

ECB STAFF MACROECONOMIC PROJECTIONS FOR THE EURO AREA

On the basis of the information available up to 22 August 2008, ECB staff have prepared projections for macroeconomic developments in the euro area.¹ Average annual real GDP growth is projected to be between 1.1% and 1.7% in 2008, and between 0.6% and 1.8% in 2009. The average rate of increase in the overall HICP is projected to be between 3.4% and 3.6% in 2008, and between 2.3% and 2.9% in 2009.

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

The technical assumptions about interest rates and both oil and non-energy commodity prices are based on market futures, with a cut-off date of 14 August 2008.² The assumption about short-term interest rates is of a purely technical nature. These rates are measured by the three-month EURIBOR, market expectations being derived from futures rates.³ The methodology implies an overall average level of short-term interest rates at 4.8% for 2008 and 4.5% for 2009. The market expectations for euro area ten-year nominal government bond yields imply an average level of 4.5% in 2008 and 4.6% in 2009. The baseline projection also includes the assumption that, over the projection horizon, bank lending rate spreads will remain large, reflecting the ongoing 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, oil prices per barrel are assumed to average USD 115.1 in 2008 and USD 120.8 in 2009. International food prices in US dollars are assumed to increase by 42.8% in 2008 and 6.9% in 2009. The prices of other commodities (non-energy and non-food) are assumed to increase by 10.6% in 2008 and -1.8% 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 1.53 in 2008 and 1.52 in 2009, and an effective exchange rate of the euro that is, on average, 6.1% 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, as available on 21 August 2008. 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.

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. Starting with the current projection exercise, the ranges for each variable and each horizon correspond to a model-based 75% probability interval. This new technique is presented in the ECB website publication entitled "New procedure for constructing ECB/Eurosystem projection ranges".

2 Oil and food price assumptions are based on futures prices up to end-2009. For other commodities, prices are assumed to follow futures until mid-2009 and thereafter to develop in line with global economic activity.

3 Starting with the current projection exercise, market expectations are now based on EURIBOR futures rates. The previous method, based on implied forward rates, had deviated increasingly from EURIBOR futures at short horizons since the beginning of the financial turmoil in August 2007 and was therefore seen to have become less representative of market expectations for the future path of three-month EURIBOR rates. Differences between the previous method and the new one are documented in the methodological note in the box entitled "ECB staff macroeconomic projections for the euro area" in the March 2007 issue of the Monthly Bulletin.

Assumptions with regard to the international environment

Following a relatively resilient first half of the year, growth in global economic activity is projected to weaken in the second half of 2008. This largely reflects the lagged impact of high commodity prices and the expected weak growth momentum in the United States, together with the associated spillovers to other economies, particularly advanced economies. In contrast, it is projected that growth in emerging markets remains supported by strong domestic demand. From early 2009, both global economic growth and euro area foreign demand are projected to recover gradually. Overall, after reaching 5.1% in 2007, average annual growth in world real GDP outside the euro area is projected to slow to 4.1% in 2008 and to 3.7% in 2009. Growth in the euro area's export markets is projected to slow to 5.2% in 2008, from 6.4% in 2007, before recovering to 5.7% in 2009.

Real GDP growth projections

Against the background of weakening foreign activity, a strong euro exchange rate and continued high commodity prices, euro area annual real GDP growth is expected to decline in 2008 after two years of growth above potential. Having stood at 2.6% in 2007, growth in average annual real GDP is projected to be between 1.1% and 1.7% in 2008, and between 0.6% and 1.8% in 2009. The dampened GDP growth expected over the projection horizon reflects weaker export growth and subdued domestic demand. Stagnant employment, higher commodity prices and adverse effects from equity and house prices are projected to weigh on private consumption. Higher financing costs, a squeeze on profit margins, weak demand and the housing market situation in some countries are expected to substantially dampen investment growth. In the course of 2009, the projected pick-up in GDP growth is supported by the assumed lower rise in commodity prices, along with an improved external environment.

Price and cost projections

Year-on-year HICP inflation increased further in the first half of 2008, reaching 4.0% in July 2008. On the basis of the latest Eurostat flash estimate, it moderated to 3.8% in August. Looking forward, HICP inflation is expected to decelerate slowly, with the average rate of increase in the overall HICP projected to be between 3.4% and 3.6% in 2008. Based on the corresponding futures, the assumed prices of oil and non-oil commodities and their

Table A Macroeconomic projections for the euro area

(average annual percentage changes)^{1),2)}

	2007	2008	2009
HICP	2.1	3.4-3.6	2.3-2.9
Real GDP	2.6	1.1-1.7	0.6-1.8
Private consumption	1.6	0.5-0.9	0.6-1.6
Government consumption	2.3	1.5-1.9	1.3-1.9
Gross fixed capital formation	4.4	0.9-2.3	-0.7-2.1
Exports (goods and services)	6.1	2.9-4.5	2.4-4.6
Imports (goods and services)	5.4	2.4-3.8	2.0-5.0

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) Slovakia is included as part of the euro area in the projection ranges for 2009. The average annual percentage changes for 2009 are based on a euro area composition that includes Slovakia already in 2008.

pass-through to consumer prices are expected to exert less pressure over time on overall inflation. As regards domestic price pressures, the projections are based on the expectation that wage growth, which has increased significantly since mid-2007, will increase further in the course of the year, reflecting higher collective wage agreements already reached in both the private and public sectors. This, combined with an additional impact of the cyclical downswing in labour productivity, largely contributes to an increase in unit labour cost growth in 2008. These unit labour cost pressures are, however, projected to be broadly offset in 2008 by movements in profit margins, in line with the weaker economic outlook. In 2009, HICP inflation is expected to be between 2.3% and 2.9%. Underlying this projection is the expectation that unit labour cost growth will fall as wage growth moderates slightly in 2009, reacting with a lag to the weakening in activity, while productivity recovers with the cycle.

Comparison with the June 2008 projections

Compared with the Eurosystem staff macroeconomic projections published in the June 2008 issue of the Monthly Bulletin, the ranges projected for real GDP growth in 2008 and 2009 have been adjusted downwards on the back of the latest information, reflecting weaker short-term economic prospects, especially affecting domestic demand.

The ranges projected for the annual rate of increase in the overall HICP in 2008 and 2009 are now in the upper part of the previous ranges, mostly reflecting higher energy and, to a lesser extent, food and services prices than envisaged in the June 2008 projections.

Table B Comparison with the June 2008 projections

(average annual percentage changes)

	2007	2008	2009
Real GDP – June 2008	2.7	1.5-2.1	1.0-2.0
Real GDP – September 2008	2.6	1.1-1.7	0.6-1.8
HICP – June 2008	2.1	3.2-3.6	1.8-3.0
HICP – September 2008	2.1	3.4-3.6	2.3-2.9