


Executive summary

The ELNEP forecasts the strong economic growth in the euro area in 2006 (2.6%) to slow somewhat to 2.2% in 2007 and 2.1% in 2008. That will still be strong enough to reduce unemployment, but growth rates are coming down after just one year of high growth and a long period of virtual stagnation. This largely reflects external factors but also the German VAT increase, tighter monetary conditions and concerns about the sustainability of fast growth in some countries.

Key forecast figures for the euro area			
% change on previous year			
	2006	2007	2008
Gross domestic product	2.6	2.2	2.1
Private final consumption expenditure	1.8	1.7	1.9
Government consumption expenditure	2.1	1.6	1.4
Gross fixed capital formation	4.5	4.1	3.3
Net exports of goods and services ¹	0.4	0.1	0.1
Exports ²	8.4	5.8	5.0
Imports ²	7.8	5.7	5.0
Current account balance ³	-0.2	-0.3	-0.3
Employment	1.4	1.3	1.0
Unemployment rate ⁴	7.8	7.3	7.0
Unit labour cost	1.0	1.8	1.4
Inflation (HICP)	2.2	1.8	1.8
Budget surplus/deficit ³	-1.8	-1.2	-0.9

¹ contribution to growth. ³ % of nominal GDP.
² includes intra-area trade. ⁴ % of the labour force.
 Source: Eurostat, ECB, OECD, ELNEP forecast.



The European upturn seems stable and broad, but some potential downside risk factors remain. The ECB, despite the fact that inflation is well contained might continue to hike interest rates. The ELNEP estimates that a one percentage point increase in the ECB rate would reduce growth by half a percentage point by 2008 and cost 380,000 jobs. If the euro were to appreciate against the US dollar and other world currencies, the effects would be much more severe: a 10% depreciation of the dollar would, it calculates, reduce employment by more than 1 million jobs.

There are no signs of increasing inflation. Indeed the ELNEP forecasts HICP inflation to fall from 2.2% last year to 1.8% in both 2007 and 2008, meeting the ECB target of close to but below 2% despite the inflationary effect of the VAT increase in Germany.

Wage developments pose no threat to inflation. Unit labour cost growth has been strongly disinflationary (just 1.0% in 2006). The ELNEP expects

this to increase to 1.8% in 2007 before falling back once again to just 1.4% in 2008. Given the rate of productivity growth, wage increases could be higher without causing inflationary pressure. The ECB's calls for the social partners to moderate wage settlements are therefore unjustified in the current economic situation.

On the other hand the slightly faster pace of wage growth will help boost private consumption, which has been a weak point of the recovery so far. Wage increases have been substantially lower than productivity growth, causing the share of wages in national income to fall further. At the same time wage developments within the euro area have diverged, in both directions, from national productivity trends leading to competitive tensions and current account imbalances within the euro area.

It is vital that the European recovery is kept on track and growth is given a chance to lastingly reduce the still high rates of unemployment and promote fiscal consolidation. The ELNEP makes the following policy recommendations:

- Monetary policy should adopt a wait-and-see strategy, refraining from further tightening, given continued low inflation expectations, while preparing to act swiftly in response to unexpected developments such as a sharp appreciation of the euro.
- Fiscal policymakers should consolidate public finances on the back of faster economic growth, while ensuring better coordination to pay greater attention to area-wide requirements, Faster-growing countries should actively consolidate fiscal positions leaving room for low growth countries to have a more expansive fiscal policy. This would help reduce asymmetries in growth and inflation across the member-states, easing the task of the monetary authority.
- Wage-setters should move towards nominal wage increases in line with national productivity growth plus a price component compatible with the ECB's inflation target. This implies a somewhat faster overall pace of wage increases and, as with fiscal policy, a more balanced pattern across the euro area countries to avoid competitive tensions and beggar-thy-neighbour strategies.

Against a favourable economic background, 'positive' structural reforms should be implemented, in line with the Lisbon agenda, to increase labour supply and raise productivity, primarily by increasing investment in areas such as education, innovation, and childcare.

The data cut-off point for this forecast was 28 March 2007.

