EUROPEAN CENTRAL BANK

EUROSYSTEM

EUROSYSTEM STAFF MACROECONOMIC PROJECTIONS FOR THE EURO AREA[1]

On the basis of the information available up to 22 May 2013, Eurosystem staff have prepared projections for macroeconomic developments in the euro area.[2] Following a further decline in the first quarter of 2013, real GDP is projected to recover in the course of 2013, with momentum building somewhat in 2014. The recovery in economic activity is expected to be supported by the favourable impact on exports of a gradually rising external demand. Domestic demand should also pick up over time, initially mainly benefiting from a fall in commodity price inflation supporting real incomes and from the accommodative monetary policy stance. In 2014, domestic demand should also benefit from the progress made in fiscal consolidation. However, weak labour market developments and the need for further private sector balance sheet correction in some euro area countries are expected to dampen the medium-term outlook. Altogether, having fallen by 0.5% in 2012, real GDP is projected to decline by 0.6% in 2013 and to increase by 1.1% in 2014. Euro area HICP inflation is projected to decline markedly, from an average rate of 2.5% in 2012 to 1.4% in 2013 and 1.3% in 2014. The initial decline is expected to be driven mainly by a deceleration in the food and energy components, as well as by a small decline in HICP inflation excluding food and energy, reflecting the weakness of economic activity. The stable medium-term outlook reflects the counteracting effects of a decline in energy prices, a moderate rebound in food price inflation and, as the economy recovers, an edging up of domestic inflationary pressure, albeit a moderate one, since capacity utilisation remains low.

Box 1

TECHNICAL ASSUMPTIONS ABOUT INTEREST RATES, EXCHANGE RATES, COMMODITY PRICES AND FISCAL POLICIES

The technical assumptions about interest rates and commodity prices are based on market expectations, with a cut-off date of 14 May 2013. The assumption about short-term interest rates is of a purely technical nature. Short-term rates are measured by the three-month EURIBOR, with market expectations derived from futures rates. The methodology gives an average level for these short-term interest rates of 0.2% for 2013 and 0.3% for 2014. The market expectations for euro area ten-year nominal government bond yields imply an average level of 2.8% in 2013 and 3.1% in 2014. Reflecting the path of forward market interest rates and the gradual pass-through of changes in market rates to lending rates, both short-term and long-term bank lending rates are expected to bottom out in the second half of 2013 and to rise gradually thereafter. As regards commodity prices, on the basis of the path implied by futures markets in the two-week

1 On 2 May 2013, the Governing Council decided to publish the projections in the form of midpoints and ranges. The publication of midpoints is expected to enhance transparency and further facilitate the communication of the projection results, while ranges should be seen as a means to reflect the uncertainty surrounding the projections. 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 method used for calculating the ranges, involving a correction for exceptional events, is documented in “New procedure for constructing Eurosystem and ECB staff projection ranges”, ECB, December 2009, also available on the ECB’s website.

2 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.

period ending on the cut-off date, the price of a barrel of Brent crude oil is assumed to fall from USD 112.0 in 2012 to USD 105.5 in 2013 and USD 100.0 in 2014. The prices of non-energy commodities in US dollars are assumed to fall by 5.6% in 2013, before increasing by 0.5% in 2014[3].

Bilateral exchange rates are assumed to remain unchanged over the projection horizon at the average levels prevailing in the two-week period ending on the cut-off date. This implies an exchange rate of USD per EUR of 1.31 throughout the projection horizon, which is 1.8% higher than in 2012. The effective exchange rate of the euro is assumed to appreciate by 2.8% in 2013 and remain unchanged in 2014.

Fiscal policy assumptions are based on individual euro area countries' national budget plans that were available on 22 May 2013. 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

World real GDP growth (excluding the euro area) is projected to pick up gradually over the projection horizon, rising from 3.6% in 2013 (the same rate as in 2012) to 4.2% in 2014. Since the beginning of 2013, business sentiment and global financial market conditions have improved, as certain key risks – such as a sharp fiscal cliff-induced contraction in the United States and a hard landing in China – have diminished. However, recent declines in some business surveys have underscored the fragility of the global recovery. The medium-term outlook for the key advanced economies continues to be constrained by several factors: despite some progress in the rebalancing of private sector debt, the level of households' indebtedness remains elevated, while there is still a pressing need for fiscal consolidation in some economies. Other obstacles to growth (e.g. high unemployment) are dissipating only gradually. At the same time, growth in emerging economies is expected to remain robust, supported by buoyant credit growth. Many of these economies are expanding at rates close to potential, thereby providing an important support to global growth. World trade is assumed to pick up gradually over the course of next year. In terms of annual growth rates, following a rate of 3.6% in 2012, euro area foreign demand is estimated to grow by 2.7% in 2013 and by 5.6% in 2014.

REAL GDP GROWTH PROJECTIONS

Euro area real GDP fell by 0.2% in the first quarter of 2013, declining for the sixth consecutive quarter. Domestic demand declined in the first quarter of the year mainly due to a large fall in investment, reflecting low confidence and the adverse impact of the cold winter weather, mainly on construction activity, particularly in Germany. Private consumption rose slightly, while public consumption declined somewhat. Exports fell in the first quarter, albeit less than imports, resulting in a positive net trade contribution.

Looking ahead, real GDP is expected to increase in the course of 2013 and to gain momentum in 2014. The recovery is expected to be supported by the favourable impact on exports of a gradually rising external demand. Domestic demand should also pick up over time, initially

3 Oil and food commodity price assumptions are based on futures prices up to the end of the projection horizon. The prices of other non-energy hard commodities are assumed to follow futures until the first quarter of 2014 and thereafter to evolve in line with global economic activity. EU farm gate prices (in euro), which are now used for forecasting food consumer prices, are projected on the basis of an econometric model that takes into account developments in international food commodity prices. This is the first projection exercise in which these assumptions for EU farm gate prices have been used.

bolstered by the unwinding of the effects of the adverse winter weather on activity, especially construction in Germany. Domestic demand should also initially benefit notably from a fall in commodity price inflation supporting real incomes and from the accommodative monetary policy stance. In 2014, it should also be supported by the progress made in fiscal consolidation. However, the adverse impact on domestic demand stemming from still overall low levels of consumer and business sentiment, weak labour market developments and remaining private sector deleveraging needs in some countries is expected to diminish only gradually over the projection horizon.

Overall, the recovery is projected to remain subdued by historical standards. In annual average terms, while real GDP is expected to decline by 0.6% in 2013, it largely reflects a negative carry-over effect stemming from the declines in GDP in late 2012 and in early 2013. In 2014, economic activity is projected to increase by 1.1%. This growth pattern reflects a substantially negative contribution of domestic demand in 2013 and its recovery thereafter, combined with positive contributions from net trade.

Extra-euro area export growth is projected to recover moderately during the course of 2013 and to gain momentum in 2014, mostly supported by a gradual strengthening of external demand. Euro area export market shares, which rose substantially between 2009 and 2012 on the back of improved competitiveness (as measured by the relative performance of extra-euro area export prices compared with competitors' export prices in euro terms), are projected to decline somewhat this year, reflecting the appreciation of the euro in 2013, before stabilising during the remainder of the projection horizon. Intra-euro area exports are projected to grow much more slowly than extra-euro area exports owing to the relative weakness of domestic demand within the euro area.

Business investment is projected to stay weak for the greater part of this year due to low sentiment, low capacity utilisation and fragile demand prospects. However, it is projected to pick up from late 2013 onwards, supported by the gradual strengthening of domestic and external demand, the very low level of interest rates, the need to gradually replace the capital stock after several years of subdued investment and a strengthening of profit mark-ups. Nevertheless, the need for further corporate balance sheet restructuring and adverse financing conditions in some euro area countries and sectors are likely to continue to dampen the projected recovery of business investment over the forecast horizon, albeit to a diminishing extent. Residential investment is likely to decline further in 2013 and is expected to remain weak into 2014 owing mostly to further adjustment needs in the housing markets in some countries, weak growth in disposable income and still fragile consumer sentiment. The adverse impact of these factors is expected to more than offset the effect of the relative attractiveness of housing investment in some other countries, where residential investment is supported by historically low mortgage rates. Government investment is expected to decline over the projection horizon owing to the expected fiscal consolidation measures in several euro area countries.

Table 1 Macroeconomic projections for the euro area

(average annual percentage changes) [1)]

	2012	2013	2014
HICP	2.5	1.4 [1.3 – 1.5]	1.3 [0.7 – 1.9]
Real GDP	-0.5	-0.6 [-1.0 – -0.2]	1.1 [0.0 – 2.2]
Private consumption	-1.3	-0.8 [-1.1 – -0.5]	0.6 [-0.5 – 1.7]
Government consumption	-0.4	-0.1 [-0.6 – 0.4]	0.6 [-0.1 – 1.3]
Gross fixed capital formation	-4.2	-2.9 [-4.1 – -1.7]	1.8 [-0.9 – 4.5]
Exports (goods and services)	2.9	0.8 [-1.0 – 2.6]	4.1 [0.3 – 7.9]
Imports (goods and services)	-0.7	-0.7 [-2.5 – 1.1]	3.8 [0.1 – 7.5]

1) The projections for real GDP and its components refer to working day-adjusted data. The projections for imports and exports include intra-euro area trade.

Private consumption is expected to be broadly flat for the remainder of 2013 in the context of a stabilisation in real disposable income. This stabilisation broadly reflects the offsetting effects of a further fall in employment and declines in non-wage income against a rise in real compensation per employee, which is benefiting from a fall in inflation rates. Private consumption growth is expected to gain some momentum in 2014, supported by the progress made in fiscal consolidation and by a pick-up in labour income as labour market conditions improve. Government consumption is projected to broadly stagnate in 2013 owing to fiscal consolidation efforts and to increase modestly in 2014.

Extra-euro area imports are projected to recover in the course of 2013, while remaining constrained by the still subdued total demand.

The crisis is expected to have adversely affected potential growth, although the exact magnitude of the impact remains highly uncertain. Notably, the continued weakness in employment and investment is weighing on the outlook for potential output growth. Given the outlook for real GDP growth, the output gap is projected to remain negative, although it is difficult to estimate its size with precision.

PRICE AND COST PROJECTIONS

Overall HICP inflation is projected to decline from an average rate of 2.5% in 2012 to 1.4% in 2013 and 1.3% in 2014. HICP inflation is expected to decrease markedly in the course of 2013 owing to the projected strong decline in energy price inflation and, to a lesser extent, food price inflation from the elevated levels reached in 2012. The drop in energy price inflation partly reflects downward base effects owing to the expected fading away of the impact of past increases in oil prices and the assumed gradual decline in oil prices over the projection horizon. Similarly, the pattern of food price inflation reflects initial downward base effects, as the impact of past increases is expected to fade away, followed by upward pressures related to the assumed increase in international and European food commodity prices over the projection horizon. HICP inflation excluding food and energy is projected to ease slightly this year, reflecting weak developments in economic activity. In 2014, it is expected to edge up slightly, reflecting the modest recovery in activity. External price pressures have eased in recent months owing to the appreciation of the euro in 2013 and declines in oil and non-oil commodity prices. Thus, the annual growth rate of the import deflator is projected to decline strongly in 2013, before picking up gradually towards the end of the projection horizon as the downward impact of the previous appreciation of the euro fades away, non-energy commodity prices increase and import demand gains momentum.

Turning to domestic price pressures, the annual growth rate of compensation per employee is expected to be broadly stable in 2013 and 2014. Taking into account projected consumer price inflation, real compensation per employee is expected to rise moderately over the projection horizon, following declines in 2011 and 2012. Unit labour cost growth is projected to remain relatively high in 2013, broadly unchanged from 2012, before declining in 2014 owing to a cyclical rise in productivity growth. Following a strong decline in 2012, profit margins are expected to fall slightly further in 2013, reflecting the weakness of domestic activity and the relatively strong increase in unit labour costs. Thereafter, lower unit labour cost growth and gradually improving economic conditions are expected to support a recovery in profit margins. Increases in administered prices and indirect taxes that are included in fiscal consolidation plans are expected to make significant contributions to HICP inflation in 2013 and 2014, albeit less than in 2012.

COMPARISON WITH THE MARCH 2013 PROJECTIONS

Compared with the ECB staff macroeconomic projections published in the March 2013 issue of the Monthly Bulletin, the real GDP growth projection for 2013 has been revised marginally downwards, largely reflecting the incorporation of the latest GDP data releases. The real GDP growth projection for 2014 has been revised slightly upwards, reflecting the upward impact of lower interest rates and the lower effective exchange rate of the euro. With regard to HICP inflation, the projection for 2013 has been revised downwards, mostly reflecting lower oil prices in US dollars, which are only partly offset by the lower effective exchange rate of the euro.

Table 2 Comparison with the March 2013 projections

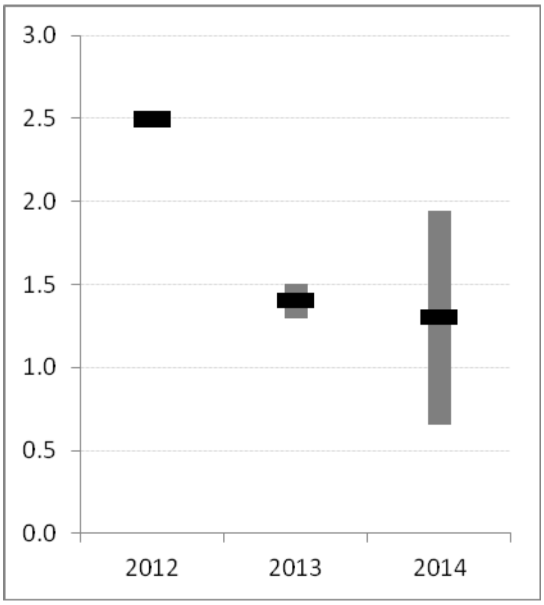
(average annual percentage changes)

	2013	**2014**
Real GDP – March 2013	-0.5 [-0.9 – -0.1]	1.0 [0.0 – 2.0]
Real GDP – June 2013	-0.6 [-1.0 – -0.2]	1.1 [0.0 – 2.2]
HICP – March 2013	1.6 [1.2 – 2.0]	1.3 [0.6 – 2.0]
HICP – June 2013	1.4 [1.3 – 1.5]	1.3 [0.7 – 1.9]

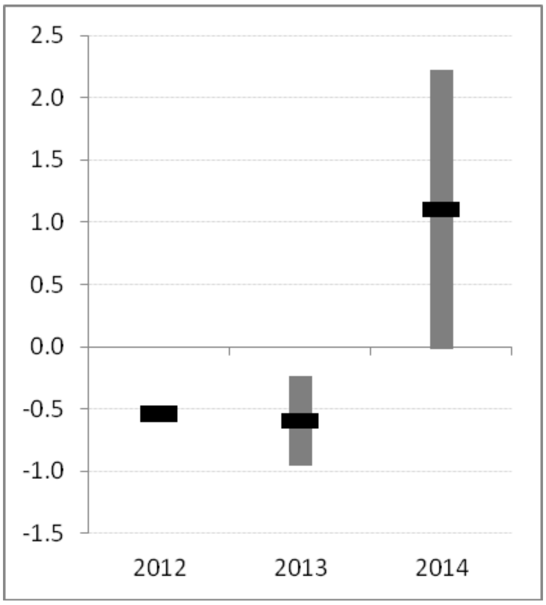
Chart Macroeconomic projections

(average annual percentage changes)

a) Euro area HICP



b) Euro area real GDP[1)]



1) The projections for real GDP refer to working day-adjusted data.

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 decline by between 0.3% and 0.6% in 2013, which is within the range of the Eurosystem staff projection and compares with a midpoint of -0.6%. For 2014, real GDP is projected to increase by between 0.9% and 1.2%, which is within the range of the Eurosystem staff projection and compares with a midpoint of 1.1%.

As regards inflation, the forecasts from other institutions point to an average annual HICP inflation of between 1.5% and 1.7% in 2013, which is somewhat higher than the range and the midpoint of the Eurosystem staff projection. In 2014, HICP inflation is expected to average between 1.2% and 1.6%, which is within the Eurosystem staff projection range and compares with a midpoint of 1.3%.

Comparison of forecasts for euro area real GDP growth and HICP inflation

(average annual percentage changes)

	Date of release	GDP growth		HICP inflation	
		2013	2014	2013	2014
IMF	April 2013	-0.3	1.1	1.7	1.5
Survey of Professional Forecasters	May 2013	-0.4	1.0	1.7	1.6
Consensus Economics Forecasts	May 2013	-0.5	0.9	1.6	1.6
Euro Zone Barometer	May 2013	-0.4	1.0	1.6	1.6
OECD	May 2013	-0.6	1.1	1.5	1.2
European Commission	May 2013	-0.4	1.2	1.6	1.5
Eurosystem staff projections	June 2013	-0.6 [-1.0 – -0.2]	1.1 [0.0 – 2.2]	1.4 [1.3 – 1.5]	1.3 [0.7 – 1.9]

Sources: European Commission Economic Forecasts, Spring 2013; IMF World Economic Outlook, April 2013; OECD Economic Outlook, May 2013; Consensus Economics Forecasts; MJEconomics; and the ECB's Survey of Professional Forecasters.

Notes: 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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