



EUROPEAN CENTRAL BANK

EUROSYSTEM

## EUROSYSTEM STAFF MACROECONOMIC PROJECTIONS FOR THE EURO AREA

On the basis of the information available up to 24 May 2007, 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 2.3% and 2.9% in 2007, and between 1.8% and 2.8% in 2008. The average rate of increase in the overall Harmonised Index of Consumer Prices (HICP) is projected to be between 1.8% and 2.2% in 2007, and between 1.4% and 2.6% in 2008.

### Box 1

#### TECHNICAL ASSUMPTIONS

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

The technical assumptions about interest rates and both oil and non-energy commodity prices are based on market expectations, with a cut-off date of 11 May 2007. With regard to short-term interest rates as measured by the three-month EURIBOR, market expectations are measured by forward rates, reflecting a snapshot of the yield curve at the cut-off date. This implies an increase from the mid-May level of 4.0% to an average of 4.2% in 2007, and a further increase to an average of 4.5% in 2008. The market expectations for euro area ten-year nominal government bond yields imply a flat profile around the mid-May level of 4.2%, with an average of 4.2% in 2007 and 4.3% in 2008. On the basis of the path implied by futures markets in the two-week period ending on the cut-off date, annual average oil prices are assumed to be USD 65.0 per barrel in 2007 and USD 69.9 per barrel in 2008. The average annual increase in non-energy commodity prices in US dollars is assumed to be 22.0% in 2007 and 4.9% in 2008.

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 1.36 and an effective exchange rate of the euro that is 3.7% higher than the average for 2006.

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

The external environment of the euro area is expected to remain favourable over the projection horizon. While real GDP growth in the United States and Japan is expected to be somewhat lower than in recent years, growth in emerging Asia is expected to remain well above the global average. Growth in most other large economies is also projected to remain dynamic. In addition, the countries that joined the European Union on 1 May 2004 are expected to continue to record robust growth rates.

<sup>1</sup> 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.

Overall, following an annual growth rate of 6.0% in 2006, world real GDP growth outside the euro area is projected to average about 5.1% in 2007 and 5.0% in 2008. Growth in the euro area's external export markets is projected to be about 5.6% in 2007 and 6.9% in 2008.

## REAL GDP GROWTH PROJECTIONS

Following a real GDP growth rate of 0.9% quarter on quarter in the fourth quarter of last year, Eurostat's first estimate for euro area GDP in the first quarter of this year indicates quarter-on-quarter growth of 0.6%. Over the projection horizon, growth in real GDP is expected to continue to expand at quarterly rates of about 0.6%. Against this background, average annual real GDP growth is projected to be between 2.3% and 2.9% in 2007, and between 1.8% and 2.8% in 2008.

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

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

	2006	2007	2008
HICP	2.2	1.8-2.2	1.4-2.6
Real GDP	2.9	2.3-2.9	1.8-2.8
Private consumption	1.8	1.7-2.1	1.6-2.8
Government consumption	2.0	1.0-2.0	1.0-2.0
Gross fixed capital formation	5.1	3.8-6.0	1.9-5.1
Exports (goods and services)	8.5	4.8-7.6	4.0-7.2
Imports (goods and services)	8.0	4.6-8.0	3.9-7.3

1) For each variable and horizon, ranges are based on the average absolute difference between the actual outcomes and previous 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.

2) The reported numbers include Slovenia already in 2006, except with regard to the HICP, where they include Slovenia only from 2007. The weight of Slovenia in euro area GDP is approximately 0.3%.

Among the domestic expenditure components of GDP, private consumption is expected to well absorb the increase in indirect taxes at the beginning of 2007, reflecting ongoing increases in disposable income. The latter, in turn, is projected to be supported by improvements in the labour market, and to some extent also by increases in non-labour income growth in the context of high corporate profit rates. The saving ratio is expected to remain broadly stable over the horizon, and average annual growth in private consumption is projected to be between 1.7% and 2.1% in 2007, and between 1.6% and 2.8% in 2008. Government consumption is expected to grow moderately at a pace between 1.0% and 2.0% in both 2007 and 2008.

Business investment should continue to benefit from favourable demand prospects, high corporate profit rates and continued favourable financing conditions. Government investment growth is also expected to remain above GDP growth. By contrast, residential private investment is expected to slow down over the projection horizon, reflecting the ongoing moderation in housing markets. Overall, the average annual rate of growth in total fixed investment is projected to be between 3.8% and 6.0% in 2007, and between 1.9% and 5.1% in 2008.

Export growth is expected to continue to support economic activity, as foreign demand is projected to continue growing at a robust pace. Extra-euro area export market shares are, however, expected to decline slightly over the projection horizon, owing to increased global competition and to lagged effects from past losses in price competitiveness. Overall, the average annual rate of change in total exports, which includes intra-euro area trade, is projected to be between 4.8% and 7.6% in 2007, and between 4.0% and 7.2% in 2008. The average annual rate of growth in total imports is projected to be between 4.6% and 8.0% in 2007, and between 3.9% and 7.3% in 2008. The contribution from net trade is projected to be roughly neutral over the projection period.

The recent favourable labour market trend is projected to continue. Total employment is projected to continue to grow steadily over the projection period, benefiting from aggregate demand growth and from the assumption of still contained labour cost growth. 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. In parallel, the unemployment rate is projected to decline further over the projection horizon.

## PRICE AND COST PROJECTIONS

Since September 2006 annual inflation has been hovering around rates slightly below 2%, benefiting from favourable trends in energy prices. Looking ahead, the projections for inflation are very much shaped by varying contributions from indirect taxes and unit labour costs. While in 2007 higher indirect taxes are expected to have a major impact on HICP inflation (with an aggregate euro area contribution of 0.5 percentage point), for 2008, the indirect tax measures known about so far are, on balance, expected to have a neutral impact on HICP inflation. At the same time, the projections are based on the expectation that total economy wage growth will increase slightly over the projection period. As labour productivity growth is projected to remain roughly stable, this implies a projection of moderately increasing unit labour cost growth over the horizon. Finally, the HICP projections are also based on expectations of steady, albeit slightly declining, growth in profit margins and only limited price pressures from non-commodity imports, as well as a continued positive contribution from administered prices to inflation. As a result of these various elements, the average rate of increase in the overall HICP is projected to be between 1.8% and 2.2% in 2007, and between 1.4% and 2.6% in 2008.

## COMPARISON WITH THE MARCH 2007 PROJECTIONS

With regard to real GDP growth, the current range projected for 2007 is within the upper part of the range contained in the ECB staff macroeconomic projections published in the March 2007 issue of the Monthly Bulletin. The range for 2008 has been adjusted slightly downwards, in line with the anticipated effects of slightly higher energy prices and a stronger exchange rate of the euro than previously assumed. With regard to HICP inflation, the range projected for 2007 has been shifted upwards, mainly reflecting the assumption of slightly higher energy prices than in the last exercise, while the range projected for 2008 has remained unchanged.

**Table 2 Comparison with the March 2007 projections**

(average annual percentage changes)

	2006	2007	2008
Real GDP – March 2007	2.8	2.1-2.9	1.9-2.9
Real GDP – June 2007	2.9	2.3-2.9	1.8-2.8
HICP – March 2007	2.2	1.5-2.1	1.4-2.6
HICP – June 2007	2.2	1.8-2.2	1.4-2.6

## 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 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 growth is seen to be between 2.3% and 2.7% in 2007, and between 2.2% and 2.5% in 2008. The forecasts anticipate annual average HICP inflation to be between 1.8% and 2.0% in 2007, and between 1.9% and 2.0% in 2008. All forecasts fall within the ranges 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		
		2006	2007	2008	2006	2007	2008
IMF	Apr. 2007	2.6	2.3	2.3	2.2	2.0	2.0
European Commission	May 2007	2.7	2.6	2.5	2.2	1.9	1.9
OECD	May 2007	2.8	2.7	2.3	2.2	1.8	2.0
Consensus Economics Forecasts	May 2007	2.8	2.5	2.2	2.2	1.9	1.9
Survey of Professional Forecasters	May 2007	2.8	2.5	2.3	2.2	1.9	1.9
Eurosystem staff projections	June 2007	2.9	2.3-2.9	1.8-2.8	2.2	1.8-2.2	1.4-2.6

Sources: European Commission Economic Forecasts, Spring 2007; IMF World Economic Outlook, April 2007; OECD Economic Outlook No 81 – May 2007, 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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