Europe Flash

Eurozone inflation slowed in December due to the favourable base effect in energy prices, with core inflation remaining stable

Bottom line: Inflation slowed in December, as expected, driven by the moderation in energy inflation. This driver is expected to remain in coming moths, but a lower slowdown in oil prices than anticipated combined with the depreciation of the euro suggest that headline inflation should remain slightly above the ECB target at the end of Q1. Leaving energy aside, inflationary pressures are expected to ease further in coming months due to the weakness of domestic demand. Still, potential hikes in both taxes and administered prices to meet fiscal targets pose upside risks to this scenario.

- **Underlying December's slowdown of inflation was mainly the lower growth in prices of the most volatile components**
  Eurostat has revised slightly downwards (by 0.1pp) the final headline inflation rate for December to 2.7% y/y (BBVA Research and Consensus: 2.8% y/y), slowing from 3% y/y in November. The slight discrepancy with our forecast mainly reflects a rounding issue (see Table 2). As expected, energy inflation decelerated by around 2.5pp to 9.7% y/y (see Table 1), explaining almost all the 0.3pp fall of headline inflation. In addition, inflation in non-processed food also decelerated in December, interrupting the upward trend observed in previous months. On average, headline inflation was 2.7% in 2011.

- **Core inflation remained unchanged at 2% y/y in December for the fourth month in a row**
  This is in line with our forecasts (BBVA Research: 2.0% y/y). In particular, inflation in services increased by less than 0.1pp, but remaining stable at 1.9% y/y, and offsetting the slight decline observed in inflation of both processed food and non-energy industrial goods. Overall, core inflation remained stable for the fourth consecutive month, confirming that the strong acceleration observed in September (+0.5pp) was mainly due to the effect of methodological changes, while inflationary pressures continue to ease as a result of the weakness of domestic demand. December's figures imply that core inflation averaged at 1.7% in 2011.

- **We expect inflation to slow further in coming months**
  However, the slowdown in oil prices is smaller than expected, which along with the depreciation of the euro suggests that headline inflation should remain slightly above the ECB target at the end of Q1 (around 2.1% y/y), contrary to our previous forecasts. In particular, we expect headline inflation to decline further in January by around 0.1, mainly due to favorable base effect in energy prices again, but also to winter sales. Nevertheless, after the methodological changes introduced in 2011 and the limited information available on the new model to assess the seasonality of the series, the uncertainty around forecasts of non-energy industrial inflation increases, and thus a larger slowdown (-0.2pp) should not be ruled out.

Table 1
Eurozone. Annual HICP inflation rate

	% y/y		% m/m	
December 2011	**Current**	**Previous**	**Current**	**Previous**
HICP	**2.7**	**3.0**	**0.3**	**0.1**
Energy	9.7	12.3	-0.1	0.7
Fresh Food	1.6	1.9	0.4	0.7
Core excluding Fresh Food and Energy	**2.0**	**2.0**	**0.4**	**0.0**
Services	1.9	1.9	0.9	-0.2
Non-Energy Industrial Goods	1.2	1.3	-0.2	0.1
Processed Food	4.1	4.3	0.1	0.3

Source: Eurostat and BBVA Research

Table 2

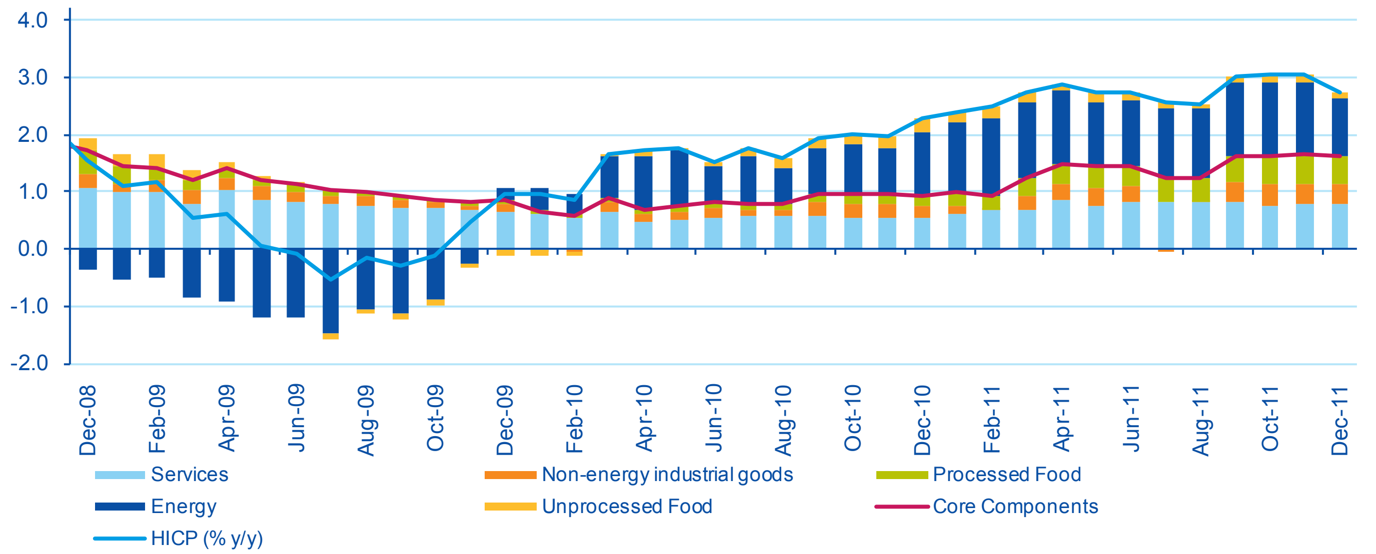
HICP: Forecast evaluation

December 2011	Weigth %	Forecast %	Observed %	Confidence Interval Forecast (*)
Headline	**100.0**	2.77	2.75	(2.6 ; 3.0)
Energy	**10.33**	9.79	9.68	(9.3 ; 10.2)
Unprocessed food	**7.35**	1.82	1.61	(1.3 ; 2.4)
Excluding energy and unprocessed food	**82.29**	1.98	1.98	(1.8 ; 2.1)
Services	**41.43**	1.86	1.93	(1.7 ; 2.0)
Non-energy industrial goods	**28.91**	1.22	1.18	(1.0 ; 1.4)
Processed food	**11.95**	4.25	4.08	(4.1 ; 4.4)

(*) 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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