



## EUROPEAN CENTRAL BANK

### ECB staff macroeconomic projections for the euro area

On the basis of the information available up to 20 August 2004, ECB staff have prepared projections for macroeconomic developments in the euro area.<sup>1</sup>

The ECB staff projections are based on a series of 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. The technical assumptions concerning long-term interest rates and both oil and non-energy commodity prices are based on market expectations.<sup>2</sup> Fiscal policy assumptions are based on national budget plans in the individual euro area member 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 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 recovery in world economic activity outside the euro area is projected to remain robust over the horizon. The United States and non-Japan Asia are expected to remain important contributors to global growth. Economic activity in other regions, which benefited from improved global conditions in 2003, is also expected to remain dynamic and to become more broadly based. The growth in world real GDP outside the euro area is however expected to remain somewhat below the high rates observed in late 2003 and in the first quarter of 2004, as the recovery reaches a more advanced stage and economic policies gradually return to a more neutral stance.

The average annual growth in world real GDP outside the euro area is projected to be about 5.5% in 2004 and 4.5% in 2005. Growth in world trade is assumed to follow a pattern consistent with that of world real GDP. Growth in the euro area's external export markets is expected to be about 8% in both 2004 and 2005.

### Main results

Economic activity in the euro area is projected to be slightly stronger than according to the Eurosystem staff macroeconomic projections published in the June 2004 issue of the Monthly Bulletin. The projections for the rate of increase in the overall HICP have been shifted upwards somewhat, reflecting higher oil prices.

<sup>1</sup> The ECB staff 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.

<sup>2</sup> Short-term interest rates as measured by the three-month Euribor are assumed to remain constant over the projection horizon at slightly above 2.1%. The technical assumption of constant exchange rates implies that the EUR/USD exchange rate stays at 1.21 over the horizon and that the effective exchange rate of the euro is 2.0% higher than the average for 2003. Market expectations for euro area ten-year nominal government bond yields imply a slightly rising profile, up from an average of 4.3% in 2004 to an average of 4.6% in 2005. Average annual non-energy commodity prices are assumed to increase by 17% in USD terms in 2004 and to remain broadly unchanged in 2005. Based on the path implied by futures markets, average annual oil prices are assumed to be at USD 36.6 per barrel in 2004 and to remain at USD 36.8 per barrel in 2005. Oil prices in recent years have, however, often been higher than indicated by futures markets. Higher oil prices than assumed would have a negative impact on GDP growth and a stronger upward impact on inflation.

### **Real GDP growth projections**

The quarter-on-quarter growth rate of euro area real GDP is estimated by Eurostat to have been 0.5% in the second quarter of this year, following a rate of 0.6% in the first quarter. Quarter-on-quarter growth rates are expected to remain at around these levels over the projection horizon. Average annual real GDP growth is projected to increase to between 1.6% and 2.2% in 2004 and be between 1.8% and 2.8% in 2005. Robust export growth, as implied by the assumption of continued strength in foreign demand, is expected to spill over gradually to domestic demand in the course of this year. Total employment is projected to pick up slowly in 2004 before gaining strength in 2005, while the unemployment rate should decline in 2005.

Among the domestic expenditure components, private consumption is projected to pick up in line with disposable income for the euro area as a whole, with the household savings ratio remaining largely constant over the horizon. The growth in households' real disposable income is projected to increase in 2005 from a subdued level in 2004, supported by stronger employment growth and by higher real wage incomes. While consumer confidence should increase as labour market conditions improve, the level of saving is expected to remain high due to the concerns about the course of public finances and, in particular, the longer-term prospects for public health care and pension systems. The projected recovery in total investment stems mainly from business investment, which is supported by the improvement in the global economic environment and by the low level of real interest rates. Residential private investment is also projected to recover over the horizon, following three years of decline.

### **Price and cost projections**

The average rate of increase in the overall HICP is projected to be between 2.1% and 2.3% in 2004 and between 1.3% and 2.3% in 2005. Based on the aforementioned assumptions for oil prices, the energy component is projected to contribute significantly to HICP inflation in 2004 but only moderately in 2005. The rate of increase in the non-energy component of the HICP is projected to decline slightly in 2005, reflecting a continuation of contained domestic cost pressures and limited increases in import prices. In addition, the fiscal assumptions for 2005 contain a smaller contribution from increases in indirect taxes and administered prices compared with the significant measures implemented in 2004.

Notwithstanding the recent increase in oil prices, import prices are projected to remain relatively subdued in 2004, owing to the delayed impact of the euro's appreciation. With commodity prices being assumed to stay at about constant levels in 2005, import prices are projected to increase modestly over the same period.

The growth in nominal compensation per employee is assumed to remain moderate over the horizon. This projection takes into account current wage settlements and the projected modest improvement in labour market conditions, but it is also conditional on the assumption that second-round effects from higher oil prices on nominal compensation do not materialise. The projections for real GDP growth and employment imply that labour productivity growth will remain relatively strong over the horizon. As a result, unit labour cost growth is projected to remain contained in both 2004 and 2005.

**Table: Macroeconomic projections for the euro area**(average annual percentage changes)<sup>1)</sup>

	2003	2004	2005
HICP	2.1	2.1 – 2.3	1.3 – 2.3
Real GDP	0.5	1.6 – 2.2	1.8 – 2.8
Private consumption	1.0	1.2 – 1.6	1.5 – 2.7
Government consumption	1.9	0.7 – 1.7	0.5 – 1.5
Gross fixed capital formation	- 0.4	0.8 – 2.4	2.0 – 5.2
Exports (goods and services)	0.3	4.8 – 7.6	5.6 – 8.8
Imports (goods and services)	2.1	3.7 – 6.7	5.3 – 8.7

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

### Comparison with June 2004 projections

The ranges projected for euro area real GDP growth have been shifted slightly upwards for both 2004 and 2005 compared with the Eurosystem staff macroeconomic projections published in the June issue of the 2004 Monthly Bulletin. The upward shifts reflect a stronger contribution from net exports in 2004.

The lower bounds of the ranges projected for the annual rate of increase in the overall HICP have also been shifted slightly upwards compared with the June 2004 macroeconomic projections. This reflects the upward shift in the assumptions for oil prices for both 2004 and 2005, which are higher by about 6% and 16% respectively. These assumptions imply a larger contribution of the energy component to the overall HICP, whereas the projections for the non-energy component are largely unchanged compared with the June projections.

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

(average annual percentage changes)

	2003	2004	2005
HICP – September 2004	2.1	2.1 – 2.3	1.3 – 2.3
HICP – June 2004	2.1	1.9 – 2.3	1.1 – 2.3
Real GDP – September 2004	0.5	1.6 – 2.2	1.8 – 2.8
Real GDP – June 2004	0.5	1.4 – 2.0	1.7 – 2.7