

## Box 10

**ECB STAFF MACROECONOMIC PROJECTIONS FOR THE EURO AREA**

On the basis of the information available up to 18 February 2005, ECB staff have prepared projections for macroeconomic developments in the euro area.<sup>1</sup>

The ECB staff projections are based on a series of assumptions about 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, based on the levels prevailing in the two-week period up to 8 February. The technical assumptions concerning long-term interest rates and both oil and non-energy commodity prices are based on market expectations until 8 February.<sup>2</sup> Fiscal policy assumptions are based on national budget plans in the individual euro area member countries. They include all 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 over a number of years. The width of the ranges is twice the average absolute value of these differences.

**Assumptions with regard to the international environment**

World economic growth is expected to remain robust over the horizon, albeit at a slower pace than in 2004. Real GDP growth in the United States should also remain robust, although lower than in 2004. Real GDP growth in non-Japan Asia is expected to remain well above the global average, but also at lower rates than in recent years. Growth in the other large economies is projected to remain dynamic. In addition, the countries that joined the European Union on 1 May 2004 are expected to continue to record strong growth rates. Over the projection horizon, global inflation is projected to increase slightly with the continuation of global expansion.

1 The ECB staff projections complement the Eurosystem staff macroeconomic projections that are produced jointly by experts from the ECB and from euro area national central banks on a biannual basis. The techniques used are consistent with those of the Eurosystem staff projections as described in "A guide to Eurosystem staff macroeconomic projection exercises", ECB, June 2001.

2 Short-term interest rates as measured by the three-month EURIBOR are therefore assumed to remain constant at 2.14% over the projection horizon. The technical assumption of constant exchange rates implies that the EUR/USD exchange rate stays at 1.30 over the horizon and that the effective exchange rate of the euro is 1.8% higher than the average for 2004. Market expectations for euro area ten-year nominal government bond yields imply a small increase from an average of 3.7% in 2005 to an average of just under 4.0% in 2006. The increase in annual average non-energy commodity prices in USD is assumed to be 3.3% in 2005 and 1.5% in 2006. Based on the path implied by futures markets, annual average oil prices are assumed to decrease gradually from USD 44.7 per barrel in 2005 to USD 42.2 per barrel in 2006.

Annual growth in world real GDP outside the euro area is estimated to average about 4.7% in 2005 and 4.6% in 2006. Growth in the euro area's external export markets is projected to be about 8.0% in 2005 and 7.4% 2006.

### Real GDP growth projections

Eurostat's flash estimate for quarter-on-quarter growth of euro area real GDP in the fourth quarter of 2004<sup>3</sup> confirms a slowdown in activity in the second half of the year. However, there are reasons to assume that this slowdown will be temporary. Against this background, it is projected that average annual real GDP growth will be between 1.2% and 2.0% in 2005 and between 1.6% and 2.6% in 2006. Export growth, as implied by the assumption of continued strength in foreign demand, is, over the horizon, expected to continue to support economic activity. Domestic demand and employment should gradually strengthen. At the same time, labour supply is expected to increase as a result of improved job prospects and structural labour market reforms in various euro area countries. Overall, according to the projections, the unemployment rate should start to decline this year.

Among the domestic expenditure components of GDP, private consumption is projected to pick up in line with real disposable income. Growth in real disposable income will be supported by stronger growth in employment, lower inflation and a positive contribution from other income components such as distributed profits. The savings ratio, however, is expected to remain high, due inter alia to on-going concerns about the development of public finances and the longer-term prospects for public health care and pension systems. Total investment growth is projected to recover due mainly to business investment, which should benefit from favourable credit conditions and robust corporate earnings. Residential private investment is projected to continue to grow at moderate rates over the horizon. As domestic demand will stimulate import growth, net trade is not expected to contribute to real GDP growth over the projection horizon.

### Price and cost projections

The average rate of increase in the overall HICP is projected to be between 1.6% and 2.2% in 2005 and between 1.0% and 2.2% in 2006. This projection is based on the assumptions of lower

<sup>3</sup> The growth rate in the fourth quarter of 2004 is strongly influenced by a statistical downward adjustment for the unusually high number of working days in that quarter.

**Table A Macroeconomic projections for the euro area**

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

	2004	2005	2006
HICP	2.1	1.6-2.2	1.0-2.2
Real GDP	1.8	1.2-2.0	1.6-2.6
Private consumption	1.1	1.2-1.8	1.2-2.6
Government consumption	1.5	0.7-1.7	0.6-1.6
Gross fixed capital formation	1.7	1.6-4.2	2.1-5.3
Exports (goods and services)	6.1	4.0-7.0	4.9-8.1
Imports (goods and services)	6.5	4.7-8.1	4.9-8.3

<sup>1)</sup> For each variable and horizon, ranges are based on the average absolute differences between actual outcomes and past projections by euro area central banks. The projections for real GDP refer to working-day-adjusted data.

oil prices and a smaller contribution of indirect taxes and administered prices in 2005 and 2006, compared with 2004.

The growth in nominal compensation per employee is assumed to remain moderate over the horizon. This projection not only takes into account current wage settlements and the projected, only modest, improvement in labour market conditions, but also embodies the assumption of no significant second-round effects of higher oil prices on nominal compensation. The projections for real GDP growth and employment imply that labour productivity growth will slowly pick up. As a result of the developments in wages and productivity, unit labour cost growth is assumed to remain relatively contained in both 2005 and 2006.

### Comparison with December 2004 projections

Compared with the Eurosystem staff macroeconomic projections published in the December 2004 issue of the Monthly Bulletin, the range projected for growth in euro area real GDP has been adjusted slightly downwards for 2005 and 2006. Revisions to technical assumptions in comparison with the December projections are small and have a limited impact. The downward adjustment for 2005 reflects mainly a carry-over effect from the weaker than expected fourth quarter of 2004.

The range projected for the annual rate of increase in the overall HICP for 2005 is within the range of the December 2004 macroeconomic projections. The HICP projection range for 2006 remains unchanged.

**Table B Comparison of macroeconomic projections for the euro area**

(average annual percentage changes)

	2004	2005	2006
HICP – March 2005	2.1	1.6-2.2	1.0-2.2
HICP – December 2004	2.1-2.3	1.5-2.5	1.0-2.2
Real GDP – March 2005	1.8	1.2-2.0	1.6-2.6
Real GDP – December 2004	1.6-2.0	1.4-2.4	1.7-2.7