

MACROECONOMIC ANALYSIS

Eurozone inflation: new downward surprise

Europe Unit

May inflation down to 0.5% YoY as both services and food prices decelerate. As a result, inflation excluding energy and food also slowed by 0.3pp to 0.7% YoY

Eurozone inflation slowed by 0.2pp to at 0.5% YoY in May, more than expected before the release of national data yesterday (BBVA Research: 0.7% YoY; Consensus: 0.6% YoY)

After the volatility in inflation figures in March and April due to seasonal factors, May figures show further evidence on the weakness of inflation. Underlying the downward surprise was a larger than expected moderation in services inflation (1.1% YoY after 1.6% YoY, see Table 1), likely stemming from the fall of prices of holiday packages, as German figures published yesterday suggest. The rest of the components performed in line with expectations, resulting also in a moderation of inflation excluding energy and food prices to 0.7% YoY, from 1% YoY in April. Nonetheless, looking 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 eurozone.

Although we will update our forecast with the final figures (to be released in June, 16), our scenario envisages that inflation should remain relatively stable in coming months, to increase slightly in the last quarter of the year. This poses clear downside risks to our forecast of 0.9% annual inflation in 2014. The new figures imply that average inflation for 2014 will probably be around 0.6%/0.7% YoY.

We expect the ECB to ease monetary policy on Thursday

After today's inflation flash estimate, we expect the ECB staff to revise its inflation projection downwards (by around -0.3pp in 2014 and -0.1pp in 2015), while forecasts for GDP are likely to remain broadly unchanged over the forecast horizon (they were 1.2% in 2014 and 1.5% in 2015 in March).

The new inflation forecasts and recent inflation surprises increase the possibility that the "package of measures" expected for this week's ECB meeting is more charged than not.

We expect the GC to start by exhausting the more conventional measures that remain available, i.e. lowering refi and depo rates by 10 bps. It is also likely that the ECB will also announce other measures on the funding side (targeted to new credit, extension LTROs, not sterilization of the SMP program, ect ...). The probability of a "pure" QE remains still low, but is an option for the future.

Table 1

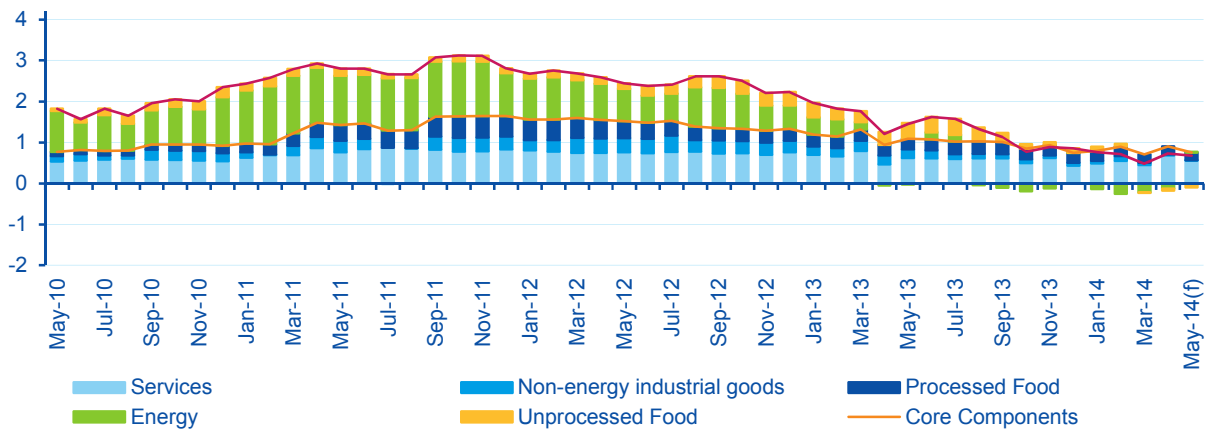
Eurozone. Annual HICP inflation rate (% YoY)

	Observed		Flash estimate	BBVA Research
	March 2014	April 2014	May 2014	May 2014
HICP	0.5	0.7	0.5	0.7
Energy	-2.1	-1.2	0.0	0.2
Fresh Food	-0.1	-0.7		-1.3
HICP excluding energy and food	0.7	1.0	0.7	0.8
Core excluding Fresh Food and Energy	0.9	1.1		0.9
Services	1.1	1.6	1.1	1.3
Non-Energy Industrial Goods	0.2	0.1	0.0	0.0
Processed Food	1.7	1.6		1.5

Source: Eurostat and BBVA Research

Figure 1

Eurozone. Annual HICP inflation rate. Contribution by component



Source: Eurostat and BBVA Research

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