



EUROPEAN CENTRAL BANK

EUROSYSTEM STAFF MACROECONOMIC PROJECTIONS FOR THE EURO AREA

On the basis of the information available up to 21 November 2005, Eurosystem staff have prepared projections for macroeconomic developments in the euro area.¹ Average annual real GDP growth is estimated at between 1.2% and 1.6% in 2005. It is projected to be between 1.4% and 2.4% in both 2006 and 2007. 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 2005. It is projected to range between 1.6% and 2.6% in 2006, and between 1.4% and 2.6% in 2007.

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 assumption is made that short-term market interest rates and bilateral exchange rates remain unchanged over the projection horizon at the levels prevailing in the first half of November. Short-term interest rates as measured by the three-month EURIBOR are therefore assumed to remain constant at 2.28%. The technical assumption of constant exchange rates implies a EUR/USD exchange rate of 1.19 and an effective exchange rate of the euro that is 2% lower than the average for 2004.

The technical assumptions about long-term interest rates and both oil and non-energy commodity prices are based on market expectations in the first half of November. Market expectations for euro area ten-year nominal government bond yields imply a slightly rising profile, from an average of 3.5% in 2005 to an average of 3.7% in 2007. The increase in annual average non-energy commodity prices in US dollars is assumed to be 5.8% in 2005, 3.8% in 2006 and 5.2% in 2007. Based on the path implied by futures markets, annual average oil prices are assumed to be USD 60.0 per barrel in 2006 and USD 59.5 per barrel in 2007.

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 parliament or that have been specified in detail and are likely to pass the legislative process. The cut-off date for updating the fiscal assumptions was 21 November 2005. This implies that the measures recently agreed in Germany have been taken into account in these projections.

THE INTERNATIONAL ENVIRONMENT

The external environment of the euro area is expected to remain favourable over the projection horizon. Real GDP growth in the United States is projected to 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, albeit slightly lower than in recent years. 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 strong growth rates.

Overall, annual growth in *world real GDP outside the euro area* is estimated to average about 4.9% in 2005, while it is projected to average about 4.8% in 2006 and 4.5% in 2007. Growth in the *euro area's*

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. 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.

external export markets is estimated at 7.2% in 2005 and projected to be about 7.1% in both 2006 and 2007.

Table 1 Macroeconomic projections

(average annual percentage changes)¹⁾

	2004	2005	2006	2007
HICP	2.1	2.1 – 2.3	1.6 – 2.6	1.4 – 2.6
Real GDP	1.8	1.2 – 1.6	1.4 – 2.4	1.4 – 2.4
Private consumption	1.4	1.1 – 1.5	0.9 – 1.9	0.6 – 2.2
Government consumption	1.1	0.4 – 1.6	1.1 – 2.1	0.5 – 1.5
Gross fixed capital formation	1.6	1.4 – 2.4	1.6 – 4.6	1.5 – 4.7
Exports (goods and services)	6.1	2.6 – 5.4	4.3 – 7.5	4.1 – 7.3
Imports (goods and services)	6.3	3.4 – 6.0	4.2 – 7.6	3.5 – 6.9

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.

REAL GDP GROWTH PROJECTIONS

Eurostat's first estimate for euro area real GDP in the third quarter of this year indicates quarter-on-quarter growth of 0.6%, following rates of 0.3% and 0.4% in the first and second quarters respectively. Looking ahead, quarter-on-quarter growth rates are projected to stabilise at levels around 0.5%. As a result, average annual real GDP growth is estimated to range between 1.2% and 1.6% in 2005, while it is projected to range between 1.4% and 2.4% in both 2006 and 2007. Over the projection horizon, export growth is expected to continue to support economic activity on the back of the assumed continued strength in foreign demand and domestic demand should firm.

Among the domestic expenditure components of GDP, average annual growth in *private consumption* is estimated to range between 1.1% and 1.5% in 2005, partly reflecting the dampening effects of restrained income growth and high energy prices on household purchasing power. Consumption is projected to grow at a rate of between 0.9% and 1.9% in 2006, and 0.6% and 2.2% in 2007. Households' disposable income is projected to be supported by some progress in employment and continued strong capital income, but real income growth will remain moderate. The saving ratio is expected to remain broadly stable over the horizon.

The average annual rate of growth in *total fixed investment* is estimated to be between 1.4% and 2.4% in 2005, while it is projected to be between 1.6% and 4.6% in 2006, and between 1.5% and 4.7% in 2007. *Business investment* should benefit from strong external demand, favourable financing conditions and robust corporate profits. At the same time, *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 2.6% and 5.4% in 2005, and is projected to be between 4.3% and 7.5% in 2006, and between 4.1% and 7.3% in 2007. Extra-euro area export market shares are expected to remain relatively stable over the projection horizon owing, on the one hand, to increased global competition and, on the other hand, to some price-competitiveness gains. The average annual rate of growth in *total imports* is expected to be somewhat above that in exports in 2005 and to fall below it in the course of the projection horizon. On balance, net trade is projected to make a small positive contribution to GDP growth.

Growth in *total employment* is projected to rise somewhat over the horizon, in line with more favourable developments than recently observed. 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. The unemployment rate is projected to decline further over the projection horizon.

PRICE AND COST PROJECTIONS

The average rate of increase in the overall HICP is estimated to be between 2.1% and 2.3% in 2005, while it is projected to be between 1.6% and 2.6% in 2006, and between 1.4% and 2.6% in 2007. The price projections are conditional on a number of assumptions. First, oil prices, which have implied a significant positive contribution from the energy component to HICP inflation in recent years, are assumed to be roughly stable over the projection period. Second, the growth in nominal compensation per employee is assumed to remain moderate over the horizon. The price projections thus embody the expectation of limited second-round effects from oil price increases on wages. They also embed a projection of a small pick-up in productivity, which contributes to maintaining unit labour cost growth broadly stable over the horizon. Third, the projections incorporate only those changes in indirect taxes that were known with sufficient certainty before 21 November 2005.² Finally, they are based on the expectation that price pressures from non-commodity imports remain low.

COMPARISON WITH THE ECB STAFF MACROECONOMIC PROJECTIONS OF SEPTEMBER 2005

Table 2 Comparison with September 2005 projections

(average annual percentage changes)

	2004	2005	2006
Real GDP – September 2005	1.8	1.0 – 1.6	1.3 – 2.3
Real GDP – December 2005	1.8	1.2 – 1.6	1.4 – 2.4
HICP – September 2005	2.1	2.1 – 2.3	1.4 – 2.4
HICP – December 2005	2.1	2.1 – 2.3	1.6 – 2.6

In the new projections, the range projected for real GDP growth in 2005 is within the upper part of the range of the September 2005 projections. For 2006 the range projected has been adjusted slightly upwards. With regard to HICP inflation, the current range projected for 2005 is unchanged from the September 2005 projections. For 2006 the range projected has been adjusted upwards. This revision is due mainly to the fact that the distorting statistical impact of the Dutch health care reform in 2006, which was estimated to contribute -0.2 percentage point to the September 2005 projections, is no longer incorporated in the December projections.

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.

In the forecasts currently available from other institutions, euro area annual GDP growth averages between 1.2% and 1.4% in 2005, between 1.7% and 2.1% in 2006, and between 2.0% and 2.2% in 2007. At the same time, the forecasts anticipate annual average HICP inflation to be between 2.1% and 2.3% in 2005, between 1.8% and 2.2% in 2006, and between 1.6% and 1.9% in 2007. All of these rates fall within the ranges of the Eurosystem projections.

² In the case of Germany, the assumption of a VAT increase of 3 percentage points in 2007 is taken into account.

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

(average annual percentage changes)

	Date of release	GDP growth			HICP inflation		
		2005	2006	2007	2005	2006	2007
European Commission	Oct. 2005	1.3	1.9	2.1	2.3	2.2	1.8
IMF	Sep. 2005	1.2	1.8	2.2	2.1	1.8	1.9
OECD	Nov. 2005	1.4	2.1	2.2	2.2	2.1	1.6
Consensus Economics Forecasts	Nov. 2005	1.3	1.7	n.a.	2.2	1.9	n.a.
Survey of Professional Forecasters	Oct. 2005	1.3	1.7	2.0	2.2	2.0	1.8

Sources: European Commission Economic Forecasts, Autumn 2005; IMF World Economic Outlook, September 2005; OECD Economic Outlook No 78; Consensus Economics Forecasts; and the ECB's Survey of Professional Forecasters. 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.

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