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Economic Research

Economic Briefing

€ inflation details – The ECB may underestimate the core rate

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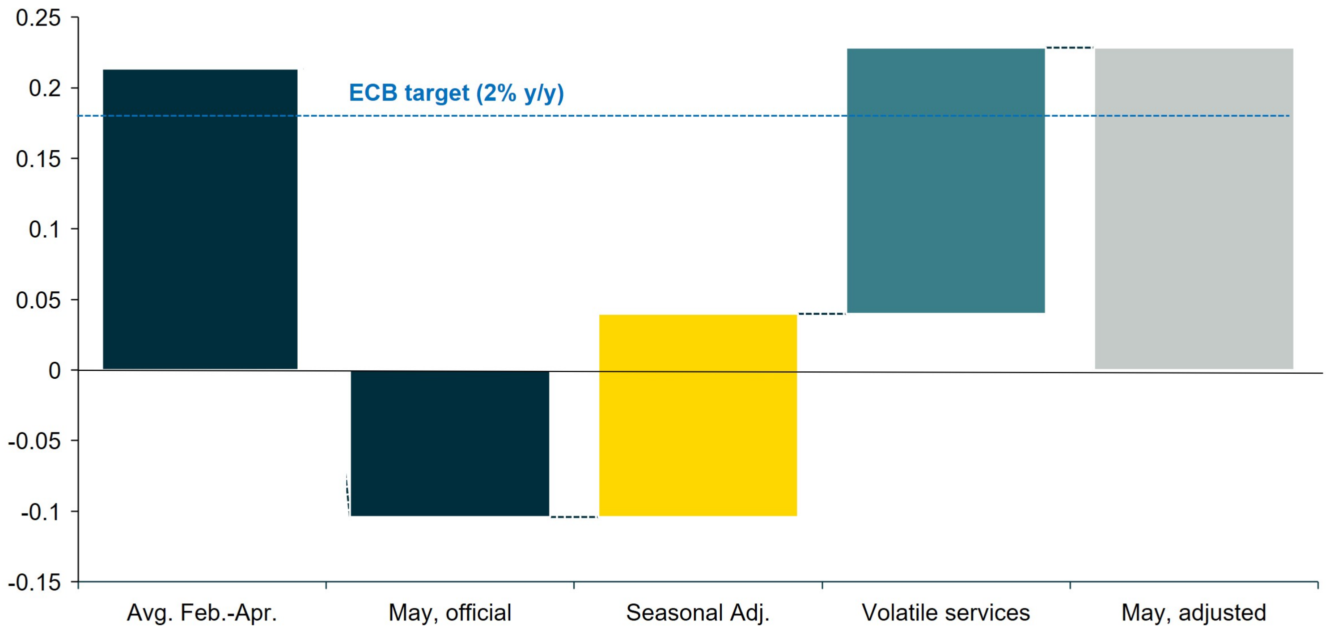
For the first time in four years, consumer prices in the euro area excluding energy, food, alcohol and tobacco fell on a month-on-month basis. This follows the ECB's final inflation figures for May published this week. However, the inflation details show that one-off effects have significantly distorted core inflation downwards. Without these special effects, core inflation would even be above the ECB's target when extrapolated to an annual rate. This implies that the core rate may not fall as quickly as previously envisioned.

Strong one-off effects distort the core rate downwards

According to final figures from Eurostat and the ECB, consumer prices in the euro area excluding energy, food, alcohol and tobacco (core rate) fell by 0.1% in May compared with April on a seasonally adjusted basis. This puts the core rate well below the average for the previous three months and below the ECB's target (Chart 1). However, the inflation details published this week show that special effects related to Easter have significantly distorted inflation downward: both seasonal adjustments and volatile services such as transportation services have artificially depressed the core rate. Adjusted for these special effects, the inflation rate is likely to be above the ECB's target at 0.23%.

Chart 1 - Official data downplay the core rate

Harmonized consumer price index in the euro area, excluding energy, food, acohol and tobacco seasonally adjusted, month-over-month rates in %; adjustments in percentage points



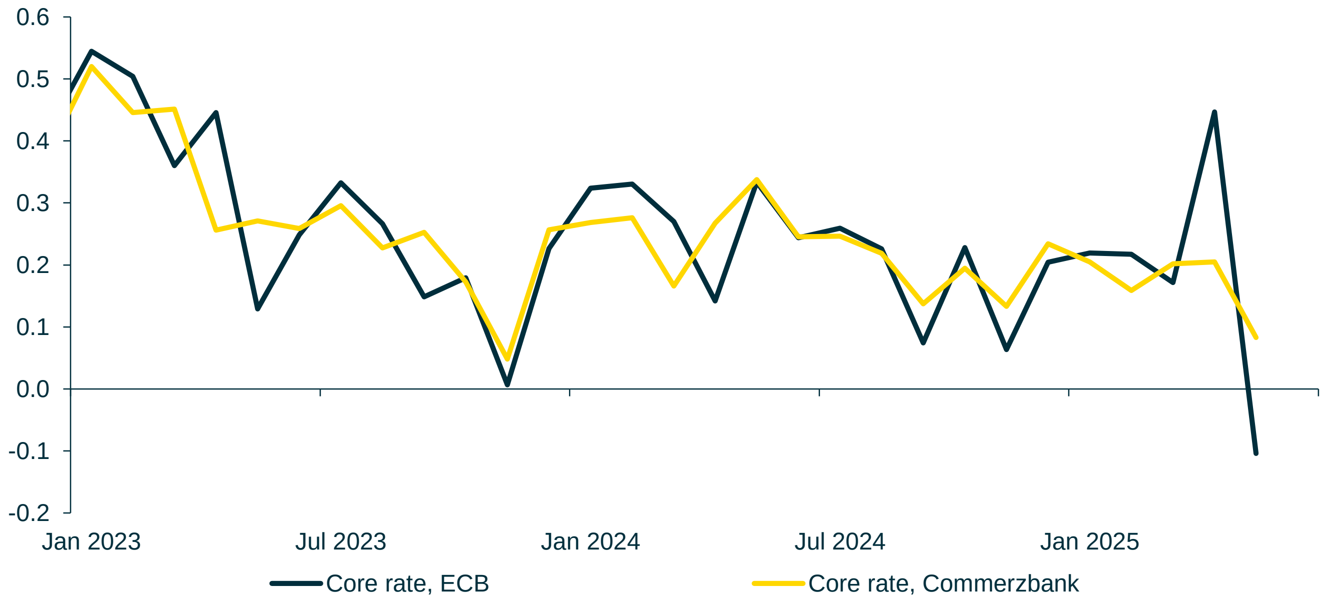
Source: ECB, Commerzbank-Research

The ECB's seasonal adjustment again faces problems

The ECB's seasonal adjustment procedure may have significantly underestimated the core rate for May. This is mainly due to the fact that service prices related to travel typically fall again after the Easter travel season, but the effect does not always occur in May due to the varying dates of Easter. The ECB's seasonal adjustment procedure apparently does not interpret the price decline in May of this year as a seasonal effect, thereby distorting the seasonally adjusted core rate downward. If, instead, the month-on-month core rate is adjusted using our preferred method (X-13 ARIMA model), the core rate in May would be just under 0.1% (Chart 2).

Chart 2 - The ECB's seasonal adjustment underestimates the inflation

Core rate of consumer prices in the euro area, seasonally adjusted month-over-month rates in %, Commerzbank adjustment using X-13 method



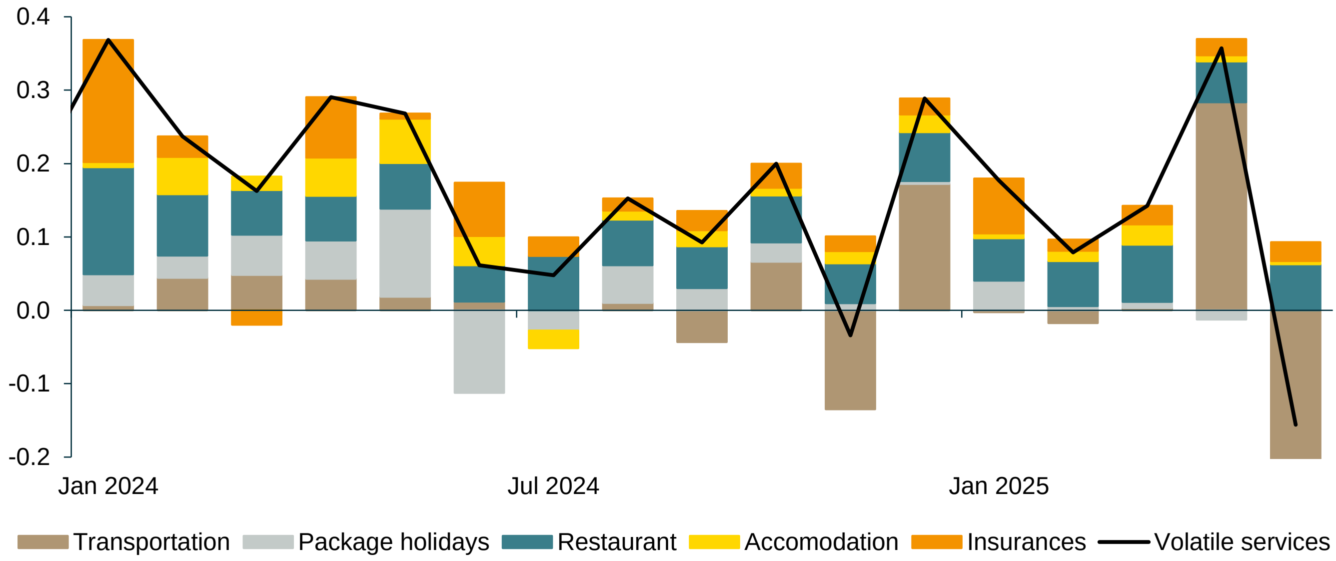
Source: Eurostat, Commerzbank-Research

Transportation prices were the main drivers of the core rate in May

In addition, inflation details show that volatile service prices significantly lowered the core rate in May. These include insurance premiums, package holidays, restaurant visits, hotel stays, and transportation services. The exceptional decline in service prices in May was mainly due to transport services, such as airline tickets for vacation travel (Chart 3). Even when seasonal trends are taken into account, transport prices fell unusually sharply. Adjusting the core rate for price developments in particularly volatile services would have resulted in a higher core rate. Without these volatile components, the core rate would have been 0.23% in May (seasonally adjusted previous month's rate).

Chart 3 - Falling transport prices distort the core rate

Consumer price index in the euro area, contributions to the month-on-month service price index from selected sectors, in percentage points



Source: Eurostat, Commerzbank-Research

A friendly reminder for the ECB

Our analysis of the details shows that the underlying inflation trend in May was significantly higher than the ECB's adjusted figures suggest. In the coming months, the core rate should no longer be influenced by Easter and reveal the underlying price trend more apparently. After the ECB significantly lowered its staff projections for inflation recently, the higher-than-expected core rate and the rise in oil prices are likely to remind central bankers of the dangers of more persistent inflation. This is another reason why we consider a further cut in key interest rates in July to be out of the question.

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