



EUROPEAN CENTRAL BANK

EUROSYSTEM

EUROSYSTEM STAFF MACROECONOMIC PROJECTIONS FOR THE EURO AREA

On the basis of the information available up to 24 May 2011, Eurosystem staff have prepared projections for macroeconomic developments in the euro area.¹ Supported by sustained global demand and a strengthening of investment, the measures to restore the functioning of the financial system and the still accommodative monetary policy stance, average annual real GDP growth is projected to be between 1.5% and 2.3% in 2011 and between 0.6% and 2.8% in 2012. Owing primarily to recent strong oil price increases, overall HICP inflation is projected to remain above 2.0% for the remainder of 2011. Thereafter, commodity prices are assumed to moderate and, as the direct impact of their past increases fades away, average annual headline inflation is projected to decline. In contrast, domestic price pressures are expected to pick up due to a higher capacity utilisation rate and tighter labour market conditions, as well as to a gradual and partial pass-through of past hikes in commodity prices. The average rate of overall HICP inflation is expected to be between 2.5% and 2.7% in 2011 and between 1.1% and 2.3% in 2012.

Box A

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 18 May 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 1.6% for 2011 and 2.3% for 2012. The market expectations for euro area ten-year nominal government bond yields imply an average level of 4.5% in 2011 and 4.8% in 2012. 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 owing to the gradual pass-through of forward market rate increases and a decline in the default risk for both non-financial corporations and private households. Spreads vis-à-vis long-term rates are assumed to increase gradually over the projection horizon, following their marked contraction in the last quarter of 2010, and to have returned to a level in line with their historical average by the end of the projection horizon. Credit supply conditions for the euro area as a whole are expected to normalise further but still to weigh negatively 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, the price of a barrel of Brent crude oil is assumed to average USD 111.1 in 2011 and USD 108.0 in 2012. The prices of non-energy commodities in US dollars are assumed to rise by 20.4% in 2011 and by 1.2% 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 an exchange rate of EUR/USD 1.42 in 2011 and EUR/USD 1.43 in 2012, and an effective exchange rate of the euro that, on average, appreciates moderately by 0.8% in 2011 and by 0.4% in 2012.

Fiscal policy assumptions are based on individual euro area countries' national budget plans as available on 24 May 2011. They include all policy measures that have already been approved by national

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.

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. For other commodities, prices are assumed to follow futures until the second quarter of 2012 and thereafter to evolve in line with global economic activity.

THE INTERNATIONAL ENVIRONMENT

The recovery in the global economy is continuing and becoming increasingly self-sustained. While the recovery in advanced economies becomes more engrained, the fallout from the financial crisis is expected to continue to weigh on the strength of the recovery, thwarting the prospects for a speedy recovery in the labour market. This contrasts markedly with the situation in fast-growing emerging economies, which are operating at close to – and, in some cases, above – full capacity and where overheating pressures persist. Since the previous projection exercise in March 2011, the political unrest in the Middle East and North Africa has intensified and Japan has experienced natural and nuclear disasters. Although these events have added uncertainty to the global outlook, they are not expected to derail the global recovery. World real GDP growth outside the euro area is projected to increase from 4.5% in 2011 to 4.7% in 2012. Growth in the euro area's export markets is estimated to be 8.3% in 2011 and 7.9% in 2012.

REAL GDP GROWTH PROJECTIONS

Following a relatively subdued expansion in the second half of 2010, real GDP growth picked up particularly strongly in the first quarter of 2011, with a quarter-on-quarter rate of 0.8%. The breakdown suggests that domestic demand, and especially investment, contributed significantly to real GDP growth during this period. Construction activity, in particular, appears to have recovered from its weather-related weakness in the fourth quarter. As this temporary upward effect vanishes, real GDP growth is likely to moderate in the second quarter. Looking further ahead, economic activity is projected to continue to recover, supported primarily by sustained global demand and a strengthening of investment. Domestic demand is projected to contribute increasingly to real GDP growth, while net trade is expected to make a declining, but still positive, contribution to real GDP growth over the projection horizon. Overall, in line with patterns observed following past financial crises, real GDP is expected to recover only slowly and to reach its pre-crisis level only in the course of 2012. In annual terms, real GDP is expected to increase by between 1.5% and 2.3% in 2011 and between 0.6% and 2.8% in 2012.

In more detail, private consumption growth is projected to be subdued in 2011 as rising commodity prices adversely affect real disposable income growth. Thereafter, as inflationary pressures are expected to diminish and growth in both employment and compensation per employee to increase, the growth rates of real disposable income and, consequently, private consumption are projected to pick up. The saving ratio is projected to decline in 2011, reflecting improved confidence, and to remain broadly unchanged thereafter. Reflecting the only gradual improvement in employment, the unemployment rate is expected to remain stable during most of 2011 and to decline slowly thereafter.

Non-residential private investment is expected to increase relatively strongly over the projection horizon, supported by buoyant business confidence, a gradual pick-up in demand, the emergence of capacity bottlenecks and diminishing financing constraints. In contrast, residential investment growth is expected to stay rather subdued until 2012 owing to ongoing adjustments in housing markets in some countries. In line with the consolidation packages announced in several euro area countries, government investment is assumed to decline over the projection horizon.

Following the strong rise in foreign demand in 2010, the pace of export growth is expected to weaken but remain relatively robust in 2011 and 2012. A similar path is projected for import growth. Overall, net trade is expected to make a declining, but still positive, contribution to GDP growth over the projection horizon.

Table 1 Macroeconomic projections for the euro area(average annual percentage changes) ^{1) 2)}

| | 2010 | 2011 | 2012 |
|-------------------------------|-------------|-------------|-------------|
| HICP | 1.6 | 2.5 – 2.7 | 1.1 – 2.3 |
| Real GDP | 1.7 | 1.5 – 2.3 | 0.6 – 2.8 |
| Private consumption | 0.8 | 0.6 – 1.2 | 0.4 – 2.2 |
| Government consumption | 0.6 | -0.4 – 0.6 | -0.5 – 0.9 |
| Gross fixed capital formation | -0.9 | 2.0 – 4.2 | 1.1 – 5.9 |
| Exports (goods and services) | 11.1 | 5.8 – 9.6 | 2.6 – 10.6 |
| Imports (goods and services) | 9.3 | 4.3 – 7.9 | 2.6 – 10.0 |

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 crisis is expected to have adversely affected potential growth, although the exact magnitude of this impact remains highly uncertain. Projections of potential growth, and accordingly of the output gap, are therefore surrounded by an even higher degree of uncertainty than usual. Nevertheless, potential growth is expected to recover somewhat over the projection horizon, albeit at rates significantly below pre-crisis levels, reflecting lower contributions from both labour and capital. The corresponding estimated negative output gap is projected to narrow over the projection horizon.

PRICE AND COST PROJECTIONS

Owing primarily to recent strong oil price increases, overall HICP inflation is projected to stay above 2.0% until early 2012. Thereafter, commodity price pressures are assumed to moderate and, as the direct impact of their recent increases fades away, average annual headline inflation is projected to decline. In contrast, domestic price pressures are expected to pick up due to a higher capacity utilisation rate and tighter labour market conditions, as well as to a gradual and partial pass-through of past hikes in commodity prices. The average rate of overall HICP inflation is expected to be between 2.5% and 2.7% in 2011 and between 1.1% and 2.3% in 2012. The growth rate of the HICP excluding food and energy is projected to increase gradually over the entire projection horizon.

In more detail, following a strong increase in the first quarter of 2011, stemming mainly from rising international commodity prices, external price pressures are projected to diminish over the remainder of the projection horizon. This profile largely reflects the assumed moderation in commodity price dynamics and the recent appreciation of the euro. In contrast, domestic price pressures are projected to increase somewhat over the projection horizon. Growth in nominal compensation per employee is projected to rise gradually, reflecting the improvement in the labour market and, to a limited extent, the lagged effects of higher consumer price inflation in 2011, partly on account of wage indexation mechanisms existing in some euro area countries. Owing to the staggered maturity of negotiated nominal wages and the strong pick-up in consumer price inflation, real compensation per employee is projected to decline in 2011, before recovering somewhat over the remainder of the projection horizon. Following a decline in 2010, growth in unit labour costs is expected to turn positive in 2011 and to pick up in 2012 on account of a moderation in labour productivity gains and a gradual increase in the growth rate of nominal compensation per employee. After recovering sharply in 2010, profit margins are projected to grow less in 2011 and to accelerate slightly thereafter. The initial fall in profit margin growth reflects some

buffering from the turnaround in unit labour costs, while the ensuing rise stems from the improvement in aggregate demand. Nonetheless, profit margins are expected to remain below their 2007 levels over the projection horizon. On the basis of measures already announced, indirect taxes and increases in administered prices are also assumed to make a positive contribution to HICP inflation in 2011.

COMPARISON WITH THE MARCH 2011 PROJECTIONS

Compared with the ECB staff macroeconomic projections published in the March 2011 issue of the Monthly Bulletin, there is an upward revision to the range of the real GDP growth projection for 2011, mainly on account of the more favourable than expected GDP outcome in the first quarter of 2011. For 2012, the range is broadly unchanged. With regard to HICP inflation, the projection range for 2011 has also been revised upwards, largely reflecting higher energy prices. For 2012, the range has narrowed somewhat.

Table 2 Comparison with the March 2011 projections

(average annual percentage changes)

| | 2011 | 2012 |
|-----------------------|-------------|-------------|
| Real GDP – March 2011 | 1.3 – 2.1 | 0.8 – 2.8 |
| Real GDP – June 2011 | 1.5 – 2.3 | 0.6 – 2.8 |
| HICP – March 2011 | 2.0 – 2.6 | 1.0 – 2.4 |
| HICP – June 2011 | 2.5 – 2.7 | 1.1 – 2.3 |

Box B

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 1.6% and 2.0% in 2011 and between 1.7% and 2.0% in 2012. All the forecasts are within the ranges of the Eurosystem staff projections.

As regards inflation, the forecasts from other institutions point to average annual HICP inflation of between 2.3% and 2.6% in 2011 and between 1.6% and 1.9% in 2012. With the exception of the IMF projection for HICP inflation in 2011, which is based on different commodity price assumptions, all the forecasts fall within the range of the Eurosystem staff projections.

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 |
| IMF | April 2011 | 1.6 | 1.8 | 2.3 | 1.7 |
| Survey of Professional Forecasters | May 2011 | 1.7 | 1.7 | 2.5 | 1.9 |
| Consensus Economics Forecasts | May 2011 | 1.7 | 1.7 | 2.5 | 1.9 |
| OECD | May 2011 | 2.0 | 2.0 | 2.6 | 1.6 |
| European Commission | May 2011 | 1.6 | 1.8 | 2.6 | 1.8 |
| Eurosystem staff projections | June 2011 | 1.5 – 2.3 | 0.6 – 2.8 | 2.5 – 2.7 | 1.1 – 2.3 |

Sources: European Commission Economic Forecasts, Spring 2011; IMF World Economic Outlook, April 2011; OECD Economic Outlook, May 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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