



EUROPEAN CENTRAL BANK

EUROSYSTEM

EUROSYSTEM STAFF MACROECONOMIC PROJECTIONS FOR THE EURO AREA

On the basis of the information available up to 19 May 2006, Eurosystem staff have prepared projections for macroeconomic developments in the euro area¹. Average annual real GDP growth is projected to be between 1.8% and 2.4% in 2006, and between 1.3% and 2.3% in 2007. The average rate of increase in the overall Harmonised Index of Consumer Prices (HICP) is projected to range between 2.1% and 2.5% in 2006, and between 1.6% and 2.8% 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 assumptions about interest rates and both oil and non-energy commodity prices are based on market expectations in the two-week period ending 11 May. The assumptions about short-term interest rates as measured by the three-month EURIBOR are based on forward rates², reflecting a snapshot of the yield curve at that point in time. These assumptions imply a rising profile, from an average of 3.1% in 2006 to an average of 3.9% in 2007. Market expectations for euro area ten-year nominal government bond yields imply a slightly rising profile, from an average of 4.0% in 2006 to an average of 4.3% in 2007. Based on the path implied by futures markets, annual average oil prices are assumed to be USD 70.3 per barrel in 2006 and USD 73.9 per barrel in 2007. The annual average increase in non-energy commodity prices in US dollars is assumed to be 27.6% in 2006 and 5.4% in 2007.

The technical assumption is made that bilateral exchange rates remain unchanged over the projection horizon at the levels prevailing in the two-week period ending 11 May. This implies a EUR/USD exchange rate of 1.27 and an effective exchange rate of the euro that is 0.7% higher than the average for 2005.

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 11 May 2006.

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 slightly declining rates. While slightly lower than in recent years, real GDP growth in non-Japan Asia is expected to remain well above the global average. Growth in most other large economies is also projected to remain dynamic. In

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.

² For the first time, the Eurosystem projections are based on the technical assumption that short-term market interest rates move in line with market expectations rather than, as previously assumed, remain constant over the projection horizon. This change is of a purely technical nature. It was introduced in order to further improve the quality and the internal consistency of the macroeconomic projections and does not imply any change in the ECB's monetary policy strategy or in the role of projections within that strategy.

addition, the countries that joined the European Union on 1 May 2004 are expected to continue to record strong growth rates.

Overall, following an annual growth rate of 5.1% in 2005, *world real GDP outside the euro area* is projected to average about 5.0% in 2006 and 4.5% in 2007. Growth in *euro area foreign demand* is projected to be about 7.6% in 2006 and 6.7% in 2007, after a rate of 7.7% in 2005.

REAL GDP GROWTH PROJECTIONS

Following a rate of 0.3% in the fourth quarter of last year, Eurostat's first estimate for euro area real GDP in the first quarter of 2006 indicates quarter-on-quarter growth of 0.6%. This rebound is in line with the positive signals from survey indicators. Over the horizon, quarterly growth in GDP is expected to remain roughly at around 0.5 percentage point, except in the first quarter of 2007, when growth is projected to be dampened by significant increases in indirect taxes. Against this background, it is projected that average annual real GDP growth will be between 1.8% and 2.4% in 2006, and between 1.3% and 2.3% in 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. With the exception of the temporary effect from the increase in indirect taxes, growth in domestic demand should remain broadly stable.

Table A Macroeconomic projections

(average annual percentage changes)¹⁾

	2005	2006	2007
HICP	2.2	2.1 – 2.5	1.6 – 2.8
Real GDP	1.4	1.8 – 2.4	1.3 – 2.3
Private consumption	1.4	1.4 – 1.8	0.5 – 1.7
Government consumption	1.4	1.3 – 2.3	0.7 – 1.7
Gross fixed capital formation	2.5	2.3 – 4.5	1.6 – 4.8
Exports (goods and services)	4.1	5.2 – 8.0	3.3 – 6.5
Imports (goods and services)	5.0	5.3 – 8.7	2.8 – 6.2

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.

Among the domestic expenditure components of GDP, average annual growth in *private consumption* is projected to range between 1.4% and 1.8% in 2006, and between 0.5% and 1.7% in 2007. In 2006, household purchasing power has been subjected to dampening effects from higher energy prices. The expected increases in indirect taxes in 2007 are projected to lead to a moderation in consumption growth in that year, while, in 2006, anticipation effects are expected to result in slightly higher consumption growth. 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 projected to be between 2.3% and 4.5% in 2006, and between 1.6% and 4.8% in 2007. *Business investment* should continue to benefit from strong external demand, favourable financing conditions and robust corporate profits. At the same time, *residential private investment* is projected 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 projected to be between 5.2% and 8.0% in 2006, and between 3.3% and 6.5% in 2007. Extra-euro area export market shares are expected to decline slightly over the projection horizon, owing to increased global competition, while price competitiveness is expected to remain broadly stable. The average annual rate of growth in *total imports* is expected to be somewhat above that in exports in 2006 and to fall below it in 2007, reflecting the pattern of domestic demand. On balance, net trade is projected to make a roughly neutral contribution to GDP growth, on average, over the two years.

Total employment is projected to continue to grow steadily, in line with recent developments. 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 projected to be between 2.1% and 2.5% in 2006, and between 1.6% and 2.8% in 2007. The price projections reflect a significant contribution in 2006 from higher energy and non-oil commodity prices. While this contribution is expected to decline in 2007, based on current futures prices, HICP inflation will be significantly affected by higher indirect taxes in that year. At the same time, 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 relatively steady growth rate in productivity, which leads overall to broadly stable unit labour cost growth over the horizon. Finally, the HICP projections are based on the expectation that there are no major price pressures from non-commodity imports.

COMPARISON WITH THE ECB STAFF MACROECONOMIC PROJECTIONS OF MARCH 2006

In the new projections,³ the range projected for real GDP growth in 2006 is within the range of the March 2006 projections. For 2007, the range projected has been adjusted slightly downwards. This revision reflects, in particular, the effects of higher oil prices and a stronger exchange rate. With regard to HICP inflation, the current range projected for 2006 is within the upper part of the range of the March 2006 projections. The range projected for 2007 remains unchanged.

Table B Comparison with the March 2006 projections

(average annual percentage changes)

	2005	2006	2007
Real GDP – March 2006	1.4	1.7 – 2.5	1.5 – 2.5
Real GDP – June 2006	1.4	1.8 – 2.4	1.3 – 2.3
HICP – March 2006	2.2	1.9 – 2.5	1.6 – 2.8
HICP – June 2006	2.2	2.1 – 2.5	1.6 – 2.8

³ The new methodology for the short-term interest rate assumption (see previous footnote) has a very limited impact on the projections for both GDP growth and HICP inflation, reflecting that this change implies greater consistency with the other assumptions, which remained unchanged.

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, there is a consensus that euro area annual GDP growth will average between 2.0% and 2.2% in 2006. The forecasts for GDP growth in 2007 are between 1.8% and 2.1%. At the same time, the forecasts anticipate annual average HICP inflation to be between 2.1% and 2.2% in 2006, and between 2.0% and 2.2% in 2007. All of these rates fall within the ranges of the Eurosystem projections.

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

(annual percentage changes)

	Date of release	GDP growth			HICP inflation		
		2005	2006	2007	2005	2006	2007
European Commission	May 2006	1.3	2.1	1.8	2.2	2.2	2.2
IMF	Apr. 2006	1.3	2.0	1.9	2.2	2.1	2.2
OECD	May 2006	1.4	2.2	2.1	2.2	2.1	2.0
Consensus Economics Forecasts	May 2006	1.4	2.1	1.8	2.2	2.1	2.1
Survey of Professional Forecasters	Apr. 2006	1.3	2.1	1.9	2.2	2.1	2.1

Sources: European Commission Economic Forecasts, Spring 2006; IMF World Economic Outlook, April 2006; OECD Economic Outlook No 79, Preliminary Edition; 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.

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