



EUROPEAN CENTRAL BANK

EUROSYSTEM STAFF MACROECONOMIC PROJECTIONS FOR THE EURO AREA

On the basis of the information available up to 20 May 2005, Eurosystem staff have prepared projections for macroeconomic developments in the euro area.¹ Average annual real GDP growth is projected to be between 1.1% and 1.7% in 2005, and between 1.5% and 2.5% in 2006. The average rate of increase in the overall Harmonised Index of Consumer Prices (HICP) is projected to amount to between 1.8% and 2.2% in 2005, and between 0.9% and 2.1% in 2006.

The Eurosystem 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 at the levels prevailing in the two-week period up to 17 May. The technical assumptions about long-term interest rates and both oil and non-energy commodity prices are based on market expectations until 17 May.² Fiscal policy assumptions are based on national budget plans in the individual euro area member 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 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.

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 lower than in recent years. Growth in most large economies is projected to remain dynamic. In addition, the countries that joined the European Union on 1 May 2004 are expected to continue to record strong growth rates.

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 therefore assumed to remain constant at 2.13% 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 1.4% higher than the average for 2004. Market expectations for euro area ten-year nominal government bond yields imply a small increase from an average of 3.6% in 2005 to an average of 3.8% in 2006. The increase in annual average non-energy commodity prices in US dollars is assumed to be 5.4% in 2005 and 1.3% in 2006. Based on the path implied by futures markets, annual average oil prices are assumed to be USD 50.6 per barrel in 2005 and USD 50.7 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 8.3% in 2005 and 7.3% in 2006. At the same time, inflation outside the euro area is projected to increase slightly with the continuation of global expansion and as a result of higher commodity prices.

REAL GDP GROWTH PROJECTIONS

Eurostat's flash estimate for euro area real GDP in the first quarter of this year indicates quarter-on-quarter growth of 0.5%, following a rate of 0.2% in the fourth quarter of 2004. This improvement is however judged to be partly due to statistical effects related to working-day adjustments, and the quarter-on-quarter growth rate is expected to decline again in the second quarter. The projection rests on the view that the slowdown, observed since late 2004, has been mainly due to the lagged effects of the appreciation of the euro and the rise in oil prices. Looking ahead, as these effects are assumed to fade out, quarter-on-quarter growth rates are projected to return gradually to levels close to 0.5%. As a result, average annual real GDP growth is projected to range between 1.1% and 1.7% in 2005, and between 1.5% and 2.5% in 2006. Export growth, on the back of the assumed continued strength in foreign demand, is, over the horizon, expected to continue to support economic activity, while domestic demand should gradually strengthen.

Among the domestic expenditure components of GDP, average annual growth in *private consumption* is estimated to range between 1.2% and 1.6% in 2005, as restrained income growth and high energy prices have a dampening impact on household purchasing power. In 2006 consumption is projected to grow at a rate of between 1.0% and 2.2%. Households' real disposable income will be supported by stronger growth in employment, lower inflation and a positive contribution from capital income. The saving ratio is expected to rise slightly over the horizon, partly reflecting consumption smoothing and on-going concerns about the development of public finances and the longer-term prospects for public health care and pension systems.

The average annual rate of growth in *total fixed investment* is estimated to be between 0.5% and 2.7% in 2005, and between 1.9% and 5.1% in 2006. The recovery is expected to be stronger in *business investment*, which should benefit from favourable credit conditions and robust corporate profits. *Residential private investment* is projected to continue to grow at moderate rates over the projection horizon.

The average annual rate of change in *total exports*, which includes intra-euro area trade, is estimated to range between 3.1% and 5.9% in 2005, and between 4.5% and 7.7% in 2006. Extra-euro area export market shares are expected to decline somewhat, owing to lagged effects from the past euro appreciation and, more generally, to increased global competition. The average annual rate of growth in *total imports* is expected to be slightly below that in exports in 2005 and broadly in line with it in 2006. On balance, net trade is expected to make a small positive contribution to GDP growth over the projection horizon.

Total employment is projected to strengthen slightly over the horizon. At the same time, labour supply is expected to increase as a result of improved job prospects and structural labour market reforms in a number of euro area countries. Overall, the unemployment rate is projected to start to decline in 2006.

PRICE AND COST PROJECTIONS

The average rate of increase in the overall HICP is estimated to be between 1.8% and 2.2% in 2005, and between 0.9% and 2.1% in 2006. The decline in HICP inflation in 2006 is partly the result of the statistical treatment of a proposed health care reform in the Netherlands. The contribution from this factor to overall euro area HICP inflation is estimated to be -0.2 percentage point.

The price projections are conditional also on a number of other factors. First, the assumptions for oil prices imply a significant positive contribution from the energy component to HICP inflation in 2005. However, in line with the technical assumption of stabilising oil prices, this contribution is expected to fade out towards the end of 2006. Second, 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, only modest, improvement in labour market conditions, but also embodies the assumption of no second-round effects of past price rises on nominal compensation per employee. Third, 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. Fourth, the contribution to inflation from administered prices and indirect taxes is assumed to be lower than in previous years.

Macroeconomic projections

(average annual percentage changes)¹⁾

| | 2004 | 2005 | 2006 |
|-------------------------------|------|-----------|-----------|
| HICP | 2.1 | 1.8 – 2.2 | 0.9 – 2.1 |
| Real GDP | 1.8 | 1.1 – 1.7 | 1.5 – 2.5 |
| Private consumption | 1.1 | 1.2 – 1.6 | 1.0 – 2.2 |
| Government consumption | 1.3 | 0.4 – 1.4 | 1.1 – 2.1 |
| Gross fixed capital formation | 1.7 | 0.5 – 2.7 | 1.9 – 5.1 |
| Exports (goods and services) | 6.1 | 3.1 – 5.9 | 4.5 – 7.7 |
| Imports (goods and services) | 6.1 | 2.6 – 6.0 | 4.4 – 7.8 |

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 1**COMPARISON WITH THE ECB STAFF MACROECONOMIC PROJECTIONS OF MARCH 2005**

In comparison with the March 2005 macroeconomic projections, the ranges projected for real GDP growth in 2005 and 2006 have been adjusted slightly downwards.

With regard to the HICP, the range projected for 2005 is within the range of the March 2005 projections. For 2006 the range projected has been adjusted slightly downwards, reflecting in particular the impact of the above-mentioned proposed Dutch health care reform. The revisions to the projections for unit labour costs are small.

Comparison of macroeconomic projections

(average annual percentage changes)

| | 2004 | 2005 | 2006 |
|-----------------------|------|-----------|-----------|
| HICP – March 2005 | 2.1 | 1.6 – 2.2 | 1.0 – 2.2 |
| HICP – June 2005 | 2.1 | 1.8 – 2.2 | 0.9 – 2.1 |
| Real GDP – March 2005 | 1.8 | 1.2 – 2.0 | 1.6 – 2.6 |
| Real GDP – June 2005 | 1.8 | 1.1 – 1.7 | 1.5 – 2.5 |

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 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, the forecasts for euro area annual GDP growth in 2005 and 2006 are quite similar. In the forecasts currently available from other institutions, there is a consensus that euro area annual GDP growth will average between 1.2% and 1.6% in 2005, and between 1.9% and 2.3% in 2006.

It should be borne in mind that 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. For 2004, the non-working-day-adjusted average annual growth rate of euro area GDP was around ¼ percentage point higher than the working-day-adjusted growth rate, owing to the greater number of working days that year.

Table A Comparison of forecasts for euro area real GDP growth

(average annual percentage changes)

| | Date of release | 2004 | 2005 | 2006 |
|------------------------------------|-----------------|------|------|------|
| European Commission | Apr. 2005 | 2.0 | 1.6 | 2.1 |
| IMF | Apr. 2005 | 2.0 | 1.6 | 2.3 |
| OECD | May 2005 | 1.8 | 1.2 | 2.0 |
| Consensus Economics Forecasts | May 2005 | 1.8 | 1.5 | 1.9 |
| Survey of Professional Forecasters | Apr. 2005 | 1.8 | 1.6 | 2.0 |

Sources: European Commission Economic Forecasts, Spring 2005; IMF World Economic Outlook, April 2005; OECD Economic Outlook No 77, Preliminary Edition; Consensus Economics Forecasts; and the ECB's Survey of Professional Forecasters. The European Commission Forecasts and the IMF World Economic Outlook both report growth rates that are not working-day adjusted.

The forecasts anticipate annual average HICP inflation to be between 1.8% and 1.9% in 2005, and between 1.3% and 1.8% in 2006.

Table B Comparison of forecasts for euro area overall HICP inflation

(average annual percentage changes)

| | Date of release | 2004 | 2005 | 2006 |
|------------------------------------|-----------------|------|------|------|
| European Commission | Apr. 2005 | 2.1 | 1.9 | 1.5 |
| IMF | Apr. 2005 | 2.2 | 1.9 | 1.7 |
| OECD | May 2005 | 2.1 | 1.8 | 1.3 |
| Consensus Economics Forecasts | May 2005 | 2.1 | 1.8 | 1.7 |
| Survey of Professional Forecasters | Apr. 2005 | 2.1 | 1.9 | 1.8 |

Sources: European Commission Economic Forecasts, Spring 2005; IMF World Economic Outlook, April 2005; OECD Economic Outlook No 77, Preliminary Edition; Consensus Economics Forecasts; and the ECB's Survey of Professional Forecasters.]

European Central Bank
 Press and Information Division
 Kaiserstrasse 29, D-60311 Frankfurt am Main
 Tel.: +49 69 1344 7455, Fax: +49 69 1344 7404
 Internet: <http://www.ecb.int>

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