Inflation in Retreat

Inflation is clearly on the wane in Ireland, in line with the trend in most other economies. Preliminary data for May show that prices rose by 0.3% in the month, with the annual rate of HICP inflation falling to 5.4%. This is down from 6.3% in April, 7.0% in March and 8.1% in February. It is the lowest rate of inflation since January 2022, and the rate is now well below the peak of 9.6% hit last summer.

Meanwhile, the inflation rate in the Euro area fell to 6.1% in May from 7% in April and is now also well down on the peak of 10.6% reached last October. The primary reason for the fall in inflation is that the large increases in energy prices in the spring of last year have been dropping out of the annual rate in recent months, which combined with lower fuel prices, has pushed the headline rate downwards. Food price inflation is also starting to ease.

There have also been the first signs of an easing in core inflation (which excludes energy and unprocessed food) recently, with the annual rate in the Euro area dropping for the second consecutive month in May to 6.9%, down from its recent peak of 7.5% in March. The Irish core rate stood at 5.7% in May compared to 6.2% in March.

Meantime, another large rise in energy costs in June of last year, as well as a big jump in food prices, will drop out of the annual rate this month, so a further sharp fall in the headline rate of inflation is in store for June. The Irish HICP rate could fall below 4.5%, while inflation in the Euro area may drop to near 5%.

Thereafter, the pace of decline in inflation is likely to slow considerably, but the signs are still that the headline rate will have moved significantly lower by the summer of 2024. Large increases in energy bills last autumn will drop out of annual inflation rates later this year. Electricity and gas prices should fall next year as the forward contracts that energy suppliers locked into last year at high prices, expire.

Food price inflation should also moderate considerably over the coming twelve months. Food prices have risen at an average rate of over 1% per month since February 2022. Food commodity prices, though, have fallen by over 20% in the past year and are now back at 2021 levels. Thus, there should be a marked moderation in retail food price inflation over the next twelve months.

Meantime, non-energy goods price inflation has eased from 6.8% to 5.8% since February in the Euro area. PMI data for the manufacturing sector show that both input and output prices are now falling. Thus, goods price inflation should continue to decelerate.

Service sector inflation, though, has remained sticky at around 5% in the Eurozone in recent months. Services PMI data show that price pressures remain elevated in the sector, with wage pressures intensifying amid a tight labour market. A study by the ECB also points to margin widening by firms. Hence, inflation is likely to be slower to fall in the services sector, which forms 44% of the consumer

price index in the Euro area. Thus, although headline inflation could well fall to 2% next year if wholesale energy prices remain around current levels, core inflation is likely to take longer to decline.

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