

### **Box 3**

#### **Private sector expectations for inflation and economic activity in the euro area: the results of the 2003 Q3 Survey of Professional Forecasters (SPF) and other available indicators**

The ECB conducted the 20th Survey of Professional Forecasters (SPF) between 16 and 23 July 2003. This survey asks experts affiliated with financial and non-financial institutions based in the European Union for their expectations of euro area inflation, economic activity and unemployment. It is important to bear in mind that, since the participants are not provided with a common set of assumptions, SPF aggregate results reflect a relatively heterogeneous set of subjective views and assumptions. Whenever possible, the data are presented together with other sources of private sector expectations for the same horizons.<sup>1</sup>

#### **Inflation expectations for 2003, 2004 and 2005**

Survey participants expect HICP inflation to average 1.9% in 2003, i.e. a 0.1 percentage point downward revision from the previous SPF. They also expect inflation developments in the second half of 2003 to be

*1 These horizons are the calendar years 2003, 2004, 2005 and 2008. 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 Q3 SPF, these rolling horizons were June 2004 and 2005 for the HICP inflation rate, the first quarter of 2004 and 2005 for the rate of growth in real GDP, and May 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.*

## Results from the 2003 Q3 SPF, the 2003 Q2 SPF and Consensus Economics (July 2003)

(annual percentage changes, unless otherwise indicated)

	Survey horizon					
	2003	June 2004	2004	June 2005	2005	Longer term <sup>2)</sup>
<b>HICP inflation</b>						
2003 Q3 SPF	1.9	1.5	1.5	1.7	1.7	1.9
Previous SPF (2003 Q2)	2.0	-	1.7	-	-	1.9
Consensus (July 2003)	1.9	-	1.4	-	-	1.9
<b>Real GDP growth</b>						
2003 Q3 SPF	0.7	1.2	1.7	2.1	2.3	2.4
Previous SPF (2003 Q2)	1.0	-	2.1	-	-	2.4
Consensus (July 2003)	0.6	-	1.7	-	-	2.2
<b>Unemployment rate<sup>1)</sup></b>						
2003 Q3 SPF	8.9	8.9	8.9	8.6	8.5	7.4
Previous SPF (2003 Q2)	8.8	-	8.7	-	-	7.5

1) As a percentage of the labour force.

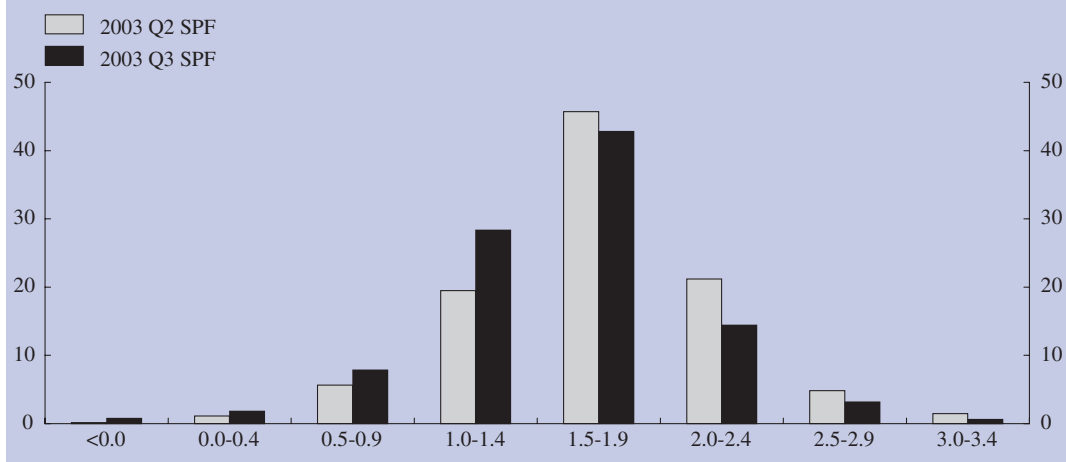
2) In the 2003 Q3 SPF longer-term expectations refer to 2008 whereas in the 2003 Q2 SPF these referred to 2007. The Consensus Economics forecast refers to the period 2009-13 (data published in the April 2003 Consensus Economics Survey).

influenced by more subdued energy prices and by weaker than previously expected real GDP growth. However, some temporary upward pressure on prices is judged to be possible on account of the hot weather and droughts that have affected several European countries so far this summer. HICP inflation for 2004 was revised downwards from the previous SPF (by 0.2 percentage point) and is now expected to average 1.5%. This revision is partly explained by lower GDP growth expectations among survey participants. Beyond 2004 inflation is expected to remain clearly below 2%, although a slight rise is expected from an average of 1.5% in 2004 to 1.7% in 2005. Overall, these results are broadly in line with the figures reported in the July 2003 issue of Consensus Economics (see table) as well as in the July 2003 Euro Zone Barometer for the same horizons (1.9% for 2003 and 1.4% for 2004).

The SPF questionnaire also asks survey participants to assign a 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 shows the aggregate probability distributions for annual average rates of HICP inflation in 2004 in the last two survey rounds. Although both distributions are centred on the interval 1.5-1.9%, which accumulates more than 40% of the probability mass in both cases, the main difference is a marked downward shift in the assessment of risks to inflation in 2004. According to qualitative information supplied by

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

(percentages)



participants, this change in the assessment is in all likelihood related to a worsening in growth prospects for 2004 (see the section on growth prospects below). The probability assigned by respondents to inflation being above 2% declined to 18% in the 2003 Q3 SPF, from 28% in the 2003 Q2 SPF. The probability of inflation averaging below 1.5% now stands at around 39%, while in the 2003 Q2 SPF this probability was 26%. However, participants clearly dismiss the possibility of there being any deflation in 2004.

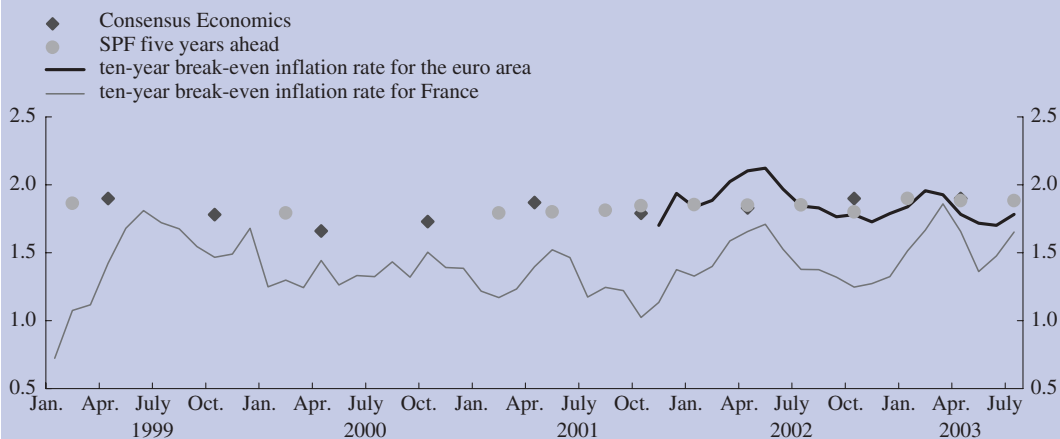
### Indicators of longer-term inflation expectations

According to the 2003 Q3 SPF, longer-term average inflation (i.e. five-year ahead) is expected to be 1.9%, unchanged from the previous round. This is also broadly consistent with other available measures of longer-term inflation expectations. For example, in April 2003 Consensus Economics also expected an inflation rate in the euro area of 1.9% for the period 2009-13 as a whole.<sup>2</sup> Meanwhile, the longer-term expectations published by the July 2003 Euro Zone Barometer have been revised downwards by 0.2 percentage point and now indicate an expected average rate of inflation of 1.7% in 2007.

Indicators of long-term inflation expectations extracted from financial market prices also convey the message that euro area price developments are expected to remain in line with price stability over the longer term. Chart B shows the ten-year break-even inflation rates extracted from French bonds linked to the French CPI and to the euro area HICP (both excluding tobacco). Both rates remain below 2%. Note, however, that these break-even inflation rates are not a pure measure of the market's inflation expectations, since they are affected by a variety of risk premia (including an inflation uncertainty premium and a liquidity premium).<sup>3</sup>

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

(average annual percentage changes)



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

### 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 to 0.7% in 2003, and to 1.7% in 2004, i.e. by 0.3 and 0.4 percentage point respectively compared with the previous survey round (see table). According to the participants, these downward revisions result from

2 Note that, before December 2002, 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.

3 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.

continued uncertainty regarding foreign demand, the appreciation of the euro/US dollar exchange rate, and weaker prospects for private investment. According to the July 2003 issues of Consensus Economics Forecasts and the Euro Zone Barometer, euro area annual rates of real GDP growth are expected to average 0.6% in 2003 and to increase to 1.7% in 2004. Long-term growth prospects, at 2.4% for 2008 according to the 2003 Q3 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 July 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 8.9% on average in 2003 and in 2004, reflecting the delayed adjustment to the past slowdown in activity and further weak growth prospects for the euro area in 2003. Thereafter it is expected to average 8.5% in 2005 and 7.4% in 2008. These results are also broadly in line with those of the July 2003 Euro Zone Barometer (8.8%, 8.8% and 7.9% in 2003, 2004 and 2007 respectively) and the July 2003 Consensus Economics (9.0% in both 2003 and 2004).