Following a long period of very low inflation rates, the pace of price increases in the euro area has stepped up notably in recent months, taking inflation to 2% in February. From the standpoint of monetary policy, and its medium-term inflation objective of close to but below 2%, it is crucial to disentangle the determinants of these developments and, in the words of the ECB president, to ascertain the extent to which this increase is self-sustaining, i.e. whether it would persist in the medium term, in a scenario in which the strong monetary stimulus introduced by the ECB in recent years were not required.

As can be seen in Chart 1, which depicts the contribution of the different components to the increase in the inflation rate since 2016, the recent dynamics would be attributable to two factors: first, the so-called comparison (or base) effects, namely the comparison with the abnormally low oil prices prevailing in early 2016; and further, certain surprises in the performance of the most volatile price components, in particular energy and food. In contrast with this behaviour, the least volatile inflation components have continued to post moderate and relatively stable growth.

The comparison effects largely explain both the recent behaviour and expected future pattern of euro area inflation in the coming months, whereby prices are estimated to grow at a rate close to 2% during the first half of 2017, to fall back subsequently, if there are no further surprises, to rates of around 1.5% (see Chart 2).

In the medium term several factors reinforce the idea that the current rise might be eminently transitory. Firstly, the increase in energy costs and the more recent depreciation of the euro have admittedly prompted an increase in the costs borne by firms in the early stages of production; but the pass-through of these pressures to producer and consumer prices appears to be very limited at present (see Chart 3). According to purchasing manager surveys, these dynamics would be in response to the fact that they still believe the situation to be one of moderate demand in a highly competitive environment.

Secondly, wage restraint remains prevalent in the euro area, even in those economies further along the cycle. The econometric models available – based mainly on the Phillips curve notion of wages, which positively relates wages with some measure of the economy's cyclical position – suggests that this restraint will continue for some time, in an environment in which the degree of slack still present in European labour markets will foreseeably diminish only at a very gradual pace (see Chart 4). Other factors also suggest that the risk of the rise in oil prices giving rise to second-round effects is limited at present. Hence, according to the data gathered by the ESCB Wage Dynamics Network[1], the number of firms that include indexation clauses in their collective bargaining agreements has fallen considerably across the whole of the euro area. For instance, in the case of France, the proportion of firms that adapted their wages to inflation before 2010 stood at 53%, while during the 2010-2013 period this percentage, according to the WDN, fell to 41.5%, mainly because collective agreements did not contain an indexation clause.

Finally, the indicators of inflation expectations estimated on the basis of market data are still consistent with relatively slow convergence towards levels closer to the medium-term reference of 2% (see Chart 5). It is nonetheless true that the rise in these indicators since last summer suggests that the risk of deflationary scenarios has declined considerably.

To conclude, there are two factors underpinning recent inflation dynamics: a leading component, the so-called base effects arising from the downward dynamics of oil prices in early 2016; and the *surprises* that have positively affected the prices of the most volatile components of the index. In the absence of second-round effects, which, moreover, may be expected to be limited in the current context of moderate growth and the persistence of a negative output gap, these factors are of an eminently transitory nature and, therefore, have very limited implications for the inflation outlook in the medium term, this term being the relevant one from the monetary policy standpoint to assess the price stability objective. This is duly reflected in the ECB's new forecasting exercise, which revises the December exercise's short-term inflation forecasts but holds the inflation levels for 2018 and 2019 at very similar levels to those projected at the end of last year (1.8% and 1.7%, respectively).

1 See http://www.ecb.europa.eu/pub/economic-research/research-networks/html/researcher_wdn.en.html.

Chart 1
CONTRIBUTIONS TO THE RISE IN INFLATION

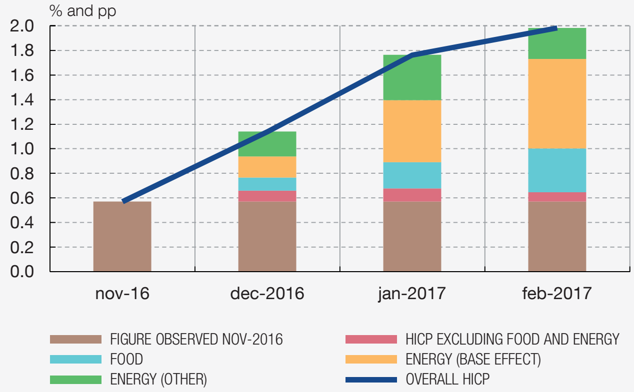


Chart 2
EURO AREA INFLATION FORECASTS

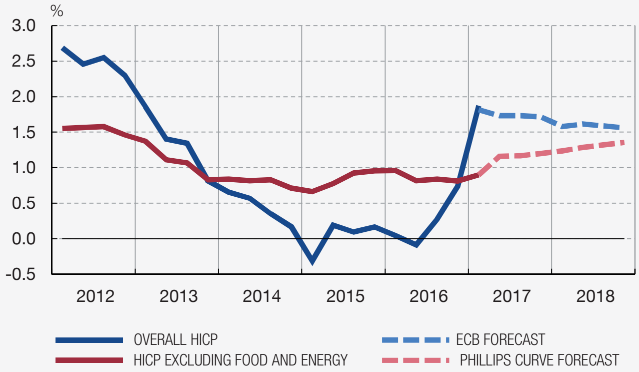


Chart 3
INFLATION INDICATORS. YEAR-ON-YEAR RATES OF CHANGE

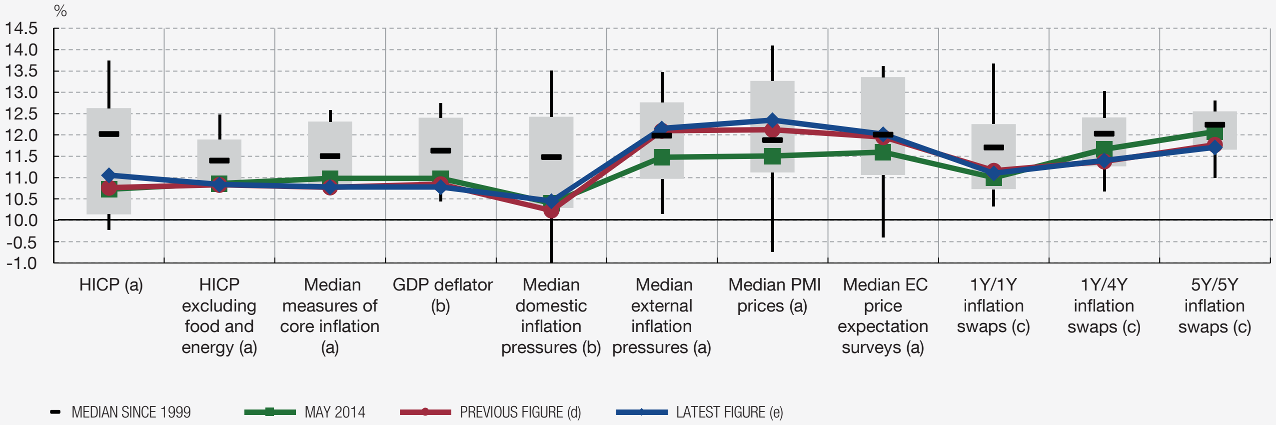


Chart 4
GROWTH IN COMPENSATION PER EMPLOYEE
(Deviations from the average of the period) Decomposition based on Phillips curve

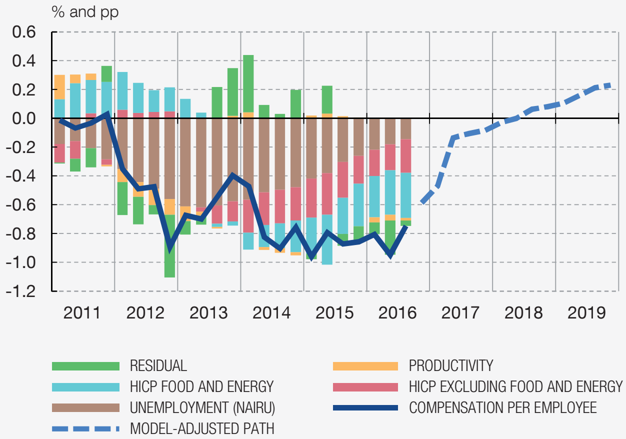
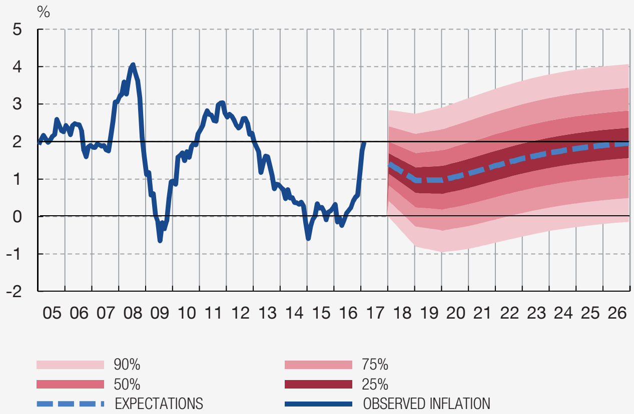


Chart 5
HICP AND EXPECTATIONS BASED ON INFLATION SWAPS



SOURCES: Eurostat, ECB and Banco de España.

a 6-month moving average.
b 2-quarter moving average.
c 5-day moving average.
d January 2017 for the monthly series, 2016 Q3 for the quarterly series and 16 February 2017 for the daily series.
e February 2017 for the monthly series, 2016 Q4 for the quarterly series and 16 March 2017 for the daily series.