

Box 4

PRIVATE SECTOR EXPECTATIONS FOR INFLATION AND ECONOMIC ACTIVITY IN THE EURO AREA: RESULTS OF THE 2004 Q3 SURVEY OF PROFESSIONAL FORECASTERS (SPF) AND OTHER AVAILABLE INDICATORS

This box reports the results of the 24th Survey of Professional Forecasters (SPF) conducted by the ECB between 16 and 26 July 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.

Inflation expectations for 2004-06

Survey participants' expectations for HICP inflation in 2004 and 2005 have been revised upwards compared with the previous SPF. Expectations for 2004 and 2005 have been revised upwards by 0.3 and 0.1 percentage point to 2.1% and 1.9% respectively. According to SPF respondents, commodity price developments, in particular oil prices, are the main factor behind these upward revisions. With regard to other external factors impacting on the inflation outlook, the euro exchange rate is expected to have a downward impact, while global growth is expected to exert an upward impact. Respondents report that domestic factors, in particular labour costs in the context of the anticipated gradual nature of the economic recovery are expected to exert a downward impact, although some of them mention the issue of possible second-round effects from commodity price increases. The profile of inflation implied by the SPF projections is quite

Results from the SPF, Consensus Economics and Euro Zone Barometer

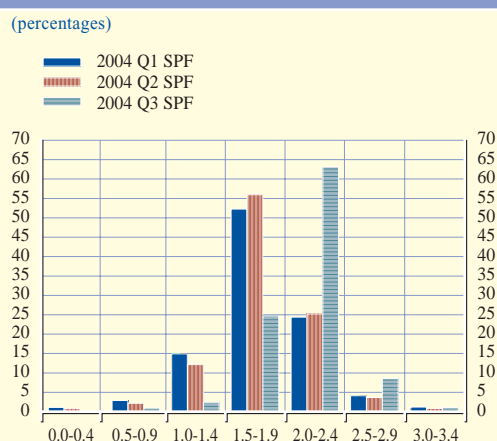
(annual percentage changes, unless otherwise indicated)

	Survey horizon					
	2004	June 2005	2005	June 2006	2006	Longer term ²⁾
HICP inflation						
2004 Q3 SPF	2.1	1.8	1.9	1.9	1.9	1.9
Previous SPF (2004 Q2)	1.8	-	1.8	-	-	1.9
Consensus (July 2004)	2.1	-	1.8	-	-	1.9
Euro Zone Barometer (July 2004)	2.1	-	1.8	-	1.9	1.9
Real GDP growth						
2004 Q3 SPF	1.8	2.1	2.1	2.3	2.3	2.3
Previous SPF (2004 Q2)	1.6	-	2.1	-	-	2.3
Consensus (July 2004)	1.7	-	2.0	-	-	2.1
Euro Zone Barometer (July 2004)	1.8	-	2.2	-	2.3	2.1
Unemployment rate¹⁾						
2004 Q3 SPF	8.9	8.7	8.6	8.3	8.3	7.5
Previous SPF (2004 Q2)	8.8	-	8.5	-	-	7.5
Consensus (July 2004)	8.9	-	8.7	-	-	-
Euro Zone Barometer (July 2004)	8.9	-	8.7	-	8.3	7.7

1) As a percentage of the labour force.

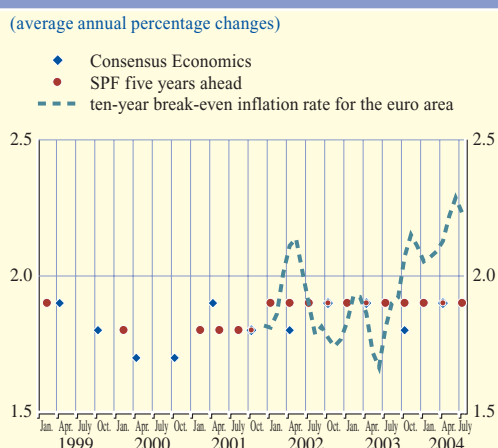
2) In the current SPF round, longer-term expectations refer to 2009. In the Euro Zone Barometer and the previous SPF round these referred to 2008. The Consensus Economics forecast refers to the period 2010-14 (data published in the April 2004 Consensus Economics Survey).

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



Sources: Eurostat, national data and ECB calculation.

Chart B Indicators of long-term inflation expectations



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

flat, with expectations for 2006 also at 1.9%. Expectations for 2006 were not surveyed in the previous round; hence it is not possible to compare with the current round.

Overall, SPF expectations are broadly in line with the figures reported in the July 2004 issues of Consensus Economics and the Euro Zone Barometer (see the table on the opposite page).

SPF participants are also asked to assign a probability distribution to their forecasts. This distribution provides information on the probability, expressed as a percentage, that the actual future outcome will fall within a specific interval. The probability distribution resulting from the aggregation of responses also 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. Compared to the previous round there has been a clear increase in the probability associated with an outcome in the 2.0-2.4% range. This movement reflects the increase in the mean expected rate. Consequently, the probability associated with inflation in 2004 falling within the 1.5-1.9% range has decreased significantly.

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 eleventh consecutive SPF (see Chart B). This is consistent with other survey measures of longer-term inflation expectations. In July 2004 the Euro Zone Barometer forecast an average inflation rate of 1.9% in 2008, and in April Consensus Economics published an average inflation rate of 1.9% for the period 2010-14 (more up-to-date information on longer-term expectations from Consensus Economics will become available in October 2004). Regarding indicators of inflation expectations extracted from financial instruments, the ten-year break-even inflation rates derived from French government bonds linked to the euro area HICP (excluding tobacco) have declined somewhat in the last few weeks,

but still remain at a relatively high level.¹ It should be noted, however, that break-even inflation rates are also affected by a variety of risk premia (including inflation uncertainty and liquidity premia). The hypothesis that the current level of the break-even inflation rate may reflect inflation uncertainty is supported by the fact that, although there was no increase in the average of respondents' point estimates for long-term inflation in the SPF, there was some increase in the probability attached to higher inflation outcomes.²

Expectations for real GDP growth and unemployment in the euro area

Expected GDP growth in 2004 has been revised upwards to 1.8%, which is 0.2 percentage point higher compared with the last SPF. The point estimate for 2005 is higher at 2.1%, unchanged since the last round. In 2006 GDP growth is expected to be 2.3%. Based on respondents' qualitative comments, forecasters expect the upturn in overall activity in 2004 to be mainly driven by strong external demand. This will in turn facilitate a more broadly based recovery thereafter. On the domestic side, favourable financing conditions should support an upswing in investment. Nevertheless, on the external side, commodity price and exchange rate developments and, on the domestic side, a lack of confidence and internal demand, and uncertainties pertaining to structural reforms are still cited as factors hindering growth prospects. The SPF forecasts for GDP growth in 2004 and 2005 are broadly similar to those published in the July issues of Euro Zone Barometer, which are 1.8% for 2004 and 2.2% for 2005, but are slightly above the ones published in the July Consensus Economics, which are 1.7% for 2004 and 2.0% for 2005 (see table above). Considering longer-term growth rates, expectations five years ahead (i.e. 2009) stand at 2.3%, which is unchanged from the previous SPF.

SPF respondents' expectations for unemployment in 2004 and 2005 have been revised upwards to 8.9% and 8.6% respectively compared with the previous round. This upward revision, despite a more positive outlook for short-term growth, mainly reflects an upward revision to historical data. The anticipated gradual nature of the economic recovery, the increasing practice of outsourcing from industries and the tendency to reduce the size of the public sector are the main factors cited as being behind the relatively slow decline forecast in unemployment in 2004 and 2005. Once the upswing gathers steam respondents expect the cycle to be the main driving factor behind the declining unemployment dynamic. The expected rate of unemployment in 2009 stands at 7.5%, unchanged 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 concerned that the magnitude of future reforms may be insufficient to have a meaningful impact on long-term unemployment.

1 It should be noted that the break-even inflation rate reflects average expected inflation over the (residual) maturity of the bonds used in its construction and is not a point estimate for a precise year (as is the case for some 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" in the February 2002 issue of the Monthly Bulletin.

2 Additional data are available on the ECB's website at www.ecb.int/stats/prices/indic/forecast/html/index.en.html