



Inflation Observatory

04th March 2008

Still at the peak

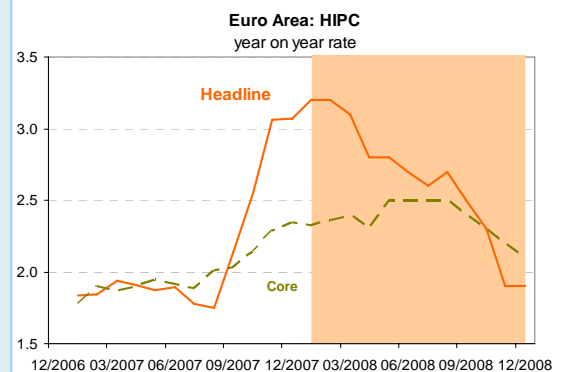
- Headline inflation rose from 3.1% to 3.2% in January, while core inflation remained unchanged at 2.3%. The flash estimate for February was to 3.2%.
- Inflation expectations moderated in services but remained at high levels across all sectors and consumers.
- We revise upwards our forecast for headline inflation from 2.4% to 2.6% in 2008, and our forecast for core inflation to 2.4% and 2.1% for 2008 and 2009, respectively.

In January consumer prices decreased by 0.4%, while the annual inflation rate rose from 3.1% to 3.2%, its highest value since 1993. Given our forecasts, that decrease was 0.1 percentage points (pp) higher than expected, mainly as a result of higher-than-expected prices in energy. Core prices decreased by 0.8%, as expected, as the positive surprise in processed food was offset by the negative in non-energy goods, and remained stable at 2.3% for the third consecutive month.

This upwards surprise in inflation (mainly in energy components) together with the recent published flash estimate of 3.2% for February are pointing both to higher inflation for 2008. In this context, our projection now postpones the moderation in inflation from the spring to the last quarter of 2008. In particular, we revise upwards our forecast for headline inflation from 2.4% to 2.6% in 2008, and our forecast for core inflation from 2.2% to 2.4% and from 1.8% to 2.1%, in 2008 and 2009, respectively.

Under this scenario and in the absence of second-round effects, we still favour an interest cut of 25bp in June (25bp), followed at least by a further one in September.

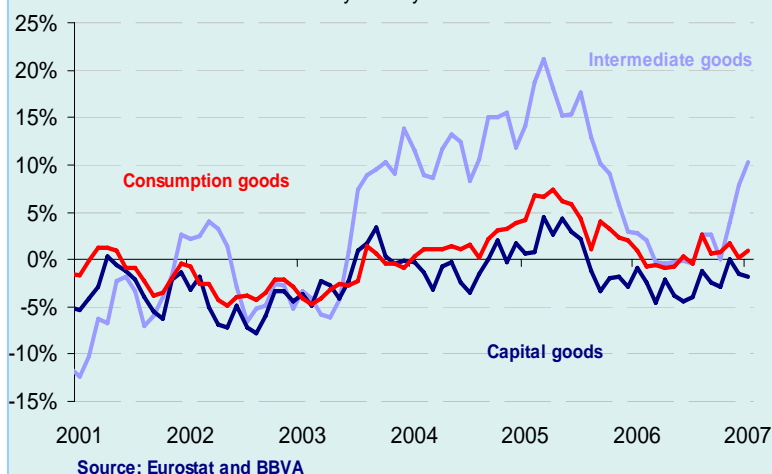
January 2007	Euro zone HICP			
	y/y		m/m	
	Current %	Previous %	Current %	Previous %
HICP	3.2	3.1	-0.4	0.4
Energy	10.6	9.2	1.6	-0.3
Fresh Food	3.3	3.1	1.2	0.5
Core excluding Fresh Food and Energy	2.3	2.3	-0.8	0.5
Services	2.5	2.5	-0.2	0.9
Non-Energy Industrial Goods	0.7	1.0	-1.3	0.1
Processed Food	5.8	5.1	1.0	0.6



		Headline (%)		Core (%)*	
		y/y	m/m	y/y	m/m
2007	ene	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
	ago	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	3.1	0.5	2.3	0.2
	dec	3.1	0.4	2.3	0.5
2008	ene	3.2	-0.4	2.3	-0.8
	feb	3.2	0.3	2.4	0.4
	mar	3.1	0.5	2.4	0.6
	abr	2.8	0.4	2.3	0.4
	may	2.8	0.3	2.5	0.4
	jun	2.7	0.0	2.5	0.0
	jul	2.6	-0.3	2.5	-0.3
	ago	2.7	0.1	2.5	0.2
	sep	2.5	0.3	2.4	0.3
	oct	2.3	0.2	2.3	0.3
	nov	1.9	0.1	2.2	0.1
	dec	1.9	0.4	2.1	0.4
Media	2007	2.1		2.0	
	2008	2.6		2.4	
	2009	2.0		2.1	

(*) HICP excluding energy and fresh food

Import prices year on year rate

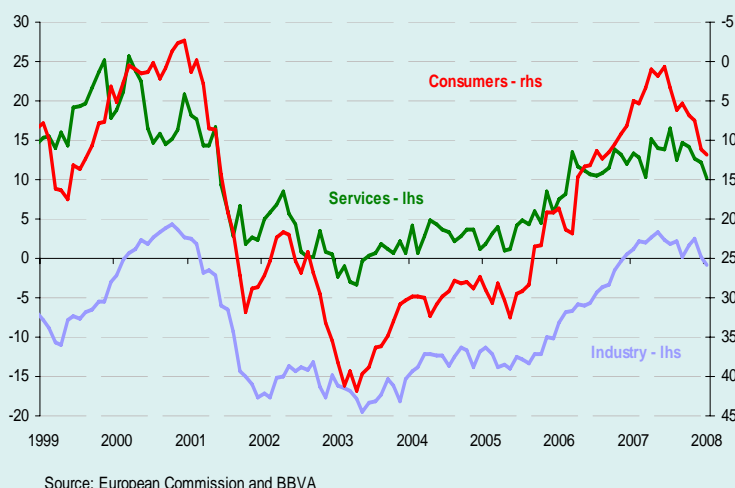


Pass through along the price chain Upward pressures from imported intermediate goods and industrial energy prices

In November, import prices increased considerably by 1.6% M/m after pause in October. On an annual basis, import prices increased from 4.2% to 5.9%, growth rates not seen since August 2006. Across components, import prices in the intermediate sector experienced the highest increases, 2.5% m/m, elevating annual inflation in this sector from 7.8% to 10.3%. However, import prices for consumer and capital goods remained stable in November.

On the producer side, industrial prices accelerated further in January from 4.3% to 4.9% y/y its highest rate since August 2006. Across sectors, prices increased significantly in the energy and consumer sector, 10.6% and 4.2% y/y respectively, while core industrial prices increased by 0.1pp to 3.3% y/y.

Employment expectations

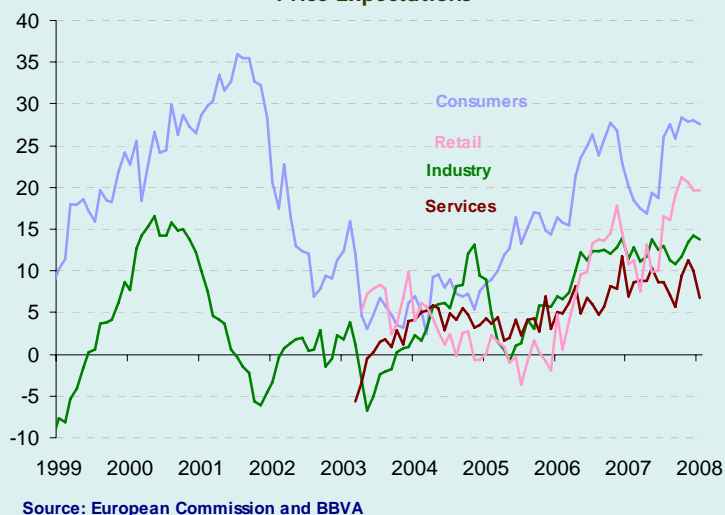


Demand and wage pressures Further deterioration in employment expectations

In February, surveys carried out by the European Commission recorded a further deterioration in employment expectations among both firms and consumers, especially in industry. Additionally, the EC survey showed also increasing concerns about labour constraints in industry while decreasing in services (last month at record-high levels).

Alternatively, PMI surveys suggests that perceptions on capacity constraints, as shown by "backlogs of work" in manufacturing and "outstanding business" in services have stabilised around 50 points.

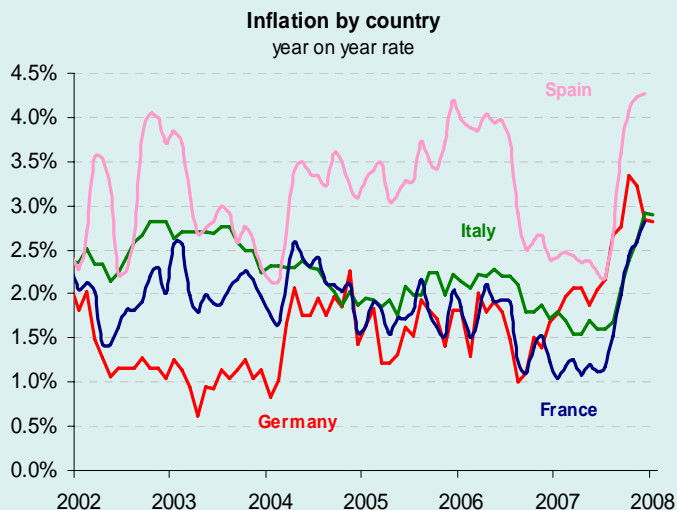
Price Expectations



Price expectations Moderation in services but still at high levels

In February, inflation rate discounted by long-term bonds remained stable at around 2.2%.

Regarding expectations among agents, surveys conducted by the European Commission pointed to stabilization in price expectations among consumers and producers, especially among services. In contrast, and as in the previous month, February PMI surveys still suggested that manufacturers and services' businesses are still expecting higher output prices and costs.



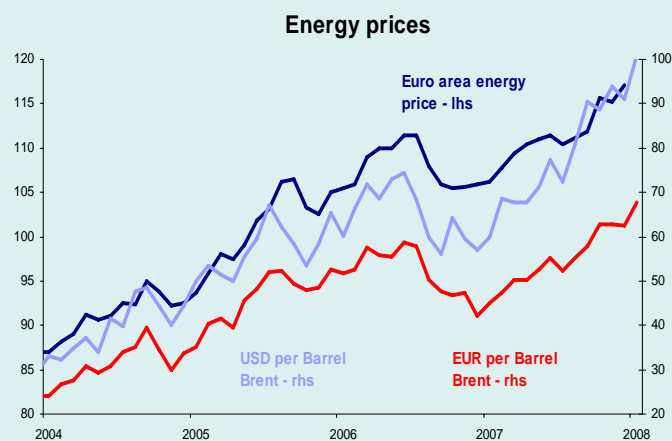
Sources: Datastream and BBVA

Developments in the largest countries Energy and food prices accelerated further

In Germany, inflation decreased by 0.4% in January, from 3.2% to 2.8% on an annual basis, though it remains at very high level with energy and food prices contributing to more than 50% of this increase. In addition, the preliminary press release for February inflation points to stabilization at 2.8%.

Overall, energy and food prices accelerated further in largest euro area countries, with the latter growing at double-digit rates. Additionally, harmonised core inflation was very heterogeneously with moderation in Spain (from 3.4% to 3.2%/y/y) and Germany (from 2.4% to 2.1%/y/y) and worsening in Italy (from 2.3% to 2.6%/y/y) and France (from 1.9% to 2.2%/y/y).

This month focuses on: the euro dampens the impact of oil prices



Source: Datastream and BBVA

Crude oil prices reached a record \$103.05 a barrel on Feb. 29 pushing up inflation in the short term. However, as shown in this chart, the high level of the euro, standing at around \$1.52, is helping to dampen somewhat the contribution of energy prices to inflation.

The recent appreciation of the euro will also affect CPI inflation through its direct impact on other import prices, while it could also exert a moderating effect on exports and activity, which could in turn contribute to reducing inflation pressures.