EUROPEAN CENTRAL BANK
EUROSYSTEM

MARCH 2015 ECB STAFF MACROECONOMIC PROJECTIONS FOR THE EURO AREA[1]

1. EURO AREA OUTLOOK: OVERVIEW AND KEY FEATURES

The economic recovery showed some gradual improvement in the second half of 2014 and, looking ahead, several factors are projected to strengthen euro area activity. First, the sharp fall in oil prices will lead to a substantial increase in real disposable income, and households are expected to spend a significant part of such gains. Second, over the projection horizon, euro area activity will be increasingly supported by the gradual strengthening of external demand and the impact of the depreciation of the euro.

The Governing Council's recent monetary policy measures are also expected to support activity significantly in the short and medium term. Domestic demand and, especially, fixed capital formation are expected to benefit from the accommodative monetary policy stance and, in particular, from the ECB's expanded asset purchase programme (APP). The recent non-standard monetary policy measures are expected to support domestic demand as a result of their impact on interest rates, the exchange rate of the euro and equity prices, as well as through other important financial channels (see Box 1).

Other domestic factors are expected to provide support to activity over the projection horizon. Domestic demand should benefit from some easing of credit supply conditions, as indicated by recent bank lending survey results, which show a net easing of credit standards. The drag on business investment resulting from the need for corporate deleveraging has also diminished. Moreover, the fiscal stance is expected to remain neutral over the projection horizon.

However, the adverse impact of a number of other factors is likely to decline only gradually. In contrast to the corporate sector, private households and the general government sector have not yet achieved a substantial turnaround in their indebtedness ratios. Moreover, labour market developments – while generally improving – will remain overshadowed by high unemployment rates, notably in some stressed countries. Furthermore, concerns about the long-term growth potential and remaining ample spare capacity in a number of countries will continue to dampen investment spending.

Overall, real GDP growth is projected to pick up from 0.9% in 2014 to 1.5% in 2015, and to 1.9% in 2016 and 2.1% in 2017. In contrast, the pace of potential output is estimated to remain rather modest, as the contribution from labour and capital remain subdued on account of high structural unemployment and in the aftermath of a long phase of weak investment. This implies that the estimated negative output gap will be closing over the projection horizon.

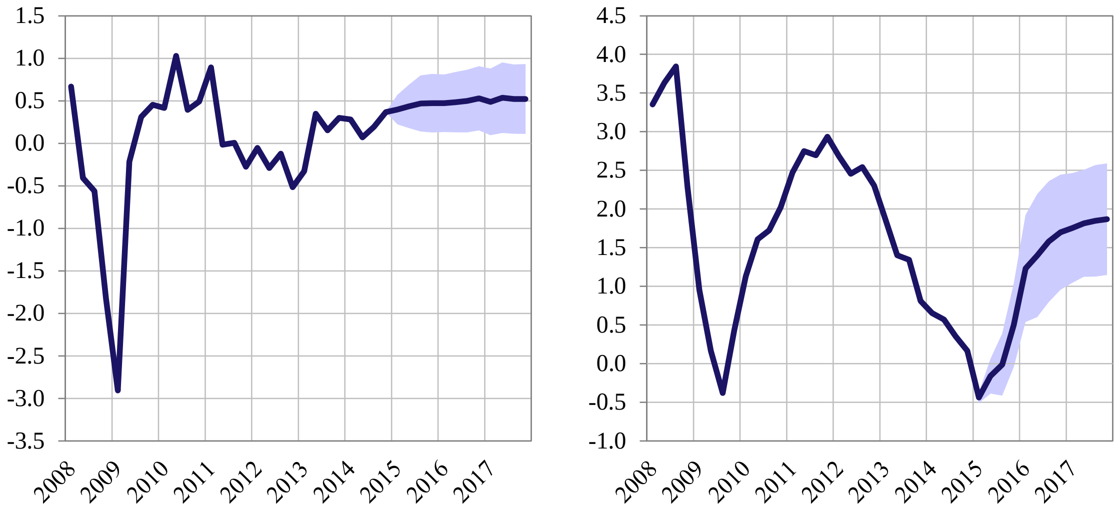
[1] ECB staff macroeconomic projections are an input to the Governing Council's assessment of economic developments and the risks to price stability. Information on the procedures and techniques used is given in *A guide to Eurosystem staff macroeconomic projection exercises*, ECB, June 2001, which is available on the ECB's website. The cut-off date for including the latest information in this exercise was 20 February 2015.
The current macroeconomic projection exercise covers the period 2015-17. Projections for a period over such a long horizon are subject to very high uncertainty, and this should be borne in mind when interpreting them. See the article entitled "An assessment of Eurosystem staff macroeconomic projections" in the May 2013 issue of the ECB's Monthly Bulletin.

Chart 1 Macroeconomic projections[1)]

(quarterly data)

Euro area real GDP[2)] (quarter-on-quarter percentage changes)

Euro area HICP (year-on-year percentage changes)



1) The ranges shown around the central projections 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, available on the ECB's website.
2) Working day-adjusted data.

Reflecting mainly the fall in oil prices, HICP inflation has recorded negative rates in recent months. The lower exchange rate of the euro provided only a small counter-effect to the strong drop in US dollar-denominated oil prices. Inflation in other HICP components has also fallen slightly in recent months.

HICP inflation is projected to average zero in 2015 but to rise to 1.5% in 2016 and further to 1.8% in 2017. The low HICP inflation rate in 2015 reflects a large negative contribution from HICP energy inflation. However, the downward price pressures from energy prices on headline inflation are projected to moderate towards the end of 2015 as past declines in energy prices gradually drop out of the annual rate of change and given that oil prices are assumed to increase over the projection horizon in line with the upward sloping oil price futures curve. As a result of these factors, energy prices are envisaged to add positively to headline inflation in 2016 and 2017.

While a large part of the swing in the inflation rate between 2015 and 2016 is likely to be explained by the turn-around in energy prices, HICP inflation excluding energy is also projected to increase as the economy recovers. This is due to the expected significant narrowing of the negative output gap, which, in turn, is reflected in stronger growth in both profit margins and compensation per employee. Furthermore, rising non-energy commodity prices, the indirect effects of rising oil prices and the lagged effects of the weaker exchange rate of the euro are also expected to contribute to the increase in HICP inflation excluding energy.

Box 1

THE INCLUSION OF THE RECENT NON-STANDARD MONETARY POLICY MEASURES IN THE PROJECTIONS

Since the cut-off date for the projections published in December 2014, there have been two new developments regarding the ECB's non-standard measures. The first was the allotment on 11 December 2014 of around €130 billion in the second TLTRO, with a cumulative take-up of around

€212 billion over the two initial tenders in which banks were entitled to an initial borrowing allowance. Six further TLTROs are still planned. The second development was the Governing Council's decision on 22 January 2015 to launch the APP, also encompassing the existing purchase programmes for asset-backed securities and covered bonds. Combined monthly purchases will amount to €60 billion. These operations are intended to be carried out until September 2016 and will, in any case, be conducted until there is a sustained adjustment in the path of inflation that is consistent with the Governing Council's aim of achieving inflation rates below, but close to, 2% over the medium term.

These two developments have led to a reconsideration of the approach generally followed in past projection exercises in order to take into account the impact of the non-standard monetary policy measures on the macroeconomic outlook. In the past the approach was based on including the macroeconomic impact of the non-standard monetary measures only to the extent that they had already affected the market-based technical financial assumptions (see Box 3 for background information), as parsed via the standard modelling framework used in the projection exercises at the cut-off date. This approach implies the risk of ignoring channels of transmission that are not fully captured by the standard modelling framework, but it was deemed appropriate due to the uncertainty concerning the volume of central bank liquidity generated by the non-standard monetary policy measures. However, in view of recent policy developments, there is currently more information about the likely volume of central bank liquidity generated by these measures. This allows a more precise assessment of the impact of the measures on the macroeconomic outlook.

The approach followed in the previous projection exercises has thus been complemented by including in the current projection the additional impact of these measures via financial transmission channels, such as a portfolio rebalancing channel, certain expectational channels and real-financial feedback loops. Such channels are not normally captured by the standard modelling framework used in the projection exercises. The impact from additional financial transmission channels on the macroeconomic outlook has been calibrated on the basis of econometric tools that explicitly model such channels. As a result, the March 2015 projection exercise comprises a more comprehensive assessment of the impact of the non-standard monetary policy measures on the macroeconomic outlook.

2. REAL ECONOMY

Growth in private consumption expenditure is expected to remain a key driver of the pick-up in activity. Private consumption gained momentum during the course of 2014, benefiting from rising growth in real disposable income due to stronger wage and non-wage income and to falling energy prices. These factors should also drive growth in real disposable income in the near term. Beyond that, wage income is expected to pick up against a background of increasing employment growth and rising wage growth, while an increase in other personal income is also expected as the overall economy recovers. Rising household net worth – reflecting both increases in financial asset prices in 2015 and further improvements in housing markets over the period 2016-17 – as well as low financing costs and easing financing conditions substantially reinforced by the APP, together with a strengthening of household loan dynamics, should also support private consumption. All in all, growth in annual private consumption is projected to average 1.7% over the projection horizon.

The saving ratio is expected to display a hump-shaped pattern. An initial increase in the saving ratio in 2015 and a subsequent decline are expected. This broadly reflects that a large share of the gains from lower oil prices is initially saved. Apart from this temporary factor, opposing effects imply a broadly unchanged level in the average saving ratio. On the one hand, very low returns tend to discourage savings, and an improvement in consumer confidence, in conjunction with gradually declining unemployment, could weaken precautionary savings. In addition, households might increasingly undertake major purchases that were previously postponed, reducing the saving ratio. On the other hand, continued deleveraging pressures in the context of still broadly unchanged household debt ratios – as a share of nominal disposable income – are projected to maintain some upward pressure on savings.

The outlook for residential investment is likely to improve gradually. A moderate recovery is expected from 2015 onwards, supported by very low mortgage rates in most countries, easing financing conditions substantially reinforced by the APP, stronger household loans and increasing growth in disposable income. As the need for housing market adjustment in some countries diminishes, residential investment should gain momentum. The projection of a gradual recovery in residential investment applies across most countries, although its pace might be dampened in some countries in view of high levels of household debt. However, unfavourable demographic effects are expected to start to have a dampening effect on housing activity in some countries towards the end of the projection horizon.

The recovery of business investment is set to gain momentum. Business investment continued its only modest recovery during the course of 2014, dampened by ample spare capacity and remaining credit supply constraints in some countries. As the adverse impact of these factors fades, the strengthening of domestic and external demand, the need to modernise the capital stock after several years of subdued investment, the accommodative monetary policy stance, underpinned by the recent non-standard monetary policy measures and especially by the APP, and a strengthening of profit mark-ups are expected to increase capital spending. In addition, the overall pressure for corporate deleveraging in the euro area eased in 2014 and should, over the forecast horizon, be less of a constraint for business investment than in the past. Nevertheless, corporate debt levels remain high in some countries, preventing an even stronger acceleration of business investment.

Euro area foreign demand is projected to pick up moderately as global activity recovers (see Box2), supporting a strengthening of extra-euro area exports. Foreign demand is expected to strengthen over the projection horizon, but to varying degrees across countries, some euro area countries being more adversely affected than others in view of their exposure to Russia and to the CIS region. At the same time, export market shares are expected to expand somewhat, owing to gains in competitiveness. Reflecting the strengthening of total demand in the euro area, extra-euro area imports are seen as growing gradually. Overall, net exports are projected to contribute positively, albeit modestly, to real GDP growth. Given some worsening in the trade balance, the current account surplus is likely to decline somewhat, falling to 2.4% of GDP in 2017.

Box 2

THE INTERNATIONAL ENVIRONMENT

The global economy remains on a gradual recovery path. World real GDP growth (excluding the euro area) is projected to pick up over the projection horizon, rising from 3.6% in 2014 to 3.8% in 2015, and to slightly above 4% in the period 2016-17. Global indicators and available country data point to a softening in growth at the end of 2014, although activity is expected to remain relatively robust.

Looking ahead, global activity should continue its gradual recovery. The global outlook is being shaped by a number of supportive factors, including (i) a significant decline in oil prices, which is considered to be mainly supply-driven and should have an overall positive impact on global activity; and (ii) an ongoing sustained recovery and a robust outlook in the United States. Nevertheless, some adverse factors also exist, such as (i) the adverse repercussions of the double shock of economic sanctions and the fall in oil prices on the Russian economy; (ii) the sharp movements in exchange rate markets, partly due to increasingly divergent monetary policies; and (iii) the disappointing growth performance in some emerging market economies, leading to downward revisions in their potential growth.

Reflecting the factors shaping the global outlook, the global recovery is characterised by uneven developments among both the advanced and emerging market economies. Advanced economies will continue to benefit from diminishing headwinds, including waning deleveraging, a moderating fiscal drag and improving labour markets, while unaddressed structural challenges and the tightening of financial conditions will still weigh on growth in emerging market economies.

Global trade gained momentum in the second half of 2014, following a weak first half. It is expected to pick up further, albeit very moderately, over the projection horizon, with its elasticity to activity expected to remain lower than in the pre-crisis period. Global trade growth (excluding the euro area) is projected to increase from 2.9% in 2014 to 5.4% in 2017.

Reflecting opposing influences, both global activity and euro area foreign demand have been hardly revised for 2015 and 2016 compared with the projections published in December 2014.

The international environment

(annual percentage changes)

	March 2015				December 2014			Revisions since December 2014		
	2014	2015	2016	2017	2014	2015	2016	2014	2015	2016
World (excluding euro area) real GDP	3.6	3.8	4.2	4.1	3.6	4.0	4.2	0.0	-0.2	-0.1
Global (excluding euro area) trade[1)]	2.9	3.9	5.1	5.4	2.7	3.9	5.2	0.2	0.0	-0.1
Euro area foreign demand[2)]	2.8	3.2	4.7	5.1	2.3	3.4	4.9	0.5	-0.1	-0.2

Note: Revisions are calculated from unrounded data.
1) Calculated as a weighted average of imports.
2) Calculated as a weighted average of imports of euro area trade partners.

Euro area labour market conditions are expected to improve over the projection horizon. Employment continued to recover in the course of 2014, rising significantly faster than suggested by historical elasticities of employment to overall activity, likely reflecting the supportive impact of past wage moderation and recent labour market reforms. Headcount employment is estimated to continue to recover. Relative to activity, the recovery in employment is expected to be particularly strong in countries where labour market reforms have been implemented. The number of hours worked per person is projected to increase somewhat, reflecting normal cyclical patterns in some countries and emerging labour supply bottlenecks in others.

The unemployment rate is expected to decline further. The number of unemployed is expected to decline by about 2.7 million over the projection horizon, reaching its lowest level since mid-2009. This decline reflects the downward impact of rising employment (up by 4.2 million), which is to some extent compensated for by the impact of a growing labour force. The unemployment rate is expected to fall to 9.9% in 2017, from 11.6% in 2014.

Substantial upward revisions have been made to the growth outlook since the staff projections published in December 2014. In addition to a more positive carry-over effect due to higher than previously expected real GDP growth in the last quarter of 2014, the upward revisions reflect, to a large extent, the favourable impact of lower oil prices, the weaker effective exchange rate of the euro and the impact of the ECB's recent non-standard monetary policy measures.

Box 3

TECHNICAL ASSUMPTIONS ABOUT INTEREST RATES, EXCHANGE RATES AND COMMODITY PRICES

Compared with the projections published in December 2014, the changes in the technical assumptions include considerably lower US dollar-denominated oil and non-energy commodity prices, a depreciation of the effective exchange rate of the euro and lower long-term interest rates in the euro area.

The technical assumptions about interest rates and commodity prices are based on market expectations, with a cut-off date of 11 February 2015. Short-term rates refer to the three-month EURIBOR, with market expectations derived from futures rates. The methodology gives an average level for these short-term interest rates of 0.1% for 2015 and 2016 and 0.2% for 2017. The market expectations for euro area ten-year nominal government bond yields imply an average level of 1.2% in 2015, 1.4% in 2016 and 1.6% in 2017.[1] Reflecting the path of forward market interest rates and the gradual pass-through of changes in market rates to lending rates, composite bank lending rates on loans to the euro area nonfinancial private sector are expected to decline somewhat in 2015, before rising modestly in the course of 2016 and 2017. 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 of 11 February, the price of a barrel of Brent crude oil is assumed to fall from USD 99.3 in 2014 to USD 58.5 in 2015, before rising to USD 66.8 in 2016 and USD 70.7 in 2017. The prices of non-energy commodities in US dollars are assumed to decrease substantially in 2015 and to rise in 2016 and 2017.[2] 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 of 11 February. This implies an exchange rate of USD 1.14 per euro in 2015 and of USD 1.13 per euro in 2016 and 2017.

Technical assumptions

	March 2015				December 2014			Revisions since December 2014[1)]		
	2014	2015	2016	2017	2014	2015	2016	2014	2015	2016
Three-month EURIBOR (percentage per annum)	0.2	0.1	0.1	0.2	0.2	0.1	0.1	0.0	0.0	-0.1
Ten-year government bond yields (percentage per annum)	2.0	1.2	1.4	1.6	2.0	1.8	2.1	0.0	-0.6	-0.7
Oil price (in USD/barrel)	99.3	58.5	66.8	70.7	101.2	85.6	88.5	-1.9	-31.6	-24.5
Non-energy commodity prices, in USD (annual percentage change)	-6.4	-11.0	2.6	4.8	-6.3	-4.8	3.8	-0.1	-6.2	-1.2
USD/EUR exchange rate	1.33	1.14	1.13	1.13	1.33	1.25	1.25	-0.1	-8.8	-9.0
Euro nominal effective exchange rate (EER19) (annual percentage change)	0.6	-7.9	-0.2	0.0	0.5	-2.8	0.0	0.0	-5.1	-0.2

1) Revisions are calculated from unrounded data and expressed as percentages for levels, differences for growth rates and percentage points for interest rates and bond yields.

1 The assumption for euro area ten-year nominal government bond yields is based on the weighted average of countries' ten-year benchmark bond yields, weighted by annual GDP figures and extended by the forward path derived from the ECB's euro area all-bonds ten-year par yield, with the initial discrepancy between the two series kept constant over the projection horizon. The spreads between country-specific government bond yields and the corresponding euro area average are assumed to be constant over the projection horizon.

2 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 2016 and thereafter to evolve in line with global economic activity. EU farm gate prices (in euro), which are 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.

3. PRICES AND COSTS

Commodity price and exchange rate developments are likely to play a key role in the inflation profile for the euro area over the projection horizon. The recent sharp drop in crude oil prices is expected to have a strong downward impact on energy inflation in 2015, which is mitigated only to a small extent by the recent depreciation of the euro. Subdued developments in non-energy commodity prices imply downward pressure on euro area consumer price inflation also via import prices other than oil. From 2016 onwards, external price developments are seen as adding upward pressure on euro area inflation. In 2016, the large swing in HICP inflation is, to a significant extent, accounted for by the fading of downward effects from the past declines in oil prices combined with upward effects stemming from the assumed increases in oil prices, which are projected to persist into 2017 and reflect the upward sloping oil price futures curve. Moreover, rising non-energy commodity prices, strengthening global demand and the lagged effects from the recent depreciation of the euro are likely to lead to a significant rise in the import deflator between 2015 and 2016.

Table 1 Macroeconomic projections for the euro area[1)]

(annual percentage changes)

	March 2015				December 2014			Revisions since December 2014[2)]		
	2014	2015	2016	2017	2014	2015	2016	2014	2015	2016
Real GDP[3)]	0.9	1.5	1.9	2.1	0.8	1.0	1.5	0.1	0.5	0.4
		[1.1 - 1.9] [4)]	[0.8 - 3.0] [4)]	[0.9 - 3.3] [4)]	[0.7 - 0.9] [4)]	[0.4 - 1.6] [4)]	[0.4 - 2.6] [4)]			
Private consumption	1.0	1.8	1.6	1.6	0.8	1.3	1.2	0.2	0.5	0.4
Government consumption	0.9	1.0	0.6	0.8	0.9	0.5	0.4	0.0	0.6	0.2
Gross fixed capital formation	0.9	1.7	4.1	4.6	0.7	1.4	3.2	0.3	0.4	0.9
Exports[5)]	3.6	4.1	5.1	5.5	3.2	3.2	4.8	0.4	0.9	0.4
Imports[5)]	3.6	4.3	5.5	5.8	3.3	3.7	4.9	0.4	0.6	0.6
Employment	0.5	0.9	0.9	0.9	0.4	0.6	0.5	0.1	0.3	0.4
Unemployment rate (percentage of labour force)	11.6	11.1	10.5	9.9	11.6	11.2	10.9	0.0	-0.2	-0.4
HICP	0.4	0.0	1.5	1.8	0.5	0.7	1.3	0.0	-0.8	0.2
		[-0.3 - 0.3] [4)]	[0.8 - 2.2] [4)]	[1.0 - 2.6] [4)]	[0.5 - 0.5] [4)]	[0.2 - 1.2] [4)]	[0.6 - 2.0] [4)]			
HICP excluding energy	0.7	0.8	1.4	1.8	0.8	1.1	1.3	0.0	-0.2	0.1
HICP excluding energy and food	0.8	0.8	1.3	1.7	0.8	1.0	1.3	0.0	-0.2	0.0
HICP excluding energy, food and changes in indirect taxes[6)]	0.7	0.8	1.3	1.7	0.7	1.0	1.3	0.0	-0.2	0.0
Unit labour costs	1.0	1.1	1.0	1.2	1.1	1.1	0.8	-0.1	0.0	0.2
Compensation per employee	1.5	1.7	2.0	2.3	1.6	1.5	1.8	-0.1	0.2	0.2
Labour productivity	0.4	0.6	1.0	1.1	0.5	0.4	1.0	0.0	0.2	0.0
General government budget balance (percentage of GDP)	-2.6	-2.3	-1.9	-1.5	-2.6	-2.5	-2.2	0.0	0.2	0.3
Structural budget balance (percentage of GDP)[7)]	-1.9	-1.8	-1.7	-1.7	-2.1	-2.1	-2.0	0.2	0.3	0.3
General government gross debt (percentage of GDP)	91.7	91.4	89.8	87.9	92.0	91.8	91.1	-0.2	-0.4	-1.3
Current account balance (percentage of GDP)	2.5	2.7	2.5	2.4	2.1	2.2	2.4	0.4	0.5	0.1

1) The data refer to the euro area including Lithuania, except for the HICP data for 2014. The average annual percentage change in the HICP for 2015 is based on a euro area composition in 2014 that already includes Lithuania.
2) Revisions are calculated from unrounded figures.
3) Working day-adjusted data.
4) The ranges shown around the projections 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, available on the ECB's website.
5) Including intra-euro area trade.
6) The sub-index is based on estimates of actual impacts of indirect taxes. This may differ from Eurostat data, which assume a full and immediate pass-through of tax impacts to the HICP.
7) Calculated as the government balance net of transitory effects of the economic cycle and temporary measures taken by governments (for the ESCB approach, see *Working Paper Series*, No 77, ECB, September 2001, and *Working Paper Series*, No 579, ECB, January 2007). The projection of the structural balance is not derived from an aggregate measure of the output gap. Under the ESCB methodology, cyclical components are calculated separately for different revenue and spending items. For more details, see the box entitled "Cyclical adjustment of the government budget balance" in the March 2012 issue of the Monthly Bulletin and the box entitled "The structural balance as an indicator of the underlying fiscal position" in the September 2014 issue of the Monthly Bulletin.

Improving labour markets and the decline in slack in the economy imply increasing domestic price pressures over the projection horizon. Ongoing employment growth and some decline in the unemployment rate are projected to sustain a gradual increase in the growth of compensation per employee, from 1.5% in 2014 to 2.3% in 2017, with high levels of unemployment and remaining cost competitiveness adjustment processes in some euro area countries hindering a stronger pick-up. At the same time, the downward impact from the second-round effects of the sharp drop in oil prices on wages is expected to be limited. This is expected to be so, given downward rigidities in wages and since the impact via automatic wage indexation systems should be small, as these systems apply mostly to upward adjustments and, in a number of countries, they have been temporarily suspended or significantly reduced in scope.

Profit margins (as measured by the difference between the GDP deflator at factor cost and unit labour cost growth) are projected to increase notably over the projection horizon as the recovery gains momentum. They are expected to be the main driver of the increase in domestic cost pressures. After an expected small decline in 2015, profit margins are likely to rise over the remaining projection horizon as productivity picks up considerably and economic activity strengthens.

Compared with the projections published in December 2014, the projection for HICP inflation has been revised substantially downwards for 2015 but revised slightly upwards for 2016. Headline inflation has been revised down by 0.8 percentage point for 2015 compared with the previous projection exercise. This reflects mainly lower US dollar-denominated oil prices than had previously been assumed, which have been compensated only to a small extent by the lower exchange rate of the euro against the US dollar. The downward revision of HICP excluding energy in 2015 amounts to 0.2 percentage point and relates to past forecast errors, reflecting, among other factors, indirect effects from the lower oil prices on the prices of goods and services. For 2016, HICP inflation has been revised up by 0.2 percentage point. The upward revision reflects the more favourable growth outlook, lagged effects from the lower exchange rate of the euro and the steeper oil price futures curve. The recent non-standard monetary policy measures, especially the APP, have contributed to this upward revision of inflation through various channels.

4. FISCAL OUTLOOK

The fiscal stance, as measured by the change in the cyclically adjusted primary balance, is projected to be broadly neutral over the projection horizon. This reflects moderate growth in government expenditure relative to trend GDP growth, which is assumed to be broadly offset by tax cuts in some countries. The positive impact from automatic fiscal stabilisers on domestic demand will diminish over time as the economy recovers.[2]

The government deficit and debt ratios are projected to decline gradually over the projection horizon. The decline in the general government deficit-to-GDP ratio is supported by the cyclical improvement of the euro area economy. The structural budget balance is projected to improve slightly over the projection horizon, reflecting mainly savings in interest payments owing to a decline in the implicit interest rate. The general government debt-to-GDP ratio is projected to peak in 2014 and to start declining over the forecast horizon on the back of the improving budget balance, strengthening economic growth and low interest rates.

Compared with the projections published in December 2014, the fiscal outlook has improved. In the absence of major news on fiscal policies, the small upward revision to the government budget balance is mainly due to an improved macroeconomic outlook and the interest relief from a further decline in sovereign borrowing costs. The outlook for government debt has also improved on the back of favourable revisions in the interest rate growth differential and, to a lesser extent, the primary balance.

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[2] The fiscal assumptions reflect the information included in budget laws for 2015 and national medium-term budgetary plans that were available as at 20 February 2015. They include all policy measures that have already been approved by national parliaments or that have been defined in sufficient detail by governments and are likely to pass the legislative process.

Box 4

SENSITIVITY ANALYSES

Projections rely heavily on technical assumptions regarding the evolution of certain key variables. Given that some of these variables can have a large impact on the projections for the euro area, the sensitivity of the latter with respect to alternative paths of these underlying assumptions can help in the analysis of risks around the projections. This box discusses the uncertainty around oil prices and exchange rates and the sensitivity of the projections with respect to these variables.

1) An alternative oil price path

The technical assumptions foresee an increase in oil prices over the projection horizon. This path is consistent with a recovery in world oil demand as the global economy gains traction and with a slight reduction in oil supply due to underinvestment and losses in oil capacity in some oil-producing countries.

However, in an alternative scenario, oil prices could also broadly stay at their current levels over the whole of the projection horizon, increasingly diverging from the baseline oil price assumptions. Such a path would be consistent with ongoing high oil supply and a muted recovery in world demand. On the basis of a number of ECB staff macroeconomic models, it has been estimated that a flat oil price path would cause euro area HICP inflation to be about 0.1-0.2 percentage point below the baseline projection for 2015 and 0.3-0.6 percentage point below the baseline projection for 2016. In 2017, HICP inflation would be about 0.2-0.3 percentage point below the baseline projection. At the same time, the alternative oil price path would support real GDP growth by about 0.1-0.2 percentage point in both 2016 and 2017.

2) An alternative exchange rate path

While the baseline assumes an unchanged effective exchange rate of the euro up to the end of the horizon, a scenario could be envisaged in which a further depreciation of the euro could result from a divergence in the euro area's and the United States' growth prospects. Such a scenario would be consistent with expectations of the monetary policy stances in these two economies further diverging. An alternative path of the euro, implying a further depreciation, has been derived from the 25th percentile of the distribution provided by the option-implied risk-neutral densities for the USD/EUR exchange rate on 12 February 2015. This path implies a gradual depreciation of the euro against the US dollar to an exchange rate of 1.04 in 2017, which is 8.8% below the baseline assumption for that year. The corresponding assumptions for the nominal effective exchange rate of the euro reflect historical regularities, whereby changes in the USD/EUR exchange rate reflect changes in the effective exchange rate with an elasticity of around 52%. This results in a gradual divergence of the effective exchange rate of the euro from the baseline, bringing it to a level 4.8% below the baseline in 2017. In this scenario, the results from a number of ECB staff macroeconomic models point to higher real GDP growth, by 0.1-0.3 percentage point, and higher HICP inflation, by 0.1-0.4 percentage point, in 2015, 2016 and 2017.

Box 5

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 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 (see the table).

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

(annual percentage changes)

	Date of release	GDP growth			HICP inflation		
		2015	2016	2017	2015	2016	2017
ECB staff projections	March 2015	1.5	1.9	2.1	0.0	1.5	1.8
		[1.1-1.9]	[0.8-3.0]	[0.9-3.3]	[-0.3-0.3]	[0.8-2.2]	[1.0-2.6]
European Commission	February 2015	1.3	1.9	-	-0.1	1.3	-
OECD	November 2014	1.1	1.7	-	0.6	1.0	-
Euro Zone Barometer	February 2015	1.3	1.8	1.6	-0.1	1.1	1.5
Consensus Economics Forecasts	February 2015	1.2	1.6	-	-0.1	1.1	-
Survey of Professional Forecasters	February 2015	1.1	1.5	1.7	0.3	1.1	1.5
IMF	January 2015	1.2	1.4	-	0.9	1.2	-

Sources: European Commission's Economic Forecast, Winter 2015; IMF World Economic Outlook, Update January 2015 (GDP); IMF World Economic Outlook, October 2014; OECD Economic Outlook, November 2014; Consensus Economics Forecasts; MJEconomics; and the ECB's Survey of Professional Forecasters.

Notes: The Eurosystem and 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.

In the forecasts currently available from other institutions, projections for euro area real GDP growth and HICP inflation are similar to or somewhat lower than the ECB staff projections.

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