

## Box 5

### Private sector expectations for inflation and economic activity in the euro area: the results of the 2003 Q2 Survey of Professional Forecasters (SPF) and other available indicators

This box presents the available indicators of private sector expectations for euro area inflation and economic activity and gives a summary of the results of the 2003 Q2 SPF conducted by the ECB in the second half of April. The survey is referred to as the Survey of Professional Forecasters (SPF) to reflect the fact that all of the participants are experts affiliated with financial or non-financial institutions based within the European Union. It is also important to bear in mind that, since the participants are not given a common set of assumptions on which to base their forecasts, the aggregate results in all likelihood reflect a relatively heterogeneous set of subjective views and assumptions. Wherever possible, the data have been presented together with other sources of private sector expectations for the same horizons.<sup>1</sup>

*1 These horizons are the calendar years 2003, 2004 and 2007. In addition, the expectations from the two additional "rolling horizons" requested in the SPF are also reported. These rolling horizons are set one and two years ahead of the period for which the latest data for each particular variable are available at the time the survey is conducted. In the 2003 Q2 SPF, these rolling horizons were March 2004 and 2005 for the HICP inflation rate, the fourth quarter of 2003 and 2004 for the rate of growth in real GDP, and February 2004 and 2005 for the unemployment rate. These rolling horizons may be useful for identifying dynamic patterns that are difficult to detect from averages over calendar years.*

### Inflation expectations for 2003 and 2004

SPF participants expect the annual inflation rate in the euro area to average 2.0% in 2003 and to decrease to 1.7% in 2004 (see the table below). Inflation expectations for 2003 have therefore been revised upwards by 0.2 percentage point, mainly as a result of high oil prices in the first months of the year. The risk of high oil prices in the event of a military conflict in the Middle East was already identified by participants in the last survey round. However, beyond 2003 inflation is expected to remain below 2%. Indeed, the latest results for 2004 show a downward revision of 0.1 percentage point. It is likely that this revised assessment is related to a deterioration in growth prospects for 2004 (see the section on growth prospects below), lower assumptions with regard to oil prices beyond mid-2003 and the stronger euro exchange rate assumed in this survey round according to the information supplied by the participants. As shown in the table below, these results are broadly in line with the figures reported both in the April 2003 issue of Consensus Economics and in the April 2003 Euro Zone Barometer for the same horizons (1.9% for 2003 and 1.6% for 2004). In the SPF, the inflation rate expected in March 2004 and March 2005 is 1.6% and 1.7% respectively.

### Results from the 2003 Q2 SPF, the 2003 Q1 SPF and Consensus Economics (April 2003)

(annual percentage changes, unless otherwise indicated)

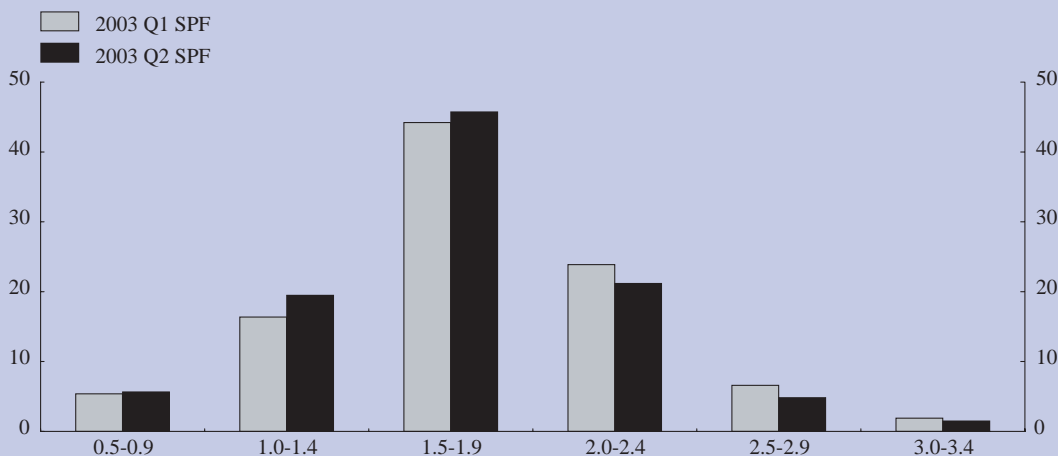
	Survey horizon				
	Mar. 2004	2003	Mar. 2005	2004	Longer term <sup>2)</sup>
<b>HICP inflation</b>					
2003 Q2 SPF	1.6	2.0	1.7	1.7	1.9
Previous SPF (2003 Q1)	-	1.8	-	1.8	1.9
Consensus (April 2003)	-	1.9	-	1.6	1.9
<b>Real GDP growth</b>	<b>2003 Q4</b>	<b>2003</b>	<b>2004 Q4</b>	<b>2004</b>	<b>Longer term <sup>2)</sup></b>
2003 Q2 SPF	1.3	1.0	2.3	2.1	2.4
Previous SPF (2003 Q1)	-	1.4	-	2.3	2.4
Consensus (April 2003)	-	1.0	-	2.0	2.2
<b>Unemployment rate <sup>1)</sup></b>	<b>Feb. 2004</b>	<b>2003</b>	<b>Feb. 2005</b>	<b>2004</b>	<b>Longer term <sup>2)</sup></b>
2003 Q2 SPF	8.9	8.8	8.5	8.7	7.5
Previous SPF (2003 Q1)	-	8.5	-	8.2	7.1
Consensus (April 2003)	-	8.8	-	8.7	-

1) As a percentage of the labour force.

2) For the SPF, longer-term inflation expectations relate to 2007. "Consensus Economics" figures refer to the period 2009-13, as reported in the April 2003 issue.

The SPF questionnaire also asks survey participants to assign some probability to actual outcomes falling within specific intervals. The probability distribution resulting from the aggregation of responses helps to assess how survey participants, on average, gauge the risk of the actual outcome being above or below the most likely range. Chart A below shows the aggregate probability distributions for average HICP inflation in 2004 in the last two survey rounds. It confirms that there have been very marginal changes in the risks surrounding the inflation outlook from the last survey round. Both distributions are centred around the interval 1.5-1.9%, which accumulates around 45% of the probability mass in both cases. Taking into account the downward revision of the estimate for 2004, the risk of the actual outcomes being above or below that interval appears to be quite balanced and the risk that inflation will be above 2% in 2004 has diminished accordingly. Inflation outcomes above the central range received a probability of 28%, while outcomes below 1.5% received around 26%. In the 2003 Q1 SPF, these probabilities were 32% and 23% respectively, which suggests that the balance of risks was on the upside.

**Chart A: Probability distribution for average inflation in 2004 in the last two SPF rounds**  
(percentages)

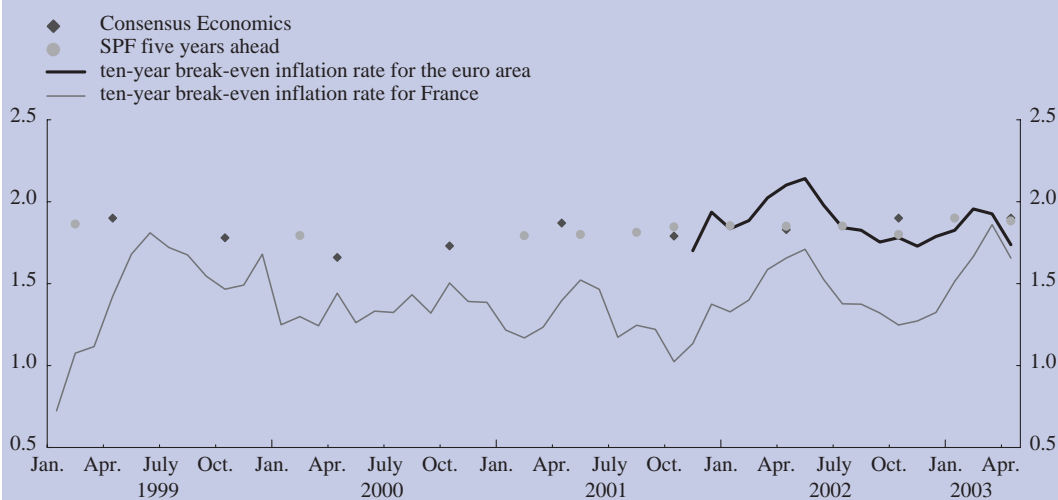


#### Indicators of longer-term inflation expectations

According to the 2003 Q2 SPF, average inflation in 2007 is expected to be 1.9%, unchanged from the previous round. This level of longer-term inflation expectations is consistent with other available measures of inflation expectations. The longer-term expectations published by the April 2003 Euro Zone Barometer have been revised upwards by 0.1 percentage point and now also indicate an expected average rate of inflation of 1.9% in 2007. Meanwhile, the April 2003 issue of Consensus Economics also expects an inflation rate of 1.9% for the period 2009-13 in the euro area as a whole.<sup>2</sup> Indicators of long-term inflation expectations extracted from financial market prices convey a similar message. Chart B below shows the ten-year break-even inflation rates extracted from French bonds linked to the French CPI and the euro area HICP (both excluding tobacco). Over

**Chart B: Indicators of long-term inflation expectations**

(average annual percentage changes)



Sources: French Treasury, Reuters, Consensus Economics and the ECB.

<sup>2</sup> Note that before this survey round the Consensus Economics figure for the euro area was constructed using national figures for Germany, Spain, France, Italy, and the Netherlands, which represent around 85% of the euro area aggregate, and these are the figures depicted in Chart B.

recent months the break-even inflation rate for the bond indexed to the euro area HICP has remained clearly below 2% after declining from the fairly high levels reached earlier in 2002. However, when interpreting the levels of these measures it is important to bear in mind that break-even inflation rates are not a direct measure of the markets' inflation expectations. This is because a variety of risk premia, including an inflation uncertainty premium and a liquidity premium, are included in the calculation.<sup>3</sup>

### **Expectations for euro area real GDP growth and unemployment**

SPF participants have revised downwards their expectations for the average annual growth rate of real GDP in 2003 to 1.0%, i.e. by 0.4 percentage point compared with the previous survey round (see the table above). These lower growth prospects in 2003 appear to be a result of the weak global economic and financial situation, although uncertainty associated with geopolitical tensions has now diminished somewhat. Growth for 2004 as a whole is expected to average 2.1%, while for 2004 Q4 a higher growth rate of 2.3% is expected. According to the April 2003 issues of Consensus Economics and the Euro Zone Barometer, euro area annual rates of real GDP growth are expected to average 1.0% in 2003 and to increase to 2.0% in 2004. Long-term growth prospects, at 2.4% for 2007 according to the SPF, 2.2% on average for the period 2009-13 on the basis of the information published by Consensus Economics, and 2.3% for 2007 according to the April 2003 Euro Zone Barometer, remain in line with the range of estimates of trend potential growth in the euro area.

According to the latest SPF, the euro area unemployment rate is expected to rise to 8.8% on average in 2003, reflecting the delayed adjustment to the past slowdown in activity and the weak growth prospects for the euro area in 2003. Thereafter it is expected to average 8.7% in 2004 and 7.5% in 2007. These results are broadly in line with those of the April 2003 Euro Zone Barometer (8.8%, 8.7% and 7.7% in 2003, 2004 and 2007 respectively) and the April 2003 Consensus Economics (8.8% and 8.7% in 2003 and 2004 respectively).

<sup>3</sup> It should be noted that the break-even inflation rate reflects the average value of inflation expectations over the maturity of the index-linked bond under consideration and is not a point estimate for a precise year (as is the case for the survey indicators of long-term inflation expectations). For a thorough description of the conceptual nature of the break-even inflation rate refer to the box entitled "Deriving long-term euro area inflation expectations from index-linked bonds issued by the French Treasury" on page 16 of the February 2002 issue of the ECB's Monthly Bulletin.