EUROPEAN CENTRAL BANK

EUROSYSTEM

EUROSYSTEM STAFF MACROECONOMIC PROJECTIONS FOR THE EURO AREA

On the basis of the information available up to 25 November 2011, Eurosystem staff have prepared projections for macroeconomic developments in the euro area[1]. Euro area economic activity weakened in the second half of 2011. This reflected a weakening in global demand and a substantial deterioration in both business and consumer confidence in recent months, in an environment of increased uncertainty stemming from intensified tensions in financial markets, with equity prices falling significantly and financing conditions worsening in an increasing number of euro area countries. Assuming that the financial crisis does not intensify further, real GDP growth is projected to recover during the course of 2012 and to improve somewhat further in 2013. The recovery is, however, expected to be dampened by the balance sheet restructuring that is taking place in many sectors and by the adverse financing conditions that prevail in many parts of the euro area over the projection horizon. At the same time, the recovery is expected to be increasingly supported by a strengthening in global demand and a decline in energy and food price inflation supporting real incomes, as well as by the favourable impact on domestic demand of the very low short-term interest rates and of the measures to restore the functioning of the financial system. Average annual real GDP growth is projected to be between 1.5% and 1.7% in 2011, between -0.4% and 1.0% in 2012 and between 0.3% and 2.3% in 2013. Euro area HICP inflation is projected to remain elevated in the near term but to decline markedly thereafter. The average rate of overall HICP inflation is expected to be between 2.6% and 2.8% in 2011, between 1.5% and 2.5% in 2012 and between 0.8% and 2.2% in 2013. This profile largely reflects downward base effects in energy and food prices in 2012 as well as assumptions of flat or declining commodity prices. HICP inflation excluding food and energy is expected to increase only slightly over the projection horizon, reflecting relatively subdued domestic demand and contained labour costs.

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 17 November 2011[1]. 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 1.4% for 2011, 1.2% for 2012 and 1.4% for 2013. The market expectations for euro area ten-year nominal government bond yields imply an average level of 4.4% in 2011, 5.3% in 2012 and 5.6% in 2013. 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 gradually increase further over the entire projection horizon. Credit supply conditions for the euro area as a whole are expected to overall weigh negatively on activity. 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, the price of a barrel of Brent crude oil is assumed to average USD 111.5 in 2011, USD 109.4 in 2012 and USD 104.0 in 2013. The prices of non-energy commodities in US dollars are assumed to rise by 17.8% in 2011, to fall by 7.3% in 2012 and to increase by 4.3% in 2013.

1 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. 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.

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 1.40 in 2011, and 1.36 in 2012 and 2013. On average, the effective exchange rate of the euro is assumed to remain unchanged in 2011 and to depreciate by 0.9% in 2012.

Fiscal policy assumptions are based on individual euro area countries' national budget plans that were available on 25 November 2011. 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.

1 Oil and food price assumptions are based on futures prices up to the end of the projection horizon. The prices of other commodities are assumed to follow futures until the fourth quarter of 2012 and thereafter to evolve in line with global economic activity.

THE INTERNATIONAL ENVIRONMENT

The momentum of global growth weakened in the course of 2011. In the second half of the year the positive impetus from the unwinding of supply chain disruptions in the aftermath of the natural disasters in Japan was thwarted by renewed global financial market tensions, largely driven by the intensification of the sovereign debt crisis in the euro area and growing concerns about fiscal sustainability in other major advanced economies. This eroded consumer and business confidence worldwide. Looking ahead, a gradual recovery is expected, although headwinds, such as the continued need to repair balance sheets and the weakness in housing and labour markets in some major advanced economies, imply a prolonged period of sluggish growth, particularly in advanced economies, which will constrain the pace of the global recovery. In emerging economies, growth is continuing at a rather strong pace, but is expected to lose momentum, owing to earlier policy tightening aimed at mitigating financial imbalances and price pressures, as well as expected weaker foreign demand and adverse spillovers from the global financial turbulence. World real GDP growth outside the euro area, which reached 5.7% in 2010, is projected to decrease to 4.1% in 2011 and 3.9% in 2012 before increasing to 4.5% in 2013. Growth in euro area foreign demand is estimated to decline from 11.8% in 2010 to 6.4% in 2011, and to 4.8% in 2012, before increasing to 6.9% in 2013.

REAL GDP GROWTH PROJECTIONS

Euro area real GDP grew only moderately in the third quarter of 2011, rising by 0.2% in quarter-on-quarter terms, which is the same rate as recorded in the second quarter. While a number of temporary factors – global as well as domestic – weighed negatively on activity in the second quarter of 2011, the weak underlying growth momentum in the euro area in the past few months increasingly reflected the impact of the sovereign debt crisis in the euro area and the associated tightening of the fiscal stance in some euro area countries. On the domestic side, the adverse impact of increased uncertainty related to intensified tensions in financial markets in the euro area resulted in a substantial deterioration in business and consumer confidence, a sharp decline in equity prices across the euro area and a worsening of financing conditions for households and non-financial corporations in a number of countries. As foreign demand also turned weaker in 2011, external factors are not expected to offset the adverse impact of these domestic factors in the near term. Looking ahead, assuming that the financial crisis does not intensify further, real GDP growth is expected to pick up during the course of 2012 and to improve somewhat further in 2013. The recovery is, however, expected to be dampened by the balance sheet restructuring that is taking place in many sectors and by the adverse financing conditions that prevail in many parts of the euro area over the projection horizon. At the same time, the recovery is expected to be supported by a strengthening in global demand, and a decline in energy and food price inflation supporting real incomes, as well as the favourable impact on domestic demand of the very low short-term interest rates and of the measures to restore the functioning of the financial system. Overall, the recovery is expected to be slow. In annual terms, euro area real GDP is expected to grow by between 1.5% and 1.7% in 2011, between -0.4% and 1.0% in 2012 and between 0.3% and 2.3% in 2013.

In more detail, euro area private consumption growth is projected to be rather subdued until mid-2012, mainly as a result of the weak pattern of real disposable income growth, and to pick up slightly thereafter. Nominal disposable income growth is projected to be dampened by subdued employment growth, in conjunction with moderate increases in wages and transfer income, which are both expected to be constrained owing to the fiscal tightening implemented in several euro area countries. While the adverse impact of past increases in commodity prices has dampened real disposable income, commodity price pressures are expected to diminish, thereby progressively supporting the dynamics of real disposable income. The euro area saving ratio is projected to be broadly unchanged from its current level over the remainder of the projection horizon. This reflects the fact that an upward impact on the saving ratio stemming from heightened uncertainty and weakened confidence is expected to be broadly compensated by a need to reduce savings in order to smooth consumption in view of the weakness in real income developments. Reflecting the only gradual expansion in employment, the euro area unemployment rate is expected to rise somewhat during the course of 2012 and to decline only slowly thereafter.

Euro area non-residential private investment is expected to be dampened as a result of persistent adverse financing conditions in some euro area countries, in an environment of elevated uncertainty. It is projected to stagnate in the near term and to recover only gradually over the remainder of the projection horizon, supported by a strengthening in export growth, a moderate pick-up in domestic demand and relatively sustained profitability. Residential investment growth is expected to be even more sluggish, dampened by ongoing adjustments in the housing market in some countries – which are also reflected in rather modest house price developments. Government investment is assumed to decline substantially in 2011 and 2012 before stabilising in 2013, owing to the fiscal consolidation packages announced in several euro area countries.

In line with the pattern of foreign demand, the pace of export growth is expected to weaken in the near term before gradually gaining momentum during the course of 2012. A similar path is projected for import growth. Overall, reflecting somewhat stronger export growth from early 2012, net trade is expected to make a positive contribution to quarterly GDP growth over the projection horizon.

Table 1 Macroeconomic projections for the euro area

(average annual percentage changes) [1) 2)]

	2010	2011	2012	2013
HICP	1.6	2.6 – 2.8	1.5 – 2.5	0.8 – 2.2
Real GDP	1.8	1.5 – 1.7	-0.4 – 1.0	0.3 – 2.3
Private consumption	0.8	0.3 – 0.5	-0.4 – 0.6	0.0 – 1.8
Government consumption	0.5	-0.3 – 0.5	-0.5 – 0.7	-0.3 – 1.3
Gross fixed capital formation	-0.6	1.6 – 2.4	-1.6 – 1.8	-0.5 – 4.3
Exports (goods and services)	10.8	5.4 – 7.2	0.3 – 6.1	2.1 – 8.9
Imports (goods and services)	9.2	4.0 – 5.4	-0.5 – 5.1	1.7 – 8.1

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.

2) Data refer to the euro area including Estonia, except for the HICP data for 2010. The average annual percentage change in the HICP for 2011 is based on a euro area composition in 2010 that already includes Estonia.

The current crisis is expected to have adversely affected potential growth, although the exact magnitude of this impact remains highly uncertain. It is likely that the continuing weakness in activity will further reduce potential output growth. Nevertheless, given the weak outlook for growth, the negative output gap is projected to widen in 2012 before narrowing somewhat in 2013.

PRICE AND COST PROJECTIONS

Driven by past hikes in commodity prices and, to some extent, by increases in indirect taxes, the overall euro area HICP inflation rate is projected to remain above 2% in the first quarter of 2012. Thereafter, it is expected to moderate considerably. This pattern largely reflects a sharply decreasing contribution from energy prices, as a result of the fading-out of the impact of past increases in oil prices and the assumed gradual decline in crude oil prices over the projection horizon. Food price inflation is expected to moderate from mid-2012, once the pressures currently in the pipeline have passed through. Finally, HICP inflation excluding food and energy is projected to increase only slightly, reflecting relatively weak domestic demand and contained labour costs. The average rate of overall HICP inflation is expected to be between 2.6% and 2.8% in 2011, between 1.5% and 2.5% in 2012 and between 0.8% and 2.2% in 2013.

In more detail, external price pressures have eased and are expected to fall markedly over the projection horizon, mainly on account of stabilising or declining commodity prices. Owing in part to the slower pace of world trade growth and lower global inflation, the annual rate of increase of the import deflator, which peaked at the beginning of 2011, is expected to decline sharply in 2012 and to fall somewhat further in 2013. Turning to domestic price pressures, the annual growth rate of compensation per employee is expected to slow in the first half of 2012, largely reflecting the impact of one-off payments in the first half of 2011. The annual growth rate of compensation per employee is expected to pick up in the second half of 2012 and to stabilise thereafter. This pattern reflects the impact of offsetting factors. On the one hand, upward pressures would stem from past increases in consumer price inflation. On the other hand, the general slowdown in economic activity and the persistently weak labour market conditions are expected to exert downward pressure on wages. Given the rather elevated consumer price inflation this year, real compensation per employee is projected to decline in 2011 and 2012 and to recover somewhat thereafter. The growth rate of unit labour costs is expected to increase somewhat in 2012 and to ease subsequently. This profile reflects a cyclical drop in productivity growth in 2012 – as activity growth weakens substantially and employment growth adjusts only partially – and a subsequent increase in 2013. The growth of profit margins is expected to remain low throughout 2011 and 2012, on the back of subdued aggregate demand and accelerating unit labour costs. In 2013 profit margins are expected to recover as activity picks up. Increases in administered prices and indirect taxes are expected to contribute substantially to HICP inflation in 2011 and 2012, reflecting the ongoing fiscal consolidation in several euro area countries. The impact in 2013 is expected to be smaller, although this reflects in part the lack of detailed information on fiscal measures for that year.

COMPARISON WITH THE SEPTEMBER 2011 PROJECTIONS

Compared with the ECB staff macroeconomic projections published in the September 2011 issue of the Monthly Bulletin, there is a narrowing of the range of the real GDP growth projection for 2011 and a significant downward revision of the range for 2012. These revisions mainly reflect the impact on domestic demand of weaker confidence and worsening financing conditions – stemming from the heightened uncertainty related to the sovereign debt crisis as well as downward revisions of foreign demand. Additional fiscal tightening and stricter financing conditions in some euro area countries have also led to downward revisions of the medium-term outlook for real GDP growth. With regard to HICP inflation, the projection ranges for 2011 and 2012 have been revised slightly upwards. This results from the upward impact of higher oil prices in euro terms, as well as a higher contribution from indirect taxes. The upward impact of these factors is expected to more than compensate the downward impact of the adjustments to profit margins and wage growth that are related to the downward revision of activity.

Table 2 Comparison with the September 2010 projections

(average annual percentage changes)

	2011	2012
Real GDP – September 2011	1.4 – 1.8	0.4 – 2.2
Real GDP – December 2011	1.5 – 1.7	-0.4 – 1.0
HICP – September 2011	2.5 – 2.7	1.2 – 2.2
HICP – December 2011	2.6 – 2.8	1.5 – 2.5

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 grow by between 1.5% and 1.6% in 2011, between 0.2% and 1.1% in 2012 and between 1.3% and 1.6% in 2013. All the forecasts are within or very close to the ranges of the Eurosystem staff projections.

As regards inflation, the forecasts from other institutions point to average annual HICP inflation of between 2.5% and 2.7% in 2011, between 1.5% and 1.8% in 2012 and between 1.2% and 1.8% in 2013. All the forecasts are within or very close to the range of the Eurosystem staff projections. The projections for 2012 are in the lower half of the Eurosystem staff projection ranges.

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	2013	2011	2012	2013
IMF	September 2011	1.6	1.1	1.5	2.5	1.5	1.7
Survey of Professional Forecasters	November 2011	1.6	0.8	1.6	2.6	1.8	1.8
Consensus Economics Forecasts	November 2011	1.6	0.4	1.5	2.7	1.8	1.8
OECD	November 2011	1.6	0.2	1.4	2.6	1.6	1.2
European Commission	November 2011	1.5	0.5	1.3	2.6	1.7	1.6
Eurosystem staff projections	December 2011	1.5 – 1.7	-0.4 – 1.0	0.3 – 2.3	2.6 – 2.8	1.5 – 2.5	0.8 – 2.2

Sources: European Commission Economic Forecasts, Autumn 2011; IMF World Economic Outlook, September 2011; OECD Economic Outlook, November 2011; Consensus Economics Forecasts; 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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