas slowing domestic demand is expected to dampen imports growth.

Graph 21.1: **Poland - GDP growth and inflation**



Average HICP inflation reached 3.9% y-o-y in 2011, on the back of a VAT rate hike, rising commodity prices and a depreciating currency. After a temporary slowdown in the third quarter of 2011 inflation accelerated due to commodity price developments and reached 4.5% in December 2011. It is expected to steadily fall to around 3% at the end of 2012, on the back of stabilising fuel and food prices, inflation-decreasing base effects and weakening domestic demand. Taking into account the higher level at the start of the year, average inflation is, however, projected to reach 3.5% in 2012.

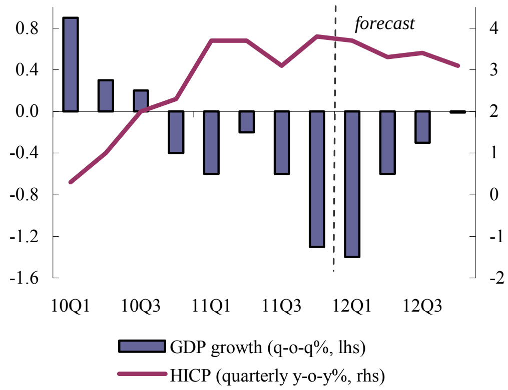
22. PORTUGAL

Real GDP contracted by 1.5% in 2011, which is 0.4 pp. less than anticipated in the autumn 2011 forecast. Preliminary data released by the national statistics institute suggest that the main reasons for this better-than-expected performance were a smaller fall in private consumption due to some consumption smoothing, as households reduced their savings to compensate for the strong fall in real disposable income, and more dynamic export growth. However, the decline in economic activity accelerated in the final quarter of 2011, with an estimated fall in real GDP of 1.3% q-o-q, following a contraction of 0.6% in the third quarter of 2011. Employment recorded a very strong decrease in the final quarter of last year, pushing the unemployment rate up to almost 14%, markedly higher than in the previous quarter. This is expected to have taken its toll on private consumption. Furthermore, trade statistics suggest that external trade recorded a strong growth contribution in the final quarter of 2011 due to a slump in import demand and relatively strong exports. However, exports decelerated markedly in December, in line with the deteriorating economic environment in Europe.

Developments in 2012 will be marked by additional fiscal consolidation efforts and accelerated deleveraging in the household and corporate sectors. Exports are predicted to suffer from a further deceleration in external demand for Portuguese products in the first semester. Moreover, credit and financial market conditions are projected to remain tight. Meanwhile, confidence indicators have reached lows across the board, although consumer and service sector confidence have recently stabilised somewhat. Private investment, especially in the construction sector, is expected to continue its decade-long decline, due in part to an expected further tightening of credit supply by banks. Furthermore, the deterioration of the economic environment in the euro area should impact on the outlook for Portuguese exports. While external trade is still expected to make a significant contribution to economic growth this year, it is not expected to offset the negative growth contribution of domestic demand. As a consequence, real GDP is now forecast to decline by 3.3% in this year, ¼ pp. lower than assumed in the autumn 2011 forecast.

HICP inflation was 3.6% in 2011, mainly due to a series of increases in indirect taxes and administered prices as well as higher oil prices. Price developments are also expected to be marked by fiscal measures in 2012, while wage restraint in a weak labour market environment should ease inflationary pressure. In 2012, HICP inflation is forecast to reach 3.3%. Employment is expected to shrink further, in line with the ongoing decline in economic activity, with a concomitant rise in unemployment.

Graph 22.1: **Portugal - GDP growth and inflation**



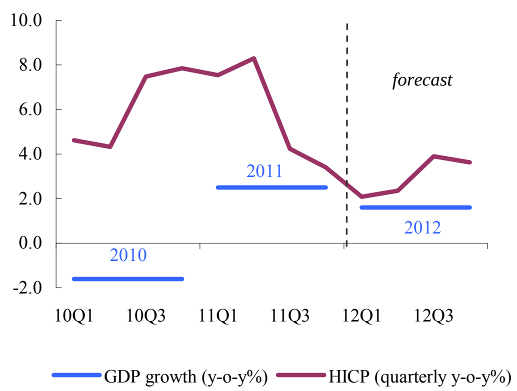
23. ROMANIA

After two years of negative readings, growth resumed in 2011, when real GDP is estimated to have grown by 2.5%. Growth was mainly driven by external demand in the first half of 2011 and an exceptional agricultural harvest in the second half. The latter is also expected to have positively affected exports in the third and fourth quarter of 2011. Industrial production growth was strong in the first half of 2011, responding to external demand, but has recently weakened on account of the slowdown in export markets. Construction output continued to increase in the last quarter of 2011, following from a rebound in the previous quarter. On the demand side, net exports were the key driver for growth in the first half of 2011, but their contribution to growth faded in the second half of the year. In 2011, private consumption did not pick up as strongly as initially projected, being held back by weak household balance sheets. Following a comprehensive Labour Code reform implemented in May 2011, the Romanian labour market improved last year; registered unemployment is around 5% and the labour force survey figures stabilised at an unemployment rate of around 7%. For the first time since the recession started, in the third quarter of 2011 investments increased by 15.3% (y-o-y) with increases in all its components.

For 2012, GDP growth has been revised downwards to 1.6% from 2.1% in the last autumn's forecast. This revision is mainly due to the negative effect on growth stemming from continuing uncertainties in the financial markets and the euro-area sovereign-debt developments. Romania's exports to the rest of the EU (70% of the country's exports) will be less dynamic and should provide less support to growth. Domestic demand is projected to be the main driver of growth in 2012. Although consumers are expected to continue their balance-sheets adjustment in the first half of 2012, the forecast improvement in employment and lower inflation should support income and thus contribute to a revival of private consumption in the second half of 2012. Government consumption is not expected to contribute much to growth in 2012, as it is constrained by the continued fiscal consolidation. However, public investment, supported by an anticipated improvement in the absorption of EU funds, is expected to play a key role in 2012. Private investment is likely to be weaker than anticipated on account of increased domestic and global uncertainty and therefore some investments planned for early 2012 are likely to be delayed to the second half of 2012 or 2013.

Risks to the 2012 growth forecast are tilted to the downside. Downside risks include: (i) possible continuing uncertainties in financial markets and sovereign-debt developments in the euro-area periphery that would weigh on Romania's growth; (ii) possible additional needs for repairing household balance sheets, coupled with tighter credit standards for lending, which may result in lower-than-expected private consumption. Upside risks include: (i) a potentially stronger contribution of investment than foreseen in the baseline in case of a significant improvement in the absorption of EU funds in 2012; and (ii) a potentially stronger contribution of domestic demand linked to possible pre-electoral fiscal slippages.

Graph 23.1: **Romania - GDP growth and inflation**



Inflation, which has been running high for a prolonged period (and was still above 8% in the second quarter of 2011), came down sharply in summer 2011 because of easing food prices and base effects linked to the VAT hike in 2010. End-year inflation was very close to the NBR's target range of 3.0% ±1 pp. Inflation is expected to further decline in the first half of 2012, before increasing again in the second half, but still staying within the NBR's target range. Over the medium term, risks to the inflation outlook appear skewed to the upside due to the need to deregulate energy markets and further hikes in other administered prices.

24. SLOVENIA

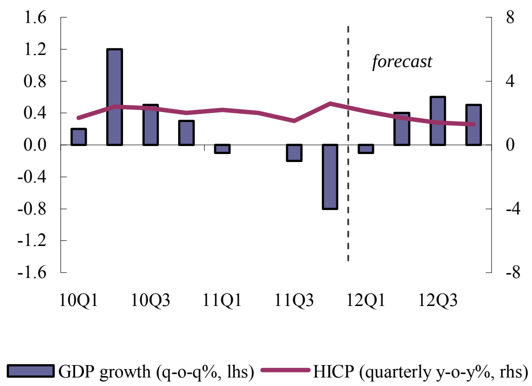
The international slowdown is hitting Slovenia through the trade channel – as it did in 2009 – but this time against a backdrop of already depressed domestic demand. A prolonged, shallow recession is in fact probably already in progress. The real GDP growth outturn in the third quarter of 2011 was slightly negative and a steeper decline is expected in the fourth quarter. Positive, but still subdued, growth is forecast to return only from the second quarter of 2012 onwards.

Real GDP growth for 2011 and 2012 as a whole has been revised downwards compared to the autumn 2011 forecast due to four factors: i) the unexpected negative outturn for real GDP growth in the third quarter of 2011; ii) substantial downward revisions to the outturns of previous quarters; iii) the worsened external environment; and finally iv) a flatter profile of construction investment.

Domestic demand was very weak in 2011, as squeezed household incomes and precautionary savings kept real consumption flat while the continued correction in construction caused gross fixed capital formation to fall precipitously. Against this backdrop, many domestically-oriented companies struggled to service debts and there were notable corporate bankruptcies, particularly in the construction sector. As a result, banks were hit by substantial further losses on their loan portfolios and credit growth remained negative. As in 2010, however, the drag on economic activity from domestic demand was more than offset by net exports and inventory accumulation; as a result, real GDP is estimated to have expanded by 0.3%.

A weak labour market is expected for 2012, resulting in shrinking real private consumption, but the overall drag from domestic demand is likely to lessen as conditions in the construction sector are expected to gradually stabilise. However, Slovenia's trade linkages leave it exposed to the worsening external environment, particularly as regards the sharp slowdown in key euro area trading partners. Export growth is thus expected to slow substantially. With lacklustre external demand compounding the pre-existing weak domestic demand, firms and banks are expected to pare back their investment plans. Overall, the lift from net exports would fail to exceed even the diminished drag from domestic demand in 2012, leading to a marginal contraction in real GDP of 0.1%. These trends imply the return of an external surplus in 2012.

Graph 24.1: **Slovenia - GDP growth and inflation**



HICP inflation is forecast to remain below the euro-area average, reaching 1.6% in 2012. On the one hand, weak domestic demand is expected to keep the prices of services in check. On the other hand, commodity price inflation is expected to ease. In this regard, Slovenia's excise duty policy delays and smoothes the inflationary impact of world oil price movements.

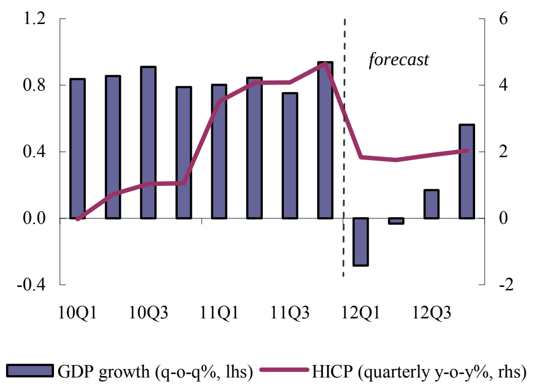
The real GDP growth forecast is subject to several downside risks. A greater-than-anticipated trade shock could cancel out the positive contribution to growth from net exports. An intensification of negative feedback loops between deleveraging banks and the credit-constrained real economy could bring further bankruptcies and a more severe retrenchment of investment. A sharp fall in house prices, which cannot be excluded given the absence of significant adjustment to date, would have wide-ranging effects that are difficult to assess ex ante. Finally, gross fixed capital formation could shrink still further if the correction in construction investment leads to significant undershooting.

25. SLOVAKIA

After rebounding in 2010, the Slovak economy continued to grow in 2011. The flash estimate for GDP suggests a strong fourth quarter, with q-o-q real growth at 0.9%, slightly higher than expected in the autumn forecast and leading to growth of about 3.3% y-o-y. Driven by growth in exports in durable manufacturing goods, economic activity strengthened throughout the year, despite the clear signs of distress in global financial markets that emerged during the summer.

However, recent high-frequency indicators on industrial production, construction and new orders point to a slowdown at the turn of the year, mostly in response to signs of deterioration in the regional economic outlook. With nearly four-fifths of total exports directed towards the single European market and with growth largely dependent on external demand, the outlook for 2012 largely reflects the economic prospects of Slovakia's main trading partners. Given the weaker outlook for the euro area, real GDP growth is expected to slow to 1.2% in 2012. This takes into account a sizeable carry-over effect from the previous year and a gradual pick-up in economic activity towards the end of 2012.

Graph 25.1: **Slovakia - GDP growth and inflation**



Despite positive employment data, especially in the earlier part of the year, real disposable income of households failed to pick-up in 2011 due to moderate nominal wage growth, a strong rebound in consumer prices and the effects of a significant consolidation effort largely based on a sizeable reduction in the public sector wage bill, on broadening of the base for the personal income tax and social contributions and a 1 pp. increase in the VAT standard rate. Accordingly, private consumption stagnated in 2011 for a third consecutive year and is expected to remain weak in 2012, given low and still deteriorating consumer confidence. Reflecting uncertainty concerning the economic environment, business confidence indicators point to cautious decisions on private investment projects, many of which are expected to be put on hold in 2012.

After two years of historically low inflation below 1%, HICP inflation spiked at 4.1% in 2011 on the back of a steep increase in energy and commodity prices, adjustments in regulated prices and increases in some excises and indirect taxes, notably the VAT standard rate. In 2012, overall HICP inflation is forecast to slow to 1.9% also reflecting a significant base effect and weak wage pressures in the context of a sluggish labour market.

Apart from risks stemming from the external environment, a sharper-than-expected deterioration of the labour market during the slowdown represents a negative risk to the forecast. An eventual resumption in major investment projects in transport infrastructure represents a positive domestic risk.

26. FINLAND

Following a strong recovery in 2010, with GDP expanding by 3.7%, the Finnish economy continued to grow in the first three quarters of 2011. However, according to the latest Statistics Finland data, economic activity appears to have slowed down significantly in the in the last quarter of 2011. Whereas growth was still projected at 3.1% in the autumn 2011 forecast, latest developments have led to a downward revision to 2.7% for 2011 as a whole. While growth dynamics for 2012 were already expected to lessen in the autumn to about 1.4%, the worsening outlook implies markedly weaker, but still positive, growth at 0.8%.

The slowdown in growth comes mainly from a decline in net exports on the back of the global economic slowdown as well as diminishing export capacity linked to on-going structural changes within some of the main Finnish industries. The observed decrease in exports in 2011 is set to continue into 2012 due to the expected slowdown in growth of the main trading partners.

In contrast, domestic demand has held up rather well in 2011 and is expected to support economic activity in 2012 also. Private consumption expenditure was strong in 2011. The volume of retail trade sales was up 2.3% on the previous year. Consumption is expected to contribute positively to growth in 2012 also, as employment remains at an elevated level and wage growth, which is settled by multiannual collective agreements, is set to remain relatively robust.

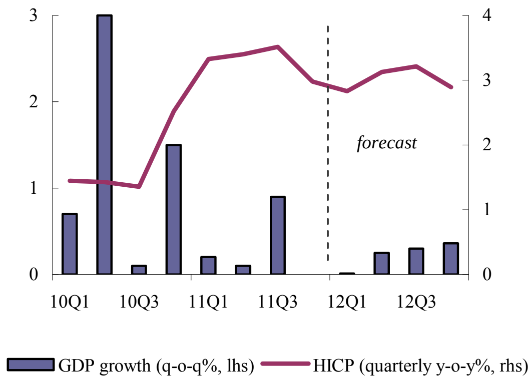
This is not to say that Finland will also escape the effects of the downturn in terms of private consumption. While unemployment continued to decline in 2011, some worsening has to be expected in 2012. Also, consumer confidence fell rapidly over the course of 2011, possibly indicating lower demand in the future.

While investment is also expected to deteriorate, on balance, it is likely to retain a positive impact on growth. It could be upheld by replacement investment needs after low levels encountered in 2009 and 2010.

Inflation decreased, in line with expectations, in the fourth quarter of 2011. However, in early 2012 increases in indirect taxes were introduced and they are set to contribute to somewhat higher inflation in the beginning of 2012. However, as the base effects from the commodity price rises in 2011 come into play, HICP inflation is nevertheless forecast to decline from the peak of 3.3% in 2011 to 2.5% in 2012.

Taking into account the high share of investment and intermediate goods in Finnish exports, the economy faces further downside risks if the lack of confidence in global markets results in a significant reduction of global investments, reducing the demand for Finnish exports.

Graph 26.1: **Finland - GDP growth and inflation**



27. SWEDEN

The Swedish economy recovered strongly from the 2008/09 recession with annual real GDP growth reaching 5.6% in 2010 and quarterly rates of 1% on average in the first three quarters of 2011. Growth in the third quarter, however, was held up by a large contribution from net trade, which weakened significantly in the final months of 2011. Retail sales continued to be very subdued, making the annual retail growth rate of 0.8% in 2011 the worst since 1996. Industrial production fell by 1.1% in the fourth quarter and services production ended the year with stagnation. Business confidence continued to fall and finished the year clearly below its long-term average. Overall, GDP is estimated to have contracted in the fourth quarter, yielding an estimated annual growth rate of 4.2% in 2011.

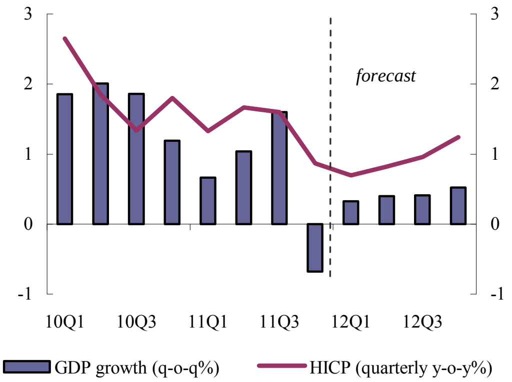
Although some of the negative momentum from the end of 2011 is expected to spill over into early 2012, a few indicators point to a return to positive economic growth already in early 2012. Consumer confidence rebounded noticeably in January as did the main index on the Stockholm stock exchange. Business surveys indicate that manufacturing companies expect new orders to pick up in the first quarter of 2012. With inflation expected to be low, the wage agreements signed last autumn should also provide some real income gains this year.

However, the recovery is expected to be subdued and relatively fragile. With low capacity utilization, slow demand growth and a stronger krona, corporate investment plans have been put on hold and companies are revising down hiring plans. This is expected to lead to only very limited employment growth in 2012. Together with a weakening housing market and only limited support from fiscal and monetary policy, household consumption is expected to remain sluggish throughout 2012. Overall, GDP growth is forecast to reach only 0.7% in 2012, with domestic demand providing a positive GDP growth contribution and net trade having a neutral impact.

A particular risk relates to household consumption. On the one hand, should consumer confidence continue to improve, households could reduce the currently high household saving rate, which would boost demand. On the other hand, a softening housing market and high household indebtedness could lead households to focus on deleveraging, with adverse effects on consumption.

HICP inflation is expected to decrease from 1.4% in 2011 to 0.9% in 2012. This slowdown is mainly due to a stable commodity prices outlook and strong carry-over effects from the last quarter of 2011, when actual inflation dropped much more than expected across most categories of the consumer basket. Although the ongoing wage bargaining round has so far resulted in moderate wage increases (corresponding to 2.4% growth over a year), the expected productivity dip in 2012 is likely to raise unit labour costs significantly. Underlying inflation is expected to remain subdued throughout 2012, however, with low demand and capacity utilisation restraining the inflationary impact of higher unit labour costs. In the second half of the year, as the recovery gains some traction and employment growth resumes, cost pressures are expected to re-emerge and inflation to pick up gradually. The continuation of the krona appreciation from late 2011 represents a downside risk to the inflation forecast.

Graph 27.1: **Sweden - GDP growth and inflation**



28. THE UNITED KINGDOM

Annual UK GDP growth for 2011 is estimated to have been 0.9%, slightly higher than the Commission's autumn forecast of 0.7%. In 2011, growth was largely driven by external demand as domestic disposable income was squeezed by a combination of high inflation, tax rises and low nominal wage growth. After remaining relatively stable through 2010, the unemployment rate rose throughout 2011, from 7.7% in the first quarter to 8.4% in the fourth quarter – the highest level since 1995.

Following stronger-than-expected growth of 0.6% in the third quarter, the UK economy contracted by 0.2% in the final quarter of 2011. The contraction observed in the fourth quarter was driven by the industrial (-1.2%) and construction (-0.5%) sectors. The activity level in the services sector remained unchanged. Economic confidence indicators also saw a broad-based fall in late 2011, linked in part to concern about developments in external markets.

However since the beginning of 2012, UK coincident and leading indicators have improved significantly. Rising unemployment will hold back private consumption growth, especially early in the year, and nominal wage growth is likely to remain subdued. A sustained fall in inflation should however lessen the squeeze on real disposable incomes and allow private consumption to stabilise in the second half of the year. Tight credit conditions are also expected to constrain internal demand. Nonetheless, investment is expected to start increasing in the second half of 2012, from a low base.

Thus, the UK economy may narrowly avoid recession and quarterly GDP growth is projected at 0.1% in each of the first two quarters of 2012. Later, a modest pick-up in growth is forecast, aided by the London Olympics, to give annual GDP growth of 0.6% in 2012, unchanged from the Commission's autumn forecast.

External demand is again expected to be the strongest driver of GDP growth in 2012. The main downside risk to the forecast is weaker growth in the UK's main export markets, particularly the euro area, as well as further negative effects on confidence from a protraction of the European sovereign-debt crisis.

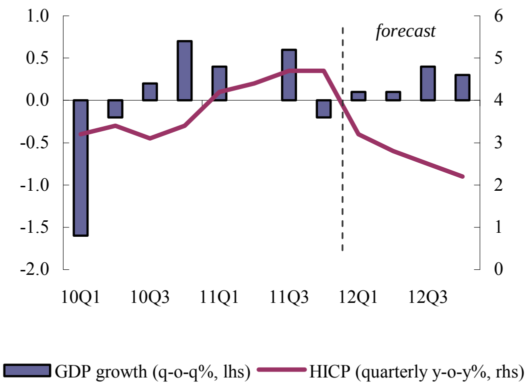
Inflation is expected to fall rapidly in 2012 to 2.7%, after having reached a peak of 5.2% y-o-y in September 2011 – the highest value since the introduction of the HICP in 1997.

The latest figures show a drop to 3.6% in January which should continue during the first quarter, as the January 2011 2.5 pp. VAT rate rise drops out of the calculations. The pass-through of the VAT increase was incomplete and gradual last year. As such, the VAT rise should continue to drop out of the calculations over the course of the first quarter.

Inflation expectations of both business and households are significantly lower than in 2011. The fall in inflation should be sustained throughout the year due to subdued internal demand and price stability in energy, oil and other categories. The large upward pressure that energy prices placed on inflation in 2011 has now subsided. Electricity and gas prices are expected to fall in the second half of 2012, with price cuts in the pipeline for most utility companies. Additionally, the modest appreciation of sterling in trade-weighted terms should help contain import prices.

These aspects were already broadly factored into the autumn forecast; hence the 2012 forecast has only been revised slightly down by 0.2 pp. to 2.7%.

Graph 28.1: **United Kingdom - GDP growth and inflation**



ANNEX

TABLE 1: Gross domestic product, volume (percentage change on preceding year, 1992-2012) 15.02.2012

	5-year averages								February 2012 forecast		*Autumn 2011 forecast*	
	1992-96	1997-01	2002-06	2006	2007	2008	2009	2010	2011	2012	*2011*	*2012*
Belgium	1.5	2.7	2.0	2.7	2.9	1.0	-2.8	2.3	**1.9**	**-0.1**	*2.2*	*0.9*
Germany	1.2	2.0	1.0	3.7	3.3	1.1	-5.1	3.7	**3.0**	**0.6**	*2.9*	*0.8*
Estonia	:	7.6	7.9	10.1	7.5	-3.7	-14.3	2.3	**7.5**	**1.2**	*8.0*	*3.2*
Ireland	6.5	8.5	5.0	5.3	5.2	-3.0	-7.0	-0.4	**0.9**	**0.5**	*1.1*	*1.1*
Greece	1.1	3.8	4.3	5.5	3.0	-0.2	-3.2	-3.5	**-6.8**	**-4.4**	*-5.5*	*-2.8*
Spain	1.5	4.4	3.3	4.1	3.5	0.9	-3.7	-0.1	**0.7**	**-1.0**	*0.7*	*0.7*
France	1.2	2.9	1.7	2.5	2.3	-0.1	-2.7	1.5	**1.7**	**0.4**	*1.6*	*0.6*
Italy	1.2	2.1	1.0	2.2	1.7	-1.2	-5.1	1.5	**0.2**	**-1.3**	*0.5*	*0.1*
Cyprus	5.5	4.2	3.2	4.1	5.1	3.6	-1.9	1.1	**0.5**	**-0.5**	*0.3*	*0.0*
Luxembourg	2.6	6.3	4.1	5.0	6.6	0.8	-5.3	2.7	**1.1**	**0.7**	*1.6*	*1.0*
Malta	5.0	3.4	1.8	2.8	4.3	4.3	-2.6	2.9	**2.1**	**1.0**	*2.1*	*1.3*
Netherlands	2.5	3.7	1.6	3.4	3.9	1.8	-3.5	1.7	**1.2**	**-0.9**	*1.8*	*0.5*
Austria	1.9	2.8	2.2	3.7	3.7	1.4	-3.8	2.3	**3.1**	**0.7**	*2.9*	*0.9*
Portugal	2.0	3.9	0.7	1.4	2.4	0.0	-2.9	1.4	**-1.5**	**-3.3**	*-1.9*	*-3.0*
Slovenia	2.0	4.2	4.2	5.8	6.9	3.6	-8.0	1.4	**0.3**	**-0.1**	*1.1*	*1.0*
Slovakia	:	2.7	5.9	8.3	10.5	5.9	-4.9	4.2	**3.3**	**1.2**	*2.9*	*1.1*
Finland	1.3	4.5	3.1	4.4	5.3	0.3	-8.4	3.7	**2.7**	**0.8**	*3.1*	*1.4*
Euro area	1.5	2.8	1.8	3.3	3.0	0.4	-4.3	1.9	**1.4**	**-0.3**	*1.5*	*0.5*
Bulgaria	-2.8	2.5	6.0	6.5	6.4	6.2	-5.5	0.2	**1.8**	**1.4**	*2.2*	*2.3*
Czech Republic	2.4	1.6	4.9	7.0	5.7	3.1	-4.7	2.7	**1.7**	**0.0**	*1.8*	*0.7*
Denmark	2.6	2.4	1.8	3.4	1.6	-0.8	-5.8	1.3	**1.0**	**1.1**	*1.2*	*1.4*
Latvia	-8.8	6.0	9.0	11.2	9.6	-3.3	-17.7	-0.3	**5.3**	**2.1**	*4.5*	*2.5*
Lithuania	-8.3	4.8	8.0	7.8	9.8	2.9	-14.8	1.4	**5.8**	**2.3**	*6.1*	*3.4*
Hungary	0.4	3.7	4.2	3.9	0.1	0.9	-6.8	1.3	**1.7**	**-0.1**	*1.4*	*0.5*
Poland	4.9	4.4	4.1	6.2	6.8	5.1	1.6	3.9	**4.3**	**2.5**	*4.0*	*2.5*
Romania	1.3	-0.1	6.2	7.9	6.3	7.3	-6.6	-1.6	**2.5**	**1.6**	*1.7*	*2.1*
Sweden	1.2	3.4	3.3	4.3	3.3	-0.6	-5.2	5.6	**4.2**	**0.7**	*4.0*	*1.4*
United Kingdom	2.5	3.7	2.8	2.6	3.5	-1.1	-4.4	2.1	**0.9**	**0.6**	*0.7*	*0.6*
EU	1.3	3.0	2.1	3.3	3.2	0.3	-4.3	2.0	**1.5**	**0.0**	*1.6*	*0.6*

TABLE 2: Profiles (qoq) of quarterly GDP, volume (percentage change from previous quarter, 2010-12)

	2010/1	2010/2	2010/3	2010/4	2011/1	2011/2	2011/3	2011/4	2012/1	2012/2	2012/3	2012/4
Belgium	0.1	1.1	0.4	0.5	0.9	0.3	-0.1	-0.2	-0.1	0.0	0.1	0.3
Germany	0.5	1.9	0.8	0.5	1.3	0.3	0.6	-0.2	0.1	0.2	0.5	0.4
Estonia	0.0	2.6	0.9	2.8	2.9	1.3	1.0	-0.8	-0.2	0.2	1.1	1.1
Ireland	1.5	-0.5	0.4	-1.4	1.8	1.4	-1.9	:	:	:	:	:
Greece	:	:	:	:	:	:	:	:	:	:	:	:
Spain	0.2	0.3	0.1	0.2	0.4	0.2	0.0	-0.3	-0.7	-0.3	-0.1	0.0
France	0.1	0.5	0.4	0.3	0.9	-0.1	0.3	0.2	-0.1	0.0	0.2	0.2
Italy	0.8	0.4	0.3	0.0	0.1	0.3	-0.2	-0.7	-0.7	-0.2	0.0	0.0
Cyprus	1.0	0.4	1.1	0.1	-0.1	0.3	-0.8	0.0	-0.7	-0.6	0.6	0.8
Luxembourg	1.2	1.5	0.0	1.2	0.2	-0.9	0.6	-0.1	0.0	0.4	0.3	0.6
Malta	1.0	-0.1	0.3	2.0	-0.3	0.4	0.3	:	:	:	:	:
Netherlands	0.4	0.6	0.1	0.8	0.7	0.1	-0.4	-0.7	-0.2	-0.2	0.1	0.1
Austria	0.1	0.8	1.4	1.1	0.9	0.5	0.2	-0.1	0.0	0.0	0.5	0.6
Portugal	0.9	0.3	0.2	-0.4	-0.6	-0.2	-0.6	-1.3	-1.4	-0.6	-0.3	0.0
Slovenia	0.2	1.2	0.5	0.3	-0.1	0.0	-0.2	-0.8	-0.1	0.4	0.6	0.5
Slovakia	0.8	0.9	0.9	0.8	0.8	0.8	0.8	0.9	-0.3	0.0	0.2	0.6
Finland	0.7	3.0	0.1	1.5	0.2	0.1	0.9	0.0	0.0	0.3	0.3	0.4
Euro area	0.4	0.9	0.4	0.3	0.8	0.2	0.1	-0.3	-0.3	0.0	0.2	0.2
Bulgaria	0.9	1.6	0.7	0.5	0.5	0.3	0.3	0.4	0.0	0.4	1.3	0.9
Czech Republic	0.7	1.0	0.7	0.6	0.6	0.2	-0.1	-0.3	-0.1	0.2	0.2	0.4
Denmark	0.0	1.5	1.1	-0.5	0.0	1.0	-0.5	0.3	0.3	0.4	0.6	0.6
Latvia	1.1	0.1	0.8	1.3	1.0	1.9	1.4	0.8	-0.3	0.3	0.6	0.7
Lithuania	1.2	0.7	0.7	1.8	2.1	1.8	1.5	-0.9	0.4	0.6	1.1	1.3
Hungary	1.1	0.4	0.7	0.3	0.7	0.1	0.4	0.3	-0.2	0.1	0.0	0.0
Poland	0.7	1.0	1.4	0.9	1.0	1.2	1.0	0.5	0.5	0.5	0.5	0.7
Romania	:	:	:	:	:	:	:	:	:	:	:	:
Sweden	1.9	2.0	1.9	1.2	0.7	1.0	1.6	-0.7	0.3	0.4	0.4	0.5
United Kingdom	0.4	1.1	0.7	-0.5	0.4	0.0	0.6	-0.2	0.1	0.1	0.4	0.3
EU	0.4	1.0	0.5	0.2	0.7	0.2	0.3	-0.3	-0.1	0.1	0.3	0.3

TABLE 3: Profiles (yoy) of quarterly GDP, volume (percentage change from corresponding quarter in previous year, 2010-12) 15.02.2012

	2010/1	2010/2	2010/3	2010/4	2011/1	2011/2	2011/3	2011/4	2012/1	2012/2	2012/3	2012/4
Belgium	1.9	2.9	2.1	2.1	2.9	2.1	1.6	0.9	-0.1	-0.4	-0.1	0.4
Germany	2.4	4.1	4.0	3.8	4.6	2.9	2.7	2.0	0.8	0.8	0.6	1.3
Estonia	-4.2	2.4	4.7	6.5	9.5	8.0	8.2	4.4	1.3	0.2	0.3	2.2
Ireland	-1.0	-0.8	0.1	0.0	0.2	2.1	-0.2	:	:	:	:	:
Greece	:	:	:	:	:	:	:	:	:	:	:	:
Spain	-1.3	0.0	0.4	0.7	0.9	0.8	0.8	0.3	-0.8	-1.2	-1.3	-0.9
France	1.0	1.5	1.6	1.4	2.2	1.6	1.5	1.4	0.3	0.4	0.3	0.3
Italy	1.0	1.6	1.5	1.6	1.0	0.8	0.3	-0.5	-1.3	-1.8	-1.6	-0.9
Cyprus	-1.0	0.8	2.3	2.5	1.5	1.4	-0.5	-0.5	-1.2	-2.0	-0.6	0.1
Luxembourg	0.6	4.3	2.0	3.9	2.9	0.5	1.1	-0.2	-0.4	0.9	0.6	1.3
Malta	3.7	2.8	2.1	3.1	1.8	2.4	2.4	:	:	:	:	:
Netherlands	0.5	2.4	1.7	2.0	2.3	1.8	1.3	-0.3	-1.2	-1.4	-1.0	-0.1
Austria	0.7	2.4	3.2	3.4	4.3	3.9	2.7	1.5	0.6	0.1	0.4	1.1
Portugal	1.7	1.6	1.3	1.0	-0.5	-1.0	-1.8	-2.7	-3.5	-3.9	-3.6	-2.3
Slovenia	-0.3	1.5	1.6	2.2	1.9	0.7	-0.1	-1.1	-1.2	-0.8	0.1	1.4
Slovakia	5.0	4.5	4.1	3.4	3.4	3.4	3.2	3.3	2.2	1.4	0.8	0.4
Finland	0.9	4.8	3.4	5.4	4.9	1.9	2.7	1.2	1.0	1.2	0.6	0.9
Euro area	1.0	2.1	2.1	2.0	2.4	1.6	1.3	0.7	-0.3	-0.5	-0.4	0.1
Bulgaria	-1.9	-0.4	0.0	3.7	3.3	2.0	1.6	1.5	1.0	1.1	2.1	2.6
Czech Republic	0.9	3.0	3.3	3.0	2.8	2.0	1.2	0.5	-0.3	-0.3	0.0	0.7
Denmark	-1.5	1.6	3.0	2.2	2.2	1.7	0.0	0.8	1.0	0.4	1.5	1.9
Latvia	-5.8	-4.6	3.2	3.3	3.2	5.1	5.7	5.3	3.8	2.2	1.4	1.3
Lithuania	-1.1	0.9	1.2	4.4	5.4	6.5	7.3	4.5	2.8	1.7	1.3	3.6
Hungary	-0.8	0.8	2.5	2.5	2.1	1.7	1.5	1.5	0.7	0.6	0.3	0.0
Poland	3.2	3.7	4.8	4.1	4.5	4.6	4.2	3.8	3.2	2.4	1.9	2.1
Romania	:	:	:	:	:	:	:	:	:	:	:	:
Sweden	2.9	4.5	6.8	7.1	5.8	4.8	4.6	2.6	2.3	1.6	0.5	1.7
United Kingdom	1.2	2.5	3.0	1.7	1.7	0.6	0.5	0.8	0.5	0.7	0.4	0.9
EU	1.0	2.2	2.4	2.2	2.4	1.7	1.4	0.9	0.1	-0.1	-0.1	0.4

TABLE 4: Harmonised index of consumer prices (national index if not available), (percentage change on preceding year, 1992-2012)

	5-year averages								February 2012 forecast		*Autumn 2011 forecast*	
	1992-96	1997-01	2002-06	2006	2007	2008	2009	2010	2011	2012	*2011*	*2012*
Belgium	2.2	1.7	2.0	2.3	1.8	4.5	0.0	2.3	**3.5**	**2.7**	*3.5*	*2.0*
Germany	3.1	1.2	1.6	1.8	2.3	2.8	0.2	1.2	**2.5**	**1.9**	*2.4*	*1.7*
Estonia	120.7	6.1	3.3	4.4	6.7	10.6	0.2	2.7	**5.1**	**3.1**	*5.2*	*3.3*
Ireland	2.2	3.0	3.2	2.7	2.9	3.1	-1.7	-1.6	**1.2**	**1.6**	*1.1*	*0.7*
Greece	11.6	3.7	3.4	3.3	3.0	4.2	1.3	4.7	**3.1**	**-0.5**	*3.0*	*0.8*
Spain	4.7	2.4	3.3	3.6	2.8	4.1	-0.2	2.0	**3.1**	**1.3**	*3.0*	*1.1*
France	2.0	1.2	2.1	1.9	1.6	3.2	0.1	1.7	**2.3**	**2.2**	*2.2*	*1.5*
Italy	4.6	2.1	2.4	2.2	2.0	3.5	0.8	1.6	**2.9**	**2.9**	*2.7*	*2.0*
Cyprus	4.3	2.7	2.6	2.2	2.2	4.4	0.2	2.6	**3.5**	**2.8**	*3.4*	*2.8*
Luxembourg	1.8	1.9	2.9	3.0	2.7	4.1	0.0	2.8	**3.7**	**2.7**	*3.6*	*2.1*
Malta	3.3	3.1	2.5	2.6	0.7	4.7	1.8	2.0	**2.4**	**2.1**	*2.6*	*2.2*
Netherlands	2.5	2.6	2.1	1.7	1.6	2.2	1.0	0.9	**2.5**	**2.0**	*2.5*	*1.9*
Austria	2.9	1.3	1.7	1.7	2.2	3.2	0.4	1.7	**3.6**	**2.4**	*3.4*	*2.2*
Portugal	5.6	2.7	2.9	3.0	2.4	2.7	-0.9	1.4	**3.6**	**3.3**	*3.5*	*3.0*
Slovenia	:	8.0	4.3	2.5	3.8	5.5	0.9	2.1	**2.1**	**1.6**	*1.9*	*1.3*
Slovakia	:	8.5	5.3	4.3	1.9	3.9	0.9	0.7	**4.1**	**1.9**	*4.0*	*1.7*
Finland	1.5	1.9	1.1	1.3	1.6	3.9	1.6	1.7	**3.3**	**3.0**	*3.2*	*2.6*
Euro area	3.8	1.7	2.2	2.2	2.1	3.3	0.3	1.6	**2.7**	**2.1**	*2.6*	*1.7*
Bulgaria	87.7	:	5.5	7.4	7.6	12.0	2.5	3.0	**3.4**	**3.0**	*3.6*	*3.1*
Czech Republic	:	5.6	1.5	2.1	3.0	6.3	0.6	1.2	**2.1**	**3.0**	*1.8*	*2.7*
Denmark	1.9	2.1	1.8	1.9	1.7	3.6	1.1	2.2	**2.7**	**1.8**	*2.6*	*1.7*
Latvia	70.3	3.9	4.9	6.6	10.1	15.3	3.3	-1.2	**4.2**	**2.5**	*4.2*	*2.4*
Lithuania	179.8	3.9	1.4	3.8	5.8	11.1	4.2	1.2	**4.1**	**2.6**	*4.0*	*2.7*
Hungary	23.2	12.3	4.8	4.0	7.9	6.0	4.0	4.7	**3.9**	**5.1**	*4.0*	*4.5*
Poland	31.4	9.8	1.9	1.3	2.6	4.2	4.0	2.7	**3.9**	**3.5**	*3.7*	*2.7*
Romania	116.9	63.2	12.9	6.6	4.9	7.9	5.6	6.1	**5.8**	**3.0**	*5.9*	*3.4*
Sweden	2.4	1.5	1.5	1.5	1.7	3.3	1.9	1.9	**1.4**	**0.9**	*1.5*	*1.3*
United Kingdom	2.8	1.3	1.7	2.3	2.3	3.6	2.2	3.3	**4.5**	**2.7**	*4.3*	*2.9*
EU	25.8	4.3	2.3	2.3	2.4	3.7	1.0	2.1	**3.1**	**2.3**	*3.0*	*2.0*

TABLE 5: Profiles of quarterly harmonised index of consumer prices (percentage change on corresponding quarter in previous year, 2010-12) 15.02.2012

	2010/1	2010/2	2010/3	2010/4	2011/1	2011/2	2011/3	2011/4	2012/1	2012/2	2012/3	2012/4
Belgium	1.2	2.4	2.6	3.2	3.6	3.3	3.6	3.4	3.2	2.8	2.4	2.1
Germany	0.8	1.0	1.2	1.6	2.2	2.5	2.6	2.6	2.2	1.9	1.9	1.6
Estonia	0.0	2.9	3.1	5.0	5.2	5.3	5.4	4.4	4.5	3.4	2.4	2.2
Ireland	-2.4	-2.1	-1.2	-0.6	0.8	1.3	1.1	1.4	1.0	1.3	1.7	2.5
Greece	3.0	5.1	5.6	5.1	4.5	3.3	2.1	2.6	1.3	-0.1	-1.3	-1.9
Spain	1.3	2.3	2.0	2.6	3.3	3.3	2.9	2.8	1.7	1.5	1.2	1.0
France	1.5	1.8	1.8	1.9	2.0	2.2	2.3	2.7	2.6	2.0	2.1	2.0
Italy	1.3	1.6	1.7	2.0	2.3	2.9	2.7	3.7	3.3	2.8	2.4	3.1
Cyprus	2.5	2.2	3.3	2.3	3.1	4.1	2.9	3.8	3.6	3.5	2.3	2.0
Luxembourg	2.8	2.8	2.7	2.9	3.8	3.9	3.6	3.7	3.0	2.6	2.6	2.5
Malta	0.9	1.5	2.6	3.2	2.9	2.7	2.4	1.7	1.7	2.0	2.1	2.3
Netherlands	0.5	0.4	1.3	1.5	2.0	2.4	2.9	2.7	2.4	1.6	1.9	2.0
Austria	1.3	1.8	1.7	2.0	3.0	3.7	3.8	3.7	2.9	2.5	2.2	2.2
Portugal	0.3	1.0	2.0	2.3	3.7	3.7	3.1	3.8	3.7	3.3	3.4	3.1
Slovenia	1.7	2.4	2.3	2.0	2.3	2.0	1.5	2.6	2.1	1.7	1.4	1.3
Slovakia	0.0	0.7	1.0	1.1	3.5	4.1	4.1	4.7	1.8	1.8	1.9	2.0
Finland	1.5	1.4	1.4	2.5	3.4	3.4	3.5	3.0	2.8	3.1	3.2	2.9
Euro area	1.1	1.6	1.7	2.0	2.5	2.8	2.7	2.9	2.5	2.1	1.9	1.9
Bulgaria	2.0	2.9	3.3	4.0	4.5	3.4	3.1	2.5	2.8	3.3	3.0	3.0
Czech Republic	0.4	1.0	1.6	2.0	1.9	1.8	2.1	2.8	3.2	3.4	3.0	2.5
Denmark	1.9	2.0	2.3	2.5	2.6	2.9	2.6	2.5	1.8	1.5	1.9	1.8
Latvia	-3.9	-2.3	-0.3	1.7	3.8	4.6	4.4	4.1	3.1	2.5	2.2	2.0
Lithuania	-0.4	0.5	1.8	2.9	3.2	4.7	4.6	4.0	3.1	2.5	2.3	2.5
Hungary	5.8	5.2	3.6	4.3	4.3	3.9	3.5	4.1	5.8	5.0	4.7	5.0
Poland	3.4	2.5	2.1	2.7	3.6	4.0	3.7	4.2	4.0	3.5	3.5	3.0
Romania	4.6	4.3	7.5	7.8	7.5	8.3	4.2	3.4	2.1	2.4	3.9	3.6
Sweden	2.7	1.9	1.3	1.8	1.3	1.7	1.6	0.9	0.7	0.8	1.0	1.2
United Kingdom	3.3	3.4	3.1	3.4	4.1	4.4	4.7	4.7	3.2	2.8	2.5	2.2
EU	1.7	2.0	2.1	2.5	2.9	3.2	3.1	3.2	2.6	2.2	2.1	2.0

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Box 2: Some technical elements behind the forecast

The cut-off date for taking new information into account in this European Economic Forecast was 15 February.

External assumptions

This forecast is based on a set of external assumptions, reflecting market expectations at the time of the forecast. To shield the assumptions from possible volatility during any given trading day, averages from a 10-day reference period (between 1 and 14 February) were used for exchange and interest rates, and for oil prices.

Exchange and interest rates

The technical assumption as regards exchange rates was standardised using fixed nominal exchange rates for all currencies. This technical assumption leads to an implied average USD/EUR rate of 1.32 in 2012. The average JPY/EUR rate is 101.0 in 2012.

Interest-rate assumptions are market-based. Short-term interest rates for the euro area are derived from futures contracts. Long-term interest rates for the euro area, as well as short- and long-term interest rates for other Member States are calculated using implicit forward swap rates, corrected for the current spread between the interest rate and swap rate. In cases where no market instrument is available, the fixed spread vis-à-vis the euro-area interest rate is taken for both short- and long-term rates. As a result, short-term interest rates are expected to be 0.8% on average in 2012 in the euro area. Long-term euro-area interest rates are assumed to be 2.0% on average in 2012.

Commodity prices

Commodity price assumptions are also based on market conditions. According to futures markets, prices for Brent oil are projected to be on average 113.1 USD/bl. in 2012. This would correspond to an oil price of 86.0 EUR/bl. in 2012.

No-policy-change assumption

Although no public-finance variables are included in this interim forecast, additional fiscal measures could have a bearing on GDP growth or inflation in the short- to medium term. Therefore the 'no-policy-change' assumption is used, whereby the GDP and inflation forecasts for 2012 take into consideration only the measures adopted or presented to national parliaments as well as other measures known in sufficient detail.

Calendar effects on GDP growth

The number of working days may differ from one year to another. The Commission's annual GDP forecasts are not adjusted for the number of working days, but quarterly forecasts are.

However, the working-day effect in the EU and the euro area is estimated to be limited over the forecast horizon, implying that adjusted and unadjusted growth rates differ only marginally.

European Commission

Directorate-General for Economic and Financial Affairs

Interim Forecast

February 2012

Press conference of 23 February 2012

OVERVIEW

The economic situation has further deteriorated around the turn of the year, but some signs of stabilisation have appeared lately.

The EU is set to experience stagnating GDP this year, and the euro area will undergo a mild recession. Several factors weigh on the outlook for the EU economy more heavily than forecast last autumn. In particular, the growth momentum seen at the end of 2011 has weakened more than previously expected, while the global economy has softened. Moreover, negative feedback loops between weak sovereign debtors, fragile financial markets and a slowing real economy do not yet appear to have been broken. Financial markets, however, are displaying signs of stabilisation, and some soft and hard indicators point to a more positive outlook. Member States have adopted additional measures to pursue necessary fiscal consolidation as the sovereign-debt crisis in some euro-area Member States lingers on, although this is likely to weigh on growth perspectives in the short run.

Support from the global economy has waned as expected in autumn.

The temporary weakening of global demand expected in the autumn forecast is ongoing, though with substantial differences across regions. Among the advanced economies, the US has recently shown signs of moderately stronger growth than forecast in the autumn, as the labour market improved and consumption rebounded. In Japan, by contrast, the economy has ended 2011 on a weak note, although the perspective of moderate growth in 2012 remains intact. Many emerging market economies have been affected by the crisis in Europe through weaker exports and reduced capital inflows. Moreover, oil prices have not continued the measured decline expected in the autumn, but have rebounded by 13% in euro terms since the autumn forecast. Overall, and broadly in line with the autumn forecast, global GDP and world trade growth, having weakened since spring 2011, are expected to recover only gradually in 2012.

Financial markets have stabilised, but the situation remains vulnerable.

Financial market indicators have shown signs of stabilisation since the autumn, with some easing of pressures on sovereign yields, although spreads remain at high levels for some Member States. While credit conditions for the private sector have been tightening, the latest measures taken by the ECB, in particular the provision of ample liquidity with a maturity of three years and the broadening of eligible collateral, have eased banks' funding stress and appear to have improved risk sentiment in financial markets more broadly. Looking at the euro area and the EU as a whole, evidence of a continued credit deceleration is building up, but the risk of an outright credit crunch in the euro area as a whole has decreased. Despite the recent tightening of credit conditions, credit supply is not expected to be a major constraint on investment and consumption as long as credit demand also remains weak. However, credit supply conditions and credit growth differ strongly across Member States. Finally, despite initial concerns, bank recapitalisation is progressing. The European Banking Authority expects that banks will reach the target capital ratio set for end-June 2012 with only limited recourse to deleveraging.

The EU economy is expected to have started the year in technical recession, with a return to recovery in the second half of 2012.

The loss of economic momentum towards the end of 2011 was stronger than anticipated. After a weak third quarter, the economy contracted in the fourth quarter – by 0.3% in the EU and the euro area according to Eurostat's flash estimate. Domestic demand was lacklustre in the third quarter of 2011 and – as shown by the continued fall in confidence in the autumn and available hard indicators – probably contributed substantially to the contraction in the fourth. Most recent readings of confidence indicators, however, have stabilised or even rebounded. Together with the improvement in financial markets, and significant recent policy action at both EU and Member-State level, this suggests that the drag on private investment and consumption from the uncertainty related to the sovereign-debt crisis should fade little by little. Global trade is also expected to recover gradually. Overall, some further contraction is forecast for early 2012 in both the EU and the euro area, and a return to the kind of modest recovery that is typical for the aftermath of financial crises is expected only from the second half of the year.

The 2012 GDP forecast for the EU and the euro area is revised down.

GDP growth for 2012 is now expected to be zero for the EU and -0.3% for the euro area. This is a downward revision compared to the autumn 2011 forecast of 0.6 percentage point and 0.8 percentage point, respectively. The quarterly profile has been lowered for all quarters, most strongly around the turn of the year, in view of the weaker-than-expected flash estimate by Eurostat for the fourth quarter of 2011. A recovery is still forecast for the second half of the year, but is expected to be more modest and to occur later than forecast in the autumn. This reflects a more gradual return of business and consumer confidence, and therefore investment and consumption, as well as additional fiscal consolidation in a number of Member States.

Growth differentials across Member States remain pronounced.

Although growth differentials remain accentuated, the broad basis of downward revisions suggests that there is no clear core/periphery pattern in the euro area. While the autumn forecast foresaw negative annual GDP growth in 2012 only for Greece and Portugal, this is now forecast also for Belgium, Spain, Italy, Cyprus, the Netherlands, Slovenia and Hungary. However, growth differentials are set to remain substantial. The largest downward revisions to annual growth (of one percentage point or more) were made for Estonia, Spain, Greece, Italy, and the Netherlands. By contrast, the forecasts were kept unchanged or revised only by little (less than ¼ percentage point) for Germany, France, Austria, Slovakia, Denmark, Poland and the UK.

Inflation has remained more persistent than forecast, but is expected to ease gradually.

Energy inflation has started to decrease only recently, but crude oil prices expressed in euro have actually increased since the autumn. At the same time, core inflation has stabilised at about 2¼ % in the EU and 2% in the euro area. Indirect tax increases have further contributed to headline inflation, by up to ½ percentage point in the EU and ¼ percentage point in the euro area in recent months. As a result, headline HICP inflation has decreased more gradually than earlier forecast. It stood at 3% in the EU in December 2011 and, according to Eurostat's flash estimate, at 2.7% in January 2012 in the euro area. In view of trends in commodity futures and the expected weakening of GDP, inflation is expected to continue its slow decline over the coming quarters. For 2012 as a whole, HICP inflation is now forecast to fall to 2.3% in the EU and 2.1% in the euro area.

Risks while remaining tilted to the downside, have become more balanced lately.

Some of the risks identified in the autumn forecast have materialised. Nonetheless the balance of risks to GDP growth remains tilted to the downside amid still-high uncertainty. This interim forecast continues to rely on the assumption that adequate policy measures are decided and implemented at the EU and Member-State level to overcome the sovereign-debt crisis. This assumption underpins the forecast of a gradual return of confidence and a recovery in investment and consumption in the second half of 2012, which is however set to occur later and be more modest than assumed in the autumn. Moreover, the financial market situation remains fragile. If the sovereign-debt crisis were to rebound massively, with a broad surge in risk premia and spillovers across countries, severe credit rationing and a collapse of domestic demand could ensue. Such an outcome would most likely trigger a deep and prolonged recession, not sparing even those countries which have shown more resilience so far.

As usual, this forecast assumes no change in fiscal policy beyond measures that are at present known with sufficient certainty. If additional fiscal tightening is decided – which appears to be needed in some Member States which still do not have a 2012 budget or need to correct the excessive deficit in 2012 – this could raise confidence and ease financial market pressure. Nonetheless, in the short run, GDP growth would probably be negatively affected. Upside risks to GDP include a stronger-than-expected rebound of confidence following decisive EU level decisions to tackle the sovereign-debt crisis, building on the recent agreement on the Greek adjustment programme. Another upside risk is a more resilient global demand, which could, for instance, stem from the decreased dependency of emerging markets on advanced economies or a stabilisation in US housing markets.

Risks to inflation appear broadly balanced.

The main risk for markedly lower inflation relates to a sharper-than-expected contraction of GDP, which would also depress underlying price dynamics. On the upside, oil prices could surge in the case of supply disruptions, in particular in the case of an intensification of geopolitical tensions; stronger demand from emerging markets could also drive commodity prices higher. Similarly, inflation could increase on the back of unanticipated increases in indirect taxes.

1. EU ECONOMY: A MILD RECESSION WITH SIGNS OF STABILISATION

The global economy has decelerated...

The overall picture of the global economy has been mixed in 2011 and economic growth has been uneven across regions. The fragile recovery from the global crisis that had started in 2009 has been negatively affected by sharp commodity price increases, natural disasters in Asia, and increased uncertainties about the resolution of the sovereign-debt crisis in the euro area. Elevated inflation pressures in emerging economies led to tightening of domestic policies, and this weighed further on global growth dynamics.

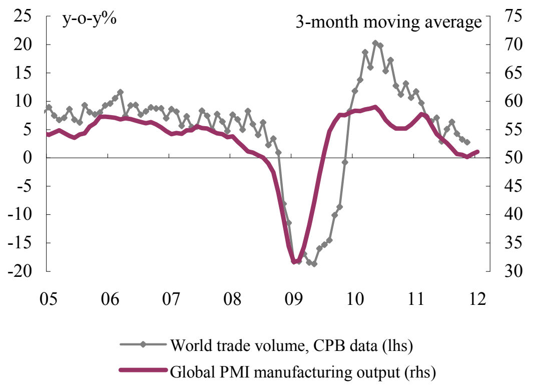
In the third quarter of 2011, global growth accelerated, led by Japan's post-disaster recovery and an improvement in the US economic activity. The advanced estimate for the fourth quarter points to a continuing growth momentum in the US driven to a large extent by inventory rebuilding and consumption financed from savings. Nevertheless, world growth is expected to have slowed down again towards the end of the year, despite the better-than-expected performance of the US economy. Preliminary estimates of GDP growth in Japan in the last quarter of 2011 surprised on the downside on the back of weak public investment and negative trade repercussions following floods in Thailand. While so far China has proved to be resilient to the slackening global economy, growing at a robust 8.9% in the last quarter of 2011, most emerging market economies continue to be affected, notably through the trade and financial channels.

... and is expected to move out of the soft patch only gradually.

Looking ahead, leading indicators of global activity, such as the global manufacturing PMI, point to a moderate expansion in the short term.

Against this background, the global economy (excl. EU) is expected to grow by 4¼% in 2012, almost the same rate as forecast in autumn. However, the overall figure masks large regional differences. Compared to autumn, a more upbeat US outlook combined with an unchanged forecast for China, counterbalances downward revisions elsewhere, particularly in Japan, Latin America and the MENA region.

Graph 1.1: **World trade and Global PMI manufacturing output**



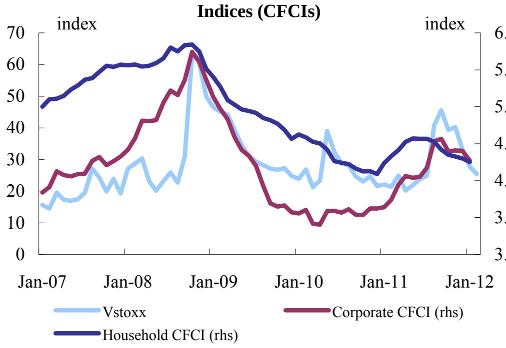
Commodity prices are trending down but still remain high from a historical perspective. Energy prices, most notably crude oil, have held up in recent months, despite a global slowdown in demand growth, reflecting geopolitical tensions and the risk of supply disruptions. Nevertheless global inflation concerns have receded recently. Across both, advanced and emerging economies, inflation is set to decelerate on the back of moderating commodity prices, subdued economic growth and base effects from commodity price increases in early 2011.

Risks to the global growth outlook remain elevated. More pronounced contagion from the sovereign-debt crisis in the euro area to the rest of the global economy and stronger spillovers between the financial and real sector remain the largest downside risks. Moreover, an aggravation of geopolitical tensions in oil-exporting regions could lead to higher oil prices. On the upside, global growth dynamics may prove to be stronger than currently envisaged in the forecast, in particular if the US economy were to rebound sooner (on account of a faster recovery in the housing market, stronger job creation and corporate investment).

Financial markets have calmed but remain vulnerable

Financial market stress has ebbed off in recent months. Financing cost indicators point to a gradual improvement, while volatility indicators suggest a return of risk appetite among market participants. Improvements have been widespread across financial market segments. Nonetheless, the financial market situation remains fragile. Yields on many euro-area sovereigns remain too high for comfort, and the risk of a sudden aggravation of the sovereign-debt crisis, with spillovers across the euro area, but also to global financial markets is still very present. The sovereign-debt crisis in the euro area continues to be the main source of instability in the global financial system. Adverse feedback loops between vulnerable sovereign debtors and weak banking systems are still active, and there is evidence of tightening credit conditions for the private non-financial sector. Breaking such negative feedback loops requires consistent policy decisions in the coming weeks.

Graph 1.2: **Volatility and Composite Financing Cost Indices (CFCIs)**



Note: The CFCI is a synthetic measure of the nomial external financing cost for the euro-area corporate sector and households.

Stabilisation in sovereign-debt markets but further measures are required

Although decreasing in several countries, sovereign yield spreads remain high by historical standards. Shortly after the autumn 2011 forecast, the euro-area sovereign-debt crisis intensified on concerns that slowing economic growth would undermine public debt sustainability, that the benefits of the fiscal consolidation efforts risked being wiped out by the further rising debt-servicing costs, and that some sovereigns (and banks) would struggle to refinance the challenging volume of maturing debt. However, since mid-November sovereign-debt spreads have come down somewhat, supported by policy measures as well as successful sovereign-bond auctions. Stronger credibility of policy in vulnerable countries and the increasing perception that a consistent strategy to tackle the sovereign-debt crisis was emerging at the EU level helped to stabilise the markets. Consequently, the market reaction to sovereign credit-rating downgrades since December has been muted.

Despite banking sector weakness...

Tensions in sovereign-debt markets have strong contagion effects into the EU banking system. Banks' funding costs and debt spreads in secondary markets remain high. Difficult bank funding conditions have been a key driver behind credit supply tightening in recent months (see Box 1.1). New liquidity measures introduced by the ECB in December 2011 and February 2012 have provided a relief, as banks now have access to longer maturity funding from the ECB and can use a wider range of eligible collateral. Euro-area interbank markets continue to be dysfunctional, though market conditions have started to ease gradually after the announcement of the ECB's additional liquidity measures in early December. The Euribor-OIS spread, an indicator of the willingness of banks to lend to each other, has decreased from a peak of 100 basis points early December, but at around 75 basis points it remains high.

... a credit crunch has been avoided

Looking forward, the risk of a full-blown credit crunch has decreased. The process of deleveraging is ongoing in the banking sector, but there is no clear-cut evidence that it has become excessive or disorderly. The transmission from central bank liquidity to additional loans to the private sector remains impaired, and credit supply conditions have tightened. However, demand for credit has also fallen, so that credit supply conditions are – at the current juncture and considering the EU and euro-area aggregates – unlikely to constrain credit growth until demand picks up more strongly. Moreover, premiums on corporate bonds have come down somewhat, and the strong liquidity of the non-financial corporate sector should sustain it through a period of more difficult financing conditions. Differences in credit conditions across countries have, however, increased, with far more severe credit supply constraints in some Member States where bank balance sheets are under particular stress.

Box 1.1: Substantial slowdown in credit growth amid very large cross-country divergences

Credit expansion in the EU and the euro area is bound to remain anaemic in 2012, despite – inter alia – the substantial relief provided by the ECB longer-term refinancing operations. However, currently decelerating bank lending growth is not expected to turn into a fully-fledged credit crunch in the EU or the euro area.

Towards the end of 2011, private sector credit growth decelerated noticeably, but was subject to large cross-country differences. Credit growth has been declining strongly in Italy, and to a smaller but still noticeable extent in France. In Ireland, the extensive credit contraction seems to be receding, while a milder credit contraction has continued in Greece and is intensifying in Spain and Portugal. In the Netherlands and Germany, credit growth turned positive in the course of 2012, but has recently shown signs of decelerating again. But credit growth in Belgium, after having turned positive in the summer of 2011, turned negative again in December 2011. Recent trends in Central and Eastern Europe do not follow a single pattern either. Credit growth has been accelerating in Romania in recent quarters, but receding in Poland and the Czech Republic, while in Hungary, the credit contraction is deepening. Annual credit growth in Bulgaria remains at low but stable levels (Table 1).

The overall slowdown in credit growth resulted both from weakening demand and tightening credit conditions, as highlighted by the ECB Bank Lending Surveys of October 2011 and January 2012. In particular, the sovereign-debt crisis has reduced banks' access to funding markets. Financial institutions are under unabated pressure to adjust balance sheets and secure liquidity provision, while funding costs remain at elevated levels (see page 5 in section 1). In the euro area, funding stress appears to be most severe in Italy, Spain and France, as indicated by the large take-up of the 3-year longer-term refinancing operations by Italian, Spanish and French banks in December 2011. Reflecting the spillover from tensions in the euro area, bank lending conditions in Emerging Europe substantially weakened in the last quarter of 2011, with deteriorating refinancing conditions reported as the most important factor behind the worsening situation.[1]

Table 1:
Bank lending to the non-financial private sector (y-o-y %)

	Dec-10	Jun-11	Nov-11	Dec-11
EA	2.2	2.1	1.7	1.2
BE	-2.0	-2.5	0.6	-1.7
DE	-0.1	-0.2	2.3	2.3
EE	-5.4	-4.8	-5.6	-4.3
IE	-20.2	-13.2	-11.0	-7.5
EL	3.0	-3.7	-4.5	-3.4
ES	0.8	-1.1	-2.8	-3.0
FR	6.0	6.9	4.5	3.7
IT	8.1	4.7	2.6	1.4
CY	6.7	6.3	7.0	7.6
LU	3.3	6.3	1.3	2.0
MT	4.3	1.0	3.1	3.1
NL	-2.9	6.6	5.8	3.8
AT	2.7	1.9	2.3	2.4
PT	0.2	-1.8	-2.8	-3.5
SI	2.5	0.3	-0.9	-2.5
SK	5.0	9.5	7.2	8.5
FI	5.4	6.3	7.9	8.3
BG	1.1	2.3	2.3	:
CZ	9.2	11.3	3.8	:
DK	1.3	-2.0	-1.7	:
LV	-8.4	-9.3	-6.2	:
LT	-6.5	-5.6	-3.4	:
HU	0.5	0.3	-6.3	:
PL	11.9	12.9	3.0	:
RO	4.2	4.6	6.2	:
SE	21.9	10.2	6.0	:
UK	4.6	-12.6	-7.2	:

Source: ECB

While the stress in bank funding markets may have prompted banks to cut back lending to the real economy, the additional liquidity injected by the ECB in December, the expected additional liquidity at the end of February, as well as some other policy measures (e.g. the broadened collateral base) should provide sufficient resources for banks to expand lending. Meanwhile, the European Banking Authority (EBA) assessed earlier this month that the imposed and ongoing strengthening of the capital ratios of banks would be met primarily through direct capital measures (capital raising, retained earnings and conversion of hybrids to common equity) while deleveraging actions would only count for a quarter of the amount of measures.[2] Nevertheless, the transformation of central bank liquidity into loans to the private sector via the bank lending or balance-sheet channel is not straightforward in the current environment, as possible bank capital shortages and high sovereign refinancing needs superimpose the expansionary monetary impulse. Moreover, cross-

(1) Institute of International Finance (IIF), Emerging Markets Bank Lending Conditions Survey – 2011Q4, January 2012

(2) See the EBA's press release: "The EBA's Board of Supervisors makes its first aggregate assessment of banks' capital plans, 9 February 2012."

(Continued on the next page)

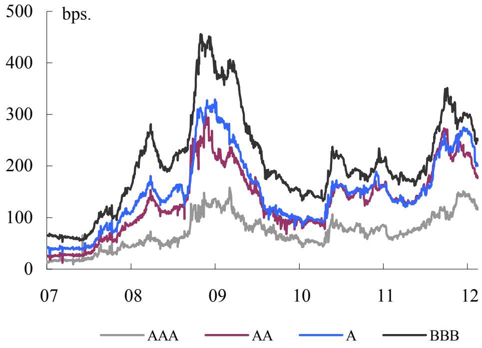
Box (continued)

border retrenchment is likely to continue, adding to possible credit constraints in some Member States. Finally, the much tighter credit conditions applied by banks to long-term loans are an immediate reflex of the particular stress on funding markets for longer maturities, but are also driven by regulatory requirements. This implies that non-financial corporations face a higher interest-rate risk for the financing of long-term investments.

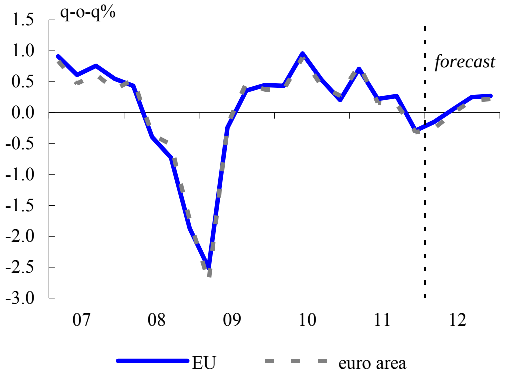
Looking forward, a number of factors suggest that weakening credit growth will not develop into a fully-fledged credit crunch despite the ongoing moderate credit deceleration. (i) Credit growth is still positive or even accelerating in most countries. (ii) The contraction of credit volumes in other Member States corresponds to declining credit demand following slowing economic activity in the last months of 2011, resulting from high uncertainty about future business projects and deleveraging of the corporate and household sector. Warned by the 2008-09 experience of tight liquidity conditions, the corporate sector has been hoarding cash and freezing investment. Fitch[1] estimates that the vast majority of European corporates is well placed to finance themselves out of existing resources in 2012-13, without the need to tap the markets.

(1) Fitch Ratings, EMEA Corporate Credit View, December 2011

Graph 1.3: **Corporate spreads over euro-area sovereign benchmark bonds (5-year maturity)**



Graph 1.4: **Quarterly GDP growth, EU and euro area**



European economic situation has worsened

In 2011 as a whole, real GDP is estimated to have grown by 1.5% in the EU and 1.4% in the euro area, broadly in line with the autumn 2011 forecast. However, the loss of momentum in the EU economy towards the end of 2011 turned out to be stronger than expected in the autumn. Sharply deteriorating confidence, the sovereign-debt crisis and a weaker global economy have all weighed on growth. In the third quarter of 2011, GDP in the EU and the euro area grew by 0.3% and 0.1% respectively, compared to the previous quarter. In the final quarter, according to Eurostat's Flash estimate of 15 February, GDP contracted by 0.3% from the previous quarter in both the EU and euro area. The contraction was particularly strong in Portugal (-1.3% q-o-q), Lithuania (-0.9%), Estonia (-0.8%), Italy (-0.7%) and the Netherlands (-0.7%).

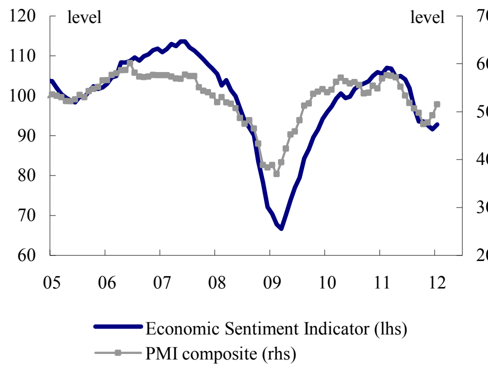
A mild, technical recession

The lower carry-over from 2011 will weigh on the outlook for this year. Growth is expected to stagnate in 2012 in the EU, and the euro-area economy should experience a mild recession: For 2012, GDP growth is now forecast at 0.0% in the EU and -0.3% in the euro area. This is a downward revision of 0.6 pp. and 0.8 pp. respectively compared to the autumn 2011 forecast. The quarterly GDP profile for 2012 has been revised down for all quarters and a technical recession, defined as two consecutive quarters of negative growth, is now expected in both regions in the last quarter of 2011 and the first quarter of 2012. Only after some quarters of zero or negative GDP growth is a gradual and feeble return of growth projected in the second half of 2012. The projection of a sluggish recovery towards the end of the year reflects the pattern of subdued growth that is typical in the aftermath of financial crises.

Still, this growth profile is based on the assumption that the uncertainty related to the sovereign-debt crisis will gradually fade.

The weaker growth prospects for 2012 compared to the autumn 2011 forecast can be explained by several factors. First, the carry-over into 2012 turned out to be lower than expected in the autumn forecast, mainly as a result of lower growth in the last quarter of 2011. Second, the additional fiscal consolidation that has been decided since the autumn forecast in a number of Member States, while necessary, will weigh on growth in 2012. Third, although the policy assumption of the autumn forecast, according to which policy measures to combat the sovereign-debt crisis would prove effective and lead to a gradual return of growth, is still valid, the timing has been delayed. On the upside, compared to the autumn forecast, the ECB's additional liquidity measures have contributed to the stabilisation of market sentiment and reduced pressure on short- and medium-term funding for banks.

Graph 1.5: **Economic Sentiment Indicator and PMI composite index, EU**

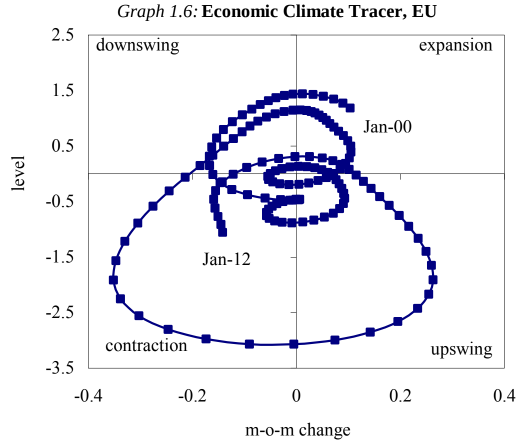


Confidence, while remaining very low, points to some stabilisation

Since the autumn 2011 forecast, survey developments have continued to trend down and began to improve only recently. The Economic Sentiment Indicator (ESI) in the EU and the euro area showed a moderation of the sharp downward trend during the fourth quarter of last year. In January 2012, it rose for the first time since May 2011 for the EU (since February 2011 for the euro area). The indicator remains, however, significantly below its long-term average in both regions. The euro-area composite PMI readings have been slightly more positive, showing a gradual increase in the index since November. In January, the index stood above the threshold of 50 points, signalling a marginal increase in economic activity in the euro area.

Despite this recent improvement, the Commission's business and consumer survey indicators still point to contraction. An Economic Climate Tracer can be constructed depicting the level and change of a (smoothened and standardised) business cycle indicator (Graph 1.6).[1] This tracer displays the position of an economy in the business cycle and its dynamics. For both the EU and the euro area, based on January data, the climate tracer remains in the contraction area. Among the largest Member States, it is now in the contraction area in all countries except Germany which remains in the downswing area and is moving in the direction of expansion.

Graph 1.6: **Economic Climate Tracer, EU**



While recent developments in survey data suggest that the expected slowdown should be mild and temporary, the turnaround of the trend still needs to be confirmed in the coming months.

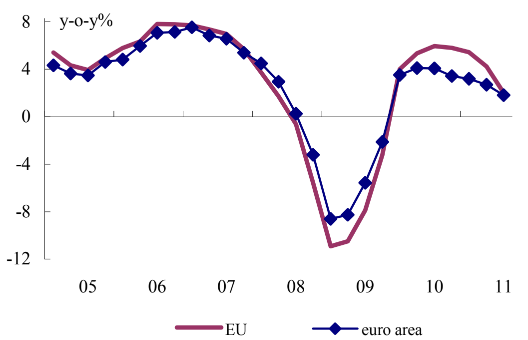
Broad-based downswing

The expected slowdown in 2012 should be broad-based and affect all GDP components. Exports seem to have been the main driver of growth in 2011 in most EU countries and are now back to their pre-crisis levels. However, with global trade expansion slowing down, its contribution to GDP growth will most probably diminish in 2012.

(1) The business cycle indicator is created from the weighted average of the five principle components from the survey series conducted in industry, services, construction and retail trade and among consumers.

The relatively strong EU export recovery in 2010-11 did not translate into a rebound in private investments. Gross fixed capital formation was rather disappointing in 2011. After a strong performance in the first quarter of 2011, investment growth was anaemic in the two following quarters, in line with declining confidence. Looking forward, several factors will contribute to unfavourable developments. The weaker prospects for trade and domestic demand for 2012 will reduce firms' incentives to invest. Furthermore the net tightening of credit standards for loans to enterprises and their declining profit share (Graph 1.7) are set to weigh on the propensity to invest beyond depreciation.

Graph 1.7: **Profit growth, EU and euro area**



Note: Profits defined as gross operating surplus and gross mixed incomes at current prices.

Domestic consumption is set to remain modest, too. After a decline of 0.4% in the EU (-0.5% in the euro area) in the second quarter of 2011, household consumption rebounded slightly in the following quarter. However, weak labour markets, subdued consumer confidence, ongoing private-sector deleveraging in many Member States and the negative impact of fiscal consolidation measures on disposable income are all depressing the outlook for consumption.

Intra-EU divergence persists

The downward revision for GDP growth in 2012 is broad-based across Member States but the magnitude of revision is very different from one country to another. While a slowdown in 2012 is expected in all EU Member States, growth differences are expected to remain pronounced. The sovereign-debt crisis affects in particular those Member States with vulnerable public finances (often compounded by a weak banking sector and low growth), while deleveraging needs stemming from the preceding boom and bust continue to weigh on domestic demand. Differences in openness to international trade and in competitiveness positions will also contribute to growth divergence.

While some countries will suffer significant recessions in 2012, other countries will experience a slowdown with growth remaining in positive territory. In fact, GDP growth rates in 2012 are forecast to range from significant contractions in Greece (-4.3%) and Portugal (-3.3%) to some rapidly growing New Member States, like Poland (2.5%) and Lithuania (2.3%). Divergence in country growth perspectives are also reflected in a number of indicators such as: unemployment rates, credit tightening, financing costs, fiscal consolidation needs and confidence.

Labour markets deteriorating

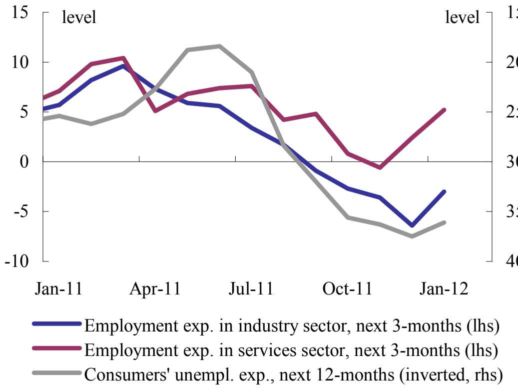
In the third quarter of 2011, employment growth turned negative for the first time since spring 2010, with a decrease of 0.1% in the EU and the euro area respectively. Although this decline was small, it shows that the favourable employment dynamics in some Member States no longer offset the deterioration in countries facing substantial structural adjustments. The unemployment rate stood at 10.4% in the euro area and 9.9% in the EU in December 2011. Labour shedding in the construction sector has continued unabated, whereas employment in the manufacturing sector decreased only slightly in the EU and stagnated in the euro area.

The largest increases in the unemployment rate in December 2011 were recorded in countries with macroeconomic adjustment needs stemming from a burst housing bubble and/or unsustainable public finances coupled with a lack of structural reforms. Greece, Portugal and Spain account for 95% of the rise in unemployment in the EU since late 2010. Additionally, Spain and Greece have seen their youth unemployment rates surge (from already high pre-crisis levels) to close to 50%. But high levels of youth unemployment are also common in several other countries, with the total of eleven Member States significantly exceeding the EU average jobless rate for the 15-24 year olds of 22.1% (as of December 2011). By contrast, the labour market situation still appears to be more benign in countries with less adjustment needs. As a consequence, the large dispersion of unemployment rates among Member States is expected to prevail in 2012.

Looking ahead, the deteriorated economic outlook is expected to leave its mark on the labour market, as the winding-down of imbalances continues, also in response to weak demand. Forward-looking labour market indicators suggest a further worsening of the labour market situation. Readings of Commission surveys of employment expectations in the EU industry and services sectors experienced their trough last autumn, whereas consumers' unemployment fears for the next twelve months have decreased (Graph 1.8). The labour market prospects in the near future are also underpinned by deteriorating PMI composite employment indices for the EU and the euro area.

Given that employment developments tend to follow output fluctuations with a time lag of two to four quarters, the expected weak GDP upturn in the second half of the year is unlikely to lift employment prospects during 2012. With the EU economy set to stagnate and a mild recession unfolding in the euro area at the current juncture, the labour market situation is likely to worsen over the forecast horizon.

Graph 1.8: **Employment expectations, Business and Consumer Surveys, EU**

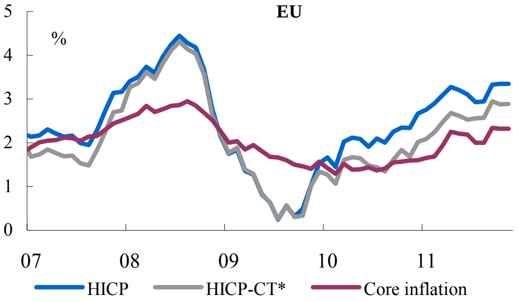


Inflation still high despite weakening economic environment...

In 2011, consumer-price inflation was shaped to a large extent by rising energy prices and changes in indirect taxation in many Member States. While in the second half of last year the oil price started to decrease in USD terms (by 7%), it increased in EUR terms (by 4%). The net effect of the oil-price increase and higher indirect taxes (adding up to ½ pp. to HICP), as well as lagged effects of oil-price increases from the first half of 2011, have resulted in inflation in the EU and the euro area that has been more persistent than expected in the autumn forecast.

Euro-area headline HICP inflation rose to 2.9% in the fourth quarter of 2011, ¼ pp. higher than forecast in autumn, bringing up the 2011 rate to 2.7%. In the EU, headline inflation was 3.2% in the fourth quarter (0.4 pp. higher than in the autumn forecast) and 3.1% for 2011 as a whole (compared with 3.0% in the autumn forecast).

Graph 1.9: **Headline, core and constant-tax* inflation, EU**



** HICP-CT = inflation at constant taxes. The difference between HICP and HICP-CT growth rates points to the theoretical impact of changes in indirect taxes (e.g. VAT and excise duties) on overall HICP inflation, assuming an instantaneous pass-through of tax rate changes on the price paid by the consumer.*

In 2011, core inflation (i.e. all items excluding energy and unprocessed food) reached 2.1% in the EU (1.7% in the euro area), up by about ¾ pp. from the previous year in both areas.

... but with weak labour market conditions ...

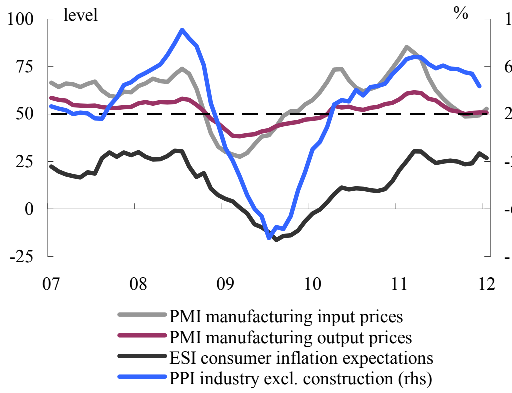
Although the labour market situation is currently highly differentiated across EU Member, conditions generally stayed weak in 2011 and have not exerted any pressures on inflation. Nevertheless, in the course of 2011, the growth of nominal compensation per employee accelerated and outpaced the productivity gains, prompting a moderate increase in nominal unit labour costs.

... and well-anchored expectations ...

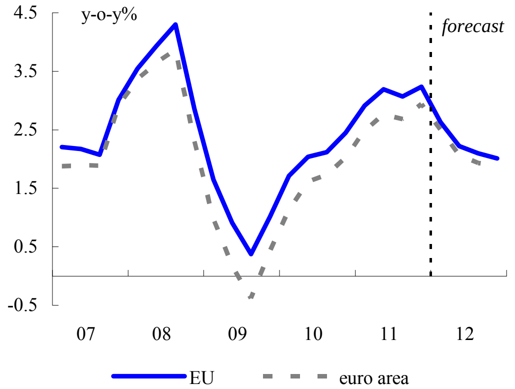
Price pressures on the producers' side have been easing since the spring of 2011, mainly reflecting lower pressures from energy input prices. Industrial producer price inflation fell below 5% in the EU and the euro area at the end of 2011 and the most substantial decrease in the course of the year was observed for intermediary goods, i.e. at the earlier stages of the production chain.

However, survey indicators of price developments (both PMI and ESI components), which signal future producer-price developments, edged up slightly at the turn of the year, suggesting an end to the downward trend. This is in line with manufacturers' expectations of stabilising economic activity in the short term as the PMIs suggest. Consumers' inflation expectations eased slightly in January, though they remain at an elevated level as, on the whole, they tend to be highly correlated with the observed (currently relatively high) inflation rates. By contrast, market-based inflation expectations for the medium- to long term point to a substantial easing of inflation going forward, with inflation rates significantly below the ECB's official target. However, in times of continued financial-market turbulences, these indicators should be interpreted with caution.

Graph 1.10: **Producer-price inflation (PPI) and survey inflation expectations, euro area**



Graph 1.11: **HICP inflation forecast, EU and euro area**



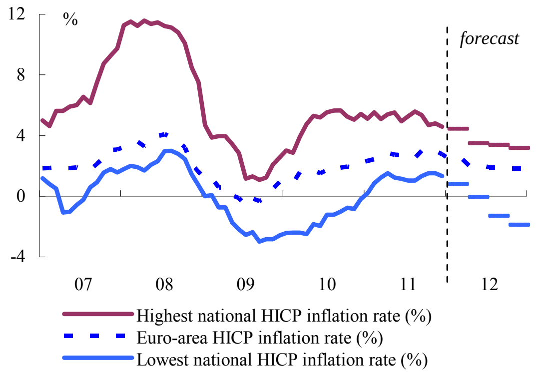
... the outlook is for a gradual decrease ...

Looking ahead, the headline inflation rate for 2012 is revised up both in the EU and the euro area (0.3 pp. and 0.4 pp. respectively compared to the autumn forecast) and is expected to reach 2.3% and 2.1% respectively. On a quarterly basis, inflation at the aggregate level is expected to have peaked in the last quarter of 2011 and is set to gradually return to about 2% towards the end of the year. This profile follows from the interaction of three main elements: the fading pass-through and negative base effects from last year's increases in energy prices combined with increases in indirect taxation and administered prices in many Member States, new tax measures to be introduced in 2012 and the overall feeble economic environment.

... though with increased dispersion among Member States

The revisions to the inflation forecast are equivocal across Member States, in line with divergent patterns in economic activity. For many euro-area countries that are implementing additional fiscal consolidation measures in the form of increasing direct and indirect taxes, inflation for 2012 has been revised up between ½ and 1 pp. Outside the euro area, revisions to the autumn 2011 forecasts have mostly been minor, with the exceptions of Poland, Hungary, Romania and Sweden, mainly on account of exchange rate movements and base effects. On the whole, the dispersion of inflation rates in the euro area is set to increase this year.

Graph 1.12: **Inflation dispersion of EA Member States - HICP inflation rates**



The outlook for public finances broadly unchanged

Turning to public finances, the available information suggests that, despite a downward revision of economic growth in 2012, the budgetary outcome for the EU and the euro area as a whole will be broadly in line with the results of the autumn forecast. The overall unchanged outlook for public finances is mainly due to additional consolidation measures taken in some Member States since the cut-off date of the autumn forecast, which offset the negative budgetary impact from the slower economic activity and fiscal slippage in some countries. A full assessment of prospects for public finances and the labour market will be carried out in the Commission's upcoming spring forecast.

Uncertainty keeps risks at high levels

Against the background of sovereign- and financial-market stress, the growth forecasts for the EU and the euro area remain subject to exceptionally high uncertainty. Despite some favourable developments in recent weeks that made the risks to growth more balanced, the downside risks remain substantial. By contrast the risks to the inflation outlook are broadly balanced.

Downside risks to the growth forecast are closely related to the euro-area sovereign-debt crisis, measures to solve it, adverse feedback loops between the financial and the real sector and the underlying assumptions about the external environment.

– The major downside risk is that the euro-area debt crisis intensifies. This could, for instance, happen if, by contrast to the main policy assumptions, measures are not adopted and/or implemented quickly enough. An intensification of the crisis would trigger an abruptly changing market sentiment, more contagion, and tensions in the financial sector of the EU and beyond. This would endanger financial stability, complicate corporates' financing (credit crunch) and depress confidence of investors and consumers. The fallout would not be restricted to a sharp decline in economic activity in the EU. Economic and financial spillovers beyond Europe could amplify the negative impact.

– Additional fiscal measures, not taken on board due to the no-policy-change assumption (cf. Box 2), may lower economic growth in the short term more than currently envisaged.

– Weaker-than-expected global economic growth would weigh on trade and thus, via merchandise exports, on the growth outlook of EU Member States. Economic growth in non-EU advanced economies is surrounded by risks emanating from the debt crisis in euro-area Member States. The larger the loss in global growth momentum would be, the more protectionist pressures might arise, constituting further downside risks to the growth outlook for the EU.

– An escalation of geopolitical tensions could push oil prices to unprecedented heights, which would weigh heavily on the EU economy. Credible threats to the accessibility of oil supplies from the Middle East could increase risk premia. The growth slowdown following the sharp price increases in the first half of 2011 may give an indication on how substantial the impact could be.

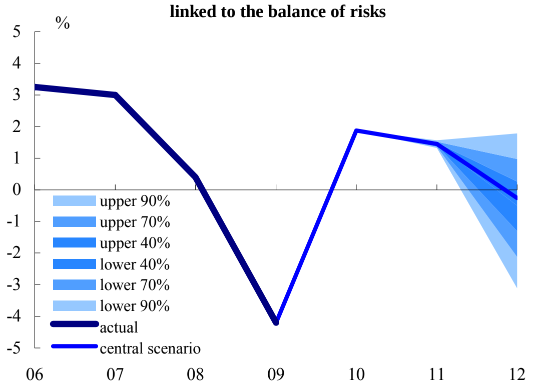
Upside risks to the growth forecast relate to the assessment of measures already taken and the external environment of the EU economy.

– The policy measures already taken and the next moves to solve the euro-area debt crisis may have a faster and more sustained impact than currently expected. A recovery in financial markets, structural reforms and determined fiscal consolidation could lead to an earlier return of confidence than assumed, allowing the EU economy to re-accelerate earlier and stronger than forecast.

– Stronger-than-expected global economic growth, particularly in emerging market economies, may pull economic growth in advanced economies.

Overall, the balance of risks to the economic growth outlook is tilted to the downside. Downside risks to growth will diminish further if decisive policy actions at EU and Member State level reduce uncertainty.

Graph 1.13: **Euro-area GDP forecasts - uncertainty linked to the balance of risks**



The uncertainty surrounding the growth outlook for the euro area is visualised in the fan chart (see

Graph 1.13) that displays the probabilities associated with various outcomes for euro-area economic growth in 2012. While the darkest area indicates the most likely development, the shaded areas represent the different probabilities of future economic growth within the growth ranges depicted on the y-axis. As the balance of risks to economic growth is assessed as tilted to the downside, the fan chart is skewed towards the bottom.

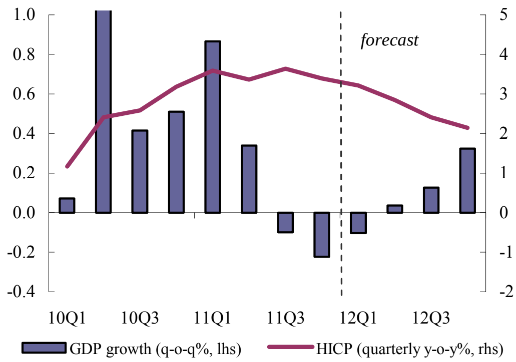
Risks to the inflation outlook are broadly balanced in the EU as a whole and in the euro area.

Downside risks to the inflation outlook are associated with a weaker-than-expected growth performance of the EU economy. In particular, further declining economic activity would reduce cost, wage and price pressures. Upside risks to the inflation outlook are related to policy measures, commodity prices, and monetary factors. More increases in indirect taxes and administered prices may be decided than currently envisaged in the forecast. Supply disruptions, may push commodity prices beyond what is currently assumed. Finally, the long-time build-up of liquidity could eventually result in stronger-than-expected price increases once economic activity re-accelerates.

2. BELGIUM

After the strong recovery in 2010 and the first half of 2011, the Belgian economy slowed down considerably in the second part of 2011. GDP declined by 0.1% and by 0.2% q-o-q in the third and fourth quarters respectively. Together with the downward revision of growth in the second quarter of 2011 (from 0.5% to 0.3%) this led to an estimated GDP growth of 1.9% for the whole year (instead of the 2.2% projected in the autumn forecast) and to a lower carry-over to 2012 (0.2 pp. versus -0.1 pp.).

Graph 2.1: **Belgium - GDP growth and inflation**



In addition to the impact of the global downturn on business and consumer confidence, the collapse of Dexia in October 2011 and the additional amount of guarantees committed by the Belgian government, gave rise to renewed concerns about the health of the banking sector and the impact on lending (conditions) to households and companies. Credit provision by Belgian banks has been slowing down since the second half of 2011, in particular for households.

The factors that led to the contraction of economic activity in the second half of 2011 are expected to remain in place at the beginning of 2012; therefore the outlook for the current year is more negative than expected at the time of the autumn forecast and real GDP is projected to decline by 0.1% over the whole year. A very modest (export-led) recovery should however start in the third quarter and would become more pronounced in the fourth quarter of the year.

After having increased slightly in December, consumer confidence fell back in January. At the start of 2012, consumers expected the general economic situation to get worse over the current year, while fears of an increase in unemployment have also been revived.

Private investment is expected to slow down considerably, with capacity utilisation having fallen back below its long-term average. Demand for mortgages is also expected to decline in the first quarter of 2012, affecting construction investment.

Finally, the consolidation measures included in the budget for 2012 and complemented by additional measures in early January, which were not included in the autumn forecast, are likely to have a limited but negative impact on growth this year.

The contribution of net trade to growth is set to remain weak in 2012 (-0.2 compared to 0.0 in the autumn forecast). While exports were still booming during the first quarter of 2011, they fell in the course of the year due to the deterioration in growth of foreign markets. Exports are expected to resume in the course of 2012, but the unfavourable starting point would limit their increase in 2012 as a whole.

Inflation has been revised upward compared to the autumn forecast, from 2% to 2.7%. The impact of the consolidation measures in the 2012 budget, in particular the increased VAT rates on tobacco, pay-tv and some professional services such as notarial services, is estimated at 0.2%. Other elements contributing to the higher inflation forecast are the increased telecommunication tariffs and the less pronounced slowdown in energy prices compared to the assumption in the autumn. The higher-than-expected level of oil prices for 2012 has an important weight on inflation in Belgium as the economy is rather energy intensive.

3. BULGARIA

The Bulgarian economy has revived relatively slowly over 2010-11, with real GDP in the fourth quarter of 2011 still about 3% below its peak value recorded in 2008. The GDP flash estimate for the fourth quarter of 2011 indicates growth of 0.4% q-o-q and 1.5% y-o-y. For 2011 as a whole, annual growth is expected to reach 1.8%. The growth momentum from 2011 has had a marginally positive carry-over to 2012. As in other EU Member States that are catching up, the growth pattern in the initial recovery has been largely driven by strong exports of both goods and services, while domestic demand has remained stagnant, reflecting a rapid adjustment and an unwinding of imbalances in the private sector.

The strong rebound in exports has been levelling off over 2011, and monthly industrial production indicators, as well as industry confidence readings point to markedly lower export growth going forward. Nevertheless, in spite of the weaker outlook in the euro area, Bulgaria is not expected to fall back into a recession. Annual growth has, however, been revised down (by 0.9 pp. less than projected in the autumn forecast) and is now forecast to reach 1.4% in 2012. GDP growth is expected to remain rather low in the first half of 2012, but to accelerate gradually thereafter in line with economic activity picking up in the EU as a whole.

Following the rapid rebound in exports over the past two years, domestic demand is expected to pick up with a lag and become a main driver of growth in 2012, especially since domestic economic fundamentals have improved amid the rapid adjustment process. Private-sector imbalances have unwound very quickly, as indicated by the current account swinging into a surplus, while the ratio of private sector debt to GDP has started to decline and the dependency of the financial sector on external financing is decreasing. In spite of vulnerabilities, the financial sector has remained stable and has provided for modest growth in private sector credit in 2011. The economy also benefits from relatively strong public finances, which do not face major adjustment needs in the longer term.

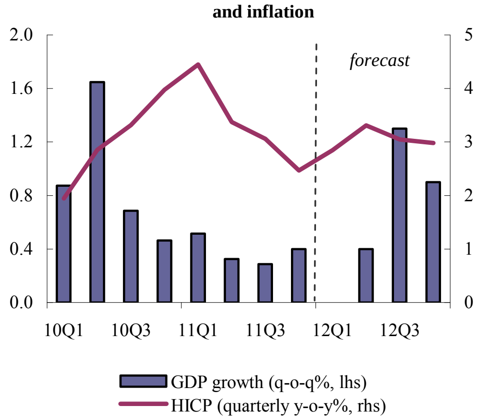
The gradual revival in private consumption is expected to continue. While economic confidence readings declined over the final quarter of 2011, sentiment recovered in January 2012 and is somewhat stronger than the EU average. Following a markedly strong and protracted period of labour shedding, the labour market appears to be stabilising in 2012. Even with weak employment performance, household income has been supported by relatively strong growth in average wages, probably driven by catching-up effects from low levels and structural changes in the labour market.

Investment is expected to be upheld by public sector projects. After a notably slow start in EU structural funds intake over the previous years, it is planned to increase absorption significantly in 2012. However, this is countered by weak private investment activity, given the relatively high debt stock of the corporate sector, which entails further deleveraging of corporate balance sheets.

HICP inflation slowed considerably over the course of 2011 and amounted to 3.4% in 2011 on average, 0.3 pp. less than expected in the autumn forecast. Inflation is expected to moderate to 3% on average in 2012, supporting growth in real purchasing power of consumers.

The forecast baseline scenario is subject to significant risks. A prolonged stress in financial markets could further delay the recovery in consumption and investment. Uncertainty regarding the consumption behaviour of households remains one of the major risks to the outlook, both on the upside and on the downside. Should households lessen their currently high precautionary savings rate, this could underpin stronger consumption growth.

Graph 3.1: **Bulgaria - GDP growth and inflation**



4. CZECH REPUBLIC

The soft patch foreseen in the autumn 2011 forecast materialised when real GDP fell by 0.1% q-o-q in the third quarter of 2011 and 0.3% in the fourth quarter, according to preliminary estimates by the Czech Statistical Office. Industrial production slowed to 2% y-o-y in December 2011 compared to 5.4% in November and 11.9% reported a year ago. The largest decline in manufacturing output was recorded in computers and electronic products (which represent about 4% of total Czech production) while other industries, including motor vehicles, machinery and equipment (about 11% of total production) still showed double-digit growth at the end of the year, although decelerating compared to the first half of 2011.

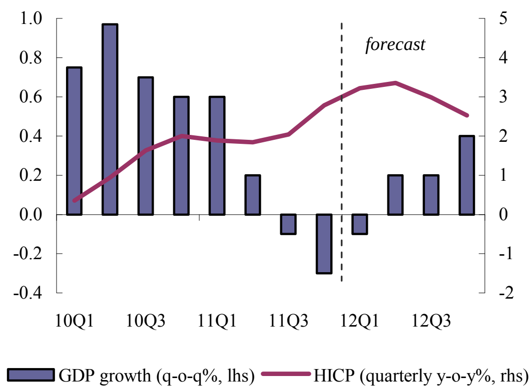
The slowdown affected all components of domestic demand; government consumption expenditure is estimated to have contracted most markedly. By contrast, net exports supported growth, particularly in the second half of the year as the growth rate of exports outpaced that of imports, which were held back by weak domestic demand. The year-end decrease in imports was, however, somewhat cushioned by the effect of pre-stocking on beverages and tobacco due to the anticipated rise in the lower VAT rate and excise taxes in January 2012.

GDP growth is projected to stall during 2012. Consumer confidence survey data suggest an ongoing decrease in household consumption expenditure at the beginning of 2012, which reflects worsening labour market conditions and wage restraint at the level of the central government. Increases in the VAT rate on food and selected services should dampen consumer demand. Investment is expected to recover only in the second half of 2012, reflecting continued uncertainty about export prospects and depressed profit margins. In a setting of generally subdued domestic demand, weak-but-still-growing net exports are likely to be the main factor supporting economic activity.

Against this backdrop, and also owing to a methodological revision to the quarterly profile of GDP components data, the current estimate of flat real GDP in 2012 growth is considerably lower than in the autumn forecast.

The harmonised index of consumer prices increased by 2.1% in 2011 and is projected to pick-up further to 3.0% in 2012. The increase is expected to be driven predominantly by the hike in the lower VAT rate and persistently high oil prices, compounded by a slightly weaker exchange rate than was assumed in the autumn forecast. Domestic demand pressures should remain very limited. The direct effect of the VAT increase on HICP is estimated at 1.1 pps. While the higher rate applies only from the beginning of 2012, part of the adjustment was visible in the price data already in the last quarter of 2011.

Graph 4.1: **Czech Republic - GDP growth and inflation**



5. DENMARK

Following the rebound in 2010, and despite solid exports, the overall performance of the Danish economy was subdued in 2011 owing in particular to low confidence among households and firms in the light of the ongoing sovereign-debt crisis. With lower than initially anticipated domestic demand in the third quarter, annual real GDP growth is not projected to exceed 1% in 2011, i.e. corresponding to a 0.2 pp. downward revision compared with the autumn 2011 forecast. Nevertheless, the improvement of indicators such as industrial production, car sales and exports in the course of the fourth quarter 2011 suggests that Denmark is likely to have avoided a technical recession towards the turn of the year.

In 2012, real GDP is expected to grow slowly at around 1%, driven by domestic demand. The downward revision as compared with the autumn 2011 forecast (1.4%) mainly reflects a weaker external environment. Private consumption is expected to accelerate in the course of 2012 as contributions to the voluntary early retirement pension (VERP) scheme are to be reimbursed following the adoption of the retirement reform by Parliament. However, it is envisaged that a fragile housing market and a stagnating labour market will continue to weigh on consumer spending. Moreover, households are likely to continue with the needed balance sheet deleveraging and to maintain precautionary savings at a relatively high level during the current period of elevated economic uncertainty.

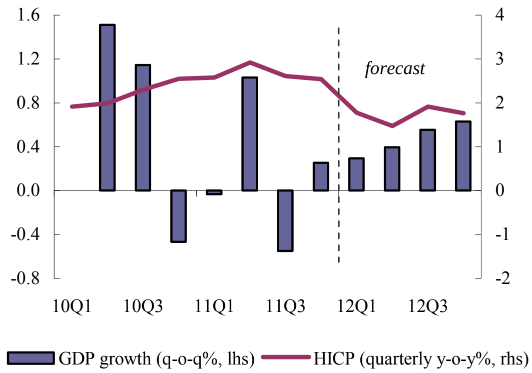
At the current juncture, low interest rates due to the safe-haven status of Danish government and mortgage bonds underpin the Danish housing market. Nevertheless, indicators such as the number of houses for sale and the long selling periods bear witness to a frail market, with house prices expected to continue to fall in 2012.

Overall investment growth is projected to have bottomed out in 2011. However, credit conditions are expected to remain tight and gross fixed capital formation continues to be driven largely by public initiatives in 2012, in line with the government's "kick-start" stimulus package and supported further by large-scale infrastructure projects (e.g. extension of the Copenhagen Metro and the railway network).

Exports proved resilient in 2011, thanks to high growth rates at the beginning of the year, i.e. prior to the slow-down in world trade. Thus in 2012, export growth is projected to be significantly lower due to a less favourable external environment, in particular the subdued growth outlook for Germany and Sweden, Denmark's main trading partners. The large share of non-cyclical goods – such as food and pharmaceuticals – in Danish exports should, on the other hand, sustain export growth.

Furthermore, with an almost steady unemployment rate and private employment not expected to pick up soon, current wage negotiations in the private sector are expected to yield moderate wage increases in the subsequent two-year period and thereby some gains in cost competitiveness. Import growth should remain strong, however, due to the strength of domestic demand.

Graph 5.1: **Denmark - GDP growth and inflation**



While real wages fell in 2011, they may pick up slightly this year as the inflation rate is projected to drop by almost 1 pp. from 2.7% in 2011 to 1.8% in 2012. Due to the oil-price hike at the beginning of 2011, the energy contribution to inflation remained relatively large throughout the year but this effect will peter out in 2012. Services and processed food should be the main contributors to inflation. In addition, a rise in taxes on cigarettes and air pollution, as part of the government's 2012 budget law, will add around ¼ pp. to inflation, just as the earlier introduction of a tax on saturated fat in the fourth quarter of 2011 will continue to contribute to inflation this year.

6. GERMANY

The upswing of the German economy continued in 2011, with real GDP estimated to have increased by 3.0% (after 3.7% in 2010). The expansion was mainly driven by domestic demand, which is expected to have contributed 2.1 pps. to growth. Private consumption saw its largest increase in five years, supported by a benign labour market, as employment reached its highest level in 20 years. Gross fixed capital formation continued to expand markedly, reflecting both continued investment in machinery and equipment and the strongest increase in construction since the mid-1990s. While exports remained dynamic, imports were also robust on the back of strong domestic demand, which is estimated to have resulted in a growth contribution of net exports of 0.8 pp. (after 1.5 pps. in 2010).

However, the growth momentum slowed noticeably in the course of the year as the crisis deepened. Uncertainty took its toll on the sentiment of economic agents, while export prospects weakened and new orders – both for domestic business and from abroad – declined considerably in the second half of 2011. Following a gain of 0.6% q-o-q in the third quarter, real GDP contracted by 0.2% q-o-q in the last quarter of the year. According to preliminary indications, exports declined amid the weak international environment, as did private consumption following the solid expansion of the previous quarter. Gross fixed capital formation increased, with buoyant construction activity likely to have been supported by the mild weather at the end of the year.

Available indicators for the first quarter of 2012 signal an improvement in sentiment among both firms and households. This suggests that the growth momentum has experienced a temporary interruption rather than signalling an entry into recession. A slight edging-up of GDP in the first quarter, followed by an acceleration of growth in the course of the year, thus continues to be the central scenario for the German economy, although risks remain particularly pronounced at the current juncture.

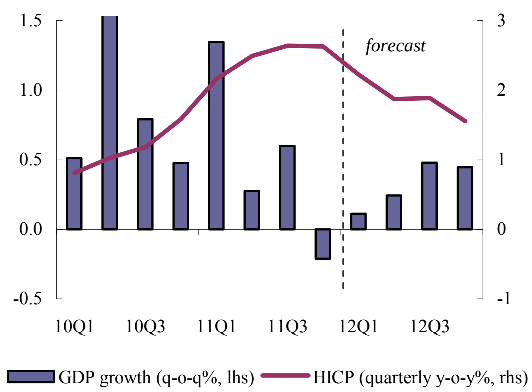
Domestic demand is expected to continue to drive the expansion. Private consumption should be further underpinned by the resilient labour market, where available working-time flexibility is likely to be used to absorb the effects of a temporary slowdown in activity, as well as by healthy wage growth amid slowing inflationary pressures. Gross fixed capital formation is likely to expand considerably more slowly than last year, with some plans for investment in machinery and equipment likely being put on hold amid the current uncertainty. However, this effect should be dampened by the fact that capacity utilisation, although diminishing, remains high, as well as by still-favourable financing conditions. While the end of temporary stimulus measures should lead to downward pressure on public investment, private housing investment should remain relatively dynamic, possibly benefitting from the increase in the perceived risk of investment alternatives.

Export prospects have worsened somewhat compared to the autumn forecast, given the weaker outlook for Germany's trading partners in the EU, which account for around 60% of the country's goods exports. Given still-lively imports on the back of robust domestic demand, net external trade should exert a considerable drag on GDP growth this year.

Overall, real GDP is expected to gain 0.6% this year. The downward revision relative to the autumn forecast is fully explained by the lower carry-over from 2011 following the weaker-than-expected outcome in the last quarter of the year.

HICP inflation was slightly higher than expected in the last quarter of 2011, driven by higher energy prices. The inflation rate is now projected to average 1.9% in 2012, reflecting more elevated oil prices than anticipated in autumn. Core inflation should also remain contained reflecting slower activity than last year.

Graph 6.1: **Germany - GDP growth and inflation**



7. ESTONIA

According to the flash estimate from Statistics Estonia, annual economic growth in Estonia reached 7.5% in 2011, i.e. 0.5 pp. lower than projected in the autumn forecast. Domestic demand was stronger than expected and export performance remarkable. However, in the last months of the year Estonia was not immune to the deteriorating confidence seen in many Member States. As a result, GDP shrank by 0.8% q-o-q in the last quarter of 2011. The contraction, however, was mostly limited to the export-oriented electronics sector, which had been one of the main growth drivers in the initial phase of the recovery. More recently, manufacturing production seems to have stabilised at somewhat below its recent peak level.

The 2012 outlook for the Estonian economy has significantly deteriorated, driven by falling confidence and weaker external demand around the turn of the year. As a result, GDP growth expectations for 2012 have been revised downwards, from 3.2% in autumn to 1.2% in the present forecast.

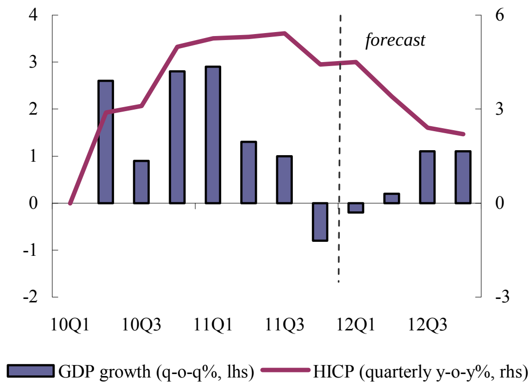
Despite remarkable productivity adjustments in the recent recession, exports are expected to remain weak in the first half of 2012. Export performance and growth will largely depend on the pace of the global recovery.

Domestic demand was mainly driven by strong fixed investment, which rose by 23% in the first three quarters of 2011 compared to first three quarters of previous year, mostly due to corporate spending targeted at increasing productivity. However, public investment surprised positively in the second half of the year. Given the lower utilisation of production capacity in January 2012 compared to the previous October (68% compared to 74%) reflecting the economic deceleration, new corporate investment projects are likely to be put on hold for a while. Nevertheless, strong public investment is expected to largely offset the slowdown in corporate investment. The robust infrastructure investment already planned reflects carbon-credit-trade contracts aimed at increasing energy efficiency, but also higher absorption of EU structural funds.

Reflecting a relatively improved labour market situation and an increased disposable income, private consumption is expected to grow moderately this year.

Average annual HICP inflation reached 5.1% in 2011, spurred by higher international food and oil prices since spring 2010. However, the contribution of non-energy industrial goods to inflation remained low, alleviating the risk of competitiveness losses. The impact of the euro changeover on 1 January 2011 appeared limited. Looking forward, lower commodity prices since mid-2011 should contribute to further inflation moderation in 2012. Given lower output growth and the slower decline in unemployment in 2012, second-round effects from earlier commodity price increases and upward pressure on wages due to skills mismatches should also be moderate.

Graph 7.1: **Estonia - GDP growth and inflation**



8. IRELAND

Ireland's economy is estimated to have returned to modest growth of 0.9% in 2011, after a sharp 10% contraction in output between 2008 and 2010. Following stronger-than-expected growth in the first half of the year (1.8% and 1.4% q-o-q in the first and second quarters respectively), third-quarter data were weaker than anticipated (with GDP contracting by 1.9% q-o-q), especially in terms of domestic demand, while exports held up rather well. [2] Indeed, for 2011 as whole, growth is estimated to have been entirely export-led. Net exports contributed an estimated 3.6 pps. to GDP in 2011, as external demand benefited from competitiveness improvements, while domestic demand continued to contract due to fiscal consolidation, falling employment and household balance sheet repair.

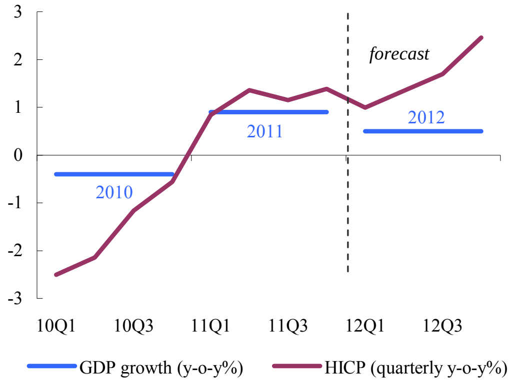
A small current-account surplus of 0.4% of GDP is expected on the basis of net export growth. Employment continued to contract, by 2.2%, although the unemployment rate stabilised through the year at 14.3%, as participation declined and net outward migration continued.

Due to weaker projected outlook for the euro area, Irish export growth is expected to slowdown in 2012, although the unchanged outlook for the UK and US economies (large trading partners for Ireland) will provide some support. Net exports are expected to contribute positively to growth, as domestic demand contracts for a fifth successive year. Overall, GDP is forecast to grow by a modest 0.5% in 2012. Private consumption is set to decline once again as households continue to adjust their balance sheets and the continuing reduction in construction activity will see investment activity decline once again

The current account is expected to move more into surplus as domestic demand continues to contract. Employment is set to fall once again as the public service and financial sector shrink, with the unemployment rate rising, with lowered participation and some further net outward migration mitigating in part the impact of the fall in employment.

Inflation turned positive in 2011, largely on the back of imported energy pressures, but remained low at 1.2%. It is expected to rise slightly to 1.6% in 2012, with upward pressure coming from the depreciation vis-à-vis sterling, and the effect of the 2 pps. increase in VAT as well as a number of administered price increases throughout 2012.

Graph 8.1: **Ireland - GDP growth and inflation**



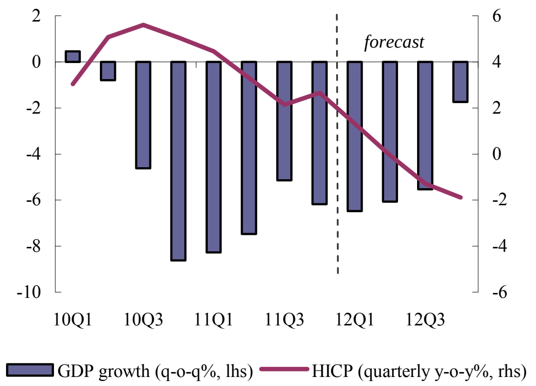
Risks to the growth outlook remain tilted to the downside. If downside risks to the euro area materialise, it could have an impact on demand for Irish exports. The continuing need for household balance sheet repair could weigh on consumption more heavily than projected. The low interest rate environment may, on the other hand, assist the household sector in this regard without impacting unduly on already-low domestic demand.

[2] Given Ireland's small and very open economy, quarterly figures are particularly volatile and subject to revision. Thus they should be interpreted with caution.

9. GREECE

In 2011, economic activity was much weaker than anticipated in the autumn forecast. Recent flash data for the last quarter of 2011 by ELSTAT reveal that real GDP fell by 6.8% for the year as a whole. The fall in domestic demand was driven by income losses, tight access to credit for the private sector and the ongoing adjustment in the labour market. Exports of goods and services rose by an estimated 3.9% in real terms, although from a low base (exports of services and goods represent about 24% of GDP in Greece), and decelerating from 4.2% in 2010.

Graph 9.1: **Greece - GDP growth and inflation**



The labour market is undergoing a painful adjustment process. According to the Labour Force Survey, in January to November 2011 the average unemployment rate was 17.2%; for the year as a whole employment is estimated to have contracted by 4.8%. The increase in unemployment is expected to continue in 2012.

Minimum wages in the private sector, and other wages regulated by the National General Collective Agreement will be reduced by around 22%. Unit labour costs for the business economy are expected to fall by 15% over the next three years. While the decision by the Government to reduce minimum wages and the expected emulation effect on other wages are intended to improve competitiveness and absorb youth and low-skilled workers, they are expected to hamper domestic demand, which in the short term may procure negative feedback loops into employment. In a medium-term perspective, other structural reforms are also expected to create more favourable conditions for employment.

In 2012, real output is expected to shrink further, by 4.3% – markedly lower than forecast in the autumn and with substantial downside risks – mirrored by very low consumer and business confidence. Apart from the weakening external demand, domestic demand is set to contract given the expected acceleration of the labour market adjustment, with wage cuts in the private sector. Overall exports are set to be even less dynamic than in the previous three years, despite the competitiveness-enhancing reductions in labour costs of Greek enterprises. On the other hand, imports will continue to be affected by weak domestic demand, so that the external sector will again make a positive contribution to GDP.

Headline HICP inflation averaged 3.1% in 2011, down from 4.7% in 2010. It rose by 2.2% in January 2012. The slow reduction in prices is mainly attributed to oil prices and tax measures implemented under the adjustment programme. Constant-tax inflation in 2011 was 1.2% in 2011. However, for an economy in deep recession, the inflation rate reveals deep inflexibility in product and services markets. In 2012 the price rise trend is expected to be reversed, resulting in slight deflation of 0.5%. The main driving force stems from anticipated falls in disposable income and consumer spending due to wage cuts in the private sector.

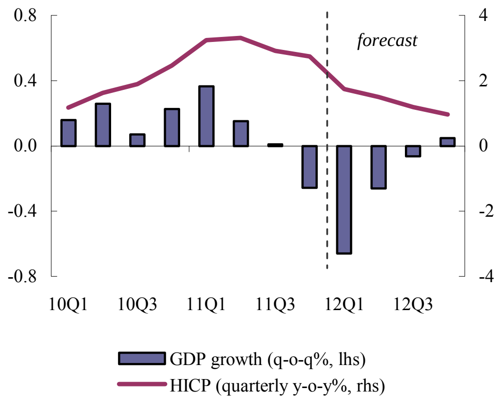
10. SPAIN

The Spanish economy lost momentum in the second half of 2011. Real GDP growth stagnated in the third quarter and declined by 0.3% q-o-q in the last quarter. This deceleration was driven by a weaker external environment, intensification of the sovereign-debt crisis with negative spillovers to the Spanish financial sector and to credit conditions, lower public expenditures, and a larger-than-expected deterioration in the labour market. For 2011, real GDP growth is still expected to have reached 0.7%, in line with the Commission services' autumn forecast.

High private sector imbalances accumulated during the housing boom and record-high unemployment continue to weigh on the outlook for the Spanish economy. The weaker outlook for the euro area and still-high uncertainty, especially in relation to the sovereign-debt crisis, are expected to have an adverse effect on growth in 2012. As a result, real GDP is expected to contract by around 1% this year, not taking into consideration additional fiscal consolidation measures still to be adopted [3].Taking into account additional fiscal measures in the forthcoming budget may significantly change the picture both for real GDP growth and for its individual components. Real GDP growth is expected to contract most significantly in the first half of the year, especially in the first quarter, followed by some improvement in the second half with growth rates close to zero in the last quarter.

Private consumption is expected to be significantly weaker this year, driven by persistently high unemployment, large household debt, and a binding credit constraint. Public consumption is also expected to shrink, as Spain continues with its fiscal consolidation programme and implements the additional measures announced at the end of December. Investment is expected to remain subdued in an environment of high corporate indebtedness (especially for construction and real estate companies), excess capacity and difficult access to credit. While domestic demand thus remains a major drag on economic growth, net exports continue to provide some support thanks to relatively resilient exports and the weaker imports implied by the subdued domestic demand.

Graph 10.1: **Spain - GDP growth and inflation**



HICP inflation is forecast to decelerate significantly, from around 3% in 2011 to 1.3% in 2012. This is mostly driven by the fading out of transitory factors that fuelled inflation in 2011 (i.e. electricity price and indirect taxes hikes) and by very weak internal demand. Moderating wage growth has also resulted in lower unit labour costs, contributing to a further easing of inflationary pressures. As a result, the inflation differential with the euro area is expected to be negative, leading to some improvement in Spanish price competitiveness.

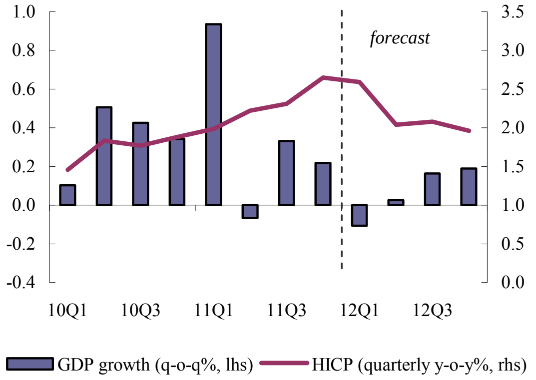
(3) Due to the general elections in November 2011, the adoption of the draft budget for 2012 was postponed until end-March. As this forecast is based on a no-policy-change assumption, it takes into account only the temporary extension of the 2011 budget together with the emergency fiscal measures taken by the Spanish government on 30 December 2011 (including a hike in direct taxes and certain expenditure cuts).

11. FRANCE

At 1.7%, estimated overall GDP growth in France for 2011 is in line with the autumn 2011 forecast, although the growth pattern was very uneven throughout the year.

After strong growth in the first quarter of 2011 (0.9%) and a slight contraction in the second quarter (–0.1%), GDP grew by 0.3% in the third quarter. Household consumption resumed as the influence of some temporary developments (including the aftermath of the phasing out of the car-scrapping premium and low energy consumption due to mild weather) that had affected the second quarter receded. At the same time, investment proved weaker than expected on amid decreasing confidence fuelled in particular by tensions on the financial markets.

Graph 11.1: **France - GDP growth and inflation**



In the last quarter of 2011, GDP growth proved much more resilient than had been forecast in the autumn. While increasing unemployment acted as a drag on household consumption, investment rebounded to 0.9%. This was in particular due to a strong increase in car purchases by companies, possibly in anticipation of the higher taxes on polluting vehicles which comes into force at the beginning of 2012. This acceleration in investment is therefore expected to be temporary. Net exports were strong but were offset by declining inventories.

The stronger-than-expected growth in the last quarter of 2011 translates into a higher carry-over for 2012. Nonetheless, GDP is expected to increase by only 0.4% for 2012 as a whole, below the 0.6% projected in the autumn forecast. Declining confidence throughout the euro area, rising unemployment and the impact of the fiscal consolidation measures included in the November fiscal package, which was announced after the cut-off date of the autumn forecast, and in the supplementary budget for 2012, are expected to bring economic growth to a standstill during the first half of this year. Growth is forecast to resume again in the second half, on the back of a gradual pick-up in domestic demand.

Turning to the components of domestic demand, higher unemployment is expected to weigh on disposable income of households, in particular in a context of increasing inflation. Consumers' assessment of their own financial situation reached a historical low in December suggesting low consumption growth in the first semester. Confidence indicators in both manufacturing industry and services have decreased sharply since the summer. The demand for loans has also receded while credit conditions have tightened somewhat. As one-off effects observed in the last quarter of 2011 dissipate, a temporary contraction of investment is expected in the first quarter. Net trade which contributed positively to growth in the last three quarter of 2011, would slow down due to the weakening of global activity, but would have an overall positive contribution to growth in 2012. Downward risks remain significant, linked in particular to the general economic development in the euro area.

HICP inflation has been revised up, to 2.2%, in 2012, 0.7 pp. above the autumn forecast. Energy prices, which had been expected to slow down markedly, have instead remained on an upward path in 2011, with a strong impact on HICP. The increase in the reduced rate of VAT for specific categories of goods and services in January 2012, together with the announced increase in the general rate from 19.6% to 21.2% in October, is expected to contribute to inflation. The adverse conditions in the labour market, which are expected to weigh on wage negotiations, should by contrast reduce inflationary pressures.

12. ITALY

The Italian economy entered recession again in the second half of 2011. The acute tensions recorded in the Italian and euro-area sovereign-debt markets in the final months of 2011, along with the ensuing tighter credit conditions affecting the private sector, implied a sharp deterioration in economic agents' confidence and a fall in demand. According to the flash estimate of the Italian statistical office (ISTAT), real GDP contracted significantly in the last quarter of 2011, by 0.7% q-o-q after -0.2% in the third quarter. Consequently, estimated real GDP growth for the year 2011 as a whole has been revised downward, from 0.5% in the autumn forecast, to only 0.2% (or 0.4% in calendar adjusted terms).

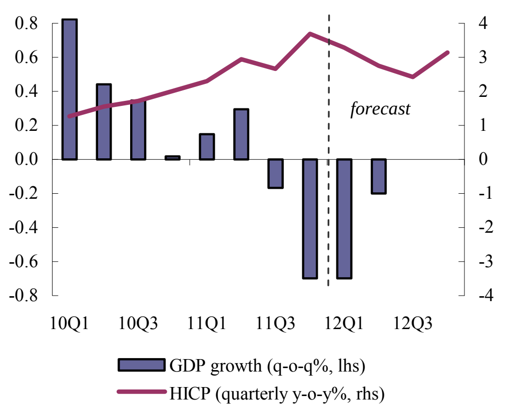
After incorporating the large GDP decline in the fourth quarter of 2011, the negative growth impulse into 2012 is 0.6 pp., much worse than the -0.1 pp. expected in the autumn 2011 forecast. As uncertainty remains elevated and thus major spending plans of consumers and firms are kept on hold, growth prospects for the first half of 2012 have also worsened relative to the autumn forecast. Real GDP is now expected to contract by a further 0.7% in the first quarter of 2012 and by 0.2% in the second quarter. Economic activity is set to stabilise in the second half of the year, under the assumption of no further deterioration in financial market conditions and a stable spread between Italian and German sovereign bonds at around 370 bps for 10-year maturities. As a result, real GDP is expected to contract by 1.3% in 2012 as a whole after the 2010-11 mild recovery. This implies that following the deep recession recorded in 2008-09, the level of real GDP in 2012 is projected to be around 6% lower than in 2007.

Looking at the demand components, very tight financing conditions and relatively low capacity utilisation are expected to hold back gross fixed capital formation. Equipment investment is set to drop substantially in 2012, while construction investment is expected to be scaled down at broadly the same pace as in 2011. Private consumption is set to fall in 2012, after increasing marginally in 2011. This is mainly due to the fall in households' real disposable income, under the impact of declining employment and the large fiscal consolidation measures adopted in 2010-11. The substantial drop in domestic demand is expected to lead to a fall in imports in 2012. By contrast, exports are set to continue to expand in 2012 on the back of sustained demand from extra-EU trade partners. As a result, the positive contribution of net exports to real GDP growth is expected to be substantial in 2012, as in 2011. Thanks to the improved trade balance, the current account deficit is projected to narrow significantly in 2012 relative to the 3¼% of GDP deficit recorded in 2011.

Negative cyclical conditions, along with some labour hoarding, are expected to lead to stagnant labour productivity over 2011-12. As a consequence, unit labour costs are projected to rise despite the moderate wage increases expected in the private sector and the wage freeze in the public sector.

HICP inflation is set to remain at 2.9% in 2012, as in 2011. Core HICP inflation, i.e. excluding energy and unprocessed food, is projected to stabilise in 2012. This relatively high inflation – despite falling domestic demand and moderate pressures from labour costs – is explained by the further rise in oil prices and the effects of fiscal consolidation measures. The standard VAT rate was increased by 1 pp. (to 21%) in September 2011, while excise duties on energy products were raised with the new consolidation package adopted in December 2011. The latter also specified the so-called "safeguard clause": an additional 2 pps. increase in both the 21% standard VAT rate and the 10% reduced rate will be effective as from October 2012, unless equivalent resources are raised through the reform of the tax and social assistance systems. This further VAT increase is incorporated in this forecast.

Graph 12.1: **Italy - GDP growth and inflation**



13. CYPRUS

The Cypriot economy grew by a modest 0.5% in 2011. After a good first half year when GDP rose by 1.5% y-o-y thanks to an exceptionally good tourist season, economic activity was badly affected by the accident in July that destroyed the Vassilikos electricity producing plant, which accounted for half of the total generating capacity of Cyprus. Moreover, a worsening external environment and tightening financial and fiscal conditions compounded the adverse effect on economic activity.

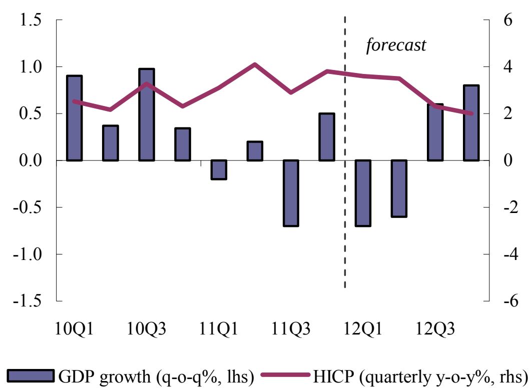
Domestic demand, traditionally the main driver of growth, shrank in 2011. Tightening bank lending conditions along with a worsening labour market outlook and weakening confidence weighed on private consumption. In addition, weak foreign demand for housing and a restructuring of corporate balance sheets kept investment on a correction path for a third year in a row. On the other hand, the external sector made a positive contribution to growth. Tourist arrivals and revenues posted an increase of 10% and 13% respectively. This was due to political instability in competing Mediterranean destinations and an increased flow of arrivals from developing markets such as Russia. Also, import growth decelerated, in line with the contraction in domestic demand.

GDP is projected to contract by 0.5% in 2012 due to weak domestic demand. The downward revision relative to the autumn 2011 forecast is explained by the worsening of the external environment and by the adoption of additional consolidation measures, not accounted for in the autumn 2011 forecast. Furthermore, the deterioration in financial markets and the tightening of credit conditions may raise the cost of financing to the private sector and limit access to it. Leading indicators point to weak albeit improving consumer and business confidence. This suggests that recovery should set in slowly, during the second half of 2012, with the improvement of the external environment, the start of the tourist season and the resumption of investment projects as uncertainty dissipates. Housing investment is expected to remain weak, while other construction investment is likely to benefit from reconstruction work in the destroyed Vassilikos power station and from other infrastructure projects. Moreover, the contribution of the external sector to growth is set to remain positive. While slowing global trade and worsening economic prospects in Cyprus' main trading partners is likely to weigh on exports of goods, this is expected to be partly offset by the healthy performance in business services and tourism. Imports are set to decline, against a backdrop of weak domestic demand.

HICP inflation is projected to decline to 2.8% in 2012 from 3.5% in 2011 on the back of easing commodity prices combined with weakening domestic demand. Furthermore, the base effect of increased electricity prices is set to dissipate in the last quarter of the year. Core inflation is forecast to remain contained at about 1.8%.

Overall, risks appear to be balanced. On the one hand, greater spillovers from potential worsening conditions in Greece, due to the large exposure of the financial sector, are substantial. Also, tightening credit conditions, coupled with already-higher financing costs and the high indebtedness of private agents, could delay the rebound in consumption and investment. On the other hand, external demand may strengthen more than expected if the announced strategic plans by the Cyprus government for attracting more tourists and foreign investors succeed (ex. plans for the introduction of new destinations, for tourist traffic growth, and incentive schemes for winter tourism). Investment, for its part, may be sustained through various announced construction and infrastructure projects.

Graph 13.1: **Cyprus - GDP growth and inflation**



14. LATVIA

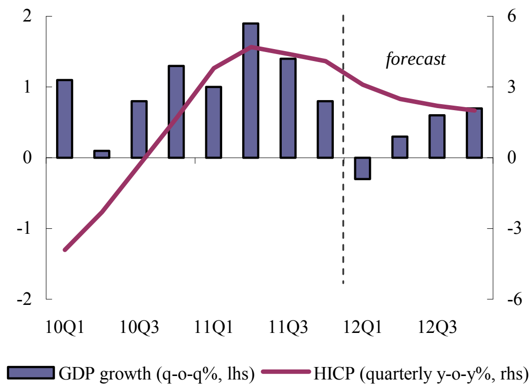
Latvia's economic growth exceeded expectations in 2011 despite a slowdown, driven by weaker external demand, in the last quarter of the year. According to the flash estimate of the national statistical office, GDP rose by 5.3% in 2011, against 4.5% in the autumn forecast. The annualised seasonally unadjusted rate slowed to 5% in the last quarter of the year from 6.6% in the previous quarter. Trends in retail trade and industrial production show a continued slowdown in early 2012, which could translate into a mild contraction in the first quarter of the year compared with the previous quarter.

On the other hand, the Economic Sentiment Indicator rebounded to 105.3 in January from an average of 102.6 in the last quarter of 2011, reaching a new four-year high. Trade volumes and transport services also remained quite resilient to the slowdown in Europe since the summer. Nevertheless, weaker demand from major trading partners, as well as risks of more cautious household consumption and corporate investments, lead to a downward correction to the growth forecast for Latvia to 2.1% in 2012 from 2.5% in the Commission autumn forecast.

The GDP breakdown by demand components confirms the continuous rebalancing of the economy towards export-oriented industries. According to data of the national statistical bureau for January-September 2011, the share of exports in GDP widened to 60% from 53% for the same period of the previous year. Despite some moderation in the last quarter of 2011, the share of exports most probably continued to rise. Balance of payments figures indicate a significant rebound in the service sector that offsets part of the slowdown in the external trade with goods. Tourism services made a substantial contribution to the growth rate in export of services in 2011, along with strong performances in ports and railway cargo services linked to transnational transport channels. However, the rebalancing toward export industries is likely to weaken substantially in 2012, as external demand restraints are expected to result into a balanced growth in the domestic and export components of GDP.

The harmonised index of consumer prices (HICP) was in line with expectations, at 4.2% in 2011 as a whole, including a large contribution from the increase in VAT rates. The constant-tax index is estimated at 2.7% in 2011 reflecting significant price hikes in the energy and food markets. For 2012 as a whole, average inflation is projected to decelerate to 2.5% as the impact of the tax hikes in 2011 weakens substantially. In comparison with the autumn forecast, the figure is revised upwards by 0.1 pp. due to an upward revision of the oil-price assumptions, only partly offset by subdued domestic demand. Uncertainties related to prices of primary energy resources represent a significant risk to the inflation forecast, as the country is strongly dependant on energy imports and the use of energy inputs in relation to GDP is one of the highest in the EU.

Graph 14.1: **Latvia - GDP growth and inflation**



15. LITHUANIA

After a strong economic performance in 2011 with real GDP growing by 5.8%, the worsened global economic outlook and persistent tensions in the world financial markets are now expected to slow Lithuania's economy more markedly than had been expected at the time of the autumn 2011 forecast. Economic output is projected to grow by 2.3% in 2012.

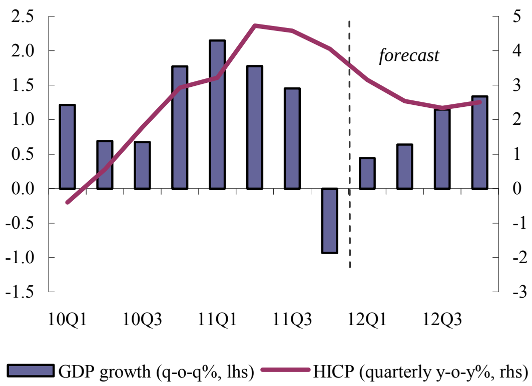
The strong growth in 2011 was initially driven by strong external demand. Substantial nominal wage declines and productivity improvements helped improve competitiveness and Lithuania took full advantage of the growing export markets. Rising exports boosted corporate profitability and contributed to improvements on the labour market. Consequently, private consumption and investment growth gained momentum, and domestic demand took over as the main driver of economic growth. However, at the end of the year, Lithuania started to feel the repercussions of the slowdown in the EU. In the last quarter of 2011, real GDP grew by 4.5% y-o-y, down from 7.3% in the third quarter.

Increased uncertainty, as well as the bankruptcy of the domestic bank Snoras at the end of 2011, have dampened consumer confidence and business expectations. These factors are expected to continue to hold back private consumption and private investment in 2012. Moreover, the on-going fiscal consolidation may further curtail domestic consumption, while public investment will continue to grow due to the frontloading of EU co-financed projects. Against this background, unemployment is likely to remain high, especially among the youth, and skill mismatches have appeared in some sectors.

Lithuania's economic performance in 2012 will depend considerably on developments in its main export markets (Germany, Poland, Russia and the other two Baltic countries) and on prospects for the wider euro area. Robust export performance in 2011 started to wither at the end of the year. Exports are projected to remain weak in the first half of 2012, before picking up in the third quarter in line with the forecast for its trading partners. This, together with a resumption of growth in private consumption, will contribute to accelerating GDP growth in the second half of 2012.

HICP inflation decreased at the end of 2011 to reach an annual average of 4.1%, after accelerating in the middle of the year, driven mainly by the energy and food – although commodity prices declined towards the end of 2011. Inflation is forecast to decelerate to 2.6% in 2012, mainly driven by lower commodity and food prices as well as weakening domestic demand. Some domestic factors, such as rising electricity and heating prices, as well as excise taxes on tobacco products, will provide limited upward pressure on inflation. Due to expected moderate wage growth and still high unemployment, overall domestic price pressures will remain rather weak.

Graph 15.1: **Lithuania - GDP growth and inflation**



16. LUXEMBOURG

GDP growth for 2011 has been revised down to 1.1% from 1.6% projected in the autumn 2011 forecast. A strong downward revision of quarterly growth in the second quarter of 2011 has only partially been compensated by a strong third quarter. As a consequence, the most recent data show an increase in GDP of only 1.1% over the first three quarters of 2011, mainly reflecting developments in domestic demand. The general weakening of global activity and the sovereign-debt crisis in the euro area have weighed on exports, especially on the performance of the important financial sector. Witnessing the further deterioration of indicators in the fourth quarter, a small contraction of 0.1% of the Luxembourg economy in the last quarter of 2011 cannot be excluded.

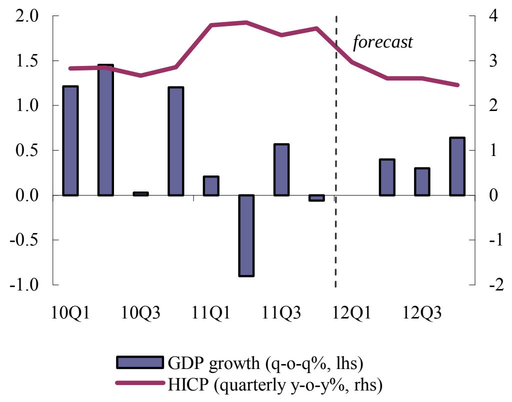
Since December 2011, there have been some signs of stabilisation. Consumer confidence improved after a two-year low had been reached in October. An improving international environment should contribute to a slow return to recovery during 2012. With the carry-over from 2011 expected to be close to zero and manufacturing and financial services contributing little to growth, overall growth in 2012 is now forecast to be around 0.7%. This has been revised down from 1.0% projected in the autumn forecast as the recovery is now only expected to materialise from the second quarter and to be less intense. Private consumption, which is estimated to have been rather weak in 2011, is expected to accelerate only a little in 2012. On the other hand, the number of building permits delivered in 2011 points to a strong performance by the construction sector in 2012, although the winter weather may affect figures for the first quarter of the year.

Job creation in Luxembourg was substantial in the first half of 2011 but slowed down afterwards. As a consequence, unemployment rose rapidly towards the end of the year (it increased from 4.9% in October to 5.2% in December). This trend is expected to continue over 2012, steering unemployment towards a historic high. In 2011, non-resident employment has grown faster than resident employment, but the difference is much smaller than in the ten years preceding the crisis.

On 1 October 2011, all wages in Luxembourg were automatically increased by 2.5% following the postponed application of the wage indexation mechanism, which was originally due in May 2011. At the end of 2011, the government of Luxembourg also decided to postpone the next automatic indexation, normally due in March 2012, to October 2012. As a consequence, wage increases in 2012 induced by the indexation mechanism will only be 2.5% instead of 4% without the postponement. Thus, wages per employee are expected to rise by 3.2%. This would result in an increase in (nominal) unit labour costs in 2012, given the small increase in output and even a negative evolution in terms of added value per employee.

Inflation (measured by the HICP) reached 3.7% in 2011, up from 2.8% in 2010. It has been driven upward by rising oil prices and price increases of other raw materials. Increases in administered prices contributed as well. Inflation is expected to slow to 2.7% in 2012. This figure is higher than in the autumn 2011 forecast due to oil prices remaining at a high level rather than decreasing moderately. The postponement of the automatic indexation of wages will result in a somewhat lower inflation for services compared to the autumn forecast. The National Index of Consumer Prices (NICP), which has a lower weight for oil products, is expected to fall from 3.4% in 2011 to 2.4% in 2012.

Graph 16.1: **Luxembourg - GDP growth and inflation**



17. HUNGARY

Growth in 2011 continued to be driven exclusively by the external balance, with the export sector performing well although losing momentum towards the end of the year against the backdrop of a weakening external environment. Domestic demand remained firmly in negative territory, although the pace of contraction slowed. Household consumption did not take off in light of uncertainties, high unemployment and the impact of the significant exchange rate depreciation against the Swiss franc on private indebtedness. The uncertainty of the policy environment, the weak economic conditions and credit supply constraints also contributed to the continued contraction of gross fixed capital formation.

However, the latest available data indicates that the Hungarian economy proved more resilient in the second half of 2011 than anticipated at the time of the autumn forecast. The implications for economic growth in 2012 are uncertain: the expansion of agricultural output contributed to lifting GDP growth in 2011, but as this was against the background of poor performance in 2010, such a strong rate of growth is unlikely to be repeated in 2012.

The external environment is worse than that expected in the autumn forecast, with Hungary's largest export markets growing at a lower rate. This has appreciable implications for economic growth prospects, since Hungary is a very open economy with exports amounting to 87% of GDP. The recent bankruptcy of the national airline carrier, Malév, will also dampen exports of services and raise imports, although the value the company added to Hungarian GDP was limited. At the same time, the Mercedes automobile factory appears on track to start production in the first half of 2012, helping Hungary gain market share as expected in the autumn forecast.

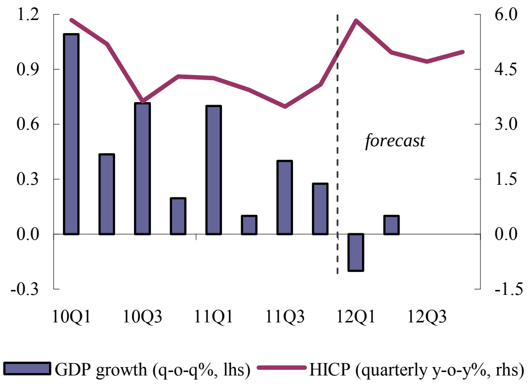
Domestic demand will be affected from the first quarter by fiscal austerity, which results in part from the need to correct for the loss of revenues from the large overall tax cuts, whose impact on the headline deficit in 2011 was obscured by the transfer of private pension fund assets to the state pillar. Employment prospects are also somewhat more negative than expected in the autumn, with consequent implications for household consumption.

On the other hand, on 15 December 2011 the government and the Banking Association signed an agreement that improved on the government's original plan, allowing the early repayment of foreign-currency denominated mortgages at discounted rates. This agreement includes four pillars whose impact is likely to play out over various channels, including a cash-flow effect for FX mortgage holders. The overall effect of the early repayment scheme in combination with the December agreement is still negative for the financial sector and thus for credit supply, although less so than before as the public sector will now share part of the cost. The wage compensation schemes that have meanwhile been specified also imply a smaller-than-expected burden on enterprises.

Overall, GDP growth is now expected to be near standstill in 2012, with some improvement after the first quarter of the year.

The pace of inflation will again rise in 2012 thanks in large part to increases in indirect taxes (including VAT, which at 27% is the highest rate in the EU) and higher-than-assumed oil prices. Other factors include the reduction in road maintenance subsidy, which is expected to raise transport prices due in part to the attendant increase in road toll fees. The inflation rate is now projected to average 5.1% in 2012 as a whole.

Graph 17.1: **Hungary - GDP growth and inflation**



18. MALTA

The Maltese economy rebounded relatively strongly after a mild contraction in real GDP in 2009, and the positive momentum was carried into 2011 as well. Buoyant private consumption, underpinned by healthy job creation and wage growth, as well as a strong performance by the tourist sector, were the main factors behind real GDP growth in the first half of 2011 and more than compensated for the relatively surprising weakness of business investment.

In the second half of 2011, however, the economy gradually lost steam. Private consumption growth slowed considerably in the third quarter, while annual export growth in volume terms turned negative for the first time since late 2009. The downward trend is expected to have continued in the final quarter of 2011, in line with the general slowdown in the euro area. Real GDP growth for 2011 as a whole is estimated at 2.1%, almost exclusively driven by net exports; this is unchanged from the autumn 2011 forecast.

The outlook for 2012 is relatively subdued. The latest consumer confidence indicators suggest that private consumption will remain weak. Households' disposable income is expected to be squeezed by a significant deterioration in labour market conditions after the very strong employment gains recorded in 2011, while average wage growth is foreseen to remain below HICP inflation. Uncertainties about the domestic and international economic environment, coupled with cautious lending behaviour by banks, are likely to continue to dampen business investment, which is likely to contract for a second consecutive year. Against this background, domestic demand is expected to continue to contribute very modestly towards real GDP growth.

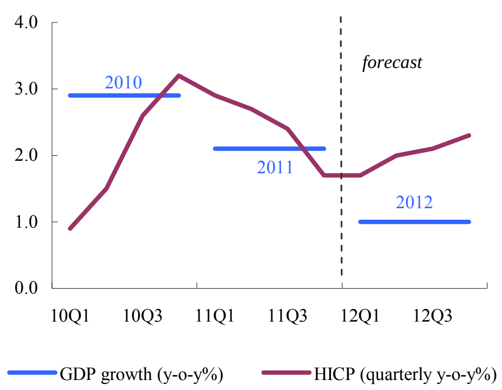
Net exports are again expected to be the main contributor to growth in 2012, but less significantly so than in 2011. Malta's exports, in particular exports of goods, benefit from a relatively high share of trade with emerging markets but are nonetheless affected by the projected further slowdown of economic activity in the euro area compared to the autumn forecast, which would have a negative impact – especially on tourism exports. Nevertheless, exports are projected to continue to outpace the expansion of imports, which are restrained by the weakness of highly import-intensive domestic demand.

Overall, real GDP growth is forecast to decelerate to 1.0% in 2012, compared to the 1.3% projected in the autumn 2011 forecast. The downward revision primarily reflects the impact of the projected further slowdown in the euro area.

The forecast is subject to downside risks emanating from possible negative feedback loops between the very large banking system and the real economy in case of a further worsening of the quality of the credit portfolio, especially in view of the already elevated share of non-performing loans and high exposure to the real estate sector. In addition, the hit through the trade channel could be larger than anticipated, for instance because of the heavy reliance of the tourist sector on the euro-area market.

Annual HICP inflation moderated gradually in the course of 2011. In 2012, energy inflation is expected to decelerate significantly given the more moderate assumed growth in oil prices compared to 2011, coupled with the government's decision to keep utility tariffs unchanged for a second consecutive year. Overall HICP inflation in 2012 is projected at 2.1%, slightly lower than in 2011 and in line with the euro area average.

Graph 18.1: **Malta - GDP growth and inflation**



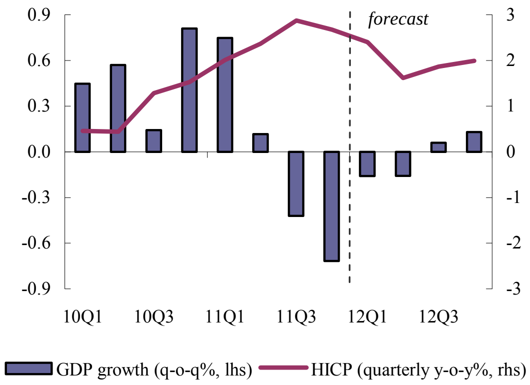
19. THE NETHERLANDS

In the second half of 2011 the Dutch economy experienced a sharp downturn, recording negative q-o-q growth of 0.4% in the third quarter and 0.7% in the fourth quarter, in and implying that the Netherlands is now in a recession. Both quarterly growth rates are significantly lower than the corresponding projections of 0.1% and 0.0% in the autumn 2011 forecast. This reflects a pronounced weakening of both internal and external demand. Consumer confidence, which was already markedly negative in the summer, deteriorated further at the end of 2011 and was at its lowest level since 2003 in January 2012. This was mirrored by a decrease in consumer spending in the second half of the year. House prices have fallen further and the number of transactions, whilst showing some recovery in December, has remained low. Producer confidence also stayed weak. This was reflected in the decrease of 1% (q-o-q) in industrial production in the manufacturing sector (excluding energy) in the fourth quarter of 2011. On the external side, Dutch exports have been adversely affected by the slowdown in global trade. Over 2011 as a whole 2011, GDP grew by at 1.2%, compared to an estimate of 1.8% in the autumn 2011 forecast.

For 2012, the outlook for growth remains subdued. Real GDP is projected to decrease by 0.9%, a marked deterioration compared to the autumn 2011 forecast, which projected modest positive growth of 0.5%. This is predominantly the result of a considerable negative carry-over, but also due to a slight downward revision of the quarterly growth profile projected for 2012. The Dutch economy is expected to record modest negative growth of 0.2% in both the first and second quarters. For the remainder of the year, a fragile and subdued recovery is envisaged, with quarter-on-quarter growth of 0.1% in the third and fourth quarter.

The growth rate of private consumption – already negative for four consecutive quarters in 2011 – is expected to remain negative in 2012, as a result of government consolidation measures, mainly affecting households, and negative wealth effects. The latter mainly emanate from falling prices in the housing market. On top of this, announced pension cuts as of 2013, along with the expectation of additional consolidation measures, may give rise to anticipatory behaviour by households in the form of precautionary savings. Investment is likely to remain weak, on the back of the weak growth outlook. While net exports are expected to remain the only component yielding a positive contribution to growth, they are likely to suffer from weakening external demand, mainly from the rest of the euro area. HICP inflation is expected to decline from 2.5% in 2011 to 2.0% on average in 2012, mainly as a result of subdued domestic demand.

Graph 19.1: **The Netherlands - GDP growth and inflation**



The risks associated with the baseline scenario are predominantly on the downside. These relate mainly to the global outlook, while domestic risks chiefly relate to a sustained and more severe fall in house prices and a worse-than-expected evolution of household disposable income.

20. AUSTRIA

The pace of the economic recovery held up remarkably well in 2011, with GDP expanding by 3.1% according to the Flash estimate. Quarter-on-quarter growth remained robust in the first half of the year, on the back of strong exports, investment and, not least, public consumption. However, the carry-over from 2010 accounted for more than half of the growth for 2011.

Economic activity is set to remain weak in the coming quarters. Corporations and households seem to be adopting an attitude of retrenchment with regard to consumption and investment outlays, setting the stage for only marginal growth throughout most of 2012.

Private consumption is likely to stay sluggish amid collapsing household confidence and stalling employment growth. The decline in unemployment came to a halt in the latter months of 2011 when the rate levelled off at around 4%. The recent wage negotiations have raised negotiated wages by 2.4% year on year on average as of January 2012. This limits the scope for sustaining the pace of employment gains during 2012. The overall impact of these counteracting trends on households' real disposable income is rather uncertain.

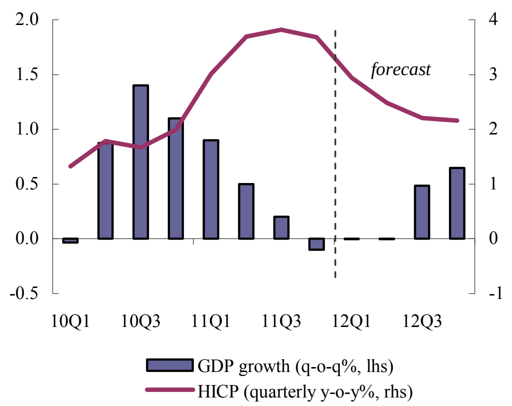
Manufacturers' order inflows and backlogs weakened throughout 2011 as did their expectations for exports. Indeed, firms have boosted their competitiveness by a renewal of capacity and by withholding productivity gains in the course of 2010 and early 2011. Their capacity to accommodate demands for wage increases has strengthened. However the outcomes of recent wage negotiations may put upward pressure on unit labour costs as the growth of output and productivity subside.

Financing conditions may tighten as banks focus on raising capital buffers and a further clean-up of balance sheets. Credit expansion, which had regained momentum since 2010 on the back of the economic recovery, is likely to tail off in the course of 2012. Credit demand from both companies and households has been shrinking of late, due to the uncertainties related to the economic outlook in Europe, while the renewed tightening of credit standards is expected to weigh additionally on credit activity in the coming months.

On the whole, the risk balance seems tilted on the downside. Upside risks are not as pronounced. On the external side, they stem from upbeat domestic demand in neighbouring Germany and possible direct or indirect benefits from still advancing import demand in emerging markets. Domestically, solid sentiment in the construction sector, together with sound corporate and household balance sheets, bode well for investment activity.

Driven by higher motor and heating fuel prices, as well as rising food prices, inflation averaged 3.8% in April-November 2011, but fell to 3.4% in December. Core inflation (HICP excluding energy and unprocessed food) has been affected by spillovers into prices in services, where the annual rate of change accelerated to a peak of 3.9% in August 2011. These effects are projected to disappear gradually, leading to a moderation of inflation in 2012. Wage growth is likely to remain contained, as the pace of economic expansion decelerates, although the translation of wage increases negotiated in various sectors into the effective wage level may well exert upward pressure on producer and consumer prices.

Graph 20.1: **Austria - GDP growth and inflation**



21. POLAND

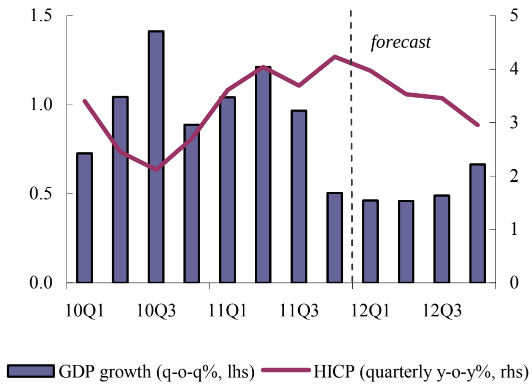
Economic activity decelerated in the last quarter of 2011, with real GDP growth expected at 0.5% q-o-q, down from 1% q-o-q in the previous quarter. The slowdown is attributed to lower private spending as consumer confidence deteriorated and the labour market worsened amid the gloomy external outlook.

For 2011 as a whole, real GDP is estimated by the national authorities to have grown by a healthy 4.3%. Growth was broad-based. Resilient consumer spending in the first half of the year benefited from supportive labour market developments and relatively upbeat consumer confidence. Public spending, as estimated by national authorities, shrank, reflecting the necessary consolidation effort. Better access to credit and increased profitability in the corporate sector, amid growing capacity utilisation levels, resulted in a strong rebound in private investment. Investment growth was further boosted by accelerated EU co-financed infrastructure spending. Moreover, the external trade balance turned positive fuelled by substantial currency depreciation in the second half of the year.

Real GDP is projected to increase by 2.5% in 2012, with quarterly real GDP growth stabilising at around 0.5% q-o-q over the year. Private consumption growth is likely to be muted, as consumer confidence and the labour market situation are set to deteriorate. Moreover, recent changes in non-tax labour costs and frozen nominal wages in public administration are likely to dampen wage growth, with inflation eroding purchasing power. Public spending is set to grow only marginally, on the back of stringent expenditure control.

Investment spending growth is expected to remain robust, supported by accelerating private investment. The corporate sector is likely to continue to increase capacity, financed by intensifying inflows of foreign capital, retained earnings and growing corporate credit. Robust public spending in infrastructure, driven by the completion of major motorway interconnections ahead of the Euro 2012 football championship, is set to support overall growth in gross fixed capital formation. However, inventory build-up is likely to become less supportive after a positive contribution to growth in 2011. The external trade balance is likely to be a major growth driver, as Polish enterprises are set to continue to benefit from a depreciated currency and the favourable sectoral structure of exports, whereas slowing domestic demand is expected to dampen imports growth.

Graph 21.1: **Poland - GDP growth and inflation**



Average HICP inflation reached 3.9% y-o-y in 2011, on the back of a VAT rate hike, rising commodity prices and a depreciating currency. After a temporary slowdown in the third quarter of 2011 inflation accelerated due to commodity price developments and reached 4.5% in December 2011. It is expected to steadily fall to around 3% at the end of 2012, on the back of stabilising fuel and food prices, inflation-decreasing base effects and weakening domestic demand. Taking into account the higher level at the start of the year, average inflation is, however, projected to reach 3.5% in 2012.

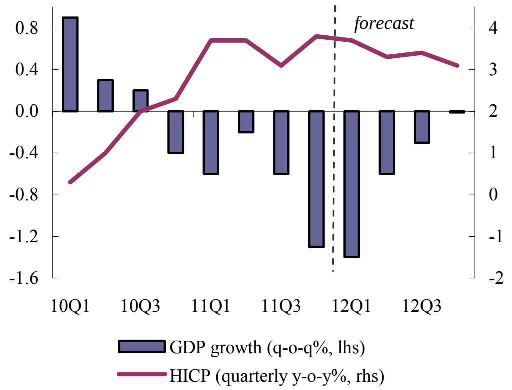
22. PORTUGAL

Real GDP contracted by 1.5% in 2011, which is 0.4 pp. less than anticipated in the autumn 2011 forecast. Preliminary data released by the national statistics institute suggest that the main reasons for this better-than-expected performance were a smaller fall in private consumption due to some consumption smoothing, as households reduced their savings to compensate for the strong fall in real disposable income, and more dynamic export growth. However, the decline in economic activity accelerated in the final quarter of 2011, with an estimated fall in real GDP of 1.3% q-o-q, following a contraction of 0.6% in the third quarter of 2011. Employment recorded a very strong decrease in the final quarter of last year, pushing the unemployment rate up to almost 14%, markedly higher than in the previous quarter. This is expected to have taken its toll on private consumption. Furthermore, trade statistics suggest that external trade recorded a strong growth contribution in the final quarter of 2011 due to a slump in import demand and relatively strong exports. However, exports decelerated markedly in December, in line with the deteriorating economic environment in Europe.

Developments in 2012 will be marked by additional fiscal consolidation efforts and accelerated deleveraging in the household and corporate sectors. Exports are predicted to suffer from a further deceleration in external demand for Portuguese products in the first semester. Moreover, credit and financial market conditions are projected to remain tight. Meanwhile, confidence indicators have reached lows across the board, although consumer and service sector confidence have recently stabilised somewhat. Private investment, especially in the construction sector, is expected to continue its decade-long decline, due in part to an expected further tightening of credit supply by banks. Furthermore, the deterioration of the economic environment in the euro area should impact on the outlook for Portuguese exports. While external trade is still expected to make a significant contribution to economic growth this year, it is not expected to offset the negative growth contribution of domestic demand. As a consequence, real GDP is now forecast to decline by 3.3% in this year, ¼ pp. lower than assumed in the autumn 2011 forecast.

HICP inflation was 3.6% in 2011, mainly due to a series of increases in indirect taxes and administered prices as well as higher oil prices. Price developments are also expected to be marked by fiscal measures in 2012, while wage restraint in a weak labour market environment should ease inflationary pressure. In 2012, HICP inflation is forecast to reach 3.3%. Employment is expected to shrink further, in line with the ongoing decline in economic activity, with a concomitant rise in unemployment.

Graph 22.1: **Portugal - GDP growth and inflation**



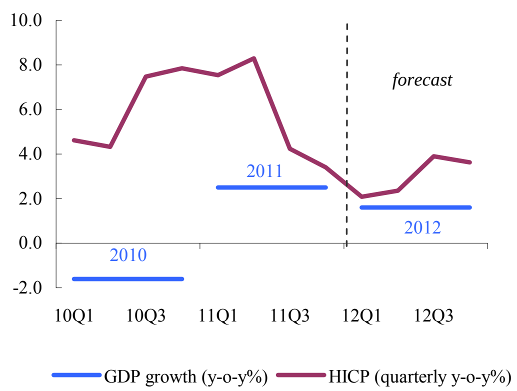
23. ROMANIA

After two years of negative readings, growth resumed in 2011, when real GDP is estimated to have grown by 2.5%. Growth was mainly driven by external demand in the first half of 2011 and an exceptional agricultural harvest in the second half. The latter is also expected to have positively affected exports in the third and fourth quarter of 2011. Industrial production growth was strong in the first half of 2011, responding to external demand, but has recently weakened on account of the slowdown in export markets. Construction output continued to increase in the last quarter of 2011, following from a rebound in the previous quarter. On the demand side, net exports were the key driver for growth in the first half of 2011, but their contribution to growth faded in the second half of the year. In 2011, private consumption did not pick up as strongly as initially projected, being held back by weak household balance sheets. Following a comprehensive Labour Code reform implemented in May 2011, the Romanian labour market improved last year; registered unemployment is around 5% and the labour force survey figures stabilised at an unemployment rate of around 7%. For the first time since the recession started, in the third quarter of 2011 investments increased by 15.3% (y-o-y) with increases in all its components.

For 2012, GDP growth has been revised downwards to 1.6% from 2.1% in the last autumn's forecast. This revision is mainly due to the negative effect on growth stemming from continuing uncertainties in the financial markets and the euro-area sovereign-debt developments. Romania's exports to the rest of the EU (70% of the country's exports) will be less dynamic and should provide less support to growth. Domestic demand is projected to be the main driver of growth in 2012. Although consumers are expected to continue their balance-sheets adjustment in the first half of 2012, the forecast improvement in employment and lower inflation should support income and thus contribute to a revival of private consumption in the second half of 2012. Government consumption is not expected to contribute much to growth in 2012, as it is constrained by the continued fiscal consolidation. However, public investment, supported by an anticipated improvement in the absorption of EU funds, is expected to play a key role in 2012. Private investment is likely to be weaker than anticipated on account of increased domestic and global uncertainty and therefore some investments planned for early 2012 are likely to be delayed to the second half of 2012 or 2013.

Risks to the 2012 growth forecast are tilted to the downside. Downside risks include: (i) possible continuing uncertainties in financial markets and sovereign-debt developments in the euro-area periphery that would weigh on Romania's growth; (ii) possible additional needs for repairing household balance sheets, coupled with tighter credit standards for lending, which may result in lower-than-expected private consumption. Upside risks include: (i) a potentially stronger contribution of investment than foreseen in the baseline in case of a significant improvement in the absorption of EU funds in 2012; and (ii) a potentially stronger contribution of domestic demand linked to possible pre-electoral fiscal slippages.

Graph 23.1: **Romania - GDP growth and inflation**



Inflation, which has been running high for a prolonged period (and was still above 8% in the second quarter of 2011), came down sharply in summer 2011 because of easing food prices and base effects linked to the VAT hike in 2010. End-year inflation was very close to the NBR's target range of 3.0% ±1 pp. Inflation is expected to further decline in the first half of 2012, before increasing again in the second half, but still staying within the NBR's target range. Over the medium term, risks to the inflation outlook appear skewed to the upside due to the need to deregulate energy markets and further hikes in other administered prices.

24. SLOVENIA

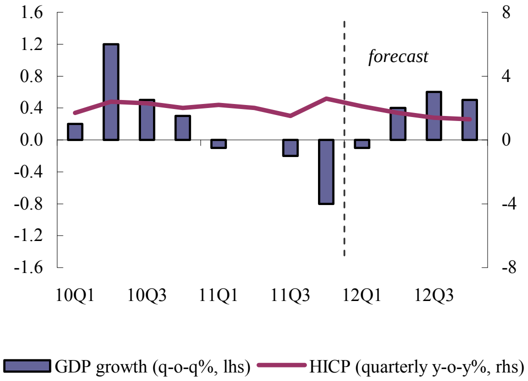
The international slowdown is hitting Slovenia through the trade channel – as it did in 2009 – but this time against a backdrop of already depressed domestic demand. A prolonged, shallow recession is in fact probably already in progress. The real GDP growth outturn in the third quarter of 2011 was slightly negative and a steeper decline is expected in the fourth quarter. Positive, but still subdued, growth is forecast to return only from the second quarter of 2012 onwards.

Real GDP growth for 2011 and 2012 as a whole has been revised downwards compared to the autumn 2011 forecast due to four factors: i) the unexpected negative outturn for real GDP growth in the third quarter of 2011; ii) substantial downward revisions to the outturns of previous quarters; iii) the worsened external environment; and finally iv) a flatter profile of construction investment.

Domestic demand was very weak in 2011, as squeezed household incomes and precautionary savings kept real consumption flat while the continued correction in construction caused gross fixed capital formation to fall precipitously. Against this backdrop, many domestically-oriented companies struggled to service debts and there were notable corporate bankruptcies, particularly in the construction sector. As a result, banks were hit by substantial further losses on their loan portfolios and credit growth remained negative. As in 2010, however, the drag on economic activity from domestic demand was more than offset by net exports and inventory accumulation; as a result, real GDP is estimated to have expanded by 0.3%.

A weak labour market is expected for 2012, resulting in shrinking real private consumption, but the overall drag from domestic demand is likely to lessen as conditions in the construction sector are expected to gradually stabilise. However, Slovenia's trade linkages leave it exposed to the worsening external environment, particularly as regards the sharp slowdown in key euro area trading partners. Export growth is thus expected to slow substantially. With lacklustre external demand compounding the pre-existing weak domestic demand, firms and banks are expected to pare back their investment plans. Overall, the lift from net exports would fail to exceed even the diminished drag from domestic demand in 2012, leading to a marginal contraction in real GDP of 0.1%. These trends imply the return of an external surplus in 2012.

Graph 24.1: **Slovenia - GDP growth and inflation**



HICP inflation is forecast to remain below the euro-area average, reaching 1.6% in 2012. On the one hand, weak domestic demand is expected to keep the prices of services in check. On the other hand, commodity price inflation is expected to ease. In this regard, Slovenia's excise duty policy delays and smoothes the inflationary impact of world oil price movements.

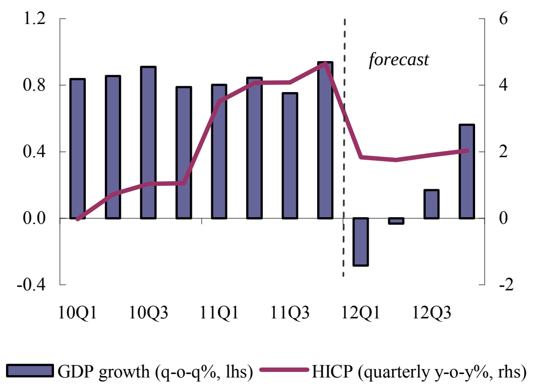
The real GDP growth forecast is subject to several downside risks. A greater-than-anticipated trade shock could cancel out the positive contribution to growth from net exports. An intensification of negative feedback loops between deleveraging banks and the credit-constrained real economy could bring further bankruptcies and a more severe retrenchment of investment. A sharp fall in house prices, which cannot be excluded given the absence of significant adjustment to date, would have wide-ranging effects that are difficult to assess ex ante. Finally, gross fixed capital formation could shrink still further if the correction in construction investment leads to significant undershooting.

25. SLOVAKIA

After rebounding in 2010, the Slovak economy continued to grow in 2011. The flash estimate for GDP suggests a strong fourth quarter, with q-o-q real growth at 0.9%, slightly higher than expected in the autumn forecast and leading to growth of about 3.3% y-o-y. Driven by growth in exports in durable manufacturing goods, economic activity strengthened throughout the year, despite the clear signs of distress in global financial markets that emerged during the summer.

However, recent high-frequency indicators on industrial production, construction and new orders point to a slowdown at the turn of the year, mostly in response to signs of deterioration in the regional economic outlook. With nearly four-fifths of total exports directed towards the single European market and with growth largely dependent on external demand, the outlook for 2012 largely reflects the economic prospects of Slovakia's main trading partners. Given the weaker outlook for the euro area, real GDP growth is expected to slow to 1.2% in 2012. This takes into account a sizeable carry-over effect from the previous year and a gradual pick-up in economic activity towards the end of 2012.

Graph 25.1: **Slovakia - GDP growth and inflation**



Despite positive employment data, especially in the earlier part of the year, real disposable income of households failed to pick-up in 2011 due to moderate nominal wage growth, a strong rebound in consumer prices and the effects of a significant consolidation effort largely based on a sizeable reduction in the public sector wage bill, on broadening of the base for the personal income tax and social contributions and a 1 pp. increase in the VAT standard rate. Accordingly, private consumption stagnated in 2011 for a third consecutive year and is expected to remain weak in 2012, given low and still deteriorating consumer confidence. Reflecting uncertainty concerning the economic environment, business confidence indicators point to cautious decisions on private investment projects, many of which are expected to be put on hold in 2012.

After two years of historically low inflation below 1%, HICP inflation spiked at 4.1% in 2011 on the back of a steep increase in energy and commodity prices, adjustments in regulated prices and increases in some excises and indirect taxes, notably the VAT standard rate. In 2012, overall HICP inflation is forecast to slow to 1.9% also reflecting a significant base effect and weak wage pressures in the context of a sluggish labour market.

Apart from risks stemming from the external environment, a sharper-than-expected deterioration of the labour market during the slowdown represents a negative risk to the forecast. An eventual resumption in major investment projects in transport infrastructure represents a positive domestic risk.

26. FINLAND

Following a strong recovery in 2010, with GDP expanding by 3.7%, the Finnish economy continued to grow in the first three quarters of 2011. However, according to the latest Statistics Finland data, economic activity appears to have slowed down significantly in the in the last quarter of 2011. Whereas growth was still projected at 3.1% in the autumn 2011 forecast, latest developments have led to a downward revision to 2.7% for 2011 as a whole. While growth dynamics for 2012 were already expected to lessen in the autumn to about 1.4%, the worsening outlook implies markedly weaker, but still positive, growth at 0.8%.

The slowdown in growth comes mainly from a decline in net exports on the back of the global economic slowdown as well as diminishing export capacity linked to on-going structural changes within some of the main Finnish industries. The observed decrease in exports in 2011 is set to continue into 2012 due to the expected slowdown in growth of the main trading partners.

In contrast, domestic demand has held up rather well in 2011 and is expected to support economic activity in 2012 also. Private consumption expenditure was strong in 2011. The volume of retail trade sales was up 2.3% on the previous year. Consumption is expected to contribute positively to growth in 2012 also, as employment remains at an elevated level and wage growth, which is settled by multiannual collective agreements, is set to remain relatively robust.

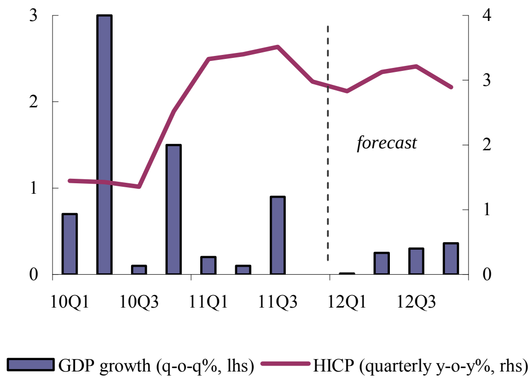
This is not to say that Finland will also escape the effects of the downturn in terms of private consumption. While unemployment continued to decline in 2011, some worsening has to be expected in 2012. Also, consumer confidence fell rapidly over the course of 2011, possibly indicating lower demand in the future.

While investment is also expected to deteriorate, on balance, it is likely to retain a positive impact on growth. It could be upheld by replacement investment needs after low levels encountered in 2009 and 2010.

Inflation decreased, in line with expectations, in the fourth quarter of 2011. However, in early 2012 increases in indirect taxes were introduced and they are set to contribute to somewhat higher inflation in the beginning of 2012. However, as the base effects from the commodity price rises in 2011 come into play, HICP inflation is nevertheless forecast to decline from the peak of 3.3% in 2011 to 2.5% in 2012.

Taking into account the high share of investment and intermediate goods in Finnish exports, the economy faces further downside risks if the lack of confidence in global markets results in a significant reduction of global investments, reducing the demand for Finnish exports.

Graph 26.1: **Finland - GDP growth and inflation**



27. SWEDEN

The Swedish economy recovered strongly from the 2008/09 recession with annual real GDP growth reaching 5.6% in 2010 and quarterly rates of 1% on average in the first three quarters of 2011. Growth in the third quarter, however, was held up by a large contribution from net trade, which weakened significantly in the final months of 2011. Retail sales continued to be very subdued, making the annual retail growth rate of 0.8% in 2011 the worst since 1996. Industrial production fell by 1.1% in the fourth quarter and services production ended the year with stagnation. Business confidence continued to fall and finished the year clearly below its long-term average. Overall, GDP is estimated to have contracted in the fourth quarter, yielding an estimated annual growth rate of 4.2% in 2011.

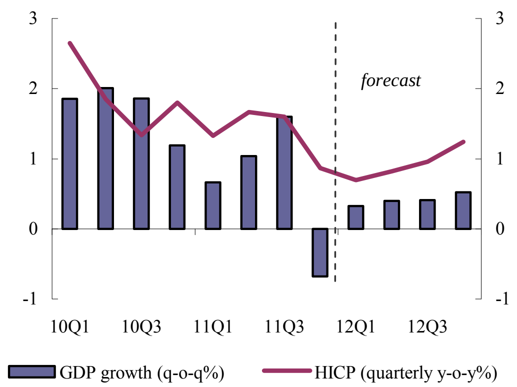
Although some of the negative momentum from the end of 2011 is expected to spill over into early 2012, a few indicators point to a return to positive economic growth already in early 2012. Consumer confidence rebounded noticeably in January as did the main index on the Stockholm stock exchange. Business surveys indicate that manufacturing companies expect new orders to pick up in the first quarter of 2012. With inflation expected to be low, the wage agreements signed last autumn should also provide some real income gains this year.

However, the recovery is expected to be subdued and relatively fragile. With low capacity utilization, slow demand growth and a stronger krona, corporate investment plans have been put on hold and companies are revising down hiring plans. This is expected to lead to only very limited employment growth in 2012. Together with a weakening housing market and only limited support from fiscal and monetary policy, household consumption is expected to remain sluggish throughout 2012. Overall, GDP growth is forecast to reach only 0.7% in 2012, with domestic demand providing a positive GDP growth contribution and net trade having a neutral impact.

A particular risk relates to household consumption. On the one hand, should consumer confidence continue to improve, households could reduce the currently high household saving rate, which would boost demand. On the other hand, a softening housing market and high household indebtedness could lead households to focus on deleveraging, with adverse effects on consumption.

HICP inflation is expected to decrease from 1.4% in 2011 to 0.9% in 2012. This slowdown is mainly due to a stable commodity prices outlook and strong carry-over effects from the last quarter of 2011, when actual inflation dropped much more than expected across most categories of the consumer basket. Although the ongoing wage bargaining round has so far resulted in moderate wage increases (corresponding to 2.4% growth over a year), the expected productivity dip in 2012 is likely to raise unit labour costs significantly. Underlying inflation is expected to remain subdued throughout 2012, however, with low demand and capacity utilisation restraining the inflationary impact of higher unit labour costs. In the second half of the year, as the recovery gains some traction and employment growth resumes, cost pressures are expected to re-emerge and inflation to pick up gradually. The continuation of the krona appreciation from late 2011 represents a downside risk to the inflation forecast.

Graph 27.1: **Sweden - GDP growth and inflation**



28. THE UNITED KINGDOM

Annual UK GDP growth for 2011 is estimated to have been 0.9%, slightly higher than the Commission's autumn forecast of 0.7%. In 2011, growth was largely driven by external demand as domestic disposable income was squeezed by a combination of high inflation, tax rises and low nominal wage growth. After remaining relatively stable through 2010, the unemployment rate rose throughout 2011, from 7.7% in the first quarter to 8.4% in the fourth quarter – the highest level since 1995.

Following stronger-than-expected growth of 0.6% in the third quarter, the UK economy contracted by 0.2% in the final quarter of 2011. The contraction observed in the fourth quarter was driven by the industrial (-1.2%) and construction (-0.5%) sectors. The activity level in the services sector remained unchanged. Economic confidence indicators also saw a broad-based fall in late 2011, linked in part to concern about developments in external markets.

However since the beginning of 2012, UK coincident and leading indicators have improved significantly. Rising unemployment will hold back private consumption growth, especially early in the year, and nominal wage growth is likely to remain subdued. A sustained fall in inflation should however lessen the squeeze on real disposable incomes and allow private consumption to stabilise in the second half of the year. Tight credit conditions are also expected to constrain internal demand. Nonetheless, investment is expected to start increasing in the second half of 2012, from a low base.

Thus, the UK economy may narrowly avoid recession and quarterly GDP growth is projected at 0.1% in each of the first two quarters of 2012. Later, a modest pick-up in growth is forecast, aided by the London Olympics, to give annual GDP growth of 0.6% in 2012, unchanged from the Commission's autumn forecast.

External demand is again expected to be the strongest driver of GDP growth in 2012. The main downside risk to the forecast is weaker growth in the UK's main export markets, particularly the euro area, as well as further negative effects on confidence from a protraction of the European sovereign-debt crisis.

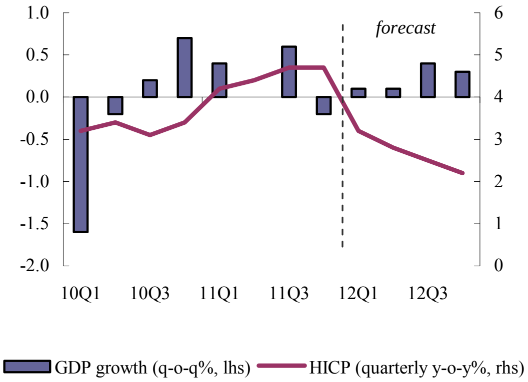
Inflation is expected to fall rapidly in 2012 to 2.7%, after having reached a peak of 5.2% y-o-y in September 2011 – the highest value since the introduction of the HICP in 1997.

The latest figures show a drop to 3.6% in January which should continue during the first quarter, as the January 2011 2.5 pp. VAT rate rise drops out of the calculations. The pass-through of the VAT increase was incomplete and gradual last year. As such, the VAT rise should continue to drop out of the calculations over the course of the first quarter.

Inflation expectations of both business and households are significantly lower than in 2011. The fall in inflation should be sustained throughout the year due to subdued internal demand and price stability in energy, oil and other categories. The large upward pressure that energy prices placed on inflation in 2011 has now subsided. Electricity and gas prices are expected to fall in the second half of 2012, with price cuts in the pipeline for most utility companies. Additionally, the modest appreciation of sterling in trade-weighted terms should help contain import prices.

These aspects were already broadly factored into the autumn forecast; hence the 2012 forecast has only been revised slightly down by 0.2 pp. to 2.7%.

Graph 28.1: **United Kingdom - GDP growth and inflation**



ANNEX

TABLE 1: Gross domestic product, volume (percentage change on preceding year, 1992-2012) 15.02.2012

	5-year averages								February 2012 forecast		*Autumn 2011 forecast*	
	1992-96	1997-01	2002-06	2006	2007	2008	2009	2010	2011	2012	*2011*	*2012*
Belgium	1.5	2.7	2.0	2.7	2.9	1.0	-2.8	2.3	1.9	-0.1	2.2	0.9
Germany	1.2	2.0	1.0	3.7	3.3	1.1	-5.1	3.7	3.0	0.6	2.9	0.8
Estonia	:	7.6	7.9	10.1	7.5	-3.7	-14.3	2.3	7.5	1.2	8.0	3.2
Ireland	6.5	8.5	5.0	5.3	5.2	-3.0	-7.0	-0.4	0.9	0.5	1.1	1.1
Greece	1.1	3.8	4.3	5.5	3.0	-0.2	-3.2	-3.5	-6.8	-4.4	-5.5	-2.8
Spain	1.5	4.4	3.3	4.1	3.5	0.9	-3.7	-0.1	0.7	-1.0	0.7	0.7
France	1.2	2.9	1.7	2.5	2.3	-0.1	-2.7	1.5	1.7	0.4	1.6	0.6
Italy	1.2	2.1	1.0	2.2	1.7	-1.2	-5.1	1.5	0.2	-1.3	0.5	0.1
Cyprus	5.5	4.2	3.2	4.1	5.1	3.6	-1.9	1.1	0.5	-0.5	0.3	0.0
Luxembourg	2.6	6.3	4.1	5.0	6.6	0.8	-5.3	2.7	1.1	0.7	1.6	1.0
Malta	5.0	3.4	1.8	2.8	4.3	4.3	-2.6	2.9	2.1	1.0	2.1	1.3
Netherlands	2.5	3.7	1.6	3.4	3.9	1.8	-3.5	1.7	1.2	-0.9	1.8	0.5
Austria	1.9	2.8	2.2	3.7	3.7	1.4	-3.8	2.3	3.1	0.7	2.9	0.9
Portugal	2.0	3.9	0.7	1.4	2.4	0.0	-2.9	1.4	-1.5	-3.3	-1.9	-3.0
Slovenia	2.0	4.2	4.2	5.8	6.9	3.6	-8.0	1.4	0.3	-0.1	1.1	1.0
Slovakia	:	2.7	5.9	8.3	10.5	5.9	-4.9	4.2	3.3	1.2	2.9	1.1
Finland	1.3	4.5	3.1	4.4	5.3	0.3	-8.4	3.7	2.7	0.8	3.1	1.4
Euro area	1.5	2.8	1.8	3.3	3.0	0.4	-4.3	1.9	1.4	-0.3	1.5	0.5
Bulgaria	-2.8	2.5	6.0	6.5	6.4	6.2	-5.5	0.2	1.8	1.4	2.2	2.3
Czech Republic	2.4	1.6	4.9	7.0	5.7	3.1	-4.7	2.7	1.7	0.0	1.8	0.7
Denmark	2.6	2.4	1.8	3.4	1.6	-0.8	-5.8	1.3	1.0	1.1	1.2	1.4
Latvia	-8.8	6.0	9.0	11.2	9.6	-3.3	-17.7	-0.3	5.3	2.1	4.5	2.5
Lithuania	-8.3	4.8	8.0	7.8	9.8	2.9	-14.8	1.4	5.8	2.3	6.1	3.4
Hungary	0.4	3.7	4.2	3.9	0.1	0.9	-6.8	1.3	1.7	-0.1	1.4	0.5
Poland	4.9	4.4	4.1	6.2	6.8	5.1	1.6	3.9	4.3	2.5	4.0	2.5
Romania	1.3	-0.1	6.2	7.9	6.3	7.3	-6.6	-1.6	2.5	1.6	1.7	2.1
Sweden	1.2	3.4	3.3	4.3	3.3	-0.6	-5.2	5.6	4.2	0.7	4.0	1.4
United Kingdom	2.5	3.7	2.8	2.6	3.5	-1.1	-4.4	2.1	0.9	0.6	0.7	0.6
EU	1.3	3.0	2.1	3.3	3.2	0.3	-4.3	2.0	1.5	0.0	1.6	0.6

TABLE 2: Profiles (qoq) of quarterly GDP, volume (percentage change from previous quarter, 2010-12)

	2010/1	2010/2	2010/3	2010/4	2011/1	2011/2	2011/3	2011/4	2012/1	2012/2	2012/3	2012/4
Belgium	0.1	1.1	0.4	0.5	0.9	0.3	-0.1	-0.2	-0.1	0.0	0.1	0.3
Germany	0.5	1.9	0.8	0.5	1.3	0.3	0.6	-0.2	0.1	0.2	0.5	0.4
Estonia	0.0	2.6	0.9	2.8	2.9	1.3	1.0	-0.8	-0.2	0.2	1.1	1.1
Ireland	1.5	-0.5	0.4	-1.4	1.8	1.4	-1.9	:	:	:	:	:
Greece	:	:	:	:	:	:	:	:	:	:	:	:
Spain	0.2	0.3	0.1	0.2	0.4	0.2	0.0	-0.3	-0.7	-0.3	-0.1	0.0
France	0.1	0.5	0.4	0.3	0.9	-0.1	0.3	0.2	-0.1	0.0	0.2	0.2
Italy	0.8	0.4	0.3	0.0	0.1	0.3	-0.2	-0.7	-0.7	-0.2	0.0	0.0
Cyprus	1.0	0.4	1.1	0.1	-0.1	0.3	-0.8	0.0	-0.7	-0.6	0.6	0.8
Luxembourg	1.2	1.5	0.0	1.2	0.2	-0.9	0.6	-0.1	0.0	0.4	0.3	0.6
Malta	1.0	-0.1	0.3	2.0	-0.3	0.4	0.3	:	:	:	:	:
Netherlands	0.4	0.6	0.1	0.8	0.7	0.1	-0.4	-0.7	-0.2	-0.2	0.1	0.1
Austria	0.1	0.8	1.4	1.1	0.9	0.5	0.2	-0.1	0.0	0.0	0.5	0.6
Portugal	0.9	0.3	0.2	-0.4	-0.6	-0.2	-0.6	-1.3	-1.4	-0.6	-0.3	0.0
Slovenia	0.2	1.2	0.5	0.3	-0.1	0.0	-0.2	-0.8	-0.1	0.4	0.6	0.5
Slovakia	0.8	0.9	0.9	0.8	0.8	0.8	0.8	0.9	-0.3	0.0	0.2	0.6
Finland	0.7	3.0	0.1	1.5	0.2	0.1	0.9	0.0	0.0	0.3	0.3	0.4
Euro area	0.4	0.9	0.4	0.3	0.8	0.2	0.1	-0.3	-0.3	0.0	0.2	0.2
Bulgaria	0.9	1.6	0.7	0.5	0.5	0.3	0.3	0.4	0.0	0.4	1.3	0.9
Czech Republic	0.7	1.0	0.7	0.6	0.6	0.2	-0.1	-0.3	-0.1	0.2	0.2	0.4
Denmark	0.0	1.5	1.1	-0.5	0.0	1.0	-0.5	0.3	0.3	0.4	0.6	0.6
Latvia	1.1	0.1	0.8	1.3	1.0	1.9	1.4	0.8	-0.3	0.3	0.6	0.7
Lithuania	1.2	0.7	0.7	1.8	2.1	1.8	1.5	-0.9	0.4	0.6	1.1	1.3
Hungary	1.1	0.4	0.7	0.3	0.7	0.1	0.4	0.3	-0.2	0.1	0.0	0.0
Poland	0.7	1.0	1.4	0.9	1.0	1.2	1.0	0.5	0.5	0.5	0.5	0.7
Romania	:	:	:	:	:	:	:	:	:	:	:	:
Sweden	1.9	2.0	1.9	1.2	0.7	1.0	1.6	-0.7	0.3	0.4	0.4	0.5
United Kingdom	0.4	1.1	0.7	-0.5	0.4	0.0	0.6	-0.2	0.1	0.1	0.4	0.3
EU	0.4	1.0	0.5	0.2	0.7	0.2	0.3	-0.3	-0.1	0.1	0.3	0.3

TABLE 3: Profiles (yoy) of quarterly GDP, volume (percentage change from corresponding quarter in previous year, 2010-12) 15.02.2012

	2010/1	2010/2	2010/3	2010/4	2011/1	2011/2	2011/3	2011/4	2012/1	2012/2	2012/3	2012/4
Belgium	1.9	2.9	2.1	2.1	2.9	2.1	1.6	0.9	-0.1	-0.4	-0.1	0.4
Germany	2.4	4.1	4.0	3.8	4.6	2.9	2.7	2.0	0.8	0.8	0.6	1.3
Estonia	-4.2	2.4	4.7	6.5	9.5	8.0	8.2	4.4	1.3	0.2	0.3	2.2
Ireland	-1.0	-0.8	0.1	0.0	0.2	2.1	-0.2	:	:	:	:	:
Greece	:	:	:	:	:	:	:	:	:	:	:	:
Spain	-1.3	0.0	0.4	0.7	0.9	0.8	0.8	0.3	-0.8	-1.2	-1.3	-0.9
France	1.0	1.5	1.6	1.4	2.2	1.6	1.5	1.4	0.3	0.4	0.3	0.3
Italy	1.0	1.6	1.5	1.6	1.0	0.8	0.3	-0.5	-1.3	-1.8	-1.6	-0.9
Cyprus	-1.0	0.8	2.3	2.5	1.5	1.4	-0.5	-0.5	-1.2	-2.0	-0.6	0.1
Luxembourg	0.6	4.3	2.0	3.9	2.9	0.5	1.1	-0.2	-0.4	0.9	0.6	1.3
Malta	3.7	2.8	2.1	3.1	1.8	2.4	2.4	:	:	:	:	:
Netherlands	0.5	2.4	1.7	2.0	2.3	1.8	1.3	-0.3	-1.2	-1.4	-1.0	-0.1
Austria	0.7	2.4	3.2	3.4	4.3	3.9	2.7	1.5	0.6	0.1	0.4	1.1
Portugal	1.7	1.6	1.3	1.0	-0.5	-1.0	-1.8	-2.7	-3.5	-3.9	-3.6	-2.3
Slovenia	-0.3	1.5	1.6	2.2	1.9	0.7	-0.1	-1.1	-1.2	-0.8	0.1	1.4
Slovakia	5.0	4.5	4.1	3.4	3.4	3.4	3.2	3.3	2.2	1.4	0.8	0.4
Finland	0.9	4.8	3.4	5.4	4.9	1.9	2.7	1.2	1.0	1.2	0.6	0.9
Euro area	1.0	2.1	2.1	2.0	2.4	1.6	1.3	0.7	-0.3	-0.5	-0.4	0.1
Bulgaria	-1.9	-0.4	0.0	3.7	3.3	2.0	1.6	1.5	1.0	1.1	2.1	2.6
Czech Republic	0.9	3.0	3.3	3.0	2.8	2.0	1.2	0.5	-0.3	-0.3	0.0	0.7
Denmark	-1.5	1.6	3.0	2.2	2.2	1.7	0.0	0.8	1.0	0.4	1.5	1.9
Latvia	-5.8	-4.6	3.2	3.3	3.2	5.1	5.7	5.3	3.8	2.2	1.4	1.3
Lithuania	-1.1	0.9	1.2	4.4	5.4	6.5	7.3	4.5	2.8	1.7	1.3	3.6
Hungary	-0.8	0.8	2.5	2.5	2.1	1.7	1.5	1.5	0.7	0.6	0.3	0.0
Poland	3.2	3.7	4.8	4.1	4.5	4.6	4.2	3.8	3.2	2.4	1.9	2.1
Romania	:	:	:	:	:	:	:	:	:	:	:	:
Sweden	2.9	4.5	6.8	7.1	5.8	4.8	4.6	2.6	2.3	1.6	0.5	1.7
United Kingdom	1.2	2.5	3.0	1.7	1.7	0.6	0.5	0.8	0.5	0.7	0.4	0.9
EU	1.0	2.2	2.4	2.2	2.4	1.7	1.4	0.9	0.1	-0.1	-0.1	0.4

TABLE 4: Harmonised index of consumer prices (national index if not available), (percentage change on preceding year, 1992-2012)

	5-year averages								February 2012 forecast		*Autumn 2011 forecast*	
	1992-96	1997-01	2002-06	2006	2007	2008	2009	2010	2011	2012	*2011*	*2012*
Belgium	2.2	1.7	2.0	2.3	1.8	4.5	0.0	2.3	**3.5**	**2.7**	*3.5*	*2.0*
Germany	3.1	1.2	1.6	1.8	2.3	2.8	0.2	1.2	**2.5**	**1.9**	*2.4*	*1.7*
Estonia	120.7	6.1	3.3	4.4	6.7	10.6	0.2	2.7	**5.1**	**3.1**	*5.2*	*3.3*
Ireland	2.2	3.0	3.2	2.7	2.9	3.1	-1.7	-1.6	**1.2**	**1.6**	*1.1*	*0.7*
Greece	11.6	3.7	3.4	3.3	3.0	4.2	1.3	4.7	**3.1**	**-0.5**	*3.0*	*0.8*
Spain	4.7	2.4	3.3	3.6	2.8	4.1	-0.2	2.0	**3.1**	**1.3**	*3.0*	*1.1*
France	2.0	1.2	2.1	1.9	1.6	3.2	0.1	1.7	**2.3**	**2.2**	*2.2*	*1.5*
Italy	4.6	2.1	2.4	2.2	2.0	3.5	0.8	1.6	**2.9**	**2.9**	*2.7*	*2.0*
Cyprus	4.3	2.7	2.6	2.2	2.2	4.4	0.2	2.6	**3.5**	**2.8**	*3.4*	*2.8*
Luxembourg	1.8	1.9	2.9	3.0	2.7	4.1	0.0	2.8	**3.7**	**2.7**	*3.6*	*2.1*
Malta	3.3	3.1	2.5	2.6	0.7	4.7	1.8	2.0	**2.4**	**2.1**	*2.6*	*2.2*
Netherlands	2.5	2.6	2.1	1.7	1.6	2.2	1.0	0.9	**2.5**	**2.0**	*2.5*	*1.9*
Austria	2.9	1.3	1.7	1.7	2.2	3.2	0.4	1.7	**3.6**	**2.4**	*3.4*	*2.2*
Portugal	5.6	2.7	2.9	3.0	2.4	2.7	-0.9	1.4	**3.6**	**3.3**	*3.5*	*3.0*
Slovenia	:	8.0	4.3	2.5	3.8	5.5	0.9	2.1	**2.1**	**1.6**	*1.9*	*1.3*
Slovakia	:	8.5	5.3	4.3	1.9	3.9	0.9	0.7	**4.1**	**1.9**	*4.0*	*1.7*
Finland	1.5	1.9	1.1	1.3	1.6	3.9	1.6	1.7	**3.3**	**3.0**	*3.2*	*2.6*
Euro area	3.8	1.7	2.2	2.2	2.1	3.3	0.3	1.6	**2.7**	**2.1**	*2.6*	*1.7*
Bulgaria	87.7	:	5.5	7.4	7.6	12.0	2.5	3.0	**3.4**	**3.0**	*3.6*	*3.1*
Czech Republic	:	5.6	1.5	2.1	3.0	6.3	0.6	1.2	**2.1**	**3.0**	*1.8*	*2.7*
Denmark	1.9	2.1	1.8	1.9	1.7	3.6	1.1	2.2	**2.7**	**1.8**	*2.6*	*1.7*
Latvia	70.3	3.9	4.9	6.6	10.1	15.3	3.3	-1.2	**4.2**	**2.5**	*4.2*	*2.4*
Lithuania	179.8	3.9	1.4	3.8	5.8	11.1	4.2	1.2	**4.1**	**2.6**	*4.0*	*2.7*
Hungary	23.2	12.3	4.8	4.0	7.9	6.0	4.0	4.7	**3.9**	**5.1**	*4.0*	*4.5*
Poland	31.4	9.8	1.9	1.3	2.6	4.2	4.0	2.7	**3.9**	**3.5**	*3.7*	*2.7*
Romania	116.9	63.2	12.9	6.6	4.9	7.9	5.6	6.1	**5.8**	**3.0**	*5.9*	*3.4*
Sweden	2.4	1.5	1.5	1.5	1.7	3.3	1.9	1.9	**1.4**	**0.9**	*1.5*	*1.3*
United Kingdom	2.8	1.3	1.7	2.3	2.3	3.6	2.2	3.3	**4.5**	**2.7**	*4.3*	*2.9*
EU	25.8	4.3	2.3	2.3	2.4	3.7	1.0	2.1	**3.1**	**2.3**	*3.0*	*2.0*

TABLE 5: Profiles of quarterly harmonised index of consumer prices (percentage change on corresponding quarter in previous year, 2010-12) 15.02.2012

	2010/1	2010/2	2010/3	2010/4	2011/1	2011/2	2011/3	2011/4	2012/1	2012/2	2012/3	2012/4
Belgium	1.2	2.4	2.6	3.2	3.6	3.3	3.6	3.4	3.2	2.8	2.4	2.1
Germany	0.8	1.0	1.2	1.6	2.2	2.5	2.6	2.6	2.2	1.9	1.9	1.6
Estonia	0.0	2.9	3.1	5.0	5.2	5.3	5.4	4.4	4.5	3.4	2.4	2.2
Ireland	-2.4	-2.1	-1.2	-0.6	0.8	1.3	1.1	1.4	1.0	1.3	1.7	2.5
Greece	3.0	5.1	5.6	5.1	4.5	3.3	2.1	2.6	1.3	-0.1	-1.3	-1.9
Spain	1.3	2.3	2.0	2.6	3.3	3.3	2.9	2.8	1.7	1.5	1.2	1.0
France	1.5	1.8	1.8	1.9	2.0	2.2	2.3	2.7	2.6	2.0	2.1	2.0
Italy	1.3	1.6	1.7	2.0	2.3	2.9	2.7	3.7	3.3	2.8	2.4	3.1
Cyprus	2.5	2.2	3.3	2.3	3.1	4.1	2.9	3.8	3.6	3.5	2.3	2.0
Luxembourg	2.8	2.8	2.7	2.9	3.8	3.9	3.6	3.7	3.0	2.6	2.6	2.5
Malta	0.9	1.5	2.6	3.2	2.9	2.7	2.4	1.7	1.7	2.0	2.1	2.3
Netherlands	0.5	0.4	1.3	1.5	2.0	2.4	2.9	2.7	2.4	1.6	1.9	2.0
Austria	1.3	1.8	1.7	2.0	3.0	3.7	3.8	3.7	2.9	2.5	2.2	2.2
Portugal	0.3	1.0	2.0	2.3	3.7	3.7	3.1	3.8	3.7	3.3	3.4	3.1
Slovenia	1.7	2.4	2.3	2.0	2.3	2.0	1.5	2.6	2.1	1.7	1.4	1.3
Slovakia	0.0	0.7	1.0	1.1	3.5	4.1	4.1	4.7	1.8	1.8	1.9	2.0
Finland	1.5	1.4	1.4	2.5	3.4	3.4	3.5	3.0	2.8	3.1	3.2	2.9
Euro area	1.1	1.6	1.7	2.0	2.5	2.8	2.7	2.9	2.5	2.1	1.9	1.9
Bulgaria	2.0	2.9	3.3	4.0	4.5	3.4	3.1	2.5	2.8	3.3	3.0	3.0
Czech Republic	0.4	1.0	1.6	2.0	1.9	1.8	2.1	2.8	3.2	3.4	3.0	2.5
Denmark	1.9	2.0	2.3	2.5	2.6	2.9	2.6	2.5	1.8	1.5	1.9	1.8
Latvia	-3.9	-2.3	-0.3	1.7	3.8	4.6	4.4	4.1	3.1	2.5	2.2	2.0
Lithuania	-0.4	0.5	1.8	2.9	3.2	4.7	4.6	4.0	3.1	2.5	2.3	2.5
Hungary	5.8	5.2	3.6	4.3	4.3	3.9	3.5	4.1	5.8	5.0	4.7	5.0
Poland	3.4	2.5	2.1	2.7	3.6	4.0	3.7	4.2	4.0	3.5	3.5	3.0
Romania	4.6	4.3	7.5	7.8	7.5	8.3	4.2	3.4	2.1	2.4	3.9	3.6
Sweden	2.7	1.9	1.3	1.8	1.3	1.7	1.6	0.9	0.7	0.8	1.0	1.2
United Kingdom	3.3	3.4	3.1	3.4	4.1	4.4	4.7	4.7	3.2	2.8	2.5	2.2
EU	1.7	2.0	2.1	2.5	2.9	3.2	3.1	3.2	2.6	2.2	2.1	2.0

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Box 2: Some technical elements behind the forecast

The cut-off date for taking new information into account in this European Economic Forecast was 15 February.

External assumptions

This forecast is based on a set of external assumptions, reflecting market expectations at the time of the forecast. To shield the assumptions from possible volatility during any given trading day, averages from a 10-day reference period (between 1 and 14 February) were used for exchange and interest rates, and for oil prices.

Exchange and interest rates

The technical assumption as regards exchange rates was standardised using fixed nominal exchange rates for all currencies. This technical assumption leads to an implied average USD/EUR rate of 1.32 in 2012. The average JPY/EUR rate is 101.0 in 2012.

Interest-rate assumptions are market-based. Short-term interest rates for the euro area are derived from futures contracts. Long-term interest rates for the euro area, as well as short- and long-term interest rates for other Member States are calculated using implicit forward swap rates, corrected for the current spread between the interest rate and swap rate. In cases where no market instrument is available, the fixed spread vis-à-vis the euro-area interest rate is taken for both short- and long-term rates. As a result, short-term interest rates are expected to be 0.8% on average in 2012 in the euro area. Long-term euro-area interest rates are assumed to be 2.0% on average in 2012.

Commodity prices

Commodity price assumptions are also based on market conditions. According to futures markets, prices for Brent oil are projected to be on average 113.1 USD/bl. in 2012. This would correspond to an oil price of 86.0 EUR/bl. in 2012.

No-policy-change assumption

Although no public-finance variables are included in this interim forecast, additional fiscal measures could have a bearing on GDP growth or inflation in the short- to medium term. Therefore the 'no-policy-change' assumption is used, whereby the GDP and inflation forecasts for 2012 take into consideration only the measures adopted or presented to national parliaments as well as other measures known in sufficient detail.

Calendar effects on GDP growth

The number of working days may differ from one year to another. The Commission's annual GDP forecasts are not adjusted for the number of working days, but quarterly forecasts are.

However, the working-day effect in the EU and the euro area is estimated to be limited over the forecast horizon, implying that adjusted and unadjusted growth rates differ only marginally.