

Box 2

TRENDS IN NON-ENERGY INDUSTRIAL GOODS PRICES

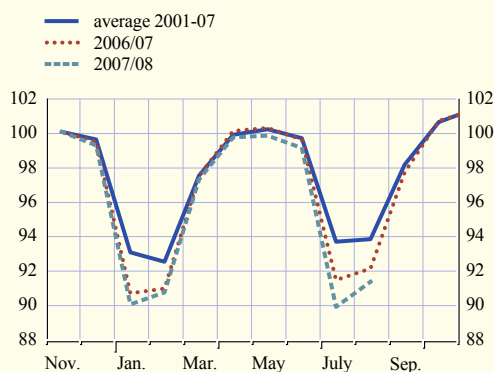
In a context of sustained upward cost pressures from increases in oil and other commodity prices at the global level, which have caused a surge in overall euro area inflation, the annual rate of change in the prices of non-energy industrial goods (NEIG)¹, one of the biggest HICP components (accounting for almost 30% of the expenditure basket), has remained remarkably stable. From early 2007 the annual NEIG inflation rates hovered around 1%, before declining somewhat in early 2008 and even reaching 0.5% in July 2008 (see Chart 19 and Table 5 in the main text). This box looks at the main determinants of the recent developments in NEIG prices and assesses why the price dynamics in this component have thus far been so moderate and whether this situation can be expected to last.

The most recent movements in annual NEIG price inflation can be attributed to specific temporary factors. The decline in the first half of the year, from an average rate of 1.0% in 2007 to 0.8% in the first half of 2008, is almost fully explained by the fact that the impact of the rise in German VAT in January 2007 dropped out of the calculation of the annual growth rate. Excluding Germany, the annual rate of change in NEIG prices has remained broadly unchanged for almost a year, at a level slightly below 1%. Furthermore, the volatility observed over the summer months (when the annual rate of change fell from 0.8% in June to 0.5% in July, before rising to 0.7% in August) largely reflected seasonal developments in textile goods which went beyond the average seasonal pattern observed over the period 2001-07 (see Chart A). The summer discounting for clothing and footwear items in July 2008 was stronger on a month-on-month basis than in the previous year, as retailers offered larger price cuts to stimulate relatively weak consumer demand. As textile prices tend to rebound to “normal” levels relatively quickly, the downward impact on NEIG inflation is expected to fade away in the next few months.

¹ NEIG consists of three sub-components: (a) non-durable goods (e.g. electronic goods for personal care, pharmaceutical products, newspapers), accounting for 27% of NEIG; (b) semi-durable goods (e.g. clothing and footwear, books, recreational equipment), accounting for 39% of NEIG; and (c) durable goods (e.g. cars, furniture, household appliances, PCs), accounting for 34% of NEIG.

Chart A Seasonal pattern of HICP clothing and footwear prices

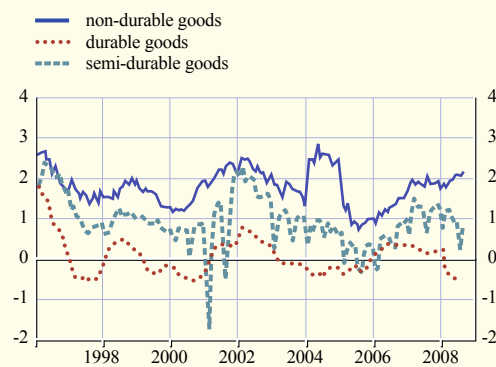
(index: November = 100)



Source: Eurostat.

Chart B Price developments in NEIG sub-components

(annual percentage changes)



Source: Eurostat.

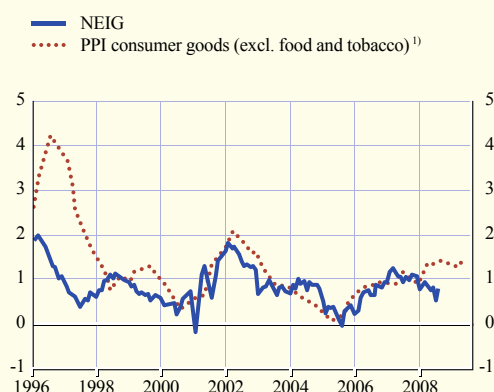
Beyond the short-term impact of seasonal volatility, the relatively stable developments in NEIG prices at the aggregate level can be explained by offsetting developments in the sub-components (see Chart B). Durable goods price inflation has decreased recently, owing mainly to a strong fall in car price inflation. This has contributed significantly to the moderate developments in NEIG price inflation in the recent period by offsetting the ongoing increase in the annual rate of change in non-durable goods prices, which has been mostly driven by developments in the prices of electronic goods for personal care, pharmaceutical products and newspapers. By contrast, the average annual rate of change in semi-durable goods prices has remained broadly stable, as a result of ongoing moderate developments in the annual rate of change in the prices of clothing and footwear, the main component of semi-durable goods.

The increases in the prices of oil and of some raw materials (metals, woods and precious metals such as gold) have exerted input cost pressure on manufactured consumer goods, particularly on certain NEIG items. There is some evidence that these higher costs have been gradually passed on to consumers, and to a notable extent in some cases (furniture, jewellery and spare parts for cars). Despite this, overall developments in NEIG price inflation have remained moderate thus far, owing to a number of mitigating factors. In particular, the significant appreciation of the euro has generally cushioned global commodity price increases and had a dampening impact on developments in the prices of imported consumer goods. The decline in import prices has a direct impact on NEIG inflation, as imported consumer goods for final use represent a notable share of NEIG at the euro area level, especially for some items such as textiles. Furthermore, strong global and domestic competition is exerting downward pressure on prices at both the producer and the retail level. More recently, there seems to have been more specific downward pressure on the consumer prices of industrial goods, as suggested by a wedge between developments in NEIG prices and the prices of domestically produced consumer goods (excluding food and tobacco) (see Chart C). A possible explanation may be the difficulty of passing on higher input costs in an environment of weak consumer demand.

Looking ahead, some upward movement in NEIG inflation might be expected, as the impact of mitigating factors appears to be declining. In particular, in view of recent exchange rate

Chart C NEIG prices and producer prices for consumer goods (excluding food and tobacco)

(annual percentage changes)

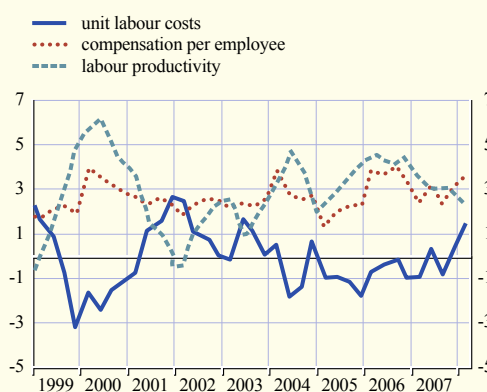


Source: Eurostat.

1) PPI data have been moved forward 12 months.

Chart D Wages, productivity and unit labour costs in industry (excluding construction)

(annual percentage changes)



Source: Eurostat.

movements, the downward impact of the euro appreciation on import prices may fade away. Moreover, indirect effects from past increases in commodity prices may strengthen, and inflationary pressures from the labour market have started to emerge. Labour cost developments generally had a moderating impact on NEIG price dynamics between 2004 and late 2007, with more or less constantly negative unit labour cost growth in the overall industrial sector (excluding construction). However, since the turn of the year, an increase in the growth rate of compensation per employee combined with a fall in labour productivity in industry has led to a rise in unit labour cost growth (see Chart D). This trend is expected to continue in the remainder of 2008, suggesting some build-up of upward pressures from labour costs in the consumer goods industry. This additional cost pressure may be passed on to consumers, depending on retailers' pricing power and the cyclical conditions. Available information, notably from the Purchasing Managers' Index survey, suggests that firms operating at the later stages of the production chain have so far accepted a margin compression.

Indirect effects from past increases in commodity prices and strengthening inflationary pressures from labour costs may reinforce the need for firms to restore their margins and may eventually force them to raise their prices. However, at the current juncture, relatively weak private consumption in an environment of sluggish growth and strong competition seems to limit the scope for further strong price increases. Overall, this would suggest that price dynamics in NEIG can be expected to accelerate slightly in the short run, but to remain moderate.