

### **Box 3**

#### **An analysis of price developments: the breakdown of the overall HICP into its main components**

The Governing Council of the ECB has defined price stability in terms of the overall Harmonised Index of Consumer Prices (HICP) for the euro area. In the context of the implementation of the ECB's monetary policy strategy, a careful analysis of past and current developments in the HICP is undertaken as part of the analysis of a wide range of indicators conducted under the second pillar. Developments in the overall HICP are a reflection of movements in the various items contained in the HICP, weighted according to their share in consumer expenditure. At present, 94 different sub-components of the HICP are published by Eurostat. In order to facilitate the analysis of consumer price developments, more aggregated sub-indices have been built (see, in particular, Box 1 on "The Harmonised Index of Consumer Prices" in the article entitled "The role of short-term economic indicators in the analysis of price developments in the euro area" in the April 1999 issue of the ECB Monthly Bulletin). In its regular analysis of price developments presented in the Monthly Bulletin, the ECB usually focuses on data for the overall HICP and a breakdown into five main components (unprocessed food, processed food, energy, non-energy industrial goods and services).

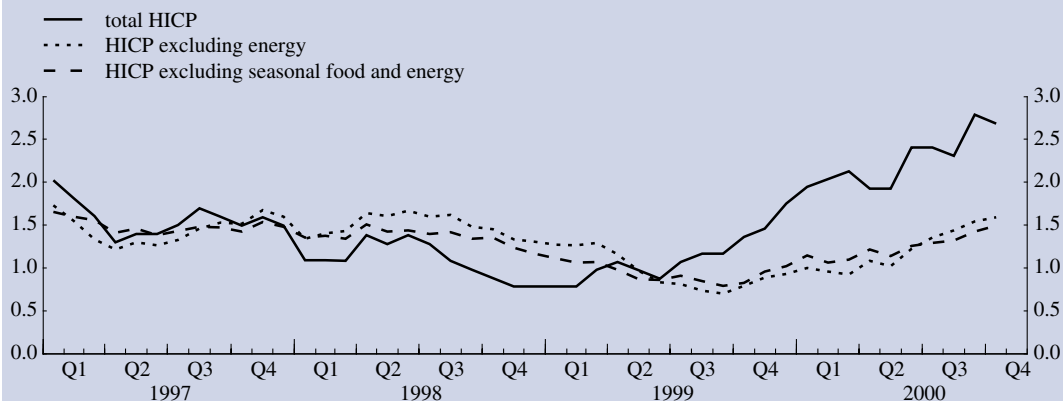
Broadly speaking, the grouping of individual price series into the five main components mentioned above is based on economic considerations. In particular, each component tends to comprise items which are related to either their use or their production and, thus, to the factors affecting their developments. For example, prices of unprocessed food items (i.e. meat, fish, fruit and vegetables) are strongly influenced by seasonal factors and weather conditions, whereas energy prices are for a large part closely related to developments in the world market price of oil. Hence, the sub-indices contained in these two main components are generally more dependent on exogenous or external factors than on domestic factors and their prices can fluctuate significantly in the short term. By contrast, the relatively less volatile prices of the items contained in the other main components are usually influenced more by developments in domestic factors such as wages and profit margins. However, they are also dependent on intermediate input costs and can, therefore, be influenced by a pass-through of changes in import prices along the domestic chain of production.

A detailed analysis of these components can help to identify and illustrate the forces behind developments in overall inflation. In addition, for analytical purposes, it can also be useful to look at aggregations of some of these components. This is identical to looking at measures of the HICP which exclude certain components, for example the HICP excluding energy or the HICP excluding energy and seasonal food (together with meat prices, seasonal food forms the unprocessed food component). In this respect, these narrower measures of consumer price inflation are useful in order to reveal the nature of "shocks" affecting price movements when

analysing current developments and assist in the assessment of risks to price stability over the medium term. However, which component should most usefully be excluded at any point in time depends on the nature of the shock in question.

### The HICP and the HICP excluding certain components in the euro area

(annual percentage changes; monthly data)



Source: Eurostat.

In the current situation, for example, it is insightful from an analytical point of view to exclude energy prices from the overall HICP. The tripling of the world market price of oil since January 1999 has led to a significant rise in the year-on-year rate of the HICP energy component over the past two years. When this component is excluded, the rate of increase in the HICP stood at 1.6% in October 2000, while overall HICP inflation was 2.7% in the same month (see the chart above). Comparing these two measures reveals that the rise in overall inflation rates over recent months has been largely a result of the direct impact of the increase in energy prices. At the same time, it shows that the increase in consumer prices excluding energy has also been on the rise since late 1999.

The exclusion of seasonal food prices (i.e. prices of fish, fruit and vegetables) or unprocessed food prices from the HICP can occasionally also be helpful. While favourable weather conditions, for example, led to a stronger than usual decline in the prices of fruit and vegetables in mid-1999, weather conditions were rather unfavourable in the middle of this year and led to a rise in those prices. Both factors are reflected in the significant increase in the annual rate of change in seasonal food prices over the summer months of 2000. Hence, the year-on-year rate of change in the HICP excluding seasonal food and energy stood at 1.5% in October 2000 and was therefore somewhat lower than HICP inflation excluding energy alone. As for meat prices, although they are not very much affected by seasonal or weather factors, they have also displayed a high degree of volatility recently, reflecting, for instance, demand shocks linked to concerns about meat safety. In October 2000 the year-on-year rate of increase in the HICP excluding unprocessed food and energy was 1.4%.

It should be noted that excluding certain items from the overall HICP does not imply that their movements can be disregarded from a monetary policy point of view. Households in the euro area ultimately have to rely on the maintenance of price stability for the whole basket of goods and services purchased by consumers. The primary objective of price stability in the euro area has therefore, for good reason, been defined in terms of the overall HICP. Moreover, in the case of energy prices, for example, there may be subsequent indirect and second-round effects on developments in the remaining components of the HICP. This is especially the case if the shock is a rather persistent phenomenon. In this respect, the narrower measures of HICP inflation are useful tools to facilitate the analysis and the illustration of developments in overall inflation, but they are not an objective for monetary policy.