

## Box 8

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

On the basis of the information available up to 19 February 2010, ECB staff have prepared projections for macroeconomic developments in the euro area.<sup>1</sup> Reflecting the prospects for the economic recovery worldwide, average annual real GDP growth is projected to increase gradually from between 0.4% and 1.2% in 2010 to between 0.5% and 2.5% in 2011. Inflation is projected to rise slightly over the projection horizon, from between 0.8% and 1.6% in 2010 to between 0.9% and 2.1% in 2011, as the recovery gathers pace.

**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 12 February 2010.<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 0.9% for 2010 and 1.7% for 2011. The market expectations for euro area ten-year nominal government bond yields imply an average level of 4.0% in 2010 and 4.5% in 2011. The baseline projection takes into account the recent further improvements in financing conditions and assumes that, over the projection horizon, bank lending rate spreads vis-à-vis the above-mentioned interest rates will stabilise or narrow somewhat. Similarly, credit supply conditions are assumed to ease over the projection horizon. 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 75.1 in 2010 and USD 79.8 in 2011. The prices of non-energy commodities in US dollars are assumed to rise by 18.4% in 2010 and a further 2.7% in 2011.

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 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. The method used, involving a correction for exceptional events, is documented in "New procedure for constructing Eurosystem and ECB staff projection ranges", ECB, December 2009, also available on the ECB's website.

2 Oil and food price assumptions are based on futures prices up to the end of the projection horizon. For other commodities, prices are assumed to follow futures until the last quarter of 2010 and thereafter to develop in line with global economic activity.

Bilateral exchange rates are assumed to 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 1.38 over the whole projection horizon and an effective exchange rate of the euro that, on average, depreciates by 2.6% in 2010 and a further 0.2% in 2011.

Fiscal policy assumptions are based on individual euro area countries' national budget plans as available on 12 February 2010. They include all policy measures that have already been approved by national parliaments or have been specified in detail by governments and are likely to pass the legislative process.

### Assumptions with regard to the international environment

The global economic outlook has shown stronger signs of improvement since the turning-point around mid-2009. In the near term, the recovery is expected to continue to be driven primarily by the impact of monetary and fiscal stimuli, the normalisation in trade and the inventory cycle. While some of these factors are temporary, the improvement in financing conditions is expected to provide more lasting support to the projected continuing global recovery. Overall, global economic growth is expected to remain below past trends over the whole projection horizon, as advanced economies in particular experience a subdued recovery, reflecting the need for balance sheet adjustment following the crisis. World real GDP outside the euro area is assumed to grow, on average, by 4.2% in 2010 and 4.0% in 2011. Reflecting the significant recovery in global trade, growth in the euro area's export markets is assumed to increase to 6.9% in 2010 and 5.4% in 2011. The stronger growth rate, in annual terms, in 2010 reflects the impact of a larger statistical carry-over from 2009 and masks the fact that the pace of quarterly growth for the global economy is actually projected to be faster in 2011 than in 2010.

### Real GDP growth projections

After a deep recession, the euro area posted a second consecutive quarter of positive real GDP growth in the last quarter of 2009. Available evidence suggests that the recovery was driven by exports, following the rebound in world trade. In addition, temporary factors, such as the fiscal stimulus packages and the inventory cycle, provided support to the recovery. As the effects of these factors fade away over time, GDP growth in 2010 is expected to remain moderate, even though activity is projected to be progressively supported by exports and a slowly recovering domestic demand, reflecting the lagged effects of monetary policy actions and of the significant

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

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

	2009	2010	2011
HICP	0.3	0.8 - 1.6	0.9 - 2.1
Real GDP	-4.0	0.4 - 1.2	0.5 - 2.5
Private consumption	-1.0	-0.3 - 0.5	0.2 - 2.0
Government consumption	2.5	0.1 - 1.1	0.2 - 1.6
Gross fixed capital formation	-10.8	-3.1 - -0.5	-1.1 - 2.9
Exports (goods and services)	-13.0	3.2 - 7.6	1.4 - 7.8
Imports (goods and services)	-11.6	1.9 - 5.7	0.7 - 6.5

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

2) Data refer to all 16 countries of the euro area.

efforts to restore the functioning of the financial system. The recovery is expected to consolidate in 2011. Growth is expected to remain on a weaker path than before the recession, owing to the need for balance sheet repair in various sectors and the fact that consumption is being dampened by weak labour market prospects and precautionary savings remain high. Furthermore, private investment, while picking up over the horizon, is projected to be dampened by high levels of unused capacity and low demand prospects. Overall, after decreasing, in annual terms, by 4.0% in 2009, real GDP is projected to increase by between 0.4% and 1.2% in 2010 and between 0.5% and 2.5% in 2011. Nonetheless, with estimates of annual potential growth also projected to be lower than before the recession, the output gap is projected to narrow over the projection horizon.

### Price and cost projections

Having reached a low of -0.4% in the third quarter of 2009, annual HICP inflation turned positive in the fourth quarter of the year. This pattern was mostly due to strong base effects from past falls in commodity prices. After rising to 1.0% in January 2010, inflation is expected to remain close to this level over the following months. Thereafter, inflation is expected to increase progressively, reflecting the gradual improvements that are expected in activity, in a context where potential output growth remains modest. The average annual inflation rate is projected to be between 0.8% and 1.6% for 2010 and between 0.9% and 2.1% for 2011. Growth in compensation per employee is expected to remain low, dampened by the continued weakness of the labour market. As employment is projected to fall further for some time to come, the resulting productivity increases are expected to contribute to a significant fall in unit labour cost growth from the high levels observed in 2009. This, in turn, is projected to allow a moderate growth in profit margins and a partial recouping of the losses incurred in 2009. The annual rate of change in the HICP excluding energy is expected to moderate further in 2010, reflecting the weakness of aggregate demand, before recovering slightly in 2011.

### Comparison with the December 2009 projections

Compared with the Eurosystem staff macroeconomic projections published in the December 2009 issue of the Monthly Bulletin, the projection range for real GDP growth in 2010 lies within the previous one. The range for 2011 has been revised slightly upwards, reflecting notably the more buoyant activity worldwide, which is expected to boost euro area exports and encourage investment.

With regard to HICP inflation, the range for 2010 has been adjusted marginally downwards with respect to that of December 2009, while the range for 2011 has been adjusted slightly upwards, in line with the improved prospects for activity.

Table B Comparison with the December 2009 projections

(average annual percentage changes)

	2009	2010	2011
Real GDP – December 2009	-4.1 - -3.9	0.1 - 1.5	0.2 - 2.2
Real GDP – March 2010	-4.0	0.4 - 1.2	0.5 - 2.5
HICP – December 2009	0.3 - 0.3	0.9 - 1.7	0.8 - 2.0
HICP – March 2010	0.3	0.8 - 1.6	0.9 - 2.1

### Comparison with forecasts by other institutions

A number of forecasts for the euro area are available from both international organisations and private sector institutions. However, these forecasts are not strictly comparable with one another or with the ECB staff macroeconomic projections, as they were finalised at different points in time. Additionally, they use different (partly unspecified) methods to derive assumptions for fiscal, financial and external variables, including oil and other commodity prices. Finally, there are differences in working day adjustment methods across different forecasts (see the table below).

According to the forecasts currently available from other organisations and institutions, euro area real GDP is expected to range between 0.7% and 1.3% in 2010 and between 1.5% and 1.7% in 2011. As regards inflation, available forecasts anticipate average annual HICP inflation to be between 0.8% and 1.3% in 2010 and between 0.7% and 1.5% in 2011. For both GDP growth and HICP inflation, the forecasts by other institutions therefore generally fall within the ranges of the ECB staff projections.

**Table C Comparison of forecasts for euro area real GDP growth and HICP inflation**

(average annual percentage changes)

	Date of release	GDP growth		HICP inflation	
		2010	2011	2010	2011
OECD	November 2009	0.9	1.7	0.9	0.7
IMF	January 2010	1.0	1.6	0.8	0.8
Consensus Economics Forecasts	February 2010	1.3	1.5	1.2	1.5
Survey of Professional Forecasters	February 2010	1.2	1.6	1.3	1.5
European Commission	February 2010	0.7	1.5	1.1	1.5
ECB staff projections	March 2010	0.4 - 1.2	0.5 - 2.5	0.8 - 1.6	0.9 - 2.1

Sources: European Commission Interim Forecast, February 2010, for 2010 figures and European Economic Forecast – autumn 2009, for 2011 figures; IMF World Economic Outlook, October 2009, for inflation and World Economic Outlook Update, January 2010, for GDP growth; OECD Economic Outlook, November 2009; Consensus Economics Forecasts; and the ECB's Survey of Professional Forecasters.

Notes: The ECB staff macroeconomic projections and the OECD forecasts both report working day-adjusted annual growth rates, whereas the European Commission and the IMF report annual growth rates that are not adjusted for the number of working days per annum. Other forecasts do not specify whether they report working day-adjusted or non-working day-adjusted data.