

Box 4

PRIVATE SECTOR EXPECTATIONS FOR INFLATION AND ECONOMIC ACTIVITY IN THE EURO AREA: RESULTS OF THE 2004 Q4 SURVEY OF PROFESSIONAL FORECASTERS (SPF) AND OTHER AVAILABLE INDICATORS

Between 18 and 21 October 2004 the ECB conducted its 25th Survey of Professional Forecasters (SPF). Expectations for euro area inflation, GDP growth and unemployment were gathered from a panel of experts affiliated to financial and non-financial organisations based in the EU. When considering the results reported in this box, it is important to bear in mind that, given the diversity of the panel participants, aggregate SPF results can reflect a 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.

Outlook for inflation remained unchanged compared with the previous SPF round

In terms of the outlook for HICP inflation, there was little change between the latest SPF round and the one carried out in the summer. Expectations for 2004 were unchanged at 2.1% and, with the year coming to an end, the uncertainty surrounding this figure narrowed. In 2005, inflation is expected to stand at 1.9% and remain at this level in 2006. The same profile was anticipated in the previous SPF round. According to SPF participants, oil prices will be an important factor shaping the overall inflation outlook. Higher oil prices are expected to feed through to consumer prices in 2005 but to be counterbalanced by an appreciation of the euro exchange rate, a downward base effect on tobacco and health care prices, and the gradual nature of the pick-up in GDP growth. Risks of increased wage pressures via second-round effects are judged to be limited, notably in view of the ongoing subdued developments in the labour market.

Overall, SPF expectations for 2004, 2005 and 2006 are broadly in line with the figures reported in the October 2004 issues of Consensus Economics and the Euro Zone Barometer (see the table below).

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 shows the aggregate probability distributions assigned to average annual rates of change in the HICP in 2005 in the last three survey rounds. The distribution of probabilities points to a further upward shift in the balance of risks, with SPF respondents now seeing a 39% chance of inflation standing between 2.0% and 2.4% in 2005. The probability distribution for 2006, however, has changed little compared with the previous SPF, with only a minor rise in the risk of inflation

Results from the SPF, Consensus Economics and Euro Zone Barometer

(annual percentage changes, unless otherwise indicated)

HICP inflation	Survey horizon					
	2004	Sep. 2005	2005	Sep. 2006	2006	Longer term ²⁾
2004 Q4 SPF	2.1	1.8	1.9	1.8	1.9	1.9
Previous SPF (2004 Q3)	2.1	-	1.9	-	1.9	1.9
Consensus Economics (Oct. 2004)	2.1	-	1.8	-	1.9	2.0
Euro Zone Barometer (Oct. 2004)	2.1	-	1.9	-	1.9	1.9
Real GDP growth	2004	2005 Q2	2005	2006 Q2	2006	Longer term ²⁾
2004 Q4 SPF	1.9	2.0	2.0	2.2	2.2	2.2
Previous SPF (2004 Q3)	1.8	-	2.1	-	2.3	2.3
Consensus Economics (Oct. 2004)	1.9	-	2.0	-	2.0	2.1
Euro Zone Barometer (Oct. 2004)	1.9	-	2.1	-	2.2	2.2
Unemployment rate ¹⁾	2004	Aug. 2005	2005	Aug. 2006	2006	Longer term ²⁾
2004 Q4 SPF	9.0	8.7	8.8	8.4	8.5	7.5
Previous SPF (2004 Q3)	8.9	-	8.6	-	8.3	7.5
Consensus Economics (Oct. 2004)	9.0	-	8.8	-	-	-
Euro Zone Barometer (Oct. 2004)	9.0	-	8.8	-	8.5	7.9

1) As a percentage of the labour force.

2) In the current and the previous SPF round longer-term expectations refer to 2009. In the Euro Zone Barometer these refer to 2008. The Consensus Economics forecast refers to the period 2010-14.

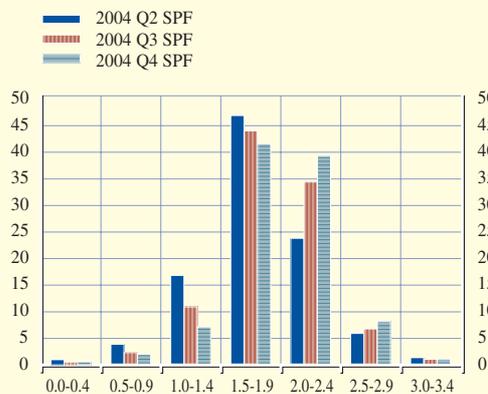
lying between 2.0% and 2.4%. The impact of geopolitical uncertainty on the inflation outlook, via oil price developments, was cited by many SPF participants as the major risk.

Unchanged longer-term inflation expectations and no further increase in the risk assessment

Longer-term inflation expectations (i.e. five years ahead) reported by SPF participants remained at 1.9% for the 12th consecutive SPF (see Chart B). This is in line with long-term

Chart A Probability distribution for average inflation in 2005 in the last three SPF rounds

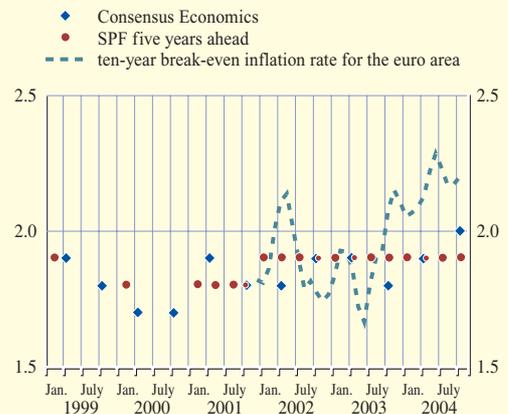
(percentages)



Sources: Eurostat, national data and ECB calculations.

Chart B Indicators of long-term inflation expectations

(average annual percentage changes)



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

inflation expectations reported in the October issue of the Euro Zone Barometer and slightly below those published in the same month by Consensus Economics, which edged up between April and October (from 1.9% to 2.0%).

Regarding indicators of inflation expectations extracted from financial instruments, the ten-year break-even inflation rate derived from French government bonds linked to the euro area HICP (excluding tobacco) remains 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 liquidity and inflation uncertainty premia). The hypothesis that the current level of the break-even inflation rate may partly reflect inflation uncertainty is supported by the fact that the probability that SPF participants attached to inflation being equal to or above 2% in the long term has also been at a relatively high level over the past year compared with earlier SPF rounds. It has, however, also declined since the previous round conducted in the summer.²

Expectations for real GDP growth and unemployment in the euro area

In 2004 GDP growth in the euro area is expected to be 1.9%, i.e. 0.1 percentage point higher than in the previous SPF. However, the forecasts for 2005 and 2006 have been revised downwards by 0.1 percentage point each, to 2.0% and 2.2%. With GDP growth seen as being driven mainly by external demand, a deceleration in world economic expansion is thought to be a major downward risk for the years ahead and explains a large part of the downward revision to the growth outlook. On the domestic side, favourable financing conditions are expected to support an upswing in investment. However, survey participants consider that low levels of confidence and weak demand due to a lack of improvement in the labour market are clouding the prospects for growth.

The SPF growth forecasts for 2004, 2005 and 2006 are broadly similar to those published in the October issues of Euro Zone Barometer, which are 1.9% for 2004, 2.1% for 2005 and 2.2% for 2006, and Consensus Economics, which are 1.9% for 2004 and 2.0% for both 2005 and 2006 (see the table above). As for longer-term growth rates, expectations five years ahead (i.e. 2009) stand at 2.2%, 0.1 percentage point lower than in the previous SPF.

The forecasts for the unemployment rate in the euro area have been revised slightly upwards compared with the previous SPF. This reflects current developments in the unemployment rate, which has not improved as expected by forecasters in the previous round, and the downward revisions to GDP growth over the next few years. The slower decline in unemployment expected in 2005 and 2006 (from 8.8% to 8.5%) reflects the fact that GDP growth is forecast to be just in line with potential. Structural reforms and population ageing are cited as factors behind the expectation of an unemployment rate of 7.5% five years ahead, unchanged from the previous SPF.

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 ECB's Monthly Bulletin.

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