

**RECENT INFLATION DYNAMICS AND OUTLOOK FOR SPAIN**

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As has occurred with many other macroeconomic variables (for instance, with GDP, the general government budget balance and employment), the performance and even the measurement of inflation in Spain and globally have been significantly affected in recent months by the COVID-19 pandemic and by the measures deployed to contain it.

In spring, shortly after the spread of the virus at global level, numerous governments decided to halt all non-essential activities in order to limit the spread of the pandemic. From a purely statistical standpoint, this decision significantly disrupted the preparation of consumer price indices by national statistical offices, since the restrictions imposed made it impossible to acquire (and, therefore, compile prices for) a broad range of consumer goods and services (notably, cultural and accommodation services, flights and package holidays). Following Eurostat recommendations, the Spanish National Statistics Institute responded by imputing to these products a month-on-month price change similar to that for the same month of the previous year, so that the year-on-year rate for these prices remained virtually unchanged.

Beyond the biases which might derive from this imputation, the pandemic also appears to have influenced consumer price index signals coming from another channel, which is related to the profound transformation of households' consumption patterns. These changes are not included in the customary inflation indicators, where weights are only updated once a year (at the start of the year). The absence of a real time update of the weights of the different categories of goods and services seems to have led, according to some studies, to inflation being underestimated.<sup>1</sup> Specifically, in the period March-May 2020 the difference between the inflation rate calculated with a reweighted index based on the effective weights at each point in time and that obtained with the customary index is estimated to range from 0.09 pp to 0.36 pp, according to the methodology used, in the case of Spain. For example, it should be taken into account that certain products whose consumption was not affected by the

lockdown, such as food, were precisely those which posted sharper price increases in those months.

Aside from the statistical issues, the declining path shown by inflation in recent months in Spain clearly evidences that, in net terms, the combined impact of different supply and demand-side factors caused by the pandemic has been widely disinflationary (see Chart 1). In this connection, although the outbreak of the health crisis raised the possibility that considerable disruptions could arise in the supply chains, exerting substantial upward pressure on inflation, they were not sufficiently strong or persistent to be reflected, in general, in a significant pick-up in prices.

An analysis of the various indicators of inflationary pressure used by the Banco de España allows a more detailed assessment of some of the channels that have shaped recent developments in inflation in Spain.<sup>2</sup> Chart 2 shows the values for several of these indicators in February 2020 (just prior to the pandemic), their latest figures (represented by the red circles and blue boxes, respectively) and their historical levels. In particular, a very sharp drop in inflationary pressure can be seen on account of the greater degree of slack in the economy. At the same time, other domestic and external factors seem to be exerting less pressure on prices. For instance, in line with the lack of significant disruptions to global value chains, no signs of inflationary pressures on import prices were observed. Furthermore, inflationary pressures exerted by inflation expectations also appear to have moderated in recent months, especially in the case of firms and consumers.

On account of their relevance to aggregate price dynamics, highlighting three specific items is useful. The first is energy. The sharp contraction in global economic activity triggered by the pandemic has caused a steep drop in global demand for oil and oil products, which in April drove crude oil prices down to lows not seen in the last 30 years. As the recent recovery in oil prices is still far from complete, this has been one of the main factors behind the marked deceleration in the HICP's energy component in recent months.

1 See, for example, Reinsdorf (2020), *COVID-19 and the CPI: Is inflation underestimated?*, IMF Working Paper, WP/20/224; Cavallo (2020), *Inflation with Covid consumption baskets*, NBER Working Paper 27352, and European Central Bank (2020), "Consumption patterns and inflation measurement issues during the COVID-19 pandemic", Box 3, *Economic Bulletin*, 2020/11.

2 For more details on these indicators, see L.J. Álvarez and I. Sánchez (2018), "Composite indicators of inflationary pressures", Analytical Articles, *Economic Bulletin*, 4/2018, Banco de España.

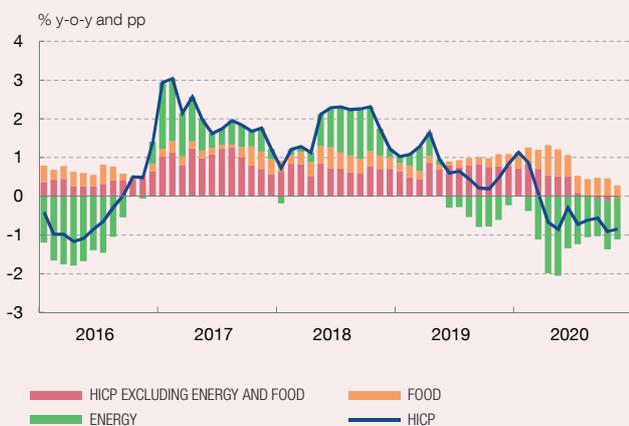
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Second, and at the other extreme, as mentioned above, the recent food price dynamics are noteworthy. During the state of alert, most fresh food and some processed food prices accelerated in Spain. These price increases were associated in part with higher household demand and also some supply-side factors related to harvesting and transporting perishable foods. In any event, these developments were relatively temporary and, in recent months, the year-on-year growth rate of food prices has

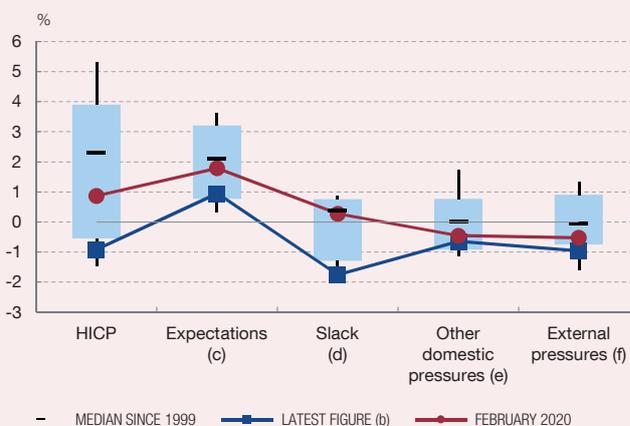
moderated, recording growth similar to that observed pre-pandemic.

Third, tourism-related services prices. The most significant event in terms of recent inflation developments was the steep drop in core inflation recorded since July. Services prices were the main contributing factor to this decline. Among them, the biggest driving force was undoubtedly the sharp deceleration in tourism-related services prices, which have

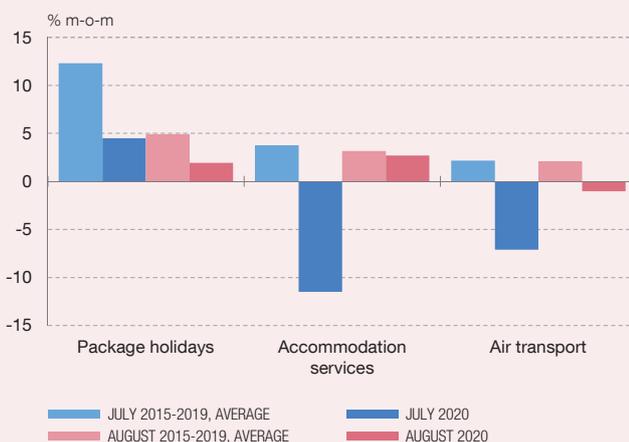
1 HICP: DEVELOPMENTS AND CONTRIBUTIONS



2 INDICATORS OF INFLATIONARY PRESSURE (a)



3 TOURISM HICP



4 HEADLINE HICP. BANCO DE ESPAÑA DECEMBER 2020 PROJECTIONS



**SOURCES:** INE, Eurostat and Banco de España.

- a See Álvarez and Sánchez (2018) for a description of the composite indicators of inflationary pressure.
- b Monthly: October 2020; quarterly: 2020 Q3; daily: 2 December 2020.
- c Inflation expectations of professional forecasters, firms, consumers and obtained from inflation swaps.
- d Includes output gap, capacity utilisation, unemployment rate, quarter-on-quarter change in the unemployment rate, recession gap and quarter-on-quarter change in GDP and in private consumption.
- e Includes labour costs, business mark-ups and domestic producer prices.
- f Imported goods prices: final products, intermediate goods and commodities.

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recorded an unprecedented collapse since the onset of the pandemic.<sup>3</sup> In particular, package holiday prices rose in July (high season) by almost two-thirds less than usual compared with June (4.5% versus 12.3% on average between 2015 and 2019) (see Chart 3).<sup>4</sup> Likewise, accommodation services prices recorded a month-on-month decline for the first time in a July, falling by 11.5%, compared with an average increase of 4% over the last four years.

Looking ahead to the coming quarters, to the extent that the severe adverse impact that the COVID-19 pandemic and the associated containment measures have had on

aggregate economic activity is expected to be relatively persistent, inflation rates are likely to hold at very low levels and only recover very gradually as the negative contribution of the energy component dissipates and core inflation recovers some momentum in line with activity (see Chart 4). That said, certain downside risks to these forecasts cannot be ruled out. These include, among others, a slower-than-forecast economic recovery in Spain and globally, inflation expectations possibly deanchoring and the crisis having more persistent effects on some services, such as those related to tourism, hospitality and entertainment.

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3 The year-on-year rate of the services component decreased by 1.3 pp between June and July, with the deceleration in the tourism-related items contributing 0.9 pp to that decline.

4 Although these rates could have been distorted by the change represented by having data available in July, after imputing the prices in the preceding months, the steep year-on-year declines in the tourism-related items highlight the severe impact of the pandemic and the containment measures on these sectors.