

## Box 6

### ECB STAFF MACROECONOMIC PROJECTIONS FOR THE EURO AREA

On the basis of the information available up to 18 August 2006, ECB staff have prepared projections for macroeconomic developments in the euro area.<sup>1</sup> Average annual real GDP growth is projected to be between 2.2% and 2.8% in 2006, and between 1.6% and 2.6% in 2007. The average rate of increase in the overall Harmonised Index of Consumer Prices (HICP) is projected to range between 2.3% and 2.5% in 2006, and between 1.9% and 2.9% in 2007.

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

The technical assumptions about interest rates and both oil and non-energy commodity prices are based on market expectations. With regard to short-term interest rates as measured by the three-month EURIBOR, market expectations are measured by forward rates as at 8 August, reflecting a snapshot of the yield curve at that point in time. This implies a rising profile, from an average of 3.1% in 2006 to an average of 3.9% in 2007. The market expectations for euro area ten-year nominal government bond yields as at 8 August imply a slightly rising profile, from an average of 3.9% in 2006 to an average of 4.1% in 2007. Based on the path implied by futures markets in the two-week period ending on 9 August, annual average oil prices are assumed to be USD 71.0 per barrel in 2006 and USD 77.6 per barrel in 2007. The annual average increase in non-energy commodity prices in US dollars is assumed to be 26.2% in 2006 and 8.4% in 2007.

The technical assumption is made that bilateral exchange rates remain unchanged over the projection horizon at the levels prevailing in the two-week period ending on 8 August. This implies a EUR/USD exchange rate of 1.28 and an effective exchange rate of the euro that is 1.2% higher than the average for 2005.

<sup>1</sup> 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.

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. While real GDP growth in the United States is projected to decline slightly compared with recent years, real GDP growth in emerging Asia is expected to remain well above the global average, and growth in most other large economies is also projected to remain dynamic.

Overall, annual growth in world real GDP outside the euro area is projected to average about 5.2% in 2006 and 4.9% in 2007. Growth in the euro area's external export markets is projected to be about 8.7% in 2006 and 6.6% in 2007.

### Real GDP growth projections

Eurostat's flash estimate for euro area real GDP in the second quarter of 2006 indicates a strong pick-up in quarter-on-quarter growth to 0.9%, following 0.6% in the first quarter of this year. This strengthening of GDP growth is in line with the favourable information from survey indicators. Over the horizon, quarterly growth in GDP is projected to remain at around 0.5%, with the exception of the first quarter of 2007, when significant increases in indirect taxes are expected to dampen growth somewhat.

Against this background, it is projected that average annual real GDP growth will be between 2.2% and 2.8% in 2006 and between 1.6% and 2.6% in 2007. Among the driving factors, export growth is expected to continue to support economic activity, despite some competitiveness losses, as foreign demand is assumed to continue to grow at a robust pace. Private consumption is projected to increase broadly in line with real disposable income, which is expected to benefit in particular from improvements in the labour market. However, rising energy prices in 2006 and increases in indirect taxes in 2007 are expected to have a dampening effect on consumption.

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

(average annual percentage changes)<sup>1),2)</sup>

	2005	2006	2007
HICP	2.2	2.3-2.5	1.9-2.9
Real GDP	1.5	2.2-2.8	1.6-2.6
Private consumption	1.5	1.8-2.2	0.9-2.1
Government consumption	1.3	1.0-2.0	0.7-1.7
Gross fixed capital formation	2.7	3.0-4.6	2.1-5.3
Exports (goods and services)	4.2	6.0-8.8	3.4-6.6
Imports (goods and services)	5.2	5.7-8.7	3.1-6.5

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.

2) The September 2006 projections for the first time include Slovenia as part of the euro area in the euro area projections for 2007. The weight of Slovenia in euro area GDP in 2005 was 0.3%. The annual percentage changes for 2007 are based on a euro area composition that includes Slovenia already in 2006.

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 2.3% and 2.5% in 2006, and between 1.9% and 2.9% in 2007. The price projections reflect a significant contribution in 2006 from higher energy and non-oil commodity prices. While this contribution is expected to decline in 2007, based on current futures prices, HICP inflation will be significantly affected by higher indirect taxes in that year. The price projections embody the expectation of limited second-round effects from oil price increases on wages and of moderate improvements in the labour market, which should result in small increases in wage growth over the horizon. Given the projection of relatively steady growth in productivity, overall unit labour costs are expected to accelerate somewhat over the horizon. Finally, the HICP projections are based on the expectation that there are no major price pressures from non-commodity imports.

### Comparison with the June 2006 projections

Compared with the Eurosystem staff macroeconomic projections published in the June 2006 issue of the Monthly Bulletin, the ranges projected for real GDP growth in 2006 and 2007 have been adjusted upwards. This primarily reflects a better than expected outturn of growth in the first half of this year, along with continued positive signals from survey indicators and the labour market, and the resulting slightly more favourable outlook for euro area domestic demand over the projection horizon.

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 June 2006 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.

**Table B Comparison with the June 2006 projections**

(average annual percentage changes)

	2005	2006	2007
Real GDP – June 2006	1.4	1.8-2.4	1.3-2.3
Real GDP – September 2006	1.5	2.2-2.8	1.6-2.6
HICP – June 2006	2.2	2.1-2.5	1.6-2.8
HICP – September 2006	2.2	2.3-2.5	1.9-2.9