



EUROPEAN CENTRAL BANK

Eurosystem staff macroeconomic projections for the euro area

On the basis of the information available up to 20 November 2004, Eurosystem staff have prepared projections for macroeconomic developments in the euro area.¹ Average annual real GDP growth is estimated at between 1.6% and 2.0% in 2004. It is projected to be between 1.4% and 2.4% in 2005 and between 1.7% and 2.7% in 2006. The average rate of increase in the overall Harmonised Index of Consumer Prices (HICP) is estimated to amount to between 2.1% and 2.3% in 2004. It is projected to range between 1.5% and 2.5% in 2005 and between 1.0% and 2.2% in 2006.

The staff projections are based on a series of assumptions with regard to 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. The technical assumptions with regard to long-term interest rates and both oil and non-energy commodity prices are based on market expectations.² The fiscal policy assumptions are based on national budget plans in the individual euro area countries. They include only those 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 express 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 by euro area central banks over a number of years. The width of the ranges is twice the average absolute value of these differences.

The international environment

The world economic cycle appears to have reached its peak and oil prices have increased in 2004, while economic policies are expected to gradually return to a more neutral stance. World economic growth, while

¹ The Eurosystem staff projections are produced jointly by experts from both 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.

² Short-term interest rates as measured by the three-month EURIBOR are assumed to remain constant at 2.16% over the projection horizon. The technical assumption of constant exchange rates implies that the EUR/USD exchange rate stays at 1.29 over the horizon and that the effective exchange rate of the euro is 6.1% higher than the average for 2003. Market expectations for euro area ten-year nominal government bond yields imply a slightly rising profile from an average of 4.2% in 2004 to an average of 4.5% in 2006. Annual average non-energy commodity prices are assumed to increase by 18% in USD terms in 2004, to remain broadly unchanged in 2005 and to again increase by 5% in 2006. Based on the path implied by futures markets, annual average oil prices are assumed to increase to USD 44.4 per barrel in 2005, from USD 39.0 per barrel in 2004, and to decline to USD 40.8 in 2006.

remaining robust over the horizon, is therefore projected to weaken slightly over the next two years. At the same time, the increase in oil and non-energy commodity prices will result in higher global inflation.

Real GDP growth in the United States is also expected to remain robust, but to decrease gradually from the rapid pace witnessed in the second half of 2003 and early 2004. GDP growth in non-Japan Asia is expected to remain well above the global average, notwithstanding the higher oil prices and the tightening of economic policy in China. Growth in the other large economies is projected to remain dynamic. In addition, the countries that joined the EU on 1 May 2004 are expected to continue to post a relatively strong pace of growth.

Annual growth in *world real GDP outside the euro area* is estimated to average about 5.5% in 2004. It is projected to decline to about 4.5% in both 2005 and 2006. Growth in the *euro area's external export markets* is estimated at 8.7% in 2004 and projected to decline to about 8.0% and 7.5% in 2005 and 2006, respectively.

Real GDP growth projections

The first Eurostat estimate shows the quarter-on-quarter growth rate of euro area real GDP at 0.3% in the third quarter of this year, following rates of 0.7% and 0.5% in the first and second quarters, respectively. Quarter-on-quarter growth rates are expected to return to levels close to 0.5% over the projection horizon. As a result, average annual real GDP growth is estimated to range between 1.6% and 2.0% in 2004. It is projected to be between 1.4% and 2.4% in 2005 and between 1.7% and 2.7% in 2006. Export growth, as implied by the assumption of continued strength in foreign demand, is expected over the horizon to continue to support economic activity, while domestic demand should grow at a stable pace.

Total employment is projected to gain some strength over the horizon. The labour supply is expected to increase as improved job prospects and structural labour market reforms in various euro area countries lead to rising participation rates. The projections for the labour supply and employment imply that the unemployment rate should start to decline in the second half of 2005.

Among the domestic expenditure components of GDP, average annual growth in *private consumption* is estimated to range between 0.9% and 1.3% in 2004, as restrained wage income growth and strong increases in energy prices have a negative impact on household purchasing power. Consumption is projected to grow at rates between 1.1% and 2.1% in 2005, and at rates between 1.2% and 2.8% in 2006. Households' real disposable income will be supported by stronger employment growth, by higher real wages as a result of lower inflation, and by a positive contribution by other income components. The household saving ratio is projected to remain roughly constant over the projection horizon. While consumer confidence should increase as labour market conditions improve somewhat, the level of saving is expected to remain relatively high due to concerns about the development of public finances and, in particular, the longer-term prospects for public health care and pension systems. On the basis of current budget plans, it is also assumed that the contribution of *government consumption* to real GDP growth will decline slightly over the projection horizon.

Total fixed investment is estimated to have picked up somewhat in the second half of 2004. The average annual rate of growth is estimated to amount to between 1.2% and 2.2% in 2004. It is projected to be between 1.7% and 4.7% in 2005 and between 2.1% and 5.3% in 2006. The recovery in total investment growth would be due mainly to *business investment*, which should benefit from favourable credit conditions and higher corporate earnings, as well as from the improving demand prospects. *Residential private investment* is projected to experience moderate rates of growth over the horizon.

The average annual rate of change in total exports is estimated to range between 4.5% and 7.3% in 2004. It is projected to be between 4.6% and 7.8% in 2005 and between 4.8% and 8.0% in 2006.³ Extra-euro area export market shares are projected to remain roughly stable over the horizon, following the significant decline in 2003 as a result of primarily the appreciation of the euro. The average annual rate of growth in total imports is expected to be broadly in line with that of exports. The projection for imports reflects the pattern of total final expenditure in the euro area, but also some delayed upward impact of the past appreciation of the euro. On balance, net trade is not expected to contribute significantly to GDP growth over the projection horizon, with export and import growth roughly offsetting one another.

Price and cost projections

The average rate of increase in the overall HICP is estimated to amount to between 2.1% and 2.3% in 2004. It is projected to be between 1.5% and 2.5% in 2005, and between 1.0% and 2.2% in 2006. The assumptions for oil prices imply a significant positive contribution of the energy component to HICP inflation in 2005, but a small negative contribution in 2006. The rate of increase in the non-energy component of the HICP is projected to decline slightly in 2005, reflecting limited increases in import prices and a continuation of contained domestic cost pressures. In addition, the fiscal assumptions for 2005 and 2006 imply a smaller contribution from increases in indirect taxes and administered prices, as compared with the significant contribution from measures implemented in 2004.

Notwithstanding the recent increase in oil prices, import prices are estimated to have remained, on average, relatively subdued in 2004, owing to the delayed impact of the euro's appreciation. The assumptions for commodity prices and exchange rates imply that import prices will increase modestly over the projection horizon.

The growth in nominal compensation per employee is assumed to remain moderate over the horizon. This projection not only takes into account current wage settlements and the projected modest improvement in labour market conditions, but also embodies the judgement that second-round effects of higher oil prices on nominal compensation will remain contained. The projections for real GDP growth and employment imply that labour productivity growth, although declining slightly over the horizon, will remain robust. As a result of these developments in wages and productivity, unit labour cost growth is projected to remain contained in both 2005 and 2006.

³ *Trade projections are consistent with national account data. They therefore include intra-euro area trade.*

Table: Macroeconomic projections*(average annual percentage changes)¹⁾*

	2003	2004	2005	2006
HICP	2.1	2.1 – 2.3	1.5 – 2.5	1.0 – 2.2
Real GDP	0.5	1.6 – 2.0	1.4 – 2.4	1.7 – 2.7
Private consumption	1.1	0.9 – 1.3	1.1 – 2.1	1.2 – 2.8
Government consumption	1.6	0.9 – 2.1	0.3 – 1.3	0.7 – 1.7
Gross fixed capital formation	-0.6	1.2 – 2.2	1.7 – 4.7	2.1 – 5.3
Exports (goods and services)	0.2	4.5 – 7.3	4.6 – 7.8	4.8 – 8.0
Imports (goods and services)	2.0	5.0 – 7.6	4.8 – 8.2	4.8 – 8.2

- 1) For each variable and horizon, ranges are based on the average absolute difference between the actual outcomes and past projections by euro area central banks. 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.

Box A**Comparison with the ECB staff macroeconomic projections of September 2004**

The technical assumptions for oil prices and exchange rates have been subject to important revisions in comparison with the ECB staff macroeconomic projections published in the September 2004 issue of the Monthly Bulletin. Oil prices are now 21% higher than assumed in the projections of September, whereas the nominal effective exchange rate of the euro is 4.2% higher. The revisions of the technical assumptions for interest rates are small.

A major change in comparison with the ECB staff macroeconomic projections published in the September 2004 issue of the Monthly Bulletin is a downward shift in the ranges projected for real GDP growth in 2005. This is broadly explained by the aforementioned upward shifts in the technical assumptions for both oil prices and the effective exchange rate of the euro. In addition, the somewhat lower than previously expected outturn with respect to real GDP growth in the third quarter of the current year mechanically reduces average annual real GDP growth for 2005.

The ranges projected for the HICP remain unchanged for 2004, but have been adjusted slightly upwards for 2005 in comparison with the projections of September 2004. This upward shift is limited, because the impact of higher oil prices is moderated by the upward shift in the assumptions for exchange rates. The revisions to the projections for unit labour costs are small.

Comparison of macroeconomic projections

(average annual percentage changes)

	2003	2004	2005
HICP – December 2004	2.1	2.1 – 2.3	1.5 – 2.5
HICP – September 2004	2.1	2.1 – 2.3	1.3 – 2.3
Real GDP – December 2004	0.5	1.6 – 2.0	1.4 – 2.4
Real GDP – September 2004	0.5	1.6 – 2.2	1.8 – 2.8

Box B**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 use different methods to derive assumptions for fiscal, financial and external variables, including oil prices. The forecasts covered by the Consensus Economics Forecasts and the ECB Survey of Professional Forecasters use a variety of unspecified assumptions. In contrast to the Eurosystem staff projections, the other forecasts are typically not conditioned on the assumption that short-term interest rates will remain unchanged over the projection horizon.

Despite different assumptions, there is a consensus in the forecasts currently available from other institutions that euro area annual GDP growth will average between 1.9% and 2¼% in 2005 and between 2¼% and 2½% in 2006. The forecasts for 2005 are very similar. For 2006, the forecasts made by the European Commission and the Survey of Professional Forecasters predict annual GDP growth of 2.2%, whereas the OECD predicts a growth rate of 2.5%.

It should be borne in mind that both the European Commission and the IMF report annual growth rates that are not adjusted for the number of working days per annum. For 2004, the non-working-day-adjusted average annual growth rate of euro area GDP will be around ¼ percentage point higher than the working-day-adjusted growth rate, owing to the greater number of working days this year. Both the IMF and the European Commission forecasts thus include, in working-day-adjusted terms, an increase in euro area GDP growth in 2005. The Eurosystem staff macroeconomic projections and the OECD forecasts report working-day-adjusted annual growth rates, whereas the other forecasts do not specify whether they report working-day-adjusted or non-working-day-adjusted data.

Table A: Comparison of forecasts for euro area real GDP growth

(annual percentage changes)

	Date of release	2004	2005	2006
European Commission	Oct. 2004	2.1	2.0	2.2
IMF	Sep. 2004	2.2	2.2	n.a.
OECD	Nov. 2004	1.8	1.9	2.5
Consensus Economics Forecasts	Nov. 2004	1.9	1.9	n.a.
Survey of Professional Forecasters	Nov. 2004	1.9	2.0	2.2

Sources: European Commission Economic Forecasts Autumn 2004; IMF World Economic Outlook September 2004; OECD Economic Outlook No 76; Consensus Economics Forecasts; and the ECB's Survey of Professional Forecasters. The European Commission forecasts and the IMF World Economic Outlook report growth rates that are not working-day-adjusted.

The forecasts anticipate annual average HICP inflation to decline to between 1.8% and 1.9% in 2005, except for the OECD which predicts a level of 2.0%. For 2006, both the European Commission and the OECD predict that HICP inflation will decline to 1.7%, while the Survey of Professional Forecasters shows HICP inflation at 1.9%.

Table B: Comparison of forecasts for euro area overall HICP inflation

(annual percentage changes)

	Date of release	2004	2005	2006
European Commission	Oct. 2004	2.1	1.9	1.7
IMF	Sep. 2004	2.1	1.9	n.a.
OECD	Nov. 2004	2.1	2.0	1.7
Consensus Economics Forecasts	Nov. 2004	2.2	1.9	n.a.
Survey of Professional Forecasters	Nov. 2004	2.1	1.9	1.9

Sources: European Commission Economic Forecasts Autumn 2004; IMF World Economic Outlook September 2004; OECD Economic Outlook No 76; Consensus Economics Forecasts; and the ECB's Survey of Professional Forecasters.