

Box 3

PRIVATE SECTOR EXPECTATIONS FOR INFLATION AND ECONOMIC ACTIVITY IN THE EURO AREA: RESULTS OF THE 2004 Q2 SURVEY OF PROFESSIONAL FORECASTERS (SPF) AND OTHER AVAILABLE INDICATORS

This box reports the results of the 23rd Survey of Professional Forecasters (SPF) conducted by the ECB between 16 and 26 April 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' expectations for HICP inflation in 2004 are unchanged at 1.8% compared with the previous SPF (2004 Q1) conducted in January 2004. However, compared with the previous round, there has been a clear increase in the number of respondents citing commodity prices developments as an upward factor. Possible indirect tax and administered price increases, due to the worsening of fiscal balances in some countries, are also factors cited as exerting an upward influence on prices. Whilst past exchange rates movements are still mentioned as a downward factor, they are given less importance than in the previous round. Developments in

Results from the 2004 Q2 SPF, the 2004 Q1 SPF and Consensus Economics (April 2004)

(annual percentage changes, unless otherwise indicated)

	Survey horizon				
	2004	Mar. 2005	2005	Mar. 2006	Longer term ²⁾
HICP inflation					
2004 Q2 SPF	1.8	1.7	1.8	1.8	1.9
Previous SPF (2004 Q1)	1.8	-	1.7	-	1.9
Consensus (April 2004)	1.7	-	1.6	-	1.9
Real GDP growth					
2004 Q2 SPF	1.6	2.0	2.1	2.2	2.3
Previous SPF (2004 Q1)	1.8	-	2.2	-	2.3
Consensus (April 2004)	1.6	-	2.0	-	2.1
Unemployment rate¹⁾					
2004 Q2 SPF	8.8	8.6	8.5	8.3	7.5
Previous SPF (2004 Q1)	8.8	-	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 2010-14 (data published in the April 2004 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 Q2 SPF, these rolling horizons were March 2005 and 2006 for the HICP inflation rate, the fourth quarter of 2004 and 2005 for the rate of growth in real GDP and February 2005 and 2006 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)

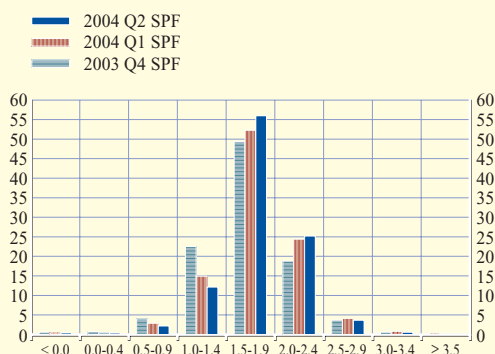
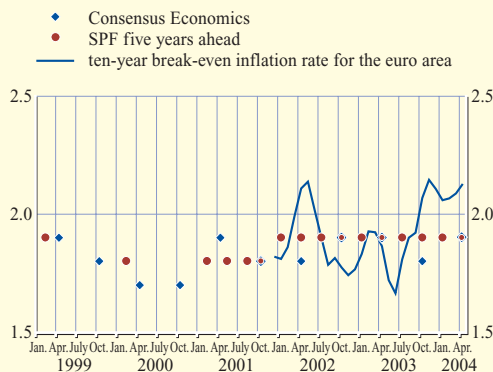


Chart B Indicators of long-term inflation expectations

(average annual percentage changes)



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

labour costs and weak domestic pressures stemming from the output gap are the main factors highlighted as exerting a downward influence on inflation over the next two years. Inflation expectations for 2005 are slightly up, to 1.8%, which appears to be due mainly to expected commodity price developments. Overall, SPF expectations are slightly higher than the figures reported in the April 2004 issues of Consensus Economics (see the table below) and the Euro Zone Barometer (1.7% for both 2004 and for 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 for expected HICP inflation in 2004 continues to be centred in the 1.5-1.9% range, there has been a further movement to the right in the latest SPF round. This movement reflects the increase in inflationary pressures, which, as highlighted above, have been driven by government measures and by commodity (oil and non-oil) price developments.

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 tenth consecutive SPF (see Chart B). This is consistent with other survey measures of longer-term inflation expectations. In April 2004 the Euro Zone Barometer forecast an average inflation rate of 1.9% in 2008, and Consensus Economics published an average inflation rate of 1.9% for the period 2010-14. In financial markets, the ten-year break-even inflation rates

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 most of 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.

derived from French government bonds linked to the euro area HICP (excluding tobacco) remains broadly unchanged in recent months.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).

Expectations for real GDP growth and unemployment in the euro area

Expected GDP growth in 2004 has been revised downwards to 1.6%, which is 0.2 percentage point lower compared with the previous SPF. While expected GDP growth in 2005 is at a higher rate, 2.1%, this has also been revised downwards by 0.1 percentage point since the last round. Based on respondents' qualitative comments, the main factors hindering growth prospects are: on the external side, recent commodity price and past exchange rate developments, and on the domestic side, a lack of confidence, subdued internal demand and a number of uncertainties relating to structural reforms. The main factors mentioned by respondents as supporting the growth outlook are, on the external side, the pick-up in global activity, and on the domestic side, an upswing in investment supported by improved profit developments and favourable financing conditions. The SPF forecasts for 2004 and 2005 are broadly similar to those published in the April issues of Consensus Economics and the Euro Zone Barometer; both forecast GDP growth of 1.6% for 2004, whilst the former forecasts 2.0% and the latter 2.1% for 2005. Considering longer-term growth rates, expectations five years ahead (i.e. 2008) stand at 2.3%, which is unchanged from the previous SPF.

Notwithstanding the small downward revisions to GDP growth, SPF respondents' expectations for unemployment in 2004 and 2005 remain unchanged compared with the previous round at 8.8% and 8.5% respectively. The gradual nature of the expected pick-up in economic activity is the main factor cited as being behind the relatively slow decline in unemployment in 2004 and 2005. However, once the economic upswing gathers steam, respondents expect the cycle to be a stronger driving factor behind the decline in unemployment.

The expected rate of unemployment in 2008 stands at 7.5%, which represents a slight upward revision compared with the previous round. Whilst some respondents cite labour market reforms as being behind the expected decline in unemployment over the longer-term horizon, a number of respondents are sceptical about the magnitude of future reforms.