



Inflation Observatory

15th November 2007

A jump beyond expectations

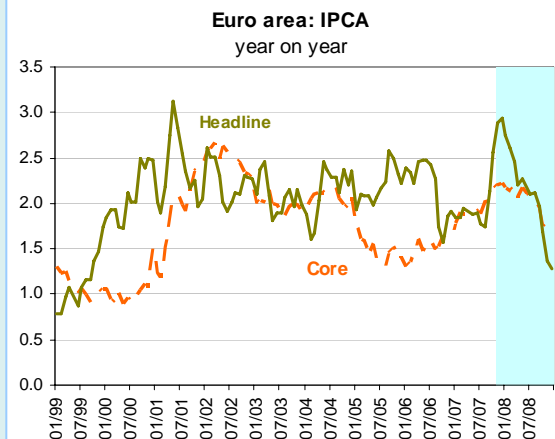
- Inflation was 0.5% MoM in October, and rose from 2.1% to 2.6% in annual terms, far above expectations.
- Core inflation also rose by 0.5%, accelerating by one decimal point in annual terms.
- Across major countries, the largest surprise came from Spain.
- Inflation expectations of consumers and industry remain high but have paused in October, while professional forecasters have only a slight upward bias for inflation projections.
- We have updated our short-term inflation forecast for 2007 and 2008 to an annual average of 2.1%, but consider that medium-term prospects have not changed.

In October, annual inflation in the euro area was 2.6% YoY, accelerating from 2.1% in September and from 1.7% in August, while the monthly inflation rate was 0.5%. Our forecast for headline inflation prior to the publication of the flash estimate was 2.3%. To some extent, this increase is the result of recent oil price hikes and base effects, but also of an unexpected acceleration of food price inflation. Unprocessed food prices have risen by 0.6% MoM, while processed food inflation was 1.2% (accelerating from 3.1% to 3.8% in annual terms). This acceleration of processed food also explains why core inflation (excluding energy and unprocessed food) rose from 2% to 2.1%.

This shock in processed food, together with higher oil prices in recent months, has prompted us to revise our short-term inflation projections. In the coming months inflation is expected to increase to 2.9% and peak by December 2007, moderating very gradually afterwards, down to 2% by the second half of 2008. Once the effects of these shocks (which we consider to be transitory) disappear, inflation is likely to hover around 2%, considering that measures of inflation expectations are contained. In a context of lower growth prospects, we do not consider that these transitory shocks will have significant second round effects on wages.

Overall, this new short-term inflation outlook supports the view that our projected interest rate cut would have to wait until next Spring.

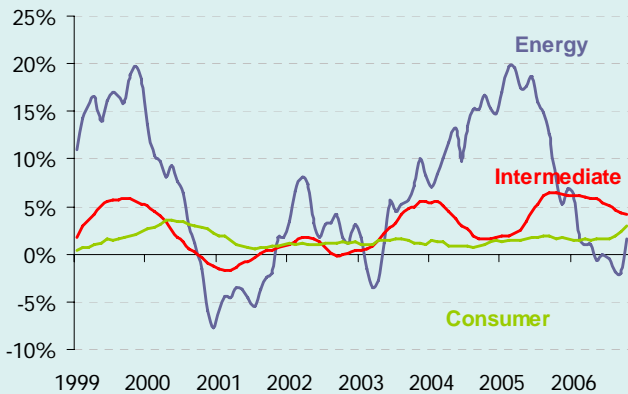
Euro zone HICP				
October 2007	y/y		m/m	
	Current %	Previous %	Current %	Previous %
HICP	2.6	2.1	0.5	0.4
Energy	5.5	3.0	0.6	0.6
Fresh Food	3.1	2.1	0.6	0.2
Core excluding Fresh Food and Energy	2.1	2.0	0.5	0.4
Services	2.5	2.5	0.0	-0.5
Non-Energy Industrial Goods	1.1	1.0	0.8	1.5
Processed Food	3.8	3.1	1.2	0.7
Optimal Trimmed Mean	2.8	2.6	0.3	0.2



		HICP (%)		Core (%)*	
		Annual	Monthly	Annual	Monthly
2007	Jan	1.8	-0.5	1.8	-0.7
	Feb	1.8	0.3	1.9	0.4
	Mar	1.9	0.7	1.9	0.6
	Apr	1.9	0.6	1.9	0.5
	May	1.9	0.2	1.9	0.2
	Jun	1.9	0.1	1.9	0.0
	Jul	1.8	-0.2	1.9	-0.3
	Aug	1.7	0.1	2.0	0.2
	Sep	2.1	0.4	2.0	0.4
	Oct	2.6	0.5	2.1	0.5
	Nov	2.9	0.4	2.2	0.1
	Dec	2.9	0.4	2.2	0.4
2008	Jan	2.8	-0.7	2.2	-0.8
	Feb	2.6	0.1	2.1	0.3
	Mar	2.5	0.5	2.2	0.7
	Apr	2.2	0.4	2.1	0.4
	May	2.3	0.3	2.2	0.3
	Jun	2.2	0.0	2.1	0.0
	Jul	2.1	-0.3	2.1	-0.3
	Aug	2.1	0.1	2.0	0.1
	Sep	2.0	0.2	1.9	0.3
	Oct	1.7	0.2	1.8	0.3
	Nov	1.4	0.0	1.7	0.0
	Dec	1.3	0.4	1.6	0.4
Average	2006	2.2		1.5	
	2007	2.1		2.0	
	2008	2.1		2.0	

(*)HICP excluding energy and fresh food

UEM: Production Prices
year on year rate

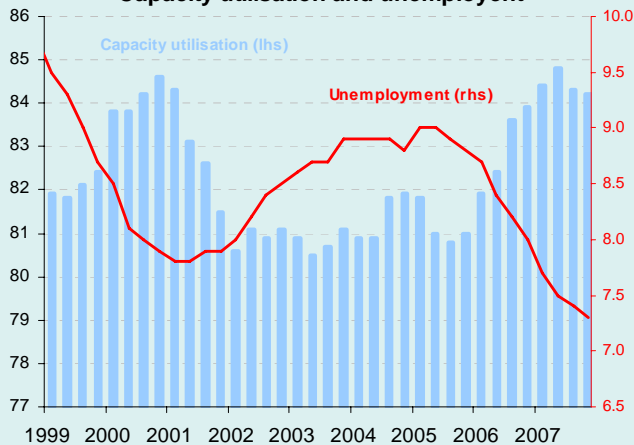


Pass through along the price chain Industrial prices pick up

Pressures from the energy and consumer goods components drove industrial price inflation up to 2.6% in September, from 1.8% in the previous month.

The energy component was the main responsible for this pick-up, with prices rising by 1% over the previous month. Consumer goods' prices also contributed, with an increase of 0.5% over August and of 1.5% over the previous three months. Most of this rise derives from non-durables. In contrast, intermediate goods moderated again in September.

Capacity utilisation and unemployment

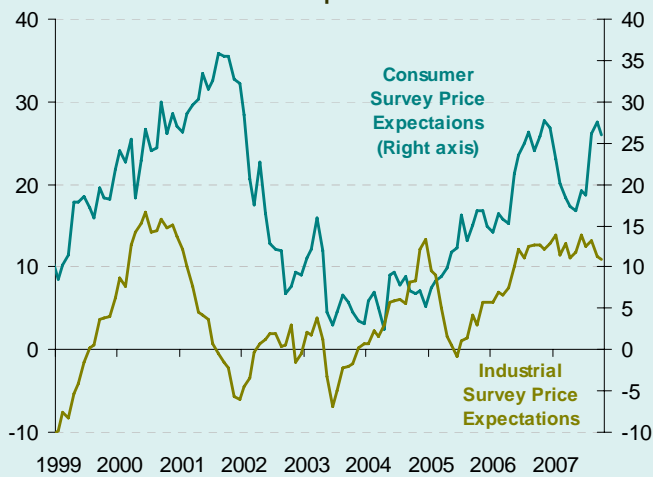


Demand and wage pressures Capacity utilization has eased back

Measures of capacity utilization published this month have eased further by one decimal point from its previous reading in August, and cumulate a fall of 0.6 points from its peak in May. However, they remain very high by historical standards. The unemployment rate continued its downward trend in September and stands at 7.3% (after a methodological revision in Germany that shifted the series up by 4 decimal points).

No new data on wages have been published for the Eurozone. Hourly wages and unit labour costs remained in check until the second quarter of this year.

Price Expectations



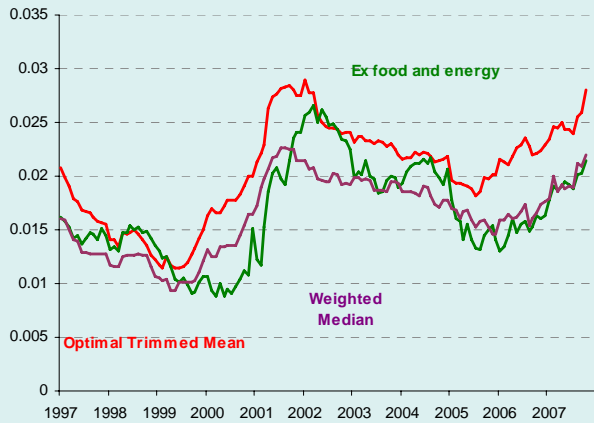
Price expectations No additional worsening

Despite renewed oil price hikes, inflation expectations from the European Commission confidence surveys did not deteriorate further, and consumers' expectations even declined marginally. Both industry and consumers' expectations remain close to their local peaks though.

Price expectations from the manufacturing PMI survey in September and October present the same moderating picture, but the index of input prices from the services PMI has risen by almost two points during the same period.

Source: European Commission and BBVA

Measures of core inflation

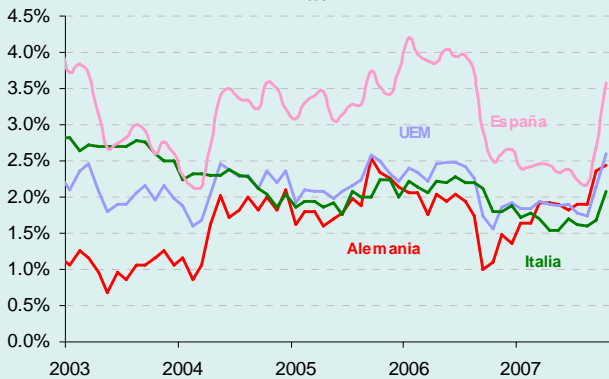


Source: Eurostat and BBVA

Measures of underlying inflation Core inflation accelerates

All measures of core inflation edged up in October. The optimal trimmed-mean inflation rate accelerated by 0.2 points in October (from 2% to 2.2%), while our other two measures (inflation excluding energy and unprocessed food and weighted median inflation) accelerated by one decimal point.

Inflación por países a/a



Fuente: ISTAT, DSTATIS, Eurostat and BBVA

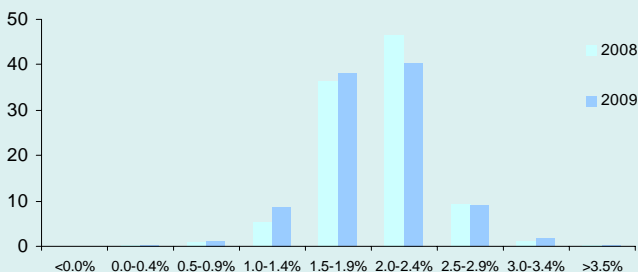
Developments in the largest countries Largest acceleration in Spanish IPC inflation

Across major countries, Spain recorded the largest acceleration in headline inflation (+0.9 points, from 2.7% to 3.6%), which came as a big surprise (the expected rate by the consensus was 3.1%). Inflation in France and Italy edged up by 0.5 and 0.4 points, respectively, to 2% and 2.1%, whereas German inflation barely moved (2.3% to 2.4%).

Core inflation has also accelerated rapidly in Spain mostly due to jumps in processed food prices (from 2.6% to 3.1%), and more slowly in Italy (+0.2 points). They remained broadly stable in France (+0.1 points) and Germany (-0.1 points).

This month focuses on: SPF (Monthly Bulletin)

Probability distribution for average annual inflation in 2008 and 2009, SPF



The Survey of Professional Forecasters for the present quarter¹ shows no change in average inflation projections for 2007 and 2008, both of them at 2%. Longer-term inflation expectations have been marginally revised downwards from 1.95% to 1.93%. However, the distribution of probabilities around the central forecast has been revised upwards, with more respondents assigning a larger probability to inflation surpassing 2% in 2007 and 2008. In the long term, break-even inflation expectations have picked-up somewhat, although this measure is likely to be contaminated by shifts in risk premia also embedded in such measures.

The distribution of probabilities is however upward biased only for inflation in 2008. For 2009 risks are broadly balanced around 2% (chart).

¹ The survey is elaborated by the ECB with data collected from 16 to 18 October, and which most probably do not fully incorporate eventual revisions to inflation forecasts derived from the *flash* estimate for October.