



EUROPEAN CENTRAL BANK

EUROSYSTEM

ECB staff macroeconomic projections for the euro area

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Overview

Real GDP growth remained unexpectedly sluggish in the fourth quarter of 2018, and recent indicators point to substantially weaker than previously expected activity also in the first half of 2019. While some temporary factors are likely to have contributed to the slowdown in activity in late 2018, the broad-based worsening of economic sentiment indicators across countries and sectors in recent months suggests that more persistent adverse factors have also been at play and that the underlying cyclical momentum is somewhat weaker than previously assessed. In the shorter term, a combination of global uncertainties (such as threats of an escalation of protectionist measures and the possibility of a disorderly Brexit) as well as adverse domestic factors in some euro area countries are likely to continue to weigh on euro area activity. Thereafter, the baseline assumes that these domestic and global headwinds gradually fade out and that the fundamental factors supporting the euro area expansion remain broadly in place. These factors include, notably, the very accommodative stance of monetary policy, rising wages, a recovery in foreign demand and some fiscal loosening. As these favourable factors are expected to gradually prevail, real GDP growth is projected to increase from 1.1% in 2019 to 1.6% in 2020 and 1.5% in 2021. Compared with the December 2018 projections, real GDP growth for 2019 has been revised down by 0.6 percentage point. HICP inflation is expected to continue to decrease in the course of 2019 and to rise over the remainder of the projection horizon, reaching 1.6% in 2021. The decrease in HICP inflation in 2019 is accounted for by a sharp decline in HICP energy inflation, reflecting the recent drop in oil prices. HICP inflation excluding energy and food is projected to pick up gradually over the projection horizon, reflecting the continued but more moderate strengthening in economic activity and the tightening of labour markets. Compared with the December 2018 projections, HICP inflation has been revised down over the entire projection horizon, mainly reflecting recent weaker data outturns, the weaker outlook for economic growth and a downward revision to the oil price assumptions.¹

¹ The cut-off date for technical assumptions, such as for oil prices and exchange rates, was 12 February 2019 (see Box 1). The cut-off date for including other information in this exercise was 21 February 2019. The current macroeconomic projection exercise covers the period 2018-21. Projections 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.

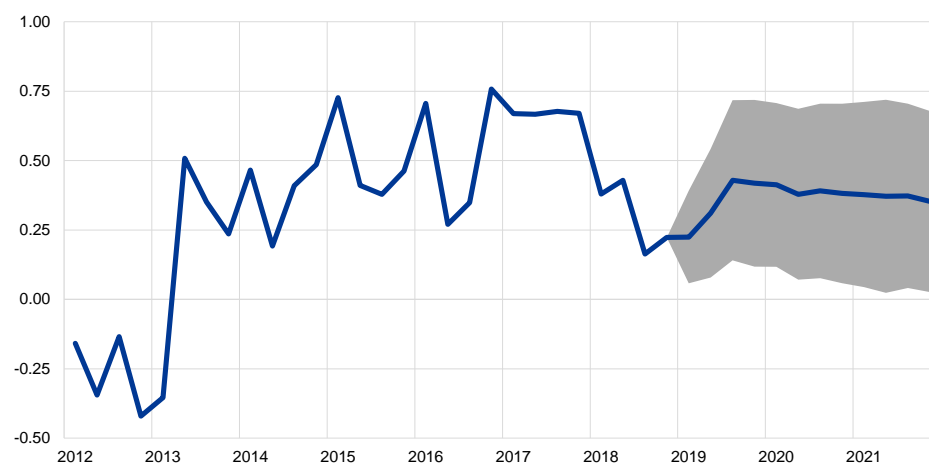
See <http://www.ecb.europa.eu/pub/projections/html/index.en.html> for an accessible version of the data underlying selected tables and charts.

1 Real economy

Growth weakened notably in the second half of 2018 and exhibited increased divergence among the largest euro area countries (see Chart 1). The slowdown in real GDP growth, from quarterly rates of 0.4% in the first half of 2018 to 0.2% in the second half, is partly related to specific factors that affected activity. Among the largest euro area countries, this was particularly the case in Germany and Italy, which recorded substantial declines in GDP growth rates (from quarterly rates of 0.4% in the first half of 2018 to a standstill in the second half of the year in Germany, and from 0.2% to negative rates for the same periods in Italy). In Germany, the sharp slowdown in the second half of 2018 was partly related to disruptions in the car industry, which have proved to be more persistent than previously expected, but it also reflected broader weakness across sectors. In Italy, uncertainty, financial market volatility and deterioration in business confidence had an increasingly adverse impact on economic activity. Quarterly GDP growth in France and Spain in the second half of 2018 slightly exceeded the pace seen in the first half of the year.

Chart 1
Euro area real GDP

(quarter-on-quarter percentage changes, seasonally and working day-adjusted quarterly data)



Note: 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. <http://www.ecb.europa.eu/pub/pdf/other/newprocedureforprojections200912en.pdf>

With few exceptions, recent sentiment indicators have broadly worsened, reflecting domestic and global uncertainties, as well as an earlier than expected weakening of the underlying cyclical momentum. The Economic Sentiment Indicator (ESI) compiled by the European Commission has continued to decline in recent months, with its decline being broad-based across euro area countries and across sectors. While remaining above historical averages, the industrial, services and consumer confidence indices included in the ESI have fallen to levels last seen in late 2016. The Purchasing Managers' Indices also continued to decline in recent months, as the assessment of new export orders and inventory stocks worsened. The

broad-based downward surprises in economic releases may reflect a stronger than previously expected impact of global uncertainties – in particular related to global trade disputes and Brexit – as well as the impact of the aforementioned uncertainties in Italy and possible adverse impacts of the protests in France. They may also suggest that the underlying cyclical momentum has weakened earlier than previously expected, acknowledging the increasingly mature cyclical position of the euro area economy. These factors are reflected in downward revisions to real GDP growth for the coming quarters.

Over the medium term, the baseline assumes a gradual dissipation of global and domestic headwinds, allowing fundamental factors supporting the euro area expansion to regain traction (see Table 1). In particular, the baseline assumes no disorderly exit of the United Kingdom from the European Union and that the current level of uncertainty regarding global trade and domestic policies in some euro area countries gradually normalises. The fading away of these negative headwinds will give way to a number of favourable fundamental factors. The ECB's monetary policy stance is expected to remain very accommodative and to continue to be transmitted to the economy. Lending to the private sector should remain resilient, spurred by low interest rates and favourable bank lending conditions for both households and non-financial corporations. Growth in private consumption and residential investment should also benefit from rising wage growth and net worth, as well as from declining unemployment. At the same time, business investment will continue to expand against a background of rising profits, high capacity utilisation and likely labour-saving investment in the context of increasing labour shortages. Euro area exports are expected to benefit from the projected recovery in euro area foreign demand and by some competitiveness gains. Finally, the fiscal stance is expected to move from broadly neutral in 2018 to loosening over the full horizon (see Section 3).

Table 1**Macroeconomic projections for the euro area**

(annual percentage changes)

	March 2019				December 2018			
	2018	2019	2020	2021	2018	2019	2020	2021
Real GDP	1.9	1.1	1.6	1.5	1.9	1.7	1.7	1.5
		[0.7 - 1.5] ¹⁾	[0.7 - 2.5] ¹⁾	[0.5 - 2.5] ¹⁾	[1.8 - 2.0] ¹⁾	[1.1 - 2.3] ¹⁾	[0.8 - 2.6] ¹⁾	[0.5 - 2.5] ¹⁾
Private consumption	1.3	1.3	1.6	1.4	1.4	1.7	1.6	1.4
Government consumption	1.1	1.7	1.6	1.4	1.1	1.6	1.4	1.4
Gross fixed capital formation	3.3	2.1	2.4	2.0	3.5	3.3	2.6	2.1
Exports²⁾	2.8	2.8	3.6	3.2	2.8	3.5	3.8	3.4
Imports²⁾	2.7	3.7	4.1	3.5	2.7	4.2	4.2	3.6
Employment	1.4	0.7	0.6	0.6	1.4	0.9	0.8	0.6
Unemployment rate (percentage of labour force)	8.2	7.9	7.7	7.5	8.2	7.8	7.5	7.1
HICP	1.7	1.2	1.5	1.6	1.8	1.6	1.7	1.8
		[0.9 - 1.5] ¹⁾	[0.8 - 2.2] ¹⁾	[0.8 - 2.4] ¹⁾	[1.8 - 1.8] ¹⁾	[1.1 - 2.1] ¹⁾	[0.9 - 2.5] ¹⁾	[0.9 - 2.7] ¹⁾
HICP excluding energy	1.2	1.4	1.6	1.6	1.3	1.5	1.7	1.8
HICP excluding energy and food	1.0	1.2	1.4	1.6	1.0	1.4	1.6	1.8
HICP excluding energy, food and changes in indirect taxes³⁾	1.0	1.2	1.4	1.6	1.0	1.4	1.6	1.8
Unit labour costs	1.8	1.7	1.4	1.6	1.7	1.3	1.6	1.8
Compensation per employee	2.2	2.1	2.4	2.6	2.2	2.1	2.5	2.7
Labour productivity	0.4	0.4	1.0	0.9	0.5	0.8	0.9	0.9
General government budget balance (percentage of GDP)	-0.5	-1.0	-1.0	-1.1	-0.5	-0.8	-0.7	-0.6
Structural budget balance (percentage of GDP)⁴⁾	-0.4	-0.8	-1.0	-1.2	-0.7	-1.0	-1.0	-1.0
General government gross debt (percentage of GDP)	85.0	83.8	82.3	81.1	84.9	83.0	80.9	79.0
Current account balance (percentage of GDP)	3.0	2.4	2.3	2.2	3.0	2.7	2.6	2.5

Note: Real GDP and components, unit labour costs, compensation per employee and labour productivity refer to seasonally and working day-adjusted data.

1) 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.

2) Including intra-euro area trade.

3) 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.

4) Calculated as the government balance net of transitory effects of the economic cycle and temporary measures taken by governments.

Nevertheless, the fading out of some tailwinds will restrain the recovery in economic growth over the latter half of the projection horizon. The technical assumptions imply that financing conditions will become gradually less favourable, although they will continue to support growth. In addition, following several years of

robust growth, employment is expected to grow at a somewhat lower rate over the medium run, mostly reflecting increasingly binding labour supply shortages in some countries.

Real disposable income is expected to maintain its solid momentum in 2019 and 2020, before weakening in 2021. This reflects offsetting developments in nominal disposable income growth and consumer price inflation in 2019 and 2020, while both weakening nominal income growth and slightly higher inflation dampen real income growth in 2021. The contribution of gross wages and salaries to nominal disposable income growth is projected to decline somewhat in 2019 (due to the impact of weaker employment growth) and to remain broadly unchanged thereafter (as an expected increase in nominal wage growth compensates for a further slowdown in employment growth). Non-labour income declined in the second half of 2018 and is projected to recover gradually over the projection horizon, broadly in line with profits. The contribution of net fiscal transfers is expected to turn positive in 2019, for the first time since 2010, reflecting a mix of cuts to direct taxation and rising transfers to households; it is expected to turn broadly neutral in 2020 and 2021.

Private consumption is projected to recover in the near term, but uncertainties in some countries are likely to weigh on its momentum. Private consumption has decelerated in the course of 2018. Looking forward, still relatively favourable consumer confidence, further expected improvements in labour market conditions and rising real wages per employee suggest stronger consumption growth over the next few quarters, further compounded by a positive effect of fiscal loosening in certain countries. At the same time, a persistent adverse impact of domestic uncertainties in some euro area countries is assumed to weigh on private consumption in the coming quarters.

Private consumption growth should be supported in the medium term by favourable financing conditions and rising net worth. Bank lending rates are projected to increase moderately over the projection horizon. However the impact of rising bank lending rates on gross interest payments is expected to be limited due to the long maturity of household debt and the relatively low share of variable rate debt on the households' balance sheet. Thus, despite the increase in lending rates, gross interest payments are expected to remain at low levels and therefore to continue to support private consumption. In addition, net worth is projected to increase by around 2.5% in real terms each year over the period 2019-21, spurred by the continued robust valuation gains on real estate holdings, which explain more than half of the projected increase. Rising real net worth should support consumption, even though household gross indebtedness remains at levels prevailing before the start of the global financial crisis.

Box 1

Technical assumptions about interest rates, exchange rates and commodity prices

Compared with the December 2018 projections, the technical assumptions include lower oil prices, a weaker effective exchange rate of the euro and lower interest rates. The technical assumptions about interest rates and commodity prices are based on market expectations, with a

cut-off date of 12 February 2019. 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 -0.3% for 2019, -0.2% for 2020 and 0.0% for 2021. The market expectations for euro area ten-year nominal government bond yields imply an average level of 1.0% in 2019, 1.3% in 2020 and 1.5% in 2021.² Compared with the December 2018 projections, market expectations for short-term interest rates have been revised down by 2 basis points for 2019, 17 basis points for 2020 and 31 basis points for 2021, while long-term interest rates have been revised down by around 40 basis points over the full horizon.

As regards commodity prices, on the basis of the path implied by futures markets by taking the average of the two-week period ending on the cut-off date of 12 February 2019, the price of a barrel of Brent crude oil is assumed to decrease from USD 71.1 in 2018 to USD 61.7 in 2019, and to ease further to USD 60.6 in 2021. This path implies that, in comparison with the December 2018 projections, oil prices in US dollars are 8.6% lower in 2019, 8.2% lower in 2020 and 8.0% lower in 2021. The prices of non-energy commodities in US dollars are assumed to rebound over the projection horizon.³

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 12 February 2019. This implies an average exchange rate of USD 1.14 per euro over the period 2019-21, which is broadly unchanged from the December 2018 projections. The effective exchange rate of the euro (against 38 trading partners) is 0.9% weaker than entailed in the December 2018 projections.

Technical assumptions

	March 2019				December 2018			
	2018	2019	2020	2021	2018	2019	2020	2021
Three-month EURIBOR (percentage per annum)	-0.3	-0.3	-0.2	0.0	-0.3	-0.3	0.0	0.3
Ten-year government bond yields (percentage per annum)	1.1	1.0	1.3	1.5	1.1	1.4	1.7	1.9
Oil price (in USD/barrel)	71.1	61.7	61.3	60.6	71.8	67.5	66.8	65.9
Non-energy commodity prices, in USD (annual percentage change)	3.9	1.2	4.3	4.3	3.0	-1.4	4.4	4.3
USD/EUR exchange rate	1.18	1.14	1.14	1.14	1.18	1.14	1.14	1.14
Euro nominal effective exchange rate (EER38) (annual percentage change)	5.2	-0.9	0.0	0.0	5.2	0.0	0.0	0.0

The expansion of residential investment is expected to continue, albeit at a more moderate pace. Confidence in the construction sector and rising granted building permits suggest a continued expansion of housing investment in the next few quarters. Nonetheless, the pace of this expansion is expected to slow. This weakening is also suggested by surveys showing a recent decline in the share of households

² 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.

³ 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 2020 and thereafter to evolve in line with global economic activity.

planning to undertake home improvements over the next year. Such moderation may emerge partly as financing conditions are set to become slightly tighter, but also as a result of increasingly binding capacity constraints in the construction sector and adverse demographic trends in some countries.

Business investment is expected to continue recovering over the projection horizon, albeit at a rather subdued pace. Business investment is estimated to have lost some momentum in the second half of 2018. Looking ahead, business investment is expected to remain rather subdued in 2019, as persistent concerns about global trade policies, a no-deal Brexit and a hard landing in China appear to have increasingly adversely affected business confidence across countries. In general, however, a number of favourable fundamentals are expected to continue to support business investment in the euro area: capacity utilisation in manufacturing remains above its long-term average and a large share of manufacturing firms report lack of equipment as a factor limiting production; financing conditions are expected to remain supportive, albeit gradually tightening over the projection horizon; profits are expected to increase, which adds further to the sizeable liquid asset overhang firms have built up in recent years; and companies may increase investment as a means of compensating for labour-related supply-side constraints.

Box 2

The international environment

After peaking in the second half of 2017, global growth momentum has continued to moderate. Economic activity in the advanced economies decelerated in the third quarter of 2018, slightly more than expected in the December 2018 projections due to the weaker performance of some non-euro area European economies and a somewhat deeper contraction in Japan. Growth in emerging market economies was steady, broadly in line with the December 2018 projections. Survey-based evidence suggests that global growth decreased in the fourth quarter of 2018 and weakened further in early 2019.

Global manufacturing activity has slowed against the backdrop of the maturing business cycle in key advanced economies. In addition, the pace of this slowdown has been accentuated by growing uncertainties weighing on the global economy, such as the escalation of the trade dispute between the United States and China, financial stress in emerging market economies during the summer months and, more recently, signs of slower growth in China with knock-on effects on other Asian economies. The slowdown of global manufacturing activity also weighed on global trade.

Global growth is projected to decrease slightly this year amid increasing headwinds. These headwinds include weaker global manufacturing activity and trade in an environment of high and rising policy and political uncertainty. Although the sizeable pro-cyclical fiscal stimulus in the United States, including lower taxes and increased public expenditures, continues to provide impetus to US and global growth this year, the partial Federal Government shutdown – the longest on record in the United States – is likely to have weighed on US activity, and the upcoming discussions on the debt ceiling could further erode US consumer confidence. In China, a slowdown in domestic demand is projected to persist in the first half of this year, as the policy support announced recently is expected to take some time to materialise. At the same time, lower oil prices are expected to provide support to growth in oil-importing countries while weighing on the activity of oil exporters.

Looking further ahead, global growth is projected to pick up somewhat over the medium term.

This reflects three key factors that shape the global growth path over the projection horizon. First, the cyclical momentum in advanced economies will slow as capacity constraints become increasingly binding and policy support gradually diminishes, amid positive output gaps and low unemployment rates across key advanced economies. In the United States, the boost to growth from the fiscal stimulus will peak in 2019 and the Federal Open Market Committee is likely to proceed with its gradual policy normalisation, albeit more cautiously. Second, an orderly transition to a lower growth path, less dependent on investment and exports, is expected to continue in China. Finally, growth is expected to recover in several emerging market economies that are currently going through, or have recently experienced, deep recessions. This applies especially, but not exclusively, to Argentina, Brazil and Turkey. In this regard, the projections assume that last year's intensification of trade tensions between the United States and China weigh mainly on activity in these two countries. Overall, the pace of global expansion will settle at below pre-crisis rates and in line with potential global growth. Global growth (excluding the euro area) is projected to decline to 3.5% this year, from 3.7% in 2018, and to increase slightly to 3.6% over the period 2020-21. Compared with the December 2018 projections, the global growth projections are broadly unrevised.

The international environment

(annual percentage changes)

	March 2019				December 2018			
	2018	2019	2020	2021	2018	2019	2020	2021
World (excluding euro area) real GDP	3.7	3.5	3.6	3.6	3.8	3.5	3.6	3.6
Global (excluding euro area) trade ¹⁾	4.9	2.4	3.4	3.6	5.1	3.5	3.6	3.6
Euro area foreign demand ²⁾	4.0	2.2	3.3	3.4	4.3	3.1	3.5	3.4

1) Calculated as a weighted average of imports.

2) Calculated as a weighted average of imports of euro area trading partners.

Slowing global industrial activity, heightened trade tensions and a weaker Asian tech cycle are expected to weigh on global trade this year, implying a more pronounced slowdown in global trade than in activity.

Looking further ahead, the global trade projections are anchored around the view that global imports will grow broadly in line with activity. Euro area foreign demand, which expanded by 4% in 2018, is expected to slow significantly, falling to 2.2% in 2019, before picking up to 3.3% and 3.4% in 2020 and 2021 respectively. Compared with the December 2018 projection exercise, euro area foreign demand has been revised down notably in 2019 and to a lesser extent in 2020, largely reflecting disappointing data in late 2018 and the projected weaker import demand from China, the rest of emerging Asia and European economies outside the euro area.

Extra-euro area exports are projected to grow slightly faster than foreign demand in the near term and in line thereafter.

Following a decline in the first quarter of 2018, extra-euro area exports are estimated to have recovered gradually in the second and third quarters and to have outpaced foreign demand in the fourth quarter. The resulting market share gains in the fourth quarter partly reflect country specific factors. As these unwind, and as foreign demand remains rather sluggish in 2019, extra-euro area export growth is expected to remain subdued in the short term, while still growing somewhat faster than foreign demand during 2019, implying slight gains in market share. The relative strength of extra-euro area exports vis-à-vis

foreign demand in the short term reflects improving price competitiveness across euro area countries, compounded by a further normalisation of car exports. Over the medium term, extra-euro area exports are expected to grow in line with foreign demand (see Box 2). Extra-euro area imports are estimated to have slowed to below the pace of exports in the fourth quarter of 2018, implying a positive contribution from net trade to real GDP growth. Looking ahead, extra-euro area imports are expected to grow broadly in line with total demand (domestic demand plus exports). As imports are projected to rise somewhat faster than exports, the contribution of net trade to economic growth is projected to turn slightly negative in 2019 and to be broadly neutral over the remainder of the projection horizon.

Employment growth is projected to decline given weakening activity and increasingly binding labour shortages in some countries.

Forward-looking surveys suggest modest employment growth in the near term. Employment growth is expected to be dampened in the near term, mainly by the sharp slowdown in activity. Over the medium term employment growth is likely to remain subdued, as labour supply is expected to limit further employment growth in some countries and labour demand is projected to moderate in line with the slowdown in activity.

The expansion of the labour force is expected to moderate over the projection horizon.

The labour force is expected to continue to expand, reflecting the projected net positive immigration of workers, the expected integration of refugees and ongoing increases in the participation rate. Nevertheless, these factors are projected to fade over the projection horizon and the adverse impact of the ageing of the population on labour force growth is expected to increase, as older cohorts leave the workforce in higher numbers than younger cohorts enter it.

The unemployment rate is expected to decline to 7.5% in 2021.

The unemployment rate stood at 7.9% in the fourth quarter of 2018, which is the lowest level observed since the third quarter of 2008. Looking ahead, the number of unemployed persons is projected to decline by around 0.9 million to 12.9 million by the end of the projection horizon, still somewhat above the level of its pre-crisis trough. While the unemployment rate is expected to drop in almost all euro area countries over the projection horizon, individual country levels are expected to still exhibit substantial differences.

Labour productivity is projected to recover over the projection horizon.

Following its strong momentum in 2017, labour productivity per worker declined slightly in quarter-on-quarter terms during the course of 2018, reflecting the unexpected weakening of activity and some labour hoarding in response to labour shortages. A moderate acceleration in productivity growth in quarter-on-quarter terms is expected later in 2019 as activity regains momentum. Beyond that, labour productivity is expected to increase at a pace close to its pre-crisis average rate of 1.0%⁴, supported by an increase in the number of hours worked per person and some gains in total factor productivity.

⁴ The average between 1999 and 2007.

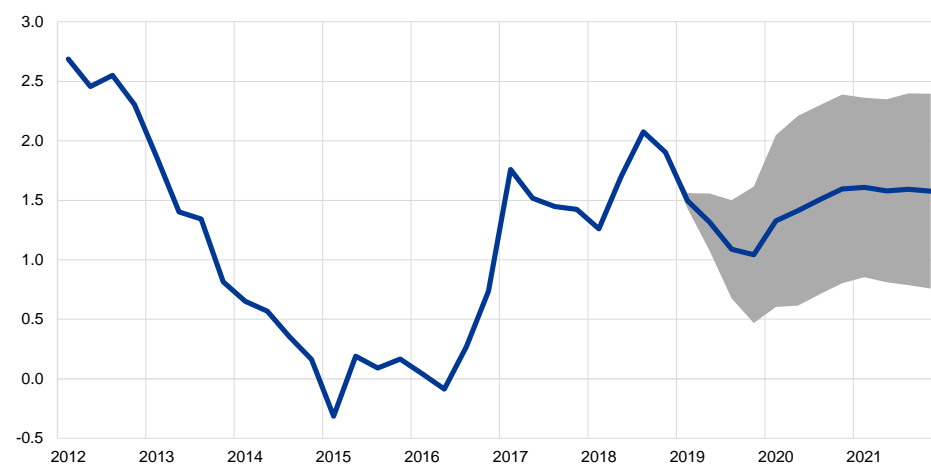
Compared with the December 2018 projections, real GDP growth has been revised down substantially for 2019 and slightly for 2020. The notable downward revision in real GDP growth for 2019 is driven by the weaker data outturn in the fourth quarter of 2018 and a less favourable assessment of the short-term outlook, reflecting a more lasting adverse impact of specific factors in some euro area countries and heightened global policy uncertainties. The medium-term projection for real GDP growth is broadly unchanged, given the assumption that a gradual dissipation of the global and domestic headwinds will allow the expansion to regain traction.

2 Prices and costs

HICP inflation is expected to continue to decrease until the fourth quarter of 2019 and to pick up over the remainder of the projection horizon, reaching 1.6% in 2021 (see Chart 2). The decline in headline inflation in 2019 is mainly accounted for by a significant decrease in HICP energy inflation given the recent strong drop in oil prices and downward base effects related to their previous increase in 2018. In 2020 and 2021, HICP energy prices are expected to rise at subdued rates consistent with the relatively flat oil price futures curve. HICP food inflation is envisaged to hover around rates of 1.9% over the projection horizon. HICP inflation excluding energy and food will be on a gradual upward path, reaching 1.6% in 2021. The pick-up in HICP inflation excluding energy and food is expected to be supported by the more gradual but continued economic recovery. Moreover, tightening labour markets will support wage growth, leading to higher domestic cost pressures. Rising non-energy commodity prices and rising underlying global prices will also bolster HICP inflation excluding energy and food.

Chart 2
Euro area HICP

(year-on-year percentage changes)



Note: 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. <http://www.ecb.europa.eu/pub/pdf/other/newprocedureforprojections200912en.pdf>

Wage growth is expected to increase somewhat further over the projection horizon as labour markets continue to tighten and measures that have dampened wage growth in some countries over the past few years expire.

Growth in compensation per employee is projected to rise from 2.2% in 2018 to 2.6% in 2021. At the same time, unit labour cost growth is expected to decline somewhat over the projection horizon, as productivity is envisaged to strengthen. The main driver behind the pick-up in wage growth is the envisaged further improvement in euro area labour market conditions over the projection horizon, with increasing labour market tightness in some parts of the euro area. Beyond the cyclical momentum, the

significant recent pick-up in headline inflation can be expected to contribute to a pick-up in wage growth in euro area countries where wage formation processes include backward-looking elements. In addition, the wage-dampening effects of crisis-related factors, such as the need for wage moderation to regain price competitiveness in some countries and pent-up wage restraint in view of binding downward rigidities in nominal wages during the crisis, should gradually abate as the economic expansion continues. Some countries have also introduced increases in minimum wages, which might pass through to the wage distribution.

Profit margins are expected to develop more favourably over the projection horizon than in 2018. Profit margins have been squeezed over the last few quarters on account of a surge in unit labour costs, reflecting the weakening in economic activity that has led to a drop in productivity growth. In addition, deteriorations in the terms of trade, related to the past increases in oil prices, weighed on profit margin developments. Both factors should lose importance over the next few quarters as the paces of economic activity and productivity pick up, while the terms of trade are expected to improve given the recent fall in oil prices.

External price pressures are expected to recede in 2019 and to rise moderately over the remainder of the projection horizon. The annual growth rate of the import deflator is envisaged to decrease in 2019, compared with 2018, and to rise gradually thereafter. This profile is strongly determined by the movements in oil prices, which pushed up import prices in 2018 and are expected to dampen their developments in 2019. At the same time, non-oil commodity prices and underlying global price pressures are assumed to rise and contribute to the gradual increase in import prices.

Compared with the December 2018 projections, the projection for HICP inflation has been revised down for the whole projection horizon. The downward revision in HICP inflation mainly reflects the assumption of significantly lower oil prices (particularly in 2019 and 2020) and a lower path for HICP inflation excluding energy and food. In turn, the downward revision in HICP inflation excluding energy and food reflects the impact of lower oil prices via indirect effects, weaker recent data outturns, a more moderate outlook for economic activity and some limited reassessment of the strength of the pass-through of wages to prices.

3 Fiscal outlook

The euro area fiscal stance is assessed to have been broadly neutral in 2018 and is projected to loosen from 2019 onwards. The fiscal policy stance is measured as the change in the cyclically adjusted primary balance net of government support to the financial sector. In 2019, the main contribution to the looser fiscal stance stems from cuts to direct taxes and social security contributions, as well as higher government expenditure in some countries. For 2020, further loosening is projected. The main contributions to this stem from further cuts to direct taxes and social security contributions, still rather strong expenditure growth and higher transfers. For 2021, the baseline incorporates some loosening that is mostly related to expenditure growth in some countries.

The euro area budget balance is projected to deteriorate in 2019 and to remain broadly unchanged for the rest of the projection horizon, while the debt ratio remains on a downward path. The widening in the government deficit is due to a deterioration in the cyclically adjusted primary balance. This is partly offset by a slight decline in interest expenditures, resulting from the replacement of high-cost old debt with new debt issued at lower interest rates. The declining path of the government debt-to-GDP ratio is supported by positive primary balances and a favourable interest-growth rate differential.

The euro area deficit outlook has deteriorated significantly compared with the December 2018 projections, in particular for 2020 and 2021. The higher budget deficit is due to a less favourable primary balance and a lower cyclical component, reflecting the weaker macroeconomic outlook. The debt-to-GDP ratio is projected to be higher, mainly reflecting an increasing interest-growth rate differential in 2019, owing to the downward revision of GDP growth, and lower primary balances.

Box 3

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, examining 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 some key underlying assumptions and the sensitivity of the projections with respect to these variables.

1) Alternative oil price paths

This sensitivity analysis aims to assess the implications of alternative oil price paths. The technical assumptions for oil price developments underlying the baseline projections, based on oil futures markets, predict a rather flat profile for oil prices, with the price of a barrel of Brent crude oil at USD 60.6 in 2021. Two alternative oil price paths are analysed. The first is based on the lower 25th percentile of the distribution provided by the option-implied densities for the oil price on 12 February

2019. This path implies a gradual decline in the oil price to USD 46.0 per barrel in 2021, which is 24.1% below the baseline assumption for that year. Using the average of the results from a number of staff macroeconomic models, this path would have a small upward impact on real GDP growth (around 0.1 percentage point in 2020 and 2021), while HICP inflation would be 0.2 percentage point lower in 2019, 0.5 percentage point lower in 2020 and 0.3 percentage point lower in 2021. The second path is based on the upper 25th percentile of the same distribution and implies an increase in the oil price to USD 77.8 per barrel in 2021, which is 28.3% above the baseline assumption for that year. This path would entail a faster increase in HICP inflation, which would be 0.4 percentage point higher in 2019, 0.5 percentage point higher in 2020 and 0.2 percentage point higher in 2021, while real GDP growth would be slightly lower (down by 0.1 percentage point in each year of the projection horizon).

2) An alternative exchange rate path

This sensitivity analysis investigates the effects of a strengthening of the exchange rate of the euro. This scenario is consistent with the distribution of the option-implied risk-neutral densities for the USD/EUR exchange rate on 12 February 2019, which is heavily skewed towards an appreciation of the euro. The 75th percentile of that distribution implies an appreciation of the euro vis-à-vis the US dollar to an exchange rate of USD 1.31 per euro in 2021, which is 15% above the baseline assumption for that year. The corresponding assumption for the nominal effective exchange rate of the euro reflects historical regularities, whereby changes in the USD/EUR exchange rate correspond to changes in the effective exchange rate with an elasticity of just above one half. In this scenario, the average of the results from a number of staff macroeconomic models points to real GDP growth being 0.1 percentage point lower in 2019, 0.6 percentage point lower in 2020 and 0.3 percentage point lower in 2021. HICP inflation would be 0.1 percentage point lower in 2019, 0.6 percentage point lower in 2020 and 0.4 percentage point lower in 2021.

Box 4

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/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).

As indicated in the table, most of other institutions' currently available projections for real GDP growth and HICP inflation are within the ranges surrounding the ECB staff projections (shown in square brackets in the table).

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

(annual percentage changes)

	Date of release	GDP growth				HICP inflation			
		2018	2019	2020	2021	2018	2019	2020	2021
Eurosystem projections	March 2019	1.9	1.1	1.6	1.5	1.7	1.2	1.5	1.6
			[0.7 - 1.5]	[0.7 - 2.5]	[0.5 - 2.5]		[0.9 - 1.5]	[0.8 - 2.2]	[0.8 - 2.4]
OECD	March 2019	1.8	1.0	1.2	-	-	-	-	-
Euro Zone Barometer	January / February 2019	1.8	1.3	1.4	1.4	1.7	1.4	1.5	1.7
Consensus Economics	January / February 2019	1.8	1.3	1.4	1.2	1.7	1.4	1.5	1.7
European Commission	February 2019	1.9	1.3	1.6	-	1.7	1.4	1.5	-
Survey of Professional Forecasters	January 2019	-	1.5	1.5	1.4	-	1.5	1.6	1.7
IMF	January 2019	1.8	1.6	1.7	-	-	-	-	-

Sources: OECD Interim Economic Outlook, March 2019; MJEconomics for the Euro Zone Barometer, February 2019 survey for 2018, 2019, 2020 and January 2019 survey for 2021; Consensus Economics Forecasts, February 2019 survey for 2018, 2019, 2020 and February 2019 survey on Trends in productivity and wages for 2021 (GDP) and January 2019 survey for 2021 (HICP); European Commission Economic Forecast, Winter 2019 (Interim) European Economic Forecast; ECB's Survey of Professional Forecasters, 2019Q1; IMF World Economic Outlook, WEO update of January 2019.

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.

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