



EUROPEAN CENTRAL BANK

EUROSYSTEM

EUROSYSTEM STAFF MACROECONOMIC PROJECTIONS FOR THE EURO AREA

On the basis of the information available up to 27 May 2010, Eurosystem staff have prepared projections for macroeconomic developments in the euro area.¹ Benefiting from the prospect of an economic recovery worldwide, average annual real GDP growth is projected to be between 0.7% and 1.3% in 2010 and between 0.2% and 2.2% in 2011. Inflation is projected to remain moderate over the projection horizon, being dampened by the slack prevailing in the euro area. The average rate of overall HICP inflation is expected to be between 1.4% and 1.6% in 2010 and between 1.0% and 2.2% in 2011.

Box 1

TECHNICAL ASSUMPTIONS ABOUT INTEREST RATES, EXCHANGE RATES, COMMODITY PRICES AND FISCAL POLICIES

The technical assumptions about interest rates and both energy and non-energy commodity prices are based on market expectations, with a cut-off date of 20 May 2010.¹ The assumption about short-term interest rates is of a purely technical nature. Short-term rates are measured by the three-month EURIBOR, with market expectations derived from futures rates. The methodology gives an overall average level of short-term interest rates of 0.8% for 2010 and 1.1% for 2011. The market expectations for euro area ten-year nominal government bond yields imply an average level of 3.9% in 2010, increasing to 4.2% in 2011. The baseline projection takes into account the recent improvements in financing conditions and assumes that, over the projection horizon, bank lending rate spreads vis-à-vis the above-mentioned interest rates will narrow somewhat. Similarly, credit supply conditions are assumed to ease gradually over the horizon. As regards commodities, on the basis of the path implied by futures markets in the two-week period ending on the cut-off date, oil prices per barrel are assumed to average USD 79.5 in 2010 and USD 83.7 in 2011. The prices of non-energy commodities in US dollars are assumed to rise by 17.9% in 2010, followed by a more modest increase of 1.2% in 2011.

Bilateral exchange rates are assumed to remain unchanged over the projection horizon at the average levels prevailing in the ten-working day period ending on the cut-off date. This implies a EUR/USD exchange rate of 1.30 in 2010 and 1.26 in 2011, and an effective exchange rate of the euro that, on average, depreciates by 6.4% in 2010 and by a further 1.8% in 2011.

Fiscal policy assumptions are based on individual euro area countries' national budget plans as available on 27 May 2010. They include all policy measures that have already been approved by national parliaments or that have been specified in detail by governments and are likely to pass the legislative process.

¹ Oil and food price assumptions are based on futures prices up to end-2011. For other commodities, prices are assumed to follow futures up to end-2010 and thereafter to develop in line with global economic activity.

¹ The Eurosystem staff macroeconomic projections are produced jointly by experts from the ECB and the euro area NCBs. 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, which is available on the ECB's website. To reflect 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 over a number of years. The width of the ranges is twice the average absolute value of these differences. The method used, involving a correction for exceptional events, is documented in "New procedure for constructing Eurosystem and ECB staff projection ranges", ECB, December 2009, also available on the ECB's website.

THE INTERNATIONAL ENVIRONMENT

The global economic outlook has continued to recover, more robustly than envisaged in the March ECB staff macroeconomic projections. Looking ahead, world growth is expected to experience a temporary deceleration in the second half of 2010, reflecting the fading-out of some of the factors that initially supported the recovery, such as policy stimuli and the inventory cycle. Thereafter, global activity is projected to be supported by a normalisation in financial conditions and by some improvements in confidence and in the labour market. Global economic growth is expected to remain below past trends over 2010-11, as advanced economies in particular experience a subdued recovery following the financial crisis. World real GDP outside the euro area is projected to increase by 4.7% in 2010 and by 4.1% in 2011. Growth in the euro area's export markets is estimated to be 8.6% in 2010 and 6.0% in 2011.

REAL GDP GROWTH PROJECTIONS

Real GDP grew modestly in the first quarter of 2010. Available evidence suggests that inventories contributed strongly to growth, while several other factors dampened domestic demand growth, such as the end of government incentives for car purchases and adverse weather conditions. In the second quarter, real GDP growth is projected to be considerably stronger, benefiting among other things from a rebound in construction activity. However, over the remainder of 2010, growth is expected to remain subdued, as the factors that temporarily boosted growth in the initial phase of the recovery – such as the fiscal stimuli and the inventory cycle – diminish in strength. Further ahead, the economic pick-up is projected to strengthen, supported by gradually rising domestic demand. The lagged effects of monetary policy moves and the significant efforts to restore the functioning of the financial system are expected to support activity over the full projection horizon. Growth in 2010 and 2011 is, however, projected to remain weaker than before the recession, owing to the ongoing need for balance sheet repair in various sectors, while private consumption is dampened by high unemployment, precautionary savings and modest income growth. In addition, the outlook also takes into account ongoing fiscal adjustments aimed at re-establishing and consolidating confidence in medium-term sustainability. In annual terms, following a decline of 4.1% in 2009, real GDP is expected to grow by between 0.7% and 1.3% in 2010, and between 0.2% and 2.2% in 2011.

In more detail, among the domestic components of GDP, non-residential private investment is expected to remain fairly weak during 2010, limited by high spare capacity, weak and uncertain demand prospects, low profitability and financing constraints, but to recover slowly thereafter. After some short-term weather-related volatility early in 2010, residential investment is projected to remain subdued, dampened by ongoing adjustments in housing markets in some countries. In line with the fiscal packages announced in several euro area countries and their subsequent withdrawal, government investment in real terms is assumed to stabilise over 2010, before declining markedly the following year.

Private consumption growth is expected to rise modestly in 2010 before gradually picking up further the following year. Real incomes are expected overall to be dampened by the weakness of projected employment growth. At the same time, the saving ratio is projected to remain substantially above its pre-crisis level, as some precautionary savings continue to be held in a context of high economic uncertainty and modest prospects for income growth. However, the saving ratio is expected to fall somewhat as the economic situation gradually improves.

Table 1 Macroeconomic projections for the euro area(average annual percentage changes)^{1),2)}

	2009	2010	2011
HICP	0.3	1.4 – 1.6	1.0 – 2.2
Real GDP	-4.1	0.7 – 1.3	0.2 – 2.2
Private consumption	-1.2	-0.2 – 0.4	-0.2 – 1.6
Government consumption	2.6	0.3 – 1.3	-0.3 – 1.1
Gross fixed capital formation	-10.8	-3.4 – -1.2	-2.1 – 2.7
Exports (goods and services)	-13.2	5.5 – 9.1	1.1 – 7.9
Imports (goods and services)	-12.0	3.8 – 7.0	0.4 – 6.8

1) 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.

2) Data refer to all 16 countries of the euro area.

Euro area exports rebounded towards the end of last year, and grew strongly again in early 2010. Over the projection horizon, the recovery in exports continues, driven by foreign demand and higher competitiveness. As a consequence, net trade is projected to contribute positively to GDP growth in both 2010 and 2011.

Reflecting the lagged adjustment to the sharp drop in output experienced until mid-2009 and the expected subdued recovery in economic activity along with downward wage rigidities, the unemployment rate is expected to increase until early 2011 before stabilising.

Largely reflecting the impact of the crisis, potential growth is expected to be modest, albeit recovering somewhat, over the projection horizon. This results from the rise in structural unemployment, lower labour force participation rates and the strong decline in investment, which weighs on the capital stock. The magnitude of these effects, however, is very uncertain and projections of potential growth, and accordingly of the output gap, are surrounded by an even higher degree of uncertainty than usual. This notwithstanding, the estimated output gap is expected to narrow somewhat but to remain negative over the projection horizon.

PRICE AND COST PROJECTIONS

Following a strong pick-up in March 2010, the overall HICP inflation rate is projected to increase slightly further in the second half of 2010, mostly driven by base effects arising from past food price decreases. Thereafter, inflation is expected to moderate slightly, in line with the assumed decline of the rate of increase in energy prices. By contrast, the growth rate of the HICP excluding food and energy is projected to increase gradually over the projection horizon, driven by improvements in activity and in the labour market. The average annual inflation rate is expected to be between 1.4% and 1.6% in 2010, and between 1.0% and 2.2% in 2011.

In more detail, external price pressures are projected to increase in 2010, broadly reflecting the assumed path of commodity prices and the depreciation of the euro, but to subside in 2011. Turning to domestic price pressures, the growth in compensation per hour is projected to decrease strongly in 2010. Thereafter, only a gradual and modest increase is expected. Combined with the projected strong recovery in labour productivity, this overall subdued wage profile implies a substantial deceleration in unit labour cost growth rates in 2010, followed by a limited rebound. Profit margins in turn are projected to recover significantly in 2010, and to continue to grow at a steady pace thereafter, supported by the rebound in activity and the moderate wage growth prospects.

COMPARISON WITH THE MARCH 2010 PROJECTIONS

With regard to real GDP growth, the projection range for 2010 has been revised upwards compared with that published in the March 2010 issue of the Monthly Bulletin, reflecting more buoyant demand in the short term than previously expected. At the same time, the range for 2011 has shifted downwards, reflecting mainly the downward revisions to domestic demand prospects.

With regard to HICP inflation, the projection range for 2010 is close to the upper end of that published in March, while the range for 2011 lies somewhat higher than in the previous projections. The upward revision relates mostly to the effects of stronger assumptions for commodity prices in euro.

Table 2 Comparison with the March 2010 projections

(average annual percentage changes)

	2010	2011
Real GDP – March 2010	0.4 – 1.2	0.5 – 2.5
Real GDP – June 2010	0.7 – 1.3	0.2 – 2.2
HICP – March 2010	0.8 – 1.6	0.9 – 2.1
HICP – June 2010	1.4 – 1.6	1.0 – 2.2

Box 2

FORECASTS BY OTHER INSTITUTIONS

A number of forecasts for the euro area are available from both international organisations and private sector institutions. 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. Additionally, they use different (partly unspecified) methods to derive assumptions for fiscal, financial and external variables, including oil and other commodity prices. Finally, there are differences in working day adjustment methods across different forecasts (see the table below).

In the forecasts currently available from other institutions, euro area real GDP is expected to grow by between 0.9% and 1.2% in 2010 and between 1.5% and 1.8% in 2011. All these forecasts fall within the ranges of the Eurosystem staff projections.

As regards inflation, available forecasts from other institutions anticipate average annual HICP inflation to be between 1.1% and 1.5% in 2010, and between 1.0 and 1.7% in 2011. These forecasts for inflation are also in line with the ranges of the Eurosystem staff projections.

Table Comparison of forecasts for euro area real GDP growth and HICP inflation

(average annual percentage changes)

	Date of release	GDP growth		HICP inflation	
		2010	2011	2010	2011
IMF	April 2010	1.0	1.5	1.1	1.3
Survey of Professional Forecasters	April 2010	1.1	1.5	1.4	1.5
European Commission	May 2010	0.9	1.5	1.5	1.7
Consensus Economics Forecasts	May 2010	1.1	1.5	1.3	1.4
OECD	May 2010	1.2	1.8	1.4	1.0
Eurosystem staff projections	June 2010	0.7 - 1.3	0.2 - 2.2	1.4 - 1.6	1.0 - 2.2

Sources: European Commission Economic Forecasts, Spring 2010; IMF World Economic Outlook, April 2010; OECD Economic Outlook, May 2010; Consensus Economics Forecasts; and the ECB's Survey of Professional Forecasters.

Notes: The Eurosystem staff macroeconomic projections and the OECD forecasts both report working day-adjusted annual growth rates, whereas the European Commission and the IMF report annual growth rates that are not adjusted for the number of working days per annum. Other forecasts do not specify whether they report working day-adjusted or non-working day-adjusted data.

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