



# Inflation Observatory

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## A (still) moderate impact of the VAT hike

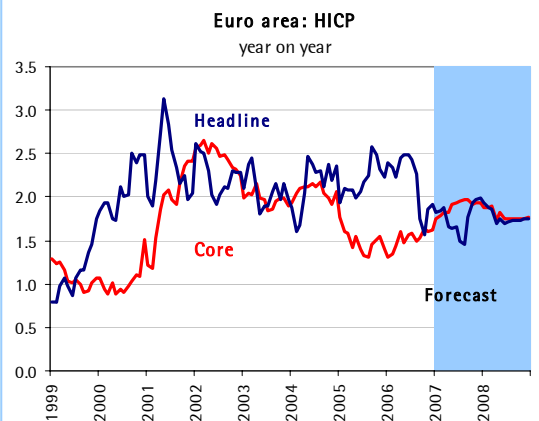
- The moderate inflation rates recorded in the Euro area in January continued throughout February reaching 1.8% according to the flash estimate. Core inflation rose to 1.8.
- In both months inflation data was below expectations. The deviation can only partly be attributed to a lower impact of the VAT hike than previously expected, because other major countries have also registered lower than expected inflation.
- German data suggest that the VAT hike impact on inflation moderated in January. We estimate that the VAT hike added 0.5 pp to German inflation this month, which implies an impact of around 0.1 pp in the euro area..
- Consumers and producers' inflation expectations diminish somewhat whereas economic analysts revise slightly downward their 2007 inflation forecast. We think it is very likely that the next ECB staff's projections, to be published next week, will move in the same direction

In January, HICP of the euro area decreased 0.5% in the month, reducing the annual rate from 1.9% to 1.8%. Core inflation has accelerated since December, from 1.6% to 1.8% year-on-year rate. Headline inflation brought surprises on the downside not only in January, but also in February, according to the flash estimate, suggesting a more moderate impact of the VAT hike than previously expected. In fact, we estimate that the VAT hike has only added around 0.1 pp to the euro area inflation (0.5pp to the German inflation). Nonetheless, the lower than expected inflation cannot be solely attributed to this factor, given that other major countries have also surprised on the downside.

In the euro area as a whole, downside surprises mainly came from the most volatile components (energy and unprocessed food) and from non-energy industrial goods. The latter may be related to particularly intense discounting season.

Although the outlook for euro area inflation remain relatively benign, with mid-point forecast in line with the ECB objective, the monetary authority cannot ignore the upside risks on inflation in a context of diminishing spare capacity, some tightness in the labour market, strong monetary and credit growth and upwards risks on growth scenario.

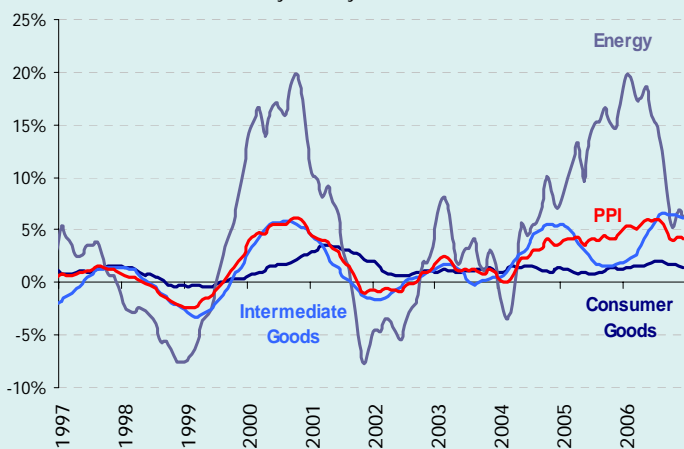
January 2007	Euro zone HICP			
	y/y		m/m	
	Current %	Previous %	Current %	Previous %
<b>HICP</b>	<b>1.8</b>	<b>1.9</b>	<b>-0.5</b>	<b>0.4</b>
Energy	0.8	2.9	0.4	0.1
Fresh Food	3.7	3.7	0.9	0.4
<b>Core excluding Fresh Food and Energy</b>	<b>1.8</b>	<b>1.6</b>	<b>-0.8</b>	<b>0.4</b>
Services	2.3	2.0	-0.2	0.9
Non-Energy Industrial Goods	0.9	0.9	-2.0	0.0
Processed Food	2.2	2.1	0.3	0.1
<b>Optimal Trimmed Mean</b>	<b>2.3</b>	<b>2.3</b>	<b>0.3</b>	<b>0.1</b>



		HICP (%)		Core (%)*	
		Annual	Monthly	Annual	Monthly
2006	jul	2.4	-0.1	1.6	-0.3
	aug	2.3	0.1	1.5	0.1
	sep	1.7	0.0	1.5	0.3
	oct	1.6	0.1	1.6	0.4
	nov	1.9	0.1	1.6	0.1
	dec	1.9	0.4	1.6	0.4
2007	jan	1.8	-0.5	1.8	-0.8
	feb	1.8	0.3	1.8	0.3
	mar	1.9	0.6	1.8	0.7
	apr	1.7	0.5	1.8	0.5
	may	1.6	0.2	1.9	0.2
	jun	1.7	0.1	1.9	0.1
	jul	1.5	-0.3	2.0	-0.3
	aug	1.5	0.1	2.0	0.1
	sep	1.8	0.3	2.0	0.3
	oct	1.9	0.2	1.9	0.3
	nov	2.0	0.1	1.9	0.1
	dec	2.0	0.4	1.9	0.4
Average	2006	2.2		1.5	
	2007	1.8		1.9	
	2008	1.8		1.8	

(\*)HICP excluding energy and fresh food

**Euro area: Production Prices**  
year on year rate



## Pass through along the price chain Strong deceleration in producer prices

The positive development of the components of producer prices in December (consumer goods annual increase reached the lowest value since March, intermediate goods stabilized around 6%, energy prices continued their considerable deceleration) confirms that the risks of pass-through remain contained.

In January, we have observed a strong deceleration in producer prices in Germany (from a 4.4% in December to a 3.2% in January) and in France (from a 2.7% in December to a 1.8% in January), that will very likely translated to EMU's producer prices as well.

## Demand and wage pressures Wages on the rise, alongside productivity

The euro area negotiated wages have reaccelerated in the fourth quarter, retuning to the same level of second quarter 2006, the highest level since mid-2003.

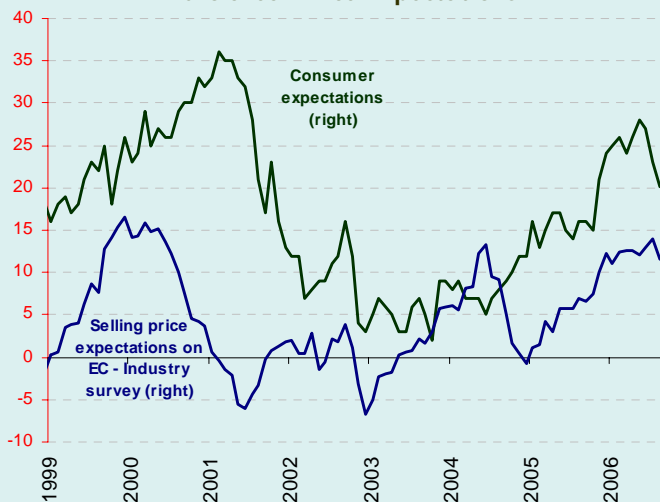
In Germany, wage demands made by the main unions point to a possible acceleration of wages. IG Metall, the largest German union demands a 6.5% increase, but this is the highest demand, the lowest being around 3.5%. Of course final settlements will be somewhat lower. Given the evolution of German productivity in the last years, we foresee that final settlements will be in line with productivity gains and therefore won't be a source of inflation pressure.

## Price expectations Expectations moderate somewhat

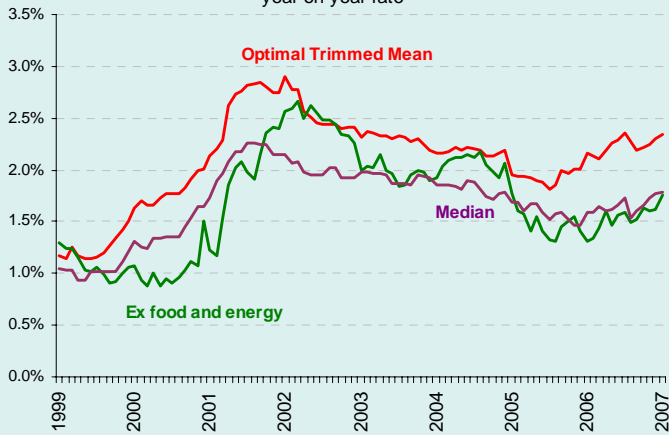
Business and Consumer Surveys show that both consumers and producers have moderated their price expectations. On the consumer side, price expectations have fallen, accumulating a three month decrease. It is possible that the rather mild impact from the VAT hike in Germany we've seen so far, along with lower energy prices, have raised consumer's optimism about future prices. The selling-price expectations in the industrial sector have marginally fallen.

In addition, the latest Survey of Professional Forecasters for 2007 Q1 show that, on average, participants revised their inflation expectation downwards for 2007 (from a 2.1% in 2006Q1 to a 2.0%). For 2008 there was no change (1.9%). Also, the ECB staff's projections are expected to be slightly reduced.

**Euro area: Price Expectations**



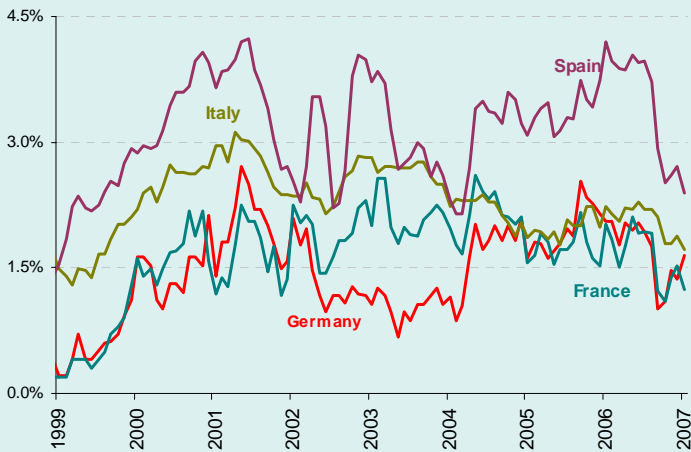
**Measures of Core Inflation**  
year on year rate



**Measures of underlying inflation**  
**Underlying measures are slightly accelerating**

All measures of core inflation accelerated slightly in January. The strongest acceleration was registered by the measure excluding fresh food and energy, that increase from 1.6 to 1.8%. Median inflation remained at 1.8% while the optimal trimmed mean continues above 2% (2.3%).

**Inflation by Country**  
year on year rate



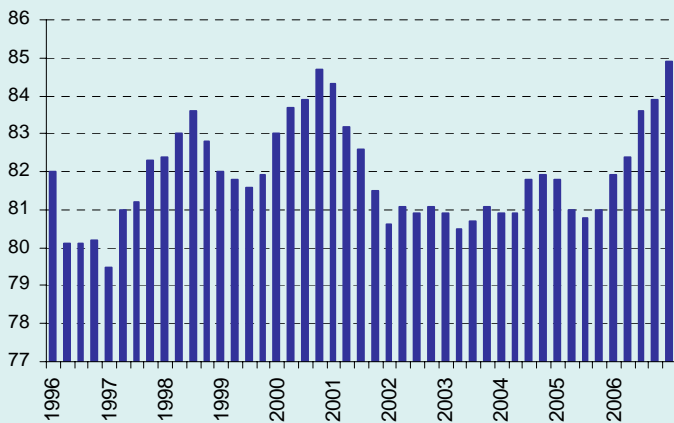
**Developments in largest countries**  
**Downward surprise in January**

The Euro area largest countries had a soft performance in inflation, lower than it has been expected by most analysts. Consumer inflation in Germany was 1.6% in January against the 1.9% expected. Furthermore, February flash data also point to a downward surprise. Although we estimate VAT impact on consumer prices in the order of 0.5% of the January monthly inflation rate, the surprise cannot be fully attributable to a mild VAT impact.

Both France and Italy also surprised downwards.

**This month focuses on: Strong activity poses upside risks on inflation**

**Euro area: Capacity Utilization**



Upside risks on inflation stem neither from commodity prices nor from the VAT hike, but from domestic factors. Capacity utilization continues in an upward trend, reaching the highest value since the fourth quarter of 1990.

Likewise, a decreasing unemployment rate, even below some measures of the non-accelerating inflation unemployment rate, suggests some labour market tightness which could eventually affect prices.

Our index of economic activity (IA BBVA) shows that the economy continues the expansion path. Economic growth in the euro area performed better than expected in 2006. We cannot rule out another surprise on the upside for 2007.