EUROPEAN CENTRAL BANK

EUROSYSTEM

EUROSYSTEM STAFF MACROECONOMIC PROJECTIONS FOR THE EURO AREA

On the basis of the information available up to 20 November 2008, Eurosystem staff have prepared projections for macroeconomic developments in the euro area. [1] Average annual real GDP growth is projected to be between 0.8% and 1.2% in 2008, between -1.0% and 0.0% in 2009 and between 0.5% and 1.5% in 2010. The average rate of increase in the overall HICP is projected to be between 3.2% and 3.4% in 2008, between 1.1% and 1.7% in 2009 and between 1.5% and 2.1% in 2010.

Box 1

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 14 November 2008.[1] The assumption about short-term interest rates is of a purely technical nature. These rates are measured by the three-month EURIBOR, market expectations being derived from futures rates. The methodology implies an overall average level of short-term interest rates of 4.7% in 2008, which falls to 2.8% in 2009 and rebounds to 3.2% in 2010. The market expectations for euro area ten-year nominal government bond yields imply a slight increase, from an average of 4.4% in 2008 to 4.5% in 2009 and 4.7% in 2010.[2] The baseline projection also includes the assumption that bank lending spreads increase further from their current level, reflecting the heightened risk consciousness in financial markets. 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 99.9 in 2008, USD 67.3 in 2009 and USD 76.6 in 2010. International food prices are assumed to rise strongly, by 28.9%, in 2008 and to decline by 9.7% in 2009, before increasing again by 4.9% in 2010. The prices of other (i.e. non-energy and non-food) commodities in US dollars are assumed to increase by 3.5% in 2008, to decrease significantly, by 22.9%, in 2009 and to grow by 5.4% in 2010.

The technical assumption is also 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 1.27 and an effective exchange rate of the euro that is, on average, 4.1% higher in 2008 than the average for 2007 and 5.5% lower in 2009 than the average for 2008.

Fiscal policy assumptions are based on individual euro area countries' national budget plans as available on 20 November 2008. 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.

1 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.
2 See Box 4 in Section 2 of the December 2008 issue of the Monthly Bulletin.

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, 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, also available on the ECB's website. In view of the prevailing exceptional economic and financial circumstances, the uncertainty surrounding the projections is larger than usual at the current juncture.

THE INTERNATIONAL ENVIRONMENT

Global economic prospects have been considerably dented by an economic downturn now extending to all advanced economies. Heightened financial strains, the ongoing housing market adjustment and increased spillovers from the United States to other economies have led to a significant worsening of the outlook for global growth. In the near term, the global cyclical downturn is projected to be driven mainly by subdued growth prospects in the United States and other advanced economies, but activity in emerging markets is also expected to slow as these economies face weaker external demand and negative financial spillovers.

Economic growth outside the euro area is projected to be weak until early 2009 and to recover only very gradually thereafter, benefiting from accommodative macroeconomic policies, an expected gradual relaxing of the financial tensions and the decline in commodity prices. On account of very weak global trade dynamics, euro area foreign demand is expected to be subdued until mid-2009, before picking up very slowly. The main contributions to euro area foreign demand are expected to stem from emerging markets and oil-exporting countries, while the contributions from advanced economies are expected to remain more moderate.

Overall, annual growth in world real GDP outside the euro area is projected to average 3.9% in 2008, 2.4% in 2009 and 3.6% in 2010, while growth in the euro area's export markets is projected to be 4.7% in 2008, 2.5% in 2009 and 5.0% in 2010.

REAL GDP GROWTH PROJECTIONS

The euro area faces a protracted period of global economic weakness and tight financing conditions, which is expected to lead to negative quarterly GDP growth rates until mid-2009. The subsequent very moderate rebound is projected to reflect a gradually improving external environment – in particular, commodity price pressures are assumed to abate considerably – along with assumed lower short-term interest rates and the gradual fading out of negative financial spillovers in the euro area. As a result, average annual real GDP growth is projected to be between 0.8% and 1.2% in 2008, between -1.0% and 0.0% in 2009 and between 0.5% and 1.5% in 2010. This pattern of weak growth in the euro area reflects both modest global activity and very subdued domestic demand.

Table 1 Macroeconomic projections for the euro area

(average annual percentage changes) [1) 2)]

	2007	2008	2009	2010
HICP	2.1	3.2-3.4	1.1-1.7	1.5-2.1
Real GDP	2.6	0.8-1.2	-1.0-0.0	0.5-1.5
Private consumption	1.6	0.1-0.5	-0.3-0.7	0.6-1.8
Government consumption	2.3	1.9-2.3	1.3-1.9	1.3-1.9
Gross fixed capital formation	4.2	0.2-1.2	-6.0--3.0	-2.4-1.0
Exports (goods and services)	5.9	2.4-3.4	-1.4-1.0	2.3-4.9
Imports (goods and services)	5.4	2.0-3.0	-1.9-1.1	1.4-5.2

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) Slovakia is included as part of the euro area in the projection for 2009. The average annual percentage changes for 2009 are based on a euro area composition that includes Slovakia already in 2008.

In particular, euro area exports are projected in the near term to reflect the global slowdown, affected also by the lagged effects of past losses in the price competitiveness of the euro area. The rebound in exports expected in the course of 2009 is explained by both higher foreign demand growth and improved price competitiveness, mostly stemming from the recent depreciation of the euro.

Among the domestic components of GDP, total investment is expected to be most significantly affected by tight financing conditions and weak global activity throughout the projection horizon. Non-residential private investment is, moreover, projected to be dampened by declining profit margins, while residential investment projections also reflect ongoing corrections in the housing markets of some euro area countries. By contrast, after declining for most of 2008, government investment growth is assumed to rebound in 2009, thereby supporting total investment. Overall, the annual growth rate of total fixed investment is projected to be between 0.2% and 1.2% in 2008, between -6.0% and -3.0% in 2009 and between -2.4% and 1.0% in 2010.

Private consumption growth is also expected to be subdued in the period ahead. The projected pattern largely mirrors developments in real disposable income, which are in turn expected to be affected by falls in employment. The expected modest growth in consumption also reflects a further increase in precautionary savings over the period 2008-09 in view of high economic uncertainty, increasing unemployment and declines in stock and house prices. Government consumption is projected to grow over the projection horizon at a more sustained rate.

In line with the profile of domestic demand and exports, euro area import growth is projected to decline in both 2008 and 2009. Given that imports are expected to grow less than exports, net trade is projected to contribute positively to GDP growth over the whole projection horizon.

Following the projected weakness in economic activity, employment is expected to decline over the whole projection horizon. In 2009, labour demand is also expected to be dampened by increases in real wages, reflecting past contract renewals. In addition, prospects for housing investment imply that the construction sector will contribute negatively to employment growth. Over the period 2009-10, the labour force is assumed to grow at rates far below those seen since 2002, owing mainly to the "discouraged-worker" effect induced by the cyclical downturn but also to the projected decline in the growth of the working-age population. Reflecting employment projections and labour force assumptions, the unemployment rate is expected to increase significantly over the projection horizon.

PRICE AND COST PROJECTIONS

Overall year-on-year HICP inflation peaked at 4.0% in July 2008. Following the decline in commodity prices and reflecting the deteriorating economic outlook, annual average HICP inflation is expected to decline sharply from between 3.2% and 3.4% in 2008 to between 1.1% and 1.7% in 2009, before rebounding to between 1.5% and 2.1% in 2010. The projected U-shaped pattern of inflation reflects mainly the effects of past increases in commodity prices (see Box 6 in Section 3 of the December 2008 issue of the Monthly Bulletin). The HICP excluding energy is expected to follow a smoother downward path over the projection horizon.

In more detail, external price pressures are projected to diminish until the end of 2009, reflecting mostly past and future assumed developments in commodity prices. Thereafter, the counteracting effects of the recent depreciation of the euro on import prices are expected to predominate, leading to somewhat higher import price increases in 2010.

Turning to domestic price pressures, the growth of compensation per employee is estimated to have risen significantly in 2008. This increase reflects significantly higher collective wage agreements in both the private and the public sectors. Looking forward, compensation per employee is expected to grow somewhat less strongly over the period 2009-10, in the context of weak labour markets with heightened international competition. Reflecting the acceleration of wages and, to a lesser extent, the cyclical downswing in productivity, unit labour cost growth is projected to increase markedly in 2008, before decreasing in 2009 and 2010, as wages decelerate and productivity rebounds. Following years of marked increases, profit margins are expected to decrease in both 2008 and 2009, absorbing part of the inflationary pressures stemming from higher unit labour cost and import price growth, as competition strengthens and activity slows. As the economy recovers and GDP growth gradually rises, profit margins are projected to increase again in 2010.

COMPARISON WITH THE SEPTEMBER 2008 PROJECTIONS

With regard to real GDP growth, the projection ranges for both 2008 and 2009 have been adjusted significantly downwards compared with those published in the September 2008 issue of the Monthly Bulletin. The revisions are particularly sizeable for 2009. These shifts reflect both much weaker short-term economic prospects and further domestic and external effects of the ongoing financial turmoil over the horizon.

With regard to HICP inflation, the ranges projected are now below those of the September 2008 projections for both 2008 and 2009, notably so in the case of the latter year. The revisions stem mostly from strong downward revisions to assumed energy and food commodity prices, but also reflect the impact of lower activity on both price and wage-setting.

Table 2 Comparison with the September 2008 projections

(average annual percentage changes)

	2007	2008	2009
Real GDP – September 2008	2.6	1.1-1.7	0.6-1.8
Real GDP – December 2008	2.6	0.8-1.2	-1.0-0.0
HICP – September 2008	2.1	3.4-3.6	2.3-2.9
HICP – December 2008	2.1	3.2-3.4	1.1-1.7

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. 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 1.0% and 1.2% in 2008, between -0.6% and 0.3% in 2009 and between 0.9% and 1.6% in 2010. Most available forecasts for growth are therefore broadly consistent with the ranges of the Eurosystem staff projections.

As regards inflation, available forecasts anticipate average annual HICP inflation to be between 3.4% and 3.5% in 2008, between 1.4% and 2.2% in 2009 and between 1.3% and 2.1% in 2010. A number of forecasts are outside the range of the Eurosystem staff projections in 2009, most likely because they were completed when oil prices were higher and therefore they used assumptions of stronger commodity prices.

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	2010	2008	2009	2010
IMF	November 2008	1.2	-0.5	n.a.	3.5	1.9	n.a.
European Commission	October 2008	1.2	0.1	0.9	3.5	2.2	2.1
Survey of Professional Forecasters	October 2008	1.2	0.3	1.4	3.4	2.2	2.0
Consensus Economics Forecasts	November 2008	1.0	-0.2	1.6	3.4	1.8	2.0
OECD	November 2008	1.0	-0.6	1.2	3.4	1.4	1.3
Eurosystem staff projections	December 2008	0.8-1.2	-1.0-0.0	0.5-1.5	3.2-3.4	1.1-1.7	1.5-2.1

Sources: European Commission Economic Forecasts, Autumn 2008; IMF World Economic Outlook update, November 2008, for GDP and World Economic Outlook, October 2008, for the HICP; OECD Economic Outlook No 84, November 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.

Address: Kaiserstrasse 29, 60311 Frankfurt am Main, Germany
Postal address: Postfach 16 03 19, 60066 Frankfurt am Main, Germany
Telephone: +49 69 1344 0
Fax: +49 69 1344 6000
Website: http://www.ecb.europa.eu