

Economic Watch

Europe and Spain

Madrid, 27 March 2014
Economic Analysis

Europe and Spain Units

Inflation expectations in Spain and Europe: low, but positive

The disinflationary process may be coming to an end. Although inflation may be decelerating in March for transitory reasons, the trend is still stable and in positive territory. However, inflation rates continue at record lows both in the EMU and in differential Spain, making more decisive policies from the ECB advisable, as well as further reforms in Spain.

- **Inflation is still close to the record lows seen since the end of summer 2013**

BBVA Research estimates suggest that inflation in Spain fell less than 0.1pp in March, to -0.1% YoY. The estimated harmonised price index (-0.1pp to 0.0%, YoY) together with the estimate for the EMU (around -0.1pp to 0.5%-0.6% YoY) indicate that the price differential with the eurozone probably remained in Spain's favour (-0.6pp compared to the historic average of +0.8pp). In terms of the core component, the price differential may also have continued demonstrating the Spanish economy's competitiveness gains (-0.8pp compared to the historical average of +0.8pp) (see Figures 1 and 2).

- **Short-term expectations: calendar adjustments for the Easter holidays and energy prices explain the temporary contraction in March inflation, although the disinflationary process may have come to an end**

The information compiled on closing this report enables us to infer that both in Europe and in Spain, the moderation in headline inflation in March corresponds to a reduction in the contribution of the core component (see Figures 3 and 4). However, this slowdown will be temporary, given that it is caused by the base effect of the Easter holidays which, as they fall in April this year, delay the seasonal uptick in tourism-related prices compared to March last year.

Residual inflation has also contributed to the March reading. Energy prices may have continued to fall in Spain and the rest of Europe (between 0.5pp and 2.0pp vs. March 2013), influenced by the downward pressure on the oil price (-3.7% YoY in dollars per barrel so far this month) and euro appreciation (6.4% YoY so far this month).

- **Medium-term expectations: the most likely scenario is that trending inflation remains low but positive**

Empirical distribution of the disaggregated data on inflation in Europe and Spain allows us to calculate their respective optimal trimmed means, a measure of trending inflation close to the median (rather than to the published mean variation), which is robust in the face of extreme, one-off price shocks (such as those mentioned in the previous section) which satisfactorily predicts CPI changes over the forecast horizon.¹

These trimmed means show that downward inflationary pressure is not a new phenomenon but one that started with the recession in 2008. Our most recent data show that, in the most likely scenario, trending inflation will stay low in the medium term, although in positive territory, both in Europe and in Spain (around 1.0% and 0.3%, respectively) (see Figures 5 and 6). This is consistent with our scenario for the 2014-15 two-year period, where official core inflation (that is, excluding energy and fresh food) will come in at around 1.1% YoY in the eurozone and 0.5% YoY in Spain.

Furthermore, at the end of the sample there is a probability mass close to 25% below a nil inflation rate in Spain. This result indicates that, with a probability close to this threshold, negative and persistent adjustments in prices cannot be ruled out in the current scenario. To a large degree, this reflects the absence of inflationary pressures in Europe and the efforts being made to continue to improve the competitiveness of the Spanish economy. In Europe there is a probability mass of less than 5.0% below a nil inflation rate which, in line with our scenario, suggests a very limited probability that the EMU might enter a period of deflation.

In line with the above, the seasonally-adjusted distribution of CPI (swda) shows that 11.6% of Spain's inflation components were negative MoM, with a persistence of between 9 and 12 months (see Figure 7). In the case of Europe this percentage is just 2.6% (see Figure 8). These figures are not significantly different to those recorded in 2009, at the beginning of the recession.

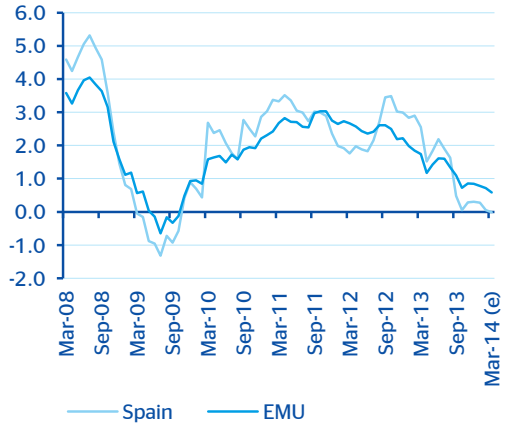
- **Inflation expectations in the eurozone need to remain anchored and Spain must continue to improve competitiveness**

Almost the entire improvement in competitiveness in Spain, which is reflected in the favourable inflation differential, is due to the greater relative increase in productivity and, to a lesser degree, greater wage moderation than in Europe². However, with inflation so low in the whole of the EMU, this makes it difficult, at least for the moment, to adjust certain imbalances. The solution to these problems lies in the implementation of policies at both a European level and in Spain. In Europe, we need to prioritise a monetary policy which ensures that inflation expectations are anchored to the ECB's target, dispelling any doubts as to the probability of a deflationary event. In Spain, it is crucial that reforms designed to increase companies' capacity for growth and, more particularly productivity, continue, so that the price gap with Europe can be maintained.

1: For more information about the method for calculating trend inflation using the trimmed means method, see Box 1 in our Spain Economic Outlook for 1Q 2014, available in http://www.bbva-research.com/KETD/fbin/mult/1402_Spain_Economic_Outlook_tcm348-426396.pdf?ts=2732014

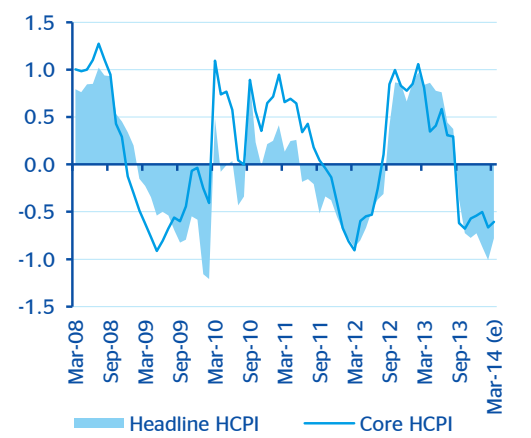
2: For more information about the method for calculating trend inflation using the trimmed means method, see Box 1 in our Spain Economic Outlook for 1Q 2014, available in http://www.bbva-research.com/KETD/fbin/mult/1402_Spain_Economic_Outlook_tcm348-426396.pdf?ts=2732014

Figure 1
Spain and EMU: HCPI (YoY)



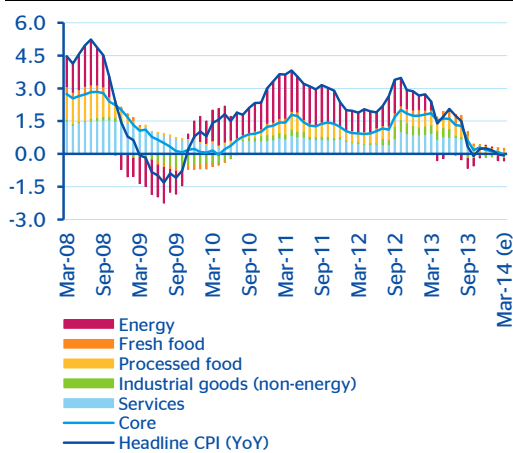
(e): estimate
Source: BBVA Research based on Eurostat

Figure 2
Spain: inflation differential with EMU (pp of HCPI YoY)



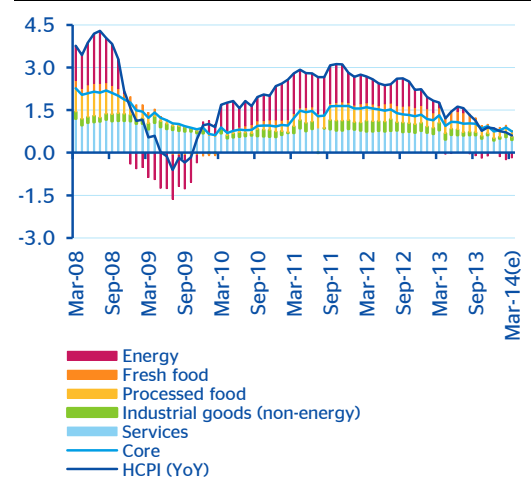
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Source: BBVA Research based on Eurostat

Figure 3
Spain: contributions to CPI growth YoY



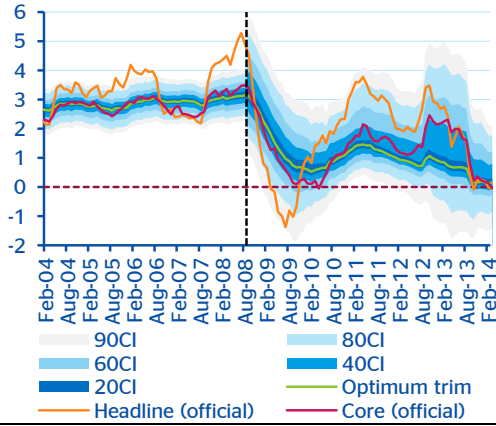
(e): estimate
Source: BBVA Research based on INE

Figure 4
EMU: contributions to HCPI growth YoY



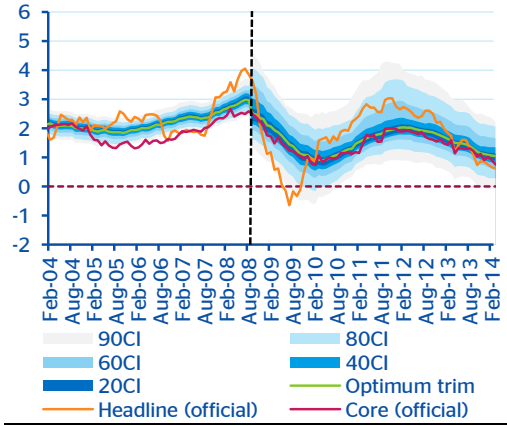
(e): estimate
Source: BBVA Research based on Eurostat

Figure 5
Spain: trending inflation
(trimmed mean method, % YoY)



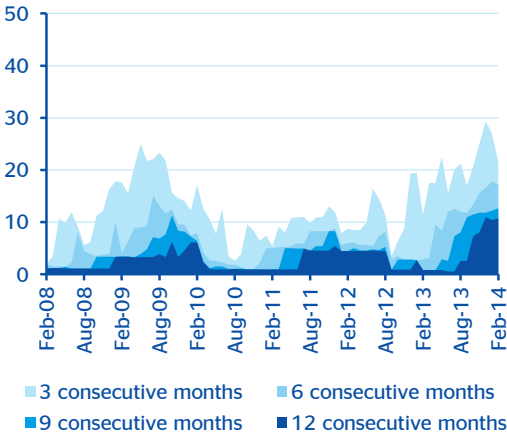
Source: BBVA Research based on INE

Figure 6
EMU: trending inflation
(trimmed mean method, % YoY)



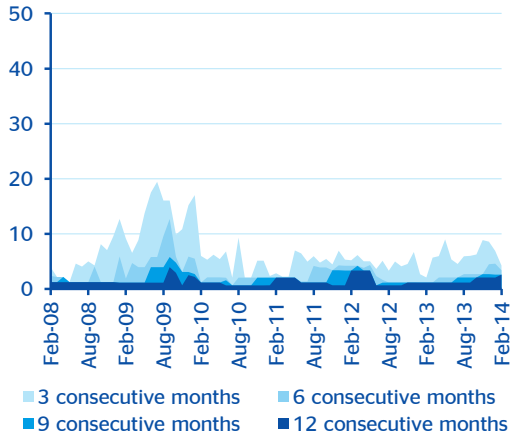
Source: BBVA Research based on Eurostat

Figure 7
Spain: proportion of CPI components with negative MoM rates by differing degree of persistence (sawd data)



Source: BBVA Research based on INE

Figure 8
EMU: proportion of CPI components with negative MoM rates by differing degree of persistence (sawd data)



Source: BBVA Research based on Eurostat

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