EUROPEAN CENTRAL BANK

EUROSYSTEM

Box

## ECB STAFF MACROECONOMIC PROJECTIONS FOR THE EURO AREA

On the basis of the information available up to 18 February 2011, ECB staff have prepared projections for macroeconomic developments in the euro area.[1] Average annual real GDP growth is projected to range between 1.3% and 2.1% in 2011 and between 0.8% and 2.8% in 2012. Inflation is projected to be between 2.0% and 2.6% in 2011 and between 1.0% and 2.4% in 2012.

### Technical assumptions about interest rates, exchange rates, commodity prices and fiscal policies

The technical assumptions about interest rates and about both energy and non-energy commodity prices are based on market expectations, with a cut-off date of 10 February 2011.[2] 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. This methodology gives an overall average level of short-term interest rates of 1.5% for 2011 and 2.4% for 2012. The technical assumptions for the euro area ten-year nominal government bond yields are also derived from market expectations and imply an average level of 4.5% in 2011 and 4.9% in 2012.[3] Regarding financing conditions, the baseline projection assumes that over the projection horizon bank lending rate spreads vis-à-vis short-term interest rates will narrow somewhat. Spreads vis-à-vis long-term rates are assumed to gradually increase, following their marked narrowing recorded in the last quarter of 2010 and will return to their historical average level at the end of the projection horizon. Credit supply conditions are assumed to normalise further but to continue weighing somewhat on activity over the projection horizon. As regards commodity prices, on the basis of the path implied by futures markets in the two-week period ending on the cut-off date, Brent crude oil prices per barrel are assumed to average USD 101.3 in 2011 and USD 102.4 in 2012. The prices of non-energy commodities in US dollars are assumed to increase strongly, rising by 27.5% in 2011 and by 1.0% in 2012.

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 a USD/EUR exchange rate of 1.37 over the whole projection horizon and an effective exchange rate of the euro that, on average, depreciates by 1.1% in 2011 and increases by 0.1% in 2012.

Fiscal policy assumptions are based on individual euro area countries' national budget plans as available on 11 February 2011. They include all policy measures that have already been approved by national parliaments or that have been specified in sufficient detail by governments and are likely to pass the legislative process.

1 The ECB staff macroeconomic projections complement the Eurosystem staff macroeconomic projections that are produced jointly by experts from the ECB and from the 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, which is available on the ECB's website. 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. The method used, 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 Oil and food price assumptions are based on futures prices up to the end of the projection horizon. For other commodities, prices are assumed to follow futures until the first quarter of 2012 and thereafter to develop in line with global economic activity.

3 The technical long-term interest rate assumption for the euro area is calculated up to the cut-off date as the average of the countries' ten-year benchmark bond yields, weighted by annual GDP figures. It is then prolonged over the projection horizon using the profile of the forward path derived from the ECB's euro area yield curve.

## Assumptions with regard to the international environment

The global economy showed some renewed growth momentum at the turn of the year, supported by overall improved global financial conditions. The near-term outlook for economic activity is also supported by the new US fiscal stimulus measures. Nonetheless, the cyclical position remains uneven across countries. In the major advanced economies, the medium-term growth prospects remain rather subdued, particularly in economies where balance sheet repair needs to continue. Moreover, widespread housing market weakness and persistently high unemployment rates are expected to cloud the outlook for private consumption in these economies over the medium term. By contrast, robust growth and increasing inflationary pressures are expected to prevail in some emerging economies. World real GDP outside the euro area is assumed to grow, on average, by 4.7% in 2011 and 4.6% in 2012. Reflecting the significant recovery in global trade, growth in euro area foreign demand is assumed to be 7.9% in 2011 and 7.6% in 2012. These growth rates are somewhat above the average rates recorded in the ten years prior to the financial crisis.

## Real GDP growth projections

Euro area real GDP increased by 0.3% in the fourth quarter of 2010, the same rate as in the previous quarter. Looking ahead, the economic recovery is projected to continue, with domestic demand increasingly taking over from exports as the main driver. This rebalancing reflects the effects of past monetary policy moves, as well as the significant efforts made to restore the functioning of the financial system. However, the need for balance sheet repair in various sectors, as well as the fiscal adjustment efforts aimed at restoring confidence in medium-term sustainability assumed in the projections, are anticipated to weigh on the outlook for growth in the euro area. In annual terms, following a growth rate of 1.7% in 2010, real GDP is expected to increase by between 1.3% and 2.1% in 2011 and between 0.8% and 2.8% in 2012. As annual potential growth is projected to be significantly lower than the pre-crisis rates, the output gap is expected to narrow over the projection horizon.

### Table A Macroeconomic projections for the euro area

(average annual percentage changes)1), 2)

| | 2010 | 2011 | 2012 |
|---|---|---|---|
| HICP | 1.6 | 2.0 – 2.6 | 1.0 – 2.4 |
| | | | |
| Real GDP | 1.7 | 1.3 – 2.1 | 0.8 – 2.8 |
| Private consumption | 0.7 | 0.6 – 1.4 | 0.4 – 2.2 |
| Government consumption | 0.8 | -0.3 – 0.5 | -0.5 – 0.9 |
| Gross fixed capital formation | -0.8 | 0.4 – 3.4 | 0.7 – 5.5 |
| Exports (goods and services) | 10.9 | 4.9 – 9.5 | 3.0 – 9.2 |
| Imports (goods and services) | 9.0 | 3.5 – 7.7 | 2.8 – 8.4 |

1) The projections for real GDP and its components are based on working day-adjusted data. The projections for imports and exports include intra-euro area trade.
2) The data refer to the euro area including Estonia, except for the HICP data in 2010. The average annual percentage change for the HICP in 2011 is based on a euro area composition in 2010 that already includes Estonia.

## Price and cost projections

According to Eurostat’s flash estimate, euro area annual HICP inflation was 2.4% in February 2011. Overall HICP inflation is projected to stay above 2% until the end of 2011, largely owing to recent strong increases in energy and food prices. Thereafter, on the basis of current futures prices for commodities, import price increases are projected to moderate. In contrast, domestic price pressures are expected to intensify somewhat, reflecting the gradual improvement in activity and higher wage growth, leading to a gradual rise in the inflation rate of the HICP excluding food and energy over the projection horizon. Overall, average annual headline inflation is projected to be between 2.0% and 2.6% in 2011 and between 1.0% and 2.4% in 2012. Growth in compensation per employee in the euro area is projected to pick up over the next two years, in line with the gradual improvement in labour market conditions. Nevertheless, real compensation per employee is expected to decline somewhat in 2011, owing to the rise in inflation, and to turn slightly positive in 2012. As productivity growth is projected to moderate over the next two years, unit labour costs, which exhibited a cyclical decline in 2010, are expected to rebound in 2011 and to grow at a faster pace in 2012. This, in turn, is projected to curtail increases in profit margins, which recovered substantially in 2010.

## Comparison with the December 2010 projections

Compared with the Eurosystem staff macroeconomic projections published in the December 2010 issue of the Monthly Bulletin, the lower ends of the projection ranges for real GDP growth in 2011 and 2012 have been revised upwards, reflecting stronger global economic growth and a projected increase in euro area exports, as well as a stronger outlook for domestic demand, as indicated by improved confidence. With regard to HICP inflation, the ranges for 2011 and 2012 have been revised upwards compared with the December 2010 projections, mainly on account of stronger than expected increases in energy and food prices.

### Table B Comparison with the December 2010 projections

(average annual percentage changes)

| | 2010 | 2011 | 2012 |
|---|---|---|---|
| Real GDP – December 2010 | 1.6 – 1.8 | 0.7 – 2.1 | 0.6 – 2.8 |
| Real GDP – March 2011 | 1.7 | 1.3 – 2.1 | 0.8 – 2.8 |
| | | | |
| HICP – December 2010 | 1.5 – 1.7 | 1.3 – 2.3 | 0.7 – 2.3 |
| HICP – March 2011 | 1.6 | 2.0 – 2.6 | 1.0 – 2.4 |

## Comparison with forecasts by other institutions

A number of forecasts for the euro area are available from both international organisations and private sector institutions (see Table C). However, these forecasts are not strictly comparable with one another or with the ECB 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.

According to the forecasts currently available from other organisations and institutions, euro area real GDP growth is expected to range between 1.5% and 1.7% in 2011 and between 1.7% and 2.0% in 2012, which is well within the ranges of the ECB staff projections. As regards inflation, available forecasts anticipate average annual HICP inflation to be between 1.3% and 2.2% in 2011. Most of these inflation forecasts are below the range of the ECB staff projections, as the former likely do not yet take into account recent increases in commodity prices. The HICP inflation forecasts for 2012 range between 1.2% and 1.8%, which is within the range of the ECB staff projections.

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

(average annual percentage changes)

| | Date of release | GDP growth | | HICP inflation | |
|---|---|---|---|---|---|
| | | 2011 | 2012 | 2011 | 2012 |
| OECD | November 2010 | 1.7 | 2.0 | 1.3 | 1.2 |
| European Commission | February 2011 | 1.6 | 1.8 | 2.2 | 1.7 |
| IMF | January 2011 | 1.5 | 1.7 | 1.5 | 1.5 |
| Survey of Professional Forecasters | February 2011 | 1.6 | 1.7 | 1.9 | 1.8 |
| Consensus Economics Forecasts | February 2011 | 1.6 | 1.7 | 2.0 | 1.8 |
| ECB staff projections | March 2011 | 1.3 – 2.1 | 0.8 – 2.8 | 2.0 – 2.6 | 1.0 – 2.4 |

Sources: European Commission Interim Forecast, February 2011, for 2011 figures and European Economic Forecasts – Autumn 2010 for 2012 figures; IMF World Economic Outlook, October 2010, for inflation and World Economic Outlook Update, January 2011, for GDP growth; OECD Economic Outlook, November 2010; Consensus Economics Forecasts; and the ECB's Survey of Professional Forecasters.

Note: The ECB 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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