

Box 9

ECB STAFF MACROECONOMIC PROJECTIONS FOR THE EURO AREA

On the basis of the information available up to 25 August 2011, ECB staff have prepared projections for macroeconomic developments in the euro area.¹ Average annual real GDP growth is projected to range between 1.4% and 1.8% in 2011 and between 0.4% and 2.2% in 2012. Inflation is projected to be between 2.5% and 2.7% in 2011 and between 1.2% and 2.2% in 2012.

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

The technical assumptions for interest rates and for both energy and non-energy commodity prices are based on market expectations, with a cut-off date of 18 August 2011.

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 average level for these short-term interest rates of 1.3% for 2011 and 1.0% for 2012. The market expectations for euro area ten-year nominal government bond yields imply an average level of 4.2% in both 2011 and 2012. The pass-through from market rates to bank lending rates is assumed to function in line with historical regularity for most parts of the euro area. However, in some parts, notably where tensions in sovereign bond markets exist,

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.

the pass-through is expected to be accompanied by adverse effects on bank credit risk premia. Credit supply conditions are assumed to gradually normalise further but to continue weighing somewhat on activity over the projection horizon.

As regards commodity prices, on the basis of the path implied by futures markets in the two-week period ending on the cut-off date, the price of a barrel of Brent crude oil is assumed to average USD 110.1 in 2011 and USD 106.5 in 2012. The prices of non-energy commodities in US dollars² are assumed to rise by 19.6% in 2011 and to decline by 0.8% in 2012.

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 of 18 August 2011. This implies an exchange rate of EUR/USD 1.42 in 2011 and EUR/USD 1.43 in 2012, and an effective exchange rate of the euro that, on average, appreciates by 0.2% in 2011 and decreases by 0.2% in 2012.

Fiscal policy assumptions are based on individual euro area countries' national budget plans as available on 19 August 2011. They include all policy measures that have already been approved by national parliaments or that have been specified in sufficient detail by governments and are likely to pass the legislative process.

Assumptions with regard to the international environment

The pace of global growth has moderated in recent months. This slowdown partly reflects temporary factors, such as the impact of the Japanese natural and nuclear disasters on the Japanese economy and on global supply chains, as well as the dampening effects of high commodity prices on incomes in the major advanced economies. Looking ahead, the gradual waning of supply chain disruptions is expected to provide some growth impetus in the second half of this year. However, the higher than expected unemployment rates, lower business and consumer confidence in advanced economies, and continued weakness in the housing market in the United States are expected to weigh adversely on growth. In addition, the recent shift in sentiment in global financial markets, while not expected to derail the global economic recovery, is anticipated to have further negative repercussions through both confidence and wealth effects in the second half of 2011. In the medium term, the legacy of the financial crisis is expected to continue to weigh adversely on the strength of the recovery in advanced economies, reflecting the need for balance sheet adjustment in various sectors. This hampers the prospects for a swift improvement in labour markets in some advanced economies. By contrast, growth in emerging economies is expected to remain relatively robust, with overheating pressures persisting. World real GDP outside the euro area is assumed to grow, on average, by 4.1% in 2011 and 4.4% in 2012. Growth in euro area foreign demand is estimated to be 7.0% in 2011 and 6.8% in 2012. These growth rates are lower than in the June 2011 Eurosystem staff projections, reflecting notably a downward revision to the outlook for the US economy.

Real GDP growth projections

Following strong growth in the euro area in the first quarter of 2011, driven by a rebound in construction output, there has been a significant deceleration in economic activity in the past

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 third quarter of 2012 and thereafter to evolve in line with global economic activity.

Table A Macroeconomic projections for the euro area

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

	2010	2011	2012
HICP	1.6	2.5 – 2.7	1.2 – 2.2
Real GDP	1.7	1.4 – 1.8	0.4 – 2.2
Private consumption	0.8	0.3 – 0.7	0.0 – 1.6
Government consumption	0.5	-0.2 – 0.8	-0.7 – 0.5
Gross fixed capital formation	-0.8	2.2 – 3.6	0.8 – 5.4
Exports (goods and services)	11.0	5.6 – 8.4	2.3 – 9.7
Imports (goods and services)	9.3	4.7 – 7.3	2.0 – 9.2

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

2) Data refer to the euro area including Estonia, except for the HICP data in 2010. The average annual percentage change in the HICP for 2011 is based on a euro area composition in 2010 that already includes Estonia.

few months. As was the case for the global economy, euro area activity was dampened by adverse effects related to the Japanese natural and nuclear disasters, as well as by the lagged impact of past oil price increases. The underlying momentum in the euro area also weakened as a result of domestic factors, such as lower equity prices, the tightening of the fiscal stance, more strict credit supply conditions and heightened uncertainty, as reflected in rising risk premia related to the sovereign debt crisis as well as in deteriorating business and consumer confidence. As several of these factors are expected to continue to have an adverse impact in the near term, real GDP is projected to increase only modestly during the second half of 2011. Thereafter, activity is expected to gradually gain momentum as euro area exports benefit from rising foreign demand, while domestic demand is projected to gradually strengthen, supported by the accommodative monetary policy stance, the measures to restore the functioning of the financial system and, eventually, the impact of robust global demand on domestic income. In annual terms, real GDP is expected to increase by between 1.4% and 1.8% in 2011 and between 0.4% and 2.2% in 2012.

Considering the demand components in more detail, the pace of growth of extra-euro area exports is expected to remain relatively strong until 2012, albeit falling below the rate of expansion of euro area foreign demand in 2012, in line with the trend decline in euro area export market shares. Following its strong rebound in the first quarter of 2011, total investment is projected to grow only moderately during the remainder of the year, before gaining more momentum in 2012. Business investment is expected to increase steadily over the projection horizon, supported by increasing profitability, sustained export growth and the emergence of capacity bottlenecks. However, residential investment growth is expected to stay relatively subdued throughout the projection period, owing to ongoing adjustments in housing markets in some countries, which are also reflected in projected modest house price increases. Moreover, government investment is assumed to decline until the end of 2012, as currently indicated in the fiscal consolidation packages announced in several euro area countries.

Private consumption growth is projected to be fairly subdued in 2011, before picking up slightly in 2012, mostly reflecting the pattern of real disposable income growth. While the adverse impact of past increases in commodity prices should dampen real disposable income growth during the remainder of 2011, inflationary pressures are expected to diminish thereafter, supporting the dynamics of real disposable income in 2012. Government consumption in real terms is projected

Table B Comparison with the June 2011 projections

(average annual percentage changes)

	2011	2012
Real GDP – June 2011	1.5 – 2.3	0.6 – 2.8
Real GDP – September 2011	1.4 – 1.8	0.4 – 2.2
HICP – June 2011	2.5 – 2.7	1.1 – 2.3
HICP – September 2011	2.5 – 2.7	1.2 – 2.2

to increase only modestly until 2012, reflecting the fiscal consolidation packages announced in several euro area countries. The pace of extra-euro area import growth is expected to pick up somewhat during 2011 before stabilising in 2012, rising faster over the projection horizon than total demand. Reflecting the somewhat stronger growth of exports, net trade is expected to make a positive, though declining, contribution to GDP growth throughout the projection period.

Price and cost projections

Euro area annual HICP inflation was 2.5% in August 2011. Overall HICP inflation is projected to stay above 2% in the next months, largely owing to the impact of past strong increases in oil and non-oil commodity prices on energy and food prices. Thereafter, on the basis of current futures prices for commodities, import price increases are projected to moderate. By contrast, domestic price pressures are expected to rise slowly, reflecting increasing labour costs as well as the pass-through of the past hikes in commodity prices, leading to a gradual rise in the inflation rate of the HICP excluding food and energy over the projection horizon. Overall, average annual headline inflation is projected to be between 2.5% and 2.7% in 2011 and between 1.2% and 2.2% in 2012. Growth in compensation per employee is projected to remain relatively moderate over the projection horizon, reflecting the expected muted improvement in labour market conditions. Owing to the partial and lagged response of nominal wages to consumer price inflation, real compensation per employee is projected to decline in 2011. Thereafter, it is expected to increase slowly. As productivity growth is projected to moderate, unit labour costs are expected to rebound in 2011 and to grow at a faster pace in 2012. As a consequence, profit margin growth is projected to be curtailed in 2011 and 2012, also reflecting the expected moderate growth of aggregate demand.

Comparison with the June 2011 projections

Compared with the Eurosystem staff macroeconomic projections published in the June 2011 issue of the Monthly Bulletin, the ranges for real GDP growth in the euro area for 2011 and 2012 have been revised downwards. The revisions for the outlook for 2011 and 2012 reflect both lower foreign demand and weaker domestic demand, the latter being dampened inter alia by higher uncertainty, reduced confidence, lower stock prices and more strict credit supply conditions, factors which overall are seen to outweigh the positive effects of the significant downward revision in the technical assumption for average euro area lending rates. The downward revision for 2012 also reflects the impact of additional fiscal tightening in some euro area countries. With regard to HICP inflation, the projection range for 2011 has been left unchanged, while the range for 2012 is slightly narrower than in the June 2011 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	
		2011	2012	2011	2012
OECD	May 2011	2.0	2.0	2.6	1.6
European Commission	May 2011	1.6	1.8	2.6	1.8
IMF	June 2011	2.0	1.7	2.6	1.8
Survey of Professional Forecasters	August 2011	1.9	1.6	2.6	2.0
Consensus Economics Forecasts	August 2011	1.9	1.5	2.6	1.9
ECB staff projections	September 2011	1.4 – 1.8	0.4 – 2.2	2.5 – 2.7	1.2 – 2.2

Sources: European Commission Economic Forecasts, Spring 2011; IMF World Economic Outlook Update, June 2011; OECD Economic Outlook, May 2011; 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.

Comparison with forecasts by other institutions

A number of forecasts for the euro area are available from both international organisations and private sector institutions (see Table C). 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.

According to the forecasts currently available from other organisations and institutions, euro area real GDP growth is expected to range between 1.6% and 2.0% in 2011, marginally higher than the range of the ECB staff projections, and between 1.5% and 2.0% in 2012, which is close to the upper end of the range of the ECB staff projections. As regards inflation, available forecasts point to an average annual HICP inflation rate of 2.6% in 2011, which is within the range of the ECB staff projections. The HICP inflation forecasts for 2012 range between 1.6% and 2.0%, which is also within the range of the ECB staff projections.