

Box 5

A review of economic prospects for the euro area up to 2001

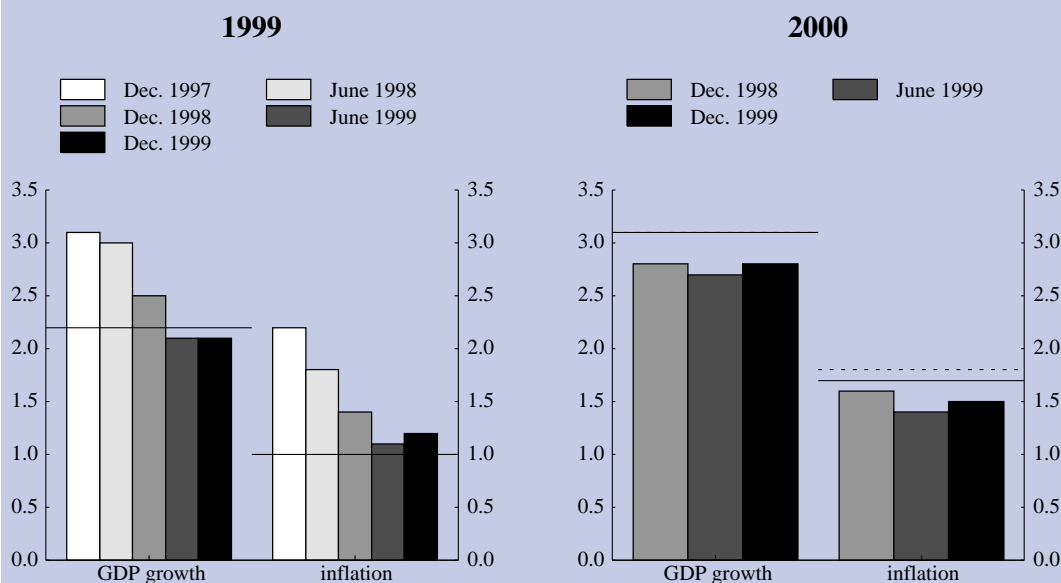
No new forecasts for the euro area have become available from the major international institutions since the end of last year (see Box 6 in the December 1999 issue of the ECB Monthly Bulletin). At that time, only the forecasts produced by the Organisation for Economic Co-operation and Development and the European Commission extended to 2001. To this can now be added the Consensus Economics forecasts and the Survey of Professional Forecasters (SPF).

Euro area real GDP growth is expected to rise significantly in 2000 and 2001

The latest estimates of economic growth in the euro area for 1999, which are currently based on data released for the first three quarters of 1999 and available information for the fourth quarter of 1999, indicate that real GDP increased by just over 2%. As shown in the chart below, the final outcome for euro area growth in 1999 is expected to have been significantly lower than was expected by major international institutions at the time the forecasts were first made for 1999, i.e. in late 1997. Forecasts for euro area growth in 1999 have been progressively revised downwards over time, primarily reflecting the impact of the crisis in emerging markets which occurred in 1997-98. Its consequences for economic growth in the euro area, and in particular for net exports, only gradually became clear.

Real GDP growth and inflation forecasts for the euro area

(annual percentage changes)



Sources: IMF, OECD, European Commission, Consensus Economics and the Survey of Professional Forecasters (SPF).

Note: The bars are averages of IMF, European Commission and OECD forecasts. December 1997 is an average of OECD and European Commission forecasts only. Horizontal solid lines represent the latest (February 2000) Consensus Economics forecast. Horizontal dotted lines represent the latest (February 2000) SPF forecast. Inflation is measured by the private consumption deflator, with the exception of Consensus Economics (CPI) and SPF (HICP).

An overview of available forecasts for the euro area up to 2001 is provided in the table below. The picture is now clearly indicating stronger growth. According to both the February 2000 Consensus Economics forecast and the SPF, real GDP growth in the euro area is now expected to grow at a rate of over 3% in 2000. For 2001 the economic expansion in the euro area is expected to continue at a similar pace to that in 2000. It should be noted that the forecasts presented here are not fully comparable as they are based on different assumptions regarding exchange rates and interest rates, and, reflecting the steep yield curve, they often assume that short-term interest rates will rise over the forecast period.

This stronger growth outlook for the euro area is based on favourable domestic and external conditions for growth. The prospects for domestic demand have improved, in line with increasing confirmation of an expansion in industrial activity and confidence indicators reaching higher levels. Monetary and financial conditions remain supportive for investment and consumption growth. Improvements in the labour market situation are expected to underpin increases in private consumption. This, together with stronger investment growth, underpins expectations that the contribution to overall growth from domestic demand will rise.

Growth is also generally expected to be supported by an improvement in the external environment, with net exports likely to make a positive contribution to growth this year. The external environment for the euro area for 1999 as a whole proved to be better than expected at the end of 1998 and early 1999, notably on account of stronger than expected growth in the United States. There has also been a significant improvement in other regions, in particular in Asia excluding Japan and in Latin American countries. Looking ahead, world growth and trade are seen to be gathering momentum and, overall, the external environment is now expected to be stronger over the period up to 2001 than previously foreseen.

The uncertainties surrounding the projections for real GDP growth in the euro area appear to have shifted to the upside in both 2000 and 2001. This relates to both domestic demand and net exports. Against the background of strong growth, rising capacity utilisation and higher business confidence, investment expenditure could rise more strongly than currently expected. Export growth could also be stronger than currently expected, owing to stronger global economic activity and/or a more rapid recovery in market shares than is currently forecast. The main downward risks to growth appear to be linked to the external environment.

The available forecasts indicate that the labour market situation in the euro area is expected to benefit from the increase in economic activity, with unemployment expected to fall to below 9% in 2001 from around 9.5% in 2000. As growth prospects improve, however, it is important that wage moderation is continued. This is necessary for the relatively favourable employment growth and the reduction in unemployment projected in recent forecasts to be achieved.

Inflation forecasts for the euro area revised upwards

The outturn for inflation for the euro area in 1999 of 1.1%, as measured by increases in the Harmonised Index of Consumer Prices (HICP), was lower than generally expected earlier on, as reflected in initial

Comparison of forecasts for the euro area

(annual percentage changes, unless otherwise indicated)

	2000					2001				
	IMF	OECD	EC ¹⁾	SPF ²⁾	CE ³⁾	IMF	OECD	EC ¹⁾	SPF ²⁾	CE ³⁾
Private consumption deflator	-	1.7	1.6	-	-	-	1.7	1.6	-	-
HICP ⁴⁾	1.3	-	1.5	1.8	1.7	-	-	1.5	1.7	1.6
GDP growth	2.8	2.8	2.9	3.1	3.1	-	2.8	2.9	3.0	3.0
Unemployment rate ⁵⁾	9.7	9.6	9.4	9.4	-	-	9.1	8.8	8.8	-

Sources: IMF World Economic Outlook (October 1999); OECD Economic Outlook (November 1999); European Commission (autumn 1999); Survey of Professional Forecasters (February 2000) and Consensus Economics forecasts (February 2000).

Note: The IMF does not provide forecasts for 2001.

1) European Commission.

2) On the basis of a questionnaire submitted to 83 professional forecasters across the EU, the Survey of Professional Forecasters provides quantitative information on inflation expectations in the euro area. To provide the appropriate background for these expectations, the survey also collects estimates for expected growth in area-wide real GDP and expected developments in the euro area unemployment rate. The sample of forecasters is based on recommendations from the respective national central banks in the EU. The forecasters are split fairly evenly between financial institutions (e.g. banks) and others (e.g. research institutes).

3) Consensus Economics forecasts.

4) For the IMF and Consensus Economics forecasts: CPI.

5) As a percentage of the labour force.

forecasts of close to 2% (using private consumption deflators). This was mainly caused by lower than forecast rates of increase in the price of food, non-energy goods and services in the course of 1999. As a result of the increase in oil prices, inflation forecasts for 2000 have been revised upwards since December 1999. Inflation in the euro area is generally expected to be higher in 2000 than in the previous year. The latest forecasts, from both Consensus Economics and the SPF, show that inflation in the euro area is expected to remain below 2% on average in 2000 and 2001. However, these annual averages do not show the inflation development over time. The pattern is characterised first by decreasing annual inflation rates in the course of this year followed by more fundamental upward tendencies later on. Furthermore, when assessing these forecasts, the assumptions upon which they are based should be borne in mind, in particular the assumption of rising short-term interest rates in the period ahead.

In addition, the forecasts concerning the outlook for prices are subject to considerable uncertainties. One source of uncertainty, particularly in the short term, is the behaviour of oil prices and the exchange rate, both of which have been relatively volatile and directly influence import price developments. While the direct effect of import prices on the rate of increase of consumer prices is largely temporary, the degree to which they may have an impact on domestic wage costs and price developments remains uncertain. Moreover, downward pressures on prices resulting from, inter alia, deregulation and increased competition (particularly in retail markets) are difficult to assess and could prove to be stronger than currently anticipated in available forecasts.

Overall, central forecasts, i.e. those considered most likely on the basis of the assumptions adopted, now point to inflation rates that are clearly closer to 2% on average in both 2000 and 2001, while there are significant uncertainties surrounding the outlook for prices. Clearly, depending on the development of the factors underlying these forecasts (including interest rates, exchange rates, oil prices and wages), projections will have to be adjusted, thus highlighting the conditional nature of such exercises.