

Box 4

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

This box reports the results of the 29th ECB Survey of Professional Forecasters (SPF), conducted between 18 and 24 October 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 indicators of private sector expectations for the same horizons.

Inflation expectations for 2005, 2006 and 2007

SPF forecasters revised their short-term inflation expectations upwards. Average HICP inflation is now expected to stand at 2.2% in 2005 and 2.0% in 2006 (compared with 2.1% and 1.8% respectively in the previous SPF round). According to respondents' qualitative explanations, it is clear that this upward revision was largely influenced by recent developments in oil and petrol prices and their expected effects on domestic prices. Expectations for 2007, however, have remained unchanged, as a large majority of SPF respondents assume that higher energy prices will not have any second-round effects on wages. Moderate wage developments are indeed generally considered to make a major contribution to limiting inflationary pressures, together with strong international competition and continuing subdued domestic demand.

Results from the SPF, Consensus Economics and Euro Zone Barometer

(annual percentage changes, unless otherwise indicated)

HICP inflation	Survey horizon					
	2005	Sep. 2006	2006	Sep. 2007	2007	Longer term ²⁾
2005 Q4 SPF	2.2	1.8	2.0	1.8	1.8	1.9
<i>Previous SPF (2005 Q3)</i>	<i>2.1</i>	-	<i>1.8</i>	-	<i>1.8</i>	<i>1.9</i>
Consensus Economics (Oct. 2005)	2.2	-	1.9	-	1.8	1.9
Euro Zone Barometer (Oct. 2005)	2.2	-	1.9	-	1.8	1.9
Real GDP growth	2005	2006 Q2	2006	2007 Q2	2007	Longer term ²⁾
2005 Q4 SPF	1.3	1.7	1.7	2.0	2.0	2.1
<i>Previous SPF (2005 Q3)</i>	<i>1.4</i>	-	<i>1.8</i>	-	<i>2.0</i>	<i>2.1</i>
Consensus Economics (Oct. 2005)	1.3	-	1.6	-	1.9	1.9
Euro Zone Barometer (Oct. 2005)	1.3	-	1.6	-	1.8	2.0
Unemployment rate ¹⁾	2005	Aug. 2006	2006	Aug. 2007	2007	Longer term ²⁾
2005 Q4 SPF	8.7	8.5	8.5	8.2	8.2	7.5
<i>Previous SPF (2005 Q3)</i>	<i>8.9</i>	-	<i>8.7</i>	-	<i>8.4</i>	<i>7.6</i>
Consensus Economics (Oct. 2005)	8.8	-	8.6	-	-	-
Euro Zone Barometer (Oct. 2005)	8.8	-	8.6	-	8.5	8.0

1) As a percentage of the labour force.

2) In the current and the previous SPF rounds, longer-term inflation expectations refer to 2010. In the Euro Zone Barometer these referred to 2009. The Consensus Economics forecast refers to the period 2011-15.

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. While the large majority of SPF forecasters expect inflationary pressures to remain contained in the near future, the probability distributions provided in the survey for the fourth quarter of 2005 indicate a shift in the risks more to the upside. Chart A, which shows the aggregate probability distribution for average annual rates of HICP inflation in 2006 in the last three rounds of the survey, indicates that the associated balance of risks has clearly shifted towards higher outcomes and SPF respondents now believe there is a 44% probability that inflation in 2006 may actually stand between 2.0% and 2.4% (compared with 29% in the previous round).¹ Indeed, several SPF forecasters highlight the risk of higher oil prices, and a few also stress the risk of higher administered prices and indirect taxes.

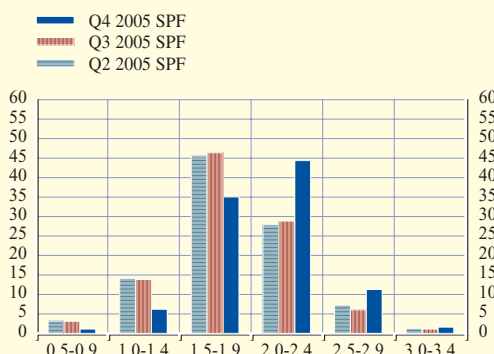
Indicators of longer-term inflation expectations

Inflation expectations five years ahead remained unchanged at 1.9% for the 16th consecutive round, in line with the recently published estimates from Euro Zone Barometer and Consensus Economics. However, as shown in Chart B, the probability that inflation five years ahead may stand at or above 2.0% rose slightly further in the fourth quarter of 2005, pointing to a slight increase in the perception of an upward risk to long-term inflation.

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. The break-even inflation rates derived from French government inflation-linked bonds (linked to the euro area HICP excluding tobacco) maturing in 2012 and 2015 have edged up

Chart A Probability distribution for average inflation in 2006 in the last three rounds of the SPF ¹⁾

(percentages)



1) Corresponds to the aggregation of each individual probability distribution provided by SPF forecasters.

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

(percentages)



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

since June 2005 (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, their development may partly reflect greater uncertainty among investors about future inflation and a resulting willingness to pay a premium for a hedge.

Expectations for real GDP growth and unemployment in the euro area

The short-term forecasts for real GDP growth were revised further downwards. Real GDP growth is now expected to stand at 1.3% in 2005 and 1.7% in 2006. The 0.1 percentage point downward revision for both years appears to have been largely driven by the relatively weak outcome resulting from data releases in the first half of 2005, as well as by the negative impact of rising oil prices. The gradual pick-up in real GDP growth expected by SPF forecasters implies a return to a 2% annual growth rate in 2007. Favourable financing conditions, price stability and improvements in profitability (mainly resulting from a fall in real unit labour costs) are seen as key factors likely to support an upswing in investment. Over the forecast horizon, the balance of risks was generally assessed to be on the downside and, according to SPF participants, largely depended on oil prices.

The SPF forecasts for 2005 are in line with the most recent estimates published by Euro Zone Barometer and Consensus Economics for 2005, but for 2006 and 2007 they are slightly more optimistic (see the table).

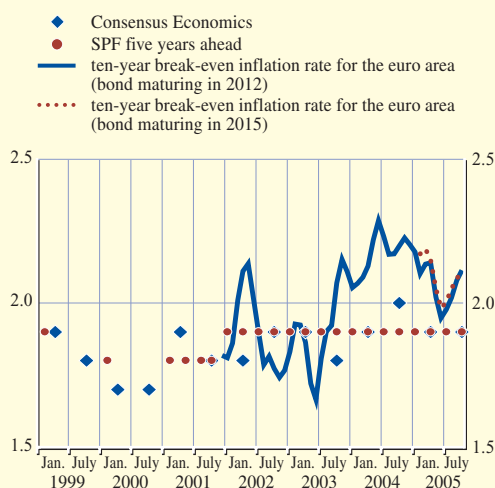
Finally, five-year ahead real GDP growth expectations stand at 2.1%, unchanged from the previous round. According to most SPF forecasters, longer-term growth prospects largely depend on structural reforms.

Despite the slightly more pessimistic economic growth outlook, the forecasts for the rate of euro area unemployment between 2005 and 2007 were revised down by 0.2 percentage point. However, these revisions were mainly due to statistical revisions to the official unemployment rate that were published between the SPF for the third quarter and the SPF for the fourth quarter of 2005. The forecast profile remained unchanged, with the euro area unemployment rate declining gradually throughout the forecast horizon. Expectations for the long-term unemployment rate were also revised down to 7.5% for 2010, but once again, it was stressed that this forecast was dependent on further labour market 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, see the article entitled "Extracting information from financial asset prices" in the November 2004 issue of the Monthly Bulletin.

Chart C Indicators of long-term inflation expectations

(average annual percentage changes)



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