

## Box 7

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

On the basis of the information available up to 19 August 2005, ECB staff have prepared projections for macroeconomic developments in the euro area.<sup>1</sup>

The ECB staff projections are based on assumptions about interest rates, exchange rates, oil prices, world trade outside the euro area and fiscal policies. In particular, the technical assumption is made that short-term market interest rates and bilateral exchange rates will remain unchanged over the projection horizon at the levels prevailing in the first half of August. The technical assumptions concerning long-term interest rates and both oil and non-energy commodity prices are based on market expectations in mid-August.<sup>2</sup> 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 likely to pass the legislative process.

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.

**Assumptions with regard to the international environment**

The external environment of the euro area is expected to remain favourable in 2005 and 2006. Real GDP growth in the United States should remain robust, although at somewhat lower rates than in 2004. Real GDP growth in non-Japan Asia is expected to remain well above the global average, but be lower than in recent years. Growth in most large economies is projected to remain dynamic.

1 The ECB staff macroeconomic projections complement the Eurosystem staff macroeconomic projections that are produced jointly by experts from the ECB and from 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.

2 Short-term interest rates as measured by the three-month EURIBOR are therefore assumed to remain constant at 2.12% over the projection horizon. The technical assumption of constant exchange rates implies that the EUR/USD exchange rate stays at 1.22 over the horizon and that the effective exchange rate of the euro is in 2005 0.1% higher than the average for 2004 and in 2006 0.8% lower. Market expectations for euro area ten-year nominal government bond yields imply a small increase from an average of 3.5% in 2005 to an average of 3.7% in 2006. The increase in annual average non-energy commodity prices in US dollars is assumed to be 6.4% in 2005 and 2.4% in 2006. Based on the path implied by futures markets, annual average oil prices are assumed to increase further, from USD 55.3 per barrel in 2005 to USD 62.8 per barrel in 2006.

Annual growth in world real GDP outside the euro area is estimated to average about 4.8% in 2005 and 4.6% in 2006. Growth in the euro area's external export markets is projected to be about 7.1% in 2005 and 7.2% in 2006.

### Real GDP growth projections

Eurostat's flash estimate for euro area real GDP in the second quarter of 2005 indicates quarter-on-quarter growth of 0.3%. It is projected that growth will pick up slightly from the second half of this year onwards. Average annual real GDP growth is projected to be between 1.0% and 1.6% in 2005 and between 1.3% and 2.3% in 2006. On the back of the assumed continued strength in foreign demand, export growth is expected to continue to support economic activity over the horizon, while domestic demand should gradually strengthen.

Private consumption is projected to increase in line with real disposable income, which should be supported by growth in employment. Consumption growth is expected to be dampened, however, predominantly by the rise in oil prices and by precautionary savings related to ongoing concerns about the development of public finances and the longer-term prospects for public health care and pension systems. At the same time, total fixed investment growth is projected to recover from its recent weakness, since business investment should benefit from strong foreign demand and eventually respond to favourable credit conditions and robust corporate earnings. Residential private investment is projected to continue to grow at moderate rates over the horizon. As domestic demand is likely to stimulate import growth, net trade is expected to contribute only slightly to real GDP growth over the projection horizon.

### Price and cost projections

The average rate of increase in the overall HICP is projected to be between 2.1% and 2.3% in 2005 and between 1.4% and 2.4% in 2006. The small decline in HICP inflation in 2006 is mainly the result of the statistical treatment of a proposed health care reform in the Netherlands, which is estimated to contribute -0.2 percentage point. It also reflects the assumption of lower energy price inflation and of a lower rate of change in import prices in 2006.

Growth in nominal compensation per employee is assumed to remain moderate over the horizon. This not only takes into account current wage settlements and the projected only

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

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

	2004	2005	2006
HICP	2.1	2.1-2.3	1.4-2.4
Real GDP	1.8	1.0-1.6	1.3-2.3
Private consumption	1.3	1.1-1.5	0.7-1.9
Government consumption	1.4	0.6-1.6	1.1-2.1
Gross fixed capital formation	1.4	0.4-2.0	1.3-4.5
Exports (goods and services)	5.9	2.4-5.2	4.6-7.8
Imports (goods and services)	6.1	2.2-5.2	4.3-7.7

1) For each variable and horizon, ranges are based on the average absolute difference between actual outcomes and previous projections by euro area central banks. The projections for real GDP and its components refer to working-day-adjusted data.

modest improvement in labour market conditions, but also embodies the assumption that the large rise in oil prices will have no significant second-round effects on nominal compensation. The projections for real GDP growth and employment imply that labour productivity growth will slowly pick up. As a result of the developments in wages and productivity, unit labour cost growth is expected to remain relatively contained in both 2005 and 2006.

### Comparison with the June 2005 projections

Compared with the Eurosystem staff macroeconomic projections published in the June 2005 issue of the Monthly Bulletin, the ranges projected for real GDP growth in 2005 and 2006 have been adjusted slightly downwards. For 2005, this mainly reflects slight downward revisions of past data, and for 2006, mainly the effect of increases in the assumptions for oil prices on real disposable income.

The ranges projected for the annual rates of increase in the overall HICP for 2005 and 2006 have been shifted upwards compared with the June 2005 projections. This mainly reflects the aforementioned increase in the assumptions for oil prices for both 2005 and 2006. These imply a larger contribution from the energy component to the overall HICP, whereas the projections for the non-energy component are largely unchanged compared with the June projections.

**Table B Comparison of macroeconomic projections for the euro area**

(average annual percentage changes)

	2004	2005	2006
HICP – June 2005	2.1	1.8-2.2	0.9-2.1
HICP – September 2005	2.1	2.1-2.3	1.4-2.4
Real GDP – June 2005	1.8	1.1-1.7	1.5-2.5
Real GDP – September 2005	1.8	1.0-1.6	1.3-2.3