



March 2008

Prices

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Authors: Vicente J. Pallardó, Nicolás Jannone, Silvano Esteve, Antonio Cutanda, Rosa Puertas, M^a Luisa Martí y Héctor Ruiz

Observatorio de Coyuntura Económica Internacional
Instituto de Economía Internacional
Universitat de València
Campus dels Tarongers
3er piso, edificio Departamental Oriental

1. U.S.A

Prices in the US: Worrying Present, Uncertain Future

a) Resurrection of Inflation

Approximately a decade ago, some articles in the press (rather than in academic circles) aroused a good deal of attention after proclaiming "inflation is dead". While such remarkable optimism was certainly uncalled for, it is true that price trends did appear to be under control following the so-called "Great Moderation" that began in 1980s.

In fact, a monograph published by the OCEI exactly two years ago¹ outlined the factors that had made it possible to curb inflation and, no less importantly, the outlook for inflation: faster productivity growth as a result of the last technological revolution, the anti-inflationary effect of globalisation after emerging nation producers of cheap intermediate and final consumer goods burst onto the international trade scene and the action taken by Central Banks towards price stability (and the credibility this earned them).

This report also highlighted the risk that had been visible in previous years: energy prices.

Barely two years later, the picture has become considerably gloomier. First, the factors that curb inflation appear to have weakened clearly or even reverted. Second, the threat we mentioned then has re-emerged and is much larger and affects many more products. Let's review the situation.

- Inflationary Globalisation?

¹ See the March 2006 report on the US economic environment, pages 8-10

A current of opinion that questions whether or not globalisation still helps to curb inflation, particularly where Asian countries led by China and India are concerned², is spreading among analysts.

The main reason lies in the fact that the enormous pressure from demand stemming from these countries is the key to the marked and prolonged increase in the price of energy products, raw materials for industry and more recently, food. In addition to this, these countries' ability to maintain low production costs (in relation to Western nations) is decreasing, which means their ability to export deflation is limited. Should these two trends continue, one of the factors that has worked in favour of price stability in developed nations over the last few years will disappear.

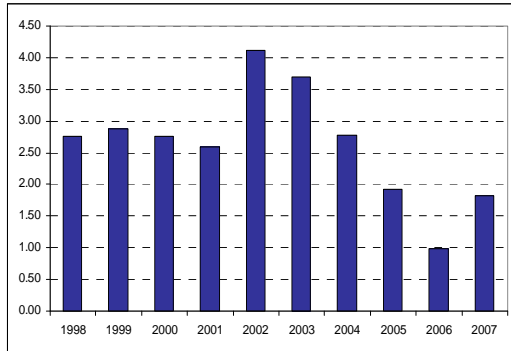
- End of the Revolution of Information and Communication Technologies?

ICTs boosted productivity in the US remarkably at the end of the last decade and the beginning of this decade (subsequently keeping unit labour costs and, in a highly domestically competitive economy, prices in check).

The benefits of this revolution appear to be running out, although they may have left an upturn in tential productivity. However, the data observed over the last three years (Figure 1) displays disappointing growth in productivity per hour (lower than 2%), while the average between 1998 and 2004 exceeds 3%.

² It is worth underlining the fact that not everyone believes globalisation has played a positive role in controlling inflation. See for example Ball, L.M. (2007): "Has globalization changed inflation?", NBER, WP 12687

Figure 1: Productivity per Hour Worked (private non farm sector; %)



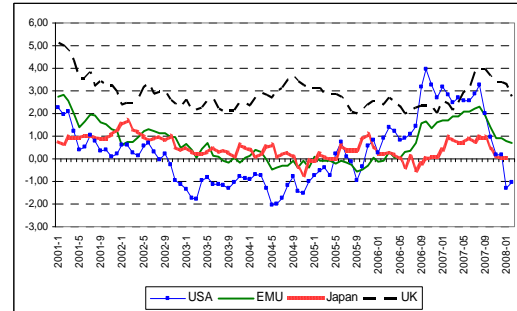
Source: own elaboration with data from FRED II

- Loss of Credibility?

Until recently, there was little doubt regarding the role Central Banks have played in controlling inflation and the outlook for inflation. However, the moves made by the Federal Reserve since the beginning of the decade have been entirely dubious to this regard (a point we at the OCEI have reiterated in these economic environment reports).

On the one hand, it is now commonplace to indicate that the Fed maintained interest rates “too low for too long” after overcoming the recession in 2001. Despite displaying similar inflation rates and lower GDP growth rates, none of the other main Western central banks followed suit (Figure 2). Undoubtedly, such accommodating conditions are to a great extent responsible for the real estate bubble, which after bursting resulted in the severe financial crisis being suffered in the present.

Figure 2: Real Interest Rates (reference rates less headline inflation; %)



Source: own elaboration with data from Central Banks

Just when the Fed had finally normalised interest rates, the current crisis once again prompts the Fed to drastically cut interest rates, even though inflationary tension is running high. This time, the concern is that the outlook for inflation may have broken free and excessive prices rises may be here to stay³.

If we examine the situation over a longer period of time, as can be appreciated in the graph at the end of this report, we must point out that despite the fact that the current inflation rate (which is slightly over 4%) being similar to the average over the last half century, it is well and truly above the average for the last decade (2.6%). However, the Fed funds rate is well below the long term average (1960-2007) and markedly so in the case of the last decade (3.8%). As a result, the long term trend reveals a downward trend in real interest rates that could be interpreted as an

³ The OCEI had already underlined this risk in its September 2007 report and has reiterated the same opinion every two months since then. A lot more analysts now share our view. Finally, the Fed itself, as mentioned previously in this report, released a press release following its latest meeting acknowledging that the outlook for inflation had indeed begun to loosen its bindings.

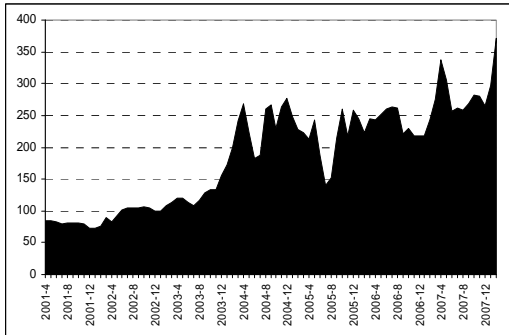
inheritance from the “Great Moderation” and the factors that have helped to control inflation in the past that we described previously. However, if these factors disappear, the Fed will very soon be forced to seriously toughen up its monetary policy.

- Threat Becomes an Even Larger Reality

While we have been overly optimistic in regard to the factors that have curbed inflation, the threat we saw two years ago has been confirmed since then. However, not only oil prices have continued to climb (Figure 6 on the next page), but industrial raw materials on the whole (see, for example, Figure 3).

Moreover, and more recently, food prices (and agricultural raw materials) have followed suit ⁴, further complicating price stability.

Figure 3: Gross Steel Prices (\$/Tn)



Source: own elaboration with data from the Ohio Department of Transportation

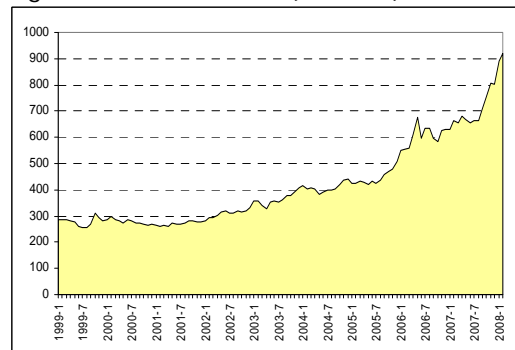
Although there are a considerable number of supply and demand fundamentals that explain a great deal of this trend in prices, at least in the case of energy and some raw materials, speculation has also played its part in this striking pattern.

⁴ We will discuss the reasons behind this price hike in agricultural products later in this report.

And the chain of events is highly peculiar: Overly accommodating monetary policy laid the foundations for a real estate bubble; when the bubble burst, the sub prime mortgage market collapsed, dragging various high risk segments of financial markets down with it; the subsequent lack of trust in the former saw investors seek new assets, in this case commodities; the increase in the price of commodities pushes up inflation worldwide and complicates monetary policy management.

Of course, other sectors apart from industrial and energy raw materials have also received an abnormal influx of capital, particularly since last summer. The trend in the price of gold is the best proof of this (Figure 4).

Figure 4: Price of Gold (\$/ounce)



Source: own elaboration with data from KITCO

- The US Dollar: a Surprise Guest

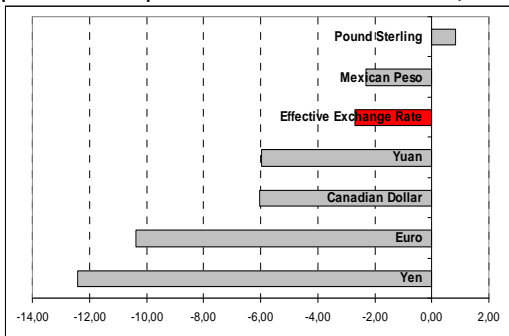
As if all the factors described above were not enough, the weakness of the US economy, its enormous current account deficit and the recent interest rate cuts on behalf of the Federal Reserve ⁵ have seen the US dollar plummet (Figure 5). While the dollar

⁵ Apart from the influence of more structural aspects, such as the logical decrease in the amount of dollars in private investor portfolios and central bank reserves, as the US share of world GDP and markets diminishes.

has depreciated by 3% in effective terms over the last half year, this fall is much more pronounced against the currencies of some of the United States' main trading partners, including a 10% decrease with respect to the euro and the yen, arousing preoccupation in the European and Japanese governments.

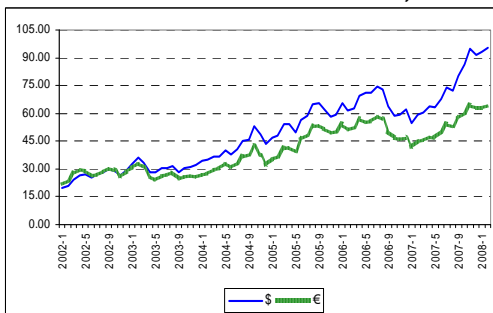
Obviously, this depreciation means the United States gains export price-competitiveness, but this also pushes up inflation. Although we have occasionally indicated in these reports that depreciation no longer passes through to internal prices as much as in the past, due to the increase in competition, the current decrease in the value of the dollar does necessarily imply somewhat of an increase in imported inflation.

Figure 5: Bilateral and Effective Exchange Rates of the Dollar (broad group of Trading partners; September 2007-March 2008)



Source: own elaboration with data from FRED II

Figure 6: Oil Prices (dollars and euros per barrel of West Texas Intermediate)



Source: own elaboration with data from FRED II

The significant gap between the increase in oil prices depending on whether it is measured in dollars or euros (Figure 6) clearly evidences the cost of the weakness of the dollar in terms of inflation⁶.

b) Specific Data

Table 1 summarises the main price trends in the US economy in recent years, paying special attention to the last few months.

The first conclusion stems from the global indicators. Headline inflation has accelerated considerably, while core inflation, despite displaying an upward trend, has remained relatively stable at around 2%.

Indeed, all the sectors (at consumer or producer level) that are most directly related to energy and raw materials display a severe (or even excessive) upturn in prices, in comparison to both the last four years and also the previous four, when the energy crisis was still incipient.

In contrast, this increase has not as yet been fully passed on to prices as a whole. This is what we perceive from the data referring to core inflation, which includes most of the sub indexes of the CPI and PPI, but excluding energy and food.

⁶ Entre principios de 2002 y el primer trimestre de 2008, el precio del barril de crudo se ha elevado aproximadamente un 400% medido en dólares, frente a un 200% cuando se computa en euros.

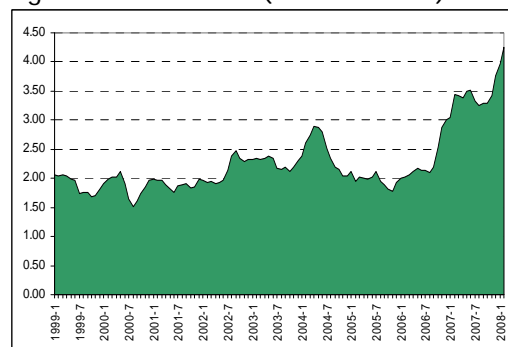
Table 1: Recent Trends in Prices by Item (period averages)

CHANGE IN PRICES (%)	2000-2003	2004-2007	Sep07-Feb08 (annual)
CONSUMER PRICES (CPI)			
HEADLINE	2.6	3.0	3.8
CORE	2.1	2.2	2.3
Food & Beverages	2.5	3.1	4.6
Household	2.9	3.2	3.0
Textiles and Dressmaking	-1.7	-0.4	-0.8
Transport	2.5	4.1	7.4
Health	4.4	4.3	4.8
Recreation	1.2	0.9	0.7
Education & Communications	2.0	2.2	2.9
Other Goods & Services	2.8	3.4	3.3
Gas for Domestic Use	10.5	7.4	2.4
Gas-oil	8.6	25.1	28.0
Petrol	4.8	19.2	26.8
PRODUCER PRICES			
Final Goods	1.9	3.8	6.3
Final Goods excl. Energy and Food	0.8	1.8	2.2
Equipment	0.4	1.8	1.6
Intermediate Goods	1.9	7.0	7.3
Intermediate Goods excl. Energy and Food	0.9	5.2	3.2
FOREIGN TRADE PRICES			
Oil Imports	12.0	31.6	47.7
Rest of Imports	-0.4	2.8	3.4
EU Imports	1.0	4.5	3.4
Chinese Imports	n.a.	-0.1	2.6
Exports	0.5	4.3	6.0

Source: own elaboration with data from BLS

However, there are three clear threats to future price stability (even forgetting energy). First, the potential consolidation of the *outlook for higher inflation*, already analysed in this and previous reports. Second, *food prices are accelerating on an international scale* (and no less in the US, as can be observed in Table 1 or Figure 7, which displays the trend in corn prices, the US cereal crop par excellence).

Figure 7: Corn Prices (dollars/bushel)



Source: own elaboration with data from the US Department of Agriculture

At least four factors have combined to trigger the worrying hike in food prices that has already caused social uprisings in several countries, the most significant cases occurring in Mexico and Indonesia.

The first (which is temporary, or not, depending on whether you attribute it to climate change) is that unusual periods of drought have coincided in the countries that are the main producers of grain. The other three are longer term and therefore more difficult to resolve. The increase in the demand from emerging countries, where people are diversifying and increasing their food consumption at the same rate as their income per capita is increasing, is a situation that will be difficult to invert.

While this problem should be easier to resolve, protectionist measures that the governments mainly in developed nations and also in developing nations have maintained throughout history remain an unsurpassable barrier today. Such policies, which in the West mainly protect minority groups to the detriment of majority interests, distort incentives, expel more efficient producers in terms of cost (located in poor countries) from international

markets and restrict the response of supply to demand needs⁷.

What is more, other steps are being taken that are incompatible with the current situation of price tensions: exporters of basic foods (cereals, rice, meat) are imposing tariffs or simply prohibiting sales abroad. Importers are (finally) eliminating barriers and are running to purchase food on international markets, including the public sector in some cases in an attempt to increase reserves. As any layman can understand, more demand and less supply equals soaring prices.

The last situation that is exercising upward pressure on food prices is that some of the land used for crops to supply people and cattle with food are being used for another, more profitable activity, crops that are to be used as bio fuels. It would be a good idea to reconsider just how convenient it is to subsidise these types of crops (which are all the rage among Western governments) as they are crowding out crops that are to be used for food⁸.

Finally, the threat to price stability in the United States, which can also be appreciated in Table 1, is the inflation that stems from imports due two factors that we have already analysed: the weakness of the US dollar and the fact that the deflationary effect of globalisation has diminished.

⁷ Apart from vulgarly inflating the price of basic goods that consumers in developed countries pay.

⁸ Developing second generation and more efficient bio fuels from products that do not substitute traditional agriculture (from plants that are harvested in particularly poor land to seaweed) could help to make food production compatible with this alternative source of energy.

It is surprising to see how non energy import prices fell between 2000 and 2003, and even between 2004 and 2007 in the case of those from China, while now they are rising, still at modest but increasing rates of round 3%.

One final observation: the prices of US exports in dollars accelerated to an annual 6% in the second half of 2007 (0.5% between 2000 and 2003). This means that companies are not only benefiting from the weakness of the dollar in terms of export volume, but also managing to pass on part of the increase in costs due to domestic inflation. Logically, the consumers in countries where currencies have appreciated most against the dollar reap most of the benefit of that depreciation⁹.

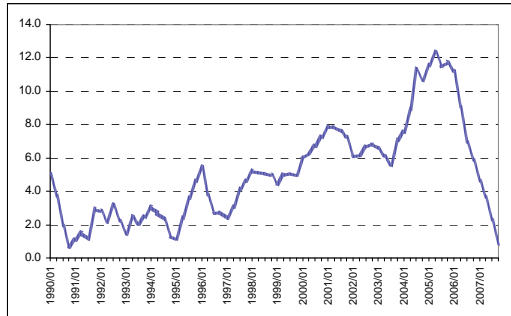
c) Asset Prices

Little more can be added to the observations we have made in recent months regarding the trend of **housing prices** and their global implications on both the US economy and also through their financial repercussions in the rest of the world.

A few years ago when we considered the trade-off between a general real estate bubble and froth markets (a phrase coined by Alan Greenspan), we argued in favour of the latter and, subsequently a progressive slowdown in Business and prices in order to avoid the collapse that ended up occurring.

⁹ It is always worth remembering that, while Exporters, for example from Europe, are penalised by a strong euro, importers, and consumers of US goods and tourists who travel to the US benefit from this situation.

Figure 8: Housing Prices (annual growth rate; %)

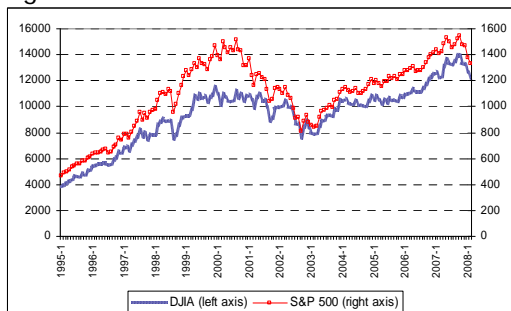


Source: own elaboration with data from OFHEO

Two factors make it possible to understand why we made a mistake (it is obviously more serious that the Fed made the same mistake). In the first place, housing prices did not slow down immediately as we expected. Instead, prices continued to rise strongly for several more months (Figure 8), leading real estate assets to be further over valued.

In the second place, at the time no one was aware of how weak the high risk sector of the real estate market was (or did not consider this factor to be important) and, above all, no one realised how closely related this sector was to a wide range of novel and highly risky financial products. The credit crisis that followed has done nothing but worsen the situation in the real estate market.

Figure 9: Main Stock Market Indexes



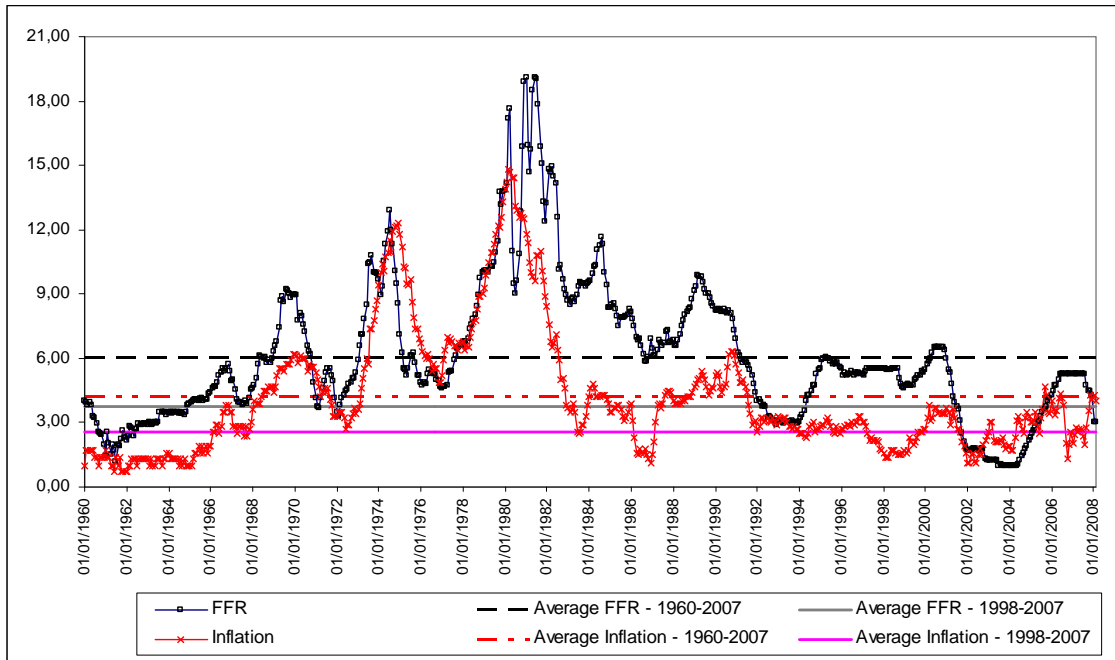
Source: own elaboration with data from DJI and S&P

During the first part of the housing crisis, the bullish trend in **financial markets** Offset, at least partly, the loss of real estate wealth (see for example the pattern of the two main stock market indexes in Figure 9). However, as a result of the financial turbulence which began in the summer of 2007 and which spread to practically all segments of markets (with the possible exception of the highest quality bonds), financial wealth also began to diminish. Nevertheless, at least in the case of the stock market, the decrease has been moderate, below 20%, a figure that is surprisingly low considering this coincided with an economic crisis (and the subsequent fall in corporate profits) and financial chaos.

In any case, the decrease in financial wealth, albeit small, adds to the loss of several hundred billion dollars in the value of real estate assets. When the loss of purchasing power caused by an upturn in inflation is added to this situation, it is easy to understand that not even the seemingly indestructible US consumer can avoid cutting back his/her demand. Finally, the collapse of a large segment of financial markets has paved the way for a slowdown that can now probably be labelled a recession.

Vicente J. Pallardó
OCEI Director
Valencia, 7 April 2008

Figure 10
Inflation Rate (CPI) and Fed Funds Rate since 1960 (%)



Source: own elaboration with data from FRED II

2. EUROZONE: REPORT ON PRICES:

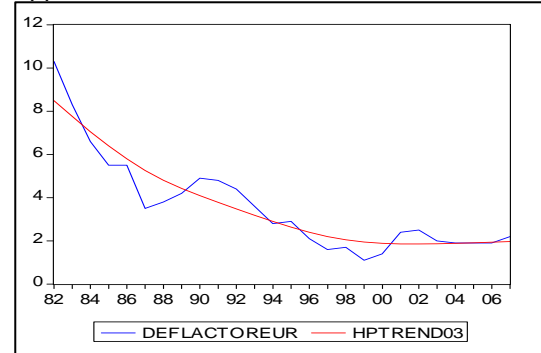
Upward Trend in Prices since 1999:

Taking into account the pattern of the Euro-zone GDP deflator between 1980 and 2007, the annual price trend has sloped downward. While the GDP deflator averaged 5.5% between 1982 and 1993, in the two following years the average dropped to 2.9%, and between 1996 and 2007 the average was 1.9%. Apart from a slowdown in the GDP deflator over the period, less volatility is also observed. If other countries were taken into account, the same conclusion would be drawn.

As regards inflation, the average between the beginning of 1999 and March 2008 is 2.1%, one decimal point higher than the ECB target rate, although with varying sub periods. For approximately two and a half years (1999 to July 2000 and October 2006 to September 2007) inflation was below the target rate (1.41% and 1.82% respectively), while for the remaining seven and a half years, inflation exceeded the target rate.

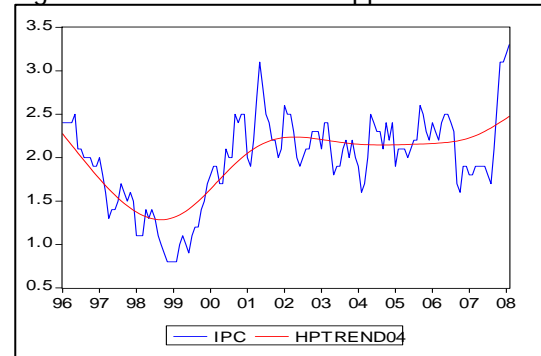
The monthly inflation rate has displayed an upward trend since 1999, particularly since October 2007, when inflation began to rise markedly, boosted not only by highly volatile energy prices, but also by processed foods, which together have pushed inflation in March up to 3.5%, the highest rate since 1996.

Figure 1: GDP Deflator and HP Filter Application



Source: ECB and own elaboration

Figure 2: CPI and HP Filter Application

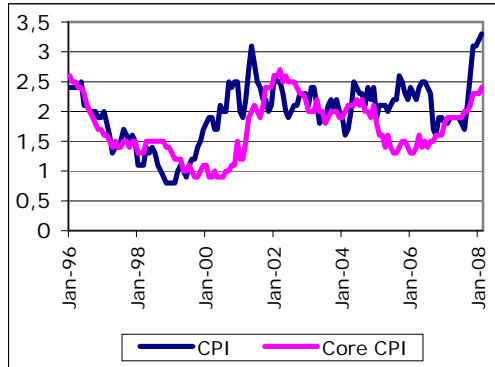


Source: ECB and own elaboration

Core inflation, which excludes energy products and fresh foods, has almost always remained below the overall level of inflation. In fact, core inflation averaged 1.72% over the period dating from 1999 to February 2008, compared to the overall inflation rate of 2.1% over the same period. The correlation between the two variables is 0.52, which means that half the change in the inflation rate can be attributed to energy and fresh food prices.

The last time that both variables crossed paths during this period was in September 2007, after registering similar figures for nine months. From that point onwards, the gap has opened up again to 0.9 percentage points, whereas the maximum difference during this period was 1.5 points.

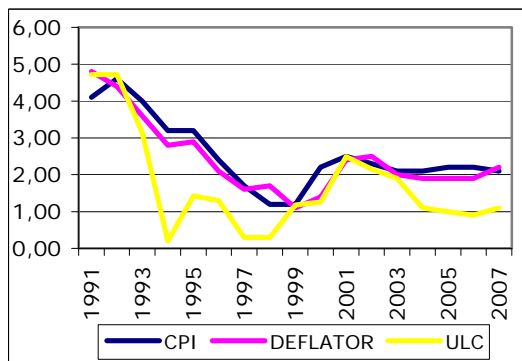
Figure 3: Inflation and Core Inflation



Source: ECB

Worker compensation or real wages cannot be considered explanatory variables of inflation. Employees' loss of power, due to companies offshoring and outsourcing activities and also to immigration have pushed up real wages by an average of 0.12% per year, which explains why wages have lost out terms of their share of Gross Value Added (GVA) and, therefore, an income distribution that is biased in favour of companies. As a result, the correlation between the CPI and worker wage rises is practically non-existent. The difference between the growth of unit labour costs and the GDP deflator stands at an annual average of 0.65 percentage points and explains the distortion described above.

Figure 4: GDP Deflator, CPI and Unit Labour Costs (ULC)



Source: ECB

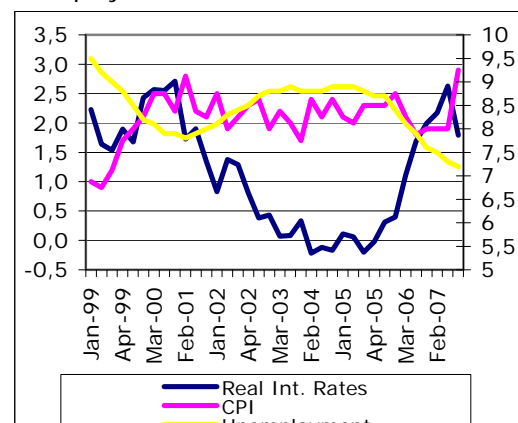
The variables that explain the trend in inflation in the Euro-zone are, apart from the current inflation itself or past inflation through persistence, the upturn in the price of raw materials and oil, unit labour costs, unemployment and real interest rates. All these aspects push up inflation except for unemployment.

A 10% increase in the price of oil pushes up inflation by 0.1%, while a 10% rise in the price of raw materials, excluding energy or food, boosts inflation by 0.6% or 0.3% respectively.¹⁰

Over the period dating from 1999 to 2007, oil has increased by approximately 650%, food raw materials by 150% and non precious metals by 425%.

Furthermore, a 1% rise in unit labour costs pushes up inflation by 1.3%. For this reason, any wage rise in real terms that is not joined by increases in labour productivity puts pressure on prices.

Figure 5: Real Interest Rates, CPI and Unemployment Rate



Source: ECB

¹⁰ Natixis Flash 470-dec 2007. What is the impact of commodities on European Inflation? P. Artus.

On the other hand, too much Money in the economy can cause inflation in the long term. An excessive rise in the money in the economy, together with a marked rise in loans and asset prices is highly likely to lead to inflationary tensions. But if the amount of money in the system grows quickly and the current inflation rate is low, the influence on inflation in the short term is minimal.¹¹

The large difference between measured inflation and how citizens perceive inflation, measured by surveys carried out by the European Commission, is also interesting. Although the largest gap was observed in 2002 when euro notes and coins were being incorporated into the system, the differences witnessed in subsequent years are difficult to understand. While between December 2001 and March 2007 the average inflation rate was 2.1%, perceived inflation was estimated to be in the vicinity of 40%.

Price Differences Among Euro-zone Countries

If we analyse the Euro-zone, the United States, the United Kingdom and Japan, inflation in average terms is seen to be similar and that all individually display a highly positive correlation to the average for the four countries of between 0.86 and 0.95. This suggests that inflation is really more of a worldwide than national phenomenon.

If Euro-zone inflation is estimated econometrically according to worldwide inflation and other variables, such as annual change in unit labour costs and the annual increase in the effective

exchange rate, a good estimate is obtained. Furthermore, in light of the value of the coefficients, worldwide inflation (0.58) has a greater impact than Euro-zone unit labour costs (0.30). This explains why inflation in the Euro-zone depends more on worldwide inflation than domestic factors themselves.

Worldwide inflation is affected positively by worldwide economic growth and the change in oil and raw material prices and negatively the degree of openness to international trade.¹²

Moreover, there can be no doubt that between 1980 and 1999, the inflation rates in the countries that made up the EMU have converged in absolute terms. By applying the test of multi-variant unit roots to EMU member state inflation rates, this absolute convergence becomes clear.¹³

¹¹ WP 749 BCE mayo 2007. Excess Money Growth and inflation dynamics. B. Roffia and A. Zaghini.

¹² CDC-Ixis Flash 2005-147 22-04-05 "Inflation: A worldwide phenomenon or a regional phenomenon? Or: Having several central banks is useless" by P. Artus.

¹³ ECB WP 574 January 2006. "Inflation convergence and divergence within the EMU" by F. Buseti and others.

Table 1: Average Inflation 1999-2007 by Euro-zone Country

Euro-zone	2,04
Belgium	1,98
Germany	1,57
Ireland	3,40
Greece	3,20
Spain	3,12
France	1,78
Italy	2,30
Luxembourg	2,72
Malta	2,31
Netherlands	2,41
Austria	1,76
Portugal	2,93
Slovenia	5,48
Finland	1,56

Source: Eurostat

Convergence continued over the period dating from 1999 to 2007. In fact, the standard deviation of Euro-zone countries halved over this period. Nevertheless, individual countries record quite different average inflation rates. Statistically, countries can be divided into three groups: those with low inflation rates (Germany, France, Austria and Finland); those with high inflation rates (Spain, Greece, Portugal and Ireland); and a group of intermediate countries (Italy, the Netherlands, Malta and Luxembourg). Inflation appears to fluctuate uniformly within each group of countries.

In terms of purchasing power parity, prices have converged since 1999, following a decrease in the convergence price from 16.5 to 12.8.

Inflation differences from one country to another, apart from being caused by countries being at different stages of the economic cycle and other short term effects such as increases in indirect taxes or administered prices, can be attributed to: different

responses to common shocks due to different levels of competition and rigidities in the economy, the lack of integration of products – difference between production costs and the price of manufactured goods – and convergence towards levels of prices that entail higher inflation rates in countries where prices are lower, such as Spain, in order to “catch up” to more expensive countries.¹⁴

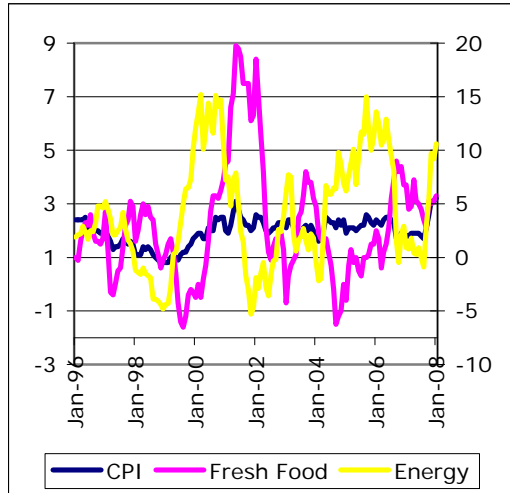
Finally, countries that share the same monetary policy but have high inflation rates suffer firstly a problem of competitiveness in industry -which is subject to concurrence - that must be corrected, linked to the trend in wages and productivity; secondly, that stemming from common monetary policy, which implies excessively low real interest rates, with an important impact on real estate and public investment. When a favourable economic period is added to this scenario, there is talk of “passive seniorage”.

Analysis of CPI Components and Other Prices

While the average inflation rate over the period dating from 1999 to 2008 was 2.07%, energy and fresh food prices, which are the most volatile, have risen on average by 5.11% and 2.38% respectively, clearly outpacing overall inflation.

¹⁴ Natixis Flash 39-2007 “Understanding inflation differentials between major EMU countries” P. Artus

Figure 6: CPI, Fresh Food and Energy

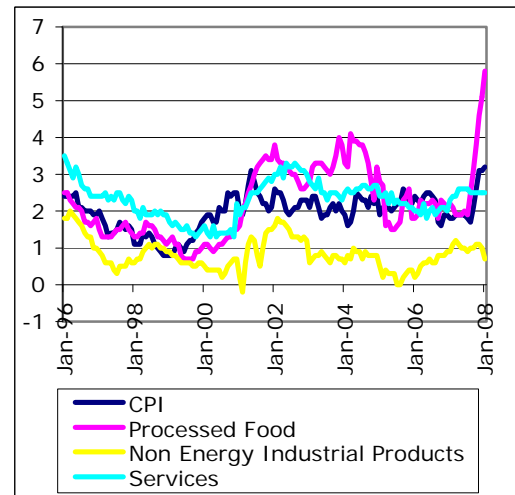


Source: ECB

Energy, with a correlation of 0.39 to inflation over the period, has fuelled inflation between 1999 and 2001, 2004 and 2006 and since 2007, following average annual rises of 8%. Energy dragged inflation down between 2001 and 2002 and September 2006 and August 2007, with annual average percentage changes of -2% and +0.85%, respectively.

The CPI items that on average have risen less than the annual inflation rate and the ECB target rate are non energy industrial products (0.77%) and minimal volatility and communications (-2.87%). In the case of non energy industrial products, the favourable price trend is due to the fact that goods are subject to international competition and that measures have been introduced in the sector to enhance productivity, and communication services, where deregulation has made it possible to steadily reduce prices.

Figure 7: CPI, Processed Foods, Non Energy Industrial Products and Services



Source: ECB

Services have increased at an average annual rate of 2.28% and have remained highly stable (standard deviation of 0.52%). By sub item, recreation and transport (2.8% average annual rise) have been systematically inflationary – outpacing the inflation rate by almost 1%, while the trend in communications (-2% on average) has been highly deflationary and that related to households has remained in line with services.

Table 2: CPI, Services and Sub Items

CPI	2,07
Services	2,28
Recreation	2,76
Telecommunications	-2,87
Transport	2,79
Households	2,24

Source: ECB

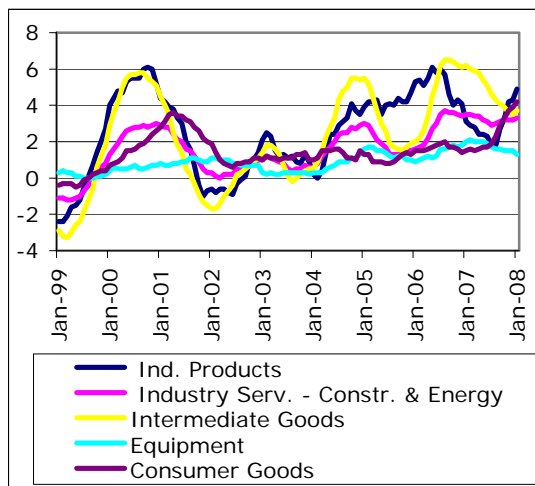
Processed foods have moderately inflationary on average over the sample period, but have fluctuated remarkably over various subperiods since 1999. Inflation was weak over the first two years (1.1% annual average), 0.7% lower than the overall inflation rate, but recorded marked price tensions over the next four years (2001-2005), 1%

higher than inflation. The following two years prices recorded similar rises to those in the CPI and finally, over the current sub period that dates from July 2007, the annual inflation rate has risen to 5.8%, the highest since at least 1996.

The reason why processed food prices have risen, apart from market structure problems, the lack of competition in the distribution sector and possible practices restricting free competition, is mainly a series of novel circumstances that may have played a role in this remarkable inflationary process.

In the first place, changes in Chinese and Indian food consumption trends towards dairy and meat products have resulted in the demand for these products soaring, triggering two effects: firstly, these foods have recorded increases in price and secondly, an increase in production that has led to a strong addition demand for grain in order to feed cattle. In the second place, the increase in biodiesel output. In the third place, poor harvests and low land productivity in developing nations and finally, low stocks of these products.

Figure 8: Industrial Production Prices

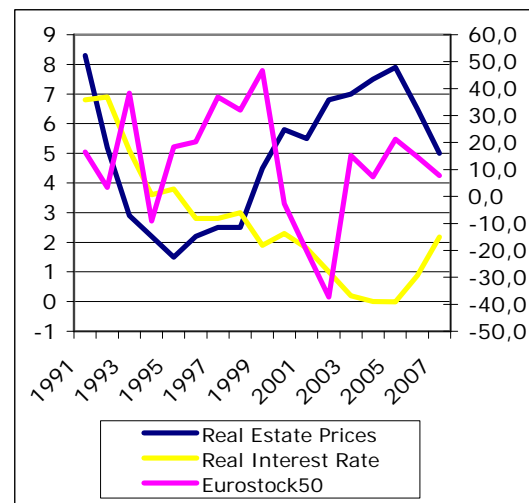


Source: ECB

The report by the European Commission on the European economy in the first quarter of this year indicates that food accounted for 26% of the CPI in 2007, whereas it normally represents 19%. It is also mentioned that processed foods such as skim dairy products had risen by around 80% and butters by 50%.

As regards producer prices, over the period dating from 1999 to 2008, there has been an average rise of 2.53% per annum, almost half a point more than inflation. Energy and intermediate goods, which have been the most changeable – they are intrinsically linked to raw material prices – rose by an annual 2.38% and 6% respectively. The least volatile and those recording the lowest rises were capital goods (0.89%) and industrial goods excluding energy (1.66%), which are perhaps the most exposed to international competition. Recently, except for the price of equipment, producer prices have maintained the strong upward trend observed over the last few months, as is the case with the CPI.

Figure 9: Real Estate and Stock Market Prices and Real Interest Rates



Source: ECB

Finally, the price of real estate assets in the Euro-zone have been and remain highly sensitive to real interest rates. They are correlated at 0.90 with real money rates and are much more sensitive than stock market assets. While a 1% increase in real interest rates reduces the value of a house by 1.14%, a share only props. By 0.10%.

Housing prices decelerated between 1991 and 1995 to rates of around 2%, before beginning an upward climb until 2005, reaching an 8% annual rise as a result of the continuous falls in real interest rates. When interest rates rose later, prices slowed down again in the real estate sector, as can be observed at present.

Is Inflation Persistent in the Euro-zone?

There are several ways to define the concept of persistent inflation:

- a) The trend whereby inflation converges gradually towards a long term value, for example, towards the ECB target rate
- b) When current inflation depends on past inflation and the sum of lag coefficients is equal to one (unit root)
- c) When inflation depends on past values and the coefficient of the lag variable of a negative output gap is low

This means that inflation is persistent when it does not change or changes little when faced with changes in the economic cycle. From the perspective of monetary policymakers, this characteristic results in the central bank's prediction consisting of ascertaining the number of periods a given shock has been absorbed in.

IPN studies do not conclude that inflation is more persistent in the Euro-

zone than in the United States. According to the IPN, however, having a very low negative output gap (0.13) implies that inflation in the Euro-zone is persistent.¹⁵

An environment of low inflation as in the Euro-zone is more persistent due to the downward resistance of nominal wages and greater sacrifices on behalf of monetary policymakers.

If inflation is eliminated from services, persistence would be reduced.¹⁶

Persistence is caused on the one hand by structural rigidities: the labour market, lack of integration and competition in domestic service markets and the fact that the consumer prices of non energy industrial goods are not all sensitive to the economic cycle; and on the other hand, either by the behaviour of companies when fixing prices, or the speed at which prices are reviewed and changed and if this occurs symmetrically, or the presence of implicit price contracts in the medium term.

According to a recent study on inflation persistence using the GDP deflator as the variable to be considered, the sum of the lags in the case of the Euro-zone is 0.66 or 0.70, depending on the number of lags considered, and is similar to the countries that have just become members of the European Union.¹⁷

¹⁵ OECD WP 435/2005 20-7-05 "Sources of inflation persistence in the Euro Area" by B. Cournède and others

¹⁶ ECB WP 466/April 2005 "Regulated and Services prices and inflation persistence" by T. Marthä.

¹⁷ WP 810 ECB September 2007 "Inflation persistence Euro Area and New EU member States." M. Franta and others.

Outlook for Inflation:

Looking into the future, inflation has generally speaking tended to decrease, due to wage moderation under the threat of offshore outsourcing and the low wages in other parts of the world along with the improvements productivity. However, if we consider a shorter period, and bearing in mind the rises in recent months, the present situation displays a slightly upward trend.

The ECB estimates that the inflation rate will stand between 2.6% and 3.2% in 2008 and between 1.5% and 2.7% in 2009, with upward risks.

The current inflation rate, as we have seen, is being affected a great deal by the price of energy and processed foods, the latter being due among other things to the pressure that countries such as China and India are putting on demand, as their eating habits change towards a diet of meat and Dairy products.

This does perhaps mean that we are already heading towards the second stage of the U-shaped inflation curve, following the first stage of slowdown in inflation due to the competition from emerging nations with a clear impact on the labour market, in which the upturn in raw material prices, the steadily ageing population and high capacity utilisation add to the inflationary impact of the increase in demand from emerging nations leading to greater pressure on prices.

This return to inflation, in which the importance of the non working consumer population (pensioners) would increase and full employment in emerging nations would push up unit

labour costs, making the inflation curve **U-shaped**.¹⁸

Valencia, 9 April 2008

Nicolás Jannone

¹⁸ CDC-IXIS Flash 18-2006 January 2006. "Global Inflation's U-shaped curve."

3.- Spain

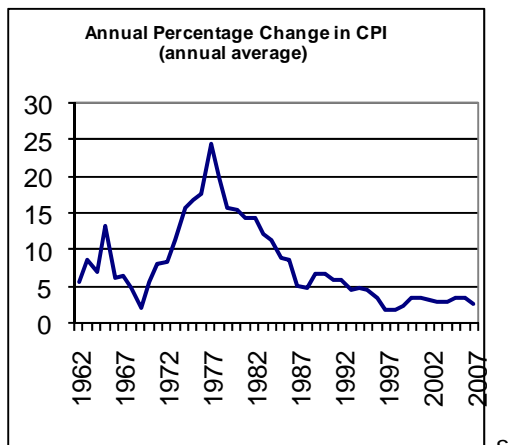
Monograph on Price Trends in Spain

This monograph is divided into three sections. In the first place, we briefly review inflation in Spain, as measured by the Consumer Price Index. In the second place, we take a detailed look at recent inflation trends, paying particular attention to the groups of items that are suffering the current episode of (global) inflationary tensions. Finally, we go over the recent trend in the price of real estate and financial assets.

Inflation in Spain: 1962-2007

Figure 1 displays the inflation pattern in Spain since the beginning of the 1960s (the long term trend was discussed in more detail in the OCEI March 2006 report). One can appreciate how the macroeconomic goal of price stability has been achieved since the second half of the 1980s and particularly so in the 1990s. Over the last few years, regardless of the ebbs and flows in raw material prices and the more or less expansive tone of economic (tax and monetary) policy, inflation (in terms of annual averages) has remained relatively stable.

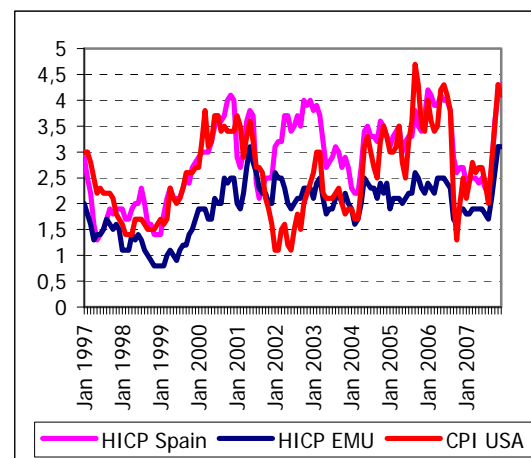
Figure 1: Inflation in Spain 1962-2007



Source: own elaboration and OCEI

Several factors have contributed to price stability, but it is worth highlighting the following: In the first place, economic globalisation, which increases the amount of competition in markets of goods and services while at the same time maintaining wages and producer costs low (together with corporate profit margins in sectors that are exposed to competition), through competition itself and migratory flows. In the second place, recent technological advances have boosted productivity, which *ceteris paribus*, lowers producer costs. In the third place, central bank independence and credibility have increased in their objective of achieving price stability, which helps to keep the outlook for inflation in check. In the fourth place, oil price rises have not affected consumer prices as much as in the past. This is mainly due to such rises not coinciding with other disturbances, greater energy efficiency in developed economies, increasing economic globalisation and also the credibility of central banks in their anti-inflation policy mentioned above.

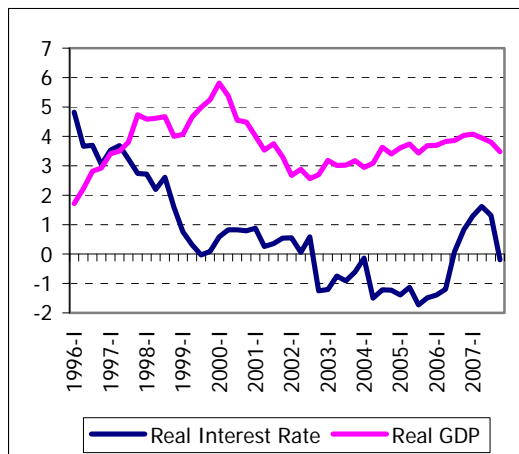
Figure 2: International Comparison - Annual Inflation Rates (%)



Source: own elaboration with data from Banco de España
HICP: Harmonised Index of Consumer Prices

As can be observed in the graph above, the inflation rate in Spain has been similar to that in neighbouring countries. However, there is still a significant inflation gap, particularly with regard to European countries, Spain's main trading partners. The constant decrease in the price-competitiveness of the Spanish economy is related to demand, cost and structural factors. On the one hand, tax policy has been insufficiently anti-cyclical for a period of strong economic growth. Furthermore, the monetary policy employed by the European Central Bank has been clear expansive, bearing in mind the cyclical situation in Spain, to the point that real interest rates were even negative (Figure 3).

Figure 3: Annual GDP Growth (%) and Real Interest Rates (minimum bid rate less headline inflation)



Source: own elaboration with data from OCEI and Banco de España

Moreover, nominal wage growth has outpaced productivity, which together with wage indexing clauses have exercised pressure on costs that have been passed on to prices in non marketable goods (unlike marketable goods – mainly manufactures – where the increase in international

competition has prevented this process from occurring). Despite increasing economic deregulation, there are still sectors in which competition is minimal and this results in high prices (and also high corporate profits). Finally, the fact that Spain is highly dependent on oil and uses it less efficiently (in relation to other developed countries), makes the country more sensitive to oil price hikes.

Recent Trends in Inflation and its Components

Global Inflationary Tensions Boost Inflation

Over the last few years, inflation, measured by the annual change in the CPI, has been rather irregular (Figure 2), tending upwards since the beginning of 2004, as a result of the pattern registered by the most volatile components of the CPI (see Figure 8 in the first half of this report), energy and fresh foods. This upward trend in prices appeared to revert in the second half of 2006 and the beginning of 2007. However, since October 2007 inflation has soared due to the combination of remarkable rises in the price of oil (and the fact that oil prices moderated towards the end of 2006, which saw the statistical effect stemming from annual comparisons in 2007 disappearing) and also raw materials, particularly in agriculture. Table 1 (opposite) provides information regarding trends in consumer, producer and export prices in recent years, in 2007 and the period dating from October 2007 to February 2008.

Table 1: Recent Price Trends

(annual percentage change)

	2002-06 Average	2007	Oct07- Feb08
Consumer Prices			
Headline Inflation	3.3	2.8	4.1
Core Inflation	3.0	2.7	3.2
COICOP Groups:			
Food & Non Alcoholic Beverages	4.0	3.7	6.5
Alcoholic Beverages & Tobacco	4.1	7.1	5.3
Clothing & Footwear	2.7	1.1	1.0
Housing	4.1	3.7	4.9
Household Items	2.0	2.6	2.5
Medicine	1.5	-1.5	-2.0
Transport	3.9	2.1	6.6
Communications	-1.9	0.2	0.7
Recreation & Culture	0.6	-0.7	-0.6
Education	4.2	4.5	4.1
Hotels, cafés & Restaurants	4.5	4.9	4.8
Other Goods & Services	3.4	3.3	2.9
Unprocessed Foods	4.8	4.8	5.0
Processed Foods	3.6	3.7	7.0
Energy	4.8	1.8	11.2
Industrial Goods (excluding Energy Products)	1.6	0.7	0.3
Industrial Goods	2.3	1.0	3.0
Services	3.9	3.8	3.8
Bread & Cereal	3.9	5.8	10.0
Dairy Products			
Cheese & Eggs	2.7	5.9	16.8
Fuels	5.9	1.3	14.0
Producer Prices			
Headline Inflation	3.2	3.3	5.8
Manufacturing Industry	3.1	3.2	6.0
Energy	6.2	0.9	10.8
Equipment	1.7	3.1	2.9
Intermediate Goods	3.1	5.8	5.4
Consumer Goods	2.5	2.6	4.9
External Sector (accumulated rates)			
Unit Value of Imports	1.3	1.0	
Unit Value of Exports	1.6	2.5	

Source: own elaboration with data from INE and Banco de España

COICOP: Classification of Individual Consumption According to Purpose

In relation to consumer prices, despite the upturn towards the end of 2007, the average inflation rate last year was lower than in previous years (2.8%). However, the average inflation rate between October 2007 and February 2008 soared to 4.1% and is likely to continue rising in forthcoming months. Once again, when faced with an upturn in global inflation, the gap with respect to the EMU increases sharply due to the consequences of certain intrinsic

characteristics of the Spanish economy mentioned previously and others that will be referred to shortly.

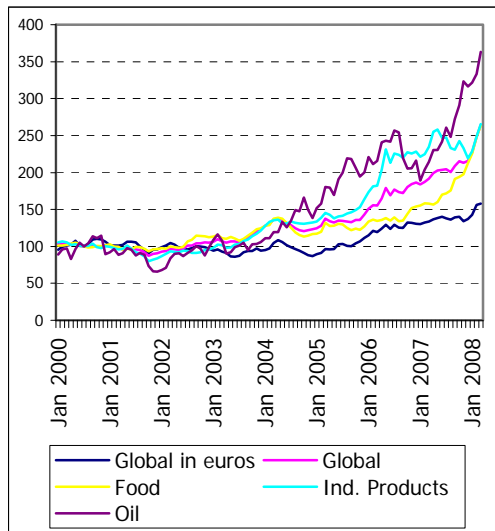
On examining the large groups of products, the increases in the price of transport, food and non alcoholic beverages stand out. The opposite is true of clothing and footwear, medicine and recreation and culture.

The lower part of the table of consumer prices allows us to identify the groups that are behind the current upturn in inflation, as well as to detect some of the structural characteristics of Spanish inflation.

Global Inflationary Tensions: Price of Oil and Raw Materials

The increase in the price of oil and raw materials (see Figure 4), particularly in agriculture, have pushed up prices, an effect that is gradually being passed on to the economy as a whole, as can be observed in Table 1. The price of certain agricultural raw materials, such as wheat, corn, soya and rape has doubled since 2006 due to poor harvests, an increase in demand from emerging nations and/or new competition in demand stemming from bio fuels. The increase in the price of such products has pushed up the price of the goods they are used to make, such as pet food, bread, milk, eggs and meat. As a result, the annual percentage change in the price of unprocessed foods, processed foods and also energy has accelerated.

Figure 4: Raw Material Prices (Price Index – Base year = 2000)



Source: own elaboration with data from Banco de España

As a result, the annual inflation rate (February 2007-February 2008) for total raw materials was 32.7% (17.6% in Euros – due to the appreciation of the euro against the dollar). In the case of agricultural raw materials, the inflation rate was 57% (39.2% in Euros), while the price of a barrel of Brent rose by 65.3% (46.5% in Euros) over the same period. Obviously, the marked appreciation of the euro has mitigated the effect this global inflationary pressure in European countries.

Inflationary Tensions Spread to Producers...

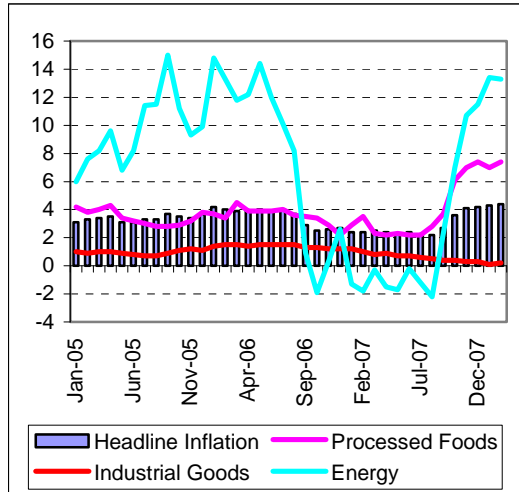
The increase in the price of production factors (such as agricultural raw materials and oil) Spreads to the economy as a whole in several ways. In the first place, there is a **direct effect** on consumer prices. How large this effect is depends on how important in relative terms the products derived from these inputs are in the overall structure of household consumption.

In the second place, there is an **indirect effect**. More expensive production factors are used to produce goods, increasing production costs. In this case, the sectors that depend the most on these inputs are more sensitive to price rises. The degree to which the price rise in inputs spreads depends on how competitive markets are, the current stage of the economic cycle and the temporary or permanent nature of the disturbance that pushed up prices in the first place.

Thirdly, an upturn in inflation, in this case due to basic products becoming more expensive, can also spark an **upward review of the outlook for inflation in the future**. This can affect final prices directly or indirectly via wage negotiations or through companies fixing higher prices as both workers and shareholders aim to maintain their real level of income. As wage rises occur, labour costs increase and this can push up final prices, depending on how competitive the sector in which a given producer operates is.

In this sense, Table 1 reveals that core inflation (which excludes energy products and unprocessed foods) is accelerating. Furthermore, in the lower part of the table, the marked rise in producer prices can be observed, particularly in the energy, manufacturing and intermediate good sectors.

Figure 5: Annual % Change in Total CPI and Components



Source: own elaboration with data from INE and Banco de España

How Inflation Spreads in Spain: Greater Sensitivity to Oil Prices

Inflation spreads in different ways depending on the structural characteristics of each economy. Spain obviously features aspects which distinguish the country from others (at least from other European countries) and make us particularly sensitive to inflationary tensions.

In the first place, regarding sensitivity to oil price rises, it is worth highlighting the fact that oil derivatives represent a higher percentage of the total expenditure of Spanish households than is the case in other Euro-zone countries, partly due to the sharp rise in the number of cars owned by residents over the last few decades. Moreover, the fact that the indirect taxation levied on public fuel prices is minimal results in a greater relative impact of changes in crude oil prices on inflation, which in turn makes inflation more variable. Likewise, Spanish companies are less efficient when it comes to using energy in their production processes, which results in

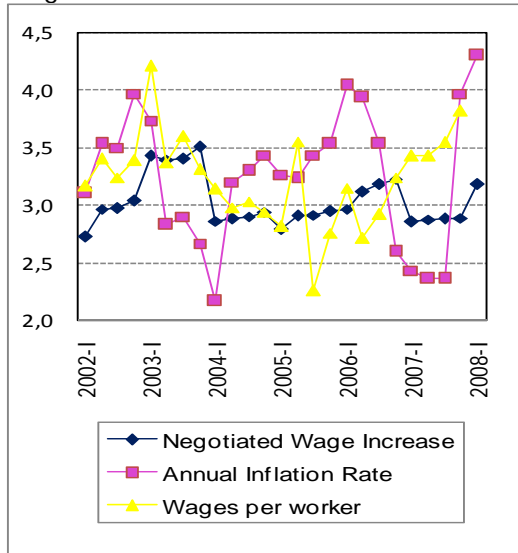
larger indirect effects when oil prices rise.

How Inflation Spreads in Spain (II): Rigidities and Minimal Competition

The second aspect that makes Spain different is the presence of rigidities in goods, services and factor markets which create larger second round effects (than in other European countries) by making the inflationary tensions faced by the economy more persistent.

In the labour market, the presence of wage indexation clauses (safeguarding clauses), which are practically nonexistent in other countries, together with relatively centralised collective negotiation processes increase the incidence of inflationary tensions. When wage indexation clauses are activated, costs are put under pressure, increasing the persistence of inflation. Furthermore, collective agreements that affect a wide range of professions further spreads wage rises (wage increases in the agreements negotiated between January and February 2008 could affect more than five million workers). In addition, this type of relatively centralised negotiation does not take into account how productive each company is and, therefore does not boost productivity. This could result in larger increases in costs for any wage rise that is agreed upon.

Figure 6: Annual % Change in Prices and Wages



Source: own elaboration with data from INE

In light of the peculiarities of the system of labour relations, Spain runs the risk of tensions in oil and raw material markets spreading to the labour costs and domestic prices, triggering a price/wage spiral. Figure 6 reveals that wages have a certain tendency to respond to price rises. Wages have risen remarkably over the first few months of 2008 (collective agreements in January and February 2008 resulted in rises of 3.3% and 3.4% respectively), which are pushing up unit labour costs. One important factor when it comes to controlling this risk is monetary policy credibility, particularly considering the current situation in which economic activity is slowing down and financial markets are unstable. The European Central Bank has maintained interest rates unchanged, constantly underlining its commitment to price stability in the medium and long term.

Finally, in goods and services markets, the lack of both foreign and domestic competition, mainly in the services sector, means that when faced with

more expensive productive factors (raw materials, labour...), companies can easily raise their prices. This contrasts with the marked competition in markets of industrial goods and as a result prices in this sector have risen very slowly. This difference between services and industry has given rise to dual inflation (see Table 1 and Figure 5), with inflation in the former standing at approximately 4% and in the latter 1% (or even lower) and growing more slowly than in other countries in Europe.

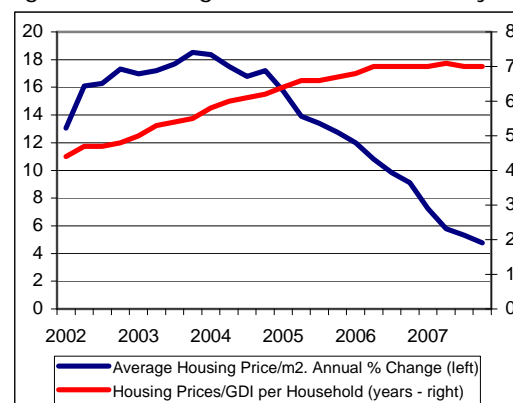
Real Estate and Financial Asset Prices

The next section briefly reviews real estate and financial asset price indicators.

Housing Prices

Figure 7 illustrates the steady slowdown in housing inflation since 2005 to 4.8% in the last quarter of 2007. As discussed at the beginning of this report, the construction sector, particularly residential construction, has slumped abruptly.

Figure 7: Housing Prices and Accessibility



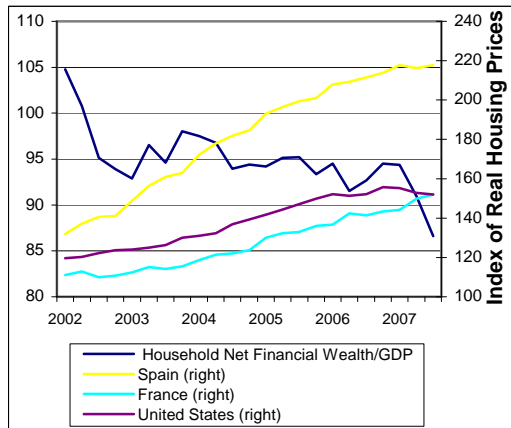
Source: own elaboration with data from Banco de España

Some of the mainstays of housing demand have become weaker over the last few quarters. On the one hand,

tougher monetary policy has considerably increased households' financial burden, as they are deep in debt and at variable interest rates. Furthermore, the current financial turmoil has made it more difficult to be granted a loan. As the increase in the value of assets levels out, a negative wealth effect is caused which also reduces house sales. Greater uncertainty as a result of the financial crisis and the economic slowdown has rapidly deteriorated conditions in the labour market (with a substantial fall in the rate of job creation), further accentuated the slowdown in demand in a scenario where there is excess supply. Nominal prices have strongly resisted to fall so far (that is, up to 2007), but will probably begin to drop, albeit slightly, this year.

As a result of the marked rise in prices in this sector (higher than in other countries – Figure 8), housing prices in relation to household Gross Disposable Income (GDI) has continued to rise. This trend has been changing over the last few quarters due to housing price inflation decelerating.

Figure 8: Household Financial Wealth and Price Comparisons (Index of Real Prices, 1996=100)

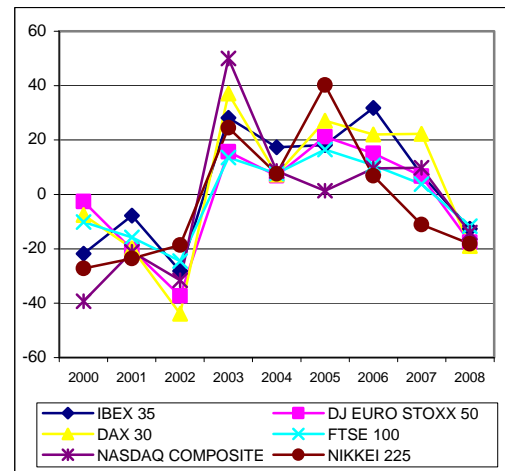


Source: own elaboration with data from Banco de España

The trend observed in stock market listings sheds light on the situation of financial asset prices. Prices have behaved highly similarly to the main stock markets worldwide, as a result of growing economic and financial globalisation. Growth in yields was sustained between 2002 and 2006, boosted by the extraordinary liquidity as a result of accommodating monetary policy and the boom in world economic growth (Figure 9).

The situation changed dramatically following the financial turmoil in August 2007 as a result of the sub prime loan crisis in the United States, which triggered a severe credit crunch in international financial markets.

Figure 9: Variable Income Markets - Accumulated Yields this Year (%)



Source: own elaboration with data from Banco de España

Silviano Esteve
Valencia, 8 April 2008

4.- France and Germany

The monograph this month is devoted to analysing price trends. This issue is highly topical at the moment in light of the recent upturn in inflation in Europe observed since halfway through 2007. Notwithstanding, this issue poses a slight statistical problem in that the data sources available dating back far enough in time do not normally coincide with those that offer more recent data when it comes to analysing the upturn in inflation mentioned above. For this reason, we have decided to present the data from both types of sources.

As regards the historical trend, inflation remained relatively in check between 1991 and 2005 in both France and Germany. As can be observed, the average inflation rates were 1.79% and 2.03% respectively, remarkably lower than the averages in Europe, the United States and the OECD. This trend is even more striking if we take into account the high rates recorded in the first few years of the sample period. Should these be excluded from the analysis, the average in both countries would drop significantly. Therefore, both France and Germany display data typical of mature economies, with inflation rates that have remained remarkably in check¹⁹.

On analysing the trend since 2006, a similar pattern is observed, in the average annual inflation rates are very close to those recorded over the period dating from 1991 to 2005. Nevertheless, the recent price hike is

clearly visible in both cases. In Germany, inflation has risen practically since the beginning of 2007, when the annual rate rose above 2%, almost certainly fuelled by the rally of economic activity at that time, while in France this did not occur until October the same year, which was also when the situation got suddenly worse in Germany. As can be observed, inflation continues to soar in both countries at present, despite moderating somewhat in Germany with regard to the situation at the end of 2007.

Table 1: General Price Index, Historical Data - Annual Inflation Rate

	France	Germany	UE15	USA	OECD
1991	3.20	4.07	5.22	4.22	6.15
1992	2.41	5.13	4.58	3.03	5.05
1993	2.13	4.41	3.77	2.94	4.24
1994	1.65	2.67	3.05	2.62	4.48
1995	1.84	1.73	3.07	0.46	5.71
1996	1.91	1.49	2.54	5.32	5.28
1997	1.25	1.89	2.15	2.31	4.55
1998	0.62	0.93	1.69	1.61	3.91
1999	0.51	0.61	1.24	2.11	3.33
2000	1.73	1.42	2.35	3.41	3.95
2001	1.60	2.00	2.40	2.80	3.50
2002	1.97	1.37	2.15	1.65	2.51
2003	2.12	1.06	2.20	2.20	2.45
2004	2.08	1.63	2.15	2.72	2.39
2005	1.76	0.09	2.29	3.37	2.61
Average	1.79	2.03	2.72	2.72	4.01

Source: OECD

¹⁹ However, these data do not appear to display any risk of deflation (which was such a concern for German policymakers) in any sub-period, particularly when compared to the data referring to the French economy.

Table 2: General Price Index, Recent Data – Annual Inflation Rate

	France	Germany
2006.1	1.99	1.82
2006.2	1.89	1.81
2006.3	1.52	1.30
2006.4	1.78	2.01
2006.5	2.14	1.81
2006.6	1.96	1.90
2006.7	1.96	1.79
2006.8	1.95	1.49
2006.9	1.24	1.00
2006.10	1.06	1.09
2006.11	1.42	1.50
2006.12	1.50	1.39
2007.1	1.24	2.18
2007.2	1.06	1.98
2007.3	1.14	2.47
2007.4	1.23	2.07
2007.5	1.05	2.66
2007.6	1.13	2.36
2007.7	1.05	2.06
2007.8	1.13	2.16
2007.9	1.48	2.66
2007.10	2.01	2.75
2007.11	2.45	3.34
2007.12	2.62	3.22
2008.1	2.89	2.33
2008.2	2.80	2.62
Average	1.68	2.07

Source: INSEE and DESTATIS

In light of the seriousness of the situation, it is necessary to find the culprit, which is what the next few pages of this monograph will be devoted to, by analysing the trends in an array of price indexes. In the first place, energy prices can be said to have been the most erratic, with the most ups and downs, judging by the information in the table that follows. As a result, there have been years such as 1998 when energy prices fell and others such as 2000 when they soared. Nevertheless, the energy price trends observed in both countries are similar to those recorded by others. It is worth mentioning that energy prices in France do appear to have remained more in check, probably due to the importance of the nuclear energy the country produces, whereas in Germany, which is much more dependent on imported

energy, the annual inflation rate of this variable is particularly high.

The pattern observed in the energy price index since March 2003 clearly illustrates the same hike in prices registered by the General Price Index since October/November 2007, while prices had remained relatively low in previous months, particularly in France, with negative rates. Therefore, we have a clear candidate to receive the blame for the recent price explosion in both countries: energy prices.

Table 3: Energy Price Index, Historical Data – Annual Inflation Rate

	France	Germany	UE15	USA	OECD
1991	2.37	9.66	7.68	0.37	5.98
1992	-1.10	4.53	2.72	0.61	3.66
1993	1.97	1.24	3.16	1.09	3.53
1994	1.33	3.43	3.06	0.48	3.55
1995	1.91	-0.83	2.02	0.60	4.39
1996	4.80	0.95	1.16	4.62	5.91
1997	2.01	2.84	2.65	1.24	5.09
1998	-2.84	-3.22	-1.91	-7.71	-1.42
1999	0.45	4.16	2.29	3.63	4.55
2000	12.11	14.03	11.73	16.82	14.55
2001	-1.60	5.70	1.30	3.80	4.50
2002	-1.52	0.28	-0.69	-5.97	-1.15
2003	2.37	3.96	3.18	12.19	7.36
2004	4.74	4.08	4.62	10.96	7.12
2005	9.91	10.29	10.04	16.95	11.95
Average	2.46	4.07	3.53	3.98	5.30

Source: OECD

Table 4: Energy Price Index, Recent Data – Annual Inflation Rate

	France	Germany
2007.3	0.60	3.5
2007.4	-0.40	1.80
2007.5	-1.40	1.90
2007.6	-0.20	1.60
2007.7	-0.60	1.50
2007.8	-1.70	0.80
2007.9	1.50	6.00
2007.10	5.20	6.30
2007.11	10.00	11.00
2007.12	10.50	8.60
2008.1	12.10	9.50
2008.2	11.30	9.00
Average	3.91	5.13

Source: EUROSTAT

Food prices will be examined next. In the first place, the trend in food prices was more moderate than the overall price trend between 1991 and 2005 in

all countries and regions under consideration. This was particularly the case in Germany, where the annual inflation rate for food remained below 1%. In contrast, the average inflation rate for food in France was very close to the overall inflation rate.

However, if we analyse the recent trend in food prices, a similar pattern is observed to that in energy prices. That is, prices have shot up since October 2007, explaining, together with energy prices, the upturn in overall inflation over the same period. In this case, however, it is worth highlighting that food price inflation has never recorded such high figures, at least in the 1990s.

Table 5: Food Price Index, Historical Data – Annual Inflation Rate

	France	Germany	UE15	USA	OECD
1991	2.82	2.73	4.33	2.66	5.35
1992	0.44	2.02	2.53	0.74	2.96
1993	-0.22	0.52	1.35	2.33	3.15
1994	0.88	-0.41	2.44	2.88	4.38
1995	1.20	3.13	2.71	3.26	5.85
1996	1.07	0.61	1.90	3.72	5.53
1997	1.81	1.41	0.93	2.50	4.21
1998	1.67	0.99	1.43	1.91	4.26
1999	0.41	-1.27	0.2	1.88	2.52
2000	2.25	-0.70	0.81	2.25	2.25
2001	5.50	4.50	4.60	3.30	4.40
2002	2.75	0.77	2.29	1.26	2.68
2003	2.31	-0.09	1.68	2.20	2.24
2004	0.45	-0.38	0.83	3.74	2.74
2005	0.18	0.38	0.64	1.89	1.42
Average	1.57	0.95	1.91	2.44	3.60

Source: OECD

Table 6: Food Price Index, Recent Data – Annual Inflation Rate

	France	Germany
2007.3	0.50	2.10
2007.4	1.20	2.70
2007.5	0.90	1.80
2007.6	1.30	1.80
2007.7	0.80	1.90
2007.8	1.20	2.50
2007.9	1.30	2.50
2007.10	2.30	4.50
2007.11	2.30	5.40
2007.12	3.20	5.70
2008.1	4.40	6.10
2008.2	5.00	6.30
Promedio	2.03	3.61

Source: EUROSTAT

Another indicator that is often analysed when studying inflation is the producer price index, as it shows whether price rises occur at the source or in the distribution of goods and services. Well, the historical trend in this index clearly shows the role that distribution has played in the upturn in prices, as producer prices, on average, have risen a lot less than overall prices in all the countries and regions in the sample and France records a particularly low average. The recent trend in this index, moreover, does not register the boom in prices suffered by other indexes in the second half of 2007 at all.

Table 7: Producer Price Index, Historical Data – Annual Inflation Rate

	France	Germany	UE15	USA	OECD
1991	-1.17	2.21	2.11	1.28	2.84
1992	-1.09	1.62	1.15	1.27	2.23
1993	-2.30	0.11	1.13	1.48	2.06
1994	-0.72	0.64	2.13	1.35	3.15
1995	7.22	2.11	4.39	2.99	5.86
1996	-2.69	0.10	0.63	2.26	3.46
1997	-0.59	0.62	0.84	0.32	2.79
1998	-0.90	-0.21	-0.52	-	1.52
				1.05	
1999	-1.61	-0.21	-0.21	1.69	1.82
2000	2.04	3.09	4.38	4.06	4.93
2001	1.20	1.30	1.10	0.80	1.50
2002	-0.20	0.20	0.00	-	0.49
				0.69	
2003	0.30	0.59	0.69	0.60	1.86
2004	1.18	1.76	2.36	6.36	3.46
2005	1.76	2.79	3.07	5.51	4.00
Average	0.16	1.12	1.55	1.88	2.80

Source: OECD

Table 8: Producer Price Index, Recent Data – Annual Inflation Rate

	France	Germany
2007.4	0.54	0.08
2007.5	0.18	0.34
2007.6	0.18	0.17
2007.7	0.53	-0.08
2007.8	0.18	0.08
2007.9	0.35	0.17
2007.10	0.70	0.42
2007.11	0.78	0.83
2007.12	0.09	-0.08
2008.1	0.52	0.83
2008.2		0.74
Average	0.40	0.32

Source: EUROSTAT

The industrial price index also failed to register the price boom observed in the overall index. As was to be expected, this index has behaved very similarly to that of producer prices, with the historical inflation rate being lower than that in the general index and no unusual trends in the recent data since the end of 2007.

Table 9: Industrial Price Index, Historical Data – Annual Inflation Rate

	France	Germany
1991		2.42
1992		1.37
1993		0.00
1994		0.56
1995		1.72
1996	-1.27	-1.23
1997	-0.69	1.18
1998	-1.69	-0.41
1999	-1.72	-1.02
2000	2.88	3.07
2001	0.90	2.96
2002	-1.19	-0.58
2003	0.20	1.71
2004	1.60	1.64
2005	2.66	4.56
2006		5.53
2007		2.01
Average	0.17	1.50

Source: IEI

Table 10: Industrial Price Index, Recent Data – Monthly Inflation Rate

	France	Germany
2007.4	0.63	0.63
2007.5	0.45	0.27
2007.6	0.18	0.27
2007.7	0.36	0.18
2007.8	0.18	0.09
2007.9	0.44	0.18
2007.10	0.44	0.35
2007.11	0.79	0.53
2007.12	0.17	-0.09
2008.1	0.35	0.35
2008.2		0.61
Average	0.40	0.31

Source: EUROSTAT

Core inflation, which excludes precisely food and energy prices, confirms the fact that these two products are responsible for the recent upturn in inflation. As regards the long term trend in this index, France and Germany display average rates that are

considerably lower than those observed in the case of the general price index. Surprisingly, in this case it is Germany that records the lower average of the two with only 0.59%. As regards the trend since 2006, there is no sign of the price boom from 2007 onwards that other indexes have recorded. Instead, figures in recent years have been in line with the long term trend. This confirms that these two components, energy and food, are clearly behind the upturn in inflation in both countries.

Table 11: Core Inflation, Historical Data – Annual Rate

	France	Germany
1991	3.76	
1992	3.34	
1993	1.87	
1994	1.25	
1995	0.76	
1996	0.98	0.35
1997	0.68	0.95
1998	0.90	0.89
1999	0.63	0.10
2000	1.33	-0.30
2001	1.95	0.32
2002	1.92	0.87
2003	1.60	0.26
2004	1.32	1.47
2005	0.94	0.48
2006	1.35	0.27
2007		1.42
Average	1.54	0.59

Source: IEI

Table 12: Core Inflation, Recent Data – Annual Rate

	Francia	Alemania
2006.1	1.08	-0.10
2006.2	0.87	0.10
2006.3	0.97	0.10
2006.4	1.13	0.30
2006.5	1.11	0.50
2006.6	1.14	0.30
2006.7	1.36	0.30
2006.8	1.13	0.20
2006.9	0.88	-0.10
2006.10	1.14	0.50
2006.11	1.20	0.40
2006.12	1.36	0.70
2007.1	0.54	1.30
2007.2	1.45	1.30
2007.3	1.39	1.29
2007.4	1.42	1.29
2007.5	1.47	1.20
2007.6	1.46	1.30
2007.7	1.42	1.61
2007.8	1.54	1.61
2007.9	1.60	1.70
2007.10	1.66	1.39
2007.11	1.72	1.59
2007.12	1.76	1.39
2008.1	2.77	0.69
2008.2	1.89	
Average	1.36	0.83

Source: INSEE and IEL

There are some price indexes that are particularly significant in the case of Germany, due to the strength of German exports and the country's dependence on foreign trade in recent years – import and export price indexes. Both indexes displayed controlled trends since 2007, to the extent that the average annual inflation rate over the period stands at 1.75%. Import prices have also remained in check, but precisely since October 2007, the overall surge in prices can be appreciated. In any case, the low price of German exports explains the strength of the country's external sector even when the euro has appreciated remarkably²⁰.

²⁰ Unfortunately, we lack the statistics necessary to carry out a similar analysis of the French economy, although these two variables are not as relevant as in Germany, due to the external sector not being so important.

Table 13: Import and Export Price Indexes in Germany – Annual Inflation Rate

	Imports	Exports
2007.1	0.7	2.40
2007.2	0.8	2.20
2007.3	0.9	2.10
2007.4	0.5	1.90
2007.5	0.6	1.80
2007.6	1.3	2.00
2007.7	0.4	1.60
2007.8	-0.6	1.60
2007.9	1.3	1.60
2007.10	2.3	1.30
2007.11	3.5	1.20
2007.12	3.7	1.30
2008.1	5.2	1.80
2008.2		
Average	1.58	1.75

Source: DESTATIS

Finally, we are going to analyse two indexes that despite not being of particular importance in regard to the trend of the overall index, are normally included in a general analysis of inflation. In the first place, we will analyse the pattern of share prices. It is worth indicating that the stock markets in France and Germany appear to be profitable than in the other countries and regions under study, as their shares offer higher yields. However, both French and German stock markets will more than likely register negative figures throughout this year, despite the fact that this does not appear in the data as the series ends in 2007, due to the financial crisis (note that the last financial crises occurred in 2001 and 2003 and they had a widespread effect).

Table 14: Share Price Index – Annual Inflation Rate

	France	Germany	UE15	USA	Euro Area
1997	32.58	44.59	42.68	29.48	39.87
1998	34.15	35.04	32.73	15.94	32.57
1999	22.93	6.43	20.28	21.30	23.04
2000	37.83	33.27	30.01	2.58	34.18
2001	-19.95	-21.15	-	-4.94	-
			19.67		20.25
2002	-24.40	-25.52	-	-9.56	-
			22.27		24.49
2003	-17.82	-23.58	-	-2.53	-
			21.04		20.76
2004	18.26	24.70	12.72	14.74	15.88
2005	15.79	17.39	12.71	2.22	14.30
2006	19.78	26.11	14.88	8.13	18.40
2007	12.08	26.65	8.24	15.44	13.67
Average	11.93	13.08	10.12	8.44	11.49

Source: EUROSTAT

Finally, we will also examine housing prices. As can be appreciated, both the long term and recent trends in this price index in France and Germany have been entirely different to the pattern registered by this asset in Spain (in fact, Germany recorded deflation up to 2004), nor is housing responsible for the upturn in prices observed since the end of 2007, although housing prices have risen precisely since then.

Table 15: Housing Price Index, Historical Data – Annual Inflation Rate

	France	Germany
1997	0.82	-3.77
1998	-0.12	0.21
1999	0.70	-2.68
2000	2.53	-0.46
2001	0.11	-0.95
2002	2.69	-1.35
2003	2.08	-1.04
2004	4.50	-3.59
2005	4.51	
2006	3.82	
2007	4.25	
Average	2.35	-1.70

Source: IEI

Table 16: Housing Price Index, Recent Data – Annual Inflation Rate

	France	Germany
2007.3	3.20	2.20
2007.4	2.60	1.90
2007.5	2.10	1.70
2007.6	2.40	1.70
2007.7	2.40	1.70
2007.8	2.30	1.60
2007.9	2.70	2.20
2007.10	3.20	2.20
2007.11	4.30	3.00
2007.12	4.30	3.10
2008.1	4.70	3.30
2008.2	4.60	3.30
Average	3.23	2.33

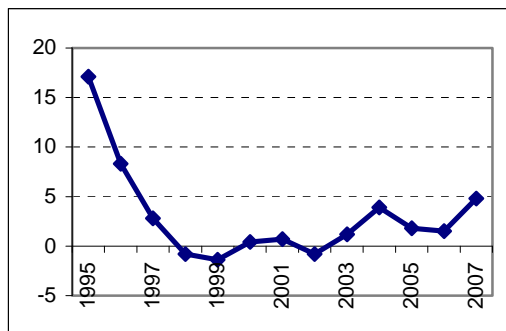
Source: EUROSTAT

Antonio Cutanda
ValAntonio Cutanda
Valencia, 7 de Abril 2008

5.- CHINA

As regards the issue of prices, the most spectacular piece of news was the 8.7% annual inflation rate recorded in February this year (the highest in 12 years), which will make it difficult for the government to avoid inflation surpassing the target rate of 4.8% for 2008. The inflation rate really is surprising considering China was fighting its way out of deflation in 1999. However, inflation began to become a problem in the second half of 2007. The CBC initially attributed inflation to an excess of liquidity and responded by using monetary policy instruments to avoid inflation from surpassing 3%. The cash ratio has been raised on eleven occasions and interest rates six, but with no success (Figure 6).

Figure 6: Annual Inflation Rate (CPI)



Source: National Bureau Statistics

At present, the price of food and manufactures is the main cause for this upturn in inflation. Moreover, there are no signs that energy and raw material prices are going to drop. The new labour law is also expected to boost labour costs. Therefore, all factors seem to be against a decrease in inflation.

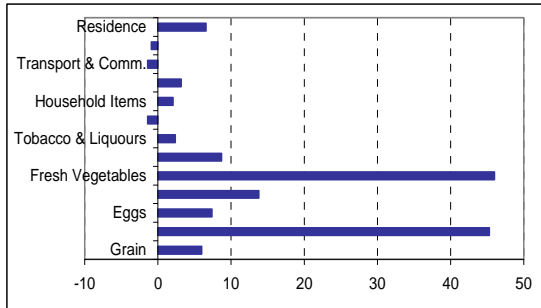
In January, the government, using the Law of Prices, decided to make an "interim intervention" in prices until they stabilised. Similarly, other steps

have been taken to curb inflation, such as freezing retail grain and oil prices and levying export duties on grain in order to increase domestic supply. However, controlling prices, as we know too well, does not solve the lack of balance between supply and demand.

One of the main reasons behind this enormous price hike in January and February 2008, as mentioned previously, was the 23.3% annual increase in food prices (Figure 7) in February. The most striking rises were observed in vegetables (46%), oil (41%) and above all pork, one of the main foods in the Chinese diet, which rose by 63.4%. Meanwhile, non food prices rose by only 1.6%. People are also attributing the upturn in prices to climatic factors, such as storms and extreme temperatures that paralysed a large part of the country in January and February.

Going into more retail regarding food prices in China, we can affirm that the problem is not just the result of climatic circumstances. The country is in the midst of a difficult debate over the future of food security, as the country must provide food for more than a fifth of the world's population, despite only having a seventh of the arable land on the planet (Bezlova, IPS Report, February 2007). This has resulted in an uncontrolled rise in food prices over the last year, as can be appreciated in Figure 8. The increase in food prices alone accounted for 83% of the overall rise in the CPI (Figure 8) and the trend continued (food represented 84.5% of the increase in the CPI in January 2008).

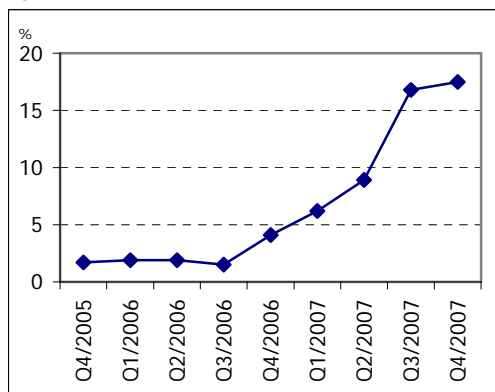
Figure 7: CPI Composition in February 2008



Source: National Bureau Statistics

In February, China raised the minimum price for purchasing rice and wheat and repeated the move in March, in an attempt to stimulate the production of grain and offset the increasingly high costs faced by farmers. Furthermore, there have been proposals to reduce the industrial use of grain and grain exports as well as to aid the low income earning population.

Figure 8: Food Price Index



Source: OECD

The president of the country has asked local governments to guarantee stable food prices and the supply of the main farm produce. The rapid growth in exports of grain and wheat, corn and soya has further boosted the domestic price of these products, which has seen the CPI soar so spectacularly. According to the latest information from the Ministry of Agriculture, Chinese foreign

trade in farm produce exceeded 8,100 million dollars in January 2008, with a trade deficit of 900 million.

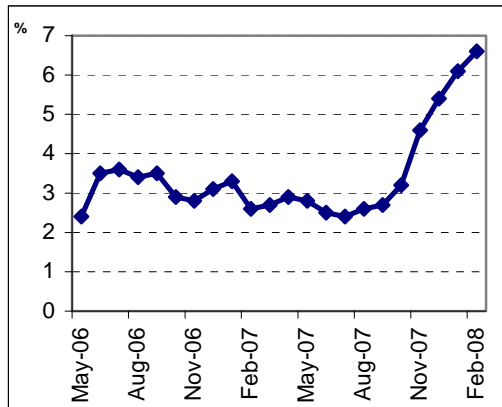
The prices of the basic Shopping basket, including cereals, meat, eggs and oil, are the greatest concern of the government. For this reason, the economic regulator announced measures to control the price of these products. As mentioned in the our previous report, the measure entails companies informing of their plan to increase prices 10 working days before the date the new prices are due to take effect and the government reserves the right to approve or reject the increase.

Other steps include the increase in subsidies for breeding pigs and taxes levied on grain exports to stabilise the local market. In reality, the government is extremely concerned about the social uprisings that could occur as a result of a lack of food. This occurred in 1989 in Tiananmen Square and ended in a blood bath.

However, the government in the PNC, in our opinion to dodge the issue, linked the increase in inflation to various aspects on the international scene, such as larger global economic imbalances, an increase in competition, the devaluation of the dollar, the subprime mortgage crisis in the United States and the increase in financial risks.

Another key indicator of inflation is the producer price index, which measures the cost of goods on leaving the factory floor. This indicator recorded a 6.6% annual rise in February due to the 37.5% surge in oil prices and a 9.7% increase in the price of raw materials, fuels and electricity.

Figure 9: Producer Price Index



Source: OECD

As can be observed in Figure 9, the PPI remained relatively stable until August 2006, never recording changes larger than 4%. It was in November when the exponential climb became worrying.

In the case of China it is important to bear in mind that the price of oil depends on the international market, but the price of refined fuels such as petrol, diesel and kerosene is still regulated by the State, which asks the companies responsible for marketing refined oil products to not raise prices in order to reduce inflationary pressure. Nevertheless, the government is working on when to reduce the gap between the relatively low price of fuel in the country and the high global price of oil, as the consequences will be vital for the current Chinese economic environment.

The export price of steel products have shot up by 263% over the last seven years and continue to climb despite the increase in the cost of raw materials such as iron and labour. However, an American study states that the boom in the metallurgy sector in China is due to government subsidies that amounted to 27,110 million dollars between 2000 and 2007. The leaders of the Chamber

of Commerce of Chinese importers and exporters of metals, minerals and Chemicals say the conclusions this study drags are false and that "the increase in steel production and exports in recent years is due to the need for steel products in China and importing countries for their economic development."

Furthermore, the increase in the price of steel is sparking rises in the price of electrical appliances, as steel is the main raw material used. The manufacturers of these appliances also attribute the price rise to higher wages and transport costs. In addition, Chinese analysts recently augured that the price of steel could surpass the barrier of 1,000 dollars a tonne in 2008. Domestic scarcity is expected to become more pronounced due to government measures aimed at eliminating obsolete extraction processes, thus further widening the gap between supply and demand.

Asset prices have risen at a monthly rate of 10% over the last few years, drawing equal to housing prices in London and New York. The average price of a house rose in January and February this year by 11.3% and 10.9% respectively. In the most expensive area in Peking, one Squire metre is worth 7,572 dollars and an apartment in an average area registers a price of 2,500 dollars/m². These astronomical prices contrast with city dwellers' income per capita which stood at 1,600 dollars a year in 2006 (\$400 in rural areas).

High housing costs together with people's desire to have their own house triggered a 36% decrease in the consumption rate of other articles in 2007. The price hike in the sector can be partly attributed to both foreign and

domestic investor speculation. However, at the beginning of 2008, real estate agencies realised that the market had reached a point of inflexion following a slowdown in sales. For this reason, they have begun to offer discounts and special gifts in order to attract a larger number of customers.

The proximity of the Olympic Games in Peking, due to be held in August, is also having a significant temporary effect on real estate prices. People say that rent prices will be nine times higher than now during the event.

The Government, concerned about this sector overheating, has taken several steps in recent years to try and cool it down, but with no success whatsoever. Such moves include:

- Increasing the initial down payment on a mortgage for a second house from 20% to 40%.
- Restrictions in the luxury construction sector.
- Imposing a veto restricting foreign investment in second hand housing transactions.
- Land distribution adjustments.
- Restrictive mortgage loan policy.

In light of the current inflationary scenario in China, other internal sources predict the CBC will look to solve the problem by means of mere monetary policy and, as a result, the expect interest rates to rise once or twice in the first half of the year. Furthermore, as indicated previously, CBC policymakers are of the opinion that revaluating the Yuan to curb inflation would partly help to solve the problem, but that this should not be used as a key measure in the fight to sustain prices. Doing so would benefit

imports and would help solve internal problems at the expense of enormously boosting global prices. Policymakers consider that it is the domestic market that should satisfy everyday needs.

Worldwide, the main danger of the marked rise in prices in China is that it may spread to export prices, which would spark price rises in the countries China trades with (European Union and the United States) thus reducing the competitiveness of these countries and further accentuating the slowdown in economic growth they are currently suffering.

M. Luisa Marti Selva & Rosa Puertas
Medina

Valencia, April 7 2008

6.- MEXICO

Monetary Policy

As regards prices, one important event that has marked the increasing convergence towards the target inflation rate of 3% was undoubtedly when the Banco of Mexico was given independence in 1993, 69 years after its foundation (1925).

Banco de Mexico decided to manage its monetary policy by means of a scheme called "Inflation Objectives", which led to a current target inflation rate of 3%.

Credibility is at the heart of this scheme, so the bank must act transparently, providing true information to all economic agents.

The bank set the target inflation rate of 3% in 2004 with a fluctuation range of plus or minus 1%.

Table 1: Inflation Rate 2004-2007

Year	Inflation Rate
2004	5.19
2005	3.33
2006	4.05
2007	3.76

Source: elaborated with information from Banco de Mexico

As can be observed in the table above, in 2004, when the target rate was established, the inflation rose by slightly more than one percentage point above the maximum threshold of 4%.

In the period under consideration, the target rate of 3%, plus or minus 1%, has only been achieved in 2005 and 2007.

Operational Interest Rate Target

Banco de Mexico decided to instrument monetary policy by means of an operational interest rate target from January 21 this year onwards.

In this sense, the central bank established the operational interest rate target (overnight Interbank rate), considering that greater stability had been achieved and financial markets had developed together with the fact that the inflation rate was low.

This scheme replaces the minimum current account balance that commercial banks had to maintain in the central bank, known as the "corto", which had been in use since 1995.

In addition to this, the central bank indicates that open market operations will be used to take the aggregate balance of these current accounts to zero at the end of each day. In order to achieve this, Banco de Mexico will continue to withdraw or inject all excess or lacking liquidity in the system.

Likewise, the rate applied to surpluses in the current accounts will be zero and that applied to overdrafts will be double the overnight cash rate (tasa de fondeo bancario a un día).

New Method for Measuring Core Inflation

Banco de Mexico modified its core price index in January 2008, incorporating education.

The core index includes private education, which is therefore no longer a part of the non core price index. According to Banco de Mexico, this helps to better measure the overall trend in inflation.

Private education prices display a seasonal trend, as price rises occur at the beginning of the school year and remain relatively stable throughout the rest of the year. Increases are recorded mainly in August, September and January.

Following this change, the core price index will account for 74.77% of the urban shopping basket, rising from 69.56% as education carries a weighting of 5.2% within the National Consumer Price Index.

Inflation and Economic Growth

The Mexican economy has been characterised, particularly from 1970 onwards, by marked ebbs and flows in both inflation and growth.

It has been said that one of the requirements in order to achieve adequate economic growth is price stability, as inflation leads to a lack of stability in planning, investment and economic growth.

Table 2: Inflation and Growth in Various Periods

Period	Inflation	GDP
1950-1970	4.2	6.7
1950-1994	23.8	6.2
1982-1987	94.6	0.0
1995-2007	12.7	2.9

Source: elaborated with information from Banco de Mexico

But this does not appear to be the case in Mexico. If we take the information in the table above, between 1950 and 1970 and a longer period from 1950 to 1994, growth as measured by GDP is very similar, with a difference of only five decimal points, whereas the inflation gap is enormous, reaching nearly 20%.

During the period dating from 1982 to 1987, part of the so-called lost decade, zero growth was recorded while inflation rose to nearly 100%.

Finally, during the most recent period, from 1995 to 2007, which began with one of the largest economic crises suffered by Mexico last Century,

inflation averaged an annual 12.7% and growth only 2.9%.

In the latest inflation report, which refers to the fourth quarter of 2007, Banco de Mexico forecasts growth in 2008 to range from 2.75% to 3.25%.

Recent Trend in Prices

The risk of inflation that has been present since September 2006 persists, particularly where food and energy are concerned.

The surge in the price of milk, sugar, tortillas and bread, which are basic foods in the Mexican staple diet was particularly striking. In 2007 and 2008, these increases become much more visible.

Another reason for the increase is the growing demand for bio fuels, which as led to an upturn in prices, as is the case of energy products and grain.

We believe there will be supply shocks on the side of food prices and that international oil prices will remain high, which will damage the Mexican economy through imports.

In the case of the supply shocks and international food prices, there is little the central bank can do.

Table 3: Inflation in 2007

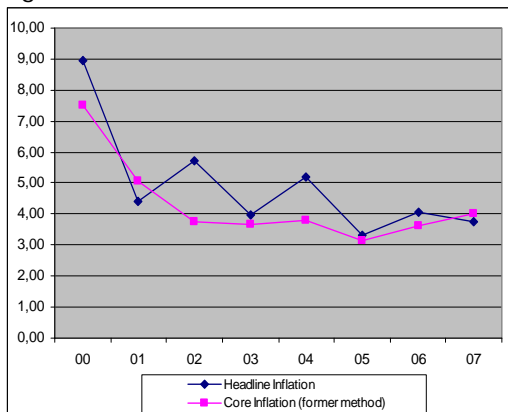
Concept	%
CPI	3.76
Core	4.00
Goods	4.52
Services	3.43
Non core	3.27
Farming and Fisheries	3.42
Administrated and bargained	2.37
Prices	
Education	5.68

Source: elaborated with information from Banco de Mexico

In 2007, as can be observed in the table above, while the overall inflation rate was 3.76%, core inflation was higher than 4% and non core inflation stood at 3.27%. This means there will be price tensions in forthcoming months, judging by the trend in core inflation.

This is mainly due the increase in food prices, as mentioned previously.

Figure 1: Annual Inflation Rate 2000-2007

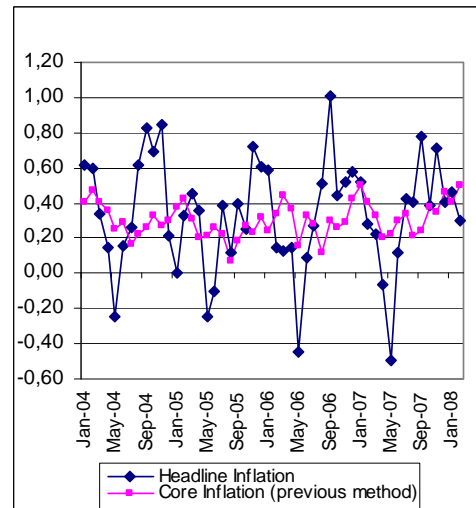


Source: elaborated with information from Banco de Mexico

Core inflation still persists and is likely to do so in the medium term due to the weighting assigned to processed foods.

The graph above illustrates the downward trend up to 2005. However, core inflation rallied from 2006 onwards to the highest level since 2002.

Figure 2: Annual Inflation Rate in 2000 - 2007

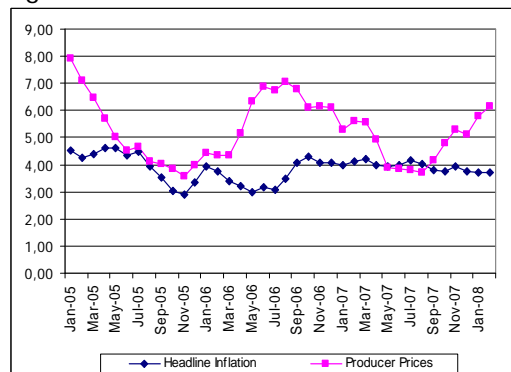


Source: elaborated with information from Banco de Mexico

Producer Prices

This indicator is highly important. If producer prices are higher than consumer prices, the final price of consumer goods will almost certainly rise.

Figure 3: Producer Prices 2005-2008



Source: elaborated with information from Banco de Mexico

The graph above shows how producer prices over the sample period have generally been higher than the overall CPI, except between May and August 2007.

Processed Food Pressure

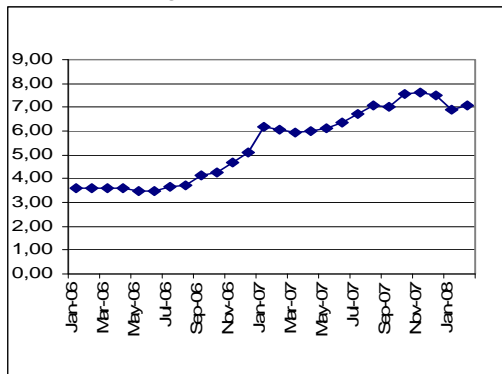
Like other economies worldwide, the increase in food prices in international markets has exercised upward pressure on inflation in Mexico.

Food price pressure is mainly external and worldwide, Mexico has been one of the least affected countries.

The increase in international prices is mainly due to the strong demand for food and energy of some of the countries now known as BRICs, such as China, India and Russia.

As mentioned in our previous report, in 2007 processed food prices rose by 7.5%, almost double the average inflation rate, which was 3.76%.

Figure 4: Annual Inflation Rate in Processed Foods, Beverages and Tobacco 2006-2008



Source: elaborated with information from Banco de Mexico

Prices have risen uninterruptedly since 2006. The graph above illustrates how prices rose from month to month at an annual rate of between 3% and 4% between January and August 2006.

The inflation rate rose to between 4% and 5% from September to November 2006 and in December it stood at 5.10%.

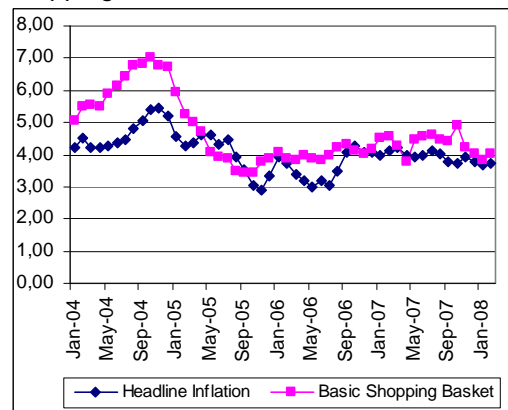
Between January and July 2007, inflation had already risen to between 6% and 7% and between August and

December to between 7% and 8%. Over the first half of 2008, prices have risen by around 7%.

Basic Shopping Basket

The basic shopping basket includes basic household goods, which means that this indicator reflects how inflation affects those households with the least resources.

Figure 5: Headline Inflation and Basic Shopping Basket 2004-2008



Source: elaborated with information from Banco de Mexico

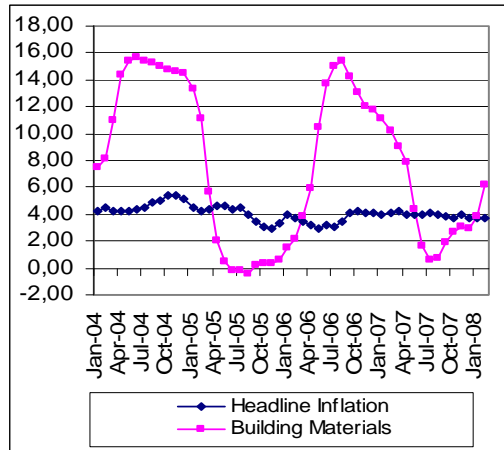
Except on rare occasions, the figures in the graph above reveal that inflation in the basic shopping basket has outpaced headline inflation.

Increase in the Price of Building Materials

It is extremely difficult to predict the trend of the building materials sector in terms of prices, due to its characteristics.

The graph below displays the marked fluctuations this sector has recorded in relation to the headline inflation rate.

Figure 6: Annual Inflation Rate in Building Materials 2004-2008



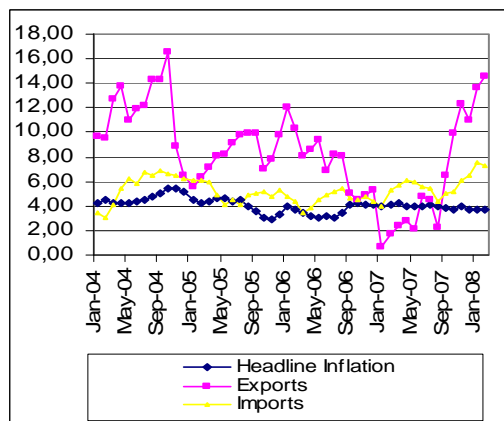
Source: elaborated with information from Banco de Mexico

The latest monthly figure available, which refers to February this year, continues the upturn in building material prices that began in August 2007. The annual headline inflation rate in February stood at 3.72%, while the construction sector recorded a rise of 6.16%.

Foreign Trade Prices

The following graph displays inflation in both exports and imports, measured in dollars.

Figure 7: Monthly Inflation Rate in Foreign Trade 2004-2008



Source: elaborated with information from Banco de Mexico

Both export and import prices have risen markedly since September 2007. Should this increase continue in imports, domestic prices will be affected.

Outlook for Inflation in 2008

Significant price rises are expected at the beginning of the year. Food, building materials and the impact of new taxes are some of the factors that make the future price trend uncertain.

However, the information referring to inflation over the first three fortnights of the year was better than expected. Unfortunately this was not the case over the next two fortnights.

The annually adjusted inflation rate stood at 3.72% in February, within the target range established by Banco de Mexico of 3%, plus or minus 1%. Core inflation stood at 4.14%, if we take the new method, or 4% in the case of the old method.

But close attention will have to be paid, as inflation rose sharply in the second half of February, particularly headline inflation (0.13% in the first half of the month and 0.29% in the second), along with core inflation (0.24% and 0.28% respectively).

Once again, processed foods recorded a 7.1% rise in February, slightly outpacing the rise in January, which was estimated at 6.9%.

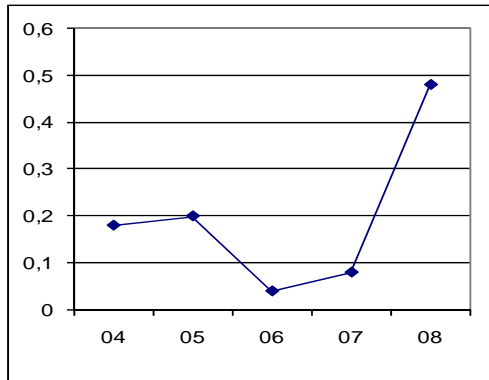
The largest increases were observed in housing, household gas and eggs.

The annually adjusted inflation rate over the first two months of the year stood at 3.71% while core inflation was 4.1%.

The last figure, which refers to the first two weeks in March evidences a significant increase of 0.48%, the

largest increase over this period in the last nine years.

Figure 8: Inflation in First Two Weeks of March 2008



Source: elaborated with information from Banco de Mexico

In the first two weeks of March, headline inflation rose to 4.24% and core inflation to 4.41%. Both these figures are higher than the figure for the first two months of the year.

The annually adjusted inflation rate up to the second half of March barely falls inside the inflation range forecast by Banco de Mexico of between 3.75% and 4.25%, which we will comment on later in this report.

Core inflation rose by 0.33%, double the rise witnessed in the same period last year, which was 0.15%. Non core inflation rose by 0.9%, well above the -0.1% rate recorded in 2006.

Within core inflation, the increases in processed foods and tourist packages once again figured prominently, while the most striking rises in non core inflation were registered by farming and fishery products, energy products and those with administered prices.

We are probably witnessing the beginning of the spread of tax costs to prices, which we believe will more than

like occur in the next few months, if the process has not begun already.

However, food prices will continue to exercise upward pressure on the inflation rate and, furthermore, those who have made their first provision IETU payments will have seen the impact of this new tax and are more than likely already passing it on to the consumer through prices.

The central bank does not foresee aggregate demand pressure. As a result, inflation will be subject to possible supply shocks.

According to the information in the table below, inflation is forecast to drop from the fourth quarter of 2008 onwards, following rises in the second and third quarters.

Table 4: Inflation Forecast by Banco de Mexico 2008-2009

Quarter	Range %
08-I	3.75 - 4.25
08-II	4.00 - 4.50
08-III	4.00 - 4.50
08-IV	3.75 - 4.25
09-I	3.50 - 4.00
09-II	3.50 - 4.00
09-III	3.00 - 3.50
09-IV	3.00 - 3.50

Source: elaborated with information from Banco de Mexico

In the first half of the year, the bank attributes the increase to a possible review of public transport rates in some cities, the IETU and increases in the price of petrol, gas and electricity.

In the second half of the year, the increases in the price of dairy products and food are expected to begin to diminish, which would help the inflation rate to drop.

However, it will be in the third quarter of 2009 when inflation really begins to

converge more clearly towards the 3% target rate.

The risks pointed out by Banco de Mexico for this year and next is that the upward pressure stemming from food and oil-related energy prices and the new tax burden could increase.

This scenario led the Board of Governors of Banco de Mexico to raise interest rates by 25bp to 7.5% at its meeting held towards the end of October last year and no changes have since been made.

According to the latest data from the survey carried out by the central bank on the economic outlook of the private sector, which refers to March 2008, inflation is expected to reach 3.98 in 2008, compared to the forecast of 3.73% recorded the previous month. Inflation is estimated at 3.52% and 3.43% for 2009 and 2010 respectively, while the period dating from 2009 to 2012 is expected to record a rate of 3.44%.

Apparently, wage increases have not contaminated prices and this bodes well for controlling inflation in the medium term. This could lead the bank to relax monetary conditions somewhat, by reducing interest rates by 25 or 50bp in the next few months, particularly if inflation records lower rises than expected.

The slowdown in US economic growth, which was tackled monetarily by reducing interest rates, has led to an increase in the gap between US and Mexican interest rates. This will certainly be an important issue that will have to be taken into account in due time.

Despite the fact that the economy is expected to grow less in 2008, inflation

is forecast to rise towards the top end of the range, at 4%.

In 2008 it will be very important to monitor the variables that could cause supply shocks and affect the fixing of prices, particularly where food, raw materials, new taxes and above all petrol and the IETU are concerned.

Despite Banco de Mexico estimating a 0.5% increase in inflation this year due to the IETU (see the OCEI January 2008 report), the decision on behalf of companies to pass on this tax cost to the price of the goods and services they supply can already be perceived. This will almost certainly appear as we assess the effect of the tax, which has been a lot more significant than expected.

Hector Ruiz Ramirez
Toluca, Mexico, 6 April 2008

