

## Box 2

### RECENT DEVELOPMENTS IN EURO AREA SERVICES PRICE INFLATION

Services prices play an important role in euro area inflation, given that the sector accounts for 40.9% of the HICP index and services prices tend to display elevated growth rates.<sup>1</sup> This box reviews recent developments in euro area services price inflation at both aggregate and disaggregated levels. It assesses price pressures resulting from labour costs and the prices of inputs – such as food and crude oil – that are used intensively by some market services sub-sectors.

Annual euro area HICP inflation in services rose in 2007 to 2.5% for the year as a whole, from 2.0% in 2006 (see Table A). This was above annual overall HICP inflation for 2007 (2.1%). The increase in annual services inflation was more marked over the first half of the year, to some extent owing to the VAT increase in Germany, thereafter receding slightly. In 2007 as a whole, growth in compensation per employee for market services averaged 2.4%, while the corresponding unit labour costs rose at an only moderately slower pace in light of low labour productivity growth in market services (see Table B). The hourly labour cost index for market services rose by 2.4% in 2007 as a whole.<sup>2</sup> Data

1 The share of the services sector in overall gross value added is much larger, at about 70% (some 50% in the case of market services and some 20% for non-market services), using the latest data from the EU KLEMS database for 2005. See M. Timmer, T. van Moergastel, E. Stuijvenwold, G. Ypma, M. O'Mahony and M. Kangasniemi, "EU KLEMS growth and productivity accounts, Version 1.0", March 2007. The groupings under market services are listed in Table B. Non-market services include public administration, education, health and some other services.

2 The hourly labour cost index refers to total compensation for all employees divided by all hours worked by employees (including overtime). The index primarily covers the non-agricultural business sector. See the boxes entitled "A comparison of the available labour cost indicators in the euro area: conceptual differences and their behaviour in the period 1999-2002" and "Latest developments in sectoral wages and labour costs in the euro area" in the June 2003 and April 2006 issues, respectively, of the ECB's Monthly Bulletin.

**Table A HICP services inflation**

(annual percentage changes, unless otherwise indicated)

	Weights		2006	2007	2007	2007	2007	2007	2007	2008	2008
	% of total services	% of total HICP index									
<b>Total services</b>	<b>100.0</b>	<b>40.9</b>	<b>2.0</b>	<b>2.5</b>	<b>2.4</b>	<b>2.6</b>	<b>2.5</b>	<b>2.5</b>	<b>2.5</b>	<b>2.5</b>	<b>2.4</b>
Recreation and personal	35.9	14.7	2.3	2.9	2.8	2.9	3.0	3.0	3.0	3.0	3.1
Transport	14.9	6.1	2.5	2.6	2.9	2.6	2.4	2.6	2.8	3.0	3.0
Communications	8.0	3.3	-3.3	-1.9	-2.1	-1.9	-1.5	-2.1	-2.3	-2.9	-3.1
Housing	24.6	10.0	2.5	2.7	2.6	2.7	2.7	2.7	2.6	2.6	2.5
Miscellaneous	16.6	6.8	2.3	3.2	2.5	3.6	3.4	3.2	3.2	3.2	3.2

Source: Eurostat.

Note: Weights are 2008 HICP index weights.

on compensation per employee and the hourly labour cost index both point to a levelling-off in wage pressure in the second half of 2007 (see Table B).<sup>3</sup>

More recently, annual services price inflation has decreased slightly, to 2.4% in February 2008. It has been below the latest figures for overall annual HICP inflation (3.5% in March, according to the flash release), which have been affected in particular by higher prices for food and energy – the most volatile of the index's main components.

<sup>3</sup> Moreover, all labour cost indicators suggest less intense wage pressure in trade and repairs, hotels and restaurants, and transport and communications than in financial intermediation and in real estate, renting and business activities (see Table B).

**Table B Labour cost indicators in market services**

(annual percentage changes, unless otherwise indicated)

	Weights		2006	2007	2007	2007	2007	2007
	% of market services	% of total economy						
<i>Hourly labour cost index</i>								
<b>Total market services</b>	<b>100.0</b>	<b>39.9</b>	<b>2.1</b>	<b>2.4</b>	<b>2.1</b>	<b>2.4</b>	<b>2.5</b>	<b>2.5</b>
Trade and repairs	37.1	14.8	2.3	1.9	1.7	2.0	1.9	1.8
Hotels and restaurants	11.6	4.6	2.8	1.8	0.8	2.2	2.3	1.7
Transport and communications	13.7	5.5	2.0	2.5	2.1	2.9	2.6	2.5
Financial intermediation	7.0	2.8	1.8	3.3	4.0	3.4	2.0	3.9
Real estate, renting and business activities	30.6	12.2	1.9	2.5	1.8	2.2	3.2	2.8
<i>Compensation per employee</i>								
<b>Total market services</b>	<b>100.0</b>	<b>39.9</b>	<b>1.9</b>	<b>2.4</b>	<b>2.7</b>	<b>2.5</b>	<b>2.1</b>	<b>2.2</b>
Trade and repairs; hotels and restaurants; transport and communications	62.4	24.9	1.6	1.8	1.8	1.9	1.8	1.8
Financial intermediation; real estate, renting and business activities	37.6	15.0	1.7	2.7	3.2	2.8	2.3	2.4
<i>Unit labour costs</i>								
<b>Total market services</b>	<b>100.0</b>	<b>39.9</b>	<b>1.1</b>	<b>1.7</b>	<b>1.4</b>	<b>1.8</b>	<b>1.6</b>	<b>2.1</b>
Trade and repairs; hotels and restaurants; transport and communications	62.4	24.9	0.4	0.5	-0.4	0.1	0.7	1.4
Financial intermediation; real estate, renting and business activities	37.6	15.0	2.0	3.3	3.5	3.8	2.8	3.1

Sources: Eurostat and ECB calculations.

Note: Weights are 2005 shares in the number of employees recorded in the national accounts. Data for compensation per employee and unit labour costs for 2007 as a whole are averages up to the third quarter. Growth rates for total market services are not weighted averages of growth rates for sub-sectors. The categories shown correspond to the broad NACE Rev. 1.1 groupings: trade and repairs (G), hotels and restaurants (H), transport and communications (I), financial intermediation (J) and real estate, renting and business activities (K).

As in past years, services items made the largest contribution to overall HICP inflation throughout 2007. In January and February 2008, however, energy equalled services' contribution, with both components contributing 1.0 percentage point (see Chart).

At a disaggregated level, annual services price inflation was in 2007 led by prices for recreational and personal services (2.9% year on year) and miscellaneous items such as education and financial services (3.2%) (see Table A). Inflation in these two sub-sectors has remained high at the start of 2008. Inflation in recreational and personal services has been driven by rises exceeding 3% year on year in the category "restaurants, cafés and the like", which represents almost 7% of the HICP index.<sup>4</sup> In the first half of 2007, the German VAT increase seems to have contributed to the higher inflation in the items included in this category, which, from the second half, experienced inflationary pressure from the sharp increase in food input prices. Most

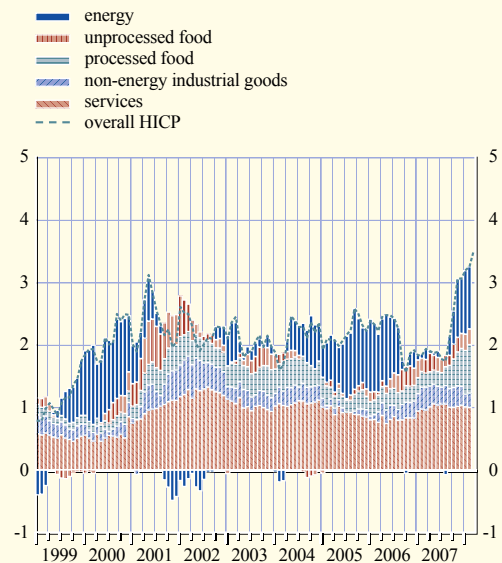
recently, the PPI for food and beverages recorded an increase of 9.4% year on year on average in January and February 2008, while the HWVI index for food and tropical beverages (in euro) rose at an even faster pace in the same period. By contrast, growth in the hourly labour cost index (available only for the group "hotels and restaurants") has remained muted, at 1.8% in 2007 as a whole and even lower in the fourth quarter of the year (see Table B).

Turning to inflation in miscellaneous services, the most dynamic item has been education (9.5% year on year on average in January and February 2008),<sup>5</sup> whose prices have been affected in particular by the marked rise in German university tuition fees in April 2007. Annual inflation in miscellaneous services items relating to financial services has recently eased markedly, which is in line with evidence of a slowdown in financial activity and in part stems from favourable base effects relating to the German insurance tax increase in January 2007. The moderation in inflation in financial services at the beginning of 2008 has taken place despite a period of relatively fast growth in the hourly labour cost index for overall financial intermediation in 2007 (see Table B). The Purchasing Managers' index (PMI) for total costs in financial intermediation services reflects this wage pressure. Although it dropped from 60.2 in the fourth quarter of 2007 to 57.7 on average in January and February 2008, it remained significantly above the 50 level indicating no change in prices.

Among the remaining services sub-components, transport and housing services price inflation slightly exceeded the overall services average in 2007, whereas inflation in communications was negative (see Table A). At the start of 2008, inflation in transport rose to 3.0% in both January and

## Contributions to HICP inflation

(percentage points; annual percentage changes)



Sources: Eurostat and ECB calculations.  
Note: The latest observation refers to March 2008 and corresponds to the flash release for overall HICP inflation.

<sup>4</sup> Annual inflation in canteen prices – an item constituting 0.7% of the HICP index – has been rising at a somewhat slower pace.

<sup>5</sup> The groups in the category "education" are pre-primary, primary, secondary, post-secondary non-tertiary, tertiary, and education not definable by level.

February, while housing services still registered annual inflation slightly above the overall services average and communications prices stood even more markedly below levels a year previously. In the case of transport, which amounts to slightly over 6% of the HICP index, the recent upward pressure appears to result mainly from oil price rises. The annual rate of increase in the PPI for refining products increased in the second half of 2007 and reached 23.6% in February 2008, while the price of Brent crude oil (in euro) has recently displayed even faster year-on-year rises. By contrast, the hourly labour cost index (available only for the total of transport and communications) suggests that wage growth may have levelled off in the second half of 2007 (see Table B).

In sum, services price inflation has remained elevated in recent months. For individual sub-components, recent cost pressures can be detected in food input prices for restaurants, cafés and related services activities, as well as in oil costs for transport. By contrast, softer price pressures are evident in financial services, where, in particular, economic activity appears to be slowing down. The latest data point to a levelling-off in the faster wage growth observed in market services in 2007. However, tighter labour market conditions represent an upside risk to euro area services price inflation, as does the possibility of a strengthening in the pricing power of firms, especially in market segments with low competition.