

countries with significant impacts included Portugal, Slovakia, Spain and Italy. In the latter country, although the VAT increase was only introduced in September 2011, it still led to a mechanical impact of 0.2 percentage point for 2011 as a whole (see Chart B).

Looking ahead, a number of countries have implemented or announced VAT increases that will have an impact in 2012, including Ireland, Cyprus, Italy, France and Portugal. This will result in continued upward pressure on inflation rates this year (see Box 10, entitled “ECB staff macroeconomic projections for the euro area”).

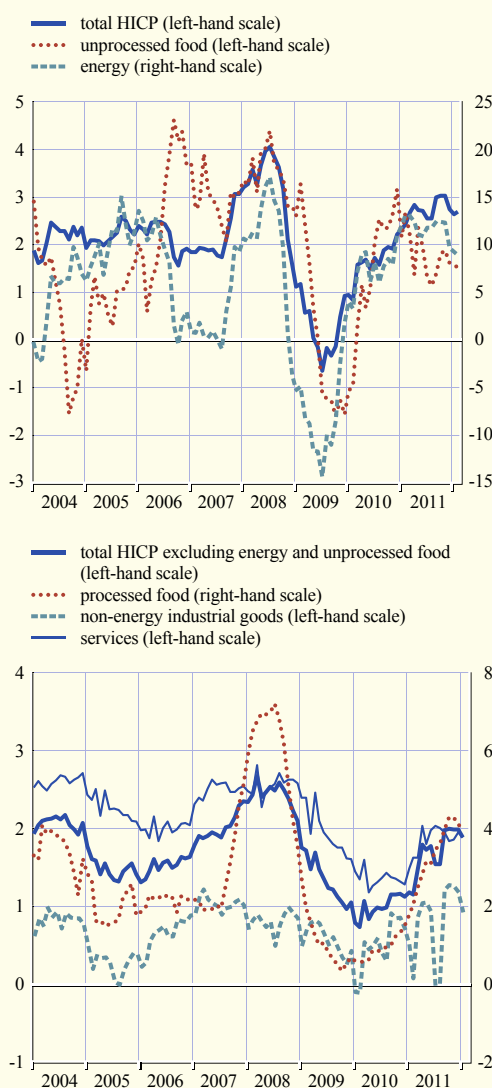
In 2011 annual HICP inflation peaked at 3.0% in September and remained at this level for three consecutive months. It then fell in December, owing to a decline in energy inflation that reflected base effects related to price hikes a year earlier.

In January 2012, the last month for which an official breakdown is available, the annual rate of change in the energy component of the HICP stood at 9.2%, down from 9.7% in December 2011. Prior to that, the annual rate of change in energy prices had been in double digits for 12 consecutive months, owing mainly to the hike in crude oil prices at the beginning of 2011 and the depreciation of the euro against the US dollar. Since the beginning of 2012 oil prices in euro terms have increased further, averaging over €90 per barrel in February. At the same time, this has pushed up prices in the sub-components of the HICP most closely linked to oil, namely transport and liquid heating fuels. Prices in the other main energy sub-components, such as gas and electricity, tend to follow trends in oil prices with a lag.

Mirroring developments in international food commodity prices, the annual rate of change in the food component of the HICP rose steadily in the course of 2011, to over 3% as of September. However, recent developments in EU internal market prices for food commodities suggest that the immediate impact of the food price shock had subsided by the end of the year. Nevertheless, the effects of the pass-through will continue to add to pipeline pressures in the food production chain in the near term. The upward trend in food price inflation in the course of 2011 was particularly

Chart 44 Breakdown of HICP inflation: main components

(annual percentage changes; monthly data)



Source: Eurostat.

visible in the processed food component (excluding tobacco), owing to increases in the prices of commodity-intensive items, such as dairy products, oil and fats and, in particular, coffee and tea.

Excluding all food and energy items, which represent around 30% of the HICP basket, annual HICP inflation decreased to 1.5% in January 2012, having been stable at 1.6% from September to December 2011. HICP inflation excluding total food and energy is determined predominantly by domestic factors, such as wages, profit mark-ups and indirect taxes, and it consists of two main components, namely non-energy industrial goods and services. Developments in these two components have been very different.

In 2011 non-energy industrial goods inflation showed an upward trend, which had started in the second quarter of 2010, owing to the pass-through of past exchange rate depreciation and commodity price increases, as well as hikes in indirect taxes. Over the last few months of 2011 non-energy industrial goods inflation stood at around 1.2%, following a high degree of volatility earlier in the year. This volatility was related to the introduction of a new regulation on the treatment of seasonal products in the HICP, which had a large impact on the semi-durable goods sub-component (clothing materials, textiles, books, etc.). The other two sub-components of the non-energy industrial goods component, namely durable goods (cars, furniture, electronic appliances, etc.) and non-durable goods (water supply, pharmaceutical products, newspapers, etc.), remained more stable. In January 2012 the annual rate of change in non-energy industrial goods prices dropped to 0.9%.

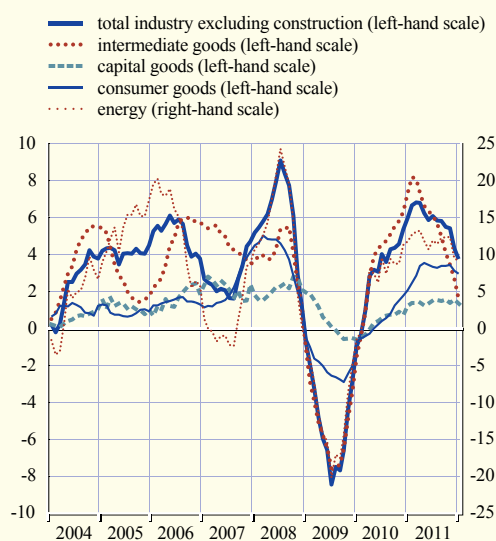
Services price inflation rose notably in the first few months of 2011. It then hovered around 1.9% from April of that year. This stabilisation was evident in all the main services sub-components, with the exception of communication services, which exhibited a stronger decline in the annual rate of change. In January 2012 services price inflation stood at 1.9% for the third consecutive month. Declines in the annual rate of change in transport services, communication services, and recreation and personal services were counterbalanced by increases in the annual rate of change in housing services and miscellaneous services over the last three months.

3.2 INDUSTRIAL PRODUCER PRICES

Owing primarily to greater global demand for raw materials, supply chain pressures rose steadily from their trough in the summer of 2009 until recently. As a result, industrial producer price inflation increased in late 2010 and the first half of 2011. Thereafter the annual rate of change in producer prices declined, mainly reflecting the fluctuations in commodity prices (see Table 7 and Chart 45). Excluding construction, industrial producer price inflation fell to 3.7% in January 2012, from 4.3% in December 2011. The energy component contributed only marginally to this decline, as a downward base effect in that component was partially counterbalanced by a strong month-on-month increase in producer prices. Over

Chart 45 Breakdown of industrial producer prices

(annual percentage changes; monthly data)



Sources: Eurostat and ECB calculations.

the same period, producer price inflation excluding construction and energy fell to 1.9% from 2.5%.

Focusing on the later stages of the production chain, the rate of inflation in producer prices for consumer goods declined marginally to 3.0% in January 2012. In the same month, the annual rate of change in consumer food prices fell to 3.9%. Further declines are expected in the coming months, owing to the recent sharp falls in EU food commodity prices. The annual rate of change in the non-food consumer goods component, which leads developments in the non-energy industrial goods component of the HICP, declined in January for the first time in more than two years, to 1.4%, having stood at the historically high level of 1.7% in the previous two months. This decline, together with that in import price inflation, signals that pipeline pressures for underlying consumer price inflation are easing.

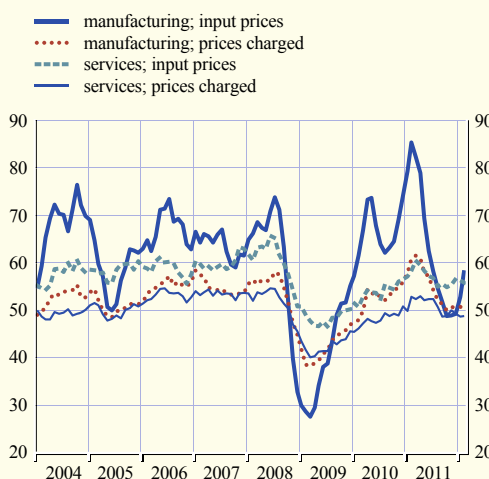
Survey indicators for selling prices in industry, which lead PPI developments, remained broadly unchanged and close to their long-run averages in February 2012. European Commission survey data on selling price expectations suggest that this was due to developments in the consumer goods and capital goods industries, as selling price expectations in intermediate goods industries are on the rise again. With regard to the Purchasing Managers' Index, the output price index for the manufacturing sector rose slightly from 50.7 in January to 51.0 in February, while the input price index surged from 52.8 to 58.5 over the same period, following recent commodity price increases and a depreciation of the euro.

3.3 LABOUR COST INDICATORS

Reflecting the improvement in labour market conditions in the first half of 2011, labour cost indicators in the euro area increased gradually (see Table 8 and Chart 47). However, the latest data on wage growth show some signs of stabilisation.

Chart 46 Producer input and output price surveys

(diffusion indices; monthly data)



Source: Markit.

Note: An index value above 50 indicates an increase in prices, whereas a value below 50 indicates a decrease.

Table 8 Labour cost indicators

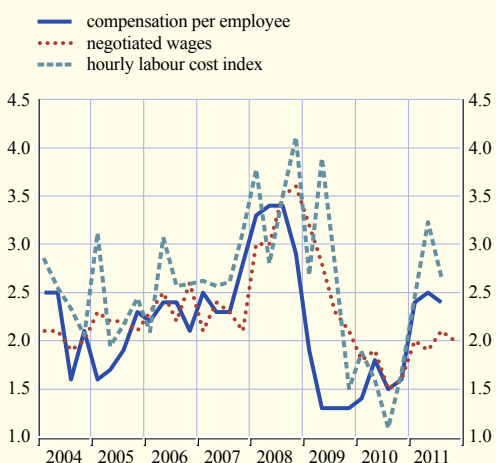
(annual percentage changes, unless otherwise indicated)

	2010	2011	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4
Negotiated wages	1.7	2.0	1.6	2.0	1.9	2.1	2.0
Hourly labour cost index	1.6	.	1.7	2.5	3.2	2.7	.
Compensation per employee	1.6	.	1.6	2.4	2.5	2.4	.
<i>Memo items:</i>							
Labour productivity	2.4	.	1.9	2.1	1.2	1.0	.
Unit labour costs	-0.8	.	-0.3	0.3	1.2	1.3	.

Sources: Eurostat, national data and ECB calculations.

Chart 47 Selected labour cost indicators

(annual percentage changes; quarterly data)

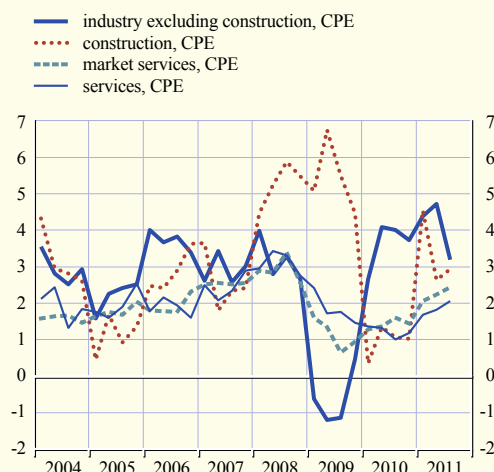


Sources: Eurostat, national data and ECB calculations.

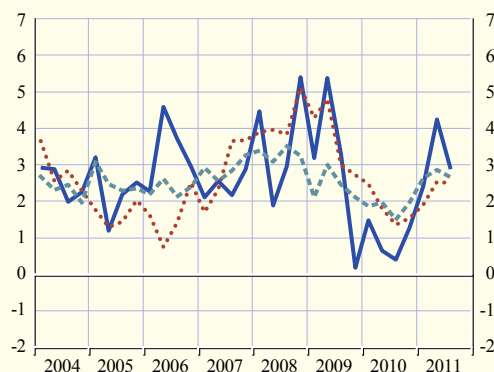
Labour market developments normally react to developments in GDP growth with a lag. However, at the beginning of the 2008-09 global recession labour markets in the euro area proved rather resilient, notably as a result of the strong adjustment in hours worked. Nevertheless, the severity and persistence of the recession eventually led to a strong fall in employment and surge in unemployment. Box 7, entitled “Labour market adjustment in the euro area”, analyses the adjustment of the euro area labour market during the 2008-09 recession by examining the evolution of employment, unemployment and wages.

Chart 48 Sectoral labour cost developments

(annual percentage changes; quarterly data)



industry excluding construction, hourly LCI
construction, hourly LCI
market services, hourly LCI



Sources: Eurostat and ECB calculations.
Note: CPE stands for compensation per employee and LCI stands for labour cost index.

Box 7

LABOUR MARKET ADJUSTMENT IN THE EURO AREA

This box looks at how the euro area labour market has adjusted since the onset of the financial crisis by examining the evolution of employment, unemployment and wages.¹ Normally, there is a relatively strong relationship between output growth and the labour market. However, the 2008-09 recession led to some divergence in this relationship in the euro area. At the beginning

¹ For a more detailed analysis of the evolution of euro area labour markets up to the first quarter of 2010, see the article entitled “Labour market adjustments to the recession in the euro area”, *Monthly Bulletin*, ECB, July 2010.

of the recession employment in most euro area countries proved rather resilient, notably as a result of the strong fall in hours worked and the implied labour hoarding. Nonetheless, the severity and persistence of the recession ultimately led to a fall in employment and a sharp rise in unemployment. During the subsequent recovery period there has been a moderate pick-up in employment growth, owing partly to labour hoarding, while unemployment has remained at high levels. Wages have adjusted somewhat, although this appears to be due to the stronger downward adjustment in the variable component of wages (i.e. bonuses, overtime payments, etc.) rather than to negotiated wages. Overall, the most recent labour market developments in the euro area seem to be back in line with the historical pattern. There is, however, a high degree of diversity in labour market adjustment across the euro area countries, largely reflecting differences in the degree of labour market flexibility and progress being made on structural reforms. Wage moderation and measures to enhance labour market flexibility are essential to support employment, particularly in those euro area countries experiencing high levels of unemployment.

Labour market typically adjusts to changes in GDP growth

If aggregate demand in the economy falls, companies usually adjust their production first, followed by the number of hours worked and, finally, the size of their workforce. There may be several reasons why companies do not immediately adjust the number of hours worked to the lower level of production. Initially they may perceive the fall in demand as temporary and, furthermore, it takes time to plan how to utilise the existing workforce in the new situation. Once it becomes evident that the downturn has set in, companies adjust the number of hours worked. This is usually done without adjusting the number of employees, so that only average working hours are reduced. Only as a last resort do companies cut the number of employees in response to the lower level of demand. In general, employment in the euro area normally adjusts to changes in production after one to two quarters, although labour hoarding can mean that it takes longer, depending on how employers perceive the nature and duration of the downturn, as well as the need to retain skilled labour.

Labour market adjustment since the 2008-09 recession

At the beginning of the 2008-09 recession employment in most euro area countries proved rather resilient, notably as a result of the strong adjustment in hours worked.² However, the severity and persistence of the recession ultimately led to a fall in employment and a considerable rise in unemployment.³ Charts A and B show the labour market adjustment in terms of unemployment and employment since 1996. From the very start of the recession, the relationship between labour market developments and economic activity appeared to diverge from its normal pattern.⁴ In particular, GDP growth fell sharply, but unemployment (employment) did not increase (decrease) as much as would have been expected on the basis of historical regularities, suggesting that some labour hoarding occurred. Recently, however, the relationship seems to be back in line with normal historical experience.

² Policy measures encouraging flexible working time arrangements, namely short-time working schemes, were used as a way of containing the impact of the recession on employment.

³ There was nevertheless considerable heterogeneity across the euro area countries. For example, in Germany, unemployment actually declined during the crisis, partly as a result of past labour market reforms, e.g. the Hartz reforms.

⁴ This was also discussed in the box entitled “Back to Okun’s Law? Recent developments in euro area output and unemployment”, *Monthly Bulletin*, ECB, June 2011.