

Box 10

ECB STAFF MACROECONOMIC PROJECTIONS FOR THE EURO AREA

On the basis of the information available up to 14 February 2008, ECB staff have prepared projections for macroeconomic developments in the euro area.¹ Average annual real GDP growth is projected to be between 1.3% and 2.1% in 2008, and between 1.3% and 2.3% in 2009. The average rate of increase in the overall HICP is projected to be between 2.6% and 3.2% in 2008, and between 1.5% and 2.7% in 2009.

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 February 2008. 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 4.2% for 2008 and of 3.5% for 2009.² This assumption is of a purely technical nature. The market expectations for euro area ten-year nominal government bond yields imply an average level of 4.3% in 2008 and of 4.5% in 2009. The baseline projection also includes the assumption that, over the projection horizon, long-term bank lending spreads will reflect 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 90.6 per barrel in 2008 and USD 89.1 per barrel in 2009. The average annual increase in non-energy commodity prices in US dollars is assumed to be 12.7% in 2008 and 6.1% in 2009.

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 1.47 in 2008 and 1.46 in 2009, and an effective exchange rate of the euro that is, on average, 3.6% higher in 2008 than the average for 2007 and 0.2% lower in 2009 than the average for 2008.

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 slowdown of economic growth in the United States as well as in a number of developed economies is expected to dampen global growth prospects, also reflecting the effects of the financial turmoil. However, the projected stronger domestic demand in emerging markets and

1 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.

2 Market expectations as measured by forward rates may deviate slightly from EURIBOR futures rates. See the methodological note in the box entitled "ECB staff macroeconomic projections for the euro area" in the March 2007 issue of the Monthly Bulletin.

Table A Macroeconomic projections for the euro area(average annual percentage changes)^{1),2)}

	2007	2008	2009
HICP	2.1	2.6-3.2	1.5-2.7
Real GDP	2.6	1.3-2.1	1.3-2.3
Private consumption	1.6	1.1-1.7	1.0-2.4
Government consumption	1.9	1.1-2.1	1.0-2.0
Gross fixed capital formation	4.6	0.5-3.1	0.2-3.4
Exports (goods and services)	5.7	2.6-5.6	3.1-6.3
Imports (goods and services)	4.9	2.0-5.4	2.9-6.3

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 projections include Cyprus and Malta as part of the euro area in the projection ranges for 2008 and 2009. The annual percentage changes for 2008 are based on a euro area composition that includes Cyprus and Malta already in 2007. The weights of Cyprus and Malta in euro area GDP are approximately 0.2% and 0.1% respectively.

improved terms of trade, stemming from high commodity prices, in commodity-exporting countries are expected to cushion the overall weakening in demand. Overall, after having reached 5.7% in 2007, annual growth in world real GDP outside the euro area is projected to slow to 4.6% in 2008 but to recover gradually in 2009. Growth in the euro area's external export markets is projected to slow down from 6.2% in 2007 to 5.5% in 2008, before recovering to 6.2% in 2009.

Real GDP growth projections

After two years of growth above estimates of potential, real GDP growth in the euro area is expected to moderate in 2008, affected by developments in external demand, the ongoing financial turmoil and the rise in commodity prices. As a consequence, after standing at 2.6% in 2007, growth in average annual real GDP is projected to be between 1.3% and 2.1% in 2008, and between 1.3% and 2.3% in 2009. The expected slowdown reflects the lower growth of both exports and domestic demand. The growth of euro area exports is dampened by the projected weakening of foreign demand and the past appreciation of the euro. Together with a moderation in profits and tighter financing conditions, this is expected to lead to a decline in investment growth. Private consumption is expected to be affected by the adverse commodity price developments, which weigh on real disposable income.

Price and cost projections

Following the recent rise in inflation, to 3.2% in January 2008, the average rate of increase in the overall HICP is projected to be between 2.6% and 3.2% in 2008. The high annual rate of inflation during 2008 mainly relates to increases in energy and food prices. On the basis of current futures prices for energy and food, pressures from global commodity prices are expected to weaken in the course of 2008. As regards domestic price pressures, the projections are based on the expectation that wage growth will increase slightly in 2008, reflecting higher collective wage agreements, notably in the public sector. This is expected to result in stronger unit labour cost growth, as growth in labour productivity is projected to remain roughly stable throughout 2008. The upward effects of stronger unit labour cost pressure are, however, projected to be compensated by lower gains in profit margins in 2008, in line with the weaker activity outlook. In 2009 inflation is expected to be between 1.5% and 2.7%. Underlying this projection is the assumption that wage growth will remain broadly stable in 2009.

Comparison with the December 2007 projections

Compared with the Eurosystem staff macroeconomic projections published in the December 2007 issue of the Monthly Bulletin, the ranges projected for real GDP growth in 2008 and 2009 have been adjusted downwards, reflecting the effects of lower projected euro area foreign demand, stronger pressure from commodity prices and the impact of financial market developments.

The ranges projected for the annual rate of increase in the overall HICP in 2008 and 2009 have been shifted upwards, mostly reflecting stronger energy and food price inflation and expectations of somewhat higher labour cost pressures than envisaged in the December 2007 projections.

Table B Comparison with the December 2007 projections

(average annual percentage changes)

	2007	2008	2009
Real GDP – December 2007	2.4-2.8	1.5-2.5	1.6-2.6
Real GDP – March 2008	2.6	1.3-2.1	1.3-2.3
HICP – December 2007	2.0-2.2	2.0-3.0	1.2-2.4
HICP – March 2008	2.1	2.6-3.2	1.5-2.7