



## EUROPEAN CENTRAL BANK

### **Eurosystem staff macroeconomic projections for the euro area**

*On the basis of the information available up to 17 May 2004, Eurosystem staff have prepared projections for macroeconomic developments in the euro area.<sup>1</sup> Average annual real GDP growth is projected to be between 1.4% and 2.0% in 2004 and between 1.7% and 2.7% in 2005. The average rate of increase in the overall Harmonised Index of Consumer Prices (HICP) is projected to be between 1.9% and 2.3% in 2004 and between 1.1% and 2.3% in 2005.*

The staff projections are based on a series of assumptions with regard to interest rates, exchange rates, oil prices, world trade outside the euro area and fiscal policies. In particular, the technical assumption is made that short-term market interest rates and bilateral exchange rates will remain unchanged over the projection horizon. The technical assumptions with regard to long-term interest rates and both oil and non-energy commodity prices are based on market expectations.<sup>2</sup> Fiscal policy assumptions are based on national budget plans in the individual euro area countries. They include only those policy measures that have already been approved by parliament or that have been specified in detail and are likely to pass the legislative process.

To express the uncertainty surrounding the projections, ranges are used to present the results for each variable. The ranges are based on the differences between actual outcomes and previous projections carried out by euro area central banks over a number of years. The width of the ranges is twice the average absolute value of these differences.

### **The international environment**

The recovery in world economic activity has broadened and strengthened since autumn 2003, supported partly by expansionary economic policies and favourable financing conditions but also by improved corporate finances. On the assumption of a gradual decline in oil prices and moderate risk premia on financial markets, as embodied in the aforementioned assumptions, the recovery is expected to remain robust over the projection horizon.

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<sup>1</sup> *The Eurosystem staff projections are produced jointly by experts from both the ECB and the euro area national central banks. They are a biannual input into the Governing Council's assessment of economic developments and the risks to price stability. More information on the procedures and techniques used is given in "A guide to Eurosystem staff macroeconomic projection exercises", ECB, June 2001.*

<sup>2</sup> *Short-term interest rates as measured by the three-month Euribor are assumed to remain constant over the projection horizon at slightly above 2.0%. The technical assumption of constant exchange rates implies that the EUR/USD exchange rate stays at 1.19 over the horizon and that the effective exchange rate of the euro is 0.9% higher than the average for 2003. Market expectations for euro area ten-year nominal government bond yields imply a slightly rising profile from an average of 4.3% in 2004 to an average of 4.4% in 2005. Based on the path implied by futures markets, annual average oil prices are assumed to decline to USD 31.8 per barrel in 2005, from USD 34.6 per barrel in 2004. Non-energy commodity prices are assumed to increase by 18% in USD terms in 2004 and to remain broadly unchanged in 2005.*

The United States and non-Japan Asia are expected to remain the main contributors to global growth. In the United States, growth is expected to be driven by a pick-up in investment, while supported by robust private consumption in light of a continued improvement in the labour market. GDP growth in non-Japan Asia is expected to remain strong, reflecting internal growth dynamics. The picture for the other regions is more varied, although the strong demand from the United States and non-Japan Asia is expected to provide a boost to activity in most areas. The Japanese economy is expected to continue on its current recovery path, with domestic demand benefiting from ongoing structural reform measures and the easing of deflationary pressures. Real GDP growth in the UK is expected to remain dynamic over the projection horizon. In addition, the countries which joined the EU on 1 May 2004 and the transition economies are projected to continue to grow at a relatively strong pace. Overall, *world real GDP growth outside the euro area* is projected to increase to around 5.0% in both 2004 and 2005, from 4.5% in 2003.

Growth in world trade is assumed to follow a pattern in line with that of world real GDP. Growth in the *euro area's external export markets* is expected to increase to about 8% in both 2004 and in 2005, from slightly below 6% in 2003.

### **Real GDP growth projections**

After the increase in the first quarter of this year, the quarter-on-quarter growth rates of euro area real GDP are projected to be relatively strong over the horizon, with possible volatility in the quarterly growth pattern in 2004. Average annual real GDP growth is projected to increase to between 1.4% and 2.0% in 2004 and be between 1.7% and 2.7% in 2005. The assumed strengthening in foreign demand is projected to lead to a pick-up in euro area export growth, despite some losses in market share due to the past appreciation of the euro. The recovery is also expected to become more broadly based over the horizon, with stronger growth in both investment and private consumption. Inventory investment and net exports are not projected to make significant positive contributions to real GDP growth.

In line with the usual cyclical pattern, *total employment* is projected to pick up slowly in 2004 before gaining strength in 2005. Labour supply is expected to rise as improved job prospects lead to increasing participation rates. The projections for labour supply and employment imply that the unemployment rate would start to decline towards the end of the horizon.

Among the domestic expenditure components of GDP, average annual growth in *private consumption* is projected to be between 1.0% and 1.4% in 2004 after the stagnation experienced for most of 2003. It is projected to increase to between 1.4% and 2.6% in 2005. Consumption expenditure is projected to develop broadly in line with households' real disposable income. The household saving ratio is projected to remain roughly constant over the two years. Concerns about the course of public finances and, in particular, the longer-term prospects for the public health care and pension systems are likely to continue to restrain a decline in the saving ratio over the horizon. However, consumer confidence is expected to gradually increase as economic activity picks up and the labour market conditions improve, which would tend to reduce precautionary saving. In 2004 the growth in

households' real disposable income is projected to remain relatively subdued due to weak employment growth; in 2005, it should be supported by stronger employment growth and by higher real wage growth fostered by lower inflation. The positive impact of cuts in income taxes and social security contributions on households' real disposable income in 2004 will be largely counterbalanced by higher indirect taxes and administered prices (including health charges). Finally, on the basis of current budget plans, it is assumed that the contribution of *government consumption* to real GDP growth will decline over the projection horizon.

*Total fixed investment* returned to a positive quarter-on-quarter rate of change in the fourth quarter of 2003 and is projected to contribute to the recovery in euro area domestic demand over the horizon. The average annual rate of growth is projected to increase to between 0.7% and 2.9% in 2004 and to be between 1.9% and 5.1% in 2005. The recovery in total investment would result mainly from *business investment*, which is supported by the improvement in the global economic environment and by the low level of real interest rates. *Residential private investment* is projected to record moderate positive rates of growth over the horizon, following several years of decline.

Turning to trade, the average annual rate of change in total exports is projected to increase to between 3.2% and 6.0% in 2004 and to be in a range of 5.0% to 8.2% in 2005.<sup>3</sup> The growth of extra-euro area exports would initially remain somewhat below that of the euro area's export markets, partially as a result of the past appreciation of the euro. The average annual rate of growth in total imports is projected to be between 2.8% and 6.2% in 2004 and between 5.0% and 8.4% in 2005. The projection for imports reflects the pattern of total final expenditure in the euro area, but also some delayed upward impact of the past appreciation of the euro.

### **Price and cost projections**

The average rate of increase in the overall *Harmonised Index of Consumer Prices (HICP)* is projected to be between 1.9% and 2.3% in 2004 and between 1.1% and 2.3% in 2005. Based on the aforementioned assumptions for oil prices, the energy component is projected to make a significant positive contribution to HICP inflation in 2004 but to be largely neutral in 2005. Increases in indirect taxes and administered prices implemented in early 2004 will considerably raise the non-energy component of the HICP this year. In 2005, the rate of increase in the non-energy component is projected to decline, reflecting a reduction in domestic cost pressures and limited increases in import prices. In addition, the fiscal assumptions contain only a modest contribution from increases in indirect taxes and administered prices for 2005.

Import prices continued to decrease in 2003, as a consequence of the appreciation of the euro since spring 2002 and weak external inflationary pressures. They are projected to remain subdued in 2004, as the effect of higher oil prices is counterbalanced by the delayed impact of the past euro appreciation. Import prices are projected to increase only modestly in 2005.

Taking into account current wage settlements and the modest improvement in labour market conditions, the growth in nominal compensation per employee is assumed to remain broadly unchanged over the horizon. The

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<sup>3</sup> *Trade projections are consistent with national account data. They therefore include intra-euro area trade.*

projections for real GDP growth and employment imply that labour productivity growth would increase over the horizon, moving close to its long-term average in early 2005. As a result, *unit labour cost growth* is projected to decline in 2004 and 2005. The decline is projected to be accompanied by a moderate widening of *profit margins*, which in turn would support investment.

**Table : Macroeconomic projections**

*(average annual percentage changes)<sup>1)</sup>*

	2003	2004	2005
HICP	2.1	1.9 – 2.3	1.1 – 2.3
Real GDP	0.5	1.4 – 2.0	1.7 – 2.7
Private consumption	1.0	1.0 – 1.4	1.4 – 2.6
Government consumption	2.0	0.9 – 1.9	0.4 – 1.4
Gross fixed capital formation	- 0.8	0.7 – 2.9	1.9 – 5.1
Exports (goods and services)	-0.2	3.2 – 6.0	5.0 – 8.2
Imports (goods and services)	1.7	2.8 – 6.2	5.0 – 8.4

- 1) For each variable and horizon, ranges are based on the average absolute difference between actual outcomes and past projections by euro area central banks. The projections for real GDP and its components refer to working-day-adjusted data. The projections for exports and imports include intra-euro area trade.

**Box A****Comparison with the December 2003 projections**

The projections for euro area GDP growth have remained almost unchanged compared with the Eurosystem staff macroeconomic projections published in the Monthly Bulletin in December 2003. The small downward shift in the range projected for 2005 is a result of the changes to the quarterly growth pattern in 2004, which mechanically reduce the average annual growth rate for 2005.

The lower boundary of the range projected for the annual rate of increase in the overall HICP has been shifted upwards for 2004. This is largely explained by the upward shift in the assumptions for oil prices, which are higher for both 2004 and 2005 (by about 30% and 20% respectively). The impact of oil prices on the projections for euro area HICP inflation is, however, mitigated by various factors. First, the projections for the food price component of the HICP have been shifted downwards compared with the December 2003 projections, as the impact of weather-related food price increases in 2003 has unwound more rapidly than expected. Second, the tobacco tax increases implemented in early 2004 were somewhat lower than anticipated in the fiscal assumptions underlying the December 2003 projections. Third, the assumptions for growth in nominal compensation per employee over the horizon have been revised slightly downwards compared with the December 2003 projections. This also results in a small downward revision to unit labour cost growth in 2004.

**Comparison of macroeconomic projections**

*(average annual percentage changes)*

	2003	2004	2005
HICP – June 2004	2.1	1.9 – 2.3	1.1 – 2.3
HICP – December 2003	2.0 – 2.2	1.3 – 2.3	1.0 – 2.2
Real GDP – June 2004	0.5	1.4 – 2.0	1.7 – 2.7
Real GDP – December 2003	0.2 – 0.6	1.1 – 2.1	1.9 – 2.9

**Box B****Forecasts by other institutions**

A number of forecasts for the euro area are available from various institutions, both international organisations and those in the private sector. However, these forecasts are not strictly comparable with one another or with the Eurosystem staff macroeconomic projections, as they were finalised at different points in time and use different methods to derive assumptions for fiscal, financial and external variables. The forecasts covered by the Consensus Economics Forecasts and the ECB Survey of Professional Forecasters use a variety of unspecified assumptions. In contrast to the Eurosystem staff projections, the other forecasts are typically not conditioned on the assumption that short-term interest rates will remain unchanged over the projection horizon.

Despite different assumptions, there is a consensus among the forecasts currently available from other institutions that euro area economic activity will gradually recover, leading to average annual GDP growth of slightly over 1½% in 2004 and between 2% and 2 ½% in 2005. The forecasts are very similar for 2004, but differ more for 2005. The forecasts made by the European Commission, the OECD and the IMF anticipate annual GDP growth of 2.3% or 2.4% in 2005, whereas the Consensus Economics Forecasts and the Survey of Professional Forecasters predict annual GDP growth of 2.0% and 2.1% respectively.

**Table 1: Comparison of forecasts for euro area real GDP growth**

(annual percentage changes)

	Date of release	2003	2004	2005
European Commission	Apr. 2004	0.4	1.7	2.3
IMF	Apr. 2004	0.4	1.7	2.3
OECD	Apr. 2004	0.5	1.6	2.4
Consensus Economics Forecasts	Apr. 2004	0.4	1.6	2.0
Survey of Professional Forecasters	Apr. 2004	0.5	1.6	2.1

Sources: European Commission Economic Forecasts Spring 2004; IMF World Economic Outlook April 2004; OECD Economic Outlook No 75; Consensus Economics Forecasts and the ECB's Survey of Professional Forecasters.

Note: The European Commission forecasts report non-working-day-adjusted annual growth rates, which, for 2004, are around ¼ percentage point higher than the working-day-adjusted growth rates used in the Eurosystem projections owing to the greater number of working days this year. The OECD forecasts report working-day adjusted annual growth rates, whereas the other forecasts do not specify whether they report working-day-adjusted or non-working-day-adjusted data.

The forecasts anticipate annual average HICP inflation to decline to between 1.7% and 1.8% in 2004. For 2005, the forecasts predict HICP inflation to be 1.6%, with the exception of the Survey of Professional Forecasters and the OECD, which show HICP inflation at 1.8% and 1.4% respectively.

**Table 2: Comparison of forecasts for euro area overall HICP inflation**

(annual percentage changes)

	Date of release	2003	2004	2005
European Commission	Apr. 2004	2.1	1.8	1.6
IMF	Apr. 2004	2.1	1.7	1.6
OECD	Apr. 2004	2.1	1.7	1.4
Consensus Economics Forecasts	Apr. 2004	2.1	1.7	1.6
Survey of Professional Forecasters	Apr. 2004	2.1	1.8	1.8

Sources: European Commission Economic Forecasts Spring 2004; IMF World Economic Outlook April 2004; OECD Economic Outlook No 75; Consensus Economics Forecasts and the ECB's Survey of Professional Forecasters.