

ECONOMIC ANALYSIS

Inflation in the eurozone: we expect around 0.5% YoY until the fourth quarter

Europe Unit

It was confirmed that inflation in the eurozone fell by 0.2pp to 0.5% YoY in May, more than expected (BBVA Research: 0.7% YoY; Consensus: 0.6% YoY)

After the volatility of inflation data in March and April due to the calendar effect, May's figures show further evidence of the weakness of inflation. Behind the downside surprise lies more than expected moderation in inflation of services (1.1% YoY after 1.6% YoY, see Figure 1), resulting from the fall in prices of vacation packages, and steeper falls in the prices of fresh food. The remaining components behaved in line with expectations (Figure 2), which also results in a moderation of core inflation to 0.8% YoY from 1.1% YoY in April. However, beyond the volatility of recent months, core inflation has been fluctuating around 0.8% YoY since late last year, in line with the relative weakness of domestic demand in the euro area.

We expect inflation to remain low and relatively stable in the coming months, and to increase slightly from year end

Our forecasts suggest that inflation will remain relatively stable in the coming months, although we cannot rule out a slight moderation (up to 0.4% YoY) in the third quarter due to the evolution of the prices of the more volatile components (energy and food), and will pick up to annual rates of around 1% by the year end. In fact, we expect core inflation to remain broadly stable at around 0.9% YoY for the remainder of the year.

The surprises in recent months raise clear downward biases to our forecast for annual inflation of 0.9% in 2014, as with the latest data our models now point to an average annual inflation at around 0.6-0.7% for the average of the year.

In addition, we continue to see downside risks, mainly arising from the strong euro and moderation in the prices of raw materials, while the differences between countries will continue, with very low rates in the periphery and moderate rates in the countries of central Europe, reflecting the slow recovery of domestic demand.

The ECB's measures should help to anchor inflation expectations

All this, together with the fragility of the recovery, led the ECB to announce a set of measures at the meeting this month (See ECB Watch). Although the short-term impact of these measures on inflation is very limited, it should help to anchor inflation expectations in the medium term after the surprises of recent months.

Table 1

Eurozone. Inflation rate (HCPI, %)

| | % YoY | | % MoM | |
|---|------------|------------|------------|-------------|
| | April 2014 | May 2014 | April 2014 | May 2014 |
| HCPI | 0,7 | 0,5 | 0,2 | -0,1 |
| Energy | -1,2 | 0 | -0,1 | -0,1 |
| Non-processed food | -0,7 | -2,1 | -0,1 | -0,3 |
| Core excl. Fresh food and energy | 1,1 | 0,8 | 0,2 | -0,1 |
| Services | 1,6 | 1,1 | 0,1 | -0,2 |
| Non-energy industrial goods | 0,1 | 0 | 0,4 | -0,1 |
| Processed food | 1,6 | 1,5 | 0 | 0,1 |

Source: Eurostat and BBVA Research

Table 2

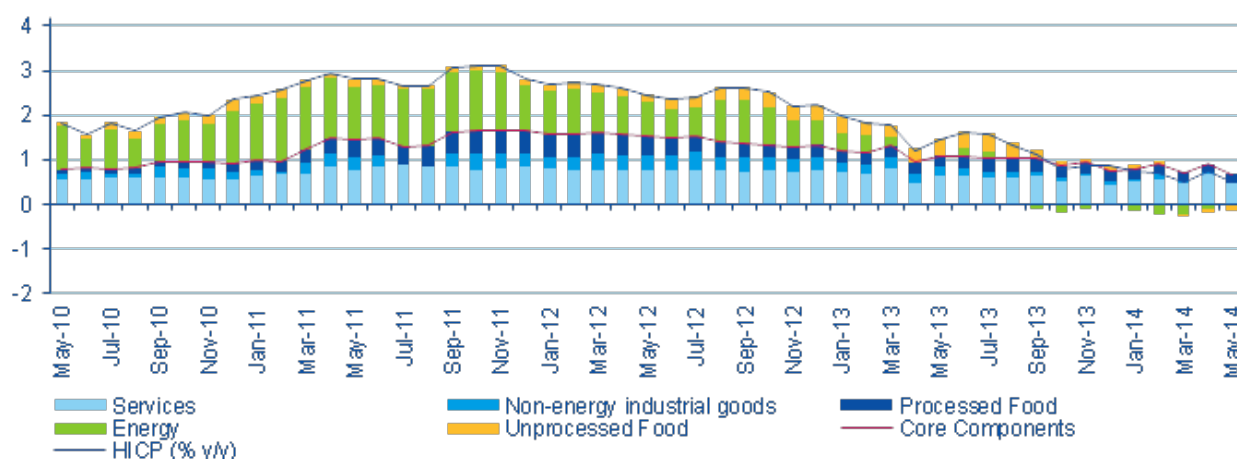
Inflation rate (HCPI, % YoY): forecast errors

| May 2014 | Weight % | Forecast % | Observed % | Confidence interval |
|---|--------------|------------|------------|---------------------|
| | | | | Forecast (%) |
| General | 100 | 0,7 | 0,5 | (0,5 ; 0,9) |
| Energy | 10,80 | 0,2 | 0,0 | (-0,2 ; 0,7) |
| Non-processed food | 7,48 | -1,3 | -2,1 | (-1,9 ; -0,7) |
| Core excl. Fresh food and energy | 81,73 | 0,9 | 0,8 | (0,7 ; 1,1) |
| Services | 42,81 | 1,3 | 1,1 | (1,2 ; 1,4) |
| Non-energy industrial goods | 26,67 | 0,0 | 0,0 | (-0,2 ; 0,3) |
| Processed food | 12,25 | 1,5 | 1,5 | (1,4 ; 1,6) |

(*) 80% of confidence. Source: Eurostat and BBVA Research

Figure 1

Eurozone. Annual HICP inflation rate. Contribution by component



Source: Eurostat and BBVA Research

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