

Box 4

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

Over the past few months new and revised forecasts concerning the economic prospects for the euro area up to 2001 have been made available by the European Commission, the IMF and the OECD. To these can be added the latest results from the Consensus Economics forecasts and the Survey of Professional Forecasters compiled by the ECB. The currently available forecasts generally incorporate an upward revision of expected economic growth in 2000 and 2001, compared with the projections made at the end of last year and earlier this year (see Box 6 and Box 5 in the December 1999 and March 2000 issues of the ECB Monthly Bulletin respectively). At the same time, average consumer price inflation is now forecast to be higher this year and next year than previously anticipated. This box discusses the projections for euro area growth and inflation in more detail. It should be borne in mind that the forecasts referred to in this box are “central projections” surrounded by a certain degree of uncertainty. Moreover, they have been prepared and finalised at specific points in time, and they are conditional upon the precise assumptions made, for example, for interest rates and exchange rates. This applies both to the starting values prevailing at the time of preparing the respective forecasts and to the assumed path of these variables over the forecast horizon. In a number of cases, the forecast results are derived on the assumption of rising short-term interest rates and of an euro exchange rate higher than recent market values. Oil price assumptions used also vary greatly between forecasts.

Comparison of growth and inflation forecasts for the euro area

(annual percentage changes)

	Finalised in	Real GDP		Consumer prices	
		2000	2001	2000	2001
European Commission ¹⁾	Apr. 2000	3.4	3.1	1.8	1.7
IMF ²⁾	Apr. 2000	3.2	3.2	1.7	1.6
OECD ²⁾	May 2000	3.5	3.3	2.0	2.0
Consensus Economics ³⁾	May 2000	3.3	3.1	1.7	1.7
Survey of Professional Forecasters ¹⁾	May 2000	3.3	3.1	1.9	1.8

Sources: European Commission; IMF World Economic Outlook; OECD preliminary Economic Outlook; Consensus Economics and Survey of Professional Forecasters.

1) Inflation forecast based on HICP.

2) Inflation forecast based on the private consumption deflator.

3) Inflation forecast based on CPI (excluding data for Luxembourg, which are unavailable).

Real GDP growth forecast to be above 3% in 2000 and 2001

The currently available forecasts point to a broad consensus that real GDP growth in the euro area will be well above 3% in 2000 and still somewhat above 3% in 2001 (see the table above), rather than slightly below 3%, as was expected at the end of last year. On average, forecasts have been revised upwards by around ½ percentage point since then. With regard to the pattern of growth over the forecast period, the projections imply continued expansion, following the strengthening of growth in the second half of 1999.

The improved outlook for euro area growth emerging from the available forecasts can be seen as reflecting favourable conditions on both the domestic and the external side. First, in broad terms, the prospects for sustained strong growth in domestic demand are supported by the fact that confidence indicators are currently at their record highs and that credit growth has remained strong. Profitability can be expected to benefit from the current upturn as wage growth is expected to remain relatively moderate, while capacity utilisation rates will increase. Consistent with this, household incomes would benefit from ongoing strong employment growth and from increased non-wage incomes related to higher profitability. These factors should underpin

growth in private consumption and investment over the forecast horizon. Second, the stronger expansion of the global economy than was previously expected, combined with the low level of the euro's effective exchange rate in recent months, should contribute to rapid growth in exports.

The uncertainties surrounding the projections for real GDP growth in the euro area are seen by most international forecasters as coming mainly from the external environment. The biggest downside risk to growth still appears to be linked to the possibility of a pronounced slowdown in the US economy and the ensuing negative effects on the growth of the world economy. This risk might be considered as being mitigated by the possibility that growth in other areas of the world could turn out to be stronger than currently expected. More generally, some uncertainty about the external demand effects of world growth on euro area growth is related to forthcoming developments in the exchange rate of the euro in relation to the specific assumptions in the respective forecasts. On the domestic side, the latest forecasts tend to point to upside risks to growth.

Consumer price inflation forecast to be close to 2% in 2000 and 2001

According to the forecasts currently available, euro area inflation in 2000 and 2001 will be higher than expected at the end of last year. More specifically, following the low out-turn in 1999 of just above 1%, consumer prices are now expected to increase by close to 2% on average in each of the two forecast years (see the table above), compared with the rate of increase of around 1.5% projected at the end of last year. Part of the expected rise in inflation in 2000 is attributable to developments in oil prices in recent months. However, inflation excluding energy prices is also expected to rise steadily throughout the forecast period, essentially reflecting increasing demand pressures.

The pattern of overall consumer price inflation in 2000 and 2001 emerging from the available forecasts reflects both external and domestic influences. In the past few months import prices have accelerated rapidly on account of increasing oil prices and a depreciating exchange rate of the euro and they are expected to put further upward pressure on consumer prices as importers gradually pass through these effects. There is a certain degree of uncertainty in the forecasts for consumer price inflation related to the behaviour of oil prices and the exchange rate of the euro. In recent weeks oil prices are likely to have been stronger than had been assumed in many of the published forecasts, and the euro's exchange rate has been somewhat lower, despite its appreciation in late May and early June. If maintained, these factors will result in further upward pressures on consumer prices compared with the projections shown in the table. Deregulation and increased competition are noted as possible sources of downward pressure on consumer prices, but the strength of these effects is generally difficult to assess in quantitative terms.

In the context of the prospects for strong economic growth in the euro area, the more lasting effects of higher import price inflation on the rate of increase in consumer prices come via domestic factors. Reflecting the outcome of recent negotiations, currently available forecasts expect wages to grow relatively moderately over most of the forecast period up to 2001. Together with planned reductions in social security contributions and strong cyclical growth in productivity, this should result in modest increases in unit labour costs, particularly in 2000. Under these conditions, the forecasts imply that the main upward pressure on consumer prices will come from firms raising or restoring profit margins as a result of tighter demand conditions or higher cost pressures from import prices.

Overall, the consensus view regarding the economic prospects for the euro area in 2000 and 2001 emerging from currently available forecasts is that of strong economic growth in an environment in which inflation is expected to be close to 2%. However, it is important to recall that the forecast results are mostly derived on the assumption of a rise in short-term interest rates compared with the levels prevailing at the time of preparing the respective forecasts and of an euro exchange rate higher than current market values. Without these assumptions, forecasts for inflation would most likely have been higher.

Reflecting the strong economic growth and expectations of moderate wage growth anticipated by most forecasts, employment growth in 2000 and 2001 is mostly projected to remain strong and the unemployment rate to fall further over the two forecast years. The government budget deficit ratio is generally expected to decline slightly over the forecast period. However, the forecasts also imply that at the end of the period the unemployment rate will still be higher than at the beginning of the 1990s and that the fiscal stance is expansionary. Hence, while the outlook for the euro area economy is indeed favourable, the available forecasts point to a need for further efforts, notably in the area of structural reforms and fiscal consolidation. If accompanied by appropriate policies, this favourable outlook could extend into a period of sustained strong growth and stable prices.