

Europe Flash

Eurozone inflation decelerates somewhat faster than expected

Bottom line: Inflation eased in May for the second month in a row to 2.4% y/y, after remaining broadly stable at 2.7% y/y in the first quarter. We expected a more moderate slowing. Underlying this slight surprise was not only the expected fall in energy prices, but also the moderation in core inflation after remaining stable since the beginning of the year. Looking forward, we continue to expect a slow deceleration of headline inflation in coming months, remaining above the ECB target over the next quarter and reverting to around 2% by the end of the year (until now we were expecting it to be slightly above 2% by December). Nevertheless, given the current evolution of oil prices, headline inflation could be below 2% earlier than anticipated, although these lower oil prices could be partly offset by a weaker euro, which could increase import prices in terms of euros. Core inflation is likely to ease slightly next month to remain hovering around 1.6% during the second half of the year.

- **Energy inflation slowed to 7.3% y/y in May from 8.1% in April, less than expected, but offset by the moderation in fresh food inflation**

Underlying the moderation of energy inflation (7.3% y/y; BBVA Research: 7.1% y/y) was a positive base effect after the sharp increase in energy prices a year ago, although this was lower than anticipated mainly due to an increase in administered prices of both gas and electricity. However, the positive surprise observed in energy inflation was offset by the negative one observed in inflation of fresh food (from 2.1% to 1.8% y/y). Overall, the evolution of prices of the more volatile components continues to explain more than one-third of the annual headline inflation.

- **Core inflation eased further to 1.8%**

Against our expectations of stabilization (BBVA Research: 1.9% y/y). This deceleration can be explained by the lower growth of prices of processed food, while inflation of services increased slightly and that of non-energy industrial goods remained stable. Compared to our forecast, the slight downward innovation is explained by a larger slowing in processed food inflation (from 3.7% to 3.4% y/y; BBVA Research: 3.5%), while the acceleration in the growth of services prices was somewhat lower than previously anticipated (from 1.7% to 1.8% y/y; BBVA Research: 1.9%) and the evolution of non-energy industrial goods was as expected (stable at 1.3% y/y). Overall, core inflation performance in May suggests that retailers could be absorbing the past increases in input prices, especially those related to commodities, due to the weakness of domestic demand and poor expectations for coming months, limiting risks on the resurgence of indirect effects.

- **Headline inflation is expected to ease further in June**

Our updated forecasts suggest that headline inflation could decline again in June by around 0.1pp to 2.3% y/y driven not only by lower energy inflation, but also by the moderation in core inflation. The former should be the result of an ongoing base effect (after high energy inflation rates a year ago), as well as of the recent decline in oil prices, in contrast with our previous expectations. Meanwhile, the moderation in core inflation should come from a widespread lower inflation across components, except for that in non-energy industrial goods which could remain stable, in line with recent economic indicators showing a depressed domestic demand in the eurozone as a whole. Nonetheless, recent data about fuel prices suggests that there are some downside risks to this projection, as the slowdown in headline inflation could be a bit larger (around 0.2pp).

- **We expect a slower moderation of inflation in coming months**

Headline inflation is expected to moderate slowly in coming months, remaining above the ECB target over the next quarter and reverting to around 2% at the end of the year. Nonetheless, given the current evolution of oil prices, headline inflation could revert below the ECB target earlier than expected, although these lower oil prices could be partly offset by a weaker euro. In addition, we see downside risks to these projections stemming from a deeper activity contraction in coming months, although they can be offset by potential tax hikes in some member states, like Italy or Spain, to meet fiscal targets. Regarding core inflation, it is likely to ease slightly next month to remain hovering around 1.6% in the second half of the year.

Table 1

Eurozone. Annual HICP inflation rate

	% y/y		% m/m	
	April 2012	May 2012	April 2012	May 2012
HICP	2.6	2.4	0.5	-0.1
Energy	8.1	7.3	1.1	-1.4
Fresh Food	2.1	1.8	-0.1	0.2
Core excluding Fresh Food and Energy	1.9	1.8	0.4	0.0
Services	1.7	1.8	0.3	-0.1
Non-Energy Industrial Goods	1.3	1.3	0.7	0.1
Processed Food	3.7	3.4	0.2	0.1

Source: Eurostat and BBVA Research

Table 2

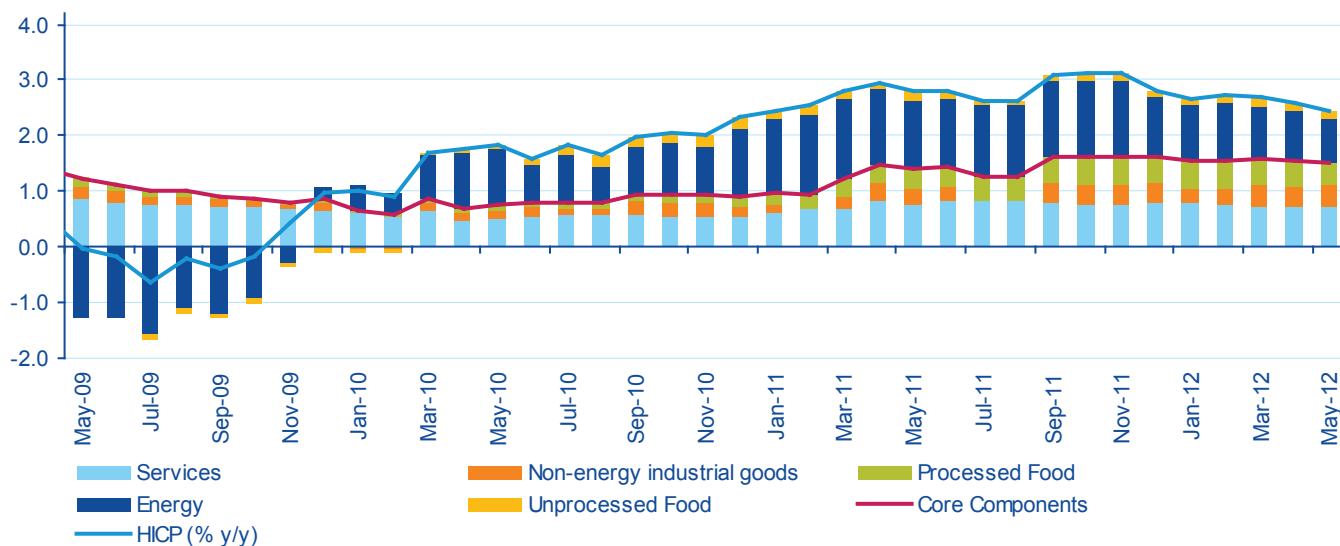
HICP: Forecast evaluation

May 2012	Weight %	Forecast %	Observed %	Confidence Interval Forecast (*)
Headline	100.0	2.46	2.43	(2.3 ;2.7)
Energy	10.99	7.08	7.32	(6.6 ;7.5)
Unprocessed food	7.22	2.00	1.77	(1.5 ;2.6)
Excluding energy and unprocessed food	81.79	1.89	1.84	(1.7 ;2.1)
Services	41.47	1.85	1.78	(1.7 ;2.0)
Non-energy industrial goods	28.47	1.28	1.29	(1.1 ;1.5)
Processed food	11.85	3.48	3.40	(3.4 ;3.6)

(*) 80% confidence

Source: Eurostat and BBVA Research

Chart 1

Eurozone. Annual HICP inflation rate. Contribution by component

Source: Eurostat and BBVA Research

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