

Box 5

PRIVATE SECTOR EXPECTATIONS FOR THE EURO AREA: RESULTS OF THE SURVEY OF PROFESSIONAL FORECASTERS FOR THE THIRD QUARTER OF 2005

This box reports the results of the 28th Survey of Professional Forecasters (SPF), conducted by the ECB between 18 and 22 July 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, 2006 and 2007

SPF forecasters revised upwards their overall inflation expectations for 2005 compared with the previous survey, conducted in April. The year-on-year rate of HICP inflation is now expected to stand at 2.1% on average in 2005, 0.2 percentage point higher than in the previous SPF. Inflation is then expected to decline to 1.8% in both 2006 (unchanged from the previous

Results from the SPF, Consensus Economics and the Euro Zone Barometer

(annual percentage changes, unless otherwise indicated)

HICP inflation	Survey horizon					
	2005	June 2006	2006	June 2007	2007	Longer term ²⁾
Q3 2005 SPF	2.1	1.7	1.8	1.8	1.8	1.9
<i>Previous SPF (Q2 2005)</i>	1.9	-	1.8	-	-	1.9
Consensus Economics (July 2005)	2.0	-	1.7	-	-	1.9
Euro Zone Barometer (July 2005)	2.0	-	1.7	-	1.9	1.9
Real GDP growth	2005	2006 Q1	2006	2007 Q1	2007	Longer term ²⁾
Q3 2005 SPF	1.4	1.6	1.8	2.0	2.0	2.1
<i>Previous SPF (Q2 2005)</i>	1.6	-	2.0	-	-	2.2
Consensus Economics (July 2005)	1.3	-	1.7	-	-	2.1
Euro Zone Barometer (July 2005)	1.3	-	1.7	-	2.0	2.0
Unemployment rate ¹⁾	2005	May 2006	2006	May 2007	2007	Longer term ²⁾
Q3 2005 SPF	8.9	8.7	8.7	8.4	8.4	7.6
<i>Previous SPF (Q2 2005)</i>	8.8	-	8.6	-	-	7.6
Consensus Economics (July 2005)	8.9	-	8.8	-	-	-
Euro Zone Barometer (July 2005)	8.9	-	8.8	-	8.5	7.9

1) As a percentage of the labour force.

2) In the current SPF round longer-term inflation expectations refer to 2010. In the Euro Zone Barometer and the previous SPF round these referred to 2009. The Consensus Economics forecast refers to the period 2011-15 (data published in the April 2005 Consensus Economics survey).

SPF round) and 2007. The latest SPF average forecasts are 0.1 percentage point higher than those of both Consensus Economics and the Euro Zone Barometer for 2005 and 2006. According to SPF forecasters, the short-term inflation outlook is mainly shaped by oil price developments. Together with the recent depreciation of the euro exchange rate, oil prices are given as a key factor in the upward revision of expected inflation. These factors are also cited by respondents as upside risks to their forecasts. Downward pressure on prices is expected from increased international competition and continued wage moderation. For 2006, some participants mentioned the possible downward impact of the Dutch healthcare reform on euro area inflation. On the other hand, several forecasters cited the possibility of an increase in the German VAT rate as an upside risk.

SPF participants are also asked to assign a probability distribution to their forecasts. This distribution provides information on the probability, expressed as a percentage, of the future outcome being 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, which shows the aggregate probability distribution for average annual rates of HICP inflation in 2005 in the last three rounds of the survey, highlights a strong increase in the probability associated with an outcome in the 2.0-2.4% range. This movement reflects the rise in the average expected rate. Consequently, the probability assigned by forecasters to inflation in 2005 falling within the 1.5-1.9% range has decreased significantly. The probability of inflation standing between 2.0 and 2.4% is now approximately twice that of inflation standing between 1.5 and 1.9%. The probability distribution for 2006, by contrast, has changed very little compared with the previous SPF and continues to assign a high probability (46%) to inflation being between 1.5% and 1.9%.¹

Indicators of longer-term inflation expectations

Five-year ahead inflation expectations remained unchanged at 1.9% for the 15th consecutive round. These expectations are in line with the recently published estimates from Consensus Economics and the Euro Zone Barometer. However, the probability distribution continues to

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

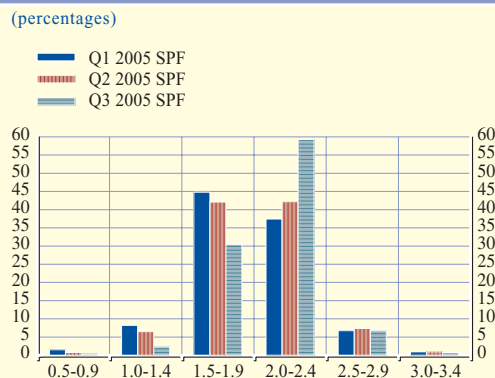
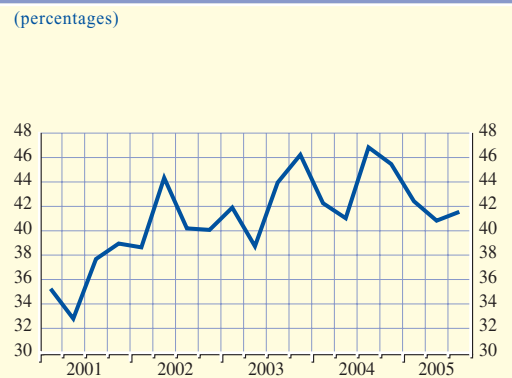


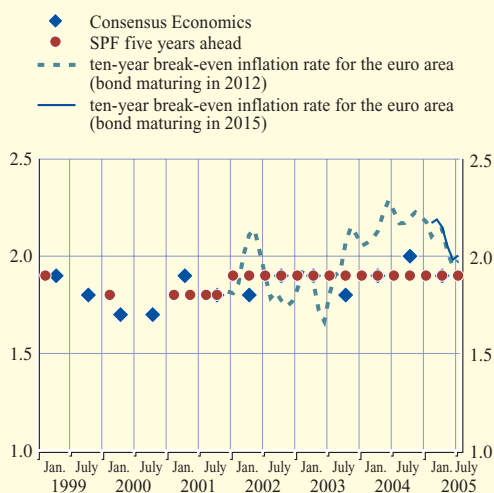
Chart B Probability of five-year ahead inflation being at or above 2%



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

Chart C Indicators of long-term inflation expectations

(average annual percentage changes)



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

point to upside risks. The probability of longer-term inflation being above 2% stands at 41.5%, slightly above the 40.8% of the last round (see Chart B).

SPF survey results can also be compared with an indicator of long-term inflation expectations among market participants calculated as the yield spread between nominal and inflation-linked bonds. In the first half of 2005 the break-even inflation rates derived from the French government inflation-linked bonds (linked to the euro area HICP excluding tobacco) maturing in 2012 and 2015 declined to a level closer to survey measures of inflation expectations (see Chart C).² However, break-even inflation rates should not be interpreted as direct measures of inflation expectations as they may also incorporate various risk premia (such as inflation uncertainty and liquidity

premia). Consequently these measures may be affected when investors become more uncertain about future inflation and are willing to pay a premium for a hedge.

Expectations for real GDP growth and unemployment in the euro area

Expectations for economic activity in the euro area in 2005 and 2006 were revised downwards compared with the previous survey round. The average annual GDP growth rate is now expected to stand at 1.4% in 2005, 0.2 percentage point lower than expected in the last SPF round. The point estimate for 2006 was 1.8%, also revised down by 0.2 percentage point since the last round. The downward revision for average growth this year is partly explained by forecasters' expectation that growth will have been relatively weak in the first half. Other reasons cited by SPF participants were the ongoing rise in oil prices and weak domestic demand. Notwithstanding the downward revisions, the overall balance of risks is seen to remain on the downside and as being closely related to the above factors.

Forecasters nevertheless mentioned a number of factors that should support euro area growth, in particular favourable financing conditions, price stability and improvements in profitability. Also, the latest depreciation of the euro exchange rate could support exports. The SPF forecasts for 2005 and 2006 are slightly more optimistic than the most recent estimates published by Euro Zone Barometer and Consensus Economics, which were both at 1.3% for 2005 and 1.7% for 2006 (see table). Finally, five-year ahead real GDP growth expectations are now at 2.1%, 0.1 percentage point lower than in the previous round. Most SPF forecasters said that longer-term growth prospects depended largely on structural reforms.

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 description of the conceptual nature of the break-even inflation rate, refer to the article entitled "Extracting information from financial asset prices" in the November 2004 issue of the Monthly Bulletin.

SPF respondents' expectations for unemployment in 2005 and 2006 were revised up from the previous round by 0.1 percentage point. The unemployment rate is now expected to stand at 8.9% in 2005 and 8.7% in 2006. The revisions to the average point estimates are in line with the downward revisions to GDP growth. Respondents cited the outlook for below-potential growth in the short term, a lack of structural reforms and strong international competition as the main factors preventing unemployment from declining faster in the coming years. Nevertheless the unemployment rate is expected to continue to fall, to 8.4% in 2007. Five-year ahead unemployment rate expectations were at 7.6%, unchanged compared with the previous round. Respondents continued to stress that the decline in the unemployment rate over the long-term horizon is dependent on further labour market reforms.