

### ECB STAFF MACROECONOMIC PROJECTIONS FOR THE EURO AREA

On the basis of the information available up to 23 February 2009, ECB staff have prepared projections for macroeconomic developments in the euro area.<sup>1</sup> Reflecting the weak outlook for global growth as well as for domestic demand, average annual real GDP growth is projected to be negative in 2009, between -3.2% and -2.2%, before increasing to between -0.7% and +0.7% in 2010. Inflation is expected to be dampened by the fall in commodity prices and the slowdown in economic activity. The average rate of increase in the overall HICP is projected to be between 0.1% and 0.7% in 2009, and between 0.6% and 1.4% in 2010.

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

The technical assumptions about interest rates and both energy and non-energy commodity prices are based on market expectations, with a cut-off date of 13 February 2009.<sup>2</sup> The assumption about short-term interest rates is of a purely technical nature. Short-term rates are measured by the three-month EURIBOR, with market expectations derived from futures rates. The methodology gives an overall average level of short-term interest rates of 1.8% for 2009 and 2.1% for 2010. The market expectations for euro area ten-year nominal government bond yields imply an average level of 4.2% in 2009 and 4.6% in 2010. The baseline projection takes into account the current tightness of financing conditions but also includes the assumption that, over the projection horizon, bank lending rate spreads vis-à-vis the above-mentioned interest rates will narrow somewhat. Similarly, credit conditions are assumed to ease gradually over the horizon from their current tightness. As regards commodities, 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 49.3 in 2009 and USD 57.4 in 2010. International food prices in US dollars are assumed to decline by 11.8% in 2009 and to rise by 4.9% in 2010. The prices of other (i.e. non-energy and non-food) commodities in US dollars are assumed to decrease significantly, by 29.8%, in 2009 and to rise by 6.0% in 2010.

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 1.29 in both 2009 and 2010, and an effective exchange rate of the euro that is, on average, 2.4% lower in 2009 than the average for 2008 and 0.1% lower in 2010 than the average for 2009.

Fiscal policy assumptions are based on individual euro area countries' national budget plans as available on 13 February 2009. They include all policy measures that have already been approved

1 The ECB staff macroeconomic projections complement the Eurosystem staff macroeconomic projections that are produced jointly by experts from the ECB and from the 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, which is available on the ECB's website. To reflect the uncertainty surrounding the projections, ranges are used to present the results for each variable. The ranges for each variable and each horizon correspond to a model-based 75% probability interval. The method used is documented in "New procedure for constructing ECB staff projection ranges", ECB, September 2008, available on the ECB's website.

2 Oil and food price assumptions are based on futures prices up to end-2010. For other commodities, prices are assumed to follow futures until end-2009 and thereafter to develop in line with global economic activity.

by national parliaments or that have been specified in detail by governments and are likely to pass the legislative process. In particular, the fiscal stimulus packages that have been agreed in a number of countries have been accounted for in the projections.

### Assumptions with regard to the international environment

Global economic prospects deteriorated markedly in the final quarter of 2008 amid a rapid amplification of adverse feedback loops between the financial crisis and real economic activity in advanced economies and an increase in spillovers to emerging markets, particularly via the collapse of global trade. The world economy is projected to undergo its most severe and synchronised downturn in many decades. Average annual growth in world real GDP outside the euro area is projected to decline from 3.6% in 2008 to 0.2% in 2009, and to rebound moderately to 2.5% in 2010 as expansionary policy measures take hold across the globe. The main trade partners of the euro area are expected to be especially affected by the global activity slowdown. As a result, growth in the euro area's export markets, which was 4.1% in 2008, is projected to be negative in 2009, at - 5.3%, before recovering to 1.9% in 2010.

### Real GDP growth projections

Real GDP growth has been negative in the euro area since the second quarter of 2008, with GDP falling 1.5% quarter on quarter in the last quarter of that year. In line with recent short-term economic indicators and surveys, GDP is expected to continue to decline in 2009, albeit to a lesser extent than at the end of 2008. This decline reflects a drop in exports coupled with decreasing domestic demand. The investment outlook is especially affected by the weak global activity and the high level of uncertainty. Residential investment in particular is projected to fall, additionally reflecting ongoing corrections in housing markets in some euro area countries. Private consumption is projected to be dampened by a deteriorating labour market and low confidence. Recent adverse developments – such as the weakening in world trade, the fall in confidence and the tightening of financing conditions – are expected to reverse only gradually over the horizon. However, benefiting from the large macroeconomic stimulus in the euro area and the rest of the world, and reflecting the measures taken to facilitate the functioning of the financial system, a recovery is projected for 2010. It is expected to be driven by exports, the assumed gradual normalisation in financial markets and a stabilisation in housing markets.

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

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

	2008	2009	2010
HICP	3.3	0.1 - 0.7	0.6 - 1.4
Real GDP	0.8	-3.2 - -2.2	-0.7 - 0.7
Private consumption	0.5	-1.2 - -0.2	-0.4 - 1.0
Government consumption	2.1	1.3 - 2.1	1.1 - 1.9
Gross fixed capital formation	0.3	-8.6 - -5.8	-4.3 - -0.3
Exports (goods and services)	1.8	-9.7 - -6.9	-0.9 - 1.9
Imports (goods and services)	1.8	-8.0 - -5.0	-1.6 - 2.6

1) The projections for real GDP and its components are based on working-day-adjusted data. The projections for exports and imports include intra-euro area trade.

2) Data for GDP refer to all 16 countries of the euro area. For the HICP, Slovakia is included as part of the euro area in the projection ranges as of 2009. The average annual percentage changes for 2009 are based on a euro area composition that includes Slovakia already in 2008.

Overall, after having grown by 0.8% in 2008, real GDP is expected to decline by between 2.2% and 3.2% in 2009, before recording rates of change between -0.7% and +0.7% in 2010.

### Price and cost projections

As a result of declining commodity prices and base effects caused by past commodity price changes, and increasingly reflecting the deteriorating economic outlook, average annual HICP inflation is expected to fall to a range between 0.1% and 0.7% in 2009, from 3.3% in 2008. In 2010 inflation is projected to be between 0.6% and 1.4%. The weak economic outlook for the euro area is expected to keep domestic price pressures contained over the whole horizon. In particular, compensation per employee, which registered a strong increase in 2008, is expected to decelerate significantly, with lower wage growth in both the public and private sectors as the labour market deteriorates and inflation falls. Reductions in profit margins are projected to further dampen inflation. Finally, low global inflation is also expected to help to contain import prices.

### Comparison with the December 2008 projections

Compared with the Eurosystem staff macroeconomic projections published in the December 2008 issue of the Monthly Bulletin, the ranges projected for real GDP growth in 2009 and 2010 have been adjusted substantially downwards, reflecting lower activity worldwide, declines in asset prices and weakened confidence.

The ranges projected for the annual rate of increase in the overall HICP in 2009 and 2010 are both significantly below those given in December 2008, mostly reflecting downward revisions to energy and food prices but also the impact of lower activity on wages and prices.

**Table B Comparison with the December 2008 projections**

(average annual percentage changes)

	2008	2009	2010
Real GDP – December 2008	0.8 - 1.2	-1.0 - 0.0	0.5 - 1.5
Real GDP – March 2009	0.8	-3.2 - -2.2	-0.7 - 0.7
HICP – December 2008	3.2 - 3.4	1.1 - 1.7	1.5 - 2.1
HICP – March 2009	3.3	0.1 - 0.7	0.6 - 1.4