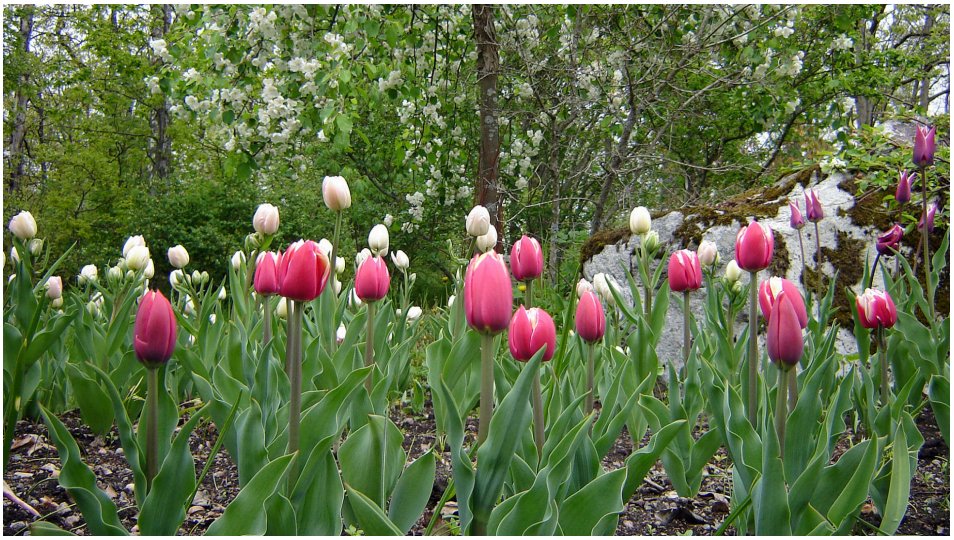
# Temporary factors have fuelled euro area inflation

4 May 2017 – Analysis – Monetary policy

The monetary policy objective in the euro area is to keep inflation as measured according to the Harmonised Index of Consumer Prices below, but close to, 2% over the medium term. This cannot be deemed to have taken place until a sustained convergence of inflation to the objective is achieved and sustained, despite exit from the current very substantial degree of monetary policy accommodation. As the objective is defined for the euro area, on average, inflation in an individual Member State may deviate from the objective. The recent pick-up in inflation has been due mainly to temporary factors.



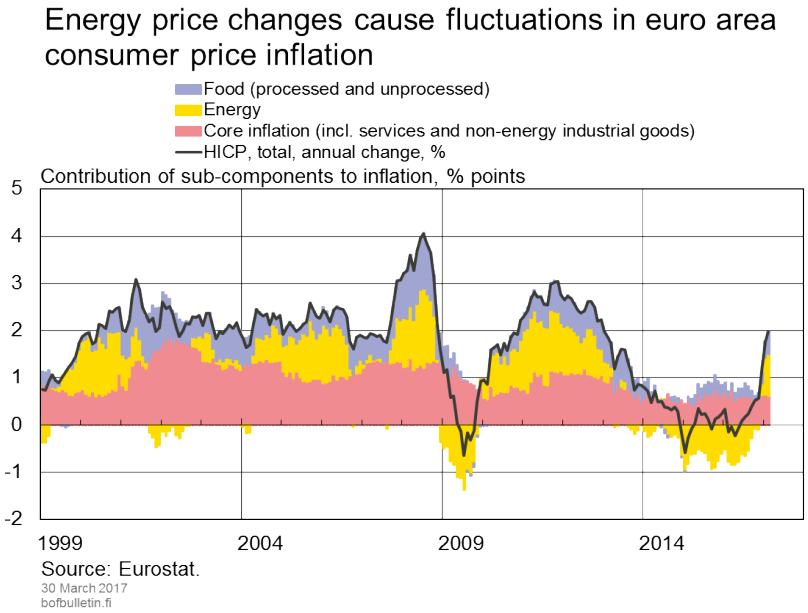
## Euro area's internal cost pressures reflected in core inflation

Inflation measured according to the euro area Harmonised Index of Consumer Prices (HICP) can be broken down into core inflation (about 71% of the total index) and the sub-components of energy (about 9.5% of the total index) and food (about 19.5% of the total index). It is advisable to conduct a separate analysis of the impact of energy and food on headline inflation, as their prices fluctuate greatly and often sporadically, for example according to supply. Supply may be affected by factors such as regulation of oil output volumes, or weather conditions in the case of unprocessed food. Euro-denominated world market prices of commodities are also influenced by exchange rate

developments.

Core inflation, covering price developments in services and non-energy industrial goods, reflects the euro area's internal cost pressures better than inflation including energy and food sub-components. For this reason, in assessing the medium-term evolution of inflation, it is also worthwhile to look at core inflation.

Chart 1




If we examine the contribution made by the sub-components of the consumer price index to the inflation rate, we can see that the impact of energy prices has displayed strong variation (Chart 1). By contrast, throughout the review period as a whole, i.e. from 1999 to early 2017, core inflation contributed much more evenly and positively to the inflation rate, in other words it exerted an upward impact on headline inflation. The chart also shows that inflation accelerated to about 2% at the beginning of 2017, mainly as a consequence of an increase in the inflation rate of energy and, in part, food. Meanwhile, core inflation in recent years has been below 1%, which is considerably lower than its average since the introduction of the euro (about 1.4%).

## Base effect has boosted energy price inflation

The inflation rate is measured as an annual change in the price index relative to the previous year's base period. For example, energy price inflation in January 2017 is affected by the level prevailing in January 2016.

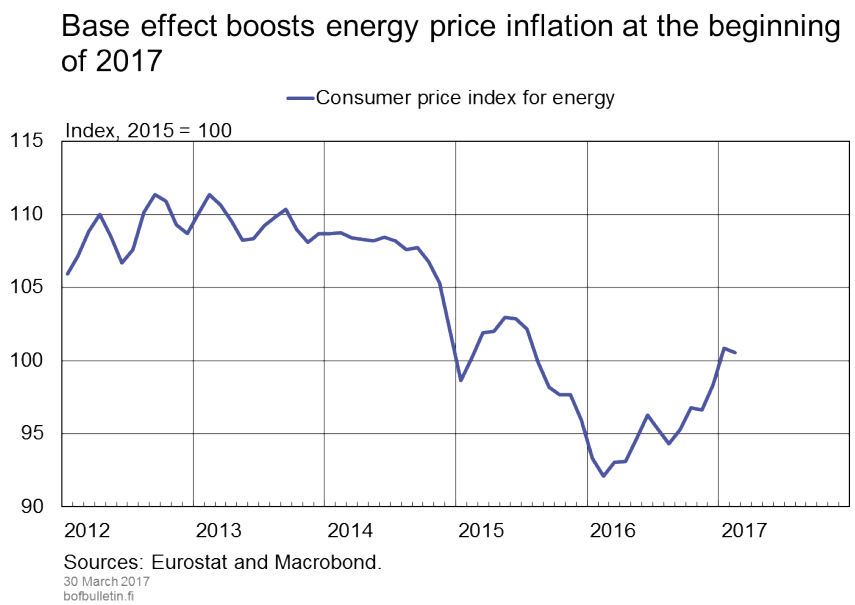
In analysing the consumer price index for energy (Chart 2), we find that in the base period, i.e. at the beginning of 2016, it was much lower than at the beginning of 2017. The reason for this is the exceptionally low price of oil in early 2016.

Therefore energy price inflation at the beginning of 2017 was very strong (around 8%), although the prices included in the energy component have no longer risen in recent

months. This phenomenon is known as the base effect. If the energy price index were to remain permanently at its current level, energy price inflation would be notably positive in 2017. After this, however, low prices in the base period would drop out of the inflation measures, meaning that in 2018 energy price inflation would be zero.

Given that energy has around a 9.5% weighting in the consumer price index, the direct impact of energy price increases on the rate of inflation in early 2017 is about 0.8 of a percentage point. If the price of oil remains stable, the upward impact of energy prices on headline inflation will fade towards the end of 2017.

Chart 2




## Second-round effects may spur inflation for a longer period

Oil price movements are reflected in inflation not only via direct effects but also indirectly through factors other than energy prices. Higher energy prices are reflected in, for example, transport costs. Although the indirect effects on inflation from oil price changes often unfold with a time lag, they are in most cases temporary. If a temporary pick-up in inflation driven by a rise in the price of oil leads to wage increases, this is a question of second-round effects[1] that may cause inflation to accelerate for a longer period.

Domestic cost pressures in the euro area have so far been subdued on the basis of realised wage inflation indicators. Any signs of effects on wages from a temporary quickening of inflation will, however, need to be closely monitored. As long as the upward impact on inflation from oil price movements is estimated to remain temporary,

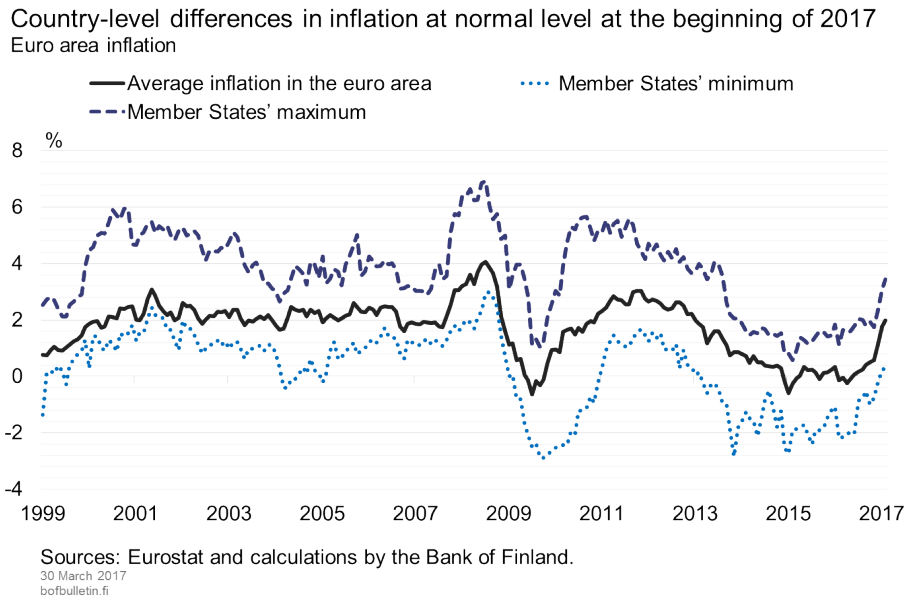
1. Direct effects, however, manifest themselves faster than indirect and second-round effects and therefore are also more easily discernible. See ECB (2010) Oil prices – their determinants and impact on euro area inflation and the macro economy. Monthly Bulletin. August.

the phenomenon can mainly be considered a change in relative prices, to which there is no need to respond by modifying the monetary policy stance.

## Cross-country variation in inflation rates

Average euro area inflation includes different rates of inflation at the country level. The differences reflect disparities in domestic cost pressures across Member States and, for example, the diverse effects of oil price changes and exchange rates.[2] The recent dispersion in country-level inflation rates does not appear to be exceptionally large (Chart 3).

Chart 3




Country-level differences in consumer price inflation are connected with the evolution of cost-competitiveness. Cost-competitiveness means the development of labour costs relative to firms' ability to pay wages compared with trading partners. Cost-competitiveness can be measured in terms of several different indicators, such as unit labour costs, which gauge the evolution of wages relative to productivity. See 'Measuring cost-competitiveness in Finland'. LINK

Since 1999 euro area average unit labour costs have increased at a good 2% rate. During the past twelve months, however, growth in unit labour costs has been only around 1% on average. A rate of increase in unit labour costs that is slower than the euro area average improves an individual euro area country's cost-competitiveness. Thus, if the country's initial cost-competitiveness is weak, this will support an adjustment process remedying the economy's internal and external imbalances. See 'Recent developments in Finland's cost-competitiveness' [LINK].

2. See e.g. Vilmi (2015) Inflation developments in the euro area — an update. Quarterly report on the euro area. Vol. 14, No 3, 29–33. European Commission.

## Tags

base effects, euroarea inflation