

Box 3

PRIVATE SECTOR EXPECTATIONS FOR INFLATION AND ECONOMIC ACTIVITY IN THE EURO AREA: RESULTS OF THE 2004 Q1 SURVEY OF PROFESSIONAL FORECASTERS (SPF) AND OTHER AVAILABLE INDICATORS

This box reports the results of the 22nd Survey of Professional Forecasters (SPF) conducted by the ECB between 21 and 28 January 2004. The SPF gathers expectations for euro area inflation, economic activity and unemployment from experts affiliated to financial or non-financial institutions based in the European Union. It is important to bear in mind that, given the diversity of the panel of participants, aggregate SPF results can reflect a relatively heterogeneous set of subjective views and assumptions. Whenever possible, SPF results are compared with other available indicators of private sector expectations for the same horizons.¹

Inflation expectations for 2004 and 2005

Survey participants have revised HICP inflation expectations for 2004 upwards compared with the previous (2003 Q4) SPF. HICP inflation is now expected to stand at 1.8% in 2004, i.e. a 0.2 percentage point upward revision from the previous SPF. HICP inflation expectations for 2005 have been revised downwards slightly compared with the previous SPF. They now stand at 1.7%, i.e. a downward revision of 0.1 percentage point. The upward revision for 2004, despite the appreciation of the euro, is mainly driven by indirect tax and administered price changes. These were, for the most part, incorporated only as risks in the previous survey round.

Results from the 2004 Q1 SPF, the 2003 Q4 SPF and Consensus Economics (January 2004)

(annual percentage changes, unless otherwise indicated)

	Survey horizon				
	Dec. 2004	2004	Dec. 2005	2005	Longer term ²⁾
HICP inflation					
2004 Q1 SPF	1.7	1.8	1.8	1.7	1.9
Previous SPF (2003 Q4)	-	1.6	-	1.8	1.9
Consensus (Jan. 2004)	-	1.7	-	1.7	1.8
Real GDP growth					
	2004 Q3	2004	2005 Q3	2005	Longer term ²⁾
2004 Q1 SPF	2.0	1.8	2.3	2.2	2.3
Previous SPF (2003 Q4)	-	1.7	-	2.3	2.4
Consensus (Jan. 2004)	-	1.8	-	2.1	2.1
Unemployment rate¹⁾					
	Nov. 2004	2004	Nov. 2005	2005	Longer term ²⁾
2004 Q1 SPF	8.7	8.8	8.4	8.5	7.4
Previous SPF (2003 Q4)	-	8.9	-	8.5	7.4

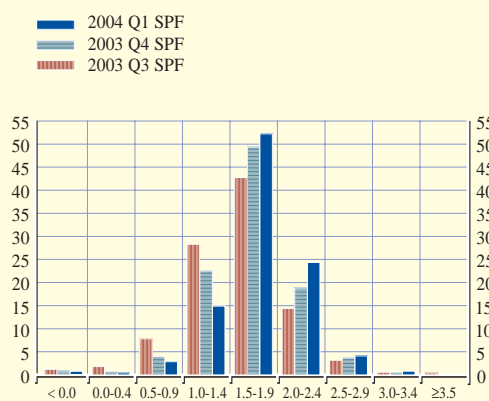
1) As a percentage of the labour force.

2) Longer-term inflation expectations refer to 2008. The Consensus Economics forecast refers to the period 2009-13 (data published in the October 2003 Consensus Economics Survey).

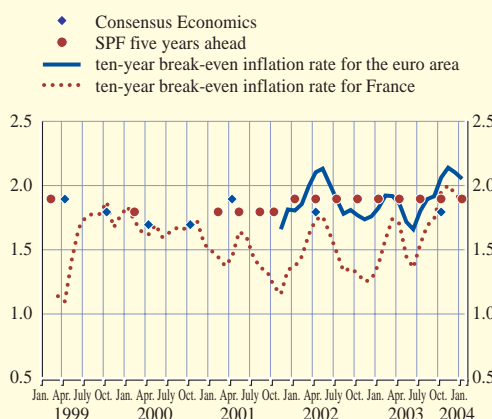
1 These horizons are the calendar years 2004, 2005 and “five years ahead, i.e. 2008”. Expectations for two additional “rolling horizons” requested in the SPF are also reported. These rolling horizons are set one and two years ahead of the period for which the latest data for each particular variable are available at the time the survey is conducted. In the 2004 Q1 SPF, these rolling horizons were December 2004 and 2005 for the HICP inflation rate, the third quarters of 2004 and 2005 for the rate of growth in real GDP and November 2004 and 2005 for the euro area unemployment rate. These rolling horizons may be useful to identify dynamic patterns that are difficult to detect from averages over calendar years.

Chart A Probability distribution for average inflation in 2004 in the last three SPF rounds

(percentages)

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

(average annual percentage changes)



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

In terms of the factors underlying inflation developments, the appreciation of the euro and low domestic price pressures are the main factors identified as exerting downward pressure. Government measures, either via indirect taxes or administered prices, and commodity price developments are the main factors cited as exerting an upward impact on prices. Overall, SPF expectations are broadly in line with the figures reported in the January 2004 issues of Consensus Economics (see the table above) and the Euro Zone Barometer (also 1.7% for both 2004 and 2005).

SPF participants are also asked to assign a probability distribution to their forecasts. This probability distribution is expressed in percentages falling within specific intervals. The probability distribution resulting from the aggregation of responses thus helps to assess how, on average, survey participants gauge the risk of the actual outcome being above or below the most likely range. Chart A reports the aggregate probability distributions for average annual rates of HICP inflation in 2004 in the last three survey rounds. Even though the bulk of the distribution continues to be centred in the 1.5-1.9% range for expected HICP inflation in 2004, there has been a further shift to the right in the latest SPF round. This shift reflects the increase in the mean expected rate, which, as highlighted above, has been driven by the gradual incorporation of indirect tax and administered price developments in forecasters' views.

Indicators of longer-term inflation expectations

Longer-term inflation expectations (i.e. five years ahead) reported by SPF participants remained at 1.9%, unchanged for the ninth consecutive SPF (see Chart B). This is broadly consistent with other available measures of longer-term inflation expectations. In October 2003 the Euro Zone Barometer forecast an average inflation rate of 1.9% in 2007, and Consensus Economics published an average inflation rate of 1.8% for the period 2009-13. Furthermore, in financial markets, there has been some reversal of the increase observed in the second half of 2003 in the ten-year break-even inflation rates derived from French government bonds linked to the euro

area HICP (excluding tobacco).² It should be noted, however, that these break-even inflation rates are not pure measures of market participants' long-term inflation expectations. They are also affected by a variety of risk premia (including inflation uncertainty and liquidity premia). Thus, while there has been some movement in the break-even inflation rate, actual long-term inflation expectations in the SPF have remained unchanged. However, there was a slight upward shift in the probability distribution of long-term inflation expectations in the 2003 Q4 round, which has been reversed in the current SPF round.³ These movements parallel developments in the break-even inflation rate.

Expectations for real GDP growth and unemployment in the euro area

Expected GDP growth in 2004 has been revised upwards slightly by 0.1 percentage point compared with the last SPF and now stands at 1.8%. For 2005, expected growth has been revised downwards slightly, by 0.1 percentage point from the previous survey round, to 2.2%. Based on respondents' qualitative answers, the expectation of an upturn in overall activity in 2004 is driven to a large extent by the recovery in the global economy, notwithstanding past exchange rate developments, followed by a recovery in domestic demand. The SPF forecasts for 2004 and 2005 are similar to those published in the January issues of Consensus Economics and the Euro Zone Barometer; both forecast GDP growth of 1.8% in 2004 and 2.1% in 2005. Finally, the expected long-term growth rate five years ahead (i.e. in 2008) stands at 2.3%, i.e. 0.1 percentage point lower than in the previous SPF survey round.

The unemployment rate in the euro area is expected to stand at 8.8% in 2004, a slight downward revision as compared with the last SPF round. This revision reflects the fact that unemployment did not rise as much as expected during the last slowdown and the fact that expectations for GDP growth have been revised upwards slightly. However, the recovery in 2004 is not expected to be strong enough to produce a noticeable improvement in the euro area unemployment rate until 2005, when that rate is expected to fall to 8.5%. The optimism shown by respondents regarding long-term developments, i.e. a decline to 7.4% in the unemployment rate in 2008, is explicitly linked to the implementation of further labour market reforms.

² 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.

³ More detailed data collected as part of the survey are available on the ECB's website (<http://www.ecb.int/stats/spf/spf.html>).