

## Box 9

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

On the basis of the information available up to 24 August 2007, 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 2007, and between 1.8% and 2.8% in 2008. The average rate of increase in the overall HICP is projected to be between 1.9% and 2.1% in 2007, and between 1.5% and 2.5% in 2008.

**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 a cut-off date of 14 August 2007. With regard to short-term interest rates as measured by the three-month EURIBOR, market expectations are measured by forward rates, reflecting a snapshot of the yield curve at the cut-off date. This implies an overall average level of 4.3% for 2007 and 4.5% for 2008. The market expectations for euro area ten-year nominal government bond yields imply a flat profile at their mid-August level of 4.5%. The baseline also includes the assumption that bank lending spreads will rise slightly over the projection horizon, reflecting the recent episode of heightened risk consciousness in financial markets. On the basis of the path implied by futures markets in the two-week period ending on the cut-off date, annual average oil prices are assumed to be USD 68.1 per barrel in 2007 and USD 71.9 per barrel in 2008. The average annual increase in non-energy commodity prices in US dollars is assumed to be 20.0% in 2007 and 5.7% in 2008.

The technical assumption is made that bilateral exchange rates remain unchanged over the projection horizon at the average levels prevailing in the two-week period ending on the cut-off date. This implies a EUR/USD exchange rate of 1.37 and an effective exchange rate of the euro that is, on average, 3.1% higher in 2007 than the average for 2006 and 0.5% higher in 2008 than the average for 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**

In the baseline projection, the external environment of the euro area is expected to remain favourable over the projection horizon. While the projections for real GDP growth in the United States and Japan are somewhat lower than in 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.

<sup>1</sup> The ECB staff macroeconomic projections complement the Eurosystem staff macroeconomic projections that are produced jointly by experts from the ECB and the euro area NCBs 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. At this juncture, however, owing to financial market developments, the uncertainty surrounding the projections is presumably larger than usual.

**Table A Macroeconomic projections for the euro area**(average annual percentage changes)<sup>1), 2)</sup>

	2006	2007	2008
HICP	2.2	1.9-2.1	1.5-2.5
Real GDP	2.9	2.2-2.8	1.8-2.8
Private consumption	1.9	1.4-1.8	1.5-2.7
Government consumption	1.9	1.3-2.3	1.2-2.2
Gross fixed capital formation	5.2	3.6-5.2	1.4-4.6
Exports (goods and services)	8.2	4.6-7.4	3.9-7.1
Imports (goods and services)	7.9	3.7-6.7	3.6-7.0

1) 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 figures reported include Slovenia already for 2006, with the exception of the HICP, where they include Slovenia only from 2007. The September 2007 projections include, for the first time, Cyprus and Malta as part of the euro area in the projection ranges for 2008. The annual percentage changes for 2008 are computed using a euro area composition that includes data for Cyprus and Malta for both 2007 and 2008. The weights of Cyprus, Malta and Slovenia in euro area GDP are approximately 0.2%, 0.1% and 0.3% respectively.

Overall, annual growth in world real GDP outside the euro area is projected to average about 5.6% in 2007 and 5.3% in 2008. Growth in the euro area's external export markets is projected to be about 5.5% in 2007 and 6.9% in 2008.

### Real GDP growth projections

Eurostat's first estimate of euro area real GDP growth in the second quarter of 2007 indicates quarter-on-quarter growth of 0.3%, following 0.7% in the first quarter of this year. Real GDP is projected to expand over the horizon at quarterly growth rates of around 0.5-0.6%. Against this background, growth in average annual real GDP is projected to be between 2.2% and 2.8% in 2007, and between 1.8% and 2.8% in 2008. Among the driving factors, export growth is expected to continue to support economic activity, as foreign demand is assumed to continue to grow at a robust pace. Robust growth in exports and rising profits are expected to support investment growth, although the pace of the latter is expected to moderate as the cycle matures and financing conditions tighten. Growth in private consumption is expected to be supported by favourable labour market trends.

### Price and cost projections

The average rate of increase in the overall HICP is projected to be between 1.9% and 2.1% in 2007, and between 1.5% and 2.5% in 2008. In line with the oil price assumptions, as derived from current oil futures prices, the positive contribution from energy and non-oil commodity prices to consumer price developments is expected to decline considerably in comparison with recent years. In addition, the contribution from indirect taxes anticipated thus far is currently assumed to be zero in 2008, against 0.5 percentage point in 2007. At the same time, the projections are based on the expectation that wage growth will be slightly higher over the projection horizon than in 2006. Since growth in labour productivity is projected to remain roughly stable, it implies an increase in unit labour cost growth. The upward effects of higher unit labour costs are, however, dampened in the baseline projection by the expectation of slightly declining growth in profit margins.

### Comparison with the June 2007 projections

Compared with the Eurosystem staff macroeconomic projections published in the June 2007 issue of the Monthly Bulletin, the range projected for real GDP growth in 2007 has been adjusted slightly downwards, reflecting the effects of somewhat higher oil prices and slightly tighter financing conditions. The range projected for real GDP growth in 2008 remains unchanged.

The new ranges projected for the annual rate of increase in the overall HICP in 2007 and 2008 are within the ranges of the June 2007 projections.

**Table B Comparison with the June 2007 projections**

(average annual percentage changes)

	2006	2007	2008
Real GDP – June 2007	2.9	2.3-2.9	1.8-2.8
Real GDP – September 2007	2.9	2.2-2.8	1.8-2.8
HICP – June 2007	2.2	1.8-2.2	1.4-2.6
HICP – September 2007	2.2	1.9-2.1	1.5-2.5