



EUROPEAN CENTRAL BANK

EUROSYSTEM

## EUROSYSTEM STAFF MACROECONOMIC PROJECTIONS FOR THE EURO AREA

On the basis of the information available up to 20 May 2008, Eurosystem staff have prepared projections for macroeconomic developments in the euro area.<sup>1</sup> Average annual real GDP growth is projected to be between 1.5% and 2.1% in 2008 and between 1.0% and 2.0% in 2009. The average rate of increase in the overall HICP is projected to be between 3.2% and 3.6% in 2008 and between 1.8% and 3.0% in 2009.

### Box 1

#### TECHNICAL ASSUMPTIONS

The Eurosystem staff projections are based on a series of assumptions about interest rates, exchange rates, oil prices, commodity prices and fiscal policies.

The technical assumptions about interest rates and commodity prices are based on market expectations, with a cut-off date of 14 May 2008.<sup>2</sup> With regard to short-term interest rates, as measured by the three-month EURIBOR, market expectations are derived from forward rates, reflecting a snapshot of the yield curve at the cut-off date. They imply an average level of 4.9% in 2008, falling to 4.3% in 2009.<sup>3</sup> The market expectations for euro area ten-year nominal government bond yields imply a gradual increase, from an average of 4.4% in 2008 to 4.6% in 2009. The baseline projection also includes the assumption that bank lending spreads will remain at their current level, reflecting the current episode of 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 113.3 in 2008 and USD 117.7 in 2009. The average annual increase in the prices of non-energy hard (i.e. non-food) commodities in US dollars is assumed to be 13.8% in 2008 and 6.2% in 2009. International food prices are assumed to increase by 44.0% in 2008 and 6.1% 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 1.54 and an effective exchange rate of the euro that is, on average, 6.4% higher in 2008 than the average for 2007 and 0.4% higher in 2009 than the average for 2008.

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 national parliaments or that have been specified in detail by governments and are likely to pass the legislative process.

#### THE INTERNATIONAL ENVIRONMENT

Global economic growth (outside the euro area) is projected to weaken in 2008 before accelerating gradually in the course of 2009. The moderation projected for 2008 mainly reflects the slowdown in the United States as well as in a number of other developed economies that are affected by the ongoing

- 1 The Eurosystem staff macroeconomic projections are produced jointly by experts from the ECB and the euro area NCBs. They are a biannual input into the Governing Council's assessment of economic developments and the risks to price stability. More information on the procedures and techniques used is given 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. 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. At this juncture, however, owing to financial market and commodity price developments, the uncertainty surrounding the projections is presumably larger than usual.
- 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 Market expectations as measured by forward rates may deviate slightly from EURIBOR futures rates. See the methodological note in the box entitled "ECB staff macroeconomic projections for the euro area" in the March 2007 issue of the Monthly Bulletin.

financial turmoil. Following a weak first half of 2008, activity in the United States is projected to gradually recover, supported by monetary easing and, temporarily, by the stimulus provided by the recent fiscal package, as well as by the ongoing strength of net exports. Although the slowdown in the United States is expected to spill over to other economies, in particular to its closest trading partners, spillovers are assumed to remain relatively limited for emerging markets and commodity-producing countries.

Overall, annual growth in world real GDP outside the euro area is projected to average about 4.0% in both 2008 and 2009. Growth in the euro area's external export markets is projected to be about 5.6% in 2008 and 5.8% in 2009.

## REAL GDP GROWTH PROJECTIONS

The underlying pace of euro area economic growth has been on a moderating path since 2006. The latest indicators have confirmed the slowdown, which owes to the rise in commodity prices, the appreciation of the exchange rate and the slowdown in the global economy. Eurostat's first estimate of euro area real GDP growth in the first quarter of 2008 indicates a quarter-on-quarter growth rate of 0.8%, following 0.3% in the fourth quarter of 2007. As this very favourable outturn is related partly to transitory factors, some volatility is expected in the quarterly growth rates, and economic activity in the euro area is projected to slow, in the coming quarters. Economic activity is projected to start to accelerate in 2009, benefiting from the global recovery and reaching quarterly growth rates of around 0.5% towards the end of the projection horizon. As a result, average annual real GDP growth is projected to be between 1.5% and 2.1% in 2008, being affected by a carry-over effect of 0.7 percentage point from the economic growth in 2007. In 2009, annual real GDP growth is projected to be between 1.0% and 2.0%.

**Table 1: Macroeconomic projections for the euro area**

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

	2007	2008	2009
HICP	2.1	3.2-3.6	1.8-3.0
Real GDP	2.7	1.5-2.1	1.0-2.0
Private consumption	1.6	1.1-1.5	0.9-2.1
Government consumption	2.1	1.3-2.3	1.2-2.2
Gross fixed capital formation	4.7	1.3-3.5	-0.4-2.8
Exports (goods and services)	5.7	3.5-6.3	2.4-5.6
Imports (goods and services)	5.2	2.9-6.3	2.2-5.6

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) The reported figures include Cyprus and Malta already in 2007, except with regard to the HICP, where they include Cyprus and Malta from 2008 only. The weights of Cyprus and Malta in euro area GDP are approximately 0.2% and 0.1% respectively.

Among the domestic components of GDP, private consumption growth is expected to decrease in 2008, mainly owing to real income weakness resulting from higher commodity prices. In 2009, as inflation is projected to decline and real income to gradually recover, private consumption growth is expected to rise again. Government consumption is expected to grow moderately over the projection horizon.

Business investment is expected to decelerate over the projection horizon, reflecting the cyclical slowdown and tighter financing conditions. It is, however, expected to continue to grow at robust rates, supported by the high capacity utilisation rate and reported equipment shortages. Residential private investment is expected to decline over the projection horizon, reflecting, beyond the cyclical pattern, the ongoing correction in the housing market and the tightening of credit standards. Finally, after an assumed decline in 2008, growth in government investment is expected to rebound markedly in 2009. Overall, the average annual growth rate of total fixed investment is projected to be between 1.3% and 3.5% in 2008 and between -0.4% and 2.8% in 2009.

Export growth will be affected by the slowdown in the world economy in the projection period. In addition, the euro area's export market shares are projected to decline, owing to increased competition from emerging markets and to losses in price competitiveness. The average annual rate of growth in total imports is projected to be slightly below that of total exports, resulting overall in a slightly positive contribution from net trade to real GDP growth over the projection period.

Employment is expected to continue to grow, albeit at moderating pace over the projection horizon, reflecting the pattern of economic activity but also the dampening impact of the projected stronger real wage growth on labour demand. The labour force is also assumed to grow at a slower rate than in recent years. This results from an assumed decline in the growth of the working-age population and an expected moderation in the rise in participation rates, the latter stemming partly from less favourable labour demand conditions and an assumed waning impact of labour market reforms. Against this background, the unemployment rate is projected to remain almost unchanged over the projection horizon.

### PRICE AND COST PROJECTIONS

The increase in HICP inflation since end-2007 is largely explained by developments in energy and food prices. Looking ahead, the related external price pressures are assumed, on the basis of current futures prices for oil and food commodities, to diminish in 2009, partly as a result of the past appreciation of the exchange rate of the euro.

As regards domestic price pressures, total economy wages per employee are projected to grow more strongly over the projection horizon than in previous years, reflecting available information on wage agreements and indications of tightness in labour markets. In 2008, as labour productivity growth is expected to decline as a result of cyclical developments, the growth of unit labour costs is projected to increase substantially. The impact of the latter on inflation is expected to be dampened, however, by declining growth in profit margins in view of the economic slowdown. In 2009, higher labour productivity growth and lower wage growth are projected to dampen domestic cost pressures, but growth in profit margins is expected to rise again. In addition, administered prices and indirect taxes are expected to have an upward impact on HICP inflation over the horizon.

As a result of these various elements, the average rate of increase in the overall HICP is projected to be between 3.2% and 3.6% in 2008 before falling to a range between 1.8% and 3.0% in 2009.

### COMPARISON WITH THE MARCH 2008 PROJECTIONS

With regard to real GDP growth, the current range projected for 2008 is within the upper part of the range contained in the ECB staff macroeconomic projections published in the March 2008 issue of the Monthly Bulletin, largely due to the favourable latest data for the first quarter of the year. The range for 2009 has been adjusted downwards, reflecting the anticipated effects of higher energy prices and a stronger exchange rate of the euro than previously assumed. With regard to HICP inflation, the range projected has been shifted upwards for both 2008 and 2009, mainly as a result of higher energy and food price assumptions than in the March projections.

**Table 2 Comparison with the March 2008 projections**

(average annual percentage changes)

	2008	2009
Real GDP – March 2008	1.3-2.1	1.3-2.3
Real GDP – June 2008	1.5-2.1	1.0-2.0
HICP – March 2008	2.6-3.2	1.5-2.7
HICP – June 2008	3.2-3.6	1.8-3.0

## Box 2

### 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 Eurosystem staff macroeconomic projections, as they were finalised at different points in time and are therefore partly outdated. 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).

In the forecasts currently available from other institutions, euro area real GDP is expected to grow by between 1.4% and 1.7% in 2008 and by between 1.2% and 1.6% in 2009. All available forecasts for growth thus fall within the ranges of the Eurosystem projections. The forecasts anticipate average annual HICP inflation to be between 2.8% and 3.4% in 2008, which means that a number of forecasts are below the range of the Eurosystem projections, possibly owing to the use of older assumptions for commodity prices. For 2009, forecasts are within the range of the Eurosystem projections.

### Comparison of forecasts for euro area real GDP growth and HICP inflation

(average annual percentage changes)

	Date of release	GDP growth		HICP inflation	
		2008	2009	2008	2009
IMF	April 2008	1.4	1.2	2.8	1.9
European Commission	April 2008	1.7	1.5	3.2	2.2
Survey of Professional Forecasters	April 2008	1.6	1.6	3.0	2.2
Consensus Economics Forecasts	May 2008	1.5	1.6	3.1	2.1
OECD	June 2008	1.7	1.4	3.4	2.4
Eurosystem staff projections	June 2008	1.5-2.1	1.0-2.0	3.2-3.6	1.8-3.0

Sources: European Commission Economic Forecasts, Spring 2008; IMF World Economic Outlook, April 2008; OECD Economic Outlook No 83, June 2008, preliminary edition; Consensus Economics Forecasts; and the ECB's Survey of Professional Forecasters.

Note: The Eurosystem 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.

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