

## Box 3

## RECENT TRENDS IN THE HICP EXCLUDING FOOD AND ENERGY

Most of the volatility observed in headline HICP inflation in the recent past has been driven by the contributions of its food (both processed and unprocessed) and energy components, which are strongly influenced by external factors. By contrast, developments in the HICP excluding food and energy, representing around 70% of the total index in terms of weighting, have shown a much lower degree of volatility. This reflects rather smooth developments in the prices of its two components, non-energy industrial goods and services, which are to a greater extent determined by factors related to economic fundamentals. At the current juncture, it is particularly insightful to look at the less volatile components of the HICP in order to analyse the forces driving inflation.

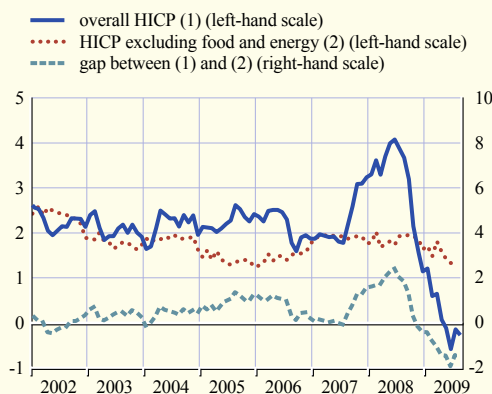
The negative gap between the annual rates of change in the overall HICP and in the HICP excluding food and energy has been gradually increasing since the beginning of 2009, almost amounting to -2 percentage points in July 2009 (see Chart A). This unprecedented large negative gap can be attributed to the unusually strong developments in the food and energy components of the HICP since mid-2007.<sup>1</sup> While overall HICP inflation was negative over the summer of 2009 and is expected to turn positive again in the coming months, the annual rate of change in the HICP excluding food and energy has been on a downward path since mid-2008 and shows no sign of reversing in the short-term.

Developments in the prices of the two less volatile components of the HICP, non-energy industrial goods and services, are largely determined by the same main drivers. While external factors have some influence, domestic factors, such as wages and profit mark-ups, play a dominant role in the determination of non-food, non-energy consumer price developments. Wage developments typically depend on conditions in the labour market, productivity, and past and expected inflation. At the same time, domestic demand and competition factors are crucial determinants of the profit mark-up.

From the external side, price developments in the HICP excluding food and energy are influenced by the transmission of changes in prices of imported inputs along the domestic chain of production. They are also affected by the prices of goods and services directly imported for final consumption. In this respect, the overall moderation in commodity prices, the easing of global inflation and the recent strengthening of the euro have lowered external price pressures and therefore have a dampening impact on non-food, non-energy consumer price developments. Beyond the impact of external factors, the moderation in

Chart A Overall HICP and HICP excluding food and energy

(annual percentage changes)

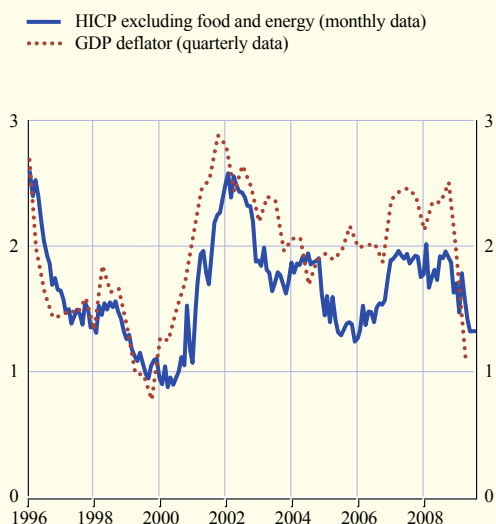


Source: Eurostat.

<sup>1</sup> For more information, see the box entitled "Recent developments in selected measures of underlying inflation for the euro area" in the June 2009 issue of the Monthly Bulletin.

**Chart B GDP deflator and the HICP excluding food and energy**

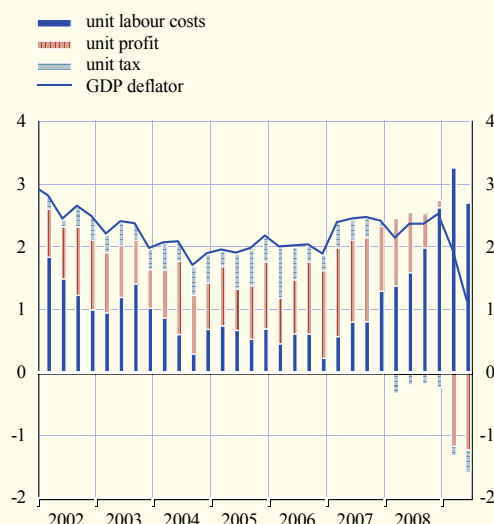
(annual percentage changes)



Source: Eurostat.

**Chart C Decomposition of the GDP deflator**

(annual percentage changes; percentage points)



Source: Eurostat.

HICP inflation excluding food and energy since mid-2008 has, however, been due mostly to the easing of domestic demand pressures. This can be shown by its close relationship with the developments in the annual growth rate of the GDP deflator, which is a summary indicator of unit labour cost and profit developments (see Chart B).

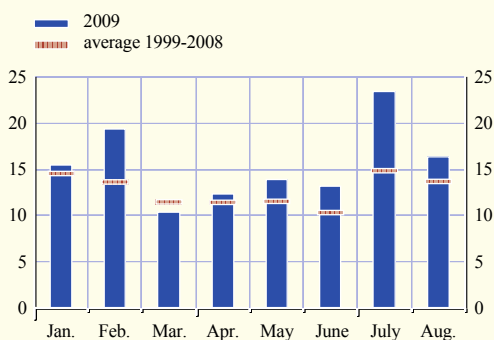
The annual growth rate of the GDP deflator peaked at 2.5% in the last quarter of 2008 and declined significantly to 1.1% in the second quarter of 2009. This was almost entirely due to the strong decrease in the contribution of unit profit growth, which turned negative in the first quarter of 2009 (see Chart C), reflecting the sharp drop in domestic demand. By contrast, over the same period, the contribution of unit labour cost growth remained particularly strong. This was due partly to the fact that several wage agreements were entered into before the worsening of economic conditions in 2008. In addition, it reflected a significant drop in productivity as employment reacted with a lag to the fall in GDP. Unit labour cost growth started to decrease, however, in the second quarter of 2009 on account of a smaller decline in productivity growth and a weakening of growth in compensation per employee.

The recent evolution of profit mark-ups reflects the depressed economic environment, characterised by considerable slack and weak consumer demand. Indeed, downward shocks to demand are an important factor in a decision to lower prices.<sup>2</sup> This is consistent with a relatively large share of price declines, in year-on-year terms, in items of the HICP excluding food and energy through most of 2009 when compared with the average share of price declines over the last ten years (see Chart D). This means that the prices of a number of HICP items – for instance cars and passenger air transport – have been displaying negative annual rates of growth for several consecutive months, which was not often the case in the past.

<sup>2</sup> See the article entitled “Price-setting behaviour in the euro area” in the November 2005 issue of the Monthly Bulletin.

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

(percentages)



Source: Eurostat.

Note: The shares are calculated using the expenditure weights of the items included in the HICP excluding food and energy.

Currently falling car prices, as recorded by the HICP, are explained mainly by weak domestic demand and strong competition. In the case of air transport prices, domestic and external factors are exerting a combined influence. The annual rate of change in HICP passenger air transport prices has been strongly decreasing since mid-2008, turning negative in March 2009. In the second half of 2008, this development was due mainly to the decrease in oil prices, which seems to have been passed through to consumer prices with a lag. More recently, however, the weakness in demand is likely to have played an important role, affecting, in particular, holiday-related services prices, in a very competitive environment.

Looking ahead, the expected developments in the drivers of inflation in the HICP excluding food and energy would suggest that the slight downward path in this measure will continue, with its extent and duration depending crucially on the timing and strength of the recovery. Indeed, in the current environment, downward pressures on inflation from domestic factors should remain. In particular, in the context of deteriorating labour markets, subdued wage developments should reduce cost pressures. In the light of an expected increase in overall HICP inflation, driven by strong base effects, this suggests that the gap between overall HICP inflation and HICP inflation excluding food and energy is likely to close in the near future.