

**Monographic January 2006:  
Economic Forecasts 2006**

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## 1.- U.S.A.

### Forecasts for 2006: one year later, the need to balance books persists. Will it happen this time?

We will now proceed to detail our habitual beginning-of-the-year list of ten forecasts (a summary can be found in Table 1). Forecasts are moderately optimistic on the whole, although the risks, while not very likely to occur, hint towards a downturn.

**Table 1**  
**OCEI Forecasts for 2006**

VARIABLE	2006 FORECAST
▲ <b>GDP (growth)</b>	3.1%
▲ Private Consumption	2.0%
▲ Non-residential investment	7.5%
▲ Residential Investment	-1.0%
▲ Federal Govt. Spending	4.5%
▲ State & Local Govt. Spending	4.0%
Inventories (contribution to the▲)	+0.1%
Net Exports (contribution to the▲)	0.0%
<b>Oil</b> (barrel of WTI; annual mean)	60\$
<b>Natural Gas</b> (millions of BTU, annual mean)	8\$
<b>Unemployment Rate</b> (annual mean)	4.9%
<b>Interest Rates</b> (end-of-year)	5.00%
<b>Inflation Rate</b> (annual mean)	2.75%
<b>Core Inflation Rate</b> (annual mean)	2.4%
<b>\$/€ Exchange Rate</b> (annual mean / end-of-year)	1.24 / 1.28
<b>Federal Govt. Deficit</b> (% of GDP)	3.25%
<b>State &amp; Local Govt. Deficits</b> (% of GDP)	0.4%
<b>Current a/c deficit</b> (% of GDP)	6.5%
▲ <b>Productivity</b> (annual mean)	2.0%
▲ <b>Unit labour cost</b> (annual mean)	2.5%

Source: own elaboration

1) In the absence of exceptional circumstances (2006 has started badly in this sense with problems in both the Persian Gulf and Nigeria), **oil** prices should remain relatively stable, a real necessity following the surge in prices in previous years. If we allow a little room for an increase, we would be

talking about an annual average of \$60/barrel of WTI. Therefore, prices should tend to drop rather quickly once winter is over.

On the other hand, we expect **natural gas** prices to normalise after the excessive rise following the hurricane season, which would imply somewhat of a decrease from the \$8.80 average per million BTU (\$12.20 on average since September), towards the vicinity of \$8.00.

Obviously, the main risk faced by the global scenario is the possibility of tension between Iran and the main western nations escalating and leading to the second most important OPEC oil exporter interrupting or significantly cutting back its supply of petroleum.

2) We anticipate a moderate slowdown in **economic growth**, with GDP forecast to rise by 3.1%, which is closer to the lower end of forecasts on behalf of public and private institutions.

We once again believe the most significant slump will occur in **private consumption**, which we do not think will grow more than 2%. Although many coincide that the financial situation of households will force them to rebuild their savings and, therefore, reduce their consumption, forecasts generally speaking contemplate smaller decreases than we do.

Record household borrowing, the end of monetary accommodation and the absence of foreseeable tax cuts mean that two key factors will determine the sustainability of household consumption. Firstly, the real estate market, which has been a key factor in recent years. On the one hand, if the market loses steam, it will weaken consumption, but on the other hand, if the potential bubble bursts, the market

could collapse. We do not think the latter is likely, although it is the second risk factor in our global analysis.

The second key factor is the source of the best part of household income, the labour market. In this case, we agree with those who do not anticipate remarkable progress in this area, neither in terms of job creation nor wages (for more detail, see point 3 in the list of forecasts).

The probable slowdown in private consumption will be partially offset by an upturn in **government expenditure** in 2006, which we predict will increase by more than 4%.

The Federal government will continue with its plan of extraordinary aid to the region of New Orleans (including spending on infrastructure, family aid and tax benefits) valued at 50 billion dollars. In addition to this, the reform of the medicine supply plan tied to Medicare will involve a supplementary outlay of some 30 billion dollars.

State and local government expenditure should increase even more. Following three years of budget balancing, it is more than likely that these governments will the plans for investment, benefits to underprivileged groups and hiring more staff for public services, which were abruptly interrupted due to the financial crisis in 2002.

Growth in **Non-residential investment** will remain strong in 2006, on the back of remarkably healthy corporate balance sheets and the strong profits obtained over the past three years. This should help to make up for lost time in terms of renewing equipment and software and increase somewhat investment in new

facilities, which has been under tight control to date.

All in all, we do not agree with those who expected double-figure growth, as production capacity utilisation remains between 3% and 4% below the highs recorded in prior expansions and the foreseeable slowdown in consumption will not stimulate a significant increase in production capacity.

The most widespread agreement among analysts, including the OCEI, is observed in the forecast for **residential investment**, which will at least go flat and more than likely decrease somewhat in 2006. The speed at which houses have been built in the past is unsustainable and data revealing a slump in the real estate market has been in the economic headlines in recent weeks.

Finally, we expect foreign trade to stop detracting from GDP (see point seven in the list of ten forecasts) and inventories to make a contribution, albeit minimal, offsetting the decrease observed in 2005.

3) In light of the outlook for growth, we expect the **labour market** to be somewhat less buoyant than over the past two years. This will result in job creation being slightly higher than the growth in the labour force, and only because we are taking for granted that the latter will not reach past figures in this economic cycle. This scenario would produce an unemployment rate of 5% (one tenth less than in 2005), far from the rates of below 4% that were recorded in 2000.

In addition to this, we believe few changes will occur in what some authors have labelled the "wageless

recovery"<sup>1</sup>. It is true that the decrease in inflation will mean that the moderate nominal wage increases will result in real gains. In exchange, the tendency to eliminate part of the non-wage benefits (health, pensions) received by workers in US companies seems to be consolidating.

If the spectacular staff cuts announced by large manufacturers in Detroit are anything to go by, our outlook for the labour market may well even be overly optimistic.

4) The Federal Reserve made it clear in a press statement on its last meeting and in speeches made by top level representatives that the main phase of monetary normalisation is over. Future decisions will depend on the economic results in 2006.

However, we believe that the reference interest rate will be raised by 25 basis points in both the next two meetings in January (the last to be chaired by Greenspan) and in March (the first with Bernanke as governor). The first rise will signify the end of the monetary accommodation in recent years, while the second will be a display of an unmistakable commitment on behalf of the new Chairman to combat inflation.

Experts and economic journalists are in greater disaccord over what will happen after this. In our opinion, with growth, private consumption and housing prices all tending downwards, the Fed will feel at home with the monetary conditions currently in force. One further rise in the second quarter will probably be the last in this series of increases. Further rises would only occur if the increase in

energy costs were passed on to the rest of the economy.

On the flipside of the coin, we do not expect the Fed to cut interest rates during 2006, unless one of the risks that have been outlined in this report becomes a reality<sup>2</sup>.

We therefore expect the Fed Funds rate to remain at 5% in the second half of 2006.

5) The **inflation** rate will tend to drop steadily throughout 2006. With demand exercising less pressure and in the absence of negative shocks, worldwide globalisation and strong domestic competition should push CPI growth down to little more than 2% by the end of 2006, leaving the average for the year at around 2.75%.

On the other hand, slightly higher inflation expectations following almost five years of accommodating monetary policy and a decrease in idle production capacity (the size of which depends on the sector), could push core inflation up slightly to 2.4% (two decimal points above the figure for 2005). However, we do not think wages will threaten price restraint (see points 2 and 3 in the top ten).

6) As far as the **US dollar** is concerned, our outlook is for progressive depreciation.

In the case of the euro particularly, while the average for 2006 will not differ significantly from the 1.244 mean registered in 2005, trend will be the exact opposite. The \$/€ exchange rate

<sup>1</sup> Morgan Stanley Chief Economist Stephen Roach, for example.

<sup>2</sup> The fact that interest rates have begun to drop in the past some six or seven months after the end of a period of increases is, in our opinion, no reason to believe in robot-like behaviour on behalf of the Fed, as some analysts seem to suggest.

will be in the low 1.20's in the first half of the year, tending to rise towards 1.30 in the second half of the year. As economic (and productivity) growth in the Euro-zone approaches that of the United States, the advantage of the dollar in real economic terms will diminish. At the same time, the end of monetary normalisation on behalf of the Fed in comparison to the European Central Bank, which is still in the midst of the same process, will stop the interest rate gap between the two sides of the Atlantic from increasing, thus redirecting financial investment flows in favour of Europe.

These factors should see the US foreign trade deficit once again hit the headlines by the second half of 2006 and the dollar will be one of the elements (although not the most important) used to correct it.

Note, however, that we do not believe the value of the dollar will plummet with respect to the euro, as interest rate and growth differences still favour the United States.

The same situation could occur with the **yen**, but with an important difference: the interest rate gap will become even wider in 2006, as the Bank of Japan shows no sign of abandoning its policy of zero interest rates. Consequently, the depreciation of the dollar will be weaker.

As regards the Chinese **yuan**, a slight appreciation is expected with respect to the US dollar, in line with the 2.5% rise recorded in 2005. A marked appreciation of the yuan is unthinkable in light of the tremendous and necessarily careful management of monetary policy on behalf of the Chinese government and with the country's dependence on foreign trade.

Chinese reserves (more than 800 billion dollars), in which assets in US dollars figure prominently, are also unlikely to be restructured for the same reasons, despite speculation in this sense in recent weeks. However, a crash in the dollar due to this cause or any other, however unlikely, is the *third risk* faced by our overall scenario.

7) The current account deficit will not be reduced at all in 2006, although we do expect it to finally stabilise at around 6.5%.

The deficit will not benefit from the depreciation of the dollar yet (initially, the effect could be negative due to imports becoming more expensive before their volume adjusts) and the increase in interest payments to US Treasury bondholders will add a few extra decimal points to the deficit<sup>3</sup>.

In contrast, weaker domestic demand in the United States and stronger economic growth in the Euro-zone and Japan will be crucial factors in preventing the deficit from further deteriorating, together with a smaller increase in the energy bill.

However, the situation seems unlikely to improve significantly, as ever reliable mathematics illustrate. In view of the current level of imports and exports, the latter would have to increase by almost 16% to offset a 10% rise in imports. In order to reduce the deficit by one percentage point, taking into account the same increase in imports, foreign sales would have to augment by 25%, which certainly seems difficult.

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<sup>3</sup> Morgan Stanley forecasts the current account deficit to increase by between 0.6% and 0.8% of GDP as a result of the increase in interest rates in the United States.

8) We have already indicated that state and local government spending is more than likely to increase substantially. However, weaker economic growth implies a smaller increase in revenue this year. Therefore, the **public-sector deficit** will increase in 2006. We forecast a deficit approaching 430 billion dollars (3.25% of GDP) for the federal government, which must be added to the balance of state and local governments that will recover the trend observed in the 1990s with a deficit of three or four decimal points of GDP.

We must insist for the umpteenth time that the ongoing imbalance in public finances should be considered terrible news, in light of the stage of the cycle and particularly after the Clinton administration had successfully eliminated the deficit during the previous expansion and converted it into a surplus. The current government has clumsily squandered this inheritance, particularly in view of the challenges on the horizon for the public sector (social security, Medicaid, Medicare).

9) The **productivity** rate will probably converge with its long term trend in 2006 now that the benefits of the factors that in the 1990s laid the foundations for the formidable performance of this variable in recent years<sup>4</sup> have been reaped. Hence, we expect productivity to grow by approximately 2% in 2006.

Growth in unit labour costs should exceed that registered in previous periods due to the slowdown in productivity described above, following the same pattern that began in 2005.

However, the aforementioned cut in non-wage earnings, together with moderate wage growth leads us to forecast an increase of no more than 2.5% in Unit Labour Costs in 2006.

In light of the pattern observed in costs and productivity together with the fact that companies have little room to increase margins and demand is levelling out, **corporate profits** should decrease from the double figure increases we have been used to over the past four years to between 5% and 7%.

10) **What about 2007?** If our outlook for moderate growth and a minimal correction of imbalances for this year are more or less accurate, these trends should become more pronounced in 2007.

Therefore, the growth rate would drop further, consumption would follow suit, while households would continue to restore their savings. Non-residential investment and public spending would slow down, while real estate activity would partly recover the strength displayed in the recent past and foreign trade would make a slightly more favourable contribution to growth. Inflation would be clearly below 2%, while the public sector and foreign trade deficits would begin to decrease, albeit timidly. Monetary policy will probably backtrack a little.

All of this is nevertheless the distant future when talking about the analysis of the current economic environment. We will first have to wait and see what 2006 has in store for us.

Vicente J. Pallardó.  
Valencia, January 24, 2006.

<sup>4</sup> See monographic article on growth and productivity in the OCEI November 2005 report for an in-depth analysis of these factors.

## 2.- Euro-zone

### Forecasts for 2006

The outlook for the world economy this year is highly favourable according to the IMF. World GDP is expected to grow by 4.3%, identical to that observed last year, while slightly lower than the figure recorded in 2004. Growth in the US and China is forecast to level out slightly. In view of the improved confidence indexes, the president of the ECB stated that growth could even exceed this figure, boosted by a recovery in investment.

As regards the Euro-zone in particular, almost all the research departments of the most important banks and official institutions such as the IMF, the OECD and the European Commission are optimistic about economic growth, which they estimate will be in line with that registered in 2005. While the IMF forecasts 1.8%, the EC and the OECD are more optimistic and forecast a growth rate of 2.1%.

Table 3.1: GDP and CPI Forecasts for 2006

	PIB	IPC
Banesto	2.0%	1.9%
SCH	1.8%	1.9%
HVB	1.5%	2.1%
BNP PARIBAS	2.1%	2.0%
Société Générale	2.1%	2.1%
CDC	1.6%	2.2%
Merrill Lynch	1.6%	1.7%
CALYON	2.0%	2.4%
BOFA	1.9%	1.9%
Commerzbank	1.8%	1.8%
JP Morgan	1.8%	1.6%
ABN AMRO	1.8%	1.9%
UBS Warburg	1.7%	2.2%
Barclays Bank	1.9%	2.2%
Citibank	1.9%	1.9%
Caja Madrid	1.8%	2.0%
Goldman Sachs	1.7%	1.3%
West LB	1.7%	1.8%
Daiwa	1.9%	1.7%
The economist	1.8%	2.0%
OECD	2.1%	1.7%
EC	2.1%	
IMF	1.8%	1.8%

Source: own elaboration

The average forecast for GDP growth in the Euro-zone of the 19 national and international banks consulted was 1.8%, the highest being 2.1% and the lowest 1.5%. By component, they expect private consumption to record similar progress to that observed in 2004 and 2005, without changing significantly. As far as gross fixed capital formation is concerned, they believe the upturn witnessed last year will continue this year. Foreign trade will continue to play a key role in the recovery throughout 2006.

The same institutions estimate that consumer prices will rise by 1.9%. The best part of analysts, therefore, consider wage moderation and the improvement in productivity guarantees of price stability in 2006, regardless of

the impact of administrative prices, indirect taxes and energy price rises.

As far as the unemployment rate is concerned, estimates of 8.4% or 8.5% (worse than in 2005) are expected. Consequently, net employment is not forecast to recover significantly this year. The overall public-sector deficit is forecast to be 2.9%, two tenths worse than the figure published in 2004.

Banks have no doubt that the ECB will raise interest rates. The point is, when and how much? The average outlook is that the ECB will only raise interest rates by 50bp throughout 2006, taking the minimum bid rate to 2.75%. The highest estimate involved a 125bp-rise. Monetary policy flattens out growth in long term yields, with the 10-year bund reaching 3.75%.

As regards the dollar/euro exchange rate, these institutions forecast on average the euro to appreciate to 1.27. Some even forecast 1.39. The reasons behind this forecast are, on the one hand, the interest rate rises of the euro together with the fact that the US interest rates are expected to remain fairly stable, is likely to make assets in dollars less appealing; on the other hand, growth in the USA is expected to drop slightly.

Obviously, the ECB will have to take into account how strongly consumption is recovering when deciding on the size and the date to raise interest rates so as not to risk the sustainability of growth in the Euro-zone; maintaining price stability and the degree of appreciation of the euro with respect to the dollar, so that monetary conditions do not become excessively restrictive.

### **OCEI Forecasts for 2006**

The OCEI is optimistic about growth in the Euro-zone in 2006 and also expects growth in the last quarter of 2005 to raise the overall growth for the year to 2%.

We expect the annual GDP growth rate to pick up slightly this year to between 2% and 2.2%.

We expect private consumption to surge more strongly, mainly due to a 1.1% rise in employment and assuming that housing prices will continue to climb by around 6% and stock market increases, which are correlated to increases in corporate profits. In this sense, private consumption is estimated to grow by 1.6%.

As far as gross fixed capital formation is concerned, the buoyancy observed in recent quarters is expected to be maintained, as no adverse changes are foreseen in expectations. Therefore, we forecast investment to grow by 3.3% in 2006.

Government expenditure will grow on average the same amount as in previous years. We forecast a growth rate of 1.6%.

Foreign demand will contribute 0.2% to growth. Exports will increase by 5.8%, boosted by ongoing world economic growth, but will be held back by around a 4% appreciation of the real effective exchange rate, as we expect the euro to rise from 1.18-1.19 dollars to 1.25-1.27 dollars. Imports will rise by 5.6%, in line with growth in domestic demand.

Apart from possible future pressure from energy prices, the moderation that will dominate wage negotiations, due to the factors described earlier in this report, should lead prices to remain

stable. In this sense, the inflation rate could range from 1.9% to 2%.

As regards the unemployment rate, the 1.1% growth rate forecast for net employment will push down the unemployment rate. Depending on growth in the labour force in 2006, the unemployment rate will range from 7.9% to 8.1%, almost reaching structural unemployment for the Euro-zone.

Interest rates will clearly increase. The ECB minimum bid rate has for a long time now been much lower than they should have been considering the cyclical situation. It is high time the ECB raised interest rates to between 3.25% and 4%. In this sense, we believe the bank will raise interest rates throughout 2006, taking the minimum bid rate to between 3.25% and 3.5% towards the end of the year. Obviously, the strength of consumption, how much the euro appreciates with regard to the dollar and price stability will influence the bank's decisions as to when and how much interest rates will rise. Long term interest rates will tend upwards, but the curve will be slightly flatter than the minimum bid rate, with the German 10-year bund ranging from 4%-4.25%.

#### SUMMARY OF ECONOMIC FORECASTS

VARIABLES	2005	2006
GDP*	1.9%-2%	2%-2.2%
Private Consumption*	1.2%-1.3%	1.6%
Government Spending*	1.8%	1.6%
Fixed Investment*	2.9%/3.4%	3.3%
Exports*	6%	5.8%
Imports*	5.4%	5.6%
Net Employment*	0.9%	1.1%-1.2%
Unemployment Rate	8.3%	8.1%-7.9%
Inflation Rate		1.9%-2%
ECB minimum bid rate		3.25%-3.5%
10-year Bund		4%-4.25%
Euro/Dollar		1.25-1.27

\*Annual Growth Rates

Nicolás Jannone  
Valencia, January 27 2006

### 3.- Spain

#### Macroeconomic Forecasts for 2006

After carefully revising some of the most striking aspects of the current macroeconomic scenario, we will now present and discuss our forecasts for 2006. In order to make economic forecasts, we must first reflect upon the macroeconomic situation in which economic activity will be carried out. In this sense, one of the elements that creates the most uncertainty, in view of its importance for economies, is the **price of oil**.

The upturn in oil prices affects economies in at least the following ways:

1. It slows down world demand, as those countries that are oil importers are more prone to consume than exporting countries.
2. It increases business production costs and affects profit outlooks and investment projects.
3. It increases inflation:
  - Directly: on pushing up the price of energy products
  - Indirectly: if consumers try to offset the decrease in purchasing power with nominal wage rises, or if business executives attempt to restore profit margins.
4. It affects growth expectations, inflation and profits, which has a repercussion on world financial markets, which are also affected by the way those countries that are net exporters place their savings.

The Spanish economy has a large energy deficit as the country imports oil, natural gas and, albeit to a lesser extent, coal. The energy deficit increases as both economic activity and the price of energy products grow. Furthermore, the drought in recent years has led to an increase in fossil fuel imports in order to generate energy.

In 2006, as long as there are no shocks, the price of oil is expected to be more stable, but higher. The demand pressure exercised by emerging Asian nations (that use energy resources more inefficiently) and the limitations on the supply side, can be expected to create this situation. The European Commission estimates the price of a barrel of Brent at \$61.40. In our opinion, the price will rise slightly beyond this figure to around 65\$, as pressure on the demand side will continue and price elasticity of demand remains low.

In relation to the Spanish oil bill, it is worth underlining the fact that significant fluctuation is not expected in euro-dollar exchange rate (at around \$1.20-\$1.25 per euro). In addition to this, there are other positive factors. Firstly, the cost of crude oil imported by Spain is one of the lowest in the OECD, as producers are relatively nearby (the same occurs with natural gas). Secondly, energy efficiency has improved slightly in recent years on minimally reducing dependence on oil, which is being replaced by natural gas and electricity in both industry and households and as a result of national coal being substituted by imported coal, which is less costly and contains less pollutants (despite the current account deficit increasing as a result).

On the other hand, the world economy will more than likely continue to expand following the crisis in 2001. The European Commission expects the world economy to continue to register sound growth. The world economy (excluding EU25) will grow at a rate of around 4.9%. The USA and emerging Asian nations (mainly China and India) are responsible for a great degree of this growth. In Europe, low interest rates, strong growth in world demand, the depreciation of the euro since the beginning of 2005 and an improved business climate suggest the economy will be more buoyant this year with a growth rate of around 2.1%.

The next section of this report presents the forecasts for the Spanish economy in 2006:

1) **Economic growth** will continue. GDP will grow by around 3.1% in 2006, which despite being lower than the rate observed in 2005, remains very close to Spain's GDP growth potential. Our forecasts are in line with those carried out by various experts and institutions (see Table 2). Notwithstanding, the most optimistic forecasts are those made by the Ministry of Economic Affairs, which expects growth to reach 3.3%, three decimal points more than the forecast made by the IMF and one decimal point less than the overall growth rate expected for 2005, in the absence of the final data for the fourth quarter.

Table 2: Macroeconomic Forecasts (real growth rates unless notes indicate the contrary)

	[1]	[2]	[3]	[4]
GDP	3.3	3.2	3.2	3.0
Private Consumption	3.5	3.9	3.3	4.0
Govt. Spending	4.1	5.3	4.6	4.0
Fixed Investment	5.9	5.3	5.7	4.2
Change in Inventories	0.0	0.3	0.0	0.0
Domestic Demand*	4.4	4.7	4.4	4.0
Exports of G&S	2.6	1.7	5.1	4.0
Imports of G&S	5.8	6.4	8.1	7.0
Foreign Demand*	-1.1	-1.5	-1.2	-1.2

\* Contribution to growth

[1] Ministry of Economic and Financial Affairs. December update of the 2005-2008 Stability Programme.

[2] European Commission. European Economy. November 2005.

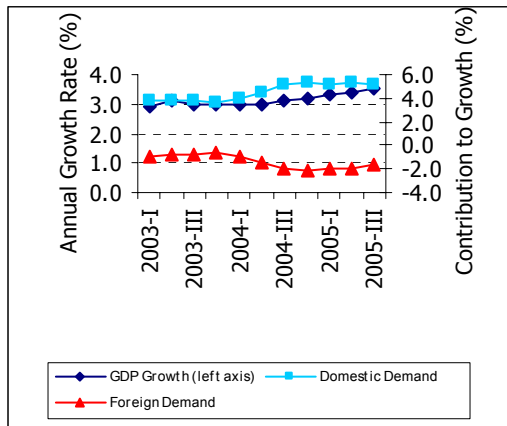
[3] OECD. Economic Outlook Nº 78. November 2005.

[4] IMF. World Economic Outlook. September 2005.

Moreover, there appears to be agreement over the fact that domestic demand (consumption and investment) will once again emerge as the economy's main growth engine, while the external sector will drain growth significantly.

2) In our opinion, which coincides with that of most experts, the **structure of growth** is likely to be more balanced than in the past (Figure 1) in terms of aggregate demand. Domestic demand is expected to slow down slightly, the external sector is forecast to detract less from growth, inflation to moderate and the unemployment rate to drop.

Figure 1: GDP Growth and Growth Contributions



However, we do not believe the change in the structure of growth will be sizeable, as opposed to government forecasts. We think the external sector could detract between 1.3 and 1.5 percentage points from GDP, similar to the forecasts made by the European Commission and the IMF. The reasons we believe foreign trade will continue to deteriorate are as follows. In the first place, monetary policy will become more restrictive quickly, which means real interest rates will remain negative in Spain. As a result, domestic demand pressure will continue and entails an increase in imports. In the second place, the price competitiveness of the Spanish economy will continue to decline while the inflation gap is not reduced. In the third place, productivity growth will be modest. The only favourable factor is that a slight recover is expected in Europe, which should boost Spanish exports, which are geographically concentrated in the region.

3) **(Public and Private) Consumption**, while remaining vigorous, will witness a slight decrease in growth.

**Private consumption** decisions are made by households. Household expenditure on consumption and residential investment accounts for approximately two thirds of GDP. Private consumption is mainly determined by real disposable household income, which is influenced mainly by the situation in the labour market (employment growth and wages) and Public Administrations (taxes, transfers etc...). In addition to this, financial and non-financial wealth (stock market progress, housing prices etc...), together with the level of real interest rates, borrowing and expectations (measured by consumer confidence indicators) are also determinants.

Taking all these factors into account, we believe private consumption will remain vigorous in 2006 (albeit to a lesser extent than in previous years), as monetary policy will remain accommodating for the Spanish economy despite possible interest rate rises throughout the year. Robust growth in employment, albeit less than in 2005, and immigration will also bolster growth. Growth in private consumption will more than likely outpace that of disposable income, causing a decrease in the private savings rate (taking household debt above 100% of disposable income). A slight slow down in housing prices will also contribute to the overall slowdown with respect to 2005. Another element that is having a similar effect is the increase in wages and the minimal growth in productivity, which could negative affect business' demand for employment. Consequently, with household income expectations dropping and interest rates on the rise, household expenditure on consumption

could slow down. Forecasts for growth in this variable range from 3.3% (OECD) and 4% (IMF).

Growth in the final **consumption of Public Administrations** will also drop slightly. Government spending includes expenditure on final consumption and public-sector investment, which depend mainly on the government's objectives, including restrictions. Government revenue also plays an important role in light of the public-sector deficit targets set by the government. In this sense, the Ministry of Economic and Financial Affairs forecasts public-sector income to uphold its contribution to GDP. In the first place because current income and property tax will increase as a result of a rise in gross disposable household income (wages, pensions, capital gains) and corporate profits. Secondly, the high growth rate of nominal aggregate household expenditure (consumption and purchase of houses) will raise income through indirect taxation together with the increase in some indirect taxes (alcohol, tobacco). Finally, growth in employment will increase social security contributions.

On the other hand, the government expects public-sector expenditure to maintain its share of GDP as a consequence of the effort towards improving basic public services (defence, national security), the commitment to maintain a high level of public-sector investment with respect to GDP, current and capital transfers, public debt interest payments, which will diminish as the debt/GDP ratio decreases. The top priority of the Ministry of Economic and Financial Affairs is to channel expenditure towards items that are more able to boost **growth in productivity**, real convergence and sustained long term

growth. These items include expenditure on R+D+i ("Plan Ingenio 2010"<sup>5</sup>), developing the society of information, investing in infrastructure (transport – "Plan Estratégico de Infraestructura y Transporte 2005-2020"<sup>6</sup> – and hydraulic investment – "Programa AGUA"<sup>7</sup>) and strengthening education policy (reform of the Organic Law of Education – "LOE" in Spanish). The Spanish economy has a compelling need to improve productivity.

As a result, government expenditure will continue to grow by more than 4%, a forecast that is shared by all the institutions we have consulted with the exception of the IMF which forecasts a 4% growth rate for both private and public-sector consumption.

4) Growth in **investment** will remain buoyant in 2006, but noticeably less than in 2005. Institutions offer a wide variety of forecasts for this variable which range from 4.2% for the IMF to 5.9% for the Ministry of Economic and Financial Affairs. In this case, we forecast growth to range from 5.6% to 5.7%.

Macroeconomic investment (in equipment and construction), depends on decisions made by households (residential investment), businesses (private production investment) and the public sector (government investment). Residential investment depends on factors such as permanent income, the real usage cost, financial wealth and the unemployment rate. On the other hand, private production investment, which includes investment in non-residential construction on behalf of

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<sup>5</sup> Inventiveness Plan 2010.

<sup>6</sup> Strategic Plan of Infrastructure and Transport 2005-2020.

<sup>7</sup> WATER Plan.

businesses, is influenced by expected demand, capital utilisation cost, relative prices of production factors, total factor productivity, etc.

**Gross fixed capital formation** is expected to continue to grow substantially. However, there are significant discrepancies as to the forecast for the future, in light of the fact that expectations play an important role in the progress of this variable.

**Investment in equipment** will continue to increase quickly (as was the case in 2005), while **residential investment** will moderate slightly. Equipment investment will remain buoyant, which will probably also be reflected by imports, due to the dependence of this sector on these capital goods. The construction sector will resist and continue to make progress. Highly accommodating financial conditions and corporate profitability, the expect recovery in exports and the possible effect of measures aimed at stimulating progress in productivity could bolster investment in equipment to certain extent. On the other hand, low (although rising) real interest rates together with the high yields of real estate assets and the mortgage loan extensions introduced recently by financial institutions suggest that residential investment will not drop suddenly, despite the high level of household borrowing. Moreover, the expected reactivation of the market for renting houses still seems a utopia.

5) The **labour market**. Employment increased strongly in 2005 (approximately 3%), which has made the increase in the labour force (immigration and an increase in the female activity rate) compatible with a significant decrease in the unemployment rate.

The rate at which jobs are created is affected by economic activity (domestic and foreign demand), together with progress in costs (including wages) and the business climate. The growth rate will seemingly be high and there will also be an improvement in foreign demand. The business scenario also appears to be satisfactory. However, economic activity will decrease slightly with respect to 2005. In addition to this, the high inflation rate recorded at the end of 2005 together with wage indexation clauses could bring about an increase in nominal wages that, combined with the weak growth in productivity, could increase unit labour costs and hence hold back job creation.

We therefore believe the economy will continue to create employment at a fair rate (although slightly less than in 2005) of approximately 2.6%.

6) **Exchange rate**. Developments in the exchange rate are related to factors such as macroeconomic imbalances and expectations as to the future action on behalf of economic policymakers. Although it could be affected by shocks, the dollar/euro exchange rate will initially remain relatively stable between 1.20 and 1.25.

7) **Interest rates** depend on how significant inflation risks are and the buoyancy of Euro-zone economies.

Recent months have anticipated an increase in interest rates in light of inflationary tension. However, the risk of holding back the recovery of key Euro-zone countries has held back interest rate rises. As European economies begin to show clear signs of recovery, monetary policy can be expected to be made tougher. We forecast interest rates to be in the

vicinity of 2.75% to 3% by the end of the year.

8) The **inflation** rate for 2005 was 3.7%. However, slightly less pressure from domestic demand together with energy prices having a less negative impact and a slow but steady increase in interest rates could lead to a slightly more favourable inflation scenario, both in terms of GDP deflator and the Consumer Price Index. Wage moderation is limited by the second round effects of the increase in the price of oil.

However, the high inflation rate observed in 2005, which well and truly exceeded government forecasts, could lead to an increase in unit labour costs due to wage and earnings being indexed. In view of this situation, the manufacturing sector, which is more exposed to international competition, could see its profit margins reduced. Meanwhile, prices in the sector of non-tradable goods (mainly services and provision of basic necessities such as electricity, water and gas) will increase, allowing margins to be maintained. The minimal competition in the services sector sparks a situation of dual inflation which makes it difficult to reduce inflation gaps with respect to the Euro-zone, which remain above 1%. Consequently, prices can be expected to rise by approximately 3.4%.

9) **Current account deficit.** As far as the external sector is concerned, factors such as worldwide growth, imbalances in the US economy, how strongly some of the largest countries in the Euro-zone (where a large proportion of Spain's exports are destined) are growing, energy prices and exchange rates (together with the government's ability to control internal

inflation and reduce the inflation gap with respect to other countries) make it more difficult to forecast the future.

In 2005, foreign demand detracted approximately two points from economic growth. The Spanish economy has become less and less competitive in recent years, as mentioned earlier, due to the inflation gap and modest growth in productivity.

Subsequently, the external sector will probably continue to deteriorate. Despite the economic recovery expected in European countries and sound growth forecast worldwide, both of which will boost Spanish exports, the trade deficit will climb to around 8.5% of GDP. Less pressure from domestic demand could moderate the increase in imports. However, if this reduction is caused by a slowdown in the construction sector, the impact on imports will be minimal due to the lack of import propensity in this sector. Investment in equipment will continue to boost the increase in imports.

On the other hand, we can expect growth in net income from tourism to remain flat and a deficit in the income and transfers balance. As a result, external borrowing will continue to increase. The current account deficit could range from 8.2% to 8.3% of GDP. The economy is forced to borrow due to private savings being insufficient to finance investment, while the State has become a net saver. Thus, external borrowing will continue to grow, which will probably cause serious problems if economic growth slumps. Furthermore, where funding is concerned, the weight of foreign direct investment will probably continue to diminish, whereas short term investments will figure more prominently.

10) **Productivity:** Despite a certain amount of government spending being redirected towards achieving improvements in productivity, progress in this area will not exceed 0.5% in 2006. As a result, employment will once more be the main source of GDP growth.

11) The **public-sector deficit** will depend on the changes in government income and expenditure. These two determinants were discussed at length in point three, so we will not expand on this topic further.

Forecasts suggest that public sector accounts will remain balanced in 2006, with a surplus in the vicinity of 0.2% of GDP.

#### Main Risks

Now that the forecasts have been reviewed, it is necessary to determine the risks to the overall macroeconomic scenario anticipated. These risks depend mainly on two factors:

- The degree of uncertainty with regard to external or financial suppositions
- The accumulation of imbalances, whose correction is subject to a variety of uncertainties

Spain's exports are highly concentrated geographically speaking, with around 60% of exports being accounted for by a high proportion of tourists from the Euro-zone. Less foreign demand due to a smaller recovery in EMU member states would hold back the expected upturn in exports of goods and services and also investment (investment in equipment is becoming increasingly correlated to the cycle of activity abroad, particularly in the EMU). The size of the recovery could depend on

what direction monetary policy takes. It could become too restrictive for some countries. Another risk is the high degree of uncertainty over energy prices, especially where oil is concerned, but also natural gas in light of its demand displaying relatively low price elasticity and the fact that the economy is highly dependent on energy. Risks also arise in the case of monetary policy becoming tougher than agents' expectations, in view of the high level of borrowing of Spanish households. An increase in interest rates would stop households from spending, as their financial burden would increase and their wealth could decrease due to housing prices more than likely levelling out.

Regardless of how accurate our forecasts are, some of the concerns we mentioned when summarising 2005 will seemingly persist in 2006. Weak competitiveness that is continuously deteriorating, reflected by the foreign trade deficit, is a sign that Spain's growth model is not sustainable in the long term. This situation has been underlined on several occasions by the OCEI, although it is difficult to know exactly when the situation will change. The slow progress expected in productivity (even in the encouraging scenario described by the Ministry of Economic and Financial Affairs) and inflation over 3%, thus maintaining the high inflation gaps, do not bode well for the situation in the short and medium term. We will have to wait and see if the government's new economic policy strategy outlined in "Actualización del programa de estabilidad 2005-2008"<sup>8</sup> promotes a change in the model by means of action aimed at increasing productivity: the "Plan de Dinamización

<sup>8</sup> Update of the 2005-2008 Stability Programme

de la Economía e Impulso a la Productividad”<sup>9</sup> and the “Programa Nacional de Reformas: Convergencia y Empleo”<sup>10</sup>. To give just one example, Spain was ranked 16th in the EU25 in terms of innovation in 2005.

Silviano Esteve  
Valencia, January 26 2006

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<sup>9</sup> Plan to Stimulate the Economy and Boost Productivity

<sup>10</sup> National Reform Plan: Convergence and Employment

#### 4.- Germany

##### Forecasts for 2006

Forecasts made by the various institutions for this year are relatively cautious with respect to the German economy, although they all coincide that the current situation will improve slightly. Not one of the institutions we have consulted predicts a growth rate of more than 2% for 2006 and some of them, such as the IMF, forecast growth rates that barely exceed 1%. Caution, in this sense, is the predominant factor in these forecasts. The fact that these forecasts suggest the German economy will be sluggish this year does not bode well for unemployment or inflation data either. Few institutions foresee unemployment dropping below 11% this year, while the average forecast for the inflation rate stands at 1.5%, with 1.7% being the figure that was most repeated. These figures therefore indicate the lack of confidence in the German economy recovering strongly in 2006.

Table 8: Selection of Forecasts for 2006

	GDP	Unemployment	Inflation
IFO	1.7	10.7	1.7
ZEW	1.5	10.4	1.5
EC	1.6		1.1
FMI	1.2	9.3	1.7
OCDE	1.8	9.1	1.7
BNP	1.7	11.1	1.4

Source: own elaboration

##### Economic Growth

As far as economic growth is concerned, our forecast falls in line with those made by other institutions. We expect GDP to grow between 1.4% and 1.7%. As hard as we try, we cannot find any elements that warrant more optimistic figures. Unfortunately, progress in the German economy continues to falter excessively.

##### GDP Components

As regards GDP components, we do not expect consumption to change its current trend. In fact, we expect quite the opposite. We once again lack signs that support a more favourable opinion. Nevertheless, we do expect investment to rally to a certain extent, even if only due to the successful end of the political crisis in 2005 and the positive action being taken by the new government on various fronts. The private sector is expected to respond favourably to these events and for this reason we forecast an increase of between 2.5% and 3.5% for gross fixed capital formation. We also expect government spending to continue propping up the economy, as has been the case to date, at least until the private sector picks up.

As far as the external sector is concerned, we expect the pattern displayed by the German economy in recent years to continue. Consequently, exports will grow significantly, despite starting out at a very high level, while growth in imports will lag behind.

In short, we see this year as a period of transition towards better times with higher growth rates which will not be achievable until a few years have passed and always providing domestic demand recovers.

##### The Unemployment Rate

We expect unemployment to decrease throughout this year, although it is still too early for a significant improvement. We do not expect the unemployment rate to drop below 10%, but do forecast a decrease of between 0.5 and 1 point with respect to the current level. Unemployment seems unlikely to decrease unless there is a prior recovery in domestic demand.

### Public Sector Deficit

The new government's intentions together with the first initiatives in this direction, lead us to believe the public sector deficit will decrease. Notwithstanding, it remains difficult to believe the Germany will comply with the criteria stipulated in Stability and Growth Pact this year unless there is a more significant improvement in the German economy than is currently foreseen. Therefore, we forecast the public sector deficit/GDP ratio to range from 3% (in the best of cases) to 3.5%.

### Inflation

Providing there are no more oil shocks, the German inflation rate will more than likely range from 1.5% to 1.7%. Prices are not expected to rise further unless domestic demand recovers. At the same time, our forecast is also based on the fact that the ECB is monitoring this issue more closely, which makes an interest rate rise likely.

In short, 2006 will be a year of transition and book balancing in the German economy, awaiting the possibility to grow more soundly in years to come.

Table 9: OCEI Forecasts for 2006

	Minimum	Maximum
GDP	1.4	1.7
<u>GDP Components</u>		
Private Consumption	0.0	0.2
Fixed Investment	2.5	3.5
Government Spending	0.7	0.9
Exports	7.5	8.5
Imports	5.5	7.5
Unemployment Rate	10.0	10.5
Public Deficit/GDP	-3.0	-3.5
Inflation Rate	1.5	1.7

Source: own elaboration

Antonio Cutanda  
Valencia, January 24 2006

## 5.- France

### Forecasts for 2006

As far as our forecasts for 2006 are concerned, most institutions predict GDP growth to be around 2%, which is a realistic figure in view of the possibilities of the French economy this year. As this is the minimum figure required in order to create employment in France, all institutions forecast the unemployment rate will remain relatively unchanged at 9.5% to 9.6%. The inflation is expected to be around 1.5%, in keeping with the weak growth scenario expected.

Table 8: Forecasts for 2006

	GDP	Unemployment	Inflation
BNP	2.0	9.5	1.4
IMF	1.8	9.6	1.8
OECD	2.1	9.6	1.7

Source: own elaboration

### Economic Growth

Our forecast for economic growth is in line with those made by the best part of institutions. In this sense, we expect the French economy to grow between 1.8% and 2%, in 2006, which would be quite an improvement on the current level of economic growth.

### GDP Components

As regards the various components that make up GDP, we believe domestic demand will continue to be the mainstay of the French economy, as has been the case in recent years. We expect private consumption to rise by between 1.8% and 2.1%, while fixed investment will increase by between 2.5% and 3%. Government spending will record a similar increase of between 1.8% and 2%. The external sector will remain a burden for the French economy, according to our predictions, although price moderation

could spark somewhat of an upturn in exports. In any case, we forecast both exports and imports to grow by between 3.5% and 5%.

### The Unemployment Rate

As far as the unemployment rate is concerned, we believe it will remain in the vicinity of its current level, as the minimal level of economic growth does not suggest unemployment will decrease significantly. Our forecast is for unemployment to range from 9.3% and 9.7%.

### Public-sector Deficit

We expect the public-sector to continue to comply with the deficit criteria in the Stability and Growth Pact this year, although we have allowed for a slight violation, just in case. Nevertheless, we trust the intentions of the new French government in this sense. We forecast the public deficit to range from 3% to 3.2% of GDP at the end of the year.

### Inflation

We expect the inflation rate in France to be moderate this year, as it was in 2005. The fact that the ECB's attitude in this area will be more belligerent further confirms our forecast. However, we maintain our precaution in relation to the possibility of another surge in oil prices, which could put paid to our forecasts.

In short, as in Germany, 2006 will in our opinion be a year of transition and balancing of accounts in France, waiting for an upturn in current trend of sustained growth which is firmer than in previous years.

Table 9: Forecasts for 2006

	Minimum	Maximum
GDP	1.8	2.0
<u>GDP Components</u>		
Private Consumption	1.8	2.1
Fixed Investment	2.5	3.0
Govt. Spending	1.8	2.0
Exports	3.5	5.0
Imports	3.5	5.0
Unemployment Rate	9.3	9.7
Public deficit/GDP	-3.0	-3.2
Inflation Rate	1.4	1.7

Source: own elaboration

Antonio Cutanda  
Valencia, January 24 2006

## 6.- Italy

### Forecasts for 2006

The recession departed with the arrival of spring. The boom in employment, price stability and favourable monetary conditions slightly boosted domestic demand. The depreciation of the euro and the recovery of the best part of the rest of the Economic and Monetary Union (EMU) help to reactivate exports. However, imports also recorded a marked increase. Overall, Italy's GDP should register a growth rate of 0.2% for 2005.

The main problems in Italy last year included:

- Circumstantially, weak domestic demand, which curbed industrial output.
- In structural terms, insufficient competitiveness on behalf of Italian companies due to the rapid growth of labour costs and the industrial organisation model (myriad of small businesses), which is not well prepared to face international competition.

### Euro-environment

The European Central Bank (ECB) raised interest rates in December 2005 by 25 basis points, as announced by President Jean-Claude Trichet. The ECB thus seeks to reinforce its credibility in financial markets and also in light of forthcoming quarterly reviews.

In any case, after benefiting from the accommodating situation in 2005, the financial climate should be more favourable in 2006.

We expect the benchmark interest rate to rise steadily in order to control inflationary tension that could arise with the recovery of the EMU. The euro interest rate should be lower by the

end of 2006, but near 3%. In the case of stagnated countries such as Italy or Greece, excessive interest rate rises could damage their economies.

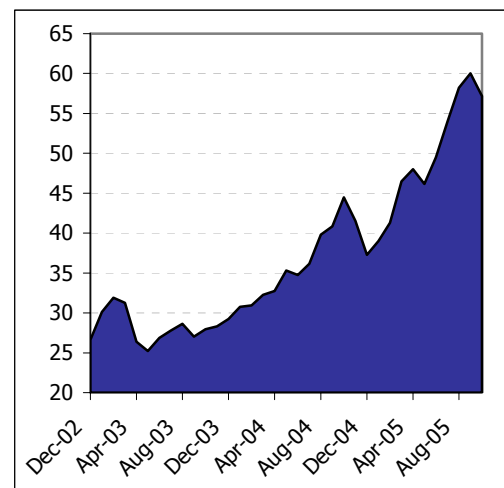
### Future of Energy Uncertain

The price of oil is shrouded in uncertainty created by a variety of geopolitical reasons all around the world. These include the aftermath of the war in Iraq, tension with Iran, events in Venezuela, the latest riots in Nigeria, and the elections in Palestine to name but a few.

Doubt also hangs over Italy's gas supply from Russia due to the polar cold and terrorist attacks on behalf of Chechen rebels. Are the gas cuts due to greater consumption in Russia as a result of the cold and rebel Chechen attacks, or is it a political ploy of the Kremlin? Whatever the case, the problems with Kiev and Tbilisi means confidence in Russia as a supplier is going through a bad period and this may influence the price of both gas and also oil.

Figure 5 shows the markedly upward trend in oil prices since December 2002.

Figure 5: Oil Prices in USD/Barrel (2002/05)



Source: International Energy Agency

The trend is clearly upward and the international geopolitical situation does not suggest that inflationary tensions in oil prices will ease in the future. Despite the price of oil already being high, we expect further increases throughout the year, which will more than likely push the price of a barrel above \$65.

Another surge in energy prices would mean higher production costs, which would aggravate the productivity problem in Italy. Furthermore, in the EMU prices could rise too quickly, sparking a larger increase in interest rates on behalf of the ECB, which would further curb private investment in Italy which is already overly weak.

In short, in the hypothetical case of a significant increase in the price of oil and/or a relatively marked increase in the benchmark interest rate would see the Italian economy stagnate even further.

#### **Domestic Demand, Industrial Output and Foreign Trade**

However, domestic demand should lift the economy once again in 2006. If this occurs, economic activity will recover substantially, providing oil prices do not soar and the €/ \$ exchange rate remains stable. In this case, GDP should grow by around an annual 1.1% in 2006.

We expect the end of the crisis in domestic demand to result in a recovery in industrial output, although the future of foreign trade remains uncertain. The enormous market share of China in traditional Italian sectors could expand further, if the euro appreciates, which would work against Italy's price competitiveness. Nevertheless, we do not expect the currency will to significantly and forecast that both domestic demand

and exports will contribute positively to economic growth.

#### **Achievement of Fiscal Objective Doubtful**

Italy must remedy its disastrous international competitiveness and public debt in order to achieve a long lasting recovery. Growth in real wages should converge more with productivity, at the same time as government spending should diminish in order to comply with the Stability and Growth Pact.

Despite the package of financial measures announced recently by the Government (€16.5bn or 1.2% of GDP will be channelled to reducing the public deficit), the fiscal objective (3.8% deficit in 2006) seems unlikely to be achieved, particularly in light of the problems with health expenditure, as well as central government and city council spending. While the deficit will approach the government's target in 2005, the objective for the end of 2007 will be difficult to accomplish. We anticipate a public deficit of 5% for 2006.

#### **Final remarks**

In this environment, it is worth entrusting the recovery of economic activity to domestic demand mainly and also to an improvement in foreign trade. The table below lists the OCEI forecasts for 2006.

Table 1: Economic Forecasts<sup>11</sup> for Italy in 2006 (%)

Gross Domestic Product	1.1
Domestic Demand	1.2
Private Consumption	1.1
Government Spending	0.5
Private Investment	2.0
Exports	5.5
Imports	5.0
Public Deficit	5.0
ECB Interest Rate	3.0
Inflation Rate	2.0
Unemployment Rate	8.0
Industrial Output	2.5

Source: own elaboration

In conclusion, it is worth pointing out that five structural factors are behind the weak economic growth in Italy: a difficult demographic scenario, excessive public deficit, unfavourable productive specialisation, increasingly less competitiveness and over-priced services.

As these aspects are tackled, and providing that the circumstances related to the exchange rate, interest rates and energy prices are favourable, the government that takes office on April 9 2006 will have a difficult task to carry out: put the Italian economy back on the same track as its main European trading partners.

Andreu Iranzo  
January 25 2006

<sup>11</sup> Las cifras relativas al PIB y a sus componentes, así como a la producción industrial, corresponden a tasas de variación anuales.

## 7.- United Kingdom

### Forecasts for 2005 and 2006

This section will update our forecasts for both 2005 and 2006 with respect to GDP growth and its components, prices, monetary aggregates and other economic variables of interest such as the current account and public-sector deficits, as we have done every six months in the past.

In the first place, we will describe the government's forecasts together with those made by independent analysts (OECD and analysts outside "The City").<sup>12</sup> Segundo, presentaremos nuestro decálogo de previsiones más significativas sobre la situación de la economía británica para el año 2006.

Table 5 presents figures on GDP growth and its components, Table 6 includes data on inflation (CPI, RPIX) and monetary aggregates (M4) and finally Table 7 contains the forecasts for growth in the current account and public sector deficits, among other variables of interest.

The most striking aspect is that interest rates are forecast to stand at 4.25% in the fourth quarter of 2006, indicating that inflation will remain in line with the 2% target rate over the next two years and the economy will grow below its potential due to slow growth in domestic demand and private consumption in particular. In view of the fact that GDP is forecast to grow by 2.4%/2.5% in 2006, analysts expect both foreign trade and the public sector to record negative results.

<sup>12</sup> The information used to compile this section has been obtained from "Forecast for the UK Economy", elaborated by HM Treasury. This publication is available on a monthly basis at [www.hm-treasure/forecast](http://www.hm-treasure/forecast)

Table 5: Growth Forecasts for GDP and its Components for 2005 and 2006

	HM Treasury	OECD	City	Non- City
<b>2005</b>				
Private Consumption	1,8	1,8	1,8	1,8
Govt. Spending	2,0	1,7	1,6	1,6
Fixed Investment	2,8	2,8	2,7	2,8
Change in Inventories	3,8	0,0	2,9	3,0
<b>Domestic Demand</b>	<b>1,8</b>	<b>1,6</b>	<b>1,8</b>	<b>1,8</b>
Exports	4,8	5,5	4,7	4,6
Imports	4,8	4,7	4,8	4,7
<b>Net Foreign Demand</b>	<b>0,0</b>	<b>0,1</b>	<b>-0,1</b>	<b>-0,1</b>
<b>GDP</b>	<b>1,8</b>	<b>1,7</b>	<b>1,6</b>	<b>1,6</b>
<b>2006</b>				
Private Consumption	2,0	1,9	1,9	1,9
Govt. Spending	3,2	2,7	2,3	2,4
Fixed Investment	4,0	4,3	3,2	3,4
Change in Inventories	3,0	0,2	1,9	2,1
<b>Domestic Demand</b>	<b>2,3</b>	<b>2,3</b>	<b>2,1</b>	<b>2,2</b>
Exports	5,0	8,4	4,8	3,9
Imports	5,0	7,0	4,4	4,1
<b>Net Foreign Demand</b>	<b>0,0</b>	<b>0,1</b>	<b>0,0</b>	<b>-0,1</b>
<b>GDP</b>	<b>2,3</b>	<b>2,4</b>	<b>2,1</b>	<b>2,1</b>

Source: own elaboration based on "Forecast for the UK Economy", HM Treasury, December 2005, N<sup>o</sup>. 224

Table 6: Inflation and Monetary Aggregate Forecasts for 2005 and 2006

	HM Treasury	City	Non- City
<b>2005</b>			
CPI (Q4)	2,2	2,3	2,3
RPIX (Q4)	-	2,4	2,3
Wages	-	4,2	4,2
REER (Sterling index) (Q4)	-	100,4	100,8
Official Interest Rate (Q4)	-	4,5	4,5
Price of Oil (\$)	-	56,3	56,1
M4	-	9,4	9,8
<b>2006</b>			
CPI (Q4)	1,8	1,9	1,9
RPIX (Q4)	-	2,2	2,2
Wages	-	4,3	4,3
REER (Sterling index) (Q4)	-	96,9	103,4
Official Interest Rate (Q4)	-	4,25	4,25
Price of Oil (\$)	-	56,7	56,7
M4	-	7,7	7,9

Source: own elaboration based on "Forecast for the UK Economy", HM Treasury, December 2005, N<sup>o</sup>. 224

Table 7: Growth Forecasts for Other Variables of Interest for 2005 and 2006

	HM Treasury	City	Non- City
	<b>2005</b>		
Real Disposable Income	1,5	2,0	2,0
Employment	-	0,7	0,7
Unemployment (Q4, mn)	-	0,90	0,89
Industrial Output	-0,5	-0,5	-0,5
Trade Deficit (billions)	-26,5	-24,3	-24,2
Public Deficit (billions) (borrowing requirement)	37,0	37,7	37,6
	<b>2006</b>		
Real Disposable Income	1,8	2,0	2,2
Employment	-	0,4	0,4
Unemployment (Q4, mn)	-	0,98	0,96
Industrial Output	1,1	0,8	1,0
Trade Deficit (billions)	-30,0	-27,1	-27,1
Public Deficit (billions) (borrowing requirement)	34,0	38,8	38,6

Source: own elaboration based on "Forecast for the UK Economy", HM Treasury, December 2004, Nº 224

The OCEI top ten HM forecasts for 2006 are as follows:

- 1) *Economic Growth.* In July 2005 we estimated growth to be 2.5%, far from the growth currently expected of between 1.6% and 1.8%. The fact that the economy is growing near its potential, consumers' response to the rise in interest rates, slower than expected growth in demand worldwide and the uncertainty surrounding the continuous upturn in oil prices appear to be behind this slump. We expect the British economy to recover in 2006 and end the year with a growth rate of 2.5%. This figure will have to be downwardly adjusted if interest rates rise in 2006 or tax and regulatory measures due to be applied in 2006 restrict the current flexibility of goods and services markets.
- 2) *Consumption and investment.* AS has been the case in previous years, GDP growth in the United Kingdom depends exclusively on domestic demand. Our prediction for a slowdown in private consumption and investment was accurate. This

scenario is dictating the pattern of GDP growth. However, the main reason behind this slowdown was not that pessimism over the progress of the world economy had spread to Britain, but rather the interest rate rise together with households' excessive level of borrowing. This situation has led households to moderate their consumption, particularly affecting durable goods financed by loans in the second half of 2005. We expect private consumption to recover slowly in by 1.9%-2%, while government spending on both health and education and R+D+I and infrastructure will increase significantly in 2006. We forecast domestic demand to grow 2.2%-2.6% by the end of 2006. However, this forecast will once again change if the Bank of England raises interest rates in the first half of 2006.

- 3) *Labour Market.* The steady decline in growth throughout 2005 saw employment growth level out somewhat in the second half of the year, while the claimant count rose every month. Notwithstanding, 2005 ended with enviable figures: almost 75% of the population was economically active and the unemployment rate was below 5%. In 2006 we expect employment growth to pick up and the unemployment rate to rise slightly above the 5% barrier.
- 4) *Productivity and Unit Labour Costs.* Labour productivity plummeted in the first three quarters of 2005 as a result of output growth being outpaced by employment. Meanwhile, unit labour costs rose slightly due to wages growing more than labour productivity. The

forecasts for a recovery in output in 2006 – in the vicinity of 2.5% according to point 4 – together with the fact that employment growth is expected to be less – around 0.4% in 2006 – means that productivity will rise significantly in 2006 (by around 2%).

5) *Public Deficit.* Real economic growth in the British economy does not mean the public deficit in terms of GDP will decrease, but quite the opposite: by the end of the financial year in April 2006, the public deficit will exceed 3% of GDP.

6) *Current Account Deficit.* In the absence of a recovery in the French and German economies together with the fact that the pound is still relatively overvalued have not aided a decrease in the current account deficit that began in 1999. We expect the current account deficit to continue deteriorating in 2006, albeit slowly, as was the case in 2005. Therefore, we forecast the deficit to be in the vicinity of 2.5% of GDP by the end of the year, a figure that remains moderate and, therefore, is not a concern.

7) *Pound Sterling.* We do not expect many fluctuations in the markets in British pounds, which will continue to be a hinge between the dollar and the euro. The \$/£ exchange rate will be approximately 0.58 and the €/£ exchange rate will be around 0.70.

8) *Inflation.* Inflation was quite predictable in 2005 and our forecast for a 2% increase in the CPI at the end of 2005 was accurate, after reaching 2.4% as a result of the surge in oil prices. We once again expect inflation to be in the vicinity of 2% in 2006 (and 2007).

9) *Real Estate Market.* It is difficult to forecast the pattern of housing prices. Housing prices will more than likely rise by between 3% and 3.5% by December 2006, similar to the inflation rate observed at the end of 2005. However, we should not discard a downward revision of this figure. Past experience shows that when the ratio of housing prices over household income exceeds the long term average, housing prices rise less than those of goods and services (CPI) for long periods in order to correct the situation. Furthermore, British households have not forgotten what happened towards the end of the 1980s, when the ratio between mortgage payments and household income was excessively high, resulting in prices registering negative growth rates between 1990 and 1992.

10) *Interest Rates.* The slowdown in domestic consumption, the shrinkage in industrial output, sluggish retail sales, the loss of business confidence, the confirmation of a moderation in housing prices and stability in the labour market explain the 25bp interest rate cut on August 25 last year to 4.5%. Our forecast is that interest rates will not drop any further and could even rise. We must once again remember that that the economy remains near its potential in terms of growth which obliges the Bank of England to monitor the situation of the factors responsible for keeping inflation under control (a strong pound and a very flexible labour market) in case the current tendency changes.

Francisco Requena Silvente  
Valencia, January 23 2006

## 8.- Japan

### Forecasts

The government forecasts a 0.5% increase in the CPI over the next financial year (which ends in March 2007), which would represent the first sustained price rise in eight years. The BoJ coincides with the forecast for inflation, as excess corporate debt has almost dissipated, meaning the end of one of the factors that contributes to deflation. According to official sources, short term interest rates could even be modified.

Merrill Lynch expects Japan to grow by 3% in real terms in 2006, while the government forecasts growth to level out to 1.9% in real terms, compared to growth in the current financial year estimated at 2.7%. These forecasts assume the BoJ will maintain the current accommodating monetary policy throughout the year.

The Organisation for Economic Co-operation and Development (OECD), in view of the current economic environment in Japan, forecasts that GDP growth could be in the vicinity of 2%. The expansion would be fuelled by private consumption and strong corporate profits, which could bring an end to the downward trend in employment and wages. Moreover, the OECD agrees with the government in that current monetary flexibility must be maintained until inflation is high enough to eliminate the risk of further deflation. Table 1 presents the forecasts suggested by the OECD in more detail.

The OECD believes the Japanese government should take advantage of the current growth cycle to further financial consolidation. The public sector deficit currently represents

almost 7% of GDP and public sector debt 150% of GDP. Consequently, not only will taxes have to be raised, but the Bank of Japan will also have to continue injecting money into the system.

In light of the fact that Japan's capital stock is currently older than ever before, it is forecast to be replaced thus giving rise to a 17.3% increase in investment this year financial year (01/04/05 - 31/03/06), according to a survey carried out by the central bank. Apart from the situation described above, Japan's exports have also boomed as a result of China's great demand for machinery and transformed products, among other things.

Table 1: OECD Forecasts for 2006

	2005	2006	2007
Private Consumption	1.7	1.5	1.7
Govt. Spending	2.0	1.4	1.4
Gross Fixed Investment	3.0	1.2	1.0
-Public	-7.8	-4.2	-3.5
-Residencial	-1.1	-0.6	-1.0
-Nonresidencial	7.4	3.0	2.6
Exports	6.5	9.8	8.9
Imports	7.6	6.0	5.6
Net Exports	0.0	0.6	0.6
GDP (Market Prices)	2,4	2,0	2,0

Source: OECD

The quarterly Tankan Survey revealed that large enterprises plan to increase their investment in facilities and equipment by 10.4% over the 2005 financial year, which ends next March.

This is due to the fact that manufacturing sales are forecast to rise by 5.4% and non-manufacturing sales by 3.6%.

As a result of this economic growth, a significant improvement in the labour market is expected to further bolster the recovery of private consumption and will enable the economic recovery to consolidate.

The OCEI has made the following forecasts for this year:

Table 2: OCEI Forecasts

	2006
GDP	2-2.5%
Interest Rates	0.1-0.3%
Inflation	0.2-0.5%

M<sup>a</sup> Luisa Martí Selva  
Rosa Puertas Medina  
Valencia, January 25 2006

## 9.- China

### Forecasts

The next five-year plan (2006-2010) indicates that 2006 could be the starting point for the country to review its economy by slowing down overheated investment and boosting consumption. Además, 2006 is a key year for the Chinese economy, as the end of the year will see China open up completely to foreign competition, in accordance with the WTO agreement signed by both parties in December 2001.

The Asian giant must face up to two serious problems this year:

- The shortage of land for millions of farmers due to real estate or industrial projects.
- The lack of education, health or unemployment coverage in a wide variety of social groups.

Labour market pressure will escalate considerably this year. According to the Ministry of Labour and Social Security, nine million new jobs will be created in 2006 and five million redundant workers will be relocated in order to maintain the urban unemployment rate at 4.6%. However, more qualified and better paid jobs are required in light of people's level of qualifications (in 2005 alone, some 3.38 million students obtained university qualifications), 20% than in 2004.

As far as the stock market is concerned, China will embark on a complex reform in 2006 that is mainly aimed at:

- Ending dual share structure (A-type for national investors and B-type which are available to foreign investors)

- Reducing the government's market share
- Creating a possible futures market in Shanghai.

The National Bureau of Statistics forecasts Chinese economic growth to slow down to between 8.7% and 9.2% as a result of a decrease in exports, which have risen by more than 20% a year for the last four years in a row and are, therefore, unlikely to continue growing at the same rate. Consequently, one wonders what factors could result in a slowdown in China's international sales. The following are some of the possibilities:

- International trade barriers and disputes
- An increase in the price of crude oil
- Uncertainty in the world economy
- A possible revaluation of the yuan
- A decrease in export tax reimbursements

However, forecasts published by the State Information Centre on January 4 indicate that China's trade surplus could swell to more than \$120bn in 2006. In fact, the Centre expects exports to grow by between 18% and 21% and imports by between 16% and 22%. Furthermore, this group of experts estimates an increase of between 1.5% and 2.5% in the CPI. They believe GDP should grow by between 8.3% and 9.3% over the next 12 months.

Similarly, international organisations offer a variety of forecasts. While the World Bank forecasts growth of 8.7% for 2006, the OECD does not appear to believe in the effectiveness of the macroeconomic control measures implemented by the Chinese

government in order to slow down growth and expects GDP to grow by more than 9% (Table 2).

Table 2: OECD Growth Forecasts

	2005	2006	2007
Real GDP Growth	9.3	9.4	9.5
Inflation <sup>1</sup>	4.2	3.5	3.7
C/A Balance <sup>2</sup>	7.8	8.9	8.3

<sup>1</sup>GDP-implicit deflator

<sup>2</sup>Percentage of GDP

Source: OECD

According to the Ministry of Commerce, China expects to reach \$60bn in foreign investment in 2006, thus equalling the sum received in 2005. This is no threat to the economy. In the industries that are most dependent on these inflows of foreign capital, foreign investment does not exceed 3%. Currently, FDI amounts to 35% of GDP, slightly higher than the average worldwide. However, if FDI per capita is measured, the figure amounts to only \$41, less than half of the figure for the rest of the world, which is why China has decided to maintain its policy of attracting foreign capital.

On the other hand, China aims to put an end to the serious energy deficit the country suffers in 2006 by balancing supply and demand. In order to achieve this objective, the output of coal, which still generates more than 70% of the energy consumed in the country, is to rise along with new oil and natural gas field operations in the west of the country. However, the chief engineer of the China Electricity Network Development Company believes supply problems will more than likely continue in 2006, but is optimistic about 2007. China managed to increase its capacity to generate electricity by 13.12% in 2005 and forecasts a similar increase in 2006.

Table 3: Growth Forecasts from the National Bureau of Statistics

Exports	Imports	GDP	CPI
18-21%	16-22%	8.3-9.3%	1.5-2.5

The Central Bank of China has set the following objectives for 2006:

- Continue to apply stable monetary policy
- Target growth rates for the M2 and M1 of 16% and 14% respectively
- Push for the reform of the share system for state-owned commercial banks
- Develop the financial market to a great extent.
- Perfect the mechanism that forms the exchange rate, maintaining stability and a reasonable and balanced level.

The Bank of Agriculture is the only one of the four state-owned banks that has not yet begun its reorganisation in order to become a bank listed on the stock market. Moreover, it still does not know when the reform will begin or whether support will be received from the Central Bank's currency reserves.

In order to smooth out social and economic inequalities in various regions, the Chinese government has decided to accelerate coordinated regional economic development. Steps will be taken to fuel economic development in poor, border and ethnical regions and old revolutionary bases<sup>13</sup>. In addition to this, the government believes that the key to rapid and sound growth lies in

<sup>13</sup> Road building, installing telecommunications, increasing education and health expenditure.

increasing domestic demand. In order to achieve this:

- "Prudent" tax and monetary policy measures will be implemented, which will also aid a closer relationship between investment and consumption
- The Budget will be adjusted to increase income and reduce spending
- Steps will be taken to coordinate financial, monetary and industrial policy.
- The government promises to make better use of tax income and to strictly apply the regulations that govern market access.

As we can see, the new year is once again full of good intentions. The OCEI's forecasts for this year are as follows:

	<b>2006</b>
<b>GDP</b>	9-9.5%
<b>Interest Rate</b>	No change
<b>Inflation</b>	1.5-1.8

M<sup>a</sup> Luisa Martí Selva  
Rosa Puertas Medina  
Valencia, January 25 2006

## 10.- Argentina

### Forecasts for 2006

As was the case last year, we will begin by reviewing the references published by the main national and international research services.

We will begin the review with the official forecast. The Ministry of Economic Affairs (MECON), in an attempt to guarantee a larger financial surplus than budgeted, forecasts a very moderate growth rate of 4%. Table 2 illustrates how the slowdown occurs as a result an across-the-board decrease in aggregate demand components.

The International Monetary Fund falls in line with the MECON in terms of prudent forecasts. The IMF forecasts GDP to rise by 4.2% and the inflation rate to rise by 10.4% in 2006.

Table 2: Macroeconomic Forecasts from the National Budget

	2005	2006
GDP	7.3%	4.0%
Consumption	6.4%	3.5%
Investment	18.0%	7.9%
Exports	14.0%	4.2%
Imports	19.0%	10.2%

Source: MECON, 2006 National Budget

The next most conservative forecast comes from the Economist Intelligence Unit. The economic consultant of the British journal The Economist forecasts that the economy will slow down as a consequence of weaker domestic demand and predicts growth of 5.2%. Continuing with the forecasts from bottom to top, we will now look at the Central Bank of the Argentinian

Republic. According to the figures released in the 2006 Monetary Programme, Gross Domestic Product (GDP) will end this year with a 6.2% growth rate. This amount of growth, which is considerably higher than the previous forecasts, is more in keeping with the predictions made by private analysts.

The Market Expectations Survey (REM in Spanish) gathers forecasts from a total of 61 participants including economists and local and international analysts and is elaborated on a weekly basis by the BCRA. In view of the data, we can see how agents have been upwardly reviewing their predictions. In the latest press release that is dated 04/01/2006, they forecast real GDP to grow by 6.4% and prices to rise by an annual 12.3% in the last month of this year. One of the most optimistic forecasts was found in the BBVA Study Service. The macroeconomic scenario envisaged for 2006 is characterised by 7% GDP growth and an inflation rate similar to that observed in 2005 (12%).

In short, there is no agreement over how much GDP will grow in 2006. Forecasts range from 4% to 7%. However, one thing all the forecasts share is that the inflation rate will remain in double figures.

### Favourable International Environment

Argentina is currently enjoying a highly favourable international environment. There is a great deal of liquidity, excessive savings, good prices for raw materials (particularly from the mining and energy sectors) and growth in world demand (especially in Asia) that has injected large quantities of foreign currencies into the economy.

And the horizon remains positive. World economic growth is expected to remain above 4% in 2006 and raw material prices are forecast to remain stable near their current level. One of the threats to the Argentinian economy could be monetary policy, which will get tougher. As a result, agents will tend to shift their investments to less risky assets. In the second place, the elections that are to be held in 12 South American countries this year generate uncertainty, which is another threat. These 12 countries include two very important nations in South America, Mexico and Brazil. Meanwhile, recently elected governments such as those in Bolivia and Honduras and Chile will be making their first moves. This political scenario undoubtedly leaves its mark of uncertainty.

### **OCEI Forecasts**

#### **Economic Activity**

After the strong growth in 2005, the statistical drag for 2006 stands at 3.5%. With this starting point, a favourable international environment and the situation that will be described below, we expect the economy to slow down somewhat, but to continue chalking up a high growth rate of between 6.5% and 7%.

Two factors are vital when it comes to forecasting the future pattern of private consumption. The labour market was highly dynamic in 2005, but as economic activity slows, the boom in employment is also expected to diminish. As regards purchasing power, wages (declared to the Social Security system by employers) rose by an annual 16% in the third quarter of 2005. However, as inflation over the same period stood at 9.85%, the

increase in wages in real terms was only 5.6%.

Inflation will also curb consumption, particularly where the retired and those who receive social benefits are concerned. At the same time, the spectre of double-figure inflation which is expected to persist could see the consumption of certain goods deviate, by anticipating the purchases. In short, while private consumption grew by around 8.5% in 2005, this year we expect growth to slow down to 6%.

As far as government spending is concerned, few changes are expected. The 2006 budget does not foresee any increases in retirements or public sector wages, but this will depend on developments in inflation. The financial situation will remain under control, with primary expenditure falling in line with the budget and revenue sustained above the level contemplated by the budget.

The increase in productive investment is crucial. Investment will continue growing, albeit more slowly than in recent years. Tax incentives and official government loans will help, but there is still some institutional uncertainty, particularly regarding the provision of energy sources. Doubts over the availability of natural gas and electricity as well as how much they cost are a bottleneck for many projects. Evo Morales' victory in Bolivia gives Argentina the possibility of importing a greater quantity of gas, but nothing has as yet been confirmed. The renegotiation of workers' contracts with public private partnerships has been paralysed, which will also be negative. And the inflation trend will not stimulate investment either.

In short, investment will continue to increase while growth is buoyant, but the multiple frictions it will be subject to will prevent the increase from being large enough to attain sustainable growth. In order to achieve this, investment would have to represent 24% of GDP. However, if our forecast for between 10% and 12% growth is accurate, investment would only represent 22%.

As regards foreign trade, we expect the import/export gap to continue closing slowly, mainly due to exports, but following the decrease in harvests that is forecast, exports will be in no position to repeat last year's success.

#### **Inflation**

Inflation will continue to be the main macroeconomic problem in 2006, as nothing as yet appears to be capable of stopping it soaring in double figures. Demand will continue to outpace supply in 2006, the dollar will remain high as will food prices due to greater foreign and domestic demand and energy costs will also be higher. There is no sign of economic policy tackling the problem, beyond the patchwork of price agreements which is not even working in the short term.

We expect the annual inflation rate to accelerate in 2006 to around 15%, which would be an average monthly rise of 1.25%.

#### **Exchange Rate**

The BCRA is poised to recover the \$9.8bn that were paid to the IMF. This demand promises a dollar above three pesos.

Table 3: 2006 Forecasts

Concept	2006 Forecasts
GDP	6.7% - 7.2%
Private Consumption	6.4% - 6.9%
Govt. Spending	5.0% - 5.5%
Investment	10.0% - 12.0%
Exports	6.5% - 7.0%
Imports	13.0% - 18.0%
Inflation Rate	14% - 15%
Exchange Rate (annual average)	3.04

Source: own elaboration

Julia Torrecabota Gordero

January 26, 2006

## 11.- Brazil

### Forecasts for 2006

This section reviews the forecasts for this year that have been made by the main institutions. Following this, the OCEI will present its own estimates.

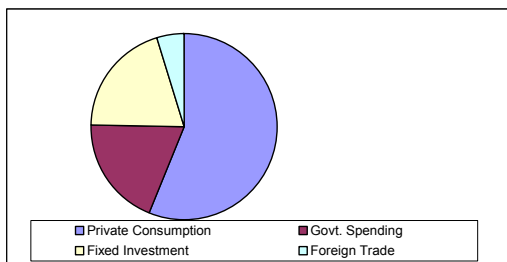
Table 5: Forecasts for 2006

	PIB	Inflación
CBB	4.0	4.5
OECD	3.7	4.7
IMF	3.5	4.6
IPEA*	3.4	4.8

\*Institute of Applied Economic Research  
Source: own elaboration

The IMF and the OECD forecast growth this year to outpace that recorded last year with estimates of 3.5% and 3.7% respectively. The IPEA is a little more prudent, estimating a growth rate of 3.4%. As always, the CBB is the most optimistic, with a growth forecast of 4%.

Figure 7: Demand Component Share of GDP in 2004



Source: own elaboration with data from the CBB

Table 6: CBB Growth Estimates for GDP and its Components

	2005	2006
GDP	2.6	4.0
Private Consumption	3.0	4.2
Government Spending	1.7	1.4
Fixed Investment	1.3	6.6
Exports	12.6	6.4
Imports	10.8	12.1

Source: CBB

The Central Bank of Brazil forecasts GDP to grow by 4%, on the demand side. As can be appreciated in the table above, private consumption would rise by 4.2%, government expenditure by slightly less than the estimated 1.4% for 2005, gross fixed capital formation would grow by 6.6%, exports by 6.4% and imports would practically double exports, increasing by 12.1%.

As far as the importance of each component is concerned, in 2004 private consumption represented 55.3% of GDP, government spending 18.8%, gross fixed capital formation 19.6% and the trade balance 4.7% (exports 18% and imports -13.3%). The items that will most contribute to GDP growth in 2006 are private consumption with 2.3 percentage points and gross fixed capital formation with 1.3 points. However, import growth is forecast to outpace export growth, so the trade balance will detract from from GDP.

Growth in investment is linked to the favourable scenario created by the decrease in country risk and by the prospect of lower domestic interest rates, together with an increase in public construction (the most important investment item), boosted by the increase in loans and the carrying out of infrastructure projects.

On the other hand, private consumption would result from an increase in earnings and better loan conditions.

On the supply side, the services sector represents more than half of GDP and is forecast to grow by 2.95%, fuelled by trade and transport, both of which suggest domestic demand is progressing. Industry, which represents approximately 38% of GDP, will record an increase of 5.3%, mainly on the back of an increase in oil output and

also due to aggregate demand remaining stable within a scenario where inflation is converging with the target rate set by the MPC. Agriculture will be the mainstay of the 4.8% growth in the farming and fisheries sector. Stockbreeding is still suffering from the outbreaks of foot and mouth disease in September. Notwithstanding, the primary sector barely represents 10% of GDP.

Table 7: OCEI Forecasts for 2006

	%
GDP	3.4
GDP Components	
Private Consumption	3.8
Fixed Investment	5.2
Government Spending	1.4
Exports	10
Imports	11
SELIC Rate	16
Public Deficit over GDP	48.5
Inflation Rate	5.0

Source: own elaboration

Our forecasts are not as optimistic as those of the CBB. We expect GDP to rise less, approximately 3.4%, but the main difference lies in our point of view regarding private consumption and investment, mainly due to the uncertainty that the forthcoming elections will create.

- Private consumption: on January 24, the Brazilian government announced an unprecedented increase in the minimum wage from 300 reais to 350 reais. This is the largest rise since the Workers' Party won the elections. In 2005, the minimum wage was raised by 8%, in 2004 by 2% and in 2003 by 0.5%. The 17% hike in 2006 is excessive, considering the current

inflation rate. But the Workers' Party is already thinking about the elections in October and seeks to regain the popularity lost in 2005 as a result of the continuous corruption scandals. This move could also boost the increase in private consumption, but as the elections draw nearer, we think the opposition will uncover further scandals affecting Lula's party and, as we saw throughout 2005, consumer confidence is very sensitive to cases of corruption. Therefore, household consumption will not record the 4.2% growth forecast by the CBB, but will rise slightly with respect to 2005, reaching 3.7%.

- We do not believe growth in government spending will slow down by 0.3 percentage points to 1.4%, but rather expect growth to remain unchanged at 1.7%
- Gross fixed capital formation: we also differ with the CBB over this aspect. In light of the 1.3% rise observed in 2005, a forecast of 6.6% is excessive. On the one hand, interest rate cuts will stimulate investment, but on the other hand, the uncertainty created by the elections towards the end of the year will discourage foreign investors. In our opinion, despite the fact that gross fixed capital formation will increase in 2006 due to the favourable

macroeconomic conditions, it will only rise by approximately 5.2%, as country risk will begin to rise from the end of summer onwards.

- Foreign Trade: exports cannot grow as much as in 2005. As indicated at the beginning of this report, last year's increase was partly due to an upturn in prices. However, we expect prices to remain stable this year and therefore estimate a rise of only 10% in exports. As regards imports, we also forecast a slowdown with respect to last year, but no as abrupt as in exports. Our forecast is for an 11% rise.

### Outlook for Inflation

The CBB is also the most optimistic institution with regard to this issue, forecasting a 4.5% increase in prices by the end of the year. The IMF and the OECD forecast inflation rates of 4.6% and 4.7% respectively.

However, we are more pessimistic in the OCEI. We forecast inflation to reach 5% by the end of the year, taking into account a variety of factors:

- Firstly, we must highlight the accommodating monetary conditions since September 2005, when the CBB began to lower interest rates. The impact of these cuts will be felt from the medium term onwards, that is, pushing up prices in 2006.
- Secondly, we must remember that the government plans to raise the minimum monthly wage

by 17%. This move will also obviously have an effect not only on consumption but also on prices.

- Finally, as always, we have the pattern of crude oil prices and the exchange rate of the real. We expect the price of oil to rise moderately in 2006, although despite being a less pronounced rise than in previous years, it will still exercise upward pressure on inflation.

### Public Debt and SELIC Rate

The government aims to reduce its debt to 40% of GDP by 2010. Here, we must take two factors into account: in the first place, the advance cancellation of the debt with the IMF and the Club de Paris and in the second place, the current debt which stands at 51% of GDP. Therefore, we calculate that by the end of the year, the public debt/GDP ratio will be approximately 48.5%.

As regards the reference interest rate, the CBB will more than likely continue the downward trend in interest rates that began in September in order to boost the economy of the country. Consequently, we expect the SELIC rate to be in the vicinity of 16% by December.

María García Alcober  
Valencia, January 26 2006

## 12.- Mexico

### 2006 Forecasts

This year is extremely difficult to forecast, as the political scenario could distort the best estimates. Politics will play an important role in the evolution of the Mexican economy this year and in forthcoming years.

Presidential Elections will be held in Mexico, which could affect the evolution of the economy or, at best, create marked temporary volatility in some of its variables. The majority of investors will more than likely wait for the final election results.

The end or beginning of a Federal Government has been accompanied by abrupt changes since the 1970s, particularly where the exchange rate is concerned, which has suffered hefty devaluations with the results known to all. This period began with the change of government in 1976, when the fixed rate of 12.50 pesos to the dollar in force since 1954 was abandoned, resulting in a strong devaluation of approximately 100%. From this moment onwards, the same story has been repeated every six years, except in 2000.

In view of this situation, Mexicans are forced to take precautions when faced with changes in government of this nature. Businesses are particularly careful with their investments and small savers buy, when possible, dollars.

This historical scenario influences Mexicans' behaviour in election years such as this one.

Nevertheless, the following section will take a look at the main variables of the economy, provide where available the final data or estimates for 2005 as a

whole and the outlook for 2006, starting with the official forecast.

### Official Target

The Official Federation Gazette published both the Income law and the Expenditure Budget for 2006 on December 14. As far as income is concerned (1.9735 billion pesos), a 6.1% increase was approved with respect to 2005, while a 6.3% increase in government spending (2.72 billion pesos) was budgeted.

Despite the fact that structural reforms have been repeatedly delayed, they have once again been included as part of the guidelines for this year in the 2006 General Criteria for Economic Policy. Among the reforms awaiting implementation, the following are worthy of mention: pension reform, labour reform, tax reform, budget process, energy reform, corporate governance of State-owned companies, the Stock Market Law and Bank acts.

The GDP growth target for 2006 has been set at 3.6%, while the target inflation rate is 3%. However, this forecast mentions the fact that international oil prices, tougher than expected US monetary policy and more intense international competition could influence these projections.

It was striking that two important variables were modified by Congress. The original proposal for the price of the Mexican mix was raised from 31.5 to 36.5 dollars a barrel.

Similarly, the public sector financial balance which initially displayed a surplus equivalent to 0.2% of GDP, was downwardly adjusted to budget equilibrium. These two important changes, together with those made in non-oil tax collection, resulted in an

increase of 92.3 million pesos with respect to the original proposal made by the government.

The following table presents the approved economic targets that the government will try to achieve this year.

Table 1: 2006 Macroeconomic Framework

Concept	2006
Real GDP growth	3.6%
Inflation	3%
Average nominal exchange rate (pesos/dollar)	11.40
Average nominal 28-day Cetes Interest Rate	8.9%
Average Real 28-day Cetes Interest Rate	6.1%
Current Account (millions of dollars)	-16,611.5
Current Account/GDP	-2.2%
Budget Balance/GDP	0.0%
Average Price of Oil (Mexican basket)	\$36.5/ barrel
Oil. Average export volume (1,000s of barrels per day)	1,868

Source: Mexican Treasury. 2006 General Criteria for Economic Policy

As regards the tax stimuli approved for this year, the most striking items were the exemption from Capital Gains Tax of individuals whose total income in the previous year does not exceed four million pesos, and the extension from three million to four million pesos of the total tax benefit for expenditure and investment in development and technology.

The corporate tax rate has been cut by one percentage point to 29% for 2006 and 28% for 2007. Moreover, interest obtained from loans to the Federal Government of the Bank of Mexico by Mexicans residing abroad, as well as those derived from the credit certificates issued by the latter will be tax free.

Similarly, the regulations due to take force this year in relation to income tax have been postponed. These included a simplified rate and an overall exclusion that enabled people to opt for a tax free income of 76,000 pesos per annum, the elimination of the tax subsidy and wage-based loan and the creation of an employment benefit and income balancing. Consequently, the same rules as in 2005 apply with the maximum marginal tax rate being 29% in 2006 and 28% in 2007.

### Economic Growth

As mentioned at the beginning of this report, the Mexican economy is estimated to have grown by around 3% in 2005. In order to predict growth in 2006, we must take into consideration the economic forecasts worldwide for South America and the United States.

According to projections made by the International Monetary Fund (IMF), the world economy will register identical growth in 2006 to that observed in 2005 (4.3%), while the United States is estimated to have grown by 3.5% in 2005 is forecast to grow by 3.3% in 2006. As far as Mexico is concerned, the fund estimates 3% growth for last year and 3.5% growth this year.

CEPAL estimates 3.2% world economic growth in 2005 and forecasts a growth rate of 3.3% for 2006. The same institution estimates 4.3% growth in 2005 for South America as a whole and forecasts the region will grow by 4.1% in 2006. As far as Mexico is concerned, CEPAL coincides with the IMF projection.

It is worth adding that the data provided by CEPAL indicate that GDP per capita in Mexico has risen by an average of only 0.4% over the last five years, well below the figure observed in

the previous five-year period which was 3.7%. Both organisations present similar forecasts for world economic growth in both 2006 and 2007, although the figures are different. As far as Mexico is concerned, figures coincide. Finally, the IMF forecasts the US economy to grow slightly less this year.

The official growth target included in the 2006 General Criteria for Economic Policy is 3.6%. Moreover, the Outlook of Private Sector Economic Experts compiled by the Bank of Mexico in December 2005 forecasts a growth rate of 3.5% for 2006.

Certain factors must be taken into account in 2006; particularly that growth worldwide and in the United States will not vary significantly, Mexico's high degree of dependence on what happens in the US economy and the lack of structural reform. Even though the US economy will continue to grow, the industrial sector has lost steam and this is the sector that most interests Mexico. Consequently, we are unable to find a dynamo to boost growth up by more than half a point higher than the figure that will more than likely be recorded for 2005.

Therefore, our forecast is that growth will range from 2.5% to 3% at the most, and only if politics has a minimal effect. Growth will continue to be based on consumer credit rather than upturns in investment or exports.

However, even if the economy grows by more than 3%, the impact on employment will be similar to that observed in 2005, which was the best in the last five years, but utterly insufficient in terms of satisfying the employment demand present in the labour market.

## Employment

Despite the improvement observed stemming from higher economic growth rates in recent years, the number of jobs that are created is insufficient. At least one million jobs per year are required to merely provide work for those who need to enter the labour market. We were promised 1.3 million jobs per year, but in reality figures tell a different tale.

In January 2005, INEGI replaced the National Urban Employment Survey (ENEU in Spanish) and the National Employment Survey (ENE) with a new survey entitled the National Survey of Occupation and Employment (ENOE). The latter is more in keeping with OECD recommendations and incorporates conceptual changes with respect to the previous two surveys.

In order to be able to compare figures from previous periods, INEGI has published a dataset that goes back to 1996 called the "unified dataset", which displays an increase of slightly more than one point in the average unemployment rate in relation to the previous data.

The ENOE recorded an unemployment rate of 2.84% with respect to the labour force in December 2005, slightly lower than in November when it stood at 2.99% and also lower than in the same month in 2004 when it was 3.52%.

Table 2: Unemployment Rate. Unified Dataset. 2001-2005

Year	Total	Men	Women
2001	2.76	2.35	3.55
2002	2.98	2.58	3.74
2003	3.41	2.93	4.30
2004	3.92	3.26	5.10
2005	3.58	3.38	3.93

Source: own elaboration with data from INEGI. The ENOE has been applied from January 2005 onwards, so this survey's new criteria has been applied to its predecessor, the National Employment Survey, thus creating the unified dataset.

The average for 2005 was 3.58%, lower than the 3.92% rate observed the previous year, but higher than in 2003 (3.41%), 2002 (2.98%) and 2001 (2.76%). By gender, the unemployment rate for women (3.93%) was higher than for men (3.38%).

As far as formal employment is concerned, 2005 was the best year out of the last six, as some 576,599 net jobs were created, of which 184,954 (32%) were permanent and 391,645 (68%) were temporary.

As regards the end-of-year totals, 2005 finally overcame the figure recorded in 2000. However, these figures show how only 539,757 net jobs have been created over the past five years, that is, 107,951 a year on average.

Table 3: Formal Employment 1999-2005

Year	Total	Permanent	Temporary
1999	12,016,920	10,628,931	1,387,989
2000	12,546,268	11,026,370	1,519,898
2001	12,163,637	10,713,268	1,450,369
2002	12,225,582	10,733,000	1,492,582
2003	12,190,792	10,635,811	1,554,981
2004	12,509,426	10,863,277	1,646,149
2005	13,086,025	11,048,231	2,037,794

Figures at 31 December each year

Source: Secretariat of Labour and Social Welfare with figures from the Mexican Institute of Social Security (IMSS)

As mentioned earlier, employment has improved, but in view of the shortage in the supply of jobs, approximately 400,000 people a year continue to migrate to the United States

Apart from the fact that the amount of employment generated is insufficient, we also have to add that only a third of the new jobs created in the formal sector of the economy are permanent.

The Bank of Mexico's Outlook mentioned above forecasts the creation of 516,000 new jobs. Our forecast is for around 400,000.

### Inflation

As we advanced in our December report, the best economic result was achieved in terms of inflation, which recorded an increase of 3.33% throughout 2005. This figure falls within the target range set by the Bank of Mexico of between 2% and 4% and slightly above the 3% target rate included in the 2005 General Criteria for Economic Policy. This figure represents a substantial decrease with regard to the 2004 figure of 5.19%.

This indicator has only been measured on a national scale since 1970 (National Index of Consumer Prices), as before this only producer prices in Mexico City were measured and then taken as the national figure. Since the appearance of the national measurement, inflation in 2005 has dropped, that is, it is the lowest rate recorded in 35 years.

The Bank of Mexico has set a 3% target rate (one point up one point down) since 2003 and last year it was closer than ever before to achieving it.

It is also worth mentioning the marked decrease in core inflation, which stood at 3.12% in 2005 in comparison to 3.79% the previous year. It would be a

real accomplishment if core inflation remained below 3% this year. This would undoubtedly give a lot of credit to the policies employed to combat inflation.

This milestone can also be observed in the inflation measured by the basic shopping basket, which recorded a remarkable decrease to 3.8% in 2005, compared to 6.73% in 2004.

Table 4: Headline, Core and Basic Shopping Basket Inflation 2000-2005

Year	Headline	Core	Basic Basket
2000	8.96	7.52	8.74
2001	4.40	5.07	3.83
2002	5.70	3.77	6.06
2003	3.98	3.66	4.71
2004	5.19	3.79	6.73
2005	3.33	3.12	3.88

Source: elaborated with information from the Bank of Mexico

Despite these magnificent results, a slight upturn in inflation is expected in the first few months of this year due to the cyclical increase in core inflation.

Agriculture, as always, will constitute a significant risk. Fruit and vegetable prices are highly volatile and red tomato prices in particular will have to be closely monitored, as they can rise by up to 100% at this time of the year.

The Bank of Mexico Outlook forecasts an inflation rate of 3.6% for 2006.

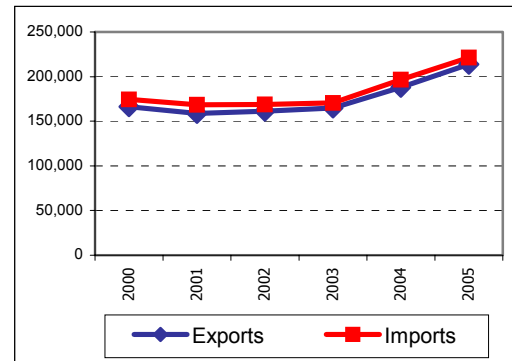
Unless there are significant supply shocks, inflation will remain at a similar level to that observed last year. We forecast inflation to range from 3.5% to 4%.

### Foreign Trade

Exports have played a leading role in economic growth since 2004, recording an 11.4% increase at the end of the year, well above the figures observed in the previous three years (2001-2003),

of -3.8%, 1.6% and 2.7%, respectively. This growth prevailed in 2005, with an increase of 13.7%.

Figure 5: Exports and Imports of Commodities 2000-2005 (millions of dollars)



Source: elaborated with information from INEGI

The high price of oil saw income from oil exports amount to 31,895.7 million dollars, a 34.8% increase with respect to the figure recorded the previous year. This helped to reduce the trade deficit in 2005 by 14.2% with respect to the previous year.

However, non oil exports only rose by 10.6% in 2005. Among these, manufactured goods also rose by 10.6%, with motor vehicle product sales figuring prominently.

A breakdown of the structure of commodity exports reveals that 81.7% were manufactured goods, 14.9% oil products and 3.4% other goods.

Imports rose by 12.4% in 2005 with respect to the previous year. Intermediate goods accounted for 73.9% of total imports, consumer goods for 14.2% and only 11.9% for capital goods.

The productive sector has not taken advantage of exchange rate stability to import capital goods in order to strengthen their installations, as imports mainly corresponded to intermediate and consumer goods.

Another interesting figure refers to the period dating from January to November 2005, when Mexican exports to the United States dropped by 2.1%, whereas those destined to China rose by almost 12%. In the case of the US, the decreases were observed in computers and computer components (-9%), clothing and footwear (-5%) and motor vehicles (-4%). In China, the largest increases were witnessed by motor vehicles (152%) and radios and televisions (72%).

### Interest Rates

The downward trend in inflation and a stable exchange rate have resulted in a decrease in interest rates throughout 2005, despite the fact that the annual average is higher than that observed in 2004.

Table 5: 28-day Cetes Rate 2000-2005

Year	Rate
2000	15.24
2001	11.31
2002	7.09
2003	6.23
2004	6.82
2005	9.20

Source: elaboration with information from the Bank of Mexico

The following table shows how between February and September 2005, the monthly average of the 28-day Cetes rate stood above nine points. The rate only begins to drop in the last quarter, pushed down by low inflation and the strength of the peso.

Table 6: Average Monthly 28-day Cetes Rate 2005

Month	Rate
January	8.60
February	9.15
March	9.41
April	9.63
May	9.75
June	9.63
July	9.61
August	9.60
September	9.21
October	8.91
November	8.71
December	8.22

Source: elaborated with information from the Bank of Mexico

In the first months of this year, the 28-day Cetes rate will probably continue to drop to 7.5%, due among other factors to a more than likely decrease of 25 to 50 basis points in the funds rate, although forthcoming months could see volatility due to the impact of the elections.

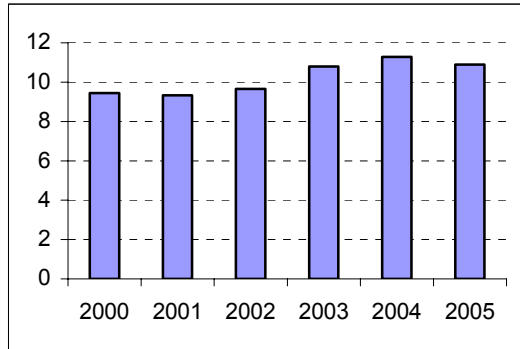
The Bank of Mexico's Outlook forecasts the 28-day Cetes rate to end 2006 at 7.74% while the 2006 General Criteria for Economic Policy estimate a yearly average of 8.9%.

### Exchange Rate

Despite widespread agreement that the Mexican peso would depreciate slightly in 2005, the currency moved in the opposite direction, recording an appreciation of approximately 3.45%.

The strength of the peso was bolstered by strong inflow of currencies due to oil sales, family remittances and foreign direct investment.

Figure 6: Average Peso/Dollar Exchange Rate 2000-2005



Source: elaborated with month data from Bank of Mexico

The appreciation of the peso was one of the factors (although not the only one and probably the least important) behind the loss of competitiveness on the international scene. We must recall that Mexico has dropped from 45th to 55th in the international ranking of this indicator in the last five years.

The Mexican peso will more than likely suffer a slight depreciation in 2006, which will push interest rates up.

The Bank of Mexico's Outlook forecasts the peso/dollar exchange rate to stand at 11.17 at the end of 2006.

In this environment, we make the following forecast: the currency will not be devaluated in 2006. We base this forecast on, among other aspects, that the peso underwent a process of appreciation in 2005 and in the present day, public finances are balanced and international reserves have never been higher.

If the dollar gains strength, as appears likely, and the elections in Mexico are only slightly felt, the exchange rate could end the year at 11.30.

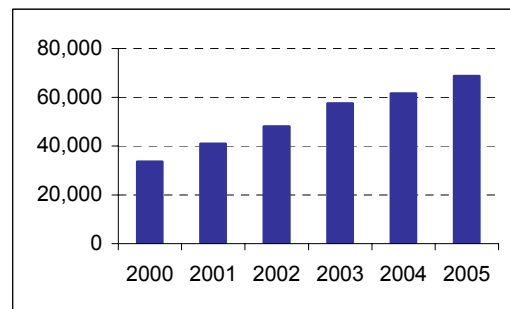
### International Reserves

International reserves at the end of 2005 amounted to 68.669 billion

dollars, similar to total public foreign debt which in November amounted to 68.479 billion dollars.

Remarkable currency inflows due to oil exports, family remittances and foreign direct investment are largely responsible for this.

Figure 7: International Reserves 2000-2005 (millions of dollars)



End-of-year figures

Source: elaborated with information from the Bank of Mexico

It is difficult to know just how much in terms of reserves a country should have. Theory has suggested that reserves should be the equivalent of approximately one third of total imports, although some propose the equivalent of three or four months to pay imports or the reserve/current account deficit ratio.

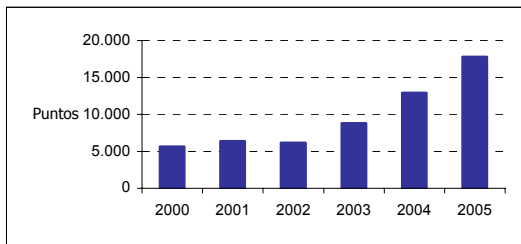
As far as Mexico is concerned, total imports amounted to \$62.321bn in the last three months of 2005 and \$80.959bn in the last four months. In other words, Mexico has enough reserves to pay the equivalent of approximately three and a half months of imports.

It is difficult to know the exact amount required because in the case of a sharp rally in speculation or a capital flight, any amount would be insufficient. However, having excess reserves is always more desirable than a shortage.

### Stock Market

The Mexcian Stock Market (BMV) Index chalked up a 37.8% increase on rising from 12,917 points in December 2004 to 17,802 points in December 2005.

Figure 8: Mexican Stock Market Index (Base=1978)



Figures as of December 31  
Source: BMV

The stock market will almost certainly feel the brunt of the bubbles or volatility in economic terms that could be sparked by July's presidential elections.

Country risk, inflation and interest rates have remained low, which will make the capital market appealing to investors, assuming elections are carried out in an orderly fashion and results are believable.

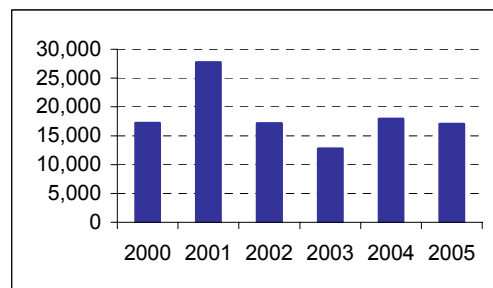
The stock market is expected to remain bullish, boosted by the effects of the new Stock Market Law, which replaces the law in force since 1975 and which was published in the Official Federation Gazette on December 30, 2005. The new law will come into force in six months' time and is expected to encourage a greater number of companies to go public.

Politics constitutes the main risk for the stock market this year. By the end of 2006, we expect the index to have risen by 23.5% with respect to the previous year to around 22,000 points.

### Foreign Direct Investment

FDI inflows between January and September 2005 amounted to \$12.894bn. Following the \$4bn in inflows expected in the fourth quarter, the overall figure for the year would amount to nearly \$17bn, which is less than in 2004 when \$17.91bn in FDI entered the country.

Figure 9: FDI 2000-2005 (millions of dollars)



\*2005 figure is an estimate  
Source: elaborated with information from the Bank of Mexico

Portfolio investment over the first nine months of 2005 amounted to \$5.818bn, more than double the figure for 2004 as a whole, which was \$2.671bn.

The Bank of Mexico Outlook forecasts foreign investment of \$15.362bn for 2005 and \$14.464bn for 2006.

Finally, once the figure for 2005 is released, on comparing it to that observed the previous year, we should take into account the sale of Bancomer shares in 2004, one of the most important banks in the country, to the value of \$4.5bn.

According to statements by the Sub-secretary of Economic Affairs, investment is expected in manufacturing and services. Ford, Nissan and Bombardier are just a few of the companies that will make investments, apart from new companies from Japan, China

(exploration and exploitation of mines) and India.

However, we must pay close attention as the US company Ford has announced heavy staff and factory cutbacks over the next six years, which could affect the company based in Mexico.

### Oil

As far as international prices are concerned, in 2005, West Texas Intermediate averaged \$56.50 a barrel and Brent \$54.50 a barrel.

The Mexican Export Mix averaged \$42.65 a barrel in 2005, well above the \$27 initially estimated as part of the country's budget.

In comparison to the average observed in 2004, the price of oil rose by 37% in 2005.

Table 7: Exports of Mexican Mix 2000-2005

Year	Average Price (\$/barrel)	1,000s of barrels/day
2000	24.79	1,604
2001	18.61	1,756
2002	21.52	1,705
2003	24.78	1,844
2004	31.02	1,870
2005	42.65	1,817

Source: elaborated with information from PEMEX

The average price of oil for 2006 is expected to be slightly higher than in 2005. Demand will continue on the back of the growth in the world economy, among other factors.

The Bank of Mexico Outlook forecasts an average price of \$40.40 per barrel of Mexican Export Mix.

We believe the average price of the Mexican Export Mix for 2006 will be in the vicinity of \$40, which would be an increase of \$3.5 dollars with respect to the budget estimate (almost 11%),

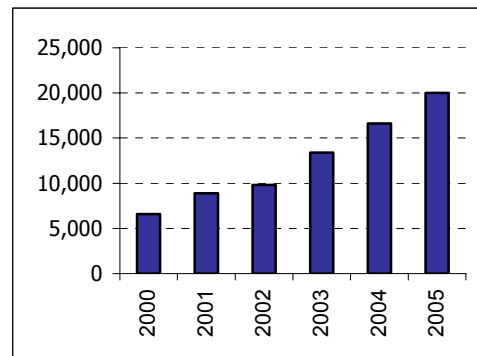
which would once again reinforce public finances.

### Family Remittances

The money that Mexicans who are working in the United States send home to their families remains of vital importance to the strength of the country's public finances, economic growth, support for the currency and helps to alleviate poverty.

Remittances are the second largest source of foreign exchange in the country, second only to oil and above foreign direct investment and tourism.

Figure 10: Family Remittances 2000-2005 (millions of dollars)



\*2005 figure is an estimate

Source: elaborated with information from the Bank of Mexico

Over the first eleven months of 2005, family remittance inflows amounted to 18,278 million dollars, surpassing the figure for the previous year as a whole, which totalled 16,613 million dollars. By the end of 2005, remittances are expected to reach 20,000 million dollars.

Migration remains on the increase, so total remittances will also more than likely grow. We forecast Mexicans to send some 23,000 million dollars home in the form of remittances in 2006.

### **Brief Conclusion**

As far as the economy is concerned, 2006 may seem very similar to 2005. Of course, this will depend on the industrial sector's performance, the US economy and the price of oil. Mexico does not have its own economic policy to determine progress by implementing strategies to face up to external factors.

However, while the economic scenario is relatively clear, the political arena could influence the course of the economy in 2006.

**Héctor Ruiz Ramírez**  
Toluca, México. 24 January 2006