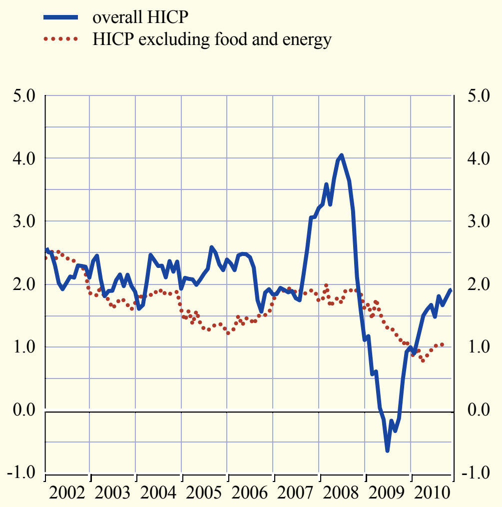
Box 5

DRIVERS OF RECENT INFLATION DEVELOPMENTS

Over the course of this year, the annual rate of change in the overall HICP has increased notably, from 0.9% in December 2009 to 1.9% in October 2010, according to Eurostat's flash estimate. At the same time, HICP inflation excluding food and energy has remained at a rather moderate level, increasing only a little so far (see Chart A). This box describes the factors behind these developments.

Chart A Overall HICP and HICP excluding food and energy

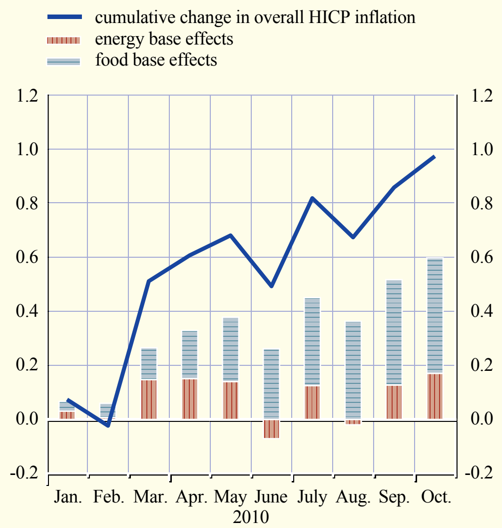
(annual percentage changes)



Source: Eurostat.

Chart B Cumulative impact of base effects on the change in annual overall HICP inflation between December 2009 and October 2010

(percentage points)



Sources: Eurostat and ECB calculations.

Food and energy prices

The rise in the annual overall HICP inflation rate up to October 2010 was partly driven by base effects stemming from the energy and food components, i.e. the impact on developments in the annual rate of change arising from movements in the index taking place 12 months earlier.[1] As depicted in Chart B, in cumulated terms, such base effects contributed by 0.6 percentage point to the 1.0 percentage point increase in overall HICP inflation between December 2009 and October 2010. The energy base effects are related to the volatile profile of energy prices in 2009, which, overall, also grew less last year than on average in previous years. The significant upward base effects from food prices can be largely explained by the muted dynamics in processed food prices and in meat prices in the course of last year, as a result of the fading-out of the shock to food commodity prices in international markets. These base effects were the main factor behind the rise in food price inflation, from -0.2% in December 2009 to 1.6% in September 2010.

By contrast, food price dynamics in the current year up to September only slightly contributed to the rise in food price inflation. This, in turn, signals that the renewed sharp increase in certain global food commodity prices seen over the summer has not yet affected consumer food prices in the euro area to any significant extent. Nevertheless, there is initial evidence of some impact on producer prices for items which are more exposed to certain international agricultural prices (such as grain mill and animal feed products). Significant increases in energy prices in the first four months of this year, triggered by a notable rise in oil prices over that period, contributed to higher overall annual HICP inflation compared with December 2009.

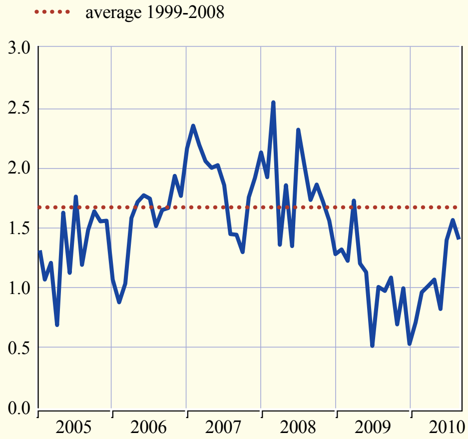
1 For an illustration of the base effects, see Box 3 entitled "Base effects and their impact on HICP inflation in 2010" in the January 2010 issue of the Monthly Bulletin.

Price developments excluding food and energy

Excluding food and energy, which leaves 70% of the HICP basket, the annual rate of change in the HICP edged up only slightly recently. It stood at 1.0% in July, August und September 2010,[2] after falling gradually from late 2008 to early 2010, reaching a trough of 0.8% in April 2010. This rise reflects the fact that short-term dynamics in the HICP excluding food and energy (as measured by the three-month annualised percentage changes based on seasonally adjusted data) have gathered momentum more recently, rebounding almost to the average growth rate seen between 1999 and 2008 (see Chart C).

Chart C Short-term dynamics in HICP excluding food and energy

(three-month annualised percentage changes, seasonally adjusted)



Source: ECB.

Several factors can explain the stronger short-term dynamics of non-energy industrial goods and services prices, which constitute the HICP excluding food and energy. First, fiscal measures, such as hikes in the VAT rate and in other indirect taxes as well as increases in administered prices in a number of euro area countries, have triggered price increases. According to the latest information based on the experimental HICP indices at constant tax rates and for administered prices available up to August 2010, fiscal measures are estimated to have added 0.5 percentage point to overall HICP inflation in the euro area since December 2009. This is in line with the average contribution over the period from 2004 to 2009, but notably above the contribution of 0.2 percentage point last year. Yet, this estimate likely overstates the realised impact of the increases in indirect taxes and administered prices. This is because the estimate assumes a full and immediate pass-through of indirect tax changes to consumer prices; may include some double-counting; and does not isolate the impact of government decisions from other influences on price-setting in the case of administered prices.[3] Second, the overall depreciation of the nominal effective exchange rate of the euro since 2009, notwithstanding the increase seen since July 2010, has likely put upward pressure on consumer prices in the euro area. The emergence of external price pressures is evidenced by the significant swing in the annual rate of change in extra-euro area import prices for consumer goods excluding food and energy, from a low of about -3% in November 2009 to rates of between 3.5% and 4% in June to August 2010. However, the extent of the pass-through of these increases to euro area consumer prices remains uncertain. Third, rises in global prices for both oil and non-oil commodities may have indirectly affected the prices of several items of the HICP excluding food and energy. Fourth, the fact that companies have been able to pass through, at least to some extent, higher indirect taxes as well as higher import and input costs could be interpreted as a sign that consumer demand has become less constrained, allowing companies to recoup some of the previously observed losses in their mark-ups.

2 Information on the annual rate of change in the HICP excluding food and energy in October 2010 will become available on 16 November 2010.

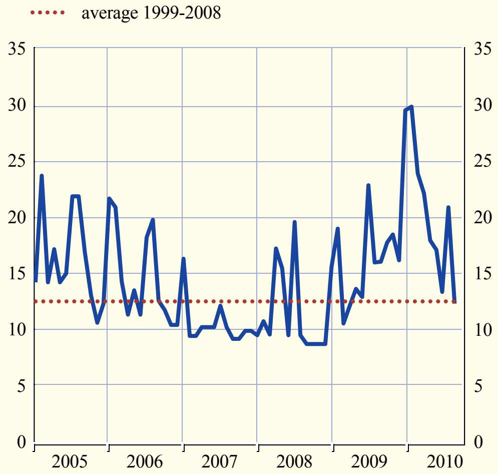
3 For further details, see Box 5 entitled "New statistical series measuring the impact of indirect taxes on HICP inflation" in the November 2009 issue of the Monthly Bulletin and Box 4 entitled "Measuring and assessing the impact of administered prices on HICP inflation" in the May 2007 issue of the Monthly Bulletin.

Overall, there are indications of a normalisation in developments of the HICP excluding food and energy following the subdued price increases, particularly from mid-2009 up to June 2010, which were of a cyclical nature owing to weak consumer demand and a significant slack in the euro area economy.

The reversal of the weakness seen lately in the HICP inflation rate excluding food and energy is also reflected in a shift in the distribution of the annual rates of change of its items. In particular, as can be seen in Chart D, the share of items with a negative annual rate of change returned, in September 2010, to its average level registered in the period from 1999 to 2008, after having strongly increased over the course of 2009 and early 2010. One noteworthy item to have displayed a reversal of the negative tendency in its annual rate of change was motor cars, as the policy of strong discounting in the wake of the financial crisis had largely come to an end. Furthermore, garment prices did not register any noticeable negative annual rate of change during the summer 2010 sales round, in contrast to the pattern seen in the summer and winter of 2009 and in the winter of 2010. This would also suggest that demand has overall improved and that deflationary pressures are virtually absent in the euro area. Nevertheless, in September 2010 there was still an unusually large share of items of the HICP excluding food and energy running at subdued annual rates of change of below 1%, signalling ongoing moderate price developments, still affected by low domestic price pressures.

Chart D Share of HICP excluding food and energy items with negative annual rates of change

(percentages)



Source: Eurostat.
Note: The share is calculated using the expenditure weights of the items included in the HICP excluding food and energy.

Conclusions

To summarise, the rise in overall HICP inflation since December 2009 can be partly attributed to base effects related to its volatile components, food and energy. In addition, notable increases in energy prices earlier this year added to the rise in overall inflation, while monthly developments in energy prices have been modest over more recent months. Food prices have also increased somewhat over the course of this year, but with still little evidence of any material impact from the recent increases in certain food commodity prices. In addition, overall HICP inflation has been upwardly affected in recent months by stronger dynamics in the HICP excluding food and energy, reflecting a certain normalisation following subdued price increases up to mid-2010, some pass-through effects from the overall depreciation of the euro, commodity price increases and above all fiscal policy measures. Looking ahead, some further, albeit small, upward base effects in the coming months are expected to shape the profile of overall HICP inflation. With some further improvement in domestic demand conditions, which may allow for an additional pass-through of tax increases and higher non-wage input costs, HICP inflation excluding food and energy can be expected to continue to edge up slightly over the coming months. Nevertheless, this rise should remain contained given moderate wage developments and the continued slack in the euro area economy.