

# Monthly Report



NUMBER 299

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Slower productivity growth lies behind Spain's higher inflation

# Forecast

% change over same period year before unless otherwise noted

	2005	2006	2007	2006				2007	
				1Q	2Q	3Q	4Q	1Q	2Q
<b>INTERNATIONAL ECONOMY</b>									
	Forecast			Forecast					
<b>Gross domestic product</b>									
United States	3.2	3.3	2.6	3.7	3.5	3.0	3.0	2.6	2.6
Japan	1.9	2.0	1.5	2.7	2.2	1.7	1.4	1.2	1.3
United Kingdom	1.9	2.7	2.4	2.4	2.7	2.9	3.0	2.4	2.6
Euro area	1.5	2.6	2.1	2.2	2.9	2.7	2.8	2.3	2.3
<i>Germany</i>	1.1	2.7	1.4	1.9	2.7	2.8	3.2	1.7	1.3
<i>France</i>	1.2	2.0	2.0	1.3	2.6	1.9	2.1	2.2	1.6
<b>Consumer prices</b>									
United States	3.4	3.2	1.9	3.7	4.0	3.3	2.0	2.1	1.5
Japan	-0.3	0.2	0.4	-0.1	0.2	0.6	0.3	0.4	0.4
United Kingdom	2.0	2.3	2.3	2.0	2.2	2.4	2.7	2.6	2.2
Euro area	2.2	2.2	2.0	2.3	2.5	2.1	1.8	2.2	1.8
<i>Germany</i>	2.0	1.7	2.3	2.0	1.9	1.6	1.3	2.5	2.3
<i>France</i>	1.7	1.7	1.6	1.8	1.9	1.7	1.3	1.4	1.3
<b>SPANISH ECONOMY</b>									
	Forecast			Forecast					
<b>Macroeconomic figures</b>									
Household consumption	4.2	3.6	3.2	3.8	3.6	3.6	3.5	3.3	3.2
Government consumption	4.8	4.2	4.3	4.3	4.2	4.2	4.2	4.3	4.3
Gross fixed capital formation	7.0	6.3	6.0	6.3	6.2	6.3	6.5	6.3	6.3
<i>Capital goods</i>	9.0	9.2	8.2	8.6	9.1	9.5	9.6	9.2	8.7
<i>Construction</i>	6.0	6.0	5.6	5.8	5.8	6.1	6.2	6.0	5.8
Domestic demand (contribution to GDP growth)	5.2	4.8	4.4	4.9	4.8	4.8	4.7	4.6	4.5
Exports of goods and services	1.5	5.2	4.2	9.5	4.9	3.2	3.5	3.8	4.1
Imports of goods and services	7.0	7.9	6.2	12.4	7.6	6.0	6.0	5.8	6.2
<b>Gross domestic product</b>	<b>3.5</b>	<b>3.7</b>	<b>3.5</b>	<b>3.6</b>	<b>3.7</b>	<b>3.8</b>	<b>3.8</b>	<b>3.8</b>	<b>3.6</b>
<b>Other variables</b>									
Employment	3.1	3.1	2.7	3.2	3.1	3.0	3.0	2.9	2.8
Unemployment (% labour force)	9.2	8.5	8.0	9.1	8.5	8.1	8.3	8.2	8.0
Consumer price index	3.4	3.5	2.5	4.0	3.9	3.5	2.6	2.5	2.3
Unit labour costs	2.2	2.6	2.2	2.5	2.7	2.6			
Current account balance (% GDP)	-7.5	-8.8	-9.7	-10.6	-8.2	-8.5			
Not lending or net borrowing rest of the world (% GDP)	-6.5	-7.9	-8.8	-10.3	-7.7	-7.9			
Government balance (% GDP)	1.1	1.6	1.2						
<b>FINANCIAL MARKETS</b>									
	Forecast			Forecast					
<b>Interest rates</b>									
Federal Funds	3.2	5.0	5.2	4.4	4.9	5.3	5.3	5.3	5.3
ECB repo	2.0	2.8	3.8	2.3	2.6	2.9	3.3	3.6	3.8
10-year US bonds	4.3	4.8	5.1	4.6	5.1	4.9	4.6	4.9	5.1
10-year German bonds	3.4	3.8	4.4	3.5	4.0	3.9	3.8	4.1	4.3
10-year Spanish bonds	3.4	3.8	4.4	3.5	4.0	3.9	3.8	4.2	4.4
<b>Exchange rate</b>									
\$/Euro	1.25	1.26	1.34	1.20	1.26	1.27	1.29	1.32	1.35

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## "la Caixa" GROUP: KEY FIGURES

As of December 31, 2005

<b>FINANCIAL ACTIVITY</b>	<b>Million euros</b>
Total customer funds	169,470
Receivable from customers	113,857
Profit attributable to Group	1,495

<b>STAFF, BRANCHES AND MEANS OF PAYMENT</b>	
Staff	25,254
Branches	5,053
Self-service terminals	7,208
Cards	8,408,956

<b>COMMUNITY PROJECTS: BUDGET FOR ACTIVITIES IN 2006</b>	<b>Million euros</b>
Social	160
Cultural	70
Science and environmental	54
Educational	19
<b>TOTAL BUDGET</b>	<b>303</b>

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## Have we beaten inflation?

For once, Lenin and Keynes were in agreement. In his work «The Economic Consequences of Peace» the distinguished English economist agreed with the Soviet communist leader in that «the best way to destroy the Capitalist System was to debauch the currency. By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency». Keynes wrote these lines in 1920. And he was not exaggerating. Only a few years later the reckless issue of paper currency in Germany, brought about by the unviable situation of the Weimar Republic, resulted in hyper-inflation that ruined a large part of the middle class thus laying the basis that led to the rise of Hitler's National Socialist Party.

Inflation has existed ever since there was money. But it was not until the 20th century that there appeared continuous inflationary processes with the widespread use of paper currency. Before this, inflation episodes, or a general rise in price levels, alternated with periods of deflation, which is just the opposite. Following the end of metal currency and the monopolization of bank note issues by nationalized or public banks, inflation became something practically normal and hyper-inflation was no longer an exceptional phenomenon. As Milton Friedman, the recently deceased Nobel Prize winning economist, never tired of saying, long-term inflation is a monetary phenomenon and it is quite clear who are those responsible.

But this does not necessarily mean that governments and their central banks have acted in bad faith. Current for some time was the theory that with a little inflation it would be possible to obtain an increase in employment. Furthermore, public deficits were considered useful instruments to fine tune the cyclical situation of economies. This idea stayed until at the beginning of the Seventies the progressive lack of budgetary control led to «stagflation» (stagnation with inflation), growing unemployment and imbalances in the public accounts that were more and more out of control. It became necessary to understand the phenomenon and to work out the solutions necessary.

The result has been brilliant. As of the Nineties, inflation rates generally began to drop and went to very low levels. In recent years we have undergone a new energy shock but the price indices have noted the higher cost of energy only in the sub-indices related to energy products. There has scarcely been any shift to other prices or to wages. Have we finally learned how to manage fiat money? The key has been to make the central banks independent, clarify the objective of price stability, let the central banks do their work and resist the enticements of fiscal policies that promise short-term improvements in growth and employment but turn out to be disastrous over the medium term. Nevertheless, we cannot rest on our laurels. Consumer price indices seem to have been tamed but many people may ask why the price of housing has gone so high. Or if the success with inflation is nothing more than the effect of globalization with the importation of manufactures at ruinous prices. Or if sooner or later the growth of the world money supply is not going to bring about unexpected inflationary pressures. But let us not be pessimistic. Inflation has been beaten because its profound causes are now understood, although it will always be necessary to keep on the alert should it return.

## OVERALL SUMMARY

**Moderate temperatures work in favour of energy savings and construction...**

**...in year when world economic growth prospects start off very well.**

**Real estate recession in United States may have hit bottom.**

### 2007 starts off on good footing

Global warming, change of course in the Niño or statistical anomaly? The fact is that in November, December and the first two weeks in January the temperature was exceptionally mild in most developed countries of the northern hemisphere. And this has worked well for the economy. The clearest effect of the meteorological windfall this winter may be noted in heating costs. This largely explains the drop in oil prices in recent weeks. Another sector benefiting from the weather is construction. Here winter activity normally drops heavily but under current conditions it has recovered and is helping job creation. The mild temperatures may also boost consumer buying although this effect is more cause for discussion.

In some way or another, climatic factors have served to improve economic prospects at the start-up of 2007. And prospects were already quite good. In mid-January, Rodrigo de Rato, director of the International Monetary Fund, stated that he expected robust world growth in 2007 of around a rate of 5%, which meant very substantial growth and one of the longest such periods since the end of World War II.

Indicators for economic activity have been especially favourable. A decisive factor in this regard was the drop in oil prices to close to 50 dollars a barrel (Brent) whereas as the end of last year it was still running at around 60-65 dollars. It should be pointed out that in the final days of January the price of crude tended to recover slightly. Apart from weather

factors, it is believed that other aspects had had an influence on this notable cut. These may have included some readjustment of supply capacity, the possible withdrawal of speculative money and even the perception of lower geo-strategic risk.

In the United States, the main uncertainty is still the extent of the real estate recession and any possible shift to the rest of the economy. Most recent figures suggest that the real estate downturn may have slowed but we cannot discount a relapse. On the supply side, economic activity and employment in construction will have benefited from the mild weather conditions at the start of winter. With regard to inflation, the drop in energy prices represents a relief although it does not affect the possible background pressures that may still exist. On the demand side, lower outlays for petrol (gasoline) and heating mean greater household purchasing power, a key factor when it comes to whether or not there comes about a shift arising from the drop in real estate.

In the meantime, the Federal Reserve is debating whether or not to lower interest rates in order to contain the real estate risk or raise them because of a possible inflation risk or to maintain them steady while waiting to clarify its ideas. This is a dilemma which also involves the markets that at this moment are unable to pronounce a unanimous verdict on the immediate course of the US economy. Nevertheless, this dilemma has helped the dollar which at the end of 2006 dropped in expectation of a cut in Fed

interest rates whereas so far this year the euro has dipped against the dollar.

In China, the other big growth engine of the world economy, things look clearer. According to the statistics office, the gross domestic product grew by 10.4% year-to-year in the fourth quarter, a figure higher than expected. As a result, total growth for 2006 stood at 10.7%, the highest rate in 11 years. This meant it was maintaining the two-digit growth rates that are allowing the Chinese economy to come close to the volume represented by Germany. Thanks to this situation, the Asian region is holding to an enviable economic strength which is also benefiting the Japanese economy whose growth depends largely on foreign demand. On the other hand, Japan's domestic demand is still failing to take off so that the risk of deflation has not entirely disappeared. At the same time, the Bank of Japan is still resisting any move to normalize its atypically low interest rates.

Economic results in Europe are also consolidating the improvement in prospects. For example, in the Euro Area retail sales and improved consumer confidence, along with the improvement in the labour market, makes it possible to expect that household spending will finally make an active contribution to the current recovery. On the supply side, industrial production is getting a positive boost from export markets. In geographical terms, Germany is showing its best growth since 2000 and has managed to meet the requirements of the Stability and Growth Pact (government deficit below 3% of GDP) for the first time since 2001. In France, the economy is not a major issue in view of the coming presidential elections but available indicators seem to be recovering from the recent dip, an improvement linked to the increased dynamic in the labour market. On the other hand, the Italian economy may

have lost some of the drive it was showing up to the third quarter of last year.

In this context of dynamic growth, inflation in the Euro Area has turned out lower than forecast. The positive effect of energy prices has counteracted a possible growth in consumer demand with the result that the harmonized index of consumer prices in the Euro Area ended 2006 at 1.9%, just below the limit desired by the European Central Bank (ECB). At the same time, underlying inflation stood at only 1.6% year-to-year. The ECB, however, has been little impressed by the moderation in prices. The growth of the money supply reference followed by ECB economists has shot up in recent months going close to 10%. Although the link with inflation is unclear, to say the least, the monetarist tradition of Frankfurt obliges it to stay on the alert. The markets are anticipating an early upward move by the ECB at the Governing Council meeting in March which could put the interest rate at 3.75%.

The Bank of England surprised everyone in January with an unexpected increase in its reference rates in view of the suspicion (shortly after confirmed) that inflation would go up to the limit of the range set by the bank as its monetary policy objective. Indicators for the British economy confirm a new drive in private consumption and progress in industry and services.

### **Spain's economy: never-ending growth**

In its recent report on Spain's economy, the Organization for Economic Cooperation and Development (OECD) gives the count. Spain's economy has had 13 years of strong growth. Again in 2006, growth was higher than in the Euro Area, this time round by more than one percentage point. As in previous years,

**China's growth holding at around 10%, a dynamic spreading throughout region, including Japan.**

**In Europe, indicators confirm good state of economic activity with Germany recovering leadership role.**

**ECB continues to indicate interest rate rises despite good results on inflation.**

**Spain's economy marks up 13 years of continuous growth thanks to drive in domestic demand.**

the growth drive came from domestic demand, backed by easy financing conditions. Resulting job creation was accompanied by some moderation in wage increases so that it was possible to integrate a large number of immigrants in the labour market and at the same time reduce the unemployment rate.

In terms of the labour market, 2006 was another year of records. For the first time, the number of persons employed went above 20 million, according to the Labour Force Survey carried out by the National Institute of Statistics. The number of persons enrolled with Social Security also reached an all-time high. The activity rate, the relation between the number of persons working or looking for work compared with the total population of working age, continues to improve, thanks to the incorporation of women in the labour market and the inclusion of recent immigrants. Also, at the end of 2006, the unemployment rate dropped to 8.3% of the labour force, a figure close to the European Union average and the lowest since 1979.

The sector in which employment rose most in 2006 was construction which contributed 30% to total job creation. As usual, the OECD devoted a lot of attention to the prolonged growth cycle in construction, underlining its concern about high housing prices and the dependence of the current growth cycle on construction activity. It should be noted, however, that the most recent indicators for the real estate sector point to an easing in prices and a slight downturn in sales.

The OECD also pays some attention to the «black mark» represented by the concurrent factors of inflation higher than that of Spain's EU neighbours, a drop in foreign competitiveness, and very meagre improvements in productivity.

Inflation end the year 2006 much better than was expected in the summer at the height of the worsening pressures in the oil markets. The consumer price index reached a year-to-year rate of 2.7%, the best result in three years. Nevertheless, in terms of annual average, the growth of consumer prices was 3.5%, one decimal more than in 2005 and clearly shows the increase in the index during a large part of the year due to energy prices. What was more important, underlying inflation (excluding fresh foods and energy) was somewhat higher in 2006 on annual average. This means that the drop in energy prices does not allow us to lower our guard on the matter of inflation.

Notable in the foreign sector was the result of the tourist season last year which showed a new high in the inflow of tourists, nearly 58 million, and a modest increase in average spending per tourist. Nevertheless, these results do not counteract concern regarding the trade deficit brought about by the loss of share in goods exports. Once more, this underlines the situation in foreign competition and the run-away current account deficit.

Underlying the imbalances in prices and the foreign sector is the slow improvement in productivity. In its annual study, the Conference Board, the international business organization, stated that Spain's productivity has shown losses in the past three years, a result that is a warning about the quality of growth in the recent economic cycle, centred as it is in sectors of low value added per worker. This means that the matter of shifting over from the traditional growth model to another with higher technological content, better education and competitive innovation is still an open question.

January 26, 2007

**Number of employed goes over 20 million for first time with construction leading job creation.**

**Inflationary pressures, worsening of foreign sector and stagnation in productivity remain main concerns.**

## CHRONOLOGY

### 2006

- January** 20 Government presents bills for reform of **personal income tax** and **corporate tax**.  
31 **Federal Reserve** raises reference rate to 4.50%.
- March** 2 **European Central Bank** raises official interest rate to 2.50%.  
28 **Federal Reserve** raises reference interest rates to 4.75%.  
31 Government approves **economic policy package** including budgetary measures and others on mortgage market, energy sector and rail transport.
- May** 4 Agreement between government, business organizations and trade unions on **labour reform** aimed at reducing extent of temporary work.  
10 **Federal Reserve** raises reference rate to 5%.
- June** 8 **European Central Bank** raises official interest rate to 2.75%.  
29 **Federal Reserve Board** increases reference rate to 5.25%.
- July** 11 European Council authorizes **Slovenia** to adopt euro as currency as of January 1, 2007.  
24 Multilateral negotiations in **Doha Round** of World Trade Organization, aimed at greater liberalization of international trade, indefinitely suspended.
- August** 3 **European Central Bank** raises official interest rate to 3.00%.  
8 One-month forward price of Brent quality **oil** goes up to all-time high of 78.49 dollars a barrel.  
12 UN Security Council approves resolution for **cease-fire in Lebanon** in conflict between Israel and Hezbollah.
- September** 26 European Commission gives go-ahead to entry of **Romania and Bulgaria** into European Union on January 1, 2007.
- October** 5 **European Central Bank** raises official interest rate to 3.25%.
- November** 29 Publication in BOE Official Bulletin of Law 35/2006 on reforms to **Personal Income Tax** and partial modification of laws on Corporate Tax, Non-resident tax and Property Tax.
- December** 7 **European Central Bank** raises official interest rate to 3.50%.

### 2007

- January** 1 **European Union** enlarged to 27 member states following inclusion of Romania and Bulgaria while **Euro Area** grows to 13 following Slovenia's adoption of Single European Currency.  
**Reforms to Personal Income Tax** and **Corporate Tax** come into force.  
24 IBEX 35 index for **Spanish stock market** marks up all-time high (14,540.7) with cumulative capital gains of 2.8% compared with end of December 2006. Dow Jones index for **New York stock exchange** reports all-time high (12,621.8), an increase of 1.3% over the end of 2006.

## AGENDA

### February

- 2 Registrations with Social Security and registered unemployment (January). Industrial production index (December).  
8 Meeting of the Governing Council of the ECB.  
13 Preliminary GDP for Spain (4th Quarter).  
14 EU GDP (4th Quarter).  
15 Balance of payments (November).  
20 CPI (January).  
21 Quarterly National Accounts (4th Quarter).  
26 Producer prices (January).  
28 Preliminary HCPI (February).  
Harmonized CPI for EU (January).

### March

- 2 Registrations with Social Security and registered unemployment (February).  
6 Industrial production index (January).  
8 Meeting of the Governing Council of the ECB.  
13 CPI (February).  
15 Balance of payments (December).  
Labour cost (4th Quarter).  
Harmonized CPI for EU (February).  
21 Open Market Committee meeting of Fed.  
26 Producer prices (February).



## INTERNATIONAL REVIEW

**Gradual economic slowdown and labour market raise fears of inflation...**

**...without ignoring real estate market.**

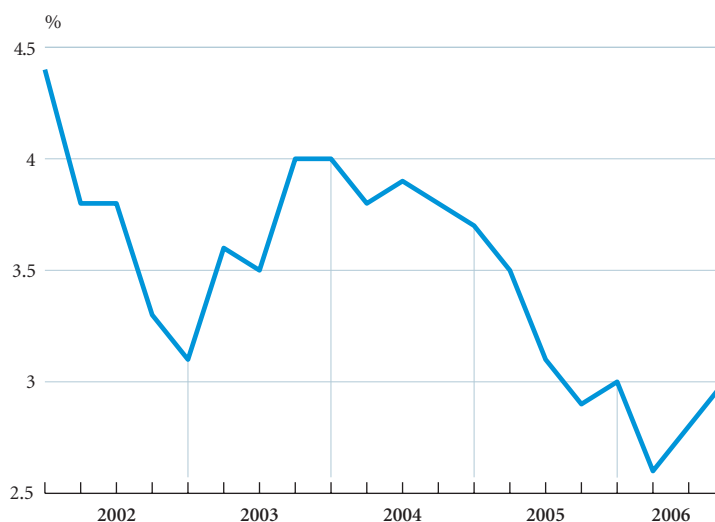
### United States: prospects reasonably optimistic

In recent weeks the messages coming from the Federal Reserve are quite ambiguous. The gross domestic product (GDP) will have grown by more than 3.0% in 2006 while prices were up 2.5%. What is still awaited is the end of the drop in housing and correction of the trade deficit. Also pending is the question whether inflation will continue to moderate, which would confirm the central hypothesis of a soft landing or, on the contrary, whether prices could move into an undesirable upward process. With the current slowdown, while more gentle than what was feared in mid-autumn, uncertainty is centred on the strength being shown by the

labour market that does not appear to be consistent with a turndown situation. In December, some 167,000 new jobs were created and figures for previous months were revised upward. Even more telling is the unemployment rate, which settled at 4.5% of the labour force, is close to 1999 values when the optimistic bells of the new economy were ringing loud. A tight labour market could give rise to a boost in inflation that so far has not happened. In any case, the labour cost index for the third quarter for private employees rose by 3.0% year-to-year, one of the lowest figures of the decade. Discounting bonuses in the form of stock options, wage pressures are rather well contained.

### UNITED STATES: EMPLOYMENT NOT RAISING PRICES

Year-to-year change in labour cost index



SOURCE: Bureau of Labour Statistics and own calculations.

The optimistic view on prices seems to be slightly higher than the pessimistic one which is based on whether the ceiling of growth possibilities is lower than believed or is growing above shown by the GDP figures. With regard to the first, some productivity indicators have been weak, which suggests that the engine, with all its resources in operation, may be able to produce less than we believed and therefore we are closer to the top, which could produce overheating, which in economics translates into price rises. The slight increase in utilization of production capacity in December to 81.8% of the total would support this thesis. In the same direction, the automotive industry seems to be slowly awakening following a long recession. Nevertheless, industrial production in December grew by a moderate but sustained 3.0% year-to-year. The economic activity index of the Institute for Supply Management also shows a fairly contained picture for the

manufacturing sector which in December stood at 51.4 points whereas those who see or foresee weaker activity nearly equal those who see strengthening. In the non-manufacturing sector, with 57.2 points, the tone is higher but the picture is a long way from that of an engine at top potential.

Regarding whether growth is stronger than it seems, things are not quite as clear. Disposal household income grew by 3.1% but with a clearly upward trend. Because of its nature, much closer to household budgets, this trend could be helping consumption with retail sales, excluding cars and petrol, which in December grew by 5.7% year-to-year, although it should be observed that this increase was helped by a downward revision of previous months.

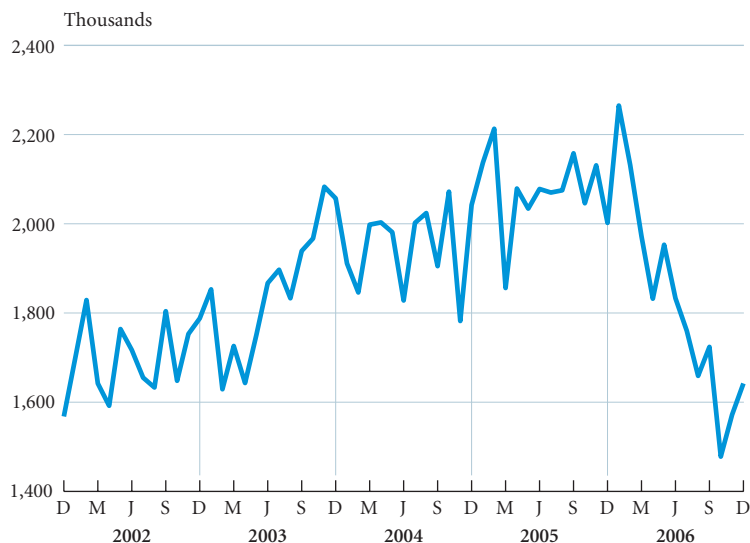
This explains the support being obtained by consumption over which

**Retail sales depending on disposable income, up somewhat more than GDP, with increase of 5.7%.**

**Housing beginning to ease its losses.**

## UNITED STATES: HOUSING CONTINUES TO DROP BUT SOMEWHAT LESS

Housing starts in annual terms



SOURCE: Federal Housing Finance Board, National Association of Realtors and own calculations.

hangs the weakness in real estate. While we have not reached the end of the tunnel, there are signs that the drops are moderating. Housing starts in December surprisingly moved up for the second month in a row to stand 11.1% above the bottom hit in October although still 18% below the same period the year before.

process is closely linked to the vagaries of the housing market we may ask if the underlying component will end up tending toward the value of the component excluding rentals or if, on the contrary, the rise in rentals will permanently settle into the public perception, something that could leave inflation at current undesirable levels.

### Inflation at 2.5% showing positive prospects.

The latest figures on inflation have a more positive bias than it would appear. In December, the consumer price index stood at a 2.5% year-to-year increase while the underlying component, excluding food and energy, grew by 2.6%. This meant a rate of increase higher than the monetary authorities consider optimum. This component is being affected by the rise in rental prices, a result of the real estate slowdown which is making people see that buying is expensive and makes them opt for renting, with the resulting increase in prices. Without this phenomenon, the rest of the underlying component grew by 1.4% in December and continued to slow gradually. As this

The response could lie in public confidence in the capacity and determination of the Fed to control prices. If this is high, as seems to be the norm in recent times, things should go well. Something similar would have to happen with the trade deficit. In recent months there has been a correction coinciding with the drop in oil prices and it could not have been otherwise. While the oil price has had limited effects on non-energy prices, its effects on the trade deficit have been more notable given that they have contributed by 93% to the deficit in the past two years up to last August when it reached its highest level.

## UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005		2006					
			3Q	4Q	1Q	2Q	3Q	October	November	December
Real GDP	3.9	3.2	3.4	3.1	3.7	3.5	3.0	–	...	–
Retail sales	6.2	7.2	8.2	6.4	8.3	6.6	5.5	4.7	4.6	5.4
Consumer confidence (*)	96.1	100.3	98.9	95.8	105.7	106.6	104.4	105.1	105.3	109.0
Industrial production	2.5	3.2	3.1	3.2	3.3	4.2	5.1	4.7	3.5	3.0
Industrial activity index (ISM) (*)	60.5	55.5	56.0	57.0	55.6	55.2	54.0	51.2	49.5	51.4
Sales of single-family homes	10.1	6.6	11.9	3.1	–11.6	–14.4	–21.5	–24.7	–15.3	...
Unemployment rate (**)	5.5	5.1	5.0	5.0	4.7	4.6	4.7	4.4	4.5	4.5
Consumer prices	2.7	3.4	3.8	3.7	3.7	4.0	3.3	1.3	2.0	2.6
Trade balance (***)	–611	–717	–689	–717	–740	–761	–779	–772	–766	...

NOTES: (\*) Value.

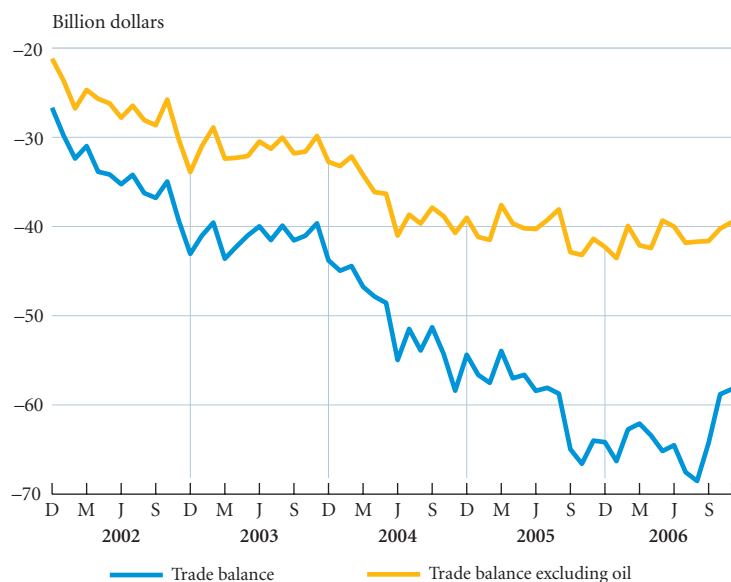
(\*\*) Percentage of labour force.

(\*\*\*) Cumulative balance for 12 months. Billion dollars.

SOURCE: OECD, national statistical bodies and own calculations.

## UNITED STATES: THE REAL EFFECT OF OIL

Trade balance, monthly data



SOURCE: Department of Commerce and own calculations.

Looking to the future, the correction will have to include the non-oil component. It is still to be seen whether dependence on crude in production processes has been reduced (this seems unlikely given that higher cost oil does not mean less consumption) and whether, on the other hand, US

competitiveness may be boosted by the pressure companies have had to face in order to maintain sales. Finally, the view of inflation, the deficit and housing will depend on the degree of optimism held and, for the moment, the figures leave some openings for a moderate dose of that.

**Trade deficit main heading affected by oil prices.**

## Housing, the CPI and through what colour glass we look at prices

General Walter G. Short was uncertain about the safest way to position his aircraft, either putting them all together or spreading them out. Finally, he decided to put them all together in the middle of the airfield to prevent possible sabotage attacks. A few days later, during the attack on Pearl Harbour, the Japanese found things easier and nearly 200 aircraft were destroyed on the ground, all of them grouped together. To change aircraft positions may be easy but the real problem is to know how information can be relied on and to know what dangers must be foreseen. In the case of economic indicators something similar happens. It is a matter of providing reliable information about the economic reality. There will be biases but what is difficult is to be able to discern what are the main ones to avoid at any given moment.

A consumer price index (CPI) should reflect the increase in cost of living in a determined period, normally one year. For this purpose, periodic surveys are done on household spending and, based on these, various

weightings are assigned to goods and services making up household consumer spending. With these weightings and by periodically looking at the trend in prices, we can calculate the change in the general CPI. Up to here, things are clear enough but only up to this point. Among the more complicated problems that come up in drawing up an inflation index is the matter of housing. This cost obviously plays an important role in household budgets and it is logical to include it in any cost of living index.

#### METHODS USED TO INCLUDE OWNER-OCCUPIED HOUSING IN CPI (\*)

	Net acquisitions	Payments	Use cost	Implied rental	Not included
<b>Euro Area</b>					
Harmonized CPI					Not included
Belgium					Not included
Finland		Payments			
France					Not included
Germany				Implied rental	
Greece					Not included
Ireland		Payments			
Italy					Not included
Luxembourg					Not included
Netherlands				Implied rental	
Portugal					Not included
Spain					Not included
<b>Rest of Europe</b>					
United Kingdom			Use cost		
Denmark				Implied rental	
Sweden			Payments		
Czech Republic				Implied rental	
Hungary				Implied rental	
Poland					Not included
Slovakia				Implied rental	
Iceland			Payments		
Norway				Implied rental	
Switzerland				Implied rental	
<b>Rest of OECD</b>					
Canada			Payments		
Mexico				Implied rental	
United States				Implied rental	
Australia	Net acquisitions				
New Zealand	Net acquisitions				
Japan				Implied rental	
South Korea				Implied rental	

NOTES: (\*) Rentals paid included in all CPIs given that they constitute spending in the purchases basket.

SOURCE: OECD and own calculations.

When a family lives in a rental home the cost is quite clear. The rental is a cost included in the basket making up the cost of living. But what happens when that family lives in a house that it owns? If the house is paid for, should we impute spending that, in fact, does not take place? If it is a matter of a house subject to a mortgage payment, should the full amount be taken into account? In other words, how do we include owner-occupied housing consumption in the CPI? Things seem even more difficult than General Short's dilemma, given that instead of two alternatives there are five different alternatives for including housing in the CPI – acquisition cost, cash payments, use cost, the imputation of rental cost or, finally, not to include this.

In the first place, the approach using acquisition cost deals with home purchase as a durable good, that is to say, it is given the same treatment as that applied in the CPI to the purchase of a car or an appliance. Here, we would only consider the cost of purchase of the new house during the period. Given that a new house is a long-lasting good, a very low proportion of consumers acquire one each year. The change in prices and swings in the construction cycle would make the prices index quite volatile. Only Australia and New Zealand use this method.

In second place, the alternative of cash payment includes all those costs associated with owning a home, including mortgage interests. This is a debatable option given that, in spite of the fact that the interest included in the mortgage payment is important in household budgets, its volatility introduces distortions in the CPI and this is not properly a consumption expenditure. This method is used in Ireland.

The third option, the user cost, includes a calculation of what it costs to own the property where one lives during the period used to calculate the change in the CPI. Included here are interest rate, services, maintenance work and possible depreciation but it is also necessary to take off the appreciation of the home (excepted appreciation since the decision to buy or rent is based on it). Curiously, if housing unit prices rise the costs of ownership are relatively lower.

The third option seems more logical than the earlier ones but including the interest rate also could have a negative effect on monetary policy. Furthermore, calculating price expectations is complicated and including profits from investment in a consumer price index is also debatable. This method is used in the United Kingdom and Scandinavian countries.

The fourth option is to impute rental costs to home owners. This is used in a large number of countries belonging to the Organization for Economic Cooperation and Development (OECD), with United States, Japan, and Germany in the lead. The imputation of a not-paid rental cost for owned-occupied homes offers undeniable attractions. On occupying a home, the owner incurs an opportunity cost given that, by not doing so, he would be able to rent it to someone else. Forgone gains are easy to calculate as they will depend on the rental market. In a market with no tax distortions, the rental should be close to the hypothetical user cost.

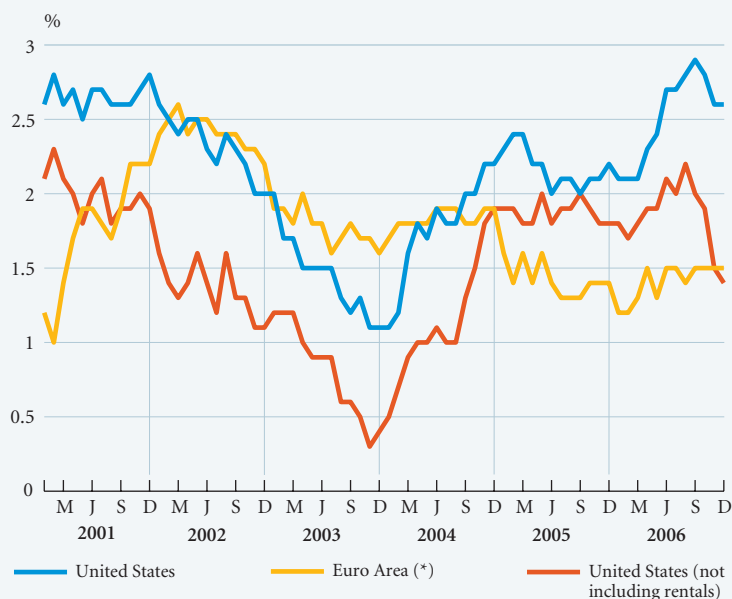
The final option is not to calculate the use of the owner-occupied home, as is done in many countries in the Euro Area, such as Spain, France and Italy and in the harmonized CPI for the Euro Area.

These last two options are the ones most used in the various countries of the OECD. For General Short, the alternative was to group or not to group aircrafts. In order to calculate the CPI, it is a matter of imputing or not imputing an expenditure that in reality is not paid out. The option of not imputing a cost is simple but it also has its biases. Prices depend on the percentage of home owners. If Spaniards decide to buy more homes,

the weight of rental that goes into the CPI is reduced even further so that, paradoxically, during a real estate boom the housing component should tend to moderate inflation.

## TWO DIFFERENT WAYS OF LOOKING AT INFLATION

Year-to-year change in underlying component excluding energy and food



NOTES: (\*) The harmonized CPI index for the Euro Area does not include rental costs imputed to homeowners.  
SOURCE: EUROSTAT, Bureau of Labour Statistics and own calculations.

Another problem in the diversity of approaches is international comparisons. In Spain, owner-occupied homes make up 85% of the total, whereas in Germany they are only 42%. As Germans are more willing to rent, the alternative of not imputing rentals would ignore higher costs of housing in Spain than in Germany. The option in the Euro Area is based on the little information provided by rental markets. In Spain, rental carries a weighting of only 2.2% in the CPI and the market is heavily regulated and not very flexible. To multiply its influence in measuring the cost of living could introduce biases. Those countries that impute rentals to homeowners are the ones with a higher proportion of rentals with more complete and extensive markets which provide more reliable information.

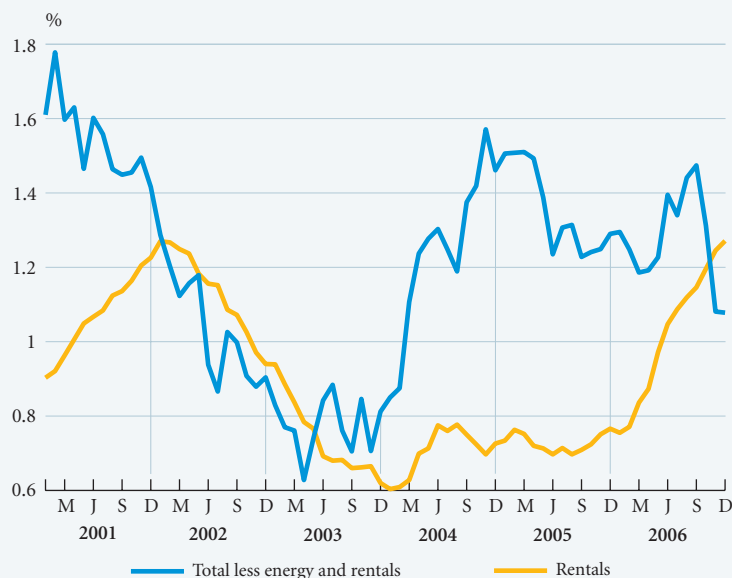
All countries have their own reasons for using one method or another, but the fact is that housing as a whole (services, maintenance, rentals, etc.) represents less than 11% in Spain's CPI, whereas this goes over 42% in the US CPI. It is clear that in the current situation where both economies have seen sharp appreciation in real estate, housing cannot affect the cost of living four times more for US households than for Spaniards. Either this means that one of the two cases is wrong or, at least, the conclusions arrived at from the trend in the CPI must be different.

In the case of the United States, its calculation system involved a shift from the real estate boom to the CPI. Expensive real estate and higher interest rates have now convinced the public that buying a house is difficult and less attractive than heretofore. Activity in the sector has dropped and real estate appreciation has slowed down. If buying is not attractive people opt for rental and prices of the latter go up. These increasing rentals account for

only 5.8% of the CPI but imputed rentals add another 23.4%. As a result, with growth of more than 4% in 2006, rental cost (real and imputed) is responsible for half of the inflationary pressures in 2006, a contribution five times higher than that for much publicized oil increases. Perfection does not exist but, in terms of macroeconomic policy, it is necessary to clearly see the limitations of the indicators used and to hope that the monetary authorities have more luck than General Walter G. Short in working out what has really to be foreseen.

### SHOULD UNITED STATES BE AFRAID OF INFLATION?

Contribution to year-to-year change in CPI



SOURCE: Bureau of Labour Statistics and own calculations.

### Japan's sun rising slowly but with stars shining

The dominant note of the month has been the discussion, now something usual, between Toshihiko Fukui, governor of Japan's central bank, and prime minister Shinzo Abe. The central bank made an effort to convince us that there were reasons for a rise in interest rates. This set off a chorus of politicians expressing their displeasure. They were not without their reasons when we see that Japanese growth has been more modest than was thought and that the end of deflation has still not been

assured. But, although the state of the economy did not seem to merit a rise in interest rates, the conditions of low-cost borrowing continue to support a strong recovery in investment based on export activity. This is bringing about an inefficient assignment of resources with heavy dependence on world demand and could be a factor for the monetary authorities to consider seriously.

The step backwards in not touching interest rates when it had been announcing the opposite sows doubt about whether it was the weakness of the level of economic activity that

**Japan's recovery fragile.**

**Retail consumption and car sales not responding...**



## JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005		2006					
			3Q	4Q	1Q	2Q	3Q	October	November	December
Real GDP	2.7	1.9	2.2	2.9	2.7	2.2	1.7	–	...	–
Retail sales	–0.9	1.4	1.1	0.7	0.6	–0.2	0.4	0.3	–0.1	...
Industrial production	5.3	1.5	–0.1	3.6	2.8	3.7	5.3	6.1	4.9	...
Tankan company index (*)	20.5	18.0	19.0	21.0	20.0	21.0	24.0	–	25.0	–
Housing construction	2.6	3.8	4.9	6.9	4.9	8.8	–0.7	2.1	4.2	...
Unemployment rate (**)	4.7	4.4	4.3	4.5	4.2	4.1	4.1	4.1	4.0	...
Consumer prices	0.0	–0.3	–0.3	–0.7	–0.1	0.2	0.6	0.4	0.3	...
Trade balance (***)	13.9	10.2	10.9	10.2	9.5	9.1	8.9	9.0	9.4	...

NOTES: (\*) Value.

(\*\*) Percentage of labour force.

(\*\*\*) Cumulative balance for 12 months. Billion yen.

SOURCE: OECD, national statistical bodies and own calculations.

convinced Fukui, which seems completely reasonable, or it was political pressure, which would put in doubt the independence of the institution and faith in its own evaluation of the current situation. In principle, the most recent demand

indicators would seem to support the Abe's criticism. Retail sales in November continued to maintain a low level and went down by 0.1% year-to-year. Along the same lines, car sales in December continued a chain of drops going down 7.3% year-to-year. Nevertheless,

## JAPAN: CAR SALES WANING

Car sales in last 12 months (\*)



NOTES: (\*) Excluding vehicles of less than 550 cc.

SOURCE: Japanese Ministry of Communications, National Statistics Office and own calculations.

consumer confidence in the fourth quarter went up to the level of 47.3 points. In turn, the housing market in December partially recovered from the poor previous months. Tokyo prices rose slightly and sales showed more moderate losses compared with the same period the year before.

Industrial production remains one of the strong points of Japanese economic activity with growth which, in spite of slowing down compared with the peak in October, continued to grow by around 5%. Apart from the growth trend, industry appears to be gaining in productivity. Unit labour costs, which decrease the more productive the employees, were down by 3.2% year-to-year in November. Two significant examples of this are the recovery in exports to China and the ambition of the Toyota automotive company to become the world's leading car manufacturer in 2007 although not all its cars will be made in Japan.

The other strong point of the economy continues to be investment already mentioned. The preliminary indicator for this heading, machinery orders, was strong in October and November with year-to-year increases of more than 15%. Practically all of this increase, however, comes from foreign demand which during those two months grew by close to 40%. The improvement in productivity, even with dependence on foreign demand, makes it difficult to evaluate the future yield to come from this drive in investment. Those having no doubt about this are the big companies which make up the Tankan index of industrial activity which marked up a level of 25.0 points. Things seem to be going well for them, something in keeping the most traditional line of Japan where manufacturers are dominant.

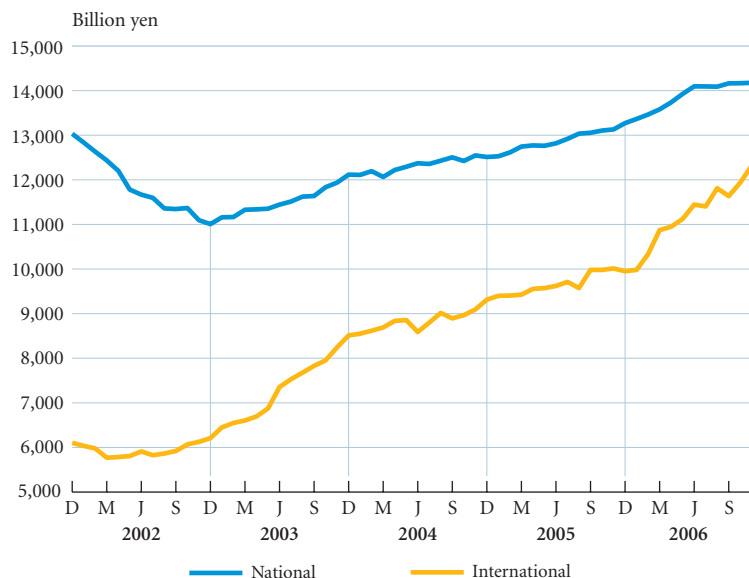
The November CPI rose by 0.3% year-to-year while the underlying component (excluding fresh foods but including energy) moved up a mere 0.2%. With

**...but industrial sector remains strong, raising production and with eye on foreign trade.**

**CPI at 0.3% does no ensure end of deflation although unemployment at 4%.**

## JAPAN: INVESTMENT GOES FULL-STEAM-AHEAD AND LOOKS ABROAD

Machinery orders in past 12 months



SOURCE: Japanese Ministry of Communications, National Statistics Office and own calculations.

## **Brazil recovering with growth of 3.3%.**

the sharp volatility of energy and taking into account that the other price indicator, the GDP deflator, continues to drop, it is difficult to say goodbye to the period of deflation. Backing the optimistic theses is the labour market with an unemployment rate of 4.0% of the labour force. While this is caused by a decreasing population, we should not forget that this is the lowest figure in recent years. In turn, the trade balance increased its surplus to 9,400 billion yen and, so long China and United States keep buying, Japanese exporters will still have a lot to talk about.

### **Brazil recovers sparkle**

The Brazilian economy confirmed the expectations raised by recent indicators and recovered strength in the third quarter, mainly thanks to investment and exports.

The third quarter GDP was up 3.3% year-to-year. Private consumption lost some of the strength of earlier periods but held up with gains of 3.4%. Nevertheless, investment was the component to lead a more significant recovery following the weakness seen in the second quarter with a boost that took it up 6.4% year-to-year, thus helping to solidify growth. The foreign sector also behaved more in keeping with the figures of the trade balance and, in spite of the fact that imports were especially heavy with increases of more than 20%, there was

notable new strength in exports which again decidedly took on a growth path.

Latest monthly supply and demand indicators are maintaining the growth trend they began to show at the end of summer. Retail sales in November were up 9.2% year-to-year and indicate the maintenance or improvement of private consumption growth in the third quarter. Pointing in the same direction are car sales which were up 20.0% year-to-year in December maintaining an upward trend in recent months. On the supply side, industrial production in November held up with growth of 4.2% year-to-year while the more significant industrial production of capital goods continued to show a strong level with increases of 7.9%.

Inflation is still one of the successes of Brazil's economy with prices moving up by 3.1% year-to-year in December after recording an all-time low of 3.0% in November. This time the November unemployment rate did not spoil the party and in the São Paulo district it went down to 14.1% of the labour force which while excessively high is the best figure this decade.

Another of Brazil's successes is in its foreign sector which is maintaining a trade surplus of 46.1 billion dollars. Nevertheless, the drop in raw materials prices will bring the real test of competitiveness and will give a clearer idea of the real value added of exports.

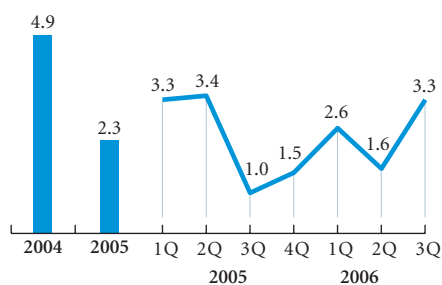
## **Consumption holding up but investment and exports are growth leaders.**

## **Retail sales and industrial production of capital goods point to continuation of growth.**

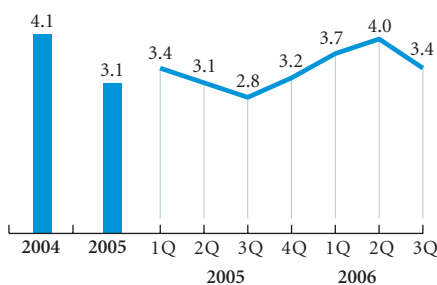
## TREND IN BRAZIL'S GDP BY COMPONENT

Percentage year-to-year change in real terms

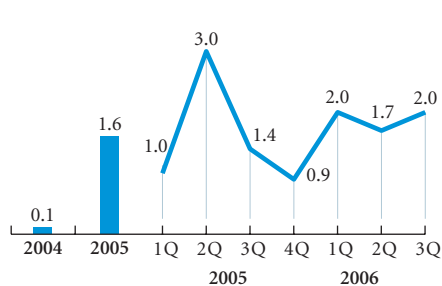
### GDP



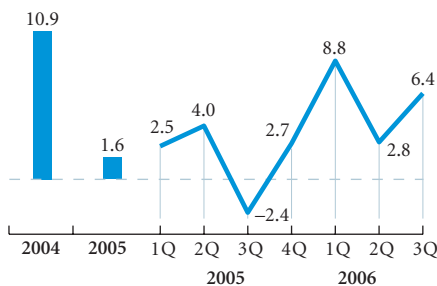
### Private consumption



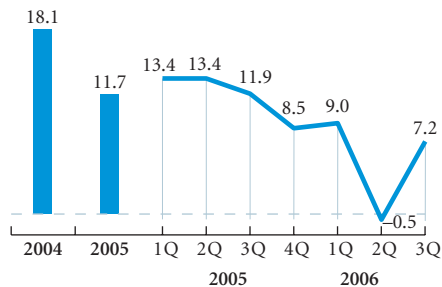
### Public consumption



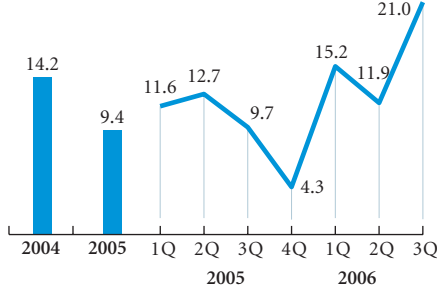
### Gross fixed capital formation



### Exports of goods and services



### Imports of goods and services



SOURCE: Brazilian Institute of Geography and Statistics, Central Bank of Brazil and own calculations.

## BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005		2006					
			3Q	4Q	1Q	2Q	3Q	Octubre	November	December
Real GDP	4.9	2.3	1.0	1.5	2.6	1.6	3.3	-	...	-
Industrial production	8.3	3.1	1.4	1.3	4.6	0.9	2.8	4.9	4.2	...
Unemployment rate São Paulo (*)	18.8	17.0	17.2	16.4	16.3	16.9	16.0	14.6	14.1	...
Consumer prices	6.6	6.9	6.2	6.1	5.5	4.3	3.8	3.3	3.0	3.1
Trade balance (**)	33.7	44.8	41.2	44.8	45.7	44.5	46.1	46.3	45.4	46.1

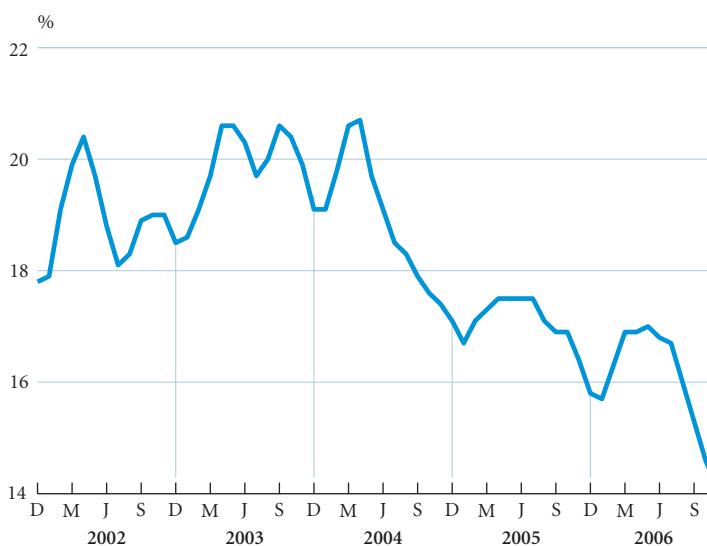
NOTES: (\*) Percentage of labour force.

(\*\*) Cumulative balance for 12 months. Billion dollars.

SOURCE: Brazilian Institute of Geography and Statistics, Central Bank of Brazil and own calculations.

## BRAZIL: UNEMPLOYMENT FINALLY BEGINNING TO DROP

Unemployment rate over labour force



SOURCE: IPEA and own calculations.

**Argentina grows by 8.7% and maintains strong growth rate.**

### Argentina growing somewhat more

The Argentine economy is strengthening its growth with a gross domestic product up 8.7% year-to-year in the third quarter, adding to its already considerable rate of increase. The distribution of growth by component, with investment and recovery of exports in the lead, indicates that this situation will continue. This is still the crucial question in order to complete recovery of economic activity and go well above the levels before the 2002 crash.

**Consumption maintains level but investment takes lead.**

Private consumption in third quarter held up with growth of 7.2% year-to-year but stopped driving more than the rest of the economy. Investment was up 20.3% and it is still the leader of the current growth cycle. Over the broader view, gross capital formation is now more than three times higher than the low point at the beginning of 2002 and stands 22% above the previous high in

1998. With public consumption dropping, exports are holding up with a modest rise of 5.9% which is truly notable in view of the strength of domestic demand.

Demand indicators continue to join this line of strong growth. Retail sales in November continued their slowdown but moved up 14.7% year-to-year. Car sales in the 12 months up to December were up 36% and are running close to 70% of the level before the crisis.

Growth continues on the supply side but there is still some loss of industrial production which was down by 4.4% year-to-year in November. Industrial activity and construction were still running at high levels.

Argentine inflation continues to be the main risk for stability. Nevertheless, it would appear that things are slowly getting back to normal. Prices were up by 9.8% in December which meant an

appreciable improvement over the highs at the end of 2005 that were over 12%. The unemployment rate in the third quarter went down to 10.2% of the

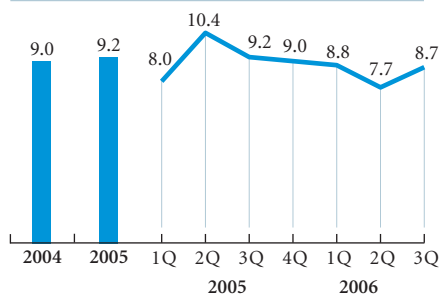
labour force but the process is slower than desirable. The trade surplus has slightly recovered in recent months thanks to some increase in exports.

**Inflation continues as biggest risk but starts to decrease.**

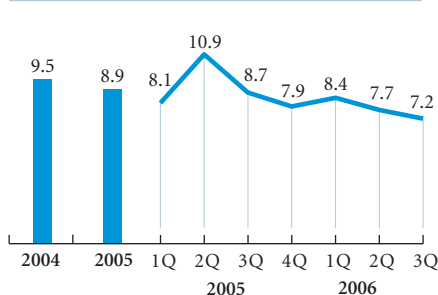
## TREND IN ARGENTINA'S GDP BY COMPONENT

Percentage year-to-year change in real terms

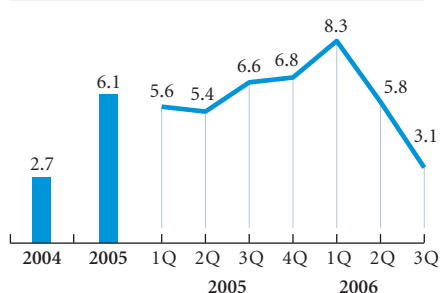
### GDP



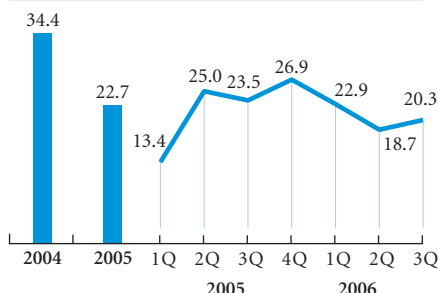
### Private consumption



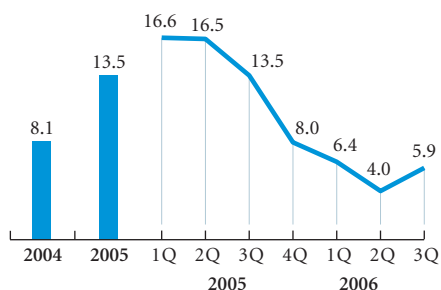
### Public consumption



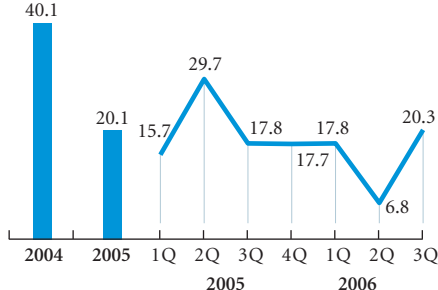
### Gross fixed capital formation



### Exports of goods and services



### Imports of goods and services



SOURCE: National Institute of Statistics and Census of Argentine Republic (INDEC) and own calculations.

## ARGENTINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005		2006					
			3Q	4Q	1Q	2Q	3Q	October	November	December
Real GDP	9.0	9.2	9.2	9.0	8.8	7.7	8.7	–	...	–
Industrial production	7.0	7.4	5.7	8.2	5.8	7.5	8.3	4.2	4.4	...
Unemployment rate (*)	13.6	11.6	11.1	10.1	11.4	10.4	10.2	...	...	...
Consumer prices	4.4	9.6	9.8	11.7	11.6	11.4	10.6	10.5	10.0	9.8
Trade balance (**)	12.1	11.7	11.6	11.7	11.7	12.3	11.7	11.8	12.1	12.4

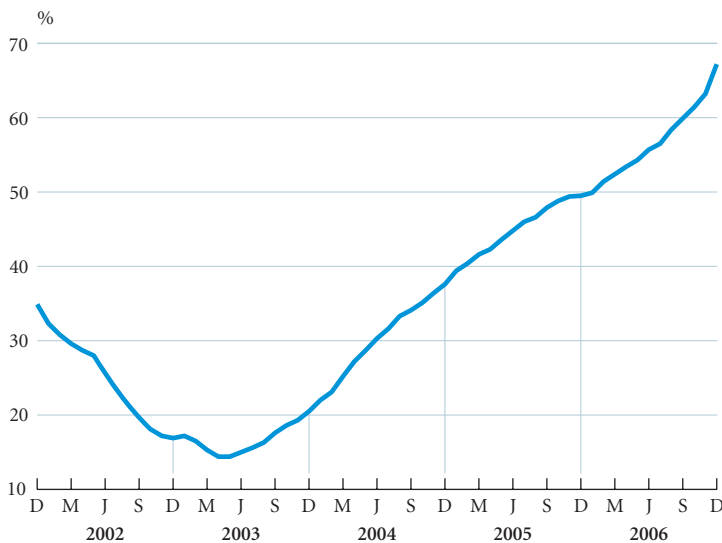
NOTES: (\*) Percentage of labour force.

(\*\*) Cumulative balance for 12 months. Billion dollars.

SOURCE: National Institute of Statistics and Census, Republic of Argentina (INDEC) and own calculations.

## ARGENTINEANS AGAIN BUYING CARS

Car sales in past 12 months compared with high in 1998



SOURCE: INDEC and own calculations.

### Oil prices drop sharply in January as also happened with other raw materials.

### Raw materials: oil price back to 2005 levels

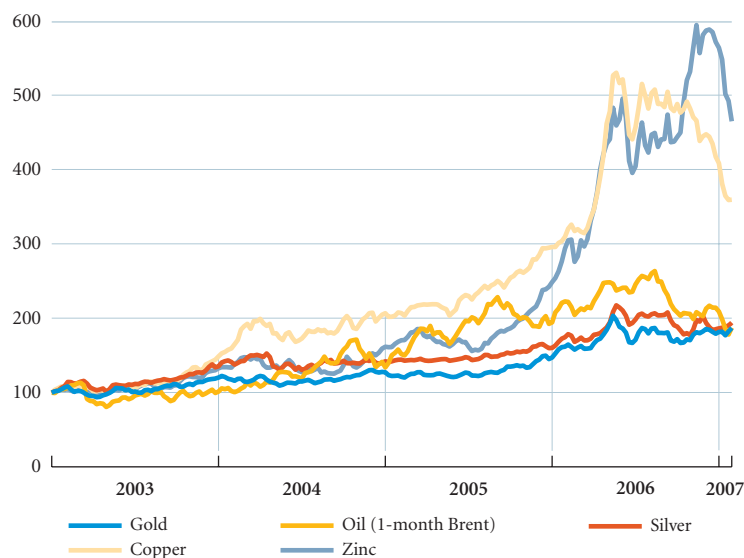
The price of oil has dropped 9% since the beginning of the year putting it at levels around 55 dollars a barrel (one-month forward, *Brent* quality) at the end of January. These prices are the lowest since November 2005. The main explanation is unusually mild temperatures in the main developed

countries. This has caused lower consumption and an increase in crude oil and refined product inventories.

Nevertheless, many other raw materials for which demand does not depend on weather conditions are also moving down. Two other factors deserve attention. First, the more speculative investors are moving out of the raw materials market. A second factor is that

## INDUSTRIAL METALS AND OIL PRICES DROPPING

January 2003 = 100 Weekly averages of prices in US dollars



SOURCE: Thomson Financial Datastream and own calculations.

## RAW MATERIALS PRICES

	2004	2005	2005	2006				2007		
			4Q	1Q	2Q	3Q	October	November	December	January
<b>«The Economist» index</b>										
<b>in dollars (*)</b>										
<b>General</b>	<b>18.8</b>	<b>3.4</b>	<b>12.1</b>	<b>18.2</b>	<b>27.9</b>	<b>30.5</b>	<b>32.9</b>	<b>35.8</b>	<b>31.2</b>	<b>23.1</b>
Food	12.8	-1.7	8.0	9.7	5.7	8.5	15.5	23.0	22.2	17.3
Industrials	27.4	10.0	16.8	28.0	54.1	55.5	51.7	48.7	40.1	28.9
<i>Non-food agricultural</i>	12.0	-2.4	10.9	15.6	19.9	12.6	1.3	2.0	2.7	5.2
<i>Metals</i>	38.5	17.4	19.5	33.8	70.8	76.4	75.4	69.4	55.8	38.7
<b>«The Economist» index</b>										
<b>in euros (*)</b>										
	7.2	3.2	22.0	28.9	28.3	24.9	26.4	24.4	17.9	13.9
<b>Oil (**)</b>										
Dollars/barrel	37.1	53.9	57.7	62.9	70.6	70.9	60.1	60.2	62.7	54.9
Change rate	32.0	44.8	29.9	32.6	33.3	14.7	1.3	6.7	8.9	-13.7
<b>Gold</b>										
Dollars/ounce	406.8	446.0	485.6	554.2	626.4	621.3	586.3	627.9	629.1	631.1
Change rate	13.9	8.5	11.9	29.7	46.5	41.5	24.8	31.7	23.4	14.9

NOTES: (\*) Year-to-year change rate.

(\*\*) Brent quality; one-month forward price.

SOURCE: «The Economist», Thomson Financial Datastream and own calculations.



**Group showing most adjustment is industrial metals with zinc and copper in lead.**

the strong level of economic activity in the final stages of 2006 may be starting to lose some of its drive in the early months of 2007. This is showing more clearly in Europe and less so in the United States.

All of this meant that key industrial metals showed significant drops in January. Zinc was down 19%, copper

11%, lead 4% and aluminium 1%. Overall, metals held at higher levels than one year ago but clearly dropping compared with the final stages of 2006. This move is repeated in raw materials as a whole as shown by the lower growth on The Economist index in dollars which went from growth of above 30% year-to-year in December to 23% in January.

# EUROPEAN UNION

## Euro Area: economic boom but energy storm

In January, European news was dominated by the energy controversy which, if not eclipsing at least put some of the newly available positive economic indicators in the shade. At the beginning of 2007, the decision of Byelorussia on

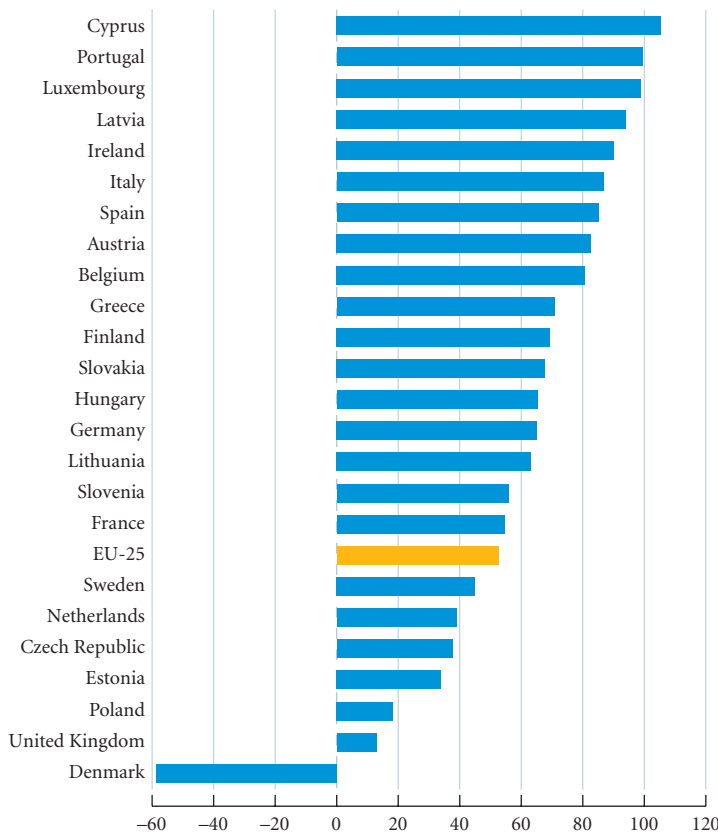
January 6 to hold back part of the oil of Russian origin being piped to the European Union brought a flood of political statements and announcements.

The chronology of the crisis had the following high-points. On January 1, the government in Minsk applied a very high duty on Russian oil in transit to

**Energy argument between Russia and Byelorussia again puts European energy sector under microscope.**

### NOTABLE NATIONAL DIFFERENCES IN ENERGY DEPENDENCE

Ratio of net energy imports compared with gross energy consumption expressed as percentage, 2005 (\*)



NOTES: (\*) Gross consumption is equal to the sum of primary energy production and imports and the change in stocks less exports. A negative dependence ratio indicates a net exporter of energy. Values above 100% appear where net imports exceed gross consumption.

SOURCE: Eurostat.

**European Commission launches new energy policy, a proposal likely to encounter difficulties because of differences between member states.**

Europe as a response to the taxes Russia applied from the same date to Byelorussia's crude oil exports. Refusal to pay the Byelorussian duty led to the holding up as of January 6 of 80,000 tons of Russian crude in Byelorussia. On January 8, the Russian state-owned company Transneft cut exports of crude through its Druzhba oil pipeline, a real umbilical cord through which it exports 70% of Russian oil going to Germany and Poland. In response to these increased tensions, the Russian government also planned to cut production. Finally, heavy pressure from the EU demanding the restoration of supply ended up making possible the renewal of oil shipments on January 10.

Beyond the specific reasons for the argument between Russia and Byelorussia, the fact is that the situation in the European energy sector is being subject to major pressure largely as a result of the coming together of three factors. First, the progressive rise in the price of oil and energy raw materials since the early years of the decade which has underlined the costly energy dependence of the European countries,

including excessive recourse to just a few suppliers. In this respect, we should point out the case of countries such as Spain, Italy, Portugal and Ireland whose energy consumption depends more than 85% on energy imports.

Second, the strong public acceptance of the challenges of climate change in recent years, with its importance in the public agenda being increased by a series of reports, especially the so-called Stern Report commissioned by the British government. Finally, there is the perception that the domestic energy market is far from being a reality, thus preventing higher energy efficiency precisely at a time when short-term and long-term challenges are coming together.

In this context, the European Commission has tried to provide a coherent overall response in the form of a proposed change in EU energy policy. Coinciding in time with the Russian oil crisis and an atypical mild winter which comes as a reminder of the risks of climate change, the European Commission had put forward a new energy policy based on three base-points.

## EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005			2006			
			4Q	1Q	2Q	3Q	October	November	December
GDP	1.7	1.5	1.8	2.2	2.9	2.7	–	...	–
Retail sales	1.5	1.3	1.3	0.8	1.6	1.8	0.9	1.4	...
Consumer confidence (*)	–14	–14	–13	–11	–10	–8	–8	–7	–6
Industrial production	2.0	1.2	2.1	3.4	4.1	3.9	3.6	2.5	...
Economic sentiment indicator (*)	99.7	98.4	100.6	103.0	107.2	108.6	110.4	110.3	110.1
Unemployment rate (**)	8.8	8.6	8.4	8.2	7.8	7.8	7.7	7.6	...
Consumer prices	2.1	2.2	2.3	2.3	2.5	2.1	1.6	1.9	1.9
Trade balance (***)	80.4	42.1	22.2	3.3	–9.6	–20.7	–18.1	–13.0	...

NOTES: (\*) Value.

(\*\*) Percentage of labour force.

(\*\*\*) Cumulative balance for 12 months. Billion euros.

SOURCE: Eurostat, European Central Bank, European Commission and own calculations.

The first, to improve European energy integration and market efficiency. Among other measures, there is notable emphasis on the separation of production and distribution. A second approach is to pay greater attention to those energy sources that have low carbon emissions. While the European Commission scrupulously respects national jurisdiction in any decision to opt for nuclear energy or not, its orientation fits perfectly with current opinion that is more and more favourable to strengthening this energy source. Finally, the third base-point of the policy is improving energy efficiency.

The prospects for the EU proposal to prosper in its current form, however, are complicated, given the profound differences existing between the member states in matters of the structure of energy consumption, supplier countries and energy sources. These are discrepancies that complicate the adoption of a single position within the European Union.

In the face of these matters, as mentioned earlier, publication of good economic situation indicators has taken second place. Perhaps the most noteworthy is the drive in retail sales which stood at 1.4% year-to-year in November (five decimals

more than in October), for what it is worth as confirmation of a recovery of the strength of consumption. The improvement in consumer confidence as of December, along with the definite recovery in employment and the decrease in the unemployment rate (7.6% in November), indicates that the level of household spending could hold up in coming months.

An additional factor favouring consumption is the trend in consumer prices, relatively contained in spite of the increased level of domestic demand. Specifically in December, growth of the harmonized consumer price index stood at 1.9% year-to-year, the same as in November. The moderation of inflation was also to be seen in the trend in the underlying core, that is to say, excluding the most volatile segments of the index, which stood at 1.6% year-to-year in December.

On the supply side, the most notable indicator is industrial production which, in spite of dropping slightly in November, continues to capitalize on the favourable drive in exports. As a result, that indicator was up 2.5% year-to-year in November, a figure that seems slim but comes following a strong 3.6% in October.

**Retail sales show new evidence of recovery in consumption.**

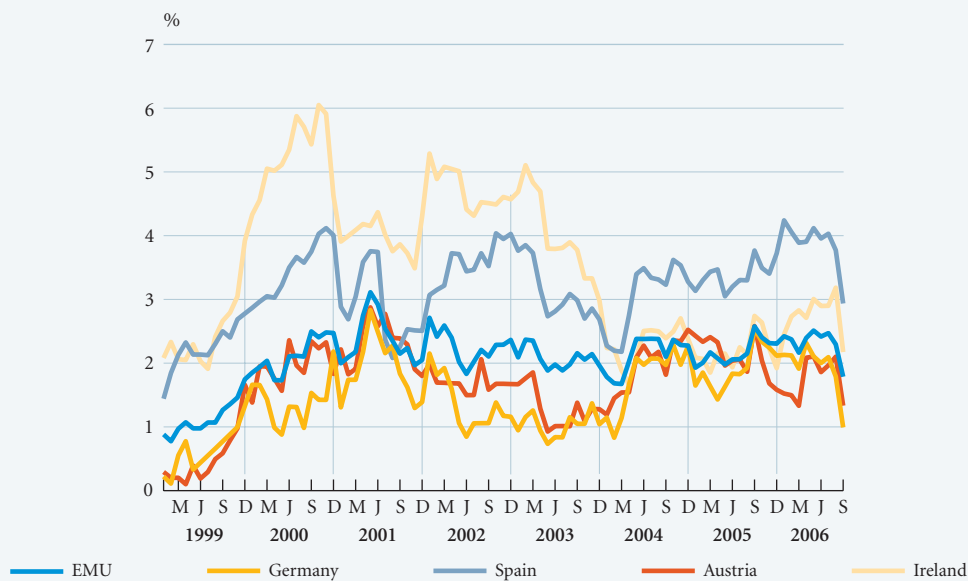
**Inflation ends year at 1,9%.**

## Euro Area: inflation a la carte?

Since the launching of the euro in January 1999, one of the main topics related to the conduct of monetary policy in the Economic and Monetary Union (EMU) has been the persistence of inflation differentials. Specifically, we refer to the fact that several countries, including Spain, have experienced inflation rates consistently above (or below) the EMU average. The following graph shows the inflation rates of a sample of EMU countries. In the past seven years inflation in Spain and Ireland has been systematically above the EMU average, whereas inflation in Germany and Austria has been below. These inflation differentials between countries are also present when we look separately at the goods and services components in the HICP as well as in core inflation (excluding energy and fresh foods).

## EURO AREA INFLATION RATES NOT YET CONVERGING

Year-on-year change in Harmonized CPI



SOURCE: Eurostat and own calculations.

Furthermore, when the euro was launched, inflation in the EMU was 1% with a standard deviation between inflation rates of member countries of one percentage point. At the present time, inflation in the Euro Area stands at 1.8% with a standard deviation of two percentage points. This increase in the divergence of inflation rates between EMU countries may seem surprising, given that in 1999 EMU countries seemed to have «done their homework» and met the nominal convergence criteria set by the Maastricht Treaty. Because of these facts, we study the reasons behind these inflation differentials within the EMU.

Three main explanations have been put forward to explain these persistent inflation differentials. The first explanation suggests that the economic integration of the countries of a monetary union involves a process of convergence, both real (GDP and income) and nominal (price level) and, as a result, countries with a lower initial income level would necessarily experience higher inflation. To the extent that countries become integrated through the dismantling of trade barriers and the adoption of a single currency facilitates price comparisons, then convergence in prices implies that during the transition those countries with the lowest price levels will necessarily suffer higher inflation.

Nevertheless, we should expect that inflation differentials due to price convergence would be more important at the start-up of the EMU than they are today. This hypothesis is corroborated in a study comparing price differentials between European cities with price dispersion in North American cities.<sup>(1)</sup> The study concludes that price differentials in Europe at the beginning of the Nineties were much higher than in North America, and that they declined significantly in the decade of the Nineties following the creation of the single market in

(1) Rogers, J., 2006, «Monetary Union, Price Level Convergence, and Inflation: How Close is Europe to the United States?» Journal of Monetary Economics (forthcoming) and International Finance Discussion Paper 2002-740, Board of Governors of the Federal Reserve System.

1992 and the elimination of trade barriers. Nowadays, price dispersion in European and North American cities is similar. It is true that a loaf of bread costs more in Helsinki than in Lisbon, just as the same loaf of bread is more expensive in New York than in Kansas City.

The second explanation suggests that, in addition to the process of convergence, it is important to keep in mind the position of each economy in the business cycle, as well as other demand factors which may have an influence on prices. Spain and Ireland have seen higher inflation rates in the past seven years, but they have also grown more than the European average. Whereas the EMU grew by 2.2% on average in the period of 1999-2005, Spain grew by 3.7% on average while Ireland showed a spectacular growth of 6.5%. On the other hand, Germany and Austria have experienced less inflation, and have also reported growth below the European average (1.2% and 2% respectively). While these figures could represent convergence effects to some extent, growth rates above potential may have also contributed to the generation of inflationary pressures. In a monetary union, each country may need monetary conditions that are different than the aggregate if economic cycles are not synchronized. If a country is growing above potential and is showing an inflation rate above the EMU average, economics textbooks would suggest that it needs higher real interest rates. Nevertheless, the European Central Bank (ECB) monitors inflation at the EMU level. If the ECB does not think it is necessary to raise interest rates for the whole of the EMU, then economic cycles of individual EMU countries will last longer and inflation differentials will become more persistent, just as we have been observing.

The third explanation would suggest that the dynamics of price and wage setting are quite different within member countries of the EMU. Therefore, although the EMU as a whole may be affected by internal shocks (changes in productivity, for example) or by external shocks (changes in oil prices, the euro exchange rate and growth of world demand), the inflationary effects in each country may be different depending on the mechanism for setting prices, wages, the production structure and trade with third countries outside the EMU.

A number of studies carried out by the European Central Bank and the European System of Central Banks suggest that the three explanations have been important in explaining the EMU experience.<sup>(2)</sup> In each country, there exists a specific factor which predominates more than others, given that the individual experiences have been different. For example, there is no single factor explaining at the same time the experience of Spain and Portugal, given that inflation in Spain's neighbour has been higher than the EMU average, while growth has been lower. In view of the experience in recent years, it is likely that inflation differentials may be an intrinsic characteristic of the EMU. On the one hand, at some point they must experience a turnaround (prices cannot grow faster in Spain and Ireland with respect to the EMU average indefinitely, and some economies that have been stagnant in recent years will have to take off sooner or later). On the other hand, the existence of rigidities in the labour market make it unlikely that wages will rapidly adjust to changes in productivity, and therefore any adjustment will have to come through inflation differentials.

(2) See ECB, 2003, «Inflation Differentials in the Euro Area: Potential Causes and Policy Implications» and Angeloni, I., and M. Ehrmann, 2004, «Euro Area Inflation Differentials» ECB Working Paper 388.

**German growth in 2006 best rate since 2000, largely thanks to better performance by domestic demand.**

## Germany: excellent 2006

Angela Merkel, the impressive president of the European Union for the first half of 2007 and of the G-8 all year long, can put her chest out. Germany is showing its highest growth since 2000 and is meeting the requirements of the Stability and Growth Pact for the first time since 2001. Growth figures for 2006 recently published confirm that Germany reached a growth rate of 2.5% in the gross domestic product (GDP), the best since the dynamic 3.2% in 2000. Corrected for days actually worked the growth rate was 2.7%.

In contrast to previous years when foreign demand was the only engine of growth, in 2006 domestic demand has proved more dynamic. Especially relevant is the recovery of private consumption (growth of 0.6%, as against 0.1% in 2005) and construction investment. The latter trend has meant that gross fixed capital formation reached growth of 7.3% (6.1% in 2005). The positive contribution of the foreign sector to the change in GDP was seven decimals, two more than the year before. This higher rate of

economic activity means that the government deficit now stands at 2.0% of the GDP.

Following this excellent year 2006, interest now is focused on measuring the strength of the German economy in 2007. While available indicators still refer to the end of 2006, the state of affairs at the beginning of the year should not be far away from these recent trends. On the demand side, the more notable factors are the continued strength of investment (industrial production of capital goods reached 7% year-to-year in November) and the progressive firming up of consumption. In this respect, we should point out that consumer confidence in December stood at its highest point since July 2001.

The sector capitalizing most from Germany's recovery is industry which continues to show an excellent level. Following some slowing down in October, industrial production in November grew by more than 6% year-to-year, going back to the growth rate seen in the third quarter. To a large extent, the drive in the industrial sector

**Drive in investment and better state of consumption represent notable aspects of current German economy.**

### GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2006						
			4 Q	1 Q	2 Q	3 Q	October	November	December
GDP	0.8	1.1	1.7	1.9	2.7	2.8	–	...	–
Retail sales	2.1	1.3	0.4	0.6	0.3	0.1	–0.5	–0.5	...
Industrial production	2.4	2.9	4.7	4.5	5.9	6.3	3.4	6.1	...
Industrial activity index (IFO) (*)	95.4	95.5	98.6	103.6	106.1	105.2	105.4	106.8	108.7
Unemployment rate (**)	10.6	11.7	11.5	11.4	11.0	10.6	10.3	10.1	9.8
Consumer prices	1.6	2.0	2.2	2.1	1.9	1.6	1.1	1.5	1.3
Trade balance (***)	149	156.3	158.4	155.2	152.3	149.9	155.3	161.1	...

NOTES: (\*) Value.

(\*\*) Percentage of labour force.

(\*\*\*) Cumulative balance for 12 months. Billion euros.

SOURCE: OECD, national statistical bodies and own calculations.

is due to the good performance in foreign markets. In this respect, it has just become known that exports continue to show substantial growth marking up a year-to-year increase of around 20% in November. This trend, along with the lower growth of imports, made possible a further increase in the trade surplus in November.

The recovery also meant that 2006 showed 580,000 fewer unemployed putting the unemployment rate below 10% of the labour force (9.8% in December). The increase in growth had not brought a toll in any excessive rise in inflation. In December, the CPI grew by 1.3% year-to-year, a contained level and one similar to that being reported since last autumn.

### France: in election year, economy holding up

As the presidential elections next April 22-May 6 and legislative elections on June 10 and 17 come closer, it is becoming reasonably clear that the economy will not be a decisive factor in the campaign, given that the economic

situation in France is recovering as we leave behind the disappointing third quarter of 2006.

Available indicators confirm that the basic support of the French economy, domestic consumption, is again growing. It returned to growth rates of the order of 5% year-to-year on average for the fourth quarter. This increase has presumably been due to the recent trend in the labour market which is showing a gradual tendency to improvement both in employment (year-to-year growth of 0.8% in the third quarter) and in unemployment (the unemployment rate dropped to 8.7% in November). Another boost to French household consumption is inflation which continues to show little increase as is to be seen in the rise of 1.5% year-to-year in December.

Nevertheless, the degree of recovery is still not very great. Specifically, it is not benefiting industrial activity (industrial production fell by 1.1% year-to-year in November), which continues to be penalized by the collapse in car production. This has meant that up until now most growth has been in services, for which confidence

**December inflation barely 1.3% while unemployment rate down below 10%.**

**With heavy electoral campaign underway in France, economy not likely decisive in political battle...**

**...given that trend in consumption, labour market and prices goes in favour of households.**

## FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005		2006				
			4Q	1Q	2Q	3Q	October	November	December
GDP	2.0	1.2	1.0	1.3	2.6	1.9	–	...	–
Domestic consumption	3.8	2.9	2.2	2.9	4.7	4.2	4.0	4.3	6.8
Industrial production	2.0	0.2	–0.5	0.5	1.7	0.6	2.4	–1.1	...
Unemployment rate (*)	10.0	9.9	9.7	9.6	9.1	8.9	8.8	8.7	...
Consumer prices	2.1	1.7	1.6	1.8	1.9	1.7	1.1	1.4	1.5
Trade balance (**)	0.1	–1.3	–1.8	–2.1	–2.1	–2.4	–2.4	–2.4	...

NOTES: (\*) Percentage of labour force.

(\*\*) Cumulative balance for 12 months. Billion euros.

SOURCE: OECD, national statistical bodies and own calculations.



**In Italy, growth barely begun already starting to lose strength...**

**...although containment of inflation and recovery in exports should help to halt economic slump.**

**Long-lived British growth now sharpening inflationary pressures with CPI at 3.0%.**

indicators are showing a robust trend to recovery.

### Italy: signs of a slowdown

As the fourth quarter of 2006 advanced, there began to emerge a picture of an economy that was losing some of the modest strength it had been displaying in the first nine months of the year. Consumer confidence was down slightly in November (a drop of one point) and on top of this came a decrease of four additional points in December. This points out the difficulties faced by consumption in consolidating recovery.

Supply indicators are running along similar lines. Industrial production has partly eased its drive (growth of 2.2% in November, 1.1 points less than in October). While this slowdown in itself is not alarming, it is more troubling when combined with a drop in economic sentiment for three consecutive months from October to December.

From this review, however, we should not take the perception of an economic collapse. The future trend is for lower economic activity but the process will be

gradual. Furthermore, the Italian economy is still showing some positive positions in exports which grew more than 10% year-to-year on average for October and November. This is also so in prices with inflation holding below the 2% level in the fourth quarter of 2006 (1.9% year-to-year in December).

### United Kingdom: a reheated economy?

The British economy continues to show signs of moving into a state where the high growth rate of economic activity (growth of 3% year-to-year in the fourth quarter of 2006) is beginning to exacerbate fundamental imbalances. The most notable is inflation which, following a fairly sharp rise in the first half of the year, now is going to more alarming levels. In December, the CPI reported a year-to-year growth rate of 3.0%, the highest since December 2005 and three decimals above the figure for November. Other indicators, such as retail prices and the GDP deflator, confirm the inflationary jump. All of this explains the further tightening of monetary policy by the Bank of England on January 11 putting the intervention rate at 5.25%.

## ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2006						
			4Q	1Q	2Q	3Q	October	November	December
GDP	0.9	0.1	0.5	1.7	1.7	1.7	–	...	–
Retail sales	–0.4	0.4	1.9	0.5	1.9	1.6	0.4	...	...
Industrial production	–0.5	–0.9	0.4	2.7	1.7	1.4	3.3	2.2	...
Unemployment rate (*)	8.0	7.7	7.5	7.2	6.9	6.8	–	...	–
Consumer prices	2.2	1.9	2.2	2.1	2.2	2.2	1.8	1.8	1.9
Trade balance (**)	–1.2	–9.4	–8.5	–12.9	–16.5	–21.3	–22.6	–21.9	–20.5

NOTES: (\*) Percentage of labour force.

(\*\*) Cumulative balance for 12 months. Billion euros.

SOURCE: OECD, national statistical bodies and own calculations.

## BRITISH INFLATION GIVES A SCARE

Year-to-year change in consumer price index



SOURCE: National Statistics Office and own calculations.

## UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005			2006			
			4Q	1Q	2Q	3Q	October	November	December
GDP	3.3	1.9	2.0	2.4	2.7	2.9	–	3.0	–
Retail sales	6.0	1.9	2.5	1.7	3.4	3.7	4.0	3.1	3.7
Industrial production	0.8	–1.9	–2.6	–1.0	–0.6	0.3	0.8	0.8	...
Unemployment rate (*)	2.7	2.7	2.8	2.9	3.0	3.0	3.0	3.0	3.0
Consumer prices	1.3	2.0	2.1	1.9	2.2	2.4	2.5	2.7	3.0
Trade balance (**)	–56.1	–64.6	–67.4	–72.5	–77.0	–81.1	–82.8	–83.4	...

NOTES: (\*) Percentage of labour force.

(\*\*) Cumulative balance for 12 months. Billion pounds.

SOURCE: OECD, national statistical bodies and own calculations.

The tightening of monetary policy makes sense if we look at the latest economic activity indicators, all of which are very expansionist. Retail sales in December held a rate identical to the strong third quarter which confirms the growing strong drive in consumption (which is also supported by the lower unemployment rate that held at 3.0% in December).

Notable on the supply side, along with the trend to an improvement in the services sector, is the fact that industry seems to be consolidating a gradual but progressive line of growth. In October and November, industrial production grew by 0.8% year-to-year, improving on the 0.3% year-to-year seen in the third quarter.

**Expansionist stage moves into industry which until now has benefited little from growth.**

# FINANCIAL MARKETS

## Monetary and capital markets

**In spite of oil price drop in recent months, central banks still concerned about inflation risks...**

**...and upward stage in interest rates being maintained as confirmed by increase in Bank of England official rate to same level as the Fed.**

### European Central Bank and Bank of Japan take a pause

The international money supply continues abundant and, in spite of the recent drop in oil prices, the upward stage in interest rates is still being maintained in view of inflationary risks. This would seem to be confirmed by the recent increase in official interest rate by the Bank of England which probably will not be its last this year.

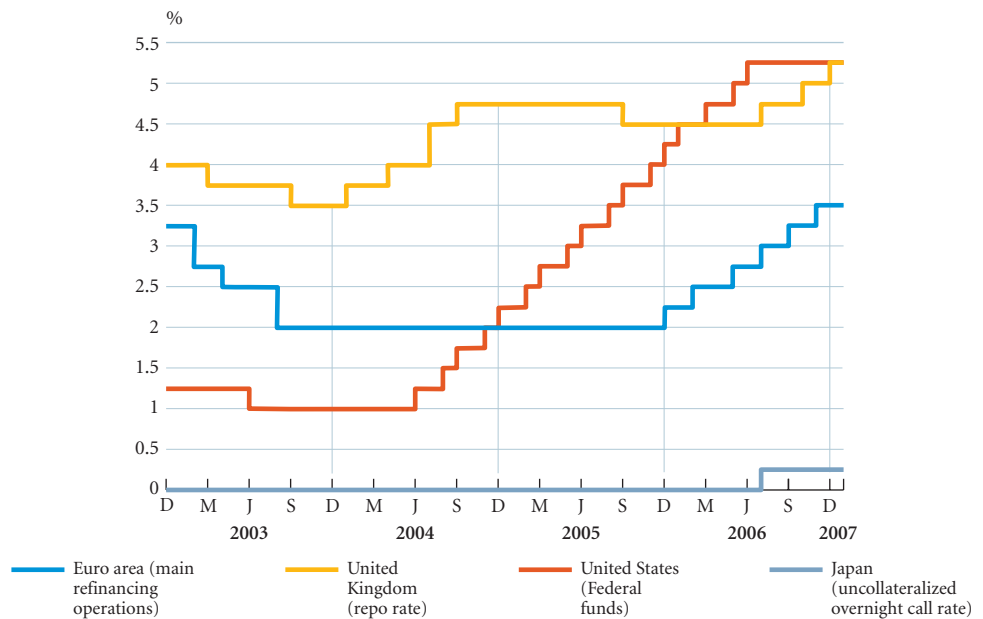
On January 11, the Monetary Policy Committee of the Bank of England decided to raise its reference rate by 25 basis points putting it at 5.25%. This was the third increase since August and it

caught most of the market by surprise seeing that, although further increases had been discounted, they were expected to come later. The British monetary authorities justified the measure because of the increase in inflationary risks, given the limited margin in utilization of production capacity. In fact, just a few days later, the figure for inflation of consumer prices in December was published showing an increase of 3.0%, substantially above the 2% objective which explained the central bank's concern.

On the other hand, on the same day the European Central Bank (ECB) decided to maintain the Eurosystem interest rate at

### BANK OF ENGLAND RAISES OFFICIAL INTEREST RATE

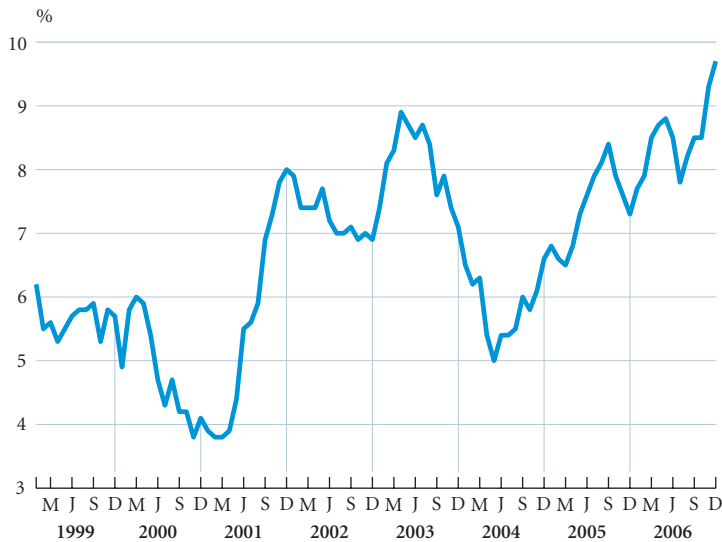
Monetary policy reference rates



SOURCE: National central banks.

## MONEY SUPPLY IN EURO AREA MARKS UP HIGHEST GROWTH SINCE LAUNCHING OF EURO

Year-to-year change rate in seasonally-adjusted statistical series for broad M3 money supply figure



NOTES: Figures go up to December.  
SOURCE: European Central Bank.

3.50%. Although no change was expected, the less belligerent tone adopted by chairman Jean-Claude Trichet at the following press conference was somewhat surprising. As a result, doubts that existed about whether the next increase would be in February were resolved in favour of a further rise in March.

In fact, the relatively low current level of the official ECB interest rate, the run-away growth of the broad M3 money supply figure (with a year-to-year change of 9.7% in December, the highest since 1999) and some risks for increased inflation point to further tightening of monetary control. Nevertheless, if we take into account that the euro has appreciated substantially in recent years, monetary conditions would suggest that there is not much further up to go, so that the level reached by the Eurosystem interest rate will possibly stand at 4% in coming months.

In addition, the market had clearly discounted the new increase in the

official interest rate by the Bank of Japan at the monetary meeting held on December 18. Nevertheless, in the end political pressure possibly prevailed and the Japanese monetary authorities made no move, leaving the reference rate at 0.25%, the vote in favour being 6 to 3. It is true that the situation of the Japanese economy is not without its good and bad features as shown, for example, in a very modest growth in bank credit, although what is most likely is that the gradual normalization of Japanese interest rates has only been postponed.

With regard to the US Federal Reserve, we could not expect changes at its meeting at the end of January. In fact, the objective level of the interest rate on US 1-day interbank deposits will probably continue at 5.25% for some months, given that the Fed is caught between fear of a sharp slowdown in the economy and the danger of inflation shown, for example, in the recent rise of industrial and consumer prices.

**Bank of Japan not sure about economic horizon and fails to raise reference interest rate in January.**

**European Central Bank could again raise Eurosystem interest rate in March.**

## Energy and inflation: a flammable mixture?

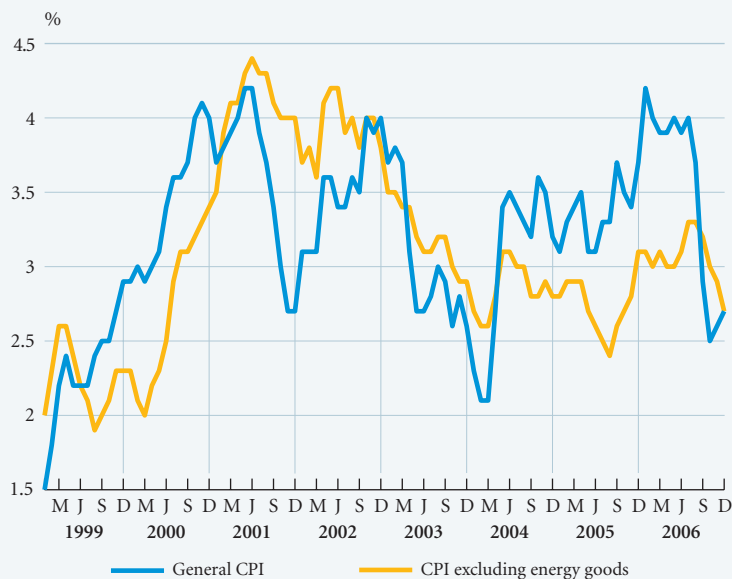
In recent years, there has been much talk about oil prices and the risk they pose for inflation. The main fear is that shocks to energy prices could pass-through into other prices and bring about an upward revision in inflation prospects. Nevertheless, the empirical evidence suggests that this pass-through has been modest over the past two decades. Does this mean that the central banks can ignore shocks to energy prices? Definitely not.

The most obvious effect of the rise in energy prices over the general price index is immediate and depends on the relative weight of energy in the basket of goods and services included in the CPI. As this weight is approximately 9% in Spain, the same as in the Euro Area and the United States, a rise of 10% in energy prices directly adds 0.9 percentage points to the general inflation rate. As well as having a considerable weight in the index, energy prices are quite volatile and because of this their direct effect on the CPI often explains a substantial part of the variations in the inflation rate. In the last three years in Spain, for example, the year-to-year inflation rate excluding energy products has swung in a range between 2.4% and 3.3%, whereas the general inflation rate has moved within a much greater range between 2.1% and 4.2%. This direct effect, however, is not the only one or the most troubling.

To illustrate this point, let us imagine a world in which all prices, except those for energy, rise at a rate of 2% each year. On the other hand, energy prices sometimes go up by 12% and at times drop by 8%. In this world if, for example, the weight of energy products is 10%, the general inflation rate would swing between 1% and 3%. As a result, all the changes in general inflation could be explained by the change in energy prices and its immediate

### ENERGY EXPLAINS A SUBSTANTIAL PART OF CHANGES IN INFLATION RATE

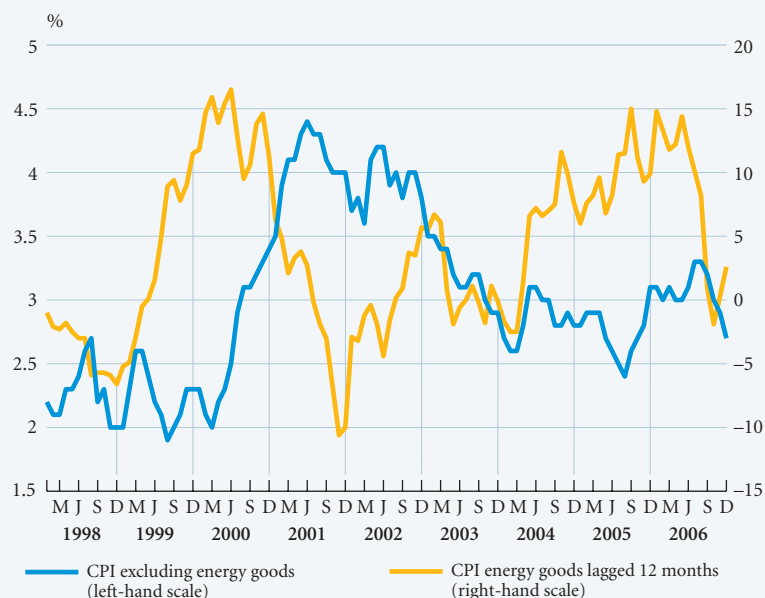
Year-to-year change in general CPI and CPI excluding energy goods in Spain



SOURCE: National Institute of Statistics.

## ENERGY PRICE SHOCKS PASS THROUGH TO OTHER PRICES

Year-to-year change in CPI excluding energy goods and in CPI for energy goods in Spain lagged over 12 months



SOURCE: National Institute of Statistics.

impact on the general index. But in this world, it would not make much sense to speak of inflationary trends. Inflation, let us call it core inflation, is always 2% and energy introduces a disturbance of more or less 1% in the general index. This disturbance, rather than a problem, is a source of information. It is no more than a change in relative prices that provides a signal to consumers so that, in certain periods, they consume less energy (because, for example, it is scarcer) and so that, at other times, they consume somewhat more. Unfortunately, the real world is much more complex and here core inflation would not remain unchanged at 2%.

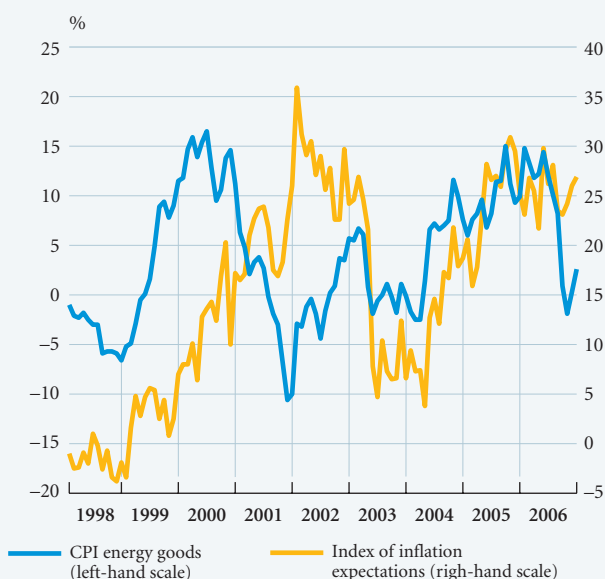
On our planet, increases in energy prices tend to pass-through into other prices. On the one hand, energy is a key input in many production processes and many companies try to shift the cost increase to the consumer, thus provoking an «indirect effect» from the rise in energy prices on the CPI. These increases are useful for bringing about an adjustment of demand for those goods and services that are most intensive in energy use. In addition, there are the so-called «second round effects». First of all, workers can ask for wage increases to compensate their loss of purchasing power (or may have previously negotiated automatic wage revision clauses) which increases unit labour costs and the general level of prices. Secondly, there is the expectations channel, perhaps the most subtle and important. This effect takes place because a rise in the general inflation level tends to increase future inflation expectations. And, as has been shown theoretically and empirically, if higher inflation is expected, the prophecy tends to be fulfilled because wage contracts are negotiated upwards and because price revisions by companies are also adjusted to that expected reality.

What does the empirical evidence have to say about the pass-through of energy prices to other prices? Most studies indicate that it exists but it is much less important than in the early Eighties. Various studies covering

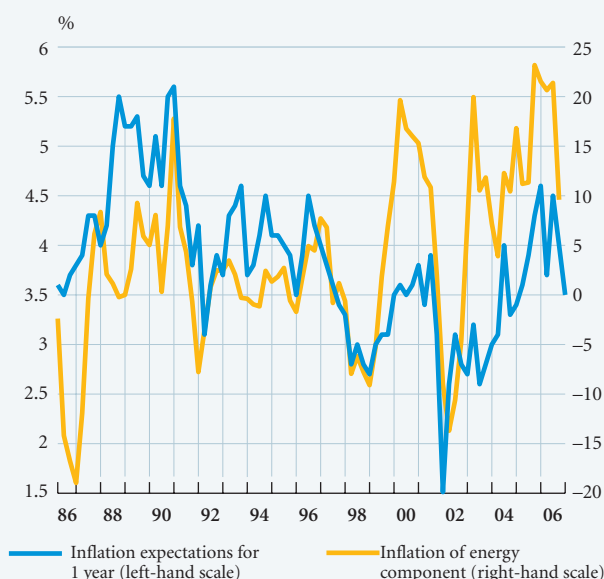
the United States and countries of the Euro Area estimate that a rise of 10% in energy prices tends to increase the rate of inflation excluding energy goods by 0.2-0.3 percentage points a year later. Shortly afterwards, however, the effect disappears and *underlying* inflation returns to its normal trend level. In general, it is also found that if energy prices return to their initial level shortly after their rise, the effect is imperceptible; that the effect is greater when the economy is operating at a high capacity, as well as for price increases and price drops, and that the effect is proportionally higher for greater increases in prices. In spite of the fact that the US economy is more energy intensive than the Euro Area, the shift of energy prices to

### ENERGY PRICE SHOCKS TEND TO INCREASE INFLATION EXPECTATIONS

Year-to-year change in CPI for energy goods and index of inflationary expectations in Spain



Inflation expectations for one year and year-to-year change in CPI for energy goods in United States



NOTES: The index for inflation expectations in Spain reflects the difference between the proportion of the population that expects inflation to be equal or higher than current inflation and the proportion expecting lower inflation over the next 12 months.

SOURCE: National Institute of Statistics, European Commission, Bureau of Labour Statistics and University of Michigan Survey of Consumers.

other prices is of similar magnitude thanks to greater flexibility in goods and labour markets which limits second round effects.

The growing emphasis of the central banks in maintaining low stable inflation has been a key factor in reducing inflationary pressures as a result of shocks in energy prices in the last two decades. There is a consensus that this factor has been much more important than the reduction in energy intensity. Today, the central banks are more concerned about inflation than about growth (the ECB states this explicitly while the Fed does it implicitly) and, as a result, they have gained credibility. As a result, their response to a shock in energy prices is now different from what it was in the Seventies. As opposed to then, it is more likely that they will raise interest rates than lower them and inflation prospects remain more stable.

The lessons are quite clear. Although energy shocks are not as inflationary as they were in the past, the central banks cannot ignore them. It is precisely their emphasis on any factor that could boost inflation (including energy) that keeps inflation prospects under control and minimizes second round effects.

## SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

Monthly averages as annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5)		Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
	3-month	1-year							
<b>2005</b>									
December	2.28	2.47	2.78	4.16	4.49	0.09	4.50	4.64	1.02
<b>2006</b>									
January	2.30	2.51	2.83	4.26	4.60	0.10	4.50	4.60	1.01
February	2.31	2.60	2.91	4.50	4.76	0.11	4.50	4.58	1.09
March	2.56	2.72	3.11	4.54	4.92	0.12	4.50	4.59	1.21
April	2.58	2.79	3.22	4.75	5.07	0.13	4.50	4.63	1.28
May	2.58	2.89	3.31	5.00	5.18	0.19	4.50	4.70	1.40
June	2.76	2.99	3.40	5.03	5.38	0.31	4.50	4.73	1.48
July	2.80	3.10	3.54	5.25	5.50	0.40	4.50	4.73	1.53
August	2.98	3.23	3.62	5.25	5.42	0.44	4.73	4.94	1.61
September	3.03	3.34	3.72	5.25	5.38	0.44	4.75	5.03	1.74
October	3.23	3.50	3.80	5.25	5.37	0.44	4.75	5.13	1.85
November	3.31	3.60	3.86	5.25	5.37	0.48	4.93	5.23	1.90
December (*)	3.50	3.68	3.92	5.25	5.36	0.53	5.00	5.29	2.02
<b>2007</b>									
January (1)	3.55	3.77	4.09	5.25	5.36	0.54	5.25	5.59	2.16

NOTES: (\*) Provisional figures.

(1) January 26.

(2) Marginal interest rate. Latest dates showing change in minimum rate: 1-12-05 (2.25%), 2-3-06 (2.50%), 8-6-06 (2.75%), 3-8-06 (3.00%), 5-10-06 (3.25%), 7-12-06 (3.50%).

(3) Latest dates showing change: 9-8-05 (3.50%), 20-9-05 (3.75%), 1-11-05 (4.00%), 13-12-05 (4.25%), 31-1-06 (4.50%), 28-3-06 (4.75%), 10-5-06 (5.00%), 29-6-06 (5.25%).

(4) Latest dates showing change: 5-2-04 (4.00%), 6-5-04 (4.25%), 10-6-04 (4.50%), 5-8-04 (4.75%), 4-8-05 (4.50%), 3-8-06 (4.75%), 9-11-06 (5.00%), 11-1-07 (5.25%).

(5) Interbank offer rate.

SOURCE: National central banks, Thomson Financial Datastream and own calculations.

### Pound sterling strengthens with wider interest rate differential in its favour

The pound sterling has taken a leading role in foreign currency markets in recent weeks with substantial appreciation as a result of the increase in official interest rates by the Bank of England on January 11 and the expectation of further tightening of British monetary policy.

As a result, the Bank of England reference rate became equal to that of

the Fed going up to 5.25%. Interest rates on the pound went above those for the dollar for both short and long terms within a picture of upward expectations in the United Kingdom and downward prospects in the United States.

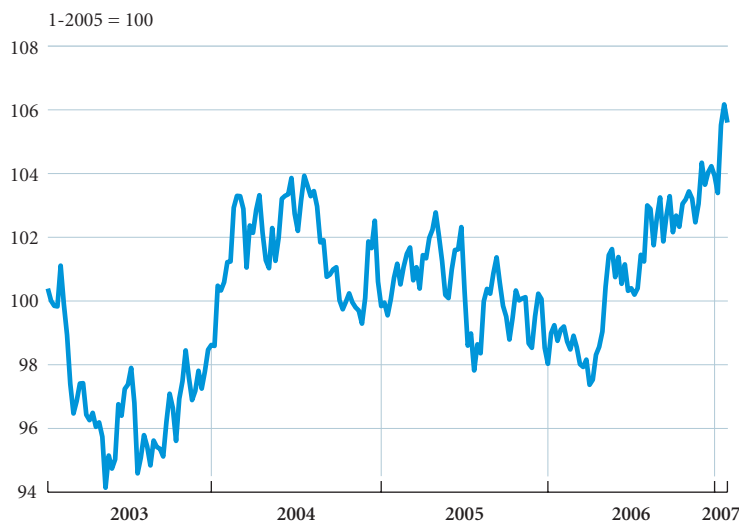
As a result, the British currency marked up an all-time high level at the beginning of the fourth week in January. Nevertheless, later statements in moderate tone by the governor of the Bank of England, Mervyn King, and publication of the minutes of the latest

**Pound sterling marks up highest level against yen since September 1992.**



## POUND STERLING MARKS UP HIGHEST LEVEL IN RECENT YEARS

Nominal effective exchange rate of pound sterling



NOTES: Figures go up to January 26.  
SOURCE: Bank of England.

**In 2006 dollar again follows downward trend begun in 2002.**

meeting which showed that the vote in favour of a rise was very close (5 against 4) cooled down expectations of further increases in the interest rates and the pound sterling lost ground. The strength of the pound has shown up in terms of all the main currencies but especially against the yen and the euro and less so against the dollar in recent weeks. In terms of the yen, the British currency marked up its highest level since September 1992 and against the euro since January 2003. Against the greenback, the pound sterling was running close to but still below 2 dollars to the pound.

In 2006, the dollar returned to the downward trend it began in 2002, pushed down by the massive foreign deficit. In terms of a broad group of currencies, the dollar depreciated by 4.4% in the course of last year after having risen 3.5% in 2005. It should be pointed out that the depreciation of the dollar in 2006 was unequally distributed.

**Euro marks up all-time high against yen at beginning of 2007.**

Against the pound sterling the decrease was 12.0%, in terms of the euro it was 10.4% and 3.3% against the yuan while it rose by 1.0% against the Japanese yen. This shows that, in general, the European currencies bore the brunt of the depreciation of the dollar.

Nevertheless, in the early stages of the year the US currency recovered strength with the disappearance of fears of a sharp slowdown of the US economy and the lessening prospect of a decrease in the Fed official rate. In any case, as the year wears on, downward pressures should predominate as interest rate differentials are reduced against the euro and the yen and because of possible moves to diversify the currency reserves of various countries, such as China.

The improvement of the European economy and the rise in the European Central Bank reference rate meant that the European currency advanced by

## EXCHANGE RATES OF MAIN CURRENCIES

December 2006

	Final session of month		Average exchange rate	Monthly figures			Exchange rate January 26, 2007
	Exchange rate	% monthly change (2)		% change (2)			
				Monthly	Over December 2005	Annual	
<b>Against US dollar</b>							
Japanese yen	119.0	2.8	117.4	0.1	-0.8	-0.8	121.5
Pound sterling (1)	1.959	-0.3	1.963	2.6	12.5	12.5	1.960
Swiss franc	1.219	1.7	1.210	-2.0	-7.3	-7.3	1.252
Canadian dollar	1.165	2.1	1.154	1.5	-0.7	-0.7	1.180
Mexican peso	10.80	-1.8	10.85	-0.6	2.1	2.1	11.04
<i>Nominal effective index (4)</i>	<i>106.9</i>	<i>0.5</i>	<i>106.7</i>	<i>-0.8</i>	<i>-4.6</i>	<i>-4.6</i>	<i>107.9</i>
<b>Against euro</b>							
US dollar	1.317	-0.2	1.321	2.6	11.4	11.4	1.290
Japanese yen	156.9	2.4	155.0	2.6	10.3	10.3	156.7
Swiss franc	1.607	1.0	1.597	0.3	3.2	3.2	1.618
Pound sterling	0.672	-0.4	0.673	-0.2	-1.0	-1.0	0.658
Swedish krona	9.040	-0.3	9.033	-0.7	-4.2	-4.2	9.084
Danish krone (3)	7.456	0.0	7.455	0.0	0.0	0.0	7.454
Polish zloty	3.831	0.5	3.813	-0.3	-0.9	-0.9	3.924
Czech crown	27.49	-1.7	27.76	-1.0	-4.2	-4.2	28.13
Hungarian forint	251.8	-1.8	253.8	-1.9	0.5	0.5	256.0
<i>Nominal effective index (5)</i>	<i>105.6</i>	<i>0.0</i>	<i>105.6</i>	<i>1.2</i>	<i>4.8</i>	<i>4.8</i>	<i>104.5</i>

NOTES: (1) Units to pound sterling.

(2) Percentages of change refer to rates as shown in table.

(3) Danish krone has central parity of 7.46038 against euro with fluctuation band of  $\pm 2.25\%$ .

(4) Broad nominal effective index of US Federal Reserve Board. Calculated as a weighted average of the foreign exchange value of the US dollar against the 26 currencies of those countries with greatest volume of trade with the United States. Base: 1-1997 = 100.

(5) European Central Bank nominal effective exchange rate index for the euro. Calculated as a weighted average of the bilateral value of the euro against the currencies of the 23 main trading partners of the euro area. Base: 1-1999 = 100.

SOURCE: Thomson Financial Datastream and own calculations.

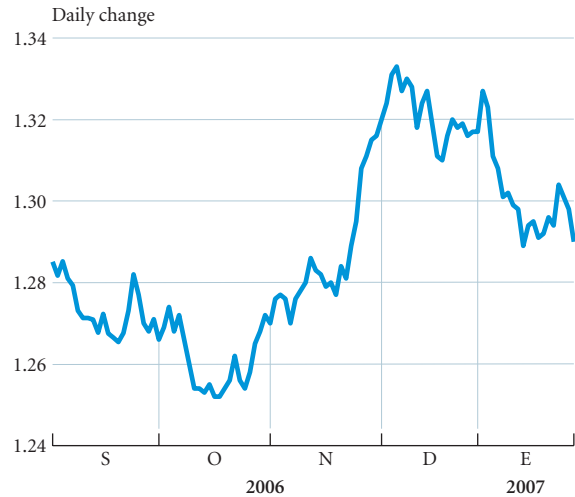
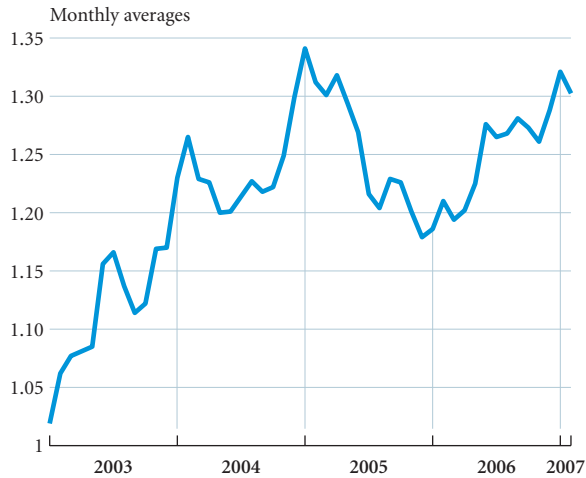
5.1% in 2006 in terms of the basket of currencies of its main trading partners. Right at the beginning of 2007, the euro continued its tendency to appreciate. Nevertheless, the euro later lost its shine with an easing of expectations regarding increases in Eurosystem interest rates. In any case, the European single currency recorded a new all-time high against the yen when it ran at 158.1 yen to the euro in the second last week in January.

In the fourth week of January the yen collapsed to its lowest level since October 1998 following the decision of the Bank of Japan to maintain its official interest rate at 0.25%. The wide difference in interest rates not in its favour again hurt the Japanese currency. In real terms, in December 2006, the Japanese currency dropped to its lowest level since October 1985.

**Yen at lowest level since October 1998 following Bank of Japan decision to maintain interest rates.**

## EURO DROPS AGAINST DOLLAR IN JANUARY

US dollars to euro

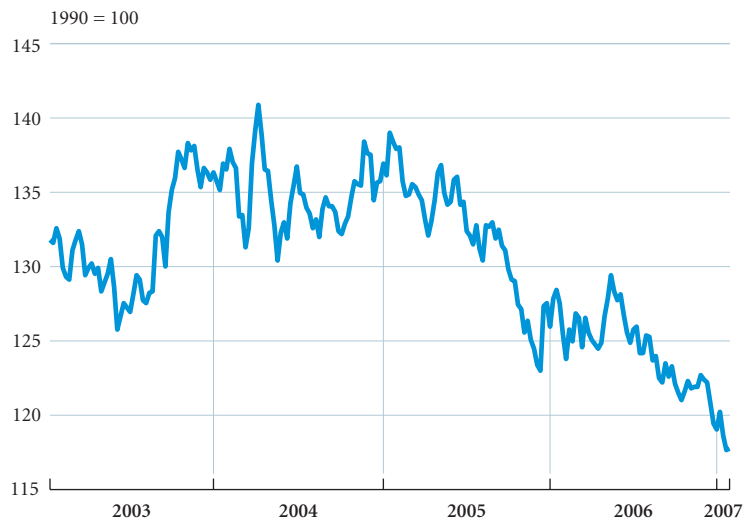


NOTES: Figures go up to January 26.

SOURCE: OCDE, Thomson Financial Datastream and own calculations.

## COLLAPSE OF YEN

Nominal effective exchange rate of Japanese yen



NOTES: Figures go up to January 26.

SOURCE: Bank of England.

**Bond yields show ups and downs in 2006 but end year with slight increases.**

### Increase in government bond yields

In 2006, the yield on US 10-year Treasury bonds rose by 31 basis points and ended the year at 4.71%. The high

for the year, however, was 5.24% reached toward the end of June. From then on, the slowdown in the economy and the halt in the upward pattern of the Fed since August brought about a drop in

long-term rates. Nevertheless, in the early weeks of 2007 the yield on US government bonds rose again to some extent with disappearance of the prospect of a cut in the Fed official interest rate in the first half of the year.

In the Euro Area, yields on long-term government bonds followed in the wake of similar bonds on the other side of the Atlantic but rose slightly more in the course of 2006, some 66 basis points in the case of German bonds. As a result, the differential in long-term interest rates between the dollar and the euro narrowed to 75 basis points whereas at the beginning of 2006 it was 110 basis points. The reduction of this differential is logical if we take into account that expectations for the differential in short-term interest rates and economic growth also went down. In this situation, it is likely that the long-term interest rate differential between the United States

and the Euro Area will continue to decrease in 2007 in spite of the slight increase seen in the early weeks of January.

On the other hand, it is worth noting that in 2006 international bond issues expressed in euros were again greater than those in dollars, according to the International Capital Market Association. Total bonds issued in euros amounted to 45% of the world market as against 36% in dollars and nearly 10% in pounds sterling. Apart from issues by European governments, a more extensive and liquid market for corporate bonds following the launching of the euro in 1999 increased the attraction of issues expressed in the European single currency.

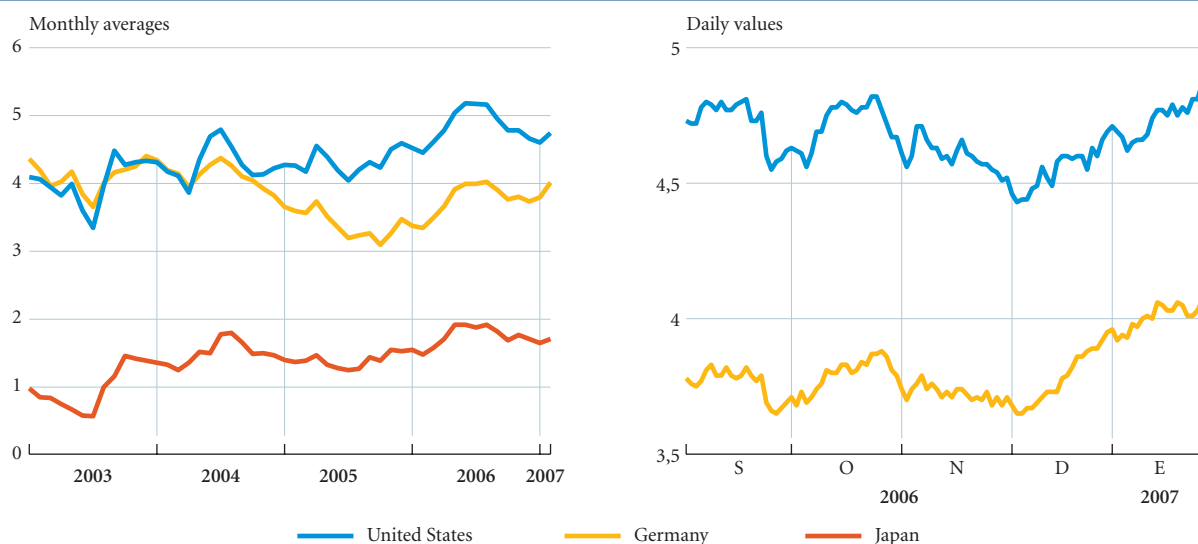
The risk premium on emerging country sovereign bonds recorded a new all-time low in the third week of January 2007

**Differential in long-term interest rates between dollar and euro to narrow in 2007.**

**Euro stands in top place in international bond market.**

### SLIGHT WIDENING OF LONG-TERM INTEREST RATE DIFFERENTIAL BETWEEN DOLLAR AND EURO

Yield on 10-year government bonds as annual percentage



NOTES: Rates go up to January 26.

SOURCE: Bank of Spain and Thomson Financial Datastream.

## LONG-TERM INTEREST RATES IN NATIONAL MARKETS

10-year government bonds: average for period as annual percentage

	2004	2005	2006						2007
			1 Q	2 Q	3 Q	October	November	December	26 January
United States	4.31	4.33	4.61	5.13	4.96	4.78	4.66	4.60	4.88
Japan	1.50	1.39	1.58	1.90	1.80	1.76	1.70	1.64	1.68
Germany	4.07	3.38	3.50	3.96	3.89	3.80	3.73	3.79	4.08
France	4.10	3.41	3.51	3.99	3.90	3.81	3.74	3.80	4.11
Italy	4.24	3.56	3.71	4.27	4.18	4.07	3.97	4.04	4.30
Spain	4.10	3.39	3.49	3.97	3.89	3.81	3.75	3.82	4.13
United Kingdom	4.93	4.47	4.23	4.65	4.67	4.67	4.60	4.69	4.98
Switzerland	2.57	2.04	2.18	2.67	2.61	2.45	2.29	2.40	2.59

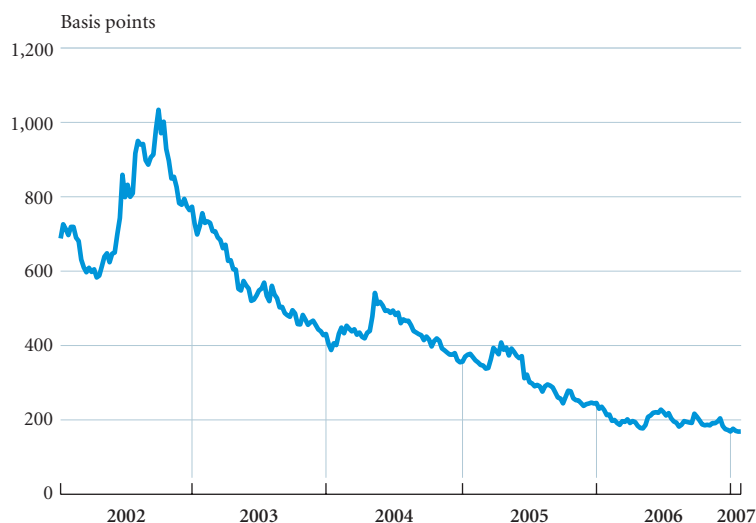
SOURCE: Bank of Spain, Thomson Financial Datastream and own calculations.

when it dropped to only 165 basis points. The risk premium on high-yield corporate bonds also dropped to low levels. In fact, according to Moody's rating agency, the default rate on low credit rating corporate bonds dropped

to 1.7% in 2006 as against 1.9% the year before, marking up the lowest figure since 1996. Nevertheless, it is likely that in coming months the risk premium on high-yield bonds will go up with an increase in the default rate.

## EMERGING COUNTRY RISK PREMIUM MARKS UP NEW ALL-TIME LOW

Differential between sovereign bonds of emerging countries and US Treasury bonds measured by JP Morgan EMBI + index



NOTES: Figures go up to January 26.

SOURCE: JP Morgan and Thomson Financial Datastream.

## Stock markets begin 2007 moderately optimistic

In 2006 the international stock markets made gains for the fourth consecutive year, marking up the best year since 2003. Excellent corporate profits, continuing ample liquidity and lively activity in mergers and acquisitions boosted the international markets. The stock market year, however, was not without its scares but in the second half it enjoyed a strong recovery fanned by the drop in oil prices and the end of the upward course of Federal Reserve interest rates.

Generally, the results in emerging markets were greater than markets as a whole, thanks to the rise in raw materials prices and a favourable economic situation. In fact, the emerging countries headed the classification of those stock markets with highest capital gains in 2006, including the so-called BRIC group (Brazil, Russia, India and China). Nevertheless, some developed countries in Europe also figured in the list, such as Luxembourg, Norway, Portugal and Spain, as may be seen in the following graph.

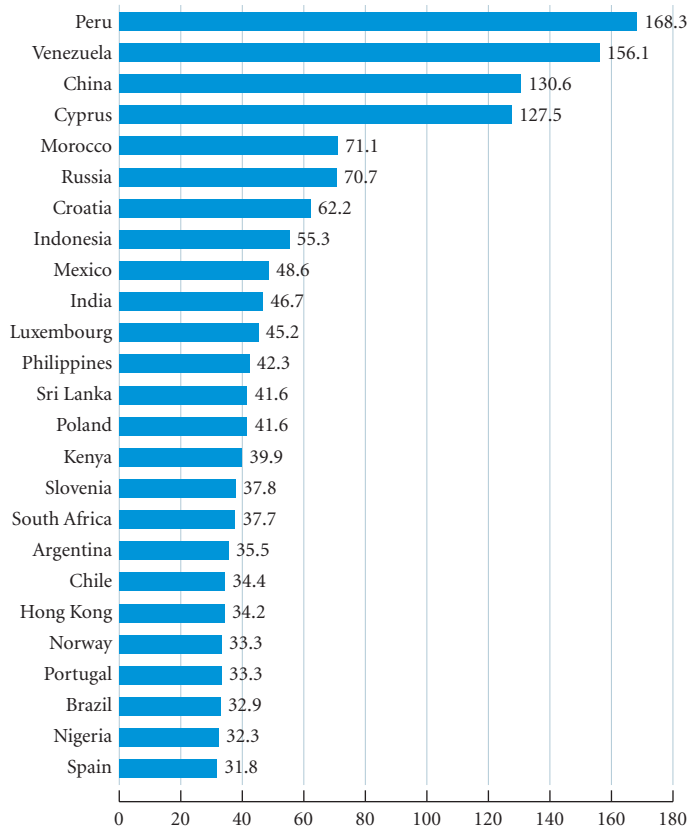
On the other hand, in the early weeks of 2007 things turned around with a

**International stock markets show capital gains for fourth consecutive year with best results since 2003.**

**Emerging countries head classification of most profitable stock markets in 2006.**

### MOST PROFITABLE STOCK MARKETS IN 2006

Annual change in representative national stock market indices as percentage



SOURCE: Thomson Financial Datastream and own calculations.

## INDICES OF MAIN WORLD STOCK EXCHANGES

December 29, 2006

	Index (*)	% monthly change	% annual change	Quotation on January 26, 2007	
				% cumulative change	% change over same date in 2004
New York					
<i>Dow Jones</i>	12,463.2	2.0	16.3	0.2	16.7
<i>Standard &amp; Poor's</i>	1,418.3	1.3	13.6	0.3	23.1
<i>Nasdaq</i>	2,415.3	-0.7	9.5	0.8	13.1
Tokyo	17,225.8	5.8	6.9	1.1	58.8
London	6,220.8	2.8	10.7	0.1	40.1
Euro area					
<i>Frankfurt</i>	6,596.9	4.6	22.0	1.4	62.0
<i>Paris</i>	5,541.8	4.0	17.5	0.7	51.9
<i>Amsterdam</i>	495.3	3.7	13.4	0.9	40.6
<i>Milan</i>	31,892.0	2.9	19.1	1.8	56.4
<i>Madrid</i>	14,146.5	2.1	31.8	1.9	79.5
Zurich	8,785.7	3.5	15.8	2.9	57.3
Hong Kong	19,964.7	5.3	34.2	1.6	47.7
Buenos Aires	2,090.5	6.3	35.5	-2.4	70.2
São Paulo	44,473.0	6.1	32.9	-0.1	82.4

NOTES: (\*) New York: Dow Jones Industrials, Standard & Poor's Composite, Nasdaq Composite; Tokyo: Nikkei 225; Euro area: DJ Eurostoxx 50; London: Financial Times 100; Frankfurt: DAX; Paris: CAC 40; Amsterdam: AEX; Milan: MIBTEL; Madrid: IBEX 35 for Spanish stock exchanges; Zurich: Swiss Market Index; Hong Kong: Hang Seng; Buenos Aires: Merval; São Paulo: Bovespa.

SOURCE: Thomson Financial Datastream and own calculations.

### IBEX 35 marks up new all-time high in January.

relatively worse performance in emerging market markets because of the drop in raw materials prices and some shocks, such as the announcement of nationalization of Venezuelan companies in strategic sectors which had earlier been privatized. North American markets, in turn, were slowed down because of the hold-over of prospects of a cut in Fed interest rates in the first half-year. The Japanese market was helped by gains among export companies as a result of an undervalued yen.

In Spain, the IBEX 35 index ended 2006 with an annual rise of 31.8%, the biggest among the main European stock markets, the highest increase since 1999. In the early stages of 2007, the selective Spanish index continued to mark up all-time highs going above the 14,400 level in mid-January. Demand for Endesa shares with an eye to the conclusion of the take-over bids underway contributed to the rise in the market.

# SPAIN: OVERALL ANALYSIS

## Economic activity

### OECD forecasts high growth rate over short term

The Organization for Economic Cooperation and Development (OECD) foresees that Spain's gross domestic product will continue to grow by more

than 3% this year and next (3.3% in 2007 and 3.1% in 2008). In the analysis this body with headquarters in Paris makes each year and a half, the OECD estimates that both national demand and the foreign sector will tend to gradually moderate although the latter

**OECD draws very favourable picture for Spain's economy over short term...**

### OECD FORECASTS FOR SPAIN'S ECONOMY

% change (unless otherwise indicated)

Macroeconomic figures	2004	2005	Forecast		
			2006	2007	2008
<b>GDP by demand components</b>					
Private consumption	4.2	4.2	3.4	3.3	3.1
Public consumption	6.3	4.8	4.0	4.0	3.6
Gross fixed capital formation	5.0	7.0	6.0	4.9	4.5
<i>Construction</i>	5.5	6.0	6.0	4.2	3.9
<i>Capital goods</i>	4.5	8.4	6.0	5.8	5.5
<b>National demand</b>	<b>4.8</b>	<b>5.0</b>	<b>4.3</b>	<b>3.9</b>	<b>3.6</b>
Exports of goods and services	4.1	1.5	6.5	5.2	5.2
Imports of goods and services	9.6	7.0	8.3	6.6	6.6
<b>GDP</b>	<b>3.2</b>	<b>3.5</b>	<b>3.7</b>	<b>3.3</b>	<b>3.1</b>
<b>Foreign sector</b>					
Contribution to GDP growth	-1.7	-1.7	-0.9	-0.8	-0.8
Current account balance (% of GDP)	-5.9	-7.5	-8.8	-9.2	9.6
<b>Prices and costs</b>					
Private consumption deflator	3.5	3.4	3.6	2.8	3.1
GDP deflator	4.0	4.1	3.7	3.5	3.7
Unit labour costs	2.6	2.5	2.5	3.1	3.2
<b>Labour market</b>					
Employment	2.6	3.1	3.0	2.7	2.3
Unemployment rate (% of labour force)	10.5	9.2	8.4	7.8	7.6
Labour productivity	0.6	0.4	0.7	0.7	0.7
<b>Other figures</b>					
Surplus (+) or deficit (-) in public sector (% of GDP)	-0.2	1.1	1.4	1.2	1.4
Household savings rate (% of disposable gross income)	11.4	10.6	10.0	10.1	10.0

SOURCE: OECD.



**...but much less positive for following decades if some basic imbalances not corrected.**

will come close to 9.6% of the GDP in 2008. The growth rate of economic activity will make it possible for the unemployment rate to near 7.5% in 2008, an important milestone in the recent history of Spain.

But congratulations are not handed out in all quarters. The OECD also expressed its concern about the slow improvement in productivity and the erosion of competitiveness of Spain's economy. Should those anomalies continue, the potential growth of Spain's economy, which stood at the threshold of 3.5% in the period 1997-2006, would drop to 1.9% over the next ten years and could even drop to 1.3% in the following decade. If these predictions turn out to be true, the advance enjoyed by Spain's economy in recent years as part of the process of convergence with the average per capita GDP of the Euro Area could come to an end.

**OECD also concerned about trend in real estate market and household indebtedness.**

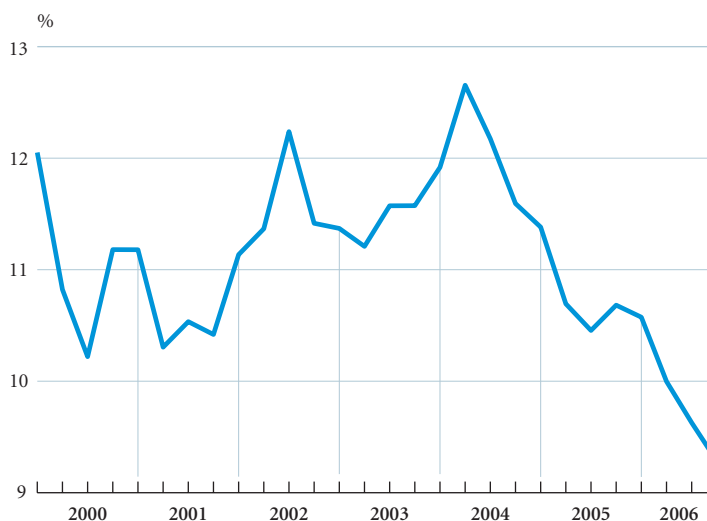
Another key factor that caught the attention of the OECD is the situation in the Spanish real estate market. According

to that body, housing prices are overvalued and to correct this situation it advocates balancing the incentives for both ownership and rental. It would not rule out some unpopular measures such as the gradual removal of supports given for home ownership (made available mainly through tax deductions). The growth of mortgage loans and the level of household indebtedness are also aspects that concern the OECD.

At this moment, housing prices have moved into a downturn, as indicated in the following section. Figures for the financial accounts of households and non-profit organizations for the third quarter of 2006, however, do not indicate a change in the trend. In the period mentioned, the proportion of disposable income of Spanish households going into consumption rose and, as a result, the part reserved for savings dropped. On top of this, as investment spending (mainly for home purchase) grew at the same time, household deficits continued to increase.

### SPANISH HOUSEHOLDS SAVING LESS AND LESS

Gross savings (disposable income less consumer spending) over disposable income



SOURCE: INE and own calculations.

This stands in contrast to the situation before 2003 when it was precisely households that provided financing for the rest of the economy.

### Economic activity indicators: growth signs predominate

At the end of 2006, the main economic activity indicators continued to show a strong expansionist profile. The background trends suggested this would continue or, at the very most, turn into a slight easing off in coming months, along the lines indicated by the OECD.

In the final months of 2006, industry had fully consolidated its recovery with increases in the general production index of more than 4%. In December, for the first time in many months, the sector confidence index reached a positive figure, thanks to the favourable situation in order books and the excellent prospects for production in the immediate future.

Construction also continues expansionist, according to the showing in the main indicators for that economic sector. Cement consumption, for example, rose by 8.4% year-to-year in

**Strong pulse  
in construction...**

## SUPPLY INDICATORS

Percentage change over same period year before

	2004	2005	2005		2006				
			4Q	1Q	2Q	3Q	October	November	December
<b>Industry</b>									
Electricity consumption (1)	4.2	3.4	2.7	1.9	2.8	5.8	4.3	1.9	4.4
Industrial production index (2)	1.6	0.7	1.6	2.6	4.0	4.2	5.2	4.1	...
Confidence indicator for industry (3)	-2.5	-4.9	-4.0	-5.4	-2.7	-2.3	-2.0	-2.0	3.0
Utilization of production capacity (4)	79.8	80.2	80.7	79.7	80.5	80.3	-	81.6	-
Imports of non-energy intermediate goods (5)	6.6	1.6	1.1	10.3	6.4	13.8	16.9	...	...
<b>Construction</b>									
Cement consumption	3.9	7.3	6.1	17.2	4.0	4.5	12.0	6.8	6.4
Confidence indicator for construction (3)	13.6	22.4	28.3	15.3	11.7	14.7	13.0	16.0	16.0
Housing (new construction approvals)	8.0	6.2	10.6	18.5	6.3	49.5	21.6	...	...
Government tendering	18.3	18.5	36.9	15.1	34.8	19.3	57.8	...	...
<b>Services</b>									
Retail sales	5.5	4.4	3.8	5.2	3.8	5.9	4.2	5.6	...
Foreign tourists	3.1	6.6	5.4	1.1	9.6	3.7	3.6	1.4	1.8
Tourist revenue inflows	3.8	5.8	4.9	-7.6	3.0	3.9	-3.9	...	...
Goods carried by rail (km-tonnes)	-3.5	-3.2	11.0	8.1	-2.7	-3.3	-4.4	-4.1	...
Air passenger traffic	8.0	9.2	9.3	5.2	10.1	4.5	6.1	6.4	9.2
Motor vehicle diesel fuel consumption	6.7	5.1	4.4	8.7	4.5	3.9	8.5	...	...

NOTES: (1) Adjusted for number of working days and temperature.

(2) Adjusted for difference in number of working days.

(3) European Commission survey: difference between percentage of positive and negative replies.

(4) Business survey: percentage of utilization inferred from replies.

(5) By volume.

SOURCE: Red Eléctrica Española, OFICEMEN, AENA, National Institute of Statistics, Bank of Spain, European Commission, Ministry of Public Works, Ministry of Industry, Commerce and Tourism, Ministry of Economy and Finances and own calculations.

## RISE IN HOUSING PRICES EASING OFF

Year-to-year change in average price per square metre for non-subsidized housing



SOURCE: Ministry of Housing and own calculations.

the final quarter. Other early indicators, such as approvals for new construction projects and government tendering, also reflect notable growth. It should be pointed out that, in the period between October 2005 and September 2006 (the last month for which figures are available), construction began on more than 728,000 new housing units, an all-time absolute record.

This strong drive in construction stands in contrast to signs of more moderation from the real estate market. In the last quarter of 2006, the average price of non-subsidized housing per square metre showed a drop in annual growth rate to 9.1%, nearly four points less than one year earlier. This was a continuation of the slowdown which began in 2005. In addition, according to figures supplied by the Ministry of Housing, growth in the number of real estate transactions has also continued to ease off. In the third quarter, this growth was only 2.4% compared with the same period in 2005. Overall, the situation seems to be following a scenario of gradual

moderation and for now the possibility of a more traumatic correction seems more remote.

With regard to services, we note generally sustained growth in nearly all sectors. The drive is especially strong in transport and company services (which include temporary work companies), according to the expansionist profile of business volume indices. The trend in confidence indicator prepared by the European Commission offers a similar interpretation.

In the specific case of tourism, the balance for 2006 has been fairly positive. The total number of foreign tourists again marked up an absolute all-time high in 2006. Nearly 58.4 million persons came to Spain as tourists, 4.5% more than in 2005. Total tourist spending during the first 11 months of the year was up by a very similar rate.

On the demand side, we note that consumption is still showing very strong with a tendency to a slight slowdown but

**...in contrast to signs of greater easing off coming from real estate market.**

## DEMAND INDICATORS

Percentage change over same period year before

	2004	2005	2005			2006			
			4Q	1Q	2Q	3Q	October	November	December
<b>Consumption</b>									
Production of consumer goods (*)	-0.1	0.9	0.9	0.6	2.1	1.9	5.2	4.0	...
Imports of consumer goods (**)	13.4	7.9	8.6	20.5	5.9	2.4	13.6	...	...
Car registrations	9.8	0.8	-4.5	2.4	-4.3	-5.3	5.8	0.1	-5.5
Credit for consumer durables	5.5	15.0	19.7	17.6	15.6	13.2	-	...	-
Consumer confidence index (***)	-10.5	-10.8	-11.2	-12.5	-12.7	-13.7	-11.0	-10.0	-10.0
<b>Investment</b>									
Capital goods production (*)	1.9	-0.1	0.8	6.7	7.6	8.0	9.5	11.6	...
Imports of capital goods (**)	14.9	20.4	8.2	10.0	-5.0	6.5	31.5	...	...
Commercial vehicle registrations	11.7	13.2	11.5	7.4	-0.2	0.5	9.9	-0.2	-10.9
<b>Foreign trade (**)</b>									
Non-energy imports	9.8	6.0	4.5	13.7	4.7	8.9	17.5	...	...
Exports	5.2	0.2	0.1	12.7	3.7	1.7	9.3	...	...

NOTES: (\*) Adjusted for difference in number of working days.

(\*\*) By volume.

(\*\*\*) European Commission survey: difference between percentage of positive and negative replies.

SOURCE: ANFAC, National Institute of Statistics, Bank of Spain, Ministry of Economy and Finance, European Commission and own calculations.

perhaps less than was at first expected. There are some exceptions, such as in the case of passenger cars which showed a drop of 2.0% in registrations compared with the year before. They just missed out on reaching the emblematic figure of

1.5 million units which they had gone above in the two previous years. Finally, the indicators for capital goods investment, at least going by available figures, still seem to reflect an upward growth rate.

**Consumption still keeps up sharp drive and investment giving signs of great strength.**

## Labour market

### Record figure for registrations with Social Security in 2006

At the end of 2006, the Social Security system had more than 18,770,000 person registered (the highest figure ever at year-end), 3.4% more than at the end of 2005. In addition, the year-to-year growth rate tended to accelerate significantly in the final months, mainly thanks to the increase in registrations by Spaniards, a group that is subject to less variation than other persons registered, which fairly faithfully reflects the background trend in the figures.

Out of the close to 614,100 new persons registered, 78% had Spanish nationality. In the foreign worker group, nearly half

of the 135,000 new persons registered came from countries that are member states of the European Union (EU). The total number of EU foreign workers grew by 23.3%, a percentage much higher than the rest of foreign workers registered (4.9%), but at the end of the year the total figure for those of EU origin (350,000) was still clearly below that for other foreign workers (1,474,000).

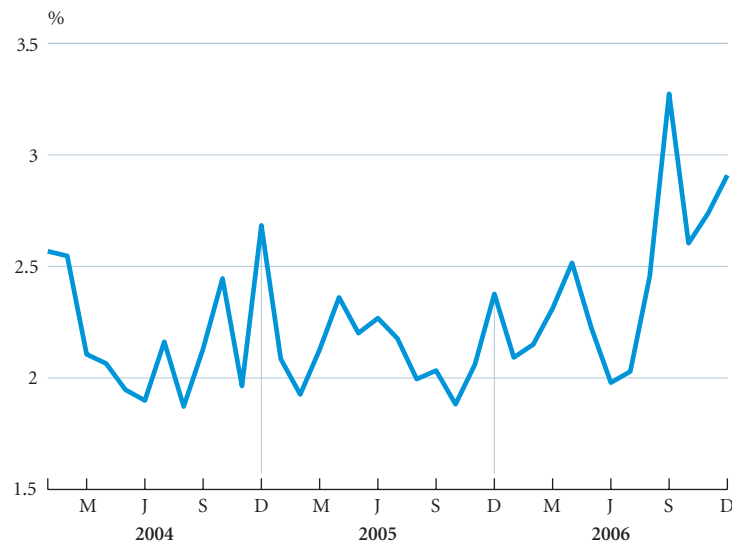
By economic activity sector, we should first point out the year-to-year growth marked up by industry which, while still of a modest nature (0.5%), was the first positive change recorded since 2000. The recovery of that sector is now beginning to show up, with the usual gaps in these

**Growth rate of total number of persons registered with Social Security tends to sharpen in final months of 2006.**

**Total registrations in industry records first positive change since 2000.**

### INCREASE IN GROWTH OF TOTAL SPANIARDS REGISTERED WITH SOCIAL SECURITY

Year-to-year change in total Spaniards registered with Social Security system



SOURCE: Ministry of Labour and Social Affairs and own calculations.

## EMPLOYMENT INDICATORS

Percentage change over same period year before

	2004	2005	2005			2006			
			4Q	1Q	2Q	3Q	October	November	December
<b>Persons registered with Social Security</b>									
Wage-earners	2.7	4.8	6.3	6.3	5.3	3.9	3.4	3.5	3.6
<i>Industry</i>	-0.5	-0.5	-0.4	-0.3	0.0	0.0	0.0	0.2	0.5
<i>Construction</i>	5.6	8.6	10.9	11.0	9.5	7.5	6.9	6.5	6.9
<i>Services</i>	3.9	5.7	6.8	6.6	5.8	4.6	3.9	4.1	4.0
Non-wage-earners	3.2	2.6	2.4	2.3	2.2	2.1	2.2	2.2	2.3
<b>Total</b>	<b>2.8</b>	<b>4.4</b>	<b>5.6</b>	<b>5.5</b>	<b>4.8</b>	<b>3.6</b>	<b>3.1</b>	<b>3.3</b>	<b>3.4</b>
<b>Persons employed (*)</b>	<b>3.9</b>	<b>5.6</b>	<b>5.6</b>	<b>4.9</b>	<b>4.2</b>	<b>3.7</b>	-	-	-
<b>Jobs (**)</b>	<b>2.6</b>	<b>3.1</b>	<b>3.2</b>	<b>3.2</b>	<b>3.1</b>	<b>3.0</b>	-	-	-
<b>Hiring contracts registered (***)</b>									
Permanent	11.8	8.7	16.1	25.6	16.1	46.6	61.7	62.3	116.7
Temporary	11.4	4.6	8.9	13.7	5.5	0.5	6.1	0.1	-5.7
<b>Total</b>	<b>11.5</b>	<b>5.0</b>	<b>9.5</b>	<b>15.0</b>	<b>6.4</b>	<b>4.1</b>	<b>11.1</b>	<b>5.8</b>	<b>4.3</b>

NOTES: (\*) Estimate from Labour Force Survey (changes for 2005 adjusted for impact of methodological changes).

(\*\*) Equivalent to full-time work. National Accounting estimate; figures adjusted for seasonal effects and number of working days.

(\*\*\*) At INEM.

SOURCE: National Institute of Statistics, Ministry of Labour and Social Services, Employment Institute and own calculations.

cases, in the creation of jobs. In construction, one of the economic activities that has led job creation in recent years, the total number of registrations was up by 6.9%, a much more moderate rate than in 2005 (11.4%), a year largely affected by the process of giving regular work status to foreign workers.

In services, the area to show a higher growth rate was education, with an increase in registrations of 10.4% year-to-year. In absolute terms, however, the laurels go to real estate business and company services (which include temporary job companies), with more than 164,300 new persons registered and a percentage increase of 8.7%. One particular case is that of the trend in the total number of those registered among domestic employees, which reported a sharp year-to-year decrease in

December 2006 (around 17.7%), due to the drop-out of foreign workers, which suggests something of a reverse in the process of giving normal work status carried out in 2005 with regard to this specific group.

Those autonomous communities to record the highest change rates were Castile-La Mancha, Cantabria, Aragon and Galicia, all with growth of more than 4%, followed by Andalusia, Extremadura, Canary Islands, Castile-Leon, Murcia, Asturias and Madrid, which showed lower growth but still above the national average. Coming at the end were the Basque Country and Catalonia with growth only slightly above 2.4% in keeping with the greater relative weight of industry in those autonomous communities.

**Real estate business and company services record highest growth in new registrations in absolute terms.**

**Registered unemployment undergoes minor decrease in December as opposed to normal trend that month.**

### Further drop in registered unemployment in 2006

The total number of unemployed in December came close to a figure of 2,023,000. While that month usually brings a slight seasonal increase in unemployment, unemployment in December 2006 showed a slight overall drop (291 persons) in contrast, for example, with the increase recorded one year earlier (7,357 persons).

Unemployment was down in three sectors. Services reported nearly 13,600 fewer unemployed, 1.1% less than the month before. In agriculture, the figure was down 2,400 (3.7%) while in those without previous employment it came to nearly 11,000 (4.8%).

On the other hand, the increase in unemployment was concentrated in industry with nearly 6,600 new unemployed, 2.4% more than in the month before and especially in construction, with an increase of 20,000

(9.2%). Male unemployment in December was close to 804,300 persons following an increase of 27,200 that month (3.5% more than in the previous month) while female unemployment stood at 1,218,600, a monthly decrease of 27,500 (2.2%).

Compared with December 2005, registered unemployment was down by nearly 80,100 persons (the biggest drop recorded in the new statistical series begun in 2000) with widespread decreases in all economic sectors and population groups. In addition, the year-to-year rate of decrease (3.8% in December 2006) tended to increase progressively during the year, as shown in the following graph.

In relative terms, the biggest annual decreases were reported in the following sectors and population groups: in industry, which showed a drop of 6.4%; among those under 25 years of age (12.3%); and in the male group (5.6%).

**Unemployment down by nearly 80,100 persons in past year.**

## REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

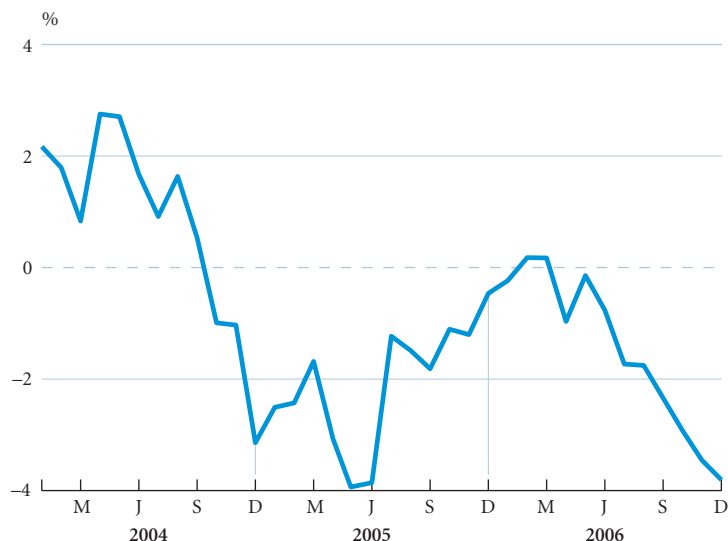
December 2006

	No. of unemployed	Change over December 2005		% share
		Absolute	%	
<b>By sector</b>				
Agriculture	61,494	-3,733	-5.7	3.0
Industry	282,148	-19,171	-6.4	13.9
Construction	236,771	-8,329	-3.4	11.7
Services	1,224,869	-41,520	-3.3	60.6
First job	217,591	-7,311	-3.3	10.8
<b>By sex</b>				
Males	804,274	-47,689	-5.6	39.8
Females	1,218,599	-32,375	-2.6	60.2
<b>By age</b>				
Under 25 years	242,012	-33,883	-12.3	12.0
All other ages	1,780,861	-46,181	-2.5	88.0
<b>TOTAL</b>	<b>2,022,873</b>	<b>-80,064</b>	<b>-3.8</b>	<b>100.0</b>

SOURCE: INEM and own calculations.

## REGISTERED UNEMPLOYMENT MAINTAINS VERY SHARP DOWNWARD PROFILE

Year-to-year change in registered unemployment at employment offices



SOURCE: Employment Institute and own calculations.

Those autonomous communities to record a relatively higher drop were Aragon, Cantabria and Galicia, all with decreases in unemployment of more than 10%. At the opposite extreme came Andalusia and Catalonia with decreases of less than 1%.

Finally, we should put a positive value on the fact that in the course of 2006

more than 2,177,000 permanent hiring contracts were signed, 41.1% more than in 2005. For the first time, a figure of two million permanent hiring contracts was reached in just one year. Some 74% of all permanent contracts were for full-time work while this proportion was even higher under the heading of temporary work contracts (77%).

**For first time, figure for permanent hiring contracts signed in one year goes above two million in 2006.**



## Prices

**Spain's economy showing notable adaptability in face of oil shock but average annual inflation up one decimal over 2005.**

### CPI ends 2006 with increase of 2.7%

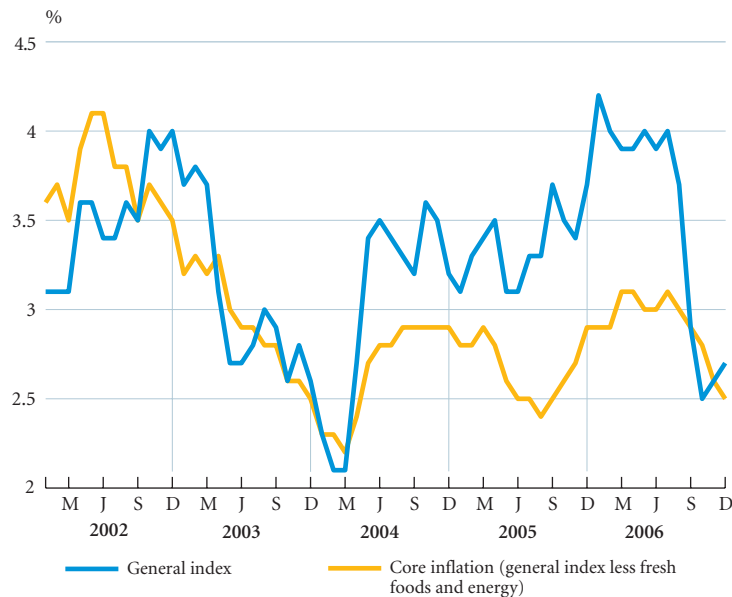
The consumer price index (CPI) ended up with a year-to-year change of 2.7% in December, one point less than at the end of 2005 and the lowest rate in the past three years. During the year inflation in consumer prices showed slight ups and downs largely linked to the trend in oil prices. It thus rose to 4.2% in January when oil was going up sharply and it still stood at 4.0% in July. Nevertheless, from the beginning of August on oil prices began to drop going down to levels close to those in December 2005. This helped to ease inflation. However, the annual average change in the CPI was 3.5%, one decimal more than in 2005 and the

highest since 2002. Given the sharp swings in oil prices, which would rise more than 35% over the end of 2005, Spain's economy has shown a notable ability to adapt.

Another volatile component of the CPI, unprocessed foods, ended 2005 with an annual increase of 4.5%, substantially above the general index but 7 decimals less than 12 months earlier. The price pressures shown in fresh foods may partly be attributed to increased demand due to the larger number of tourists and population increase. In fact, potatoes, chicken and beef head the list of most inflationary products and services in 2006 although other fresh

### DROP IN UNDERLYING INFLATION

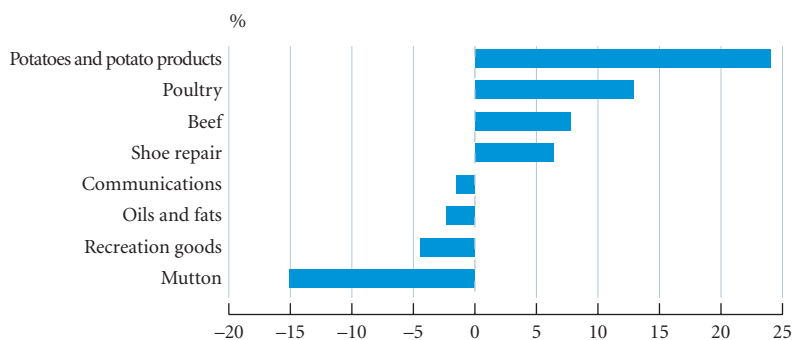
Year-to-year change in CPI



SOURCE: National Institute of Statistics and own calculations.

## CHICKEN AND POTATOES HARD ON CPI

Products and services with most notable price changes in 2006



SOURCE: National Institute of Statistics.

foods, such as mutton, showed sharp drops.

With regard to the more stable core of inflation, so-called underlying inflation, which includes services and non-energy manufactured goods, this showed an annual rise of 2.5% in December, two decimals more than the general CPI and 4 decimals below December 2005. Nevertheless, the annual average showed

an increase of 2.9%, two decimals more than in 2005. Among the components, non-energy industrial products, which are subject to heavy competition in international markets, were the least inflationary marking up only 1.2% in December although this was one decimal more than the year before.

On the other hand, services, which are generally more sheltered from foreign

**Services scarcely moderate rate of price increases.**

## CONSUMER PRICE INDEX

	2005			2006		
	% monthly change	% change over December 2004	% annual change	% monthly change	% change over December 2005	% annual change
January	-0.8	-0.8	3.1	-0.4	-0.4	4.2
February	0.3	-0.6	3.3	0.0	-0.4	4.0
March	0.8	0.2	3.4	0.7	0.3	3.9
April	1.4	1.6	3.5	1.4	1.8	3.9
May	0.2	1.8	3.1	0.4	2.1	4.0
June	0.2	2.1	3.1	0.2	2.3	3.9
July	-0.6	1.5	3.3	-0.6	1.7	4.0
August	0.4	1.9	3.3	0.2	1.9	3.7
September	0.6	2.5	3.7	-0.2	1.7	2.9
October	0.8	3.4	3.5	0.4	2.1	2.5
November	0.2	3.5	3.4	0.2	2.4	2.6
December	0.2	3.7	3.7	0.3	2.7	2.7

SOURCE: National Institute of Statistics.

**Inflation prospects in coming months favourable so long as oil fails to get in way.**

**Inflation differential with Euro Area goes up to 1.4 points annual average in 2006 and hurts competitiveness.**

competition, scarcely changed in growth rate of prices (only 2 decimals less than in December 2005) and marked up an annual increase of 3.7%. It should be pointed out that services is a very broad group and, while education and hotel and restaurant trade prices were up by a notable 4.4%, communications were down 1.5%, thanks to strong competition among telephone service operators.

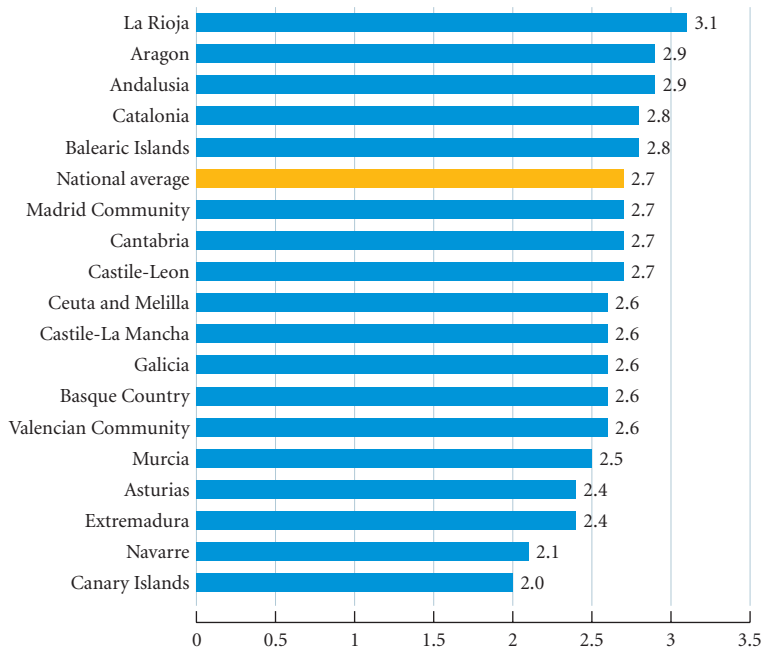
In geographical terms, in 2006 five autonomous communities ended the year with inflation higher than the 2.7% average, namely La Rioja, Aragon, Andalusia, Catalonia and Balearic Islands. Catalonia and La Rioja have followed along this line in recent years. At the other end of the scale, Canary Islands and Extremadura regularly show inflation below the average.

What are the prospects for 2007? The year has begun with the usual increases in regulated services. In January, domestic electrical power supply rose by 2.8% on average, along with natural gas and postal services. Rail fares and urban transport went up somewhat more as did some tobacco brands. Nevertheless, this upward move may be compensated by the drop in oil prices which have eased since the beginning of the year and a drop in unprocessed foods. If oil prices show no sharp rises, the annual inflation rate will likely drop slightly in coming months to then start rising in the second half-year to a level close to the current level.

In addition, the Harmonized Index of Consumer Prices (EU) also showed an annual rise of 2.7% in December 2006. On annual average, this index rose by

**LA RIOJA AUTONOMOUS COMMUNITY WITH HIGHEST INFLATION IN 2006**

Percentage change in CPI between December 2005 and 2006



SOURCE: National Institute of Statistics.

## TREND IN CONSUMER PRICE INDEX

Percentage change in December over December previous year

	Total		Special groups						Core inflation	Inflation differential with euro area (**)	
	Annual average	Year-end	Food (*)			Industrial goods					Services
			Processed	Unprocessed	Total	Non-energy	Energy	Total			
1991	5.9	5.5	4.4	2.0	3.3	4.7	1.9	4.2	9.6	6.5	
1992	5.9	5.3	5.6	-3.5	1.3	5.0	10.1	5.9	10.4	6.8	
1993	4.6	4.9	4.8	3.7	4.4	3.3	6.4	3.9	6.8	5.0	
1994	4.7	4.3	5.0	4.7	4.9	3.6	1.8	3.2	5.2	4.5	
1995	4.7	4.3	6.2	1.9	4.5	4.2	3.0	4.0	4.5	4.8	
1996	3.6	3.2	3.2	2.4	2.9	2.4	6.5	3.1	3.6	3.0	
1997	2.0	2.0	0.4	3.2	1.5	1.4	0.6	1.2	3.5	2.0	
1998	1.8	1.4	0.4	0.9	0.6	1.6	-6.6	0.1	3.7	2.2	
1999	2.3	2.9	2.6	2.0	2.4	1.3	11.5	3.1	3.2	2.4	1.1
2000	3.4	4.0	1.1	6.5	3.2	2.5	11.2	4.1	4.4	3.0	1.4
2001	3.6	2.7	5.3	6.1	5.6	2.6	-10.0	-0.4	4.2	3.8	0.5
2002	3.1	4.0	3.4	7.0	4.7	2.5	5.7	3.3	4.4	3.5	1.3
2003	3.0	2.6	2.7	6.4	3.9	1.2	-0.1	0.9	3.6	2.5	1.0
2004	3.0	3.2	4.1	1.8	3.3	1.2	7.6	2.6	3.8	2.9	1.0
2005	3.4	3.7	3.8	5.2	4.3	1.1	9.9	3.2	3.9	2.9	1.2
2006	3.5	2.7	2.2	4.5	3.0	1.2	2.6	1.5	3.7	2.5	1.4

NOTES: (\*) Includes alcoholic drinks and tobacco.

(\*\*) Percentage points calculated on basis of average annual change in HCPI.

SOURCE: National Institute of Statistics.

3.6% in 2006, some 2 decimals more than the year before. Spain's year-to-year inflation in December was the second highest in the Euro Area, beaten only by Greece. The inflation differential with

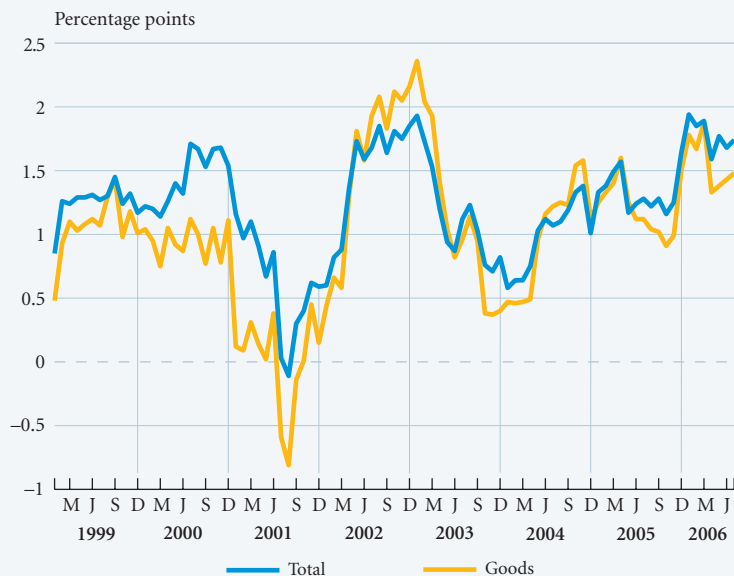
the Euro Area in December held at 0.8 percentage points although it stood at 1.4 points on annual average, 2 decimals more than in 2005. This meant a continued loss of competitiveness.

## What are causes of Spain's inflation differential?

In the European Union chapter we studied inflation differentials in the Euro Area and some possible explanations. In this box, we shall concentrate more specifically on the case of Spain to understand the effects of persistent inflation differentials. The following graph shows the inflation differential between Spain and the other Euro Area countries between 1999 and 2006. The graph also includes inflation of the goods component in the Harmonized Index of Consumer Prices. As may be seen, since 2002 the overall inflation differential between Spain and the Euro Area can be almost entirely explained by the differential in the goods component. In fact, the correlation between the two series as of 2002 is almost perfect.

## SPAIN'S INFLATION KEEPS ITS DISTANCE

Inflation differential – Spain-EMU



SOURCE: Eurostat and own calculations.

We must keep in mind that this evidence does not ignore the possible contribution of the services component, given that the goods component makes up 65% of the CPI. Nevertheless, while the services component has a higher inflation differential than the goods component, its contribution to the total differential is lower due to its lesser relative weight. Furthermore, the goods component of the HICP includes final prices paid by the consumer, and therefore includes elements of a non-tradable nature, such as distribution costs and the effect of indirect taxes that are not harmonized at the EMU level. However, if we use producer price indices for final consumption goods, the evidence is similar.

If inflation differentials are mainly driven by the goods component and the evidence examined in the previous chapter suggests that the effects of price level convergence are not a dominant cause, how do we explain this result? A recent study using a modern macroeconomic model suggests that these differentials reflect productivity differences in the tradable goods sector between Spain and the rest of the EMU. On the other hand, demand factors and different mechanisms for setting prices in the EMU seem to have a much smaller quantitative effect.<sup>(1)</sup>

As may be seen in the accompanying table, the real unit labour costs (that is, labour costs adjusted for inflation facing companies and labour productivity) grew faster in the goods sector in Spain than in the EMU. This was due both to higher growth in nominal wages in Spain compared with the EMU and to lower growth in labour productivity. This has led to an increase in real unit labour costs of 1.6% in the goods sector in Spain and to a decrease of 0.6% in the EMU. When real unit labour costs increase, this brings about a squeezing of margins, inflationary pressures (or both) in that sector. The table shows that real unit labour

(1) Rabanal, Pau, 2006, «Explaining Inflation Differentials between Spain and the Euro Area» *la Caixa* Economic Papers, No. 02/2006.

costs in the services sector have increased in a similar way in both Spain and the Euro Area (0.6% against 0.9%). This means that the big differences in inflation may be explained both by the performance in nominal wages and productivity in the goods sector between Spain and the EMU. On the other hand, there has been an erosion of real labour costs in the services sector of Spain's economy. It is likely that the impact of immigration, which has been employed largely in the services sector and construction, may have made possible the containment of wages in real terms.

### TREND IN PRICES, COSTS AND PRODUCTIVITY IN SPAIN AND THE EMU

Average annual growth 2000-2006 (\*)

	Spain		EMU	
	Goods	Services	Goods	Services
1. Nominal labour costs	4.1	3.8	3.2	3.3
2. GDP inflators	1.7	4.5	2.2	2.2
3. CPI inflation	3.0	3.9	2.1	2.4
4. Productivity	0.9	-1.4	1.6	0.1
5. Real labour costs (1-2)	2.4	-0.8	1.0	1.1
6. Real unit labour costs (1-2-4)	1.6	0.6	-0.6	0.9

NOTES: (\*) Figures for 2006 refer to September 2006.

SOURCE: INE, Eurostat, ECB and own calculations.

Finally, let us answer the following question: What are the consequences of these inflation differentials between Spain and the rest of the Euro Area? In the first place, at the aggregate level, a higher inflation rate in Spain reduces the purchasing power of the population. Furthermore, the real interest rate will be lower than in the rest of the EMU, which, in a context of high growth and high inflation, implies the loss of the ability of monetary policy to be counter-cyclical and play a stabilizing role. Secondly, it is worth distinguishing the impact of the inflation differential between tradable and non-tradable goods (i.e. services). As we have shown, the differential may be explained by tradable goods and, given that labour costs in the goods sector have grown more than productivity in Spain compared with the rest of the EMU, this could imply a loss of competitiveness of Spain's economy with possible future consequences for the growth of exports, GDP and employment. In the past it was possible to use competitive devaluations in order to correct these differentials whereas now this is no longer possible. Finally, the existence of rigidities in the economy (for example, the labour market) makes it more likely that there will be a gradual adjustment through inflation differentials than through wages.

### Moderation in import prices

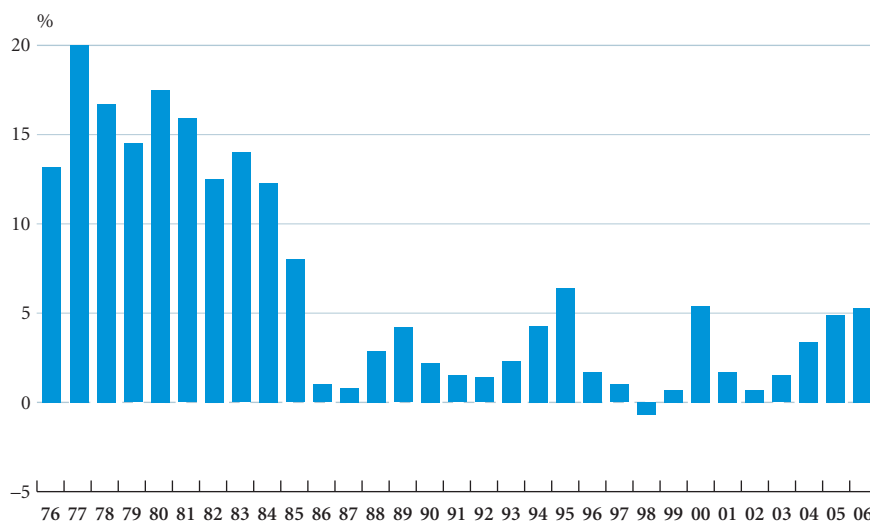
Producer prices as a whole held at the same level in the final months of 2006. As a result, the general index in December stood 3.6% above 12 months earlier, some 1.7 points less than the year before. The performance was quite different depending on the economic

end-use of goods. Under pressure of international competition, consumer and capital goods showed moderate year-to-year increases of 2.0% and 2.6% respectively. After having risen by 15.6% in 2005, energy products ended the year with an increase of 2.4%. On the other hand, intermediate goods rose by 6.8%, a rate more than twice that for

**Despite moderation in second quarter, average annual change in producer prices rises 4 decimals to 5.3% in 2006, highest increase since 2000.**

## PRODUCER PRICES: BIGGEST INCREASE SINCE 2000

Average annual change in producer prices



SOURCE: National Institute of Statistics and own calculations.

### Import prices down in November putting annual change at 2.4%.

December 2005. The increase in intermediate goods reflects the rise in raw materials, especially in metals. Metallurgy thus rose by 17.2%.

The improvement in inflation measured by producer prices largely came about in the second half of the year largely thanks to trend in energy prices. In fact, the average increase in producer prices was 5.3%, some 4 decimals more than for 2005 as a whole and the highest increase since 2000. It is hard to see the pressures still seen in intermediate goods prices being entirely shifted to capital goods and consumer goods due to foreign competition. In addition, prices of intermediate goods will tend to ease if there is some slackening in raw materials

markets. Producer prices therefore should not greatly worsen the trend in consumer prices in coming months.

In addition, import prices were down in November, according to figures from the survey of importers carried out by the National Institute of Statistics. The year-to-year change rate of these prices continued to drop, going to 2.4%, 6 decimals less than in October. It should be pointed out that consumer durables were down by 2.7% compared with November 2005 due to sharp competition in world markets, whereas non-durable consumer goods rose by only 0.5% in the same period. On the other hand, intermediate goods rose by 8.6% in the past 12 months.

## INFLATION INDICATORS

Percentage change over same period year before

	Farm prices	Producer price index					Import prices				GDP deflator (*)
		General index	Consumer goods	Capital goods	Intermediate goods	Energy goods	Total	Consumer goods	Capital goods	Intermediate goods	
<b>2005</b>											
October	-0.8	5.0	3.0	1.9	3.1	15.2	4.8	0.8	14.0	5.3	-
November	2.0	4.9	3.1	2.0	3.2	14.7	3.8	3.3	-0.8	5.6	4.1
December	2.1	5.2	3.2	2.0	3.2	15.6	7.1	0.9	10.2	8.9	-
<b>2006</b>											
January	4.0	6.3	3.5	2.1	3.6	20.6	5.6	-6.5	-5.1	15.2	-
February	0.8	6.3	3.6	2.1	3.9	20.1	6.6	2.5	3.2	9.2	4.0
March	-10.2	5.8	3.3	2.0	4.6	16.4	6.0	2.7	7.5	7.2	-
April	-8.1	5.7	2.9	2.2	5.1	15.4	7.4	3.2	-4.2	11.7	-
May	-3.6	6.6	3.2	2.3	6.1	17.8	6.1	4.2	-0.6	8.2	4.0
June	6.0	6.3	3.5	2.3	6.8	14.6	1.7	-1.5	-3.2	4.2	-
July	0.7	6.4	3.6	2.4	7.0	13.9	1.1	0.5	-7.3	3.1	-
August	0.4	5.7	3.2	2.5	7.2	10.2	2.3	-0.6	-0.5	4.0	3.8
September	1.1	4.2	2.7	2.5	6.7	4.1	0.8	2.4	-5.0	1.0	-
October	2.7	3.4	2.3	2.4	6.9	0.5	1.7	0.1	-8.2	4.5	-
November	...	3.6	2.5	2.5	6.8	1.0	...	...	...	...	...
December	...	3.6	2.0	2.6	6.8	2.4	...	...	...	...	...

NOTES : (\*) Figures adjusted for seasonal and calendar effects.

SOURCE: National Institute of Statistics, Ministry of Economy and own calculations.



## Foreign sector

**Current account deficit looks like ending 2006 at 9% of GDP due to continuous widening of trade deficit.**

### Balance of payments: further widening of current account deficit

In cumulative balance for the year, the run-away current account deficit rose to 72.52 billion euros in October, that is, a level 32% higher than in the same period in 2005. What was the main cause? The usual factor in recent times was at play, namely the widening of the trade deficit that in the first ten months of 2006 was already 66.92 billion euros (19% more than in the same period the year before).

The last straw was the drop in the services surplus and the increase in the incomes deficit.

This meant a further increase in the growth rate of the current account imbalance. As pointed out in the Organization for Economic Cooperation and Development's recent annual report on Spain, while the funding of this deficit is not at threat due to fact that the country belongs to the single currency area, it is indeed indicative of the current

### BALANCE OF PAYMENTS

October 2006

	Cumulative for year		Last 12 months		
	Balance	% annual change	Balance	Annual change	
				Absolute	%
<b>Current account balance</b>					
Trade balance	-66,918	19.4	-79,862	-13,501	20.3
Services					
<i>Tourism</i>	23,037	-3.8	25,456	-1,207	-4.5
<i>Other services</i>	-5,208	71.3	-5,903	-2,266	62.3
<b>Total</b>	17,829	-14.7	19,552	-3,472	-15.1
Income	-17,844	19.5	-20,121	-3,078	18.1
Transfers	-5,590	14.5	-3,792	-1,853	95.6
<b>Total</b>	-72,524	32.0	-84,223	-21,904	35.1
<b>Capital account</b>	3,525	-38.6	5,756	-2,056	-26.3
<b>Financial balance</b>					
Direct investment	-39,643	293.8	-42,268	-17,116	68.1
Portfolio investment	171,969	203.6	173,224	87,789	102.8
Other investment	-36,508	-	-30,585	-16,522	117.5
<b>Total</b>	95,818	67.3	100,371	54,151	117.2
Errors and omissions	-4,305	60.5	-2,518	-13	0.5
Change in assets of Bank of Spain	-22,514	317.7	-19,386	-30,178	-

NOTES: The figure resulting from the sum of current account balance, capital account balance and financial balance is compensated by the change in assets of Bank of Spain plus errors and omissions.

SOURCE: Bank of Spain and own calculations.

pressures on Spain's economy. According to the OECD's own estimates, 2006 will have closed with a current account deficit equivalent to 9% of the gross domestic product.

Key interest is thus focused on the trend in the trade deficit while its correction depends on easing or not easing the imbalance in the balance of payments. The annual trend as of November confirms the following model. The higher growth of imports (14% higher than one year ago) is more than compensated by the increase in exports which were up by 11% year-to-year. The combination of the drive in domestic demand and problems of foreign competitiveness (which prevent Spanish exporters from taking full advantage of the recovery of European markets) is an excessive hurdle in the way of correcting the negative trade balance.

With regard to the services balance, this has grown worse largely due to the lower contribution from tourism. As of October, the tourism heading was down by close to 4% year-to-year. The incomes balance recorded a deficit of 17.84 billion euros (20% higher than in the first ten months of 2005). On the other hand, the widening of the deficit in the transfers balance was marginally less compared with the situation one month earlier.

Finally, the performance of the financial balance continues to be dominated by the notable surplus in portfolio investment which reached a cumulative figure of 171.97 billion euros as of October, a figure in contrast to the surplus of 56.63 billion euros recorded in the period January-October 2005. On the other hand, net outflows for direct investment were nearly four times higher than the positive figure one year earlier which stood at 39.64 billion euros.

**Net inflows of portfolio investment come close to 172 billion euros in first 10 months of 2006.**

## Savings and financing

**After four years at negative rates we are returning to period of positive real interest rates...**

**...which is beginning to slow down financing to private sector.**

### Slight slowdown in credit

The progressive rise in interest rates brought about by the upturn by the European Central Bank beginning in December 2005 seems to be starting to have its effects on the growth of credit. The 1-year Euribor, the main reference index for mortgage loans, rose to 3.92% in December 2006, an increase of 114 basis points in the past year. As a result, we are going back to a period of positive real interest rates following four years of negative rates. In this environment, financing to the private sector rose by 23.7% in the 12 months ending in November, 3 decimals less than one month earlier, although this is still a high growth rate.

This slight slowdown showed up both in companies and households. Funding granted to non-financial companies rose by 27.1% in the period November 2005-November 2006 which represents a slight moderation after reaching the highest growth rate since at least as far back as 1996. Nevertheless, credit to companies continues to rise at a sharp rate. Leasing in order to finance capital goods and real estate rose by 16.3% in the 12 months ending in November, thus showing some increase. Commercial credit, used to finance working capital, showed robust growth although somewhat lower at 10.1%.

The figures for credit broken down by purpose recently published by the Bank

### SLOWDOWN IN BANK LOANS FOR HOUSING CONFIRMED

Year-to-year change in loans by resident credit institutions and securitized loans for housing



SOURCE: Bank of Spain.

## CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS

November 2006

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
Commercial credit	78,253	2,892	3.8	7,207	10.1	5.3
Secured loans (*)	900,102	170,815	23.4	186,796	26.2	61.0
Other term loans	412,205	86,909	26.7	93,650	29.4	27.9
Demand loans	35,345	7,287	26.0	5,693	19.2	2.4
Leasing	38,959	3,965	11.3	5,470	16.3	2.6
Doubtful loans	10,867	1,236	12.8	1,299	13.6	0.7
<b>TOTAL</b>	<b>1,475,731</b>	<b>273,103</b>	<b>22.7</b>	<b>300,114</b>	<b>25.5</b>	<b>100.0</b>

NOTES : (\*) Greater part made up of loans with mortgage security.

SOURCE: Bank of Spain and own calculations.

of Spain make possible a more detailed analysis by economic sector although they refer to the third quarter of 2006. It is noted that the main driving force in demand for bank credit was construction with a spectacular increase of 35.0% in the past 12 months, more

than 5 points above the figure for the previous quarter. Services followed with a year-to-year rise of 32.0%. However, it should be pointed out that the biggest increase in this heading came in real estate business of developers which showed an annual increase of 49.1%

## CREDIT GRANTED TO PRIVATE SECTOR BY PURPOSE

Third quarter of 2006

	Total (*)	Change this year		Change over 12 months		
	Million euros	Million euros	%	Million euros	%	
<b>Financing of production activities</b>						
Agriculture, livestock raising and fishing	22,460	1,722	8.3	2,278	11.3	
Industry	115,266	10,571	10.1	13,550	13.3	
Construction	127,420	26,660	26.5	33,010	35.0	
Services	462,911	85,044	22.5	112,198	32.0	
<b>Total</b>	<b>728,058</b>	<b>123,997</b>	<b>20.5</b>	<b>161,036</b>	<b>28.4</b>	
<b>Financing for individuals</b>						
Home purchase and renovation	519,130	73,158	16.4	100,098	23.9	
Purchase of consumer durables	50,552	4,624	10.1	5,908	13.2	
Other financing	97,291	12,937	15.3	19,621	25.3	
<b>Total</b>	<b>666,972</b>	<b>90,719</b>	<b>15.7</b>	<b>125,626</b>	<b>23.2</b>	
<b>Financing of private non-profit institutions</b>	<b>5,359</b>	<b>693</b>	<b>14.8</b>	<b>1,004</b>	<b>23.1</b>	
<b>Other unclassified</b>	<b>19,584</b>	<b>1,936</b>	<b>11.0</b>	<b>1,066</b>	<b>5.8</b>	
<b>Total</b>	<b>1,419,973</b>	<b>217,344</b>	<b>18.1</b>	<b>288,732</b>	<b>25.5</b>	

NOTES: (\*) Made up of all credit institutions: banking system, lending institutions and Official Credit.

SOURCE: Bank of Spain and own calculations.

**Default, however, marks up new all-time low in November.**

which, while slightly lower than the high recorded in March, was a higher rate than in the preceding quarter. In fact, the growth in services excluding real estate business would drop to 19.4% which, in any case, was the highest rate since the beginning of the Nineties. Industry, in turn, showed a rise of 13.3%, some 2.8 points more than in June 2006.

Credit granted to households continues to ease off gradually although it still showed a year-to-year increase of 19.5% in November. The slowdown was due mainly to housing with loans going from an annual growth rate of 24.6% in November 2005 to 20.2% twelve months later. In addition, credit for buying consumer durables (cars, motorcycles, furniture, appliances, etc.) rose by 13.2% since the third quarter of 2005 to the same quarter in 2006. In spite of showing a notable growth rate, this represents something of a slowdown seeing that this rate is 2.4 points lower than in the second quarter.

The default rate for credit to the private sector as a whole for the moment is holding at low levels in spite of the increase in loan interest rates. In

November the rate was down for the third consecutive month going to 0.74% thus marking up a new all-time low.

### **Bank deposits win out over mutual funds in 2006**

Household savings continue to show no recovery. In the third quarter of 2006, the savings rate of households and non-profit organizations (religious institutions, trade unions, NGOs, etc.) stood at 7.9% of disposable income. If we consider the average for the last four quarters, a step that makes it possible to get around the seasonal nature of the figures, the savings rate dropped to 9.3%, three decimals less than in the previous period and marking up the lowest level since 1999 at least. This drop in individual savings was due to growth in consumption (7.6%) higher than disposable income (5.9%) during the summer. As a result, given the important and growing investment in housing, the need for financing in the case of households rose to 4.7% of the quarterly gross domestic product (GDP). In turn, the need for financing of non-financial companies rose to 10% of the quarterly GDP.

**Household savings still not recovering...**

## **DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS**

November 2006

	Total		Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%		
On-demand savings (*)	420,063	23,873	6.0	37,468	9.8	38.6	
Up to 2 years	244,978	54,458	28.6	57,133	30.4	22.5	
More than 2-year term	320,889	81,407	34.0	96,392	42.9	29.5	
Repos	73,056	10	0.0	3,819	5.5	6.7	
<b>Total</b>	<b>1,058,986</b>	<b>159,748</b>	<b>17.8</b>	<b>194,814</b>	<b>22.5</b>	<b>97.3</b>	
<b>Deposits in currencies other than euro</b>	<b>29,888</b>	<b>14,249</b>	<b>91.1</b>	<b>14,737</b>	<b>97.3</b>	<b>2.7</b>	
<b>TOTAL</b>	<b>1,088,873</b>	<b>173,996</b>	<b>19.0</b>	<b>209,550</b>	<b>23.8</b>	<b>100.0</b>	

NOTES: (\*) Includes deposits redeemable at notice, according to ECB definition.

SOURCE: Bank of Spain and own calculations.

This trend meant an increase in financing to the private sector higher than that for corresponding financial assets. Nevertheless, bank deposits continue to grow at a high rate showing twice the growth in the Euro Area. The return on bank deposits kept increasing gradually in 2006 reflecting the progressive rise in the European Central Bank interest rate. As a result, as of September, the average return on new time deposits was higher than the inflation rate. Furthermore, the financial institutions diversified the nature of deposits in innovative ways. In this way, they have been increasing the attractiveness of bank deposits.

The sharp growth of bank deposits came about to the detriment of shares in mutual funds. In 2006, the assets of mutual funds increased by only 3.45%

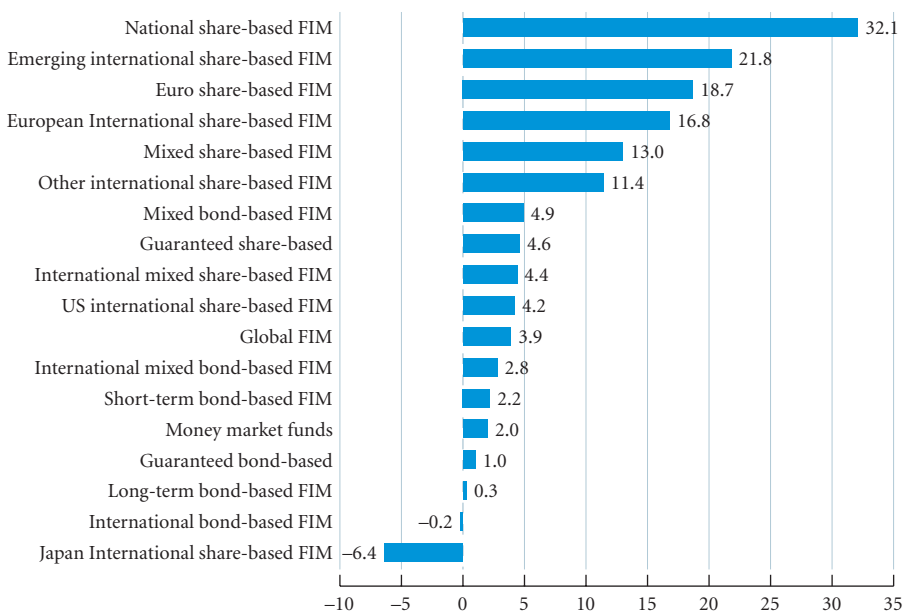
for a total of 254.3 billion euros. This may be attributed to capital gains seeing that for the year as a whole there were net withdrawals for a value of 2.43 billion euros, largely concentrated in the fourth quarter. Where the biggest outflows of money took place was in bond-based funds under the effect of low bond yields. The average annual yield on mutual funds was 5.0% but there was a notable spread. National share-based funds headed the classification with an extraordinary 32.1% while at the other extreme Japanese share-based funds reported capital losses of 6.4%. In spite of net withdrawals of shares in mutual funds, the number of participants, estimated by the number of accounts, rose by 3.1% to reach a total of 8,819,809 at the end of last year.

**...although bank deposits more attractive.**

**Average annual yield on mutual funds hits 5% in 2006.**

### NATIONAL SHARE-BASED FUNDS HEAD LIST OF HIGHEST RETURNS IN 2006

Annual return on securities mutual funds in 2006, as percentage



SOURCE: Inverco.

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