

Box 8

ECB STAFF MACROECONOMIC PROJECTIONS FOR THE EURO AREA

On the basis of the information available up to 17 February 2006, ECB staff have prepared projections for macroeconomic developments in the euro area.¹ Average annual real GDP growth is projected to be between 1.7% and 2.5% in 2006, and between 1.5% and 2.5% in 2007. The average rate of increase in the overall Harmonised Index of Consumer Prices (HICP) is projected to range between 1.9% and 2.5% in 2006, and between 1.6% and 2.8% in 2007.

Technical assumptions about interest rates, exchange rates, oil prices and fiscal policies

The technical assumption is made that short-term market interest rates and bilateral exchange rates remain unchanged over the projection horizon at the levels prevailing in the two-week period ending 7 February 2006.² Short-term interest rates as measured by the three-month EURIBOR are assumed to remain constant at 2.55%. The technical assumption of constant exchange rates implies a EUR/USD exchange rate of 1.21 and an effective exchange rate of the euro that is 1.2% lower than the average for 2005.

The technical assumptions about long-term interest rates and both oil and non-energy commodity prices are based on market expectations in the two-week period ending 7 February. Market expectations for euro area ten-year nominal government bond yields imply a slightly rising profile, from an average of 3.6% in 2006 to an average of 3.7% in 2007. Based on the path implied by futures markets, annual average oil prices are assumed to be USD 66.1 per barrel in 2006 and USD 67.5 per barrel in 2007. The increase in annual average non-energy commodity prices in US dollars is assumed to be 13.7% in 2006 and 3.8% in 2007.

Fiscal policy assumptions are based on national budget plans in the individual euro area countries. They include all policy measures that have already been approved by parliament or that have been specified in detail and are very likely to pass the legislative process.

Assumptions with regard to the international environment

The external environment of the euro area is expected to remain favourable over the projection horizon. Real GDP growth in the United States is projected to remain robust, although at slightly declining rates. Real GDP growth in non-Japan Asia is expected to remain well above the global average, albeit slightly lower than in recent years. Growth in most other large economies is also projected to remain dynamic.

1 The ECB staff macroeconomic 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. 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.

2 Starting in June 2006, Eurosystem and ECB staff macroeconomic projections will be based on the technical assumption that short-term market interest rates will move in line with market expectations rather than remain constant over the projection horizon as currently assumed. This change is of a purely technical nature. It is introduced in order to further improve the quality and the internal consistency of the macroeconomic projections and does not imply any change in the ECB's monetary policy strategy or in the role of projections within it. The Governing Council will continue to base its assessment of the risks to price stability and its policy decisions on a broad set of information provided by the economic and monetary analyses. Macroeconomic projections will continue to play an important but not all-encompassing role in the ECB's strategy, as a staff input which does not embody the judgement of the Governing Council.

Overall, annual growth in world real GDP outside the euro area is projected to average about 4.9% in 2006 and 4.5% in 2007. Growth in the euro area's external export markets is projected to be about 7.3% in 2006 and 6.9% in 2007.

Real GDP growth projections

Eurostat's flash estimate for euro area real GDP in the fourth quarter of 2005 indicates a slowdown in quarter-on-quarter growth to 0.3%. However, recent survey indicators suggest that economic activity has been gaining momentum and that this drop in real GDP growth is likely to have been temporary. Against this background, it is projected that average annual real GDP growth will be between 1.7% and 2.5% in 2006 and between 1.5% and 2.5% in 2007. Among the driving factors, export growth is expected to continue to support economic activity on the back of the assumed ongoing strength in foreign demand. Private consumption is projected to increase in line with real disposable income, which should be supported by some progress in employment over the projection horizon. However, in 2006 rising energy prices and in 2007 increases in indirect taxes are expected to have a dampening effect on consumption. Total fixed investment growth has recently accelerated and is projected to grow at a robust pace, in a context of continued favourable financing conditions, high profits and favourable demand prospects. Residential private investment is projected to continue to grow at moderate rates over the projection horizon.

Price and cost projections

The average rate of increase in the overall HICP is projected to be between 1.9% and 2.5% in 2006, and between 1.6% and 2.8% in 2007. The price projections are conditional on a number of assumptions. First, oil prices, which have led to a significant positive contribution from the energy component to HICP inflation in recent years, are assumed to be roughly stable over the projection period. Second, the growth in nominal compensation per employee is assumed to remain moderate over the horizon. The price projections do not embody significant second-round effects from oil price increases on wages. Third, the projections incorporate only those changes in indirect taxes that were known with sufficient certainty before 17 February 2006. Finally, they are based on the expectation that price pressures from non-commodity imports remain low.

Table A Macroeconomic projections for the euro area

(average annual percentage changes)¹⁾

| | 2005 | 2006 | 2007 |
|-------------------------------|------|---------|---------|
| HICP | 2.2 | 1.9-2.5 | 1.6-2.8 |
| Real GDP | 1.4 | 1.7-2.5 | 1.5-2.5 |
| Private consumption | 1.4 | 1.1-1.7 | 0.6-2.0 |
| Government consumption | 1.2 | 1.4-2.4 | 0.8-1.8 |
| Gross fixed capital formation | 2.2 | 2.4-5.0 | 1.8-5.0 |
| Exports (goods and services) | 3.8 | 4.2-7.2 | 3.8-7.0 |
| Imports (goods and services) | 4.6 | 4.2-7.6 | 3.4-6.8 |

1) For each variable and horizon, ranges are based on the average absolute difference between actual outcomes and previous 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.

Table B Comparison with the December 2005 projections

(average annual percentage changes)

| | 2005 | 2006 | 2007 |
|--------------------------|---------|---------|---------|
| Real GDP – December 2005 | 1.2-1.6 | 1.4-2.4 | 1.4-2.4 |
| Real GDP – March 2006 | 1.4 | 1.7-2.5 | 1.5-2.5 |
| HICP – December 2005 | 2.1-2.3 | 1.6-2.6 | 1.4-2.6 |
| HICP – March 2006 | 2.2 | 1.9-2.5 | 1.6-2.8 |

Comparison with the December 2005 projections

Compared with the Eurosystem staff macroeconomic projections published in the December 2005 issue of the Monthly Bulletin, the ranges projected for real GDP growth in 2006 and 2007 have been adjusted slightly upwards, reflecting a slightly more favourable outlook for the euro area economy.

The new range projected for the annual rate of increase in the overall HICP in 2006 is within the upper part of the range of the December 2005 projections. The range projected for 2007 has been adjusted upwards. This mainly reflects an increase in the assumptions for energy prices, resulting in a larger contribution from the energy component to the overall HICP. By contrast, the projections for the non-energy component are largely unchanged compared with the December projections.