

Box 4

**PRIVATE SECTOR EXPECTATIONS FOR INFLATION AND ECONOMIC ACTIVITY IN THE EURO AREA:
RESULTS OF THE SURVEY OF PROFESSIONAL FORECASTERS FOR THE FIRST QUARTER OF 2005
AND OTHER AVAILABLE INDICATORS**

This box reports the results of the 26th Survey of Professional Forecasters (SPF), conducted by the ECB between 20 and 26 January 2005. The SPF gathers expectations for euro area inflation, economic activity and unemployment from experts affiliated to financial or non-financial institutions based in the EU. 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 2005 and 2006

Compared with the previous survey, inflation expectations for 2005 were unchanged while those for 2006 were revised downwards by 0.1 percentage point. SPF panellists now expect HICP inflation to gradually decline over the two years ahead, from 1.9% on average in 2005 to 1.8% in 2006. These expectations are 0.1 percentage point higher than those reported by Consensus Economics and the Euro Zone Barometer. Over the coming months, a large majority of forecasters expect the lagged upward impact of recent oil price developments to be partly counteracted by a number of other factors. These include moderate wage developments, downward base effects from administered and food prices and the continued strength of the euro.

Results from the SPF, Consensus Economics and Euro Zone Barometer

(annual percentage changes, unless otherwise indicated)

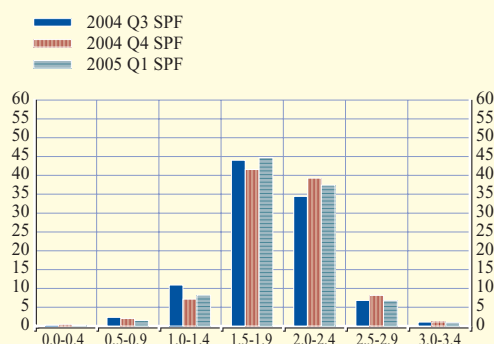
HICP inflation	Survey horizon				
	Dec. 2005	2005	Dec. 2006	2006	Longer term ²⁾
2005 Q1 SPF	1.7	1.9	1.8	1.8	1.9
Previous SPF (2004 Q4)	-	1.9	-	1.9	1.9
Consensus Economics (Jan. 2005)	-	1.8	-	1.7	2.0
Euro Zone Barometer (Jan. 2005)	-	1.8	-	1.7	1.9
Real GDP growth	2005 Q3	2005	2006 Q3	2006	Longer term ²⁾
2005 Q1 SPF	1.9	1.8	2.2	2.1	2.3
Previous SPF (2004 Q4)	-	2.0	-	2.2	2.2
Consensus Economics (Jan. 2005)	-	1.7	-	2.0	2.1
Euro Zone Barometer (Jan. 2005)	-	1.7	-	2.0	2.1
Unemployment rate ¹⁾	Nov. 2005	2005	Nov. 2006	2006	Longer term ²⁾
2005 Q1 SPF	8.7	8.8	8.4	8.5	7.5
Previous SPF (2004 Q4)	-	8.8	-	8.5	7.5
Consensus Economics (Jan. 2005)	-	8.8	-	8.6	-
Euro Zone Barometer (Jan. 2005)	-	8.9	-	8.6	7.8

1) As a percentage of the labour force.

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

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

(percentages)



Sources: Eurostat, national data and ECB calculations.

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 for average annual rates of HICP inflation in 2005 in the last three survey rounds. Since the previous round, the probability distribution has become more concentrated in the 1.5-1.9% interval. This suggests that there has been a

decline in uncertainty among forecasters regarding the average inflation rate in 2005. However, the probability distribution also points to a clear upside risk, as SPF panellists believe there is a 37.6% probability that inflation in 2005 will stand between 2.0 and 2.4%. The main risks cited by forecasters were raw material and oil prices, as well as possible unannounced tax measures.

Indicators of longer-term inflation expectations

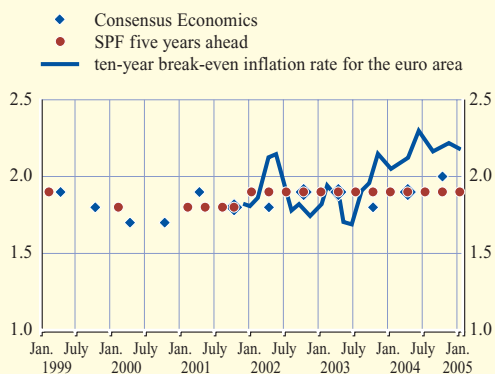
Longer-term inflation expectations remained stable at 1.9% for the 13th consecutive round of the SPF. This is in line with the recently published Euro Zone Barometer estimate and 0.1 percentage point lower than the three-month old Consensus Economics estimate (more up-to-date information on longer-term expectations from Consensus Economics will become available in April 2005). The probability distribution assigned to the longer-term inflation forecast has been shifting back towards lower outcomes for the last two SPF surveys, suggesting a slight improvement in the balance of risks to long-term inflation expectations.¹

Regarding indicators of long-term 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) has moderated in the last few weeks, although it still remains at a relatively high level.² However, the spread between the yields on nominal and inflation-linked bonds is not simply a measure of inflation expectations; it may also capture risk premia (such as inflation uncertainty and liquidity premia). The break-even inflation rate may thus increase when investors are more uncertain about their forecasts and are willing to pay a premium for a hedge. The recent decline in the break-even inflation rate may therefore be related to the slight improvement in the balance of risks to long-term expectations expressed in the SPF survey.

¹ Additional data are available on the ECB's website, at www.ecb.int/stats/prices/indic/forecast/html/index.en.html.
² 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, see 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.

Chart B Indicators of long-term inflation expectations

(average annual percentage changes)



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

Expectations for real GDP growth and unemployment in the euro area

Expected GDP growth in 2005 was revised downwards to 1.8%, which is 0.2 percentage point lower than in the previous SPF. The point estimate for 2006 was, at 2.1%, higher than for 2005 but was revised down by 0.1 percentage point compared with the previous round. On the basis of respondents' explanations, one of the main reasons for the downward revision of GDP growth was the USD/EUR exchange rate. Forecasters have revised their exchange rate assumptions upwards and now expect the euro to remain strong for the rest of 2005. Other reasons given by respondents were oil prices, which are expected to stay at a high level, and

weaker world demand. The balance of risks lay on the downside and was closely related to the above mentioned factors. Regarding upward risks, forecasters cited favourable financing conditions and improvements in profitability. The SPF forecasts are slightly more optimistic than the recent estimates from the Euro Zone Barometer and Consensus Economics, at 1.7% and 2.0% for 2005 and 2006 respectively (see table above). Looking at longer-term GDP growth rates, expectations five years ahead (i.e. for 2009) were revised up by 0.1 percentage point from the previous SPF to 2.3%. However, this revision is mainly due to rounding.

SPF respondents' expectations for unemployment in 2005 and 2006 were unchanged compared with the previous round, at 8.8% and 8.5% respectively. Forecasters did not revise their average point estimates despite the downward revision to GDP growth. However, they cited the expected gradual pace of increase in GDP and continued low capacity utilisation as the main factors preventing unemployment from declining faster in the coming years. The expected rate of unemployment in 2009 stood at 7.5%, unchanged compared with the previous round. Respondents again stressed that the decline in the unemployment rate over the long-term horizon is dependent on further labour market reforms. They said that the pick-up in economic growth and demographic developments were also likely to reduce unemployment.