



OF E.U. AND US INFLATION AND MACROECONOMIC ANALYSIS



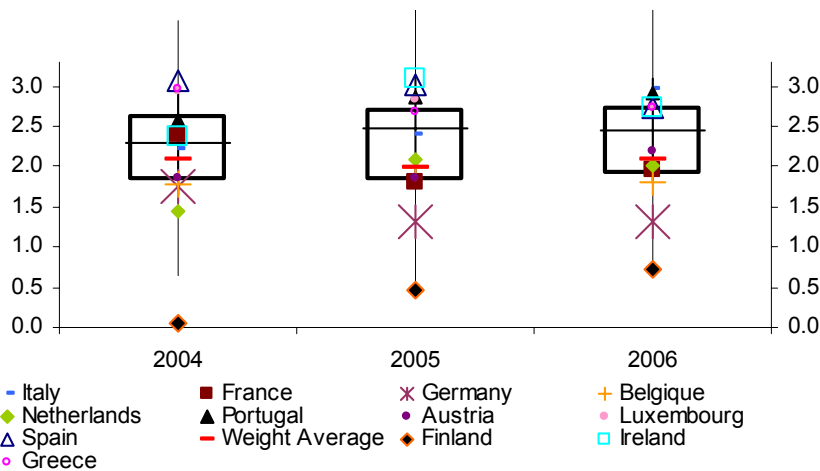
Universidad Carlos III de Madrid

Instituto Flores de Lemus

Nº 124, January 2005

Inflation in the euro area is tending towards 1.8%, consolidating the reduction in dispersion by country, although the median value is above 2.0%.

Box diagram of euro area countries dispersion on inflation



Source: Eurostat & IFL (UC3M)

Date: January 20, 2005

The differential in core inflation between the euro area and the U.S. becomes negative in 2005 and 2006.

AVERAGE RATE (YEAR-ON-YEAR RATES)		2002	2003	2004	2005	2006
CORE INFLATION (a)	EURO AREA	2.4	1.8	1.8	1.8	1.8
	USA	1.6	1.1	1.6	2.3	2.3

(a) CORE INFLATION, in both cases is defined as the CPI less food, energy goods and owner's equivalent rent of primary residence.

Source: Eurostat, BLS & IFL(UC3M)

Date: January 20, 2005

Monthly Debate

The Capitalism to Come.

PART III: FIRM, MARKET AND STATE

III.3.2 THE SCOPE OF STATE

by Juan Urrutia Elejalde. University professor in Economics See Page. 41

Contents

I. EURO AREA AND EUROPEAN UNION

I.1 Inflation

I.1.1 Main points and new results p.1

I.1.2 Tables and plots p.3

I.2 Macroeconomic table p.13

I.3 Industrial production p.15

II. UNITED STATES

II.1 Inflation

II.1.1 Main points and new results p.16

II.1.2 Tables and plots p.18

III. SPAIN

III.1 Inflation

III.1.1 Main points and new results p.26

III.1.2 Tables and plots p.28

III.2 Macroeconomic table p.34

IV. FORECAST SUMMARY

IV.1 Euro area and USA p.36

IV.2 Euro area and Spain p.38

V. INFLATION FORECAST OF DIFFERENT INSTITUTIONS p.40

VI. MONTHLY DEBATE

The Capitalism to Come p.41

PART III: FIRM, MARKET AND STATE

III.3.2 THE SCOPE OF STATE

by Juan Urrutia Elejalde

University professor in Economics

Nº124



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CONSEJERÍA DE ECONOMÍA E INNOVACIÓN TECNOLÓGICA

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OF E.U. AND US INFLATION AND MACROECONOMIC ANALYSIS



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BULLETIN OF EU & US INFLATION AND MACROECONOMIC ANALYSIS is an independent academic publication, monthly published by the Macroeconomic Forecast and Analysis Laboratory, Universidad Carlos III de Madrid.

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Depósito Legal: M22 938 - 1995

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TERMINOLOGY USED:

In inflation analysis it is advisable to break down a consumer price index for a country or an economic area in price indexes corresponding to homogenous markets. An initial basic breakdown used in this publication is 1) Non-processed Food price index (ANE) 2) Energy price index (ENE), 3) Processed Food (AE), 4) Other commodities (MAN), 5) Other services (SERV). The first two are more volatile than the others, and in Espasa et al. (1987) a **core inflation** measure exclusively based on the latter ones was proposed; the Spanish Statistical Institute and Eurostat proceed in the same way. Later, in the BULLETIN EU & US INFLATION AND MACROECONOMIC ANALYSIS was proposed to eliminate from components of core inflation those indexes which are excessively volatile.

Thus, the previous basic breakdown has been amplified for Spain in the following manner: a) ANE, b) ENE, c) Tobacco, Oils and Fats, and Tourist Packages, d) Processed Foods excluding Tobacco, Oils and Fats, (AEX).ge) Other Goods (MAN), and f) Other services, excluding Tourist Packages (SERT). The measure of inflation obtained with the AEX, MAN, and SERV indexes we term **trend inflation**, as an alternative indicator similar to core inflation, but termed trend inflation to indicate a slightly different construction. The measure of inflation established with the price indexes excluded from the CPI to calculate trend inflation or core inflation, depending on the case, is termed **residual inflation**.

For the United States the breakdown by markets is principally based on four components: Food, Energy, Services, and Commodities. **Trend inflation** or **core inflation** is based in this case as the aggregation of services and non-energy commodities.

I. EURO AREA AND EUROPEAN UNION

I.1. INFLATION

I.1.1 MAIN POINTS AND NEW RESULTS

For January, we are forecasting a 0.4% decrease in the HICP in the euro area, with January's annual rate falling to 2.1% from the 2.4% observed in December, 2004. The annual core inflation rate in January will remain at 2.0%, indicating that the expected fall in total annual inflation is due to the fall in the forecast inflation of energy prices in the euro area.

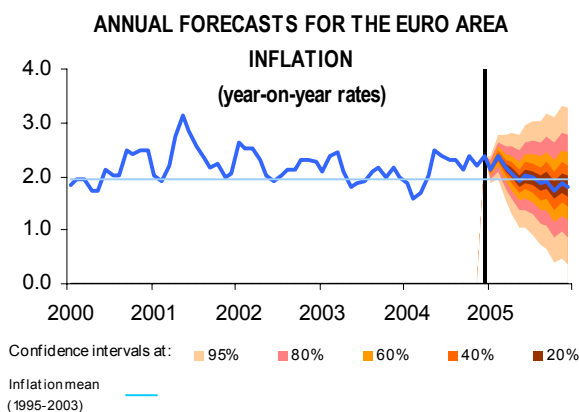
Table I.1.1.1.

Inflation	Observed values			Forecasts		
	2004	2003	Ave ⁽²⁾	2005	2005	2006
	Dec ⁽¹⁾	⁽²⁾	2004	Jan ⁽¹⁾	⁽²⁾	⁽²⁾
CORE (84,17%)	2,0	2,0	2,0	2,0	1,9	1,9
TOTAL (100%)	2,4	2,1	2,1	2,1	2,0	1,8

Source: Eurostat & IFL (UC3M) ⁽¹⁾ Growth of the month over the same month of the previous year
Date: January 20, 2005
⁽²⁾ Growth of the average of the reference year over previous average of the

Inflation performed worse than expected in December, with a monthly variation rate of 0.43% instead of the forecast growth of only a quarter of a percentage point. This is due to the upwards evolution of tobacco prices in Italy and, especially, Germany. These increases in tobacco prices have occurred earlier than usual, since they have normally occurred in the first few months of the year in the past.

Graph I.1.1.1.



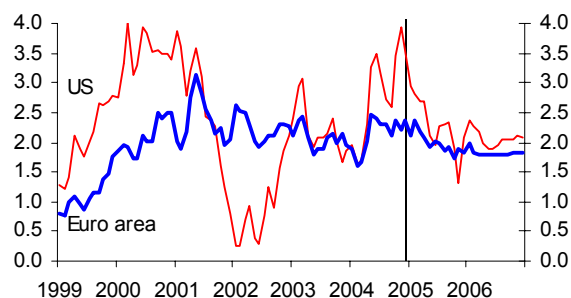
Source : Eurostat & IFL
Date: January 20, 2005

For 2005, and due to the performance of energy prices, we are expecting total inflation to gradually fall to around 2% from April on, and slightly lower at the end of the year. Therefore, the likelihood of complying with the ECB's inflation target from March 2005 on is slightly over 50%. For 2006, the mean rate forecast is around 1.8%.

The inflation differential between the euro area and the U.S. is favourable to the former from May 2004 on (using a homogeneous determination for the two areas). This differential has ranged from half to a whole percentage point since then and it is not expected to disappear in 2005 and 2006, except sporadically in some specific months.

Graph I.1.1.2.

YEAR-ON-YEAR RATES OF TOTAL INFLATION IN THE EURO AREA AND THE USA



* USA inflation less owner's equivalent rent of primary residence. This homogeneous measure of inflation has been constructed in order to compare data in the euro area and USA.

Source : Eurostat & IFL (UC3M)
Date: January 20, 2005

By country, in January we forecast total annual inflation rates of 2.1% in Germany, 3.3% in Spain, 2.0% in Italy and 2.3% in France (see Table I.1.1.2). The dispersion of inflation rates in euro country areas has fallen since 1997, but in two different stages. First, a heavy reduction in 97-99 thanks to the efforts made by the countries to comply with Maastricht convergence criteria and thus be able to join the European monetary union. A second stage started in 1999, which was characterised by a growth in dispersion until 2002, with levels similar to those registered in 1997, followed by a gradual reduction in the following years, representing a 10% decrease in dispersion per annum. The fall in dispersion in 2005 is only expected to be 50% of that registered in 2004, and inflation convergence is expected to become stronger again in 2006.



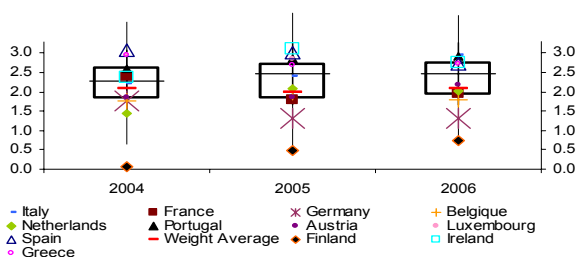
Table I.1.1.1.2.

HICP	Observed			Forecasts	
	2002	2003	2004	2005	2006
SPAIN (11.11%)	3.6	3.1	3.1	2.8	2.8
GERMANY (29.26%)	1.3	1.0	1.8	1.1	1.1
FRANCE (20.70%)	1.9	2.2	2.3	1.9	1.7
ITALY (19.26%)	2.6	2.8	2.2	2.0	2.6
EURO ÁREA (100%)	2.3	2.1	2.1	1.8	1.9
UNITED KINGDOM	1.3	1.4	1.3	1.6	1.5

Source : Eurostat & IFL (UC3M)
Date: January 20, 2005

Table I.1.1.3.

Box diagram of euro area countries dispersion on inflation



Source : Eurostat & IFL
Date: January 20, 2005

The inflation forecasts reveal significant differences between countries in the euro area, permitting a wide range of real interest rates in the different member States; for a year ahead, they range from negative values in Italy (-0.64), Portugal (-0.59), Luxembourg (-0.50), Greece (-0.44) and Spain (-0.38%) to positive values in Finland (1.61%), Germany (0.98%) or France (0.37%). This range of real interest rates is broader than in previous years and in fact, other than Germany and Finland, the rest of the member States have rates close to zero or with negative values, which should favour investment opportunities.

Table I.1.1.3.

	INFLATION EXPECTATIONS		ACTUAL REAL INTEREST RATES	
	Three Months	One Year	Three Months	One Year
Luxembourg	3.65	3.13	-1.48	-0.86
Ireland	3.19	3.13	-1.02	-0.85
Portugal	2.72	2.91	-0.55	-0.63
Spain	2.72	2.75	-0.55	-0.47
Italy	2.00	2.56	0.17	-0.29
Greece	2.72	2.50	-0.54	-0.23
Netherlands	2.07	2.20	0.10	0.08
Austria	2.13	2.07	0.04	0.21
Belgium	2.14	1.95	0.03	0.32
France	1.88	1.73	0.29	0.55
Germany	1.09	1.07	1.08	1.21
Finland	0.51	0.76	1.66	1.52

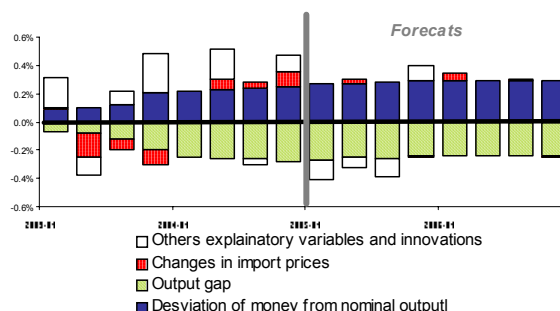
Source : Eurostat, ECB & IFL (UC3M)
Date: January 20, 2005

Annual energy price rates registered positive values which were slightly more moderate than in previous months, below 6% except for France, which registered a worrisome 9.6%. Inflation of non-energy prices performed differently, however, with Germany being the least inflationist in this category, followed by France and Italy. Spain is the most inflationist country of the four.

The effect of monetary policy is being compensated by the opposite effects of the output gap. Moreover, since core inflation tends to stabilise at 1.99%, the ECB can be expected to maintain its reference interest rate throughout the first three quarters of 2005.

Graph I.1.1.3.

CONTRIBUTIONS TO THE DEVIATIONS RESPECT TO THE MEAN (0.48%) OF THE SEASONALLY ADJUSTED QUARTER-TO-QUARTER INFLATION RATE IN THE EURO AREA



Source : Eurostat, ECB & IFL (UC3M)
Date: January 20, 2005



I.1.2. TABLES AND PLOTS

Tables:

- Euro area Harmonized Index of Consumer Price (HICP) disaggregation.
- Europe Forecast errors by sectors for euro area.
- Europe Forecast errors by countries for EU.
- Harmonized Index of Consumer Price (HICP) Annual Growth Rates by sectors in the euro area.
- Harmonized Index of Consumer Price (HICP) Monthly Growth Rates by sectors in the euro area.
- Harmonized Index of Consumer Price (HICP) Annual Growth Rates by countries in the euro area and EU.
- Harmonized Index of Consumer Price (HICP) Monthly Growth Rates by countries in the euro area and EU.

Plots:

- HCPI monthly growth rates in the euro area.
- Annual forecast for the euro area Inflation.
- Fan chart of annual forecast for the euro area Inflation.
- Year-on-year rate of euro area inflation and contributions of main components.
- Year-on-year rate of euro area inflation and contributions of main explanatory variables.
- Box diagram of the euro area countries annual average rates of growth.



METHODOLOGY: ANALYSIS OF EURO AREA INFLATION BY SECTORS

BASIC COMPONENTS AGGREGATES		BASIC COMPONENTS	
HICP TOTAL	IPSEBENE 84.178% 1 + 2 + 3 + 4	BENE 42.845% 1 + 2 + 3	(1) AE (a) 9.463% <i>HICP Processed Food</i>
			(2) TOBACCO 2.373% <i>HICP Tobacco</i>
			(3) MAN 31.009% <i>HICP Non Energy Industrial Goods</i>
	CORE INFLATION (IT IS CALCULATED ON THE IPSEBENE INDEX)	RESIDUAL INFLACION 15.822% 5 + 6 RESIDUAL INFLACION (IT IS CALCULATED ON THE RESIDUAL INDEX)	(4) SER 41.334% <i>HICP Services</i>
			(5) ANE 7.689% <i>HICP Non processed Food</i>
			(6) ENE 8.133% <i>HICP Energy</i>
$IPCA = 0.09463 \text{ AE} + 0.02373 \text{ TABACCO} + 0.31009 \text{ MAN} + 0.41334 \text{ SER} + 0.07689 \text{ ANE} + 0.08133 \text{ ENE}$			

(a) To date the aggregate AE, following Eurostat methodology, included tobacco prices. From now on, our definition of AE, processed food, is more accurate and does therefore not include tobacco prices.

Source: Eurostat & IFL (UC3M)

FORECAST ERRORS IN THE MONTHLY INFLATION RATE BY SECTORS IN THE EURO AREA					
	Weights 2004	Observed Monthly Growth	Forecast	Annual Growth Observed	Confidence interval at 80%
HICP Processed Food	118.36	0.92	0.01	3.17	± 0.14
HICP Processed Food excluding tobacco	94.63	-0.06	-0.02	0.52	± 0.09
HICP Tobacco	23.73	4.55	0.10	13.76	± 0.13
HICP Non Energy Industrial Goods	310.09	-0.19	-0.09	0.75	± 0.10
HICP Non Energy Processed Goods	428.45	0.12	-0.06	1.42	± 0.09
HICP Services	413.34	0.92	0.88	2.71	± 0.14
CORE INFLATION (1)	841.78	0.52	0.40	2.03	± 0.08
HICP Unprocessed Food	76.89	1.02	0.34	0.00	± 0.46
HICP Energy (2)	81.33	-1.76	-1.31	6.99	± 0.60
RESIDUAL INFLATION (3)	158.22	-0.48	-0.55	3.60	± 0.39
GLOBAL INFLATION (4)	1000	0.43	0.25	2.36	± 0.09
(1) aggregation error 0.02%					
(2) aggregation error -0.03%					
(3) aggregation error 0.04%					
(4) aggregation error -0.09%					

Source : Eurostat & IFL(UC3M)
Date: January 20, 2005



FORECAST ERRORS IN THE MONTHLY INFLATION RATE IN THE EURO AREA AND EUROPEAN UNION

	Weights 2004 euro area	Weights 2004 EU	Observed Monthly Rate	Forecast	Observed Annual Rate	Confidence Intervals at 80%
Spain	111.07		-0.08	-0.01	3.27	± 0.15
Germany	292.58		1.08	0.97	2.19	± 0.29
Austria	31.43		0.44	0.26	2.52	± 0.37
Belgium	33.18		-0.35	-0.21	1.95	± 0.32
Finland	15.65		0.00	0.09	0.09	± 0.37
France	206.97		0.09	0.19	2.24	± 0.20
Greece	26.55		0.52	0.27	3.12	± 0.78
Netherlands	52.90		-0.81	-0.39	1.25	± 0.33
Ireland	12.86		0.08	0.54	2.43	± 0.30
Italy	192.65		0.33	-0.02	2.36	± 0.23
Luxembourg	2.73		-0.25	0.21	3.53	± 0.32
Portugal	21.43		0.08	0.08	2.59	± 0.66
Denmark		11.78	-0.26	-0.11	0.95	± 0.27
United Kingdom		181.92	0.54	0.40	1.63	± 0.33
Sweden		18.65	0.00	0.18	0.89	± 0.50
(1) aggregation error -0.03%						
(2) aggregation error -0.08%						

Source : Eurostat & IFL(UC3M)
Date: January 20, 2005



HICP ANNUAL GROWTH BY SECTORS IN THE EURO AREA											
		Harmonized Consumer Prices Index									
		Core					Residual			TOTAL	
		Processed food excluding tobacco	Tobacco	Non energy industrial goods	Services	TOTAL	Non processed food	Energy	TOTAL		
Weights 2004	9.5%	2.4%	31.0%	41.3%	84.2%	7.7%	8.1%	15.8%	100%		
ANNUAL AVERAGE RATE	1997	0.6	5.6	0.6	2.4	1.5	1.3	2.7	2.0	1.6	
	1998	0.9	4.0	0.9	1.9	1.4	2.0	-2.6	-0.3	1.1	
	1999	0.5	3.1	0.7	1.5	1.1	0.0	2.4	1.2	1.1	
	2000	0.6	3.4	0.4	1.5	1.0	1.7	13.0	7.5	2.1	
	2001	2.7	3.8	0.9	2.5	1.9	7.0	2.3	4.4	2.3	
	2002	2.4	5.9	1.5	3.1	2.5	3.1	-0.6	1.1	2.3	
	2003	2.1	8.4	0.8	2.6	2.0	2.2	3.0	2.6	2.1	
	2004	1.3	12.2	0.8	2.6	2.0	0.6	4.5	2.6	2.1	
	2005	1.0	8.4	0.7	2.6	1.9	2.2	2.1	2.2	2.0	
	2006	1.8	6.1	0.8	2.6	1.9	2.1	0.2	1.2	1.8	
ANNUAL RATES (growth of the month over the same month of the previous year)	2004	January	1.9	9.0	0.6	2.5	1.9	2.9	-0.3	1.2	1.9
		February	1.9	8.3	0.9	2.7	2.0	1.9	-2.3	-0.2	1.6
		March	1.7	13.9	0.8	2.5	2.1	1.7	-2.0	-0.2	1.7
		April	1.7	13.1	1.0	2.5	2.1	1.6	2.0	1.8	2.0
		May	1.5	13.8	0.8	2.6	2.1	1.8	6.7	4.2	2.5
		June	1.4	13.8	0.8	2.6	2.1	1.3	5.9	3.6	2.4
		July	1.4	13.7	0.7	2.7	2.1	0.7	6.0	3.4	2.3
		August	1.2	13.5	0.9	2.6	2.2	-0.3	6.4	3.2	2.3
		September	0.9	13.2	0.8	2.6	2.0	-1.5	6.4	2.6	2.1
		October	0.6	11.7	0.8	2.6	2.0	-1.3	9.8	4.4	2.4
		November	0.6	9.2	0.8	2.7	1.9	-1.0	8.6	4.0	2.2
		December	0.5	13.8	0.7	2.7	2.0	0.0	7.0	3.6	2.4
	2005	January	0.4	13.0	0.8	2.6	2.0	0.9	4.6	2.9	2.1
		February	0.4	12.8	0.7	2.6	2.0	1.4	6.7	4.2	2.4
		March	0.5	8.4	0.8	2.8	1.9	1.7	5.3	3.6	2.2
		April	0.6	8.0	0.7	2.5	1.8	2.1	4.4	3.3	2.1
		May	0.7	7.5	0.7	2.6	1.8	2.2	1.8	2.1	1.9
		June	0.8	7.5	0.7	2.6	1.8	1.9	2.6	2.4	2.0
		July	0.9	7.7	0.8	2.6	1.9	2.3	2.0	2.3	2.0
		August	1.1	7.9	0.7	2.6	1.8	2.8	0.5	1.6	1.9
		September	1.4	8.0	0.7	2.6	1.9	3.1	0.7	1.8	1.9
		October	1.5	8.2	0.7	2.6	1.9	3.3	-2.1	0.4	1.7
		November	1.6	8.3	0.7	2.6	2.0	3.0	-0.9	0.9	1.9
		December	1.7	3.7	0.8	2.6	1.9	2.3	0.8	1.6	1.8
	2006	January	1.8	7.0	0.8	2.6	2.0	2.2	2.1	2.1	2.0
		February	1.8	7.0	0.8	2.6	2.0	2.1	0.1	1.1	1.8
		March	1.8	5.9	0.8	2.6	1.9	2.1	0.1	1.1	1.8
		April	1.8	5.9	0.8	2.6	1.9	2.1	-0.1	1.0	1.8
		May	1.8	5.9	0.8	2.6	1.9	2.1	-0.1	1.0	1.8
		June	1.8	5.9	0.8	2.6	1.9	2.1	0.0	1.0	1.8
		July	1.8	5.9	0.8	2.6	1.9	2.1	0.0	1.1	1.8
		August	1.8	5.9	0.8	2.6	1.9	2.1	0.1	1.1	1.8
		September	1.8	5.9	0.8	2.6	1.9	2.1	0.1	1.1	1.8
		October	1.8	5.9	0.8	2.6	1.9	2.1	0.1	1.1	1.8
		November	1.8	5.9	0.8	2.6	1.9	2.1	0.2	1.1	1.8
		December	1.8	5.9	0.8	2.6	1.9	2.1	0.1	1.1	1.8

Source : Eurostat & IFL(UC3M)
Date: January 20, 2005



HICP MONTHLY GROWTH BY SECTORS IN THE EURO AREA											
		Harmonized Consumer Prices Index									
		Core					Residual			TOTAL	
		Processed food excluding tobacco	Tobacco	Non energy industrial goods	Services	TOTAL	Non processed food	Energy	TOTAL		
Weights 2004	9.5%	2.4%	31.0%	41.3%	84.2%	7.7%	8.1%	15.8%	100%		
MONTHLY RATES (Growth of the month over the previous month)	January	2003	0.2	4.2	-1.4	-0.2	-0.5	1.4	3.1	2.3	-0.1
		2004	0.2	1.7	-1.6	0.0	-0.5	1.1	1.0	1.0	-0.2
		2005	0.2	1.0	-1.5	-0.1	-0.5	2.0	-1.2	0.3	-0.4
		2006	0.2	4.2	-1.5	-0.1	-0.4	1.8	0.0	0.9	-0.2
	February	2003	0.3	1.0	0.0	0.3	0.3	0.3	1.9	1.1	0.4
		2004	0.2	0.3	0.3	0.5	0.4	-0.7	-0.1	-0.3	0.2
		2005	0.2	0.1	0.2	0.5	0.3	-0.1	1.9	0.9	0.4
		2006	0.2	0.1	0.2	0.5	0.3	-0.2	0.0	-0.1	0.3
	March	2003	0.2	0.1	1.1	0.2	0.5	0.5	1.0	0.8	0.6
		2004	0.0	5.3	1.0	0.0	0.6	0.3	1.3	0.8	0.7
		2005	0.1	1.2	1.1	0.2	0.5	0.6	0.0	0.3	0.5
		2006	0.1	0.1	1.1	0.2	0.5	0.6	0.0	0.3	0.5
	April	2003	0.1	1.2	0.6	0.3	0.4	0.4	-2.9	-1.3	0.1
		2004	0.1	0.4	0.8	0.3	0.4	0.3	1.1	0.7	0.4
		2005	0.2	0.1	0.8	0.1	0.3	0.7	0.1	0.4	0.3
		2006	0.2	0.1	0.8	0.1	0.3	0.7	0.0	0.3	0.3
	May	2003	0.2	0.1	0.3	0.0	0.1	0.3	-2.1	-0.9	-0.1
		2004	0.0	0.6	0.1	0.1	0.2	0.4	2.5	1.4	0.3
		2005	0.2	0.1	0.1	0.2	0.2	0.5	0.0	0.3	0.2
		2006	0.2	0.1	0.1	0.2	0.2	0.5	0.0	0.3	0.2
	June	2003	0.2	0.1	-0.2	0.3	0.1	0.6	0.0	0.3	0.1
		2004	0.1	0.1	-0.2	0.3	0.1	0.1	-0.8	-0.3	0.0
		2005	0.2	0.1	-0.2	0.3	0.1	-0.2	0.0	-0.1	0.1
		2006	0.2	0.1	-0.2	0.3	0.1	-0.2	0.1	-0.1	0.1
	July	2003	0.1	0.1	-1.4	0.6	-0.2	-0.6	0.5	0.0	-0.1
		2004	0.1	0.0	-1.6	0.8	-0.3	-1.2	0.6	-0.2	-0.2
		2005	0.2	0.1	-1.5	0.7	-0.2	-0.8	0.0	-0.4	-0.2
		2006	0.2	0.1	-1.5	0.7	-0.2	-0.8	0.1	-0.3	-0.2
	August	2003	0.2	0.1	-0.1	0.3	0.1	-0.4	1.1	0.3	0.2
		2004	0.0	0.0	0.1	0.2	0.3	-1.3	1.5	0.2	0.2
		2005	0.2	0.1	0.0	0.2	0.2	-0.9	0.0	-0.4	0.1
		2006	0.2	0.1	0.0	0.2	0.2	-0.9	0.0	-0.4	0.1
	September	2003	0.1	0.3	1.1	-0.3	0.4	1.2	-0.1	0.5	0.4
		2004	-0.2	0.0	1.1	-0.3	0.2	-0.1	-0.2	-0.1	0.2
		2005	0.1	0.1	1.1	-0.3	0.3	0.2	0.0	0.1	0.2
		2006	0.1	0.1	1.1	-0.3	0.3	0.2	0.0	0.1	0.2
	October	2003	0.2	1.4	0.6	-0.1	0.3	-0.3	-0.3	-0.3	0.1
		2004	0.0	0.0	0.6	-0.1	0.2	-0.1	2.9	1.5	0.3
		2005	0.1	0.1	0.6	-0.1	0.2	0.2	0.0	0.1	0.2
		2006	0.1	0.1	0.6	-0.1	0.2	0.2	0.0	0.1	0.2
	November	2003	0.1	2.3	0.3	-0.1	0.1	-0.2	-0.2	-0.2	0.1
		2004	0.0	0.1	0.3	-0.1	0.0	0.1	-1.2	-0.6	-0.1
		2005	0.1	0.1	0.3	-0.1	0.1	-0.2	0.0	-0.1	0.1
		2006	0.1	0.1	0.3	-0.1	0.1	-0.2	0.0	-0.1	0.1
	December	2003	0.0	0.3	-0.1	0.9	0.4	0.0	-0.2	-0.1	0.3
		2004	-0.1	4.6	-0.2	0.9	0.5	1.0	-1.8	-0.5	0.4
		2005	0.0	0.1	-0.2	0.9	0.4	0.3	0.0	0.2	0.4
		2006	0.0	0.1	-0.2	0.9	0.4	0.3	0.0	0.1	0.4

Source : Eurostat & IFL(UC3M)

Date: January 20, 2005



HICP ANNUAL GROWTH BY COUNTRIES IN THE EURO AREA AND EU																	
		European Monetary Union															
		Euro Area															
		Germany	France	Italy	Spain	Netherlands	Belgium	Austria	Greece	Portugal	Finland	Ireland	Luxembourg	United Kingdom	Sweden	Denmark	
Weights 2004	29,3%	20,7%	19,3%	11,1%	5,3%	3,3%	3,1%	2,6%	2,1%	1,6%	1,3%	0,3%	18,2%	1,9%	1,2%		
ANNUAL AVERAGE RATE	1997	1.5	1.3	2.0	1.9	1.9	1.5	1.2	5.4	1.9	1.2	1.2	1.4	5.4	1.8	1.9	
	1998	0.6	0.7	1.9	1.8	1.8	0.9	0.8	4.5	2.2	1.4	2.1	1.0	4.5	1.0	1.3	
	1999	0.6	0.6	1.7	2.2	2.0	1.1	0.5	2.1	2.2	1.3	2.5	1.0	2.1	0.6	2.1	
	2000	1.4	1.8	2.6	3.5	2.3	2.7	2.0	2.9	2.8	3.0	5.3	3.8	0.8	1.3	2.7	
	2001	1.9	1.8	2.3	2.8	5.1	2.4	2.3	3.7	4.4	2.7	4.0	2.4	1.2	2.7	2.3	
	2002	1.3	1.9	2.6	3.6	3.9	1.6	1.7	3.9	3.7	2.0	4.7	2.1	1.3	2.0	2.4	
	2003	1.0	2.2	2.8	3.1	2.2	1.5	1.3	3.5	3.3	1.3	4.0	2.5	1.4	2.3	2.0	
	2004	1.8	2.3	2.3	3.1	1.4	1.9	2.0	3.0	2.5	0.1	2.3	3.2	1.3	1.0	0.9	
	2005	1.5	1.9	2.7	2.6	1.6	1.9	2.3	3.1	2.7	0.4	2.6	3.3	1.9	1.1	1.4	
	2006	1.3	2.0	3.0	2.7	2.0	1.8	2.2	2.7	2.9	0.7	2.7	2.7	1.6	1.3	1.8	
ANNUAL RATES (growth of the month over the same month of the previous year)	2004	January	0.9	1.9	2.9	3.8	2.7	1.2	1.7	3.3	4.0	1.4	4.7	3.3	1.4	2.6	2.6
		February	1.2	2.5	2.6	3.8	2.9	1.6	1.8	4.2	4.1	2.1	5.1	3.2	1.6	3.3	2.9
		March	1.2	2.6	2.9	3.7	2.8	1.7	1.8	3.9	3.8	1.9	4.9	3.7	1.6	2.9	2.8
		April	1.0	1.9	3.0	3.2	2.2	1.4	1.3	3.3	3.7	1.3	4.6	3.0	1.5	2.3	2.5
		May	0.6	1.8	2.9	2.7	2.3	0.9	0.9	3.5	3.7	1.1	3.9	2.3	1.2	2.0	2.1
		June	0.9	1.9	2.9	2.8	2.1	1.5	1.0	3.6	3.4	1.2	3.8	2.0	1.1	2.0	2.0
		July	0.8	1.9	2.9	2.9	2.1	1.4	1.0	3.5	2.9	1.0	3.9	1.9	1.3	2.4	1.8
		August	1.1	2.0	2.7	3.1	2.2	1.6	1.0	3.3	2.9	1.2	3.9	2.3	1.4	2.2	1.5
		September	1.1	2.3	3.0	3.0	2.0	1.7	1.4	3.3	3.2	1.2	3.8	2.7	1.4	2.3	1.7
		October	1.1	2.3	2.8	2.7	1.9	1.4	1.1	3.2	2.8	0.9	3.3	1.8	1.4	2.0	1.1
		November	1.3	2.5	2.8	2.9	2.0	1.8	1.3	3.5	2.3	1.2	3.3	2.0	1.3	2.0	1.4
		December	1.1	2.4	2.5	2.7	1.6	1.7	1.3	3.1	2.3	1.2	2.9	2.4	1.3	1.8	1.2
	2005	January	1.2	2.2	2.2	2.3	1.5	1.4	1.2	3.1	2.2	0.8	2.3	2.3	1.4	1.3	1.0
		February	0.8	1.9	2.4	2.2	1.3	1.2	1.5	2.6	2.1	0.4	2.2	2.4	1.3	0.2	0.7
		March	1.1	1.9	2.3	2.2	1.2	1.0	1.5	2.9	2.2	-0.4	1.8	2.0	0.9	0.4	0.0
		April	1.7	2.4	2.3	2.7	1.5	1.7	1.5	3.1	2.4	-0.4	1.7	2.7	1.2	1.1	0.5
		May	2.1	2.8	2.3	3.4	1.7	2.4	2.1	3.1	2.4	-0.1	2.1	3.4	1.5	1.5	1.1
		June	1.9	2.7	2.4	3.5	1.5	2.0	2.3	3.0	3.7	-0.1	2.5	3.8	1.6	1.2	0.9
		July	2.0	2.6	2.2	3.3	1.2	2.1	2.1	3.1	2.9	0.2	2.5	3.8	1.4	1.2	1.1
		August	2.1	2.5	2.4	3.3	1.2	2.0	2.2	2.8	2.4	0.3	2.5	3.6	1.3	1.3	0.9
		September	1.9	2.2	2.1	3.2	1.1	1.8	1.8	2.9	2.1	0.2	2.4	3.1	1.1	1.2	0.9
		October	2.2	2.3	2.1	3.6	1.5	2.7	2.4	3.3	2.4	0.6	2.5	4.1	1.2	1.4	1.6
		November	2.0	2.2	2.0	3.5	1.5	2.3	2.4	3.0	2.6	0.2	2.8	4.0	1.5	1.1	1.0
		December	2.2	2.2	2.4	3.3	1.2	1.9	2.5	3.1	2.6	0.1	2.4	3.5	1.6	0.9	1.0
	2006	January	1.7	2.2	2.9	3.2	1.3	2.2	2.6	3.3	2.7	0.2	2.5	4.0	1.7	1.1	1.1
		February	2.0	2.2	2.6	3.2	1.4	2.3	2.4	3.3	2.7	0.1	2.5	3.0	1.7	1.3	1.1
		March	1.8	2.1	2.5	3.1	1.5	2.3	2.4	3.0	2.8	0.3	2.7	3.2	2.0	1.1	1.5
		April	1.6	2.1	2.5	2.8	1.5	1.9	2.4	3.0	2.7	0.4	2.7	3.1	1.9	1.0	1.3
		May	1.4	1.8	2.7	2.5	1.4	1.8	2.3	3.0	2.6	0.3	2.7	3.0	1.8	0.8	1.2
		June	1.6	1.8	2.7	2.4	1.6	1.9	2.2	3.0	2.0	0.4	2.6	2.9	1.9	1.1	1.4
		July	1.5	1.9	2.8	2.4	1.7	2.1	2.3	3.2	2.6	0.6	2.6	4.0	1.9	1.2	1.4
		August	1.3	1.8	2.7	2.3	1.8	1.8	2.3	3.2	2.8	0.5	2.5	3.3	1.9	1.2	1.7
		September	1.4	1.9	2.8	2.4	1.8	1.9	2.3	3.0	2.9	0.4	2.6	3.2	2.1	1.1	1.5
		October	1.1	1.6	2.9	2.2	1.7	1.5	2.2	2.9	2.8	0.3	2.6	3.2	1.9	0.9	1.2
		November	1.3	1.7	3.0	2.4	1.8	1.7	2.2	2.9	2.9	0.5	2.5	3.0	1.8	1.2	1.6
		December	1.6	1.8	2.9	2.7	2.0	1.9	2.2	2.9	2.9	0.6	2.7	3.3	1.7	1.3	1.7

Source : Eurostat & IFL(UC3M)
Date: January 20, 2005



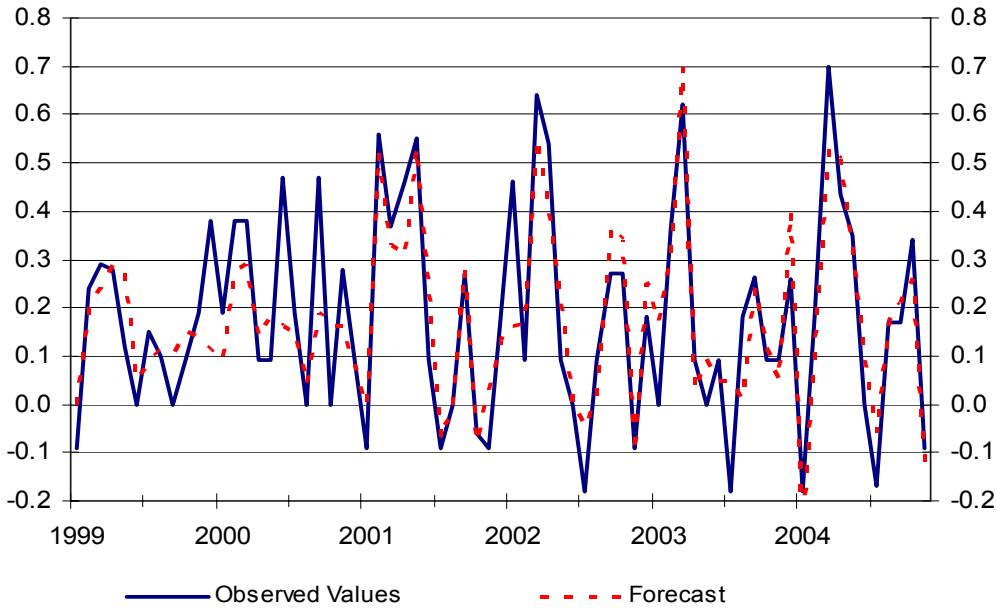
HICP MONTHLY GROWTH BY COUNTRIES IN THE EURO AREA AND EU																	
		European Monetary Union															
		Euro Area															
		Germany	France	Italy	Spain	Netherlands	Belgium	Austria	Greece	Portugal	Finland	Ireland	Luxembourg	United Kingdom	Sweden	Denmark	
Weights 2004		29,3%	20,7%	19,3%	11,1%	5,3%	3,3%	3,1%	2,6%	2,1%	1,6%	1,3%	0,3%	18,2%	1,9%	1,2%	
MONTHLY RATES (Growth of the month over the previous month)	January	2003	-0.1	0.3	-0.3	-0.4	0.6	-1.0	0.2	-0.8	0.1	0.2	0.0	-0.3	-0.6	0.3	0.2
		2004	0.0	0.1	-0.6	-0.8	0.5	-1.3	0.1	-0.8	0.0	-0.3	-0.6	-0.3	-0.5	-0.3	-0.1
		2005	-0.4	0.1	-0.1	-0.9	0.5	-1.1	0.1	-0.7	0.1	-0.1	-0.5	0.1	-0.5	-0.1	0.1
		2006	-0.4	0.1	-0.1	-0.7	0.5	-1.1	0.1	-0.6	0.1	0.0	-0.5	0.2	-0.6	-0.1	0.0
	February	2003	0.6	0.7	-0.4	0.2	0.8	2.1	0.2	-0.2	0.0	0.9	1.0	1.1	0.4	1.0	0.7
		2004	0.2	0.4	-0.2	0.1	0.6	1.9	0.5	-0.7	-0.2	0.4	0.9	1.3	0.3	-0.1	0.4
		2005	0.4	0.4	-0.4	0.1	0.6	2.0	0.3	-0.6	-0.1	0.3	0.9	0.3	0.4	0.2	0.4
		2006	0.2	0.4	-0.3	0.1	0.6	1.9	0.3	-0.6	-0.1	0.2	0.9	0.2	0.3	0.2	0.5
	March	2003	0.2	0.5	1.2	0.8	0.9	0.3	0.3	2.5	0.1	0.4	0.7	0.5	0.4	0.6	0.8
		2004	0.5	0.4	1.1	0.7	0.8	0.1	0.4	2.9	0.2	-0.4	0.4	0.1	0.0	0.9	0.1
		2005	-0.1	0.3	-0.3	-0.4	0.6	-1.0	0.2	-0.8	0.1	0.2	0.0	-0.3	-0.6	0.3	0.2
		2006	0.1	0.4	1.0	0.6	0.9	0.1	0.3	2.3	0.3	-0.1	0.5	0.2	0.2	0.5	0.5
	April	2003	-0.3	-0.2	0.8	0.8	0.1	-0.2	-0.1	0.2	0.8	-0.1	0.5	-0.2	0.3	-0.4	0.0
		2004	0.3	0.3	0.8	1.4	0.3	0.5	-0.1	0.4	1.0	0.0	0.3	0.5	0.5	0.3	0.5
		2005	0.3	0.4	1.0	0.6	0.9	0.0	0.3	2.6	0.3	-0.2	0.5	0.3	0.2	0.6	0.5
		2006	0.1	0.3	0.7	1.0	0.4	0.3	-0.1	0.3	0.9	0.1	0.4	0.2	0.4	0.1	0.3
	May	2003	-0.3	-0.1	0.2	-0.1	-0.1	-0.4	-0.2	0.5	0.7	-0.1	-0.2	-0.2	0.0	-0.1	-0.3
		2004	0.2	0.4	0.2	0.6	0.2	0.3	0.4	0.4	0.8	0.2	0.2	0.5	0.4	0.4	0.3
		2005	0.0	0.1	0.3	0.2	0.1	0.2	0.3	0.4	0.7	0.1	0.2	0.4	0.3	0.2	0.2
		2006	-0.1	0.2	0.3	0.2	0.1	0.2	0.3	0.4	0.7	0.1	0.2	0.2	0.3	0.2	0.3
	June	2003	0.2	0.2	0.1	0.1	-0.5	0.4	0.0	-0.2	0.0	-0.1	0.1	0.0	-0.1	-0.2	0.0
		2004	0.0	0.1	0.2	0.2	-0.7	-0.1	0.2	-0.2	1.2	-0.1	0.5	0.4	-0.1	-0.5	-0.3
		2005	0.2	0.1	0.2	0.1	-0.5	0.0	0.1	-0.2	0.6	0.0	0.4	0.3	0.0	-0.3	0.0
		2006	0.4	0.1	0.1	0.1	-0.5	0.0	0.1	-0.2	0.6	0.0	0.4	0.2	0.0	-0.2	0.0
	July	2003	0.3	-0.1	-0.1	-0.6	-0.1	-1.2	-0.1	-2.1	-0.2	-0.5	-0.4	-0.8	-0.1	-0.2	-0.6
		2004	0.4	-0.2	-0.2	-0.7	-0.3	-1.0	-0.3	-1.9	-0.9	-0.3	-0.4	-0.8	-0.3	-0.2	-0.3
		2005	0.3	-0.1	-0.1	-0.7	-0.2	-0.8	-0.2	-1.7	-0.3	-0.1	-0.4	0.2	-0.3	-0.1	-0.4
		2006	0.3	-0.1	-0.1	-0.7	-0.2	-0.9	-0.2	-1.6	-0.3	0.0	-0.4	0.2	-0.3	-0.1	-0.4
	August	2003	0.1	0.3	-0.3	0.5	0.2	1.7	0.3	0.0	0.1	0.2	0.6	1.2	0.4	-0.1	-0.1
		2004	0.2	0.2	-0.2	0.5	0.2	1.7	0.4	-0.3	-0.4	0.3	0.6	1.1	0.3	0.0	-0.3
		2005	0.0	0.1	-0.2	0.4	0.2	1.4	0.3	-0.3	-0.1	0.2	0.6	0.4	0.3	0.0	-0.1
		2006	0.0	0.1	-0.2	0.4	0.2	1.4	0.3	-0.2	-0.1	0.2	0.6	0.2	0.3	0.0	-0.1
	September	2003	-0.2	0.5	0.8	0.2	0.8	0.2	0.3	2.0	0.2	0.5	0.2	0.7	0.3	0.8	0.8
		2004	-0.4	0.1	0.5	0.2	0.8	-0.1	-0.1	2.1	-0.1	0.4	0.1	0.2	0.1	0.7	0.8
		2005	-0.3	0.1	0.6	0.3	0.9	0.0	0.0	1.9	0.0	0.3	0.1	0.1	0.2	0.6	0.6
		2006	-0.3	0.2	0.6	0.3	0.9	0.1	0.0	1.7	0.0	0.2	0.1	0.2	0.2	0.5	0.6
	October	2003	-0.1	0.2	0.3	0.7	-0.2	-0.4	0.0	0.4	0.2	-0.1	0.0	-0.4	0.2	0.1	-0.3
		2004	0.2	0.4	0.3	1.0	0.2	0.5	0.5	0.7	0.5	0.4	0.1	0.5	0.3	0.4	0.4
		2005	-0.1	0.1	0.4	0.8	0.1	0.1	0.4	0.7	0.4	0.2	0.1	0.4	0.1	0.2	0.1
		2006	-0.1	0.1	0.4	0.8	0.1	0.1	0.4	0.6	0.4	0.2	0.1	0.2	0.1	0.2	0.1
	November	2003	-0.2	0.1	0.3	0.3	-0.4	0.2	0.2	0.4	0.1	-0.1	0.0	0.4	-0.1	-0.3	0.2
		2004	-0.4	0.0	0.2	0.2	-0.4	-0.2	0.2	0.1	0.3	-0.5	0.2	0.3	0.2	-0.6	-0.3
		2005	-0.2	0.1	0.3	0.4	-0.4	0.0	0.2	0.1	0.4	-0.3	0.2	0.2	0.1	-0.3	0.0
		2006	-0.1	0.0	0.3	0.4	-0.4	0.0	0.2	0.1	0.4	-0.1	0.2	0.2	0.1	-0.2	0.0
	December	2003	0.9	0.1	0.0	0.2	-0.6	0.0	0.3	0.4	0.1	0.1	0.4	0.2	0.4	0.2	-0.2
		2004	1.1	0.1	0.3	-0.1	-0.8	-0.3	0.4	0.5	0.1	0.0	0.1	-0.2	0.5	0.0	-0.3
		2005	1.3	0.2	0.2	0.2	-0.6	-0.2	0.4	0.5	0.1	0.0	0.2	0.0	0.4	0.1	-0.1
		2006	1.3	0.2	0.2	0.3	-0.6	-0.1	0.4	0.4	0.1	0.1	0.2	0.2	0.4	0.1	-0.1

Source : Eurostat & IFL(UC3M)

Date: January 20, 2005

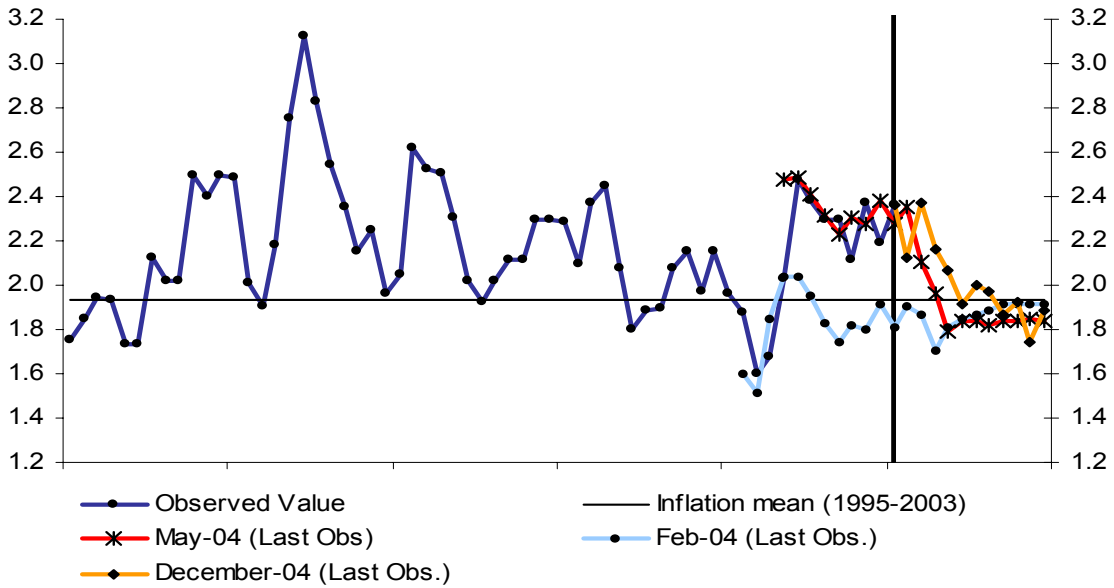


HICP MONTH-ON-MONTH RATES OF GROWTH IN THE EURO AREA



Source : Eurostat & IFL(UC3M)
Date: January 20, 2005

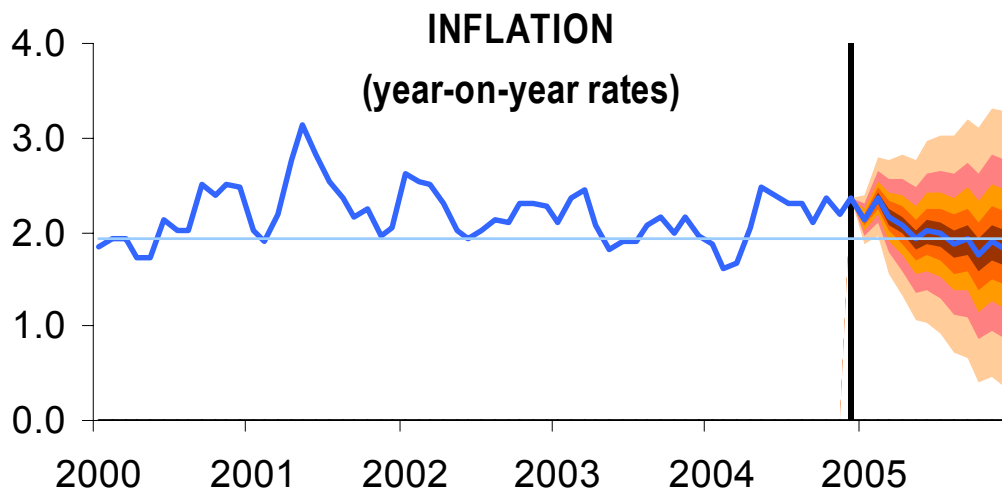
ANNUAL FORECASTS FOR THE EURO AREA INFLATION (year-on-year rates)



Source : Eurostat & IFL(UC3M)
Date: January 20, 2005



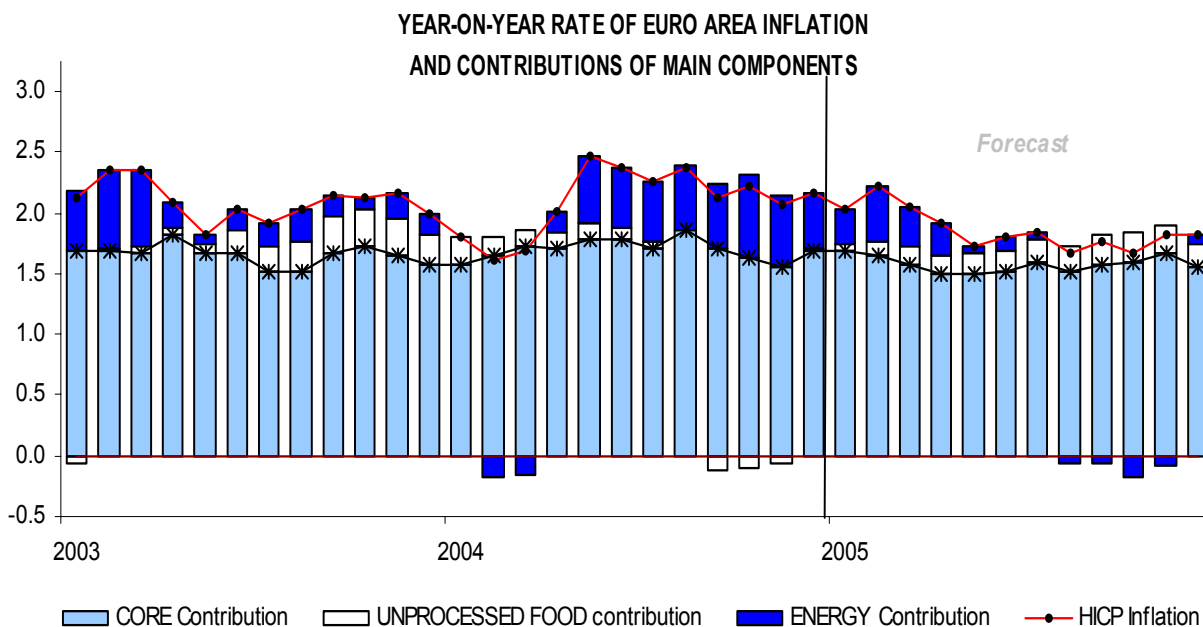
ANNUAL FORECASTS FOR THE EURO AREA



Confidence intervals at: 95% 80% 60% 40% 20%

Inflation mean (1995-2004) —

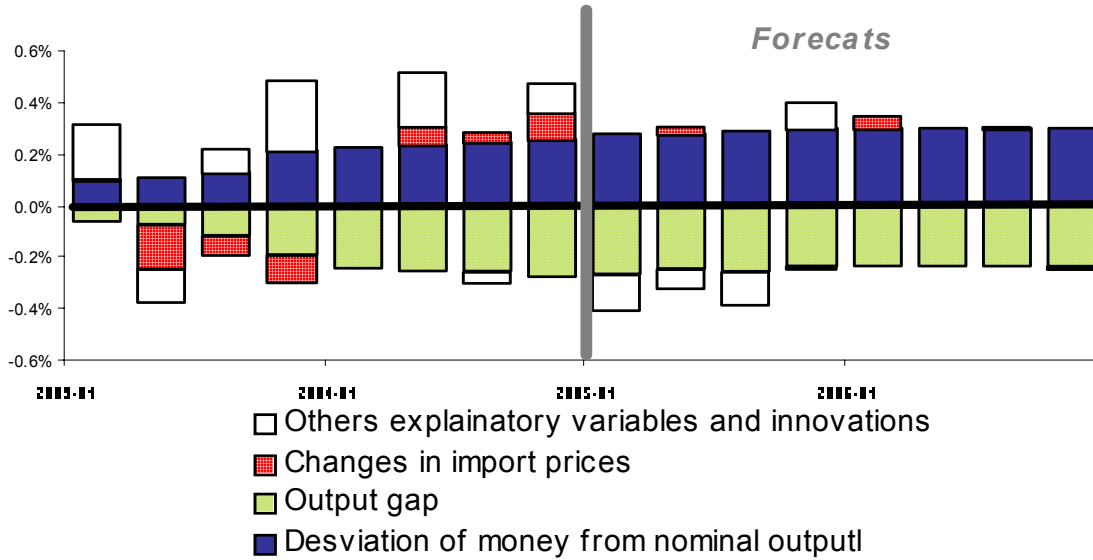
Source : Eurostat & IFL(UC3M)
Date: January 20, 2005



Source : Eurostat & IFL(UC3M)
Date: January 20, 2005

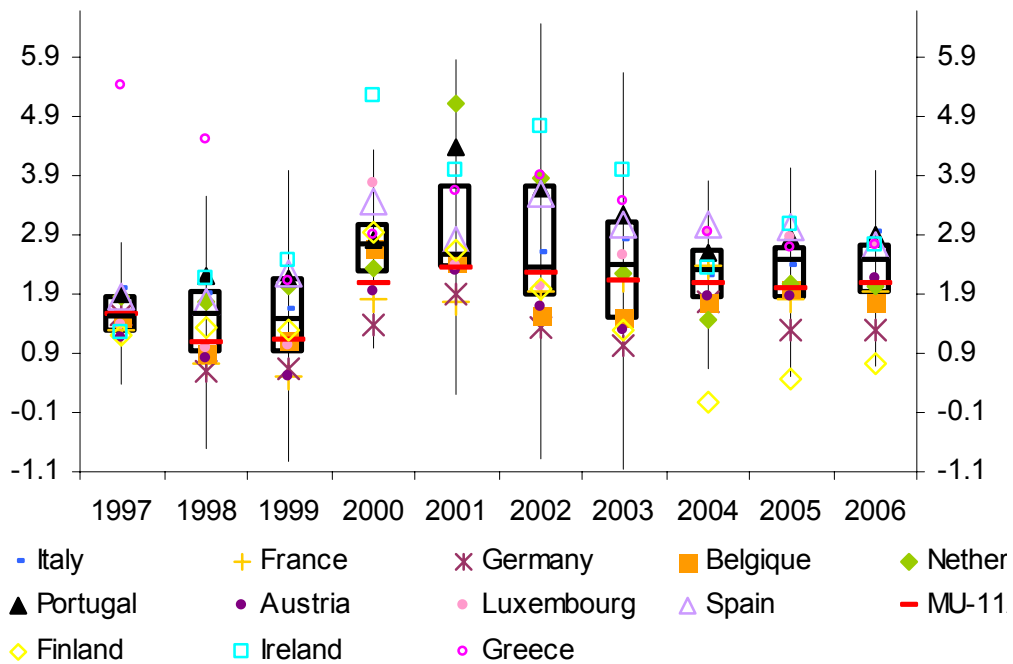


**CONTRIBUTIONS TO THE DEVIATIONS RESPECT TO THE MEAN
(0.48%) OF THE SEASONALLY AJUSTED QUARTER-TO-QUARTER
INFLATION RATE IN THE EURO AREA**



Source : Eurostat & IFL(UC3M)
Date: January 20, 2005

**Box diagram of euro area countries dispersion on
inflation**



Source : Eurostat & IFL(UC3M)
Date: January 20, 2005



I.2 MACROECONOMIC TABLE

	Annual Averages Growths				
	2002	2003	2004	Forecasts BIMA (*)	
				2005	2006
GDP p m	0.9	0.5	1.9	2.0	2.2
Demand					
Final Consumption	1.3	1.1	1.4	2.2	2.2
Capital Investment	-2.7	-0.5	1.4	2.3	2.0
Contribution Domestic Demand	0.3	1.1	1.9	2.0	2.0
Exports of Goods and Services	1.9	0.2	6.1	5.4	5.4
Imports of Goods and Services	0.5	2.0	6.6	5.8	5.2
Contribution Foreign Demand	0.6	-0.6	0.0	0.0	0.2
Supply					
Gross Value Added Total (market prices)	0.9	0.5	1.9	2.0	2.2
Net Taxes	-0.5	0.2	0.9	-1.0	0.5
Gross Value Added Total (basic prices)	1.0	0.5	2.0	2.2	2.3
Gross Value Added Agriculture	0.8	-3.9	3.4	-0.4	0.5
Gross Value Added Industry	0.2	0.0	2.5	2.6	2.4
Gross Value Added Construction	-0.6	-0.6	0.5	-0.7	-0.1
Gross Value Added Services	1.3	1.0	1.9	2.4	2.4
Private	1.0	0.9	2.1	2.7	2.8
Public	2.2	1.0	1.4	1.6	1.7
Prices					
CPI harmonized, annual average	2.3	2.1	2.1	2.0	1.8
CPI harmonized, dec./dec.	2.3	2.0	2.4	1.8	1.8
Employment					
Unemployment rate	8.4	8.9	8.9	8.8	8.7
Others Economic Indicators					
Production Index of Industry (excluding construction)	-0.5	0.3	2.0	1.2	1.8

Source: Eurostat & IFL (UC3M)

Date: January 20, 2005

(*) Bulletin EU & US Inflation and Macroeconomic Analysis.

Section Sponsorship:
Cátedra Fundación Universidad Carlos III de Predicción y Análisis Macroeconómico.





I.3. INDUSTRIAL PRODUCTION

The Industrial Production Index published for November 2004 has been an important downwards innovation in the rate of growth of the global index and in all the components considered in this publication. It is highlighted again the negative variation rates registered in durable consumer goods since August 2004. This information is shown in table I.3.1.

Table I.3.1.

FORECASTS AND OBSERVED DATA IN THE ANNUAL RATE OF GROWTH OF THE DIFFERENT EMU IPI COMPONENTS CORRESPONDING TO NOVEMBER		
	Forecast for November	Observed in November ⁽¹⁾
Capital	4.2	0.7
Durable	-2.0	-3.4
Intermediate	1.4	0.8
Non Durable	0.4	0.3
Energy	3.9	2.6
Total	2.1	0.5

Source: Eurostat & IFL (UC3M) * Working day adjusted data.
Date: January, 2005.

New forecasts have also been affected from revisions in previous published figures. The average annual rate of growth for 2004 has been revised from 2.1 to 2.0% and for 2005 from 1.7 to 1.2%. The growth expectation for 2006 is 1.8%. The expectations of growth for the different sectors are shown in table I.3.2.

Table I.3.2.

ANNUAL AVERAGE RATES FOR INDUSTRIAL PRODUCTION IN EMU ^(****)						
	2001	2002	2003	2004	2005	2006
Capital	1.6	-1.6	-0.0	3.3	2.3	3.0
Durable	-2.1	-5.6	-4.4	0.1	-2.2	-0.3
Intermediate	-0.6	0.2	0.3	1.9	1.6	1.8
Non Durable	0.8	0.6	0.2	0.6	0.1	0.8
Energy	1.3	1.1	3.0	2.2	0.5	1.4
Total EMU	0.4	-0.5	0.3	2.0	1.2	1.8

Source: Eurostat & IFL (UC3M) ^(****)Bold figures are forecasts.
Date: January, 18th, 2005 Working day adjusted data.

In US, the last published data corresponds to December and has been preceded by the annual historical revision since 1972. Overall, the changes of total production are small but the industrial output is now reported to have increased a little less than previously from the fourth quarter of 2002 to the third quarter of 2004.

Related to the figure observed in December 2004, the rate of growth has been superior than it was expected (4.32% instead of 3.72%). There have been upwards innovations in all the components analyzed in this publication. This information is shown in table I.3.3.

Table I.3.3.

FORECASTS AND OBSERVED DATA IN THE ANNUAL RATE OF GROWTH OF THE DIFFERENT EMU IPI COMPONENTS CORRESPONDING TO DECEMBER		
	Forecast for December	Observed in December
Durable Consumer Goods	0.11	1.70
Non Durable Consumer Goods	2.16	3.08
Equipment and Supplies	4.48	5.09
Materials	3.06	3.90
TOTAL US	3.72	4.32

Source: Federal Reserve & IFL (UC3M)
Date: January, 2005

Table I.3.4. shows the updated forecasts. The average rate of growth for IP in 2004 has been slightly revised from 4.4% to 4.3% and in 2005 from 2.9% to 2.3%. The average growth rate forecasted for 2006 is 3.0%.

Table I.3.4.

ANNUAL AVERAGE RATES FOR INDUSTRIAL PRODUCTION IN US ⁽¹⁾						
	2001	2002	2003	2004	2005	2006
Durable	-5.8	4.7	4.9	2.9	2.8	4.1
Non Durable	0.4	-0.6	-0.04	2.6	2.0	1.5
Equipment & Supplies	-4.1	-0.6	0.7	5.0	3.6	3.1
Materials	-4.5	0.4	-0.5	3.7	3.5	3.6
TOTAL US	-3.5	-0.6	0.05	4.1	3.2	3.2

Source: Federal Reserve & IFL (UC3M). ⁽¹⁾Bold figures are forecasts.
Date: January 17th, 2005



II. UNITED STATES

II.1. INFLATION

II.1.1. MAIN POINTS AND NEW RESULTS

For the general January CPI, we are forecasting a 0.18% increase, decreasing the annual rate from 3.26% to 2.94%. This moderation in price growth would be explained by the performance of the energy index, for which the annual rate is expected to fall from 16.62% to 10.73%.

On the other hand, for the core index we are forecasting a 0.27% increase, which would take the annual rate up a little from 2.17% to 2.23%. This slight upwards change in the annual rate is explained by the increase in non-energy industrial good prices, although a slight fall is expected in services.

Table II.1.1.1

	Monthly Growth (T ¹)			Confidence Intervals at 80% level (+ -)
	observed (a)	forecasts (b)	(a)-(b)	
Food (1)	0.16	0.23	-0.07	0.39
Energy (2)	-3.09	-2.45	-0.64	1.11
Residual Inflation (3=2+1)	-1.03	-0.75	-0.28	0.42
Non-food and non-energy goods (4)	-0.57	-0.50	-0.07	0.30
Non-energy services (5)	0.00	-0.01	0.01	0.15
Core Inflation (6=4+5)	-0.15	-0.15	0.00	0.16
Total Inflation (7=6+3)	-0.37	-0.28	-0.08	0.13

Source: BLS & IFL (UC3M)
Date: January 19, 2005

In December, the U.S. CPI fell by 0.37% from the previous month's figure, slightly better than expected, due to food and energy prices (see Table II.1.1.1.), with the annual rate falling from 3.52% to 3.26%.

Core inflation, on the other hand, fell by 0.15%, exactly as forecast, with the annual rate remaining at 2.17%. Nevertheless, there have been upwards innovations in housing rental, which have been compensated by transport services. Everything appears to indicate that housing rental was abnormal in November (see Graph II.1.1.1.). Other services and non-energy industrial goods performed in line with our forecasts.

Indeed, there has been a fall of 0.57%, similar to our forecast (0.50%), in non-energy industrial goods, with the annual rate increasing from 0.50% to 0.58%. Likewise, as expected, service prices remained stable, with the annual rate growing slightly from 2.79% to 2.84%.

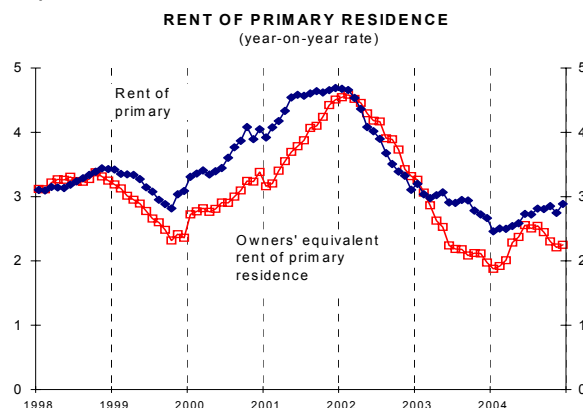
The core index, not including owner's equivalent rent of primary residence and tobacco, and therefore comparable to the core index in Europe excluding food, fell by 0.29%, somewhat more than

expected, with the annual rate falling from 2.16% to 2.12%.

In greater detail, durable good prices increased by 0.17%, exactly as forecast, with the annual rate going from 0.17% to 0.43%. Non-durable good prices, excluding tobacco, fell by 1.51% instead of the forecast 1.30%, with the annual rate decreasing from 0.75% to 0.45%.

The services index –not including owner's equivalent rent of primary residence- fell by 0.12%, more than the 0.05% forecast, and the annual rate rose from 3.22% to 3.26%. Real rental prices grew more than expected, 0.33% instead of 0.19%, taking the annual rate up from 2.75% to 2.89%, the opposite of what occurred the previous month. On the other hand, owner's equivalent rent of primary residence increased by 0.18%, significantly more than expected, 0.05%, with the annual rate rising from 2.21% of 2.25%, after four months of decreases.

Graph II.1.1.1.



Source: BLS & IFL (UC3M)
Date: January 19, 2005

For 2005 and 2006, we forecast mean annual total inflation rates of 2.4% and 2.2%, respectively. Core inflation tends to stabilise at around 2.4% (see Table II.1.1.2. and Graph II.1.1.2.).

Core inflation has grown by more than a percentage point during 2004. This is largely due to the prices of non-energy industrial goods, the annual variation rate of which has gone from a negative value of 2.3% in January, 2004 to a positive value of 0.6% in December the same year.

The forecast evolution of crude oil prices has worsened somewhat since our last report, although

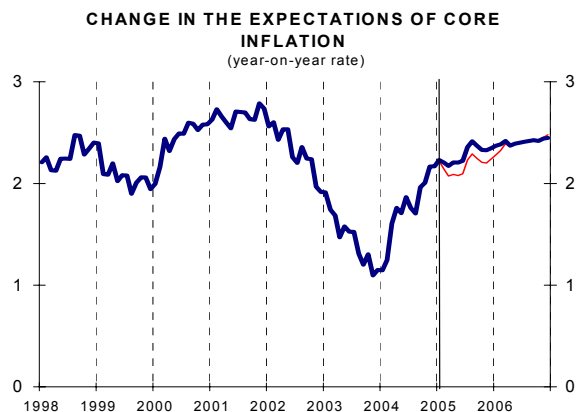


it is highly volatile. Likewise, we expect the dollar to appreciate slightly from last month's forecast.

As this report shows, recent data identifies two trends with regards to core inflation: on the one hand, the present and future impact of the depreciation of the \$ on non-energy industrial goods, considering that the use of productive capacity is at its highest since May, 2001, but still far from its historic mean and, on the other, the contained evolution of the service sector.

Monetary policy. Although total inflation will be falling by over a percentage point in 2005, inflationist perspectives are poor in view of the expected evolution of core inflation. This strengthens our forecast for a gradual rate increase on behalf of the Federal Reserve.

Graph II.1.1.2.



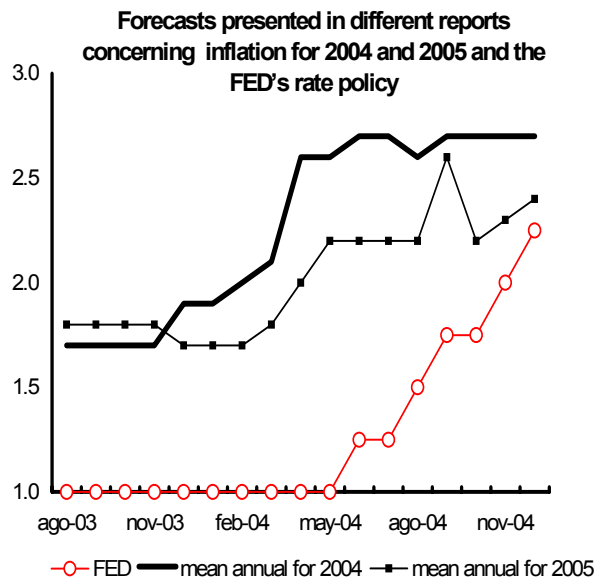
Source: BLS & IFL (UC3M)
Date: January 19, 2005

The Federal Reserve's stricter monetary policy after historically low levels is consistent with the inflation forecasts provided in our reports.

Graph II.1.1.3. shows the forecasts presented in different reports concerning mean annual inflation for 2004 and 2005 and the FED's rate policy. We can observe how inflationist forecasts worsened in March, April and May, 2004 to stabilise around those levels in the following months. The FED increases rates gradually from June on, when higher forecasts are consolidated and growth becomes more sustained.

Break-even inflation, a term used to refer to the 10-year return differential between nominal and inflation indexed bonds, which represents an approximation of market expectations, has decreased slightly in recent weeks to 2.51%, above the figure forecast for the next two years.

Graph II.1.1.3.



Source: BLS & IFL (UC3M)
Date: January 19, 2005

Table II.1.1.2.

ANNUAL AVERAGE GROWTH		
	Total inflation	Core inflation
	% annual	% annual
2004 November	3.5	2.2
December	3.3	2.2
2005 January	2.9	2.2
February	2.9	2.2
March	2.8	2.2
April	2.7	2.2
May	2.1	2.2
June	3.16	0.00
July	3.17	0.00
August	3.24	0.00
September	3.21	0.00
October	3.31	0.00
November	3.25	0.00
December	3.19	0.00
average annual		
2002	1.6	2.3
2003	2.3	1.5
2004	2.7	1.8
2005	2.4	2.3
2006	2.2	2.4

Source: BLS & IFL (UC3M)
Date: January 19, 2005



II.1.2. TABLES AND PLOTS ABOUT USA INFLATION

Tables:

- USA Index of Consumer Price (ICP) desagregation.
- Forecast errors by sectors for USA
- Index of Consumer Price (ICP) Annual Growth Rates by sectors in USA.
- Index of Consumer Price (ICP) Monthly Growth Rates by sectors in USA.

Plots:

- CPI monthly growth rates in USA.
- Annual Forecast for the USA Inflation.
- Annual rates of different components for the USA inflation.



METHODOLOGY: ANALYSIS OF USA INFLATION BY SECTORS

BASIC COMPONENTS AGGREGATES		BASICS COMPONENTS	
TOTAL CPI	CORE CPI 78.54% (1+2+3+4+5)	SERVICES LESS ENERGY 56.28% (1+2)	(1) OWNERS' EQUIVALENT RENT OF PRIMARY RESIDENCE 23.38%
		COMMODITIES LESS FOOD AND ENERGY 22.25% (3+4+5)	(2) SERVICES LESS OWNER' EQUIVALENT RENT OF PRIMARY RESIDENCE 32.90%
	RESIDUAL CPI 21.46% (6+7+8+9)	ENERGY 7.08% (7+8+9)	(3) TOBACCO 0.81%
			(4) NON DURABLES LESS TOBACCO 10.71%
			(5) DURABLES 11.28%
			(6) FOOD 14.38%
			(7) GAS 1.17%
			(8) ELECTRICITY 2.43%
			(9) MOTOR FUEL AND FUEL OIL 3.48%

$CPI = 0.4591(SERV. - ENERGY) + 0.2937(COMM. - FOOD AND ENERGY) + 0.1486FOOD + 0.0986ENERGY$

Source: BLS & IFL (UC3M)

OBSERVED VALUES AND FORECAST ON CPI IN US December 2004					
CONSUMER PRICES INDEX (CPI)	Relative importance Dec. 2003	Annual Growth (T ¹ ₁₂) observed	Monthly Growth (T ¹ ₁)		Confidence Intervals at 80% level (+ -)
			observed (a)	forecasts (b)	
Food (1)	14.4	2.67	0.16	0.23	0.39
Energy (2)	7.1	16.62	-3.09	-2.45	1.11
Residual Inflation (3=2+1)	21.5	7.27	-1.03	-0.75	0.42
Non-food and non-energy goods (4)	22.3	0.58	-0.57	-0.50	0.30
Less tobacco	21.4	0.48	-0.62	-0.53	0.23
-Durable goods	11.3	0.43	0.17	0.17	0.34
-Nondurable goods	11.0	0.64	-1.35	-1.16	0.42
-Non-durable goods less tabacco	10.2	0.45	-1.51	-1.30	0.30
Non-energy services (5)	56.3	2.84	0.00	-0.01	0.15
-Services less owner's equivalent rent of primary residence (5-a)	32.9	3.26	-0.12	-0.05	0.23
(a) -Owner's equivalent rent of primary residence	23.4	2.25	0.18	0.05	0.13
Core Inflation (6=4+5)	78.5	2.17	-0.15	-0.15	0.16
Core inflation less owner's equivalent rent of primary residence (6-a)	55.2	2.14	-0.29	-0.23	0.20
Core inflation less owner's equivalent rent of primary residence and tobacco	54.3	2.12	-0.30	-0.24	0.18
Total Inflation (7=6+3)	100.0	3.26	-0.37	-0.28	0.13
All items less owner's equivalent rent of primary residence (7-a)	76.6	3.56	-0.53	-0.38	0.16

Source : BLS & IFL (UC3M)
Date: January 19, 2005



USA ANNUAL RATES OF GROWTH ON CPI AND ITS COMPONENTS

Consumer Price Index													
	Core Inflation							Residual Inflation			TOTAL		
	Non energy commodities less food			Non energy services				TOTAL	Food	Energy		TOTAL	
	durables	non durables less energy	TOTAL	Owner's equivalent rent of primary residence	Other services	TOTAL							
IR December 2003	11.3%	11.0%	22.3%	23.4%	32.9%	56.3%	78.5%	14.4%	7.1%	21.5%	100.0%		
TASAS ANUALES MEDIAS	1997	-0.5	1.7	0.7	2.9	3.2	3.1	2.4	2.6	1.3	2.1	2.3	
	1998	-0.9	2.3	0.6	3.2	2.9	3.1	2.3	2.2	-7.7	0.1	1.6	
	1999	-1.2	2.4	0.7	2.7	2.7	2.7	2.1	2.1	3.6	0.8	2.2	
	2000	-0.5	1.4	0.5	3.0	3.5	3.3	2.4	2.3	16.9	6.8	3.4	
	2001	-0.6	1.1	0.3	3.8	3.6	3.7	2.7	3.1	3.8	3.3	2.8	
	2002	-2.6	0.4	-1.1	4.1	3.6	3.8	2.3	1.8	-5.9	-0.8	1.6	
	2003	-3.2	-0.7	-2.0	2.4	3.2	2.9	1.5	2.1	12.2	5.3	2.3	
	2004	-2.3	0.5	-0.9	2.3	3.3	2.9	1.8	3.4	10.9	6.0	2.7	
	2005	1.2	0.5	0.9	2.3	3.2	2.8	2.3	2.5	3.0	2.7	2.4	
	2006	1.4	0.5	0.9	2.6	3.2	3.0	2.4	2.4	-0.1	1.5	2.2	
TASAS ANUALES (crecimiento del mes de referencia respecto al mismo mes del año anterior)	2004	January	-4.0	-0.5	-2.3	1.9	3.0	2.5	1.1	3.5	7.8	4.9	1.9
		February	-3.7	-0.3	-2.0	1.9	2.9	2.5	1.2	3.3	3.8	3.5	1.7
		March	-3.7	0.5	-1.6	2.0	3.6	2.9	1.6	3.2	0.4	2.3	1.7
		April	-3.5	0.8	-1.4	2.3	3.7	3.1	1.8	3.4	5.6	4.2	2.3
		May	-3.1	1.0	-1.1	2.4	3.3	2.9	1.7	4.1	15.0	7.8	3.1
		June	-3.0	0.9	-1.0	2.6	3.3	3.0	1.9	3.7	17.0	8.3	3.3
		July	-2.8	0.3	-1.2	2.5	3.4	3.0	1.8	4.0	14.2	7.5	3.0
		August	-2.6	0.1	-1.1	2.5	3.2	2.9	1.7	3.5	10.5	6.0	2.7
		September	-1.4	0.4	-0.6	2.4	3.4	3.0	2.0	3.3	6.7	4.6	2.5
		October	-0.4	0.7	0.1	2.3	3.2	2.8	2.0	3.4	15.2	7.5	3.2
		November	0.2	0.9	0.5	2.2	3.2	2.8	2.2	3.2	19.2	8.5	3.5
		December	0.4	0.6	0.6	2.3	3.3	2.8	2.2	2.7	16.6	7.3	3.3
	2005	January	0.7	0.9	0.8	2.2	3.2	2.8	2.2	3.0	10.7	5.6	2.9
		February	0.6	0.9	0.8	2.3	3.1	2.8	2.2	2.9	10.3	5.4	2.9
		March	0.9	0.4	0.7	2.3	3.0	2.7	2.2	2.8	9.0	5.0	2.8
		April	0.8	0.7	0.8	2.2	3.1	2.7	2.2	2.9	7.0	4.3	2.7
		May	1.0	0.3	0.7	2.2	3.1	2.8	2.2	2.3	1.8	2.1	2.1
		June	1.3	0.3	0.8	2.2	3.2	2.8	2.2	2.3	0.1	1.5	2.0
		July	1.6	0.6	1.2	2.3	3.2	2.8	2.4	2.3	1.4	2.0	2.3
		August	1.9	0.6	1.3	2.2	3.2	2.8	2.4	2.5	1.2	2.0	2.3
		September	1.5	0.5	1.1	2.3	3.2	2.8	2.4	2.7	1.9	2.4	2.3
		October	1.3	0.3	0.8	2.3	3.3	2.9	2.3	2.3	-1.7	0.8	2.0
		November	1.1	0.3	0.8	2.5	3.3	2.9	2.3	2.2	-3.1	0.2	1.8
		December	1.3	0.5	0.9	2.5	3.2	2.9	2.3	2.3	0.4	1.6	2.2
	2006	January	1.1	0.5	0.8	2.5	3.3	3.0	2.4	2.3	2.1	2.2	2.3
		February	1.1	0.5	0.8	2.6	3.3	3.0	2.4	2.3	0.2	1.6	2.2
		March	1.1	0.7	0.9	2.6	3.3	3.0	2.4	2.4	-0.6	1.3	2.2
		April	1.4	0.3	0.8	2.6	3.2	3.0	2.4	2.3	-0.9	1.2	2.1
		May	1.4	0.5	0.9	2.6	3.2	3.0	2.4	2.4	-1.4	1.0	2.1
		June	1.4	0.5	0.9	2.6	3.2	3.0	2.4	2.4	-1.4	1.0	2.1
		July	1.4	0.5	0.9	2.6	3.2	3.0	2.4	2.4	-0.6	1.3	2.2
		August	1.4	0.5	1.0	2.6	3.2	3.0	2.4	2.4	0.1	1.6	2.2
		September	1.5	0.5	1.0	2.6	3.2	3.0	2.4	2.4	0.3	1.6	2.2
		October	1.5	0.5	1.0	2.7	3.2	3.0	2.4	2.4	0.3	1.7	2.2
		November	1.6	0.5	1.0	2.7	3.2	3.0	2.4	2.4	0.4	1.7	2.3
		December	1.6	0.5	1.0	2.7	3.2	3.0	2.4	2.4	0.1	1.6	2.3

Source : BLS & IFL (UC3M)

Date: January 19, 2005



USA MONTHLY RATES OF GROWTH ON CPI AND ITS COMPONENTS

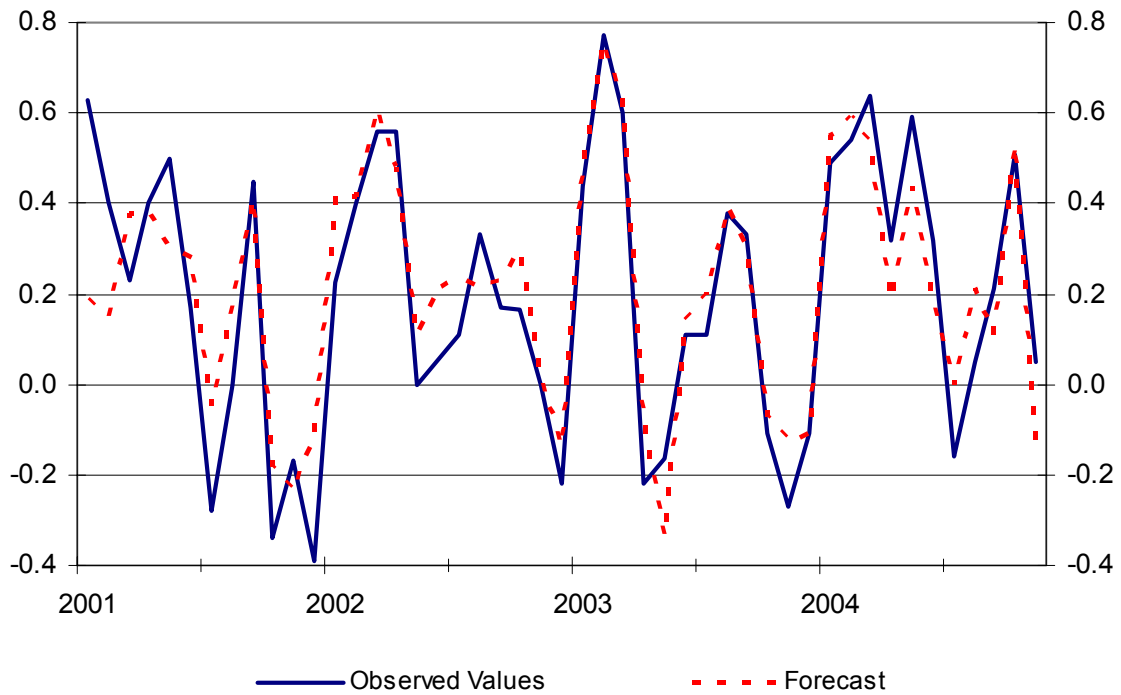
Consumer Price Index													
	Core Inflation							Residual Inflation			TOTAL		
	Non energy commodities less food			Non energy services				TOTAL	Food	Energy		TOTAL	
	durables	non durables less energy	TOTAL	Owner's equivalent rent of primary residence	Other services	TOTAL							
IR December 2003	11.3%	11.0%	22.3%	23.4%	32.9%	56.3%	78.5%	14.4%	7.1%	21.5%	100.0%		
TASAS MENSUALES (crecimiento del mes de referencia respecto al mes inmediatamente anterior)	Enero	2003	-0.2	-0.9	-0.6	0.3	0.7	0.5	0.2	0.1	3.4	1.2	0.4
		2004	0.1	-0.8	-0.4	0.2	0.7	0.5	0.2	0.1	4.2	1.5	0.5
		2005	0.3	-0.6	-0.2	0.2	0.6	0.4	0.3	0.4	-1.0	-0.1	0.2
		2006	0.2	-0.6	-0.2	0.2	0.7	0.5	0.3	0.4	0.6	0.5	0.3
	Febrero	2003	-0.2	0.8	0.3	0.1	0.6	0.4	0.4	0.5	6.2	2.3	0.8
		2004	0.2	1.0	0.6	0.1	0.6	0.4	0.5	0.2	2.3	0.9	0.5
		2005	0.2	1.0	0.6	0.2	0.6	0.4	0.4	0.1	1.9	0.8	0.5
		2006	0.1	1.0	0.5	0.2	0.6	0.4	0.5	0.1	0.1	0.1	0.4
	Marzo	2003	-0.2	0.9	0.4	0.1	0.3	0.2	0.3	0.2	5.3	1.9	0.6
		2004	-0.2	1.7	0.7	0.2	0.9	0.6	0.6	0.2	1.8	0.7	0.6
		2005	0.0	1.2	0.6	0.2	0.8	0.6	0.6	0.1	0.6	0.3	0.5
		2006	0.1	1.4	0.7	0.2	0.9	0.6	0.6	0.2	-0.2	0.0	0.5
	Abril	2003	-0.3	0.1	-0.1	0.0	0.1	0.0	0.1	-0.1	-3.2	-1.2	-0.2
		2004	-0.1	0.4	0.1	0.3	0.2	0.2	0.2	0.1	2.0	0.7	0.3
		2005	-0.1	0.7	0.2	0.2	0.3	0.2	0.2	0.1	0.0	0.1	0.2
		2006	0.1	0.3	0.2	0.2	0.2	0.2	0.2	0.1	-0.2	0.0	0.1
	Mayo	2003	-0.6	-0.5	-0.6	0.1	0.4	0.3	0.1	0.2	-3.0	-0.9	-0.2
		2004	-0.2	-0.3	-0.2	0.2	0.0	0.1	0.0	0.9	5.6	2.5	0.6
		2005	0.0	-0.6	-0.3	0.2	0.1	0.1	0.0	0.2	0.6	0.4	0.1
		2006	0.0	-0.5	-0.2	0.2	0.1	0.1	0.0	0.3	0.0	0.2	0.1
	Junio	2003	-0.4	-0.9	-0.6	0.0	0.3	0.2	-0.1	0.4	1.9	0.9	0.1
		2004	-0.3	-1.0	-0.6	0.2	0.3	0.3	0.1	0.1	3.6	1.4	0.3
		2005	0.0	-1.0	-0.5	0.2	0.3	0.3	0.1	0.1	1.9	0.8	0.2
		2006	0.0	-1.0	-0.5	0.2	0.3	0.3	0.1	0.1	1.8	0.7	0.2
	Julio	2003	-0.5	-0.7	-0.6	0.2	0.4	0.4	0.1	0.1	0.3	0.1	0.1
		2004	-0.3	-1.3	-0.9	0.2	0.5	0.3	0.0	0.3	-2.1	-0.6	-0.2
		2005	0.0	-1.0	-0.5	0.2	0.5	0.4	0.1	0.3	-0.9	-0.1	0.1
		2006	0.0	-1.0	-0.5	0.2	0.5	0.4	0.1	0.2	0.0	0.1	0.1
	Agosto	2003	-0.6	0.3	-0.1	0.2	0.3	0.3	0.2	0.4	2.7	1.2	0.4
		2004	-0.4	0.1	-0.1	0.3	0.1	0.2	0.1	0.0	-0.6	-0.2	0.1
		2005	-0.1	0.1	0.0	0.2	0.2	0.2	0.2	0.2	-0.8	-0.2	0.1
		2006	0.0	0.1	0.1	0.2	0.2	0.2	0.2	0.2	-0.1	0.1	0.2
	Septiembre	2003	-0.9	1.4	0.4	0.3	-0.2	0.0	0.1	0.2	2.8	1.1	0.3
		2004	0.4	1.6	0.9	0.2	0.0	0.1	0.3	-0.1	-0.6	-0.3	0.2
		2005	-0.1	1.5	0.7	0.2	0.0	0.1	0.3	0.1	0.0	0.1	0.2
		2006	0.0	1.5	0.7	0.2	0.0	0.1	0.3	0.1	0.2	0.1	0.2
	Octubre	2003	-0.4	0.7	0.1	0.3	0.5	0.4	0.4	0.6	-5.3	-1.5	-0.1
		2004	0.5	1.0	0.8	0.2	0.2	0.2	0.4	0.6	2.2	1.2	0.5
		2005	0.3	0.8	0.6	0.2	0.3	0.3	0.4	0.2	-1.4	-0.4	0.2
		2006	0.4	0.8	0.6	0.2	0.3	0.3	0.4	0.2	-1.4	-0.3	0.2
	Noviembre	2003	-0.1	-0.6	-0.4	0.2	-0.3	-0.1	-0.2	0.4	-2.8	-0.7	-0.3
		2004	0.5	-0.4	0.1	0.1	-0.2	-0.1	-0.1	0.2	0.6	0.3	0.1
		2005	0.3	-0.4	0.0	0.3	-0.3	-0.1	-0.1	0.1	-0.8	-0.2	-0.1
		2006	0.4	-0.4	0.0	0.3	-0.3	0.0	0.0	0.1	-0.8	-0.2	-0.1
	Diciembre	2003	-0.1	-1.1	-0.6	0.1	-0.2	0.0	-0.2	0.7	-1.0	0.1	-0.1
		2004	0.2	-1.4	-0.6	0.2	-0.1	0.0	-0.2	0.2	-3.1	-1.0	-0.4
		2005	0.3	-1.2	-0.4	0.2	-0.2	0.0	-0.1	0.3	0.4	0.3	0.0
		2006	0.3	-1.2	-0.4	0.2	-0.2	0.0	-0.1	0.3	0.1	0.2	0.0

Source :BLS & IFL (UC3M)

Date: January 19, 2005

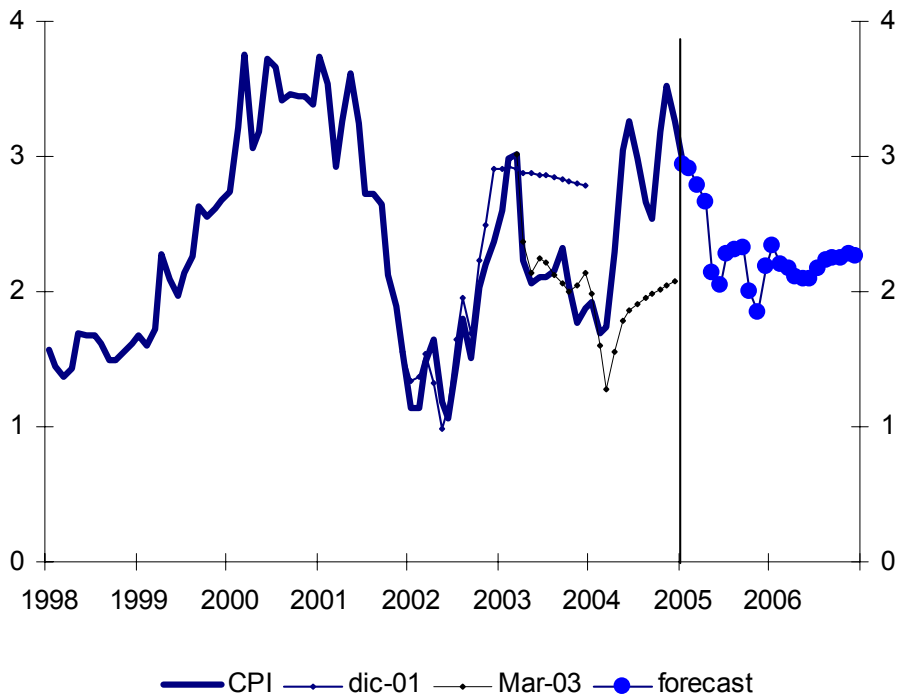


CPI MONTHLY GROWTH RATES IN USA



Source :BLS & IFL (UC3M)
Date: January 19, 2005

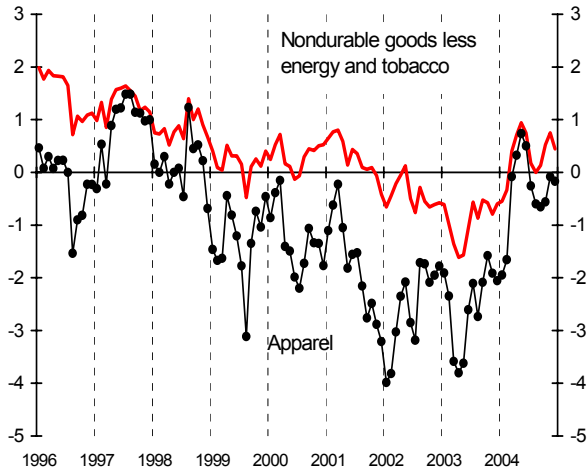
ANNUAL FORECASTS FOR US INFLATION



Source :BLS & IFL (UC3M)
Date: January 19, 2005

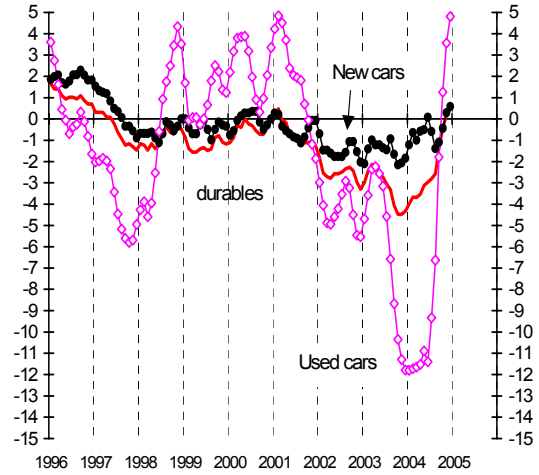


.SOME COMMODITIES.
(YEAR ON YEAR RATES)



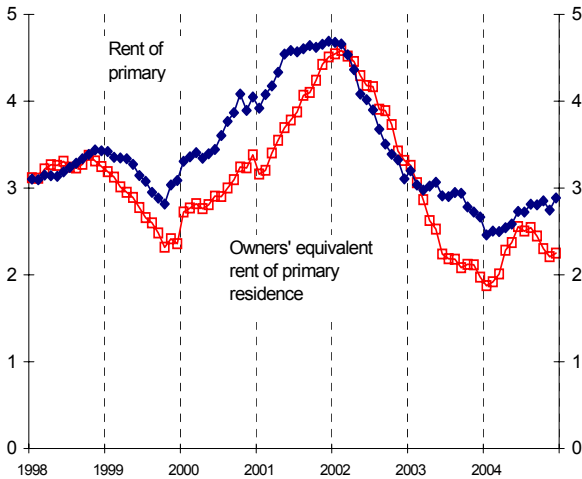
Source :BLS & IFL (UC3M)
Date: January 19, 2005

.SOME COMMODITIES.
(YEAR ON YEAR RATES)



Source :BLS & IFL (UC3M)
Date: January 19, 2005

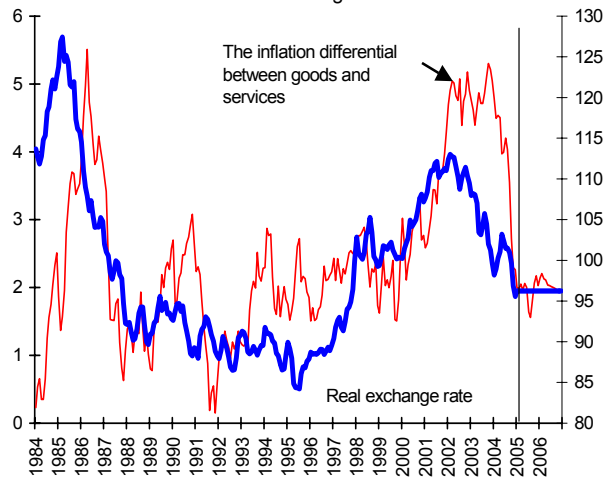
RENT OF PRIMARY RESIDENCE
(year-on-year rate)



Source :BLS & IFL (UC3M)
Date: January 19, 2005

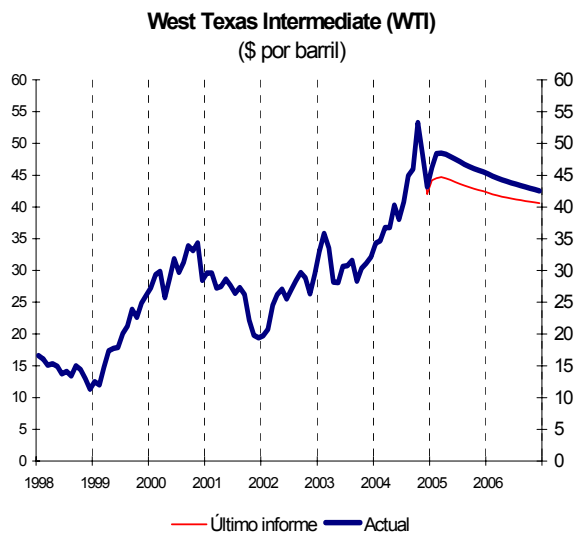
RELATION BETWEEN:

1. The inflation differential between goods and services
2. Real exchange rate

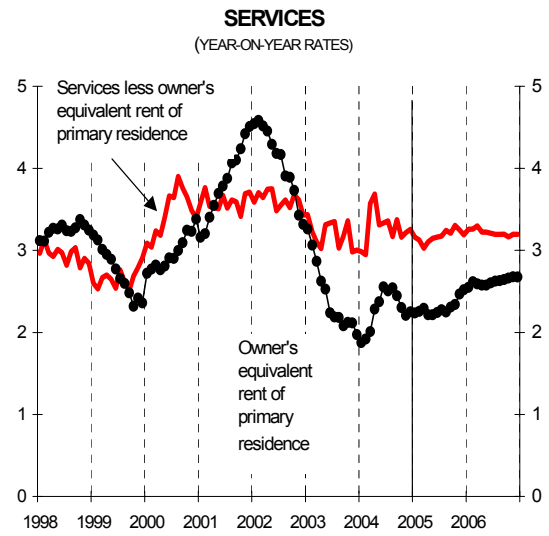


Source :BLS & IFL (UC3M)
Date: January 19, 2005

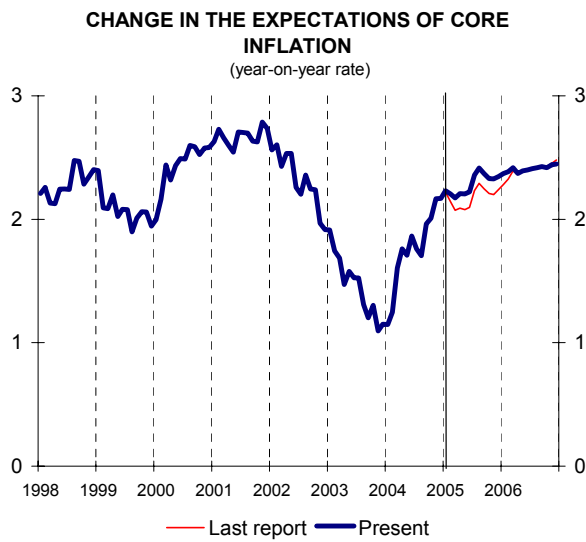




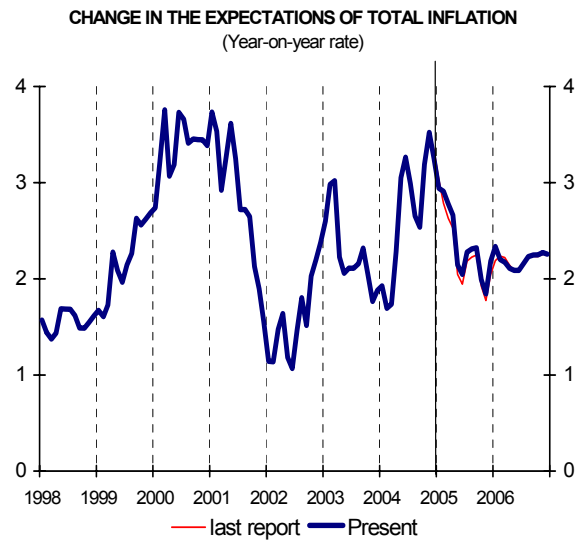
Source :BLS & IFL (UC3M)
Date: January 19, 2005



Source :BLS & IFL (UC3M)
Date: January 19, 2005



Source :BLS & IFL (UC3M)
Date: January 19, 2005



Source :BLS & IFL (UC3M)
Date: January 19, 2005





III. SPAIN

III.1. INFLATION

III.1.1. MAIN POINTS AND NEW RESULTS

For January 2005 we are forecasting a negative monthly total inflation rate in Spain of 0.9%, due to the fall in energy prices and the prices of non-energy industrial goods resulting from the positive effect of the January sales. The annual rate of total inflation will fall from the 3.2% observed in December, 2004 to the 3% forecast for January.

The monthly rate of total inflation in December 2004 performed better than expected, registering a fall of 0.1% instead of the negative value of 0.01%. This downwards innovation in total inflation was due to the improved performance in core inflation, and especially residual inflation (Table III.1.1.1.). With the components of residual inflation, the price of energy products registered a 2.46% decrease in its monthly rate, greater than the negative value of 1.99% forecast due particularly to the 4.92% decrease in fuel prices instead of our forecast negative value of 2.55%. Unprocessed food prices also registered a better than expected performance, with a rate of 0.35% instead of the forecast 0.58%. Graph III.1.1.1. shows the fall to values of close to 2.0% in the annual rate of unprocessed food in the second half of 2004. These rates had not been seen since December, 1999 and they helped to compensate the high annual rates observed in energy products.

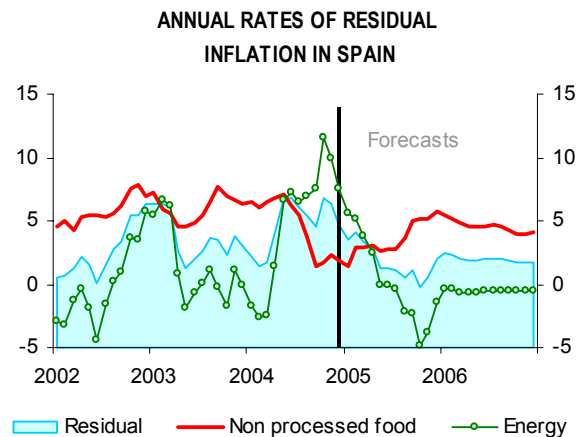
Table III.1.1.1.

OBSERVED AND FORECAST VALUES ON CPI COMPONENTS				
CPI Inflation	Weights 2004 (%)	Monthly Observed Rates	Monthly Forecast Rates	Confidence Interval 80%
Total	100	0.25	0.24	± 0.15
Core	82,28	0.39	0.30	± 0.13
Residual	17,72	-0.38	-0.07	± 0.22

Source: INE & IFL (UC3M)
Date: January 14, 2005

Core inflation also registered a slight downwards innovation caused by the prices of services and non-energy industrial goods. In services we observed a monthly rate of 0.37% instead of the 0.43% expected, largely due to a 1.15% decrease in culture prices instead of an expected 0.50% increase. As for non-energy industrial goods, apparel prices performed better than expected with a negative monthly rate of 0.93% instead of the forecast 0.76% decrease. Finally, processed food registered an upwards innovation due to a worse than expected performance by fat and oil prices, which registered a negative monthly rate of 0.53%, lower than the forecast 0.72%.

Graph III.1.1.1.



Source : INE & IFL (UC3M)
Date: January 20, 2005

For this month, we forecast that the annual total inflation rate will fall from 3.2% to 3.0% (Table III.1.1.2.). The annual core inflation rate in January will remain at the 2.9% observed since August, 2004. For 2005, we expect mean annual growth similar to that observed in 2004. On the other hand, the components of residual inflation will perform with more moderation (graph III.1.1.1.), with a forecast mean annual rate of total inflation of 2.5%.

Table III.1.1.2.

CPI Inflation	Observed values			Forecasts		
	2004 Dec ⁽¹⁾	2003 ⁽²⁾	Ave ⁽²⁾ 2004	2005 Jan ⁽¹⁾	2005 ⁽²⁾	2006 ⁽²⁾
Core (84,17%)	2,0	2.0	2.0	2.0	1.9	1.9
Total (100%)	2,4	2.1	2.1	2.1	2.0	1.8

Source: INE & IFL (UC3M)
Date: January 20, 2005

⁽¹⁾ Growth of the month over the same month of the previous year
⁽²⁾ Growth of the average of the reference year over previous average of the

Table III.1.1.3. shows the mean annual rates of total inflation and its main components. As for core inflation, we expect greater growth rates in the prices of non-energy industrial goods and lower rates in service prices, with core inflation remaining without significant changes from the values observed in 2004. On the other hand, the mean rates for unprocessed food and energy will be significantly lower than those observed in 2004, leading to lower mean rates of residual inflation.

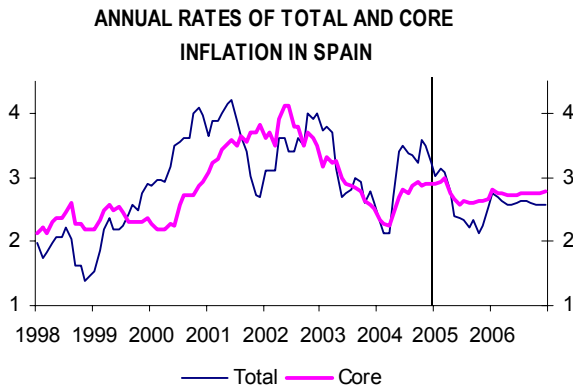


Table III.1.1.3.

ANNUAL AVERAGE RATES OF GROWTH					
CPI inflation	Observed			Forecasts	
	2002	2003	2004	2005	2006
Total (100%)*	3.5	3.0	3.0	2.5	2.6
Core (82,3%)	3.7	2.9	2.7	2.6	2.7
Non-energy Industrial goods (30,1%)	2.5	2.0	0.9	1.1	1.2
Services (35,1%)	4.6	3.7	3.7	3.4	4.0
Processed Food (17,2%)	4.3	3.0	3.6	3.5	2.7
Residual (17,7%)	2.6	3.6	4.7	1.8	2.0
Non-processed Food (8,6%)	5.8	6.0	4.6	3.6	4.5
Energy (9,1%)	-0.2	1.4	4.8	0.1	-0.5

Source: INE & IFL
Date: January 28, 2005

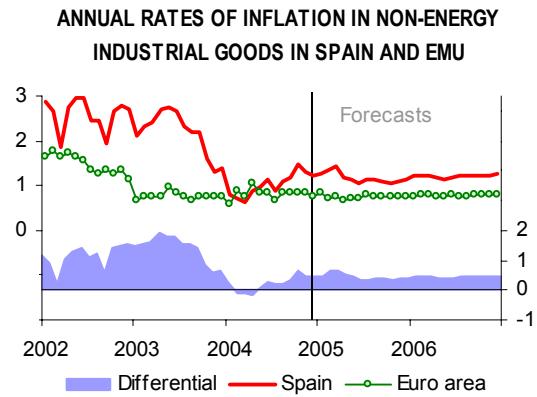
Graph III.1.1.2.



Source: INE & IFL (UC3M)
Date: January 28, 2005

The inflation differential between Spain and the euro area is a variable of interest in goods likely to be subject to more competition in the euro area. The annual inflation rates of non-energy industrial goods are expected to be 0.7% in 2005 in the euro area and 1.1% in 2005 in Spain, so the differential between the annual inflation rate in Spain and the euro area will be around 0.4% in the last few months of 2005 (see graph III.1.1.2.). As for the annual core inflation rate in December in the euro area, it remained at 1.9%. The forecast for the mean annual core inflation rate remain at 1.9% in 2005 and 2006 in the euro area, compared to the values forecast for Spain, 1.1% in 2005 and 1.2% in 2006.

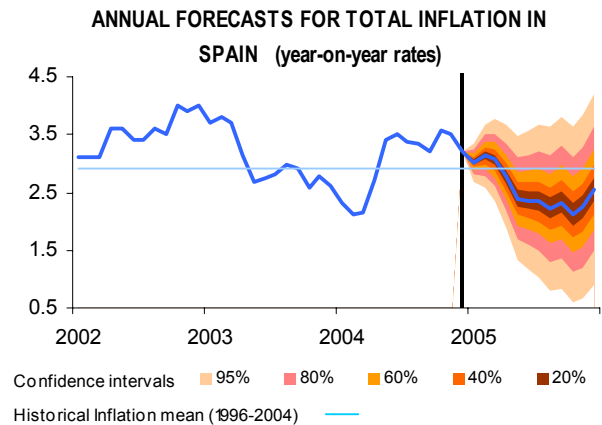
Graph III.1.1.3.



Source: INE & IFL (UC3M)
Date: January 28, 2005

Graph III.1.1.4. shows that there is a 80% probability that the annual inflation rate will remain around the mean value of 2.9% (1996-2004) for the first few months of 2005. The mean annual total inflation rate was 3.0% in 2003 and 2004, and the forecast is for 2.5% in 2005 and 2.6% in 2006 (Table III.1.1.3.). The contributions of core inflation and unprocessed food to annual inflation in Spain are expected to remain stable until 2005. The fall in the contribution of energy prices to total inflation for the second half of 2005 will bring the annual total CPI return to levels close to those observed in 2003 (see graph III.1.1.4.).

Graph III.1.1.4.



Source: INE & IFL (UC3M)
Date: January 28, 2005



III.1.2. TABLES AND PLOTS ABOUT SPAIN INFLATION

Tables:

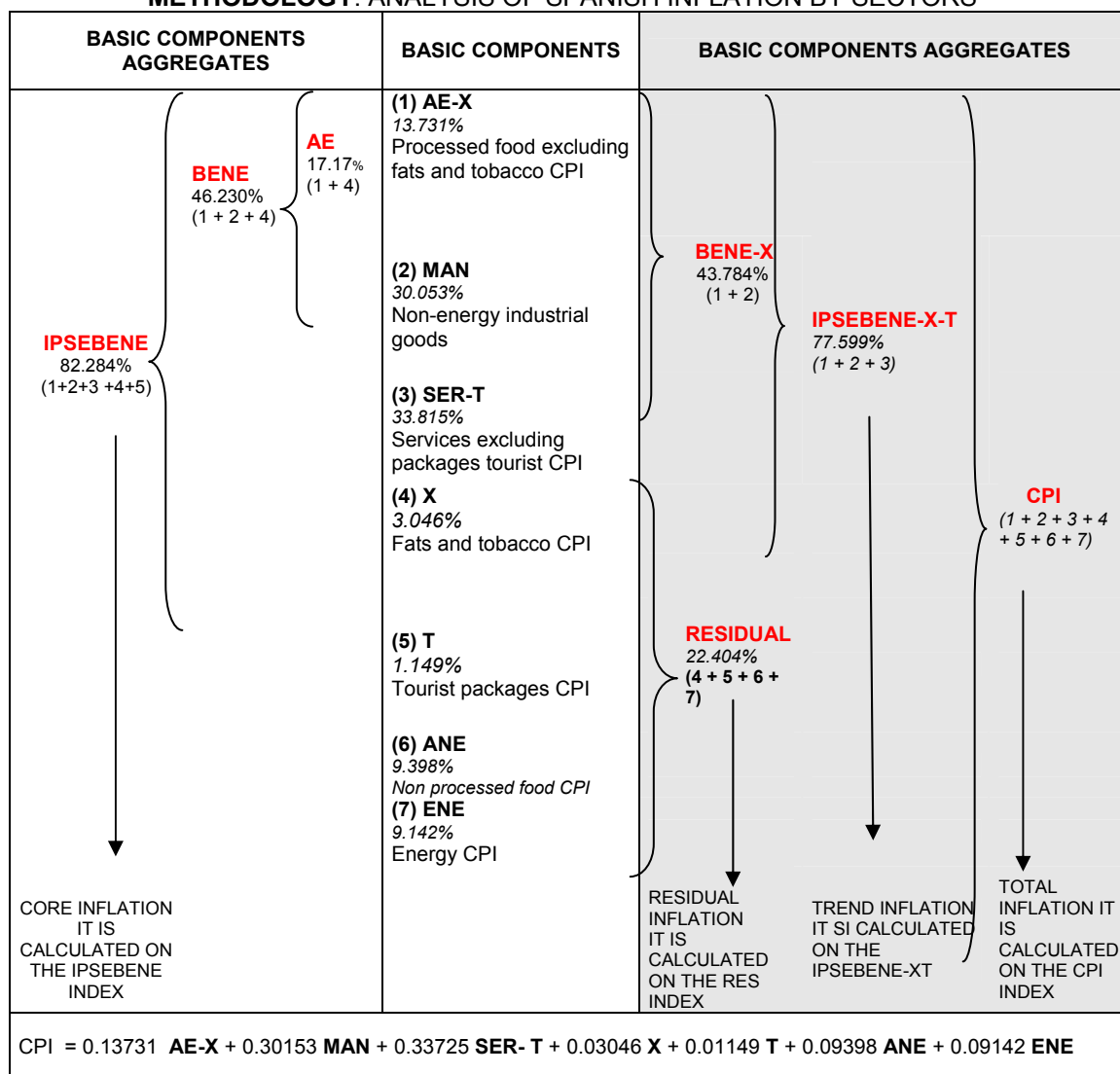
- Spain Index of Consumer Price (CPI) disaggregation.
- Forecast errors by sectors for Spain.
- Index of Consumer Price (CPI) Annual Growth Rates by sectors in the Spain.
- Index of Consumer Price (CPI) Monthly Growth Rates by sectors in the Spain.

Plots:

- CPI monthly growth rates in Spain.
- Annual forecast for total Inflation in Spain.
- Fan chart of annual forecast for total inflation in Spain.
- Year-on-year rate of Spain inflation and contributions of main components



METHODOLOGY: ANALYSIS OF SPANISH INFLATION BY SECTORS



Source : INE & IFL (UC3M)

FORECAST ERRORS IN THE MONTHLY INFLATION RATE BY SECTORS IN SPAIN						
	Weights 2004	Observed Monthly Growth	Forecast	Annual Growth Observed	Confidence interval at 80%	
Processed food	17.17	0.18	0.07	4.12	0.29	
Non energy industrial goods	30.05	-0.16	-0.12	1.16	0.33	
Services	35.05	0.37	0.43	3.79	0.19	
CORE	82.28	0.14	0.16	2.90	0.16	
Non-processed food	8.60	0.35	0.58	1.79	0.99	
Energy	9.12	-2.46	-1.99	7.56	0.85	
RESIDUAL	17.72	-1.15	-0.80	4.76	0.55	
TOTAL INFLATION	100.00	-0.10	-0.01	3.22	0.17	

Source : INE & IFL (UC3M)
Date: January 28, 2005



CPI ANNUAL GROWTH BY SECTORS IN SPAIN										
		Consumer Prices Index								
		Core				Residual			TOTAL 100%	
		Processed food	Non energy industrial goods	Services	TOTAL	Non processed food	Energy	TOTAL		
Weights 2004	17.2%	30.1%	35.1%	82.3%	8.6%	9.1%	17.7%			
ANNUAL AVERAGE RATE	1997	0.3	1.7	3.5	2.1	0.9	2.4	1.5	2.0	
	1998	1.3	1.5	3.6	2.3	2.1	-3.8	-0.2	1.8	
	1999	2.1	1.5	3.4	2.4	1.2	3.2	2.2	2.3	
	2000	0.9	2.1	3.7	2.5	4.2	13.3	8.8	3.4	
	2001	3.4	2.6	4.2	3.5	8.7	-1.0	3.6	3.6	
	2002	4.3	2.5	4.6	3.7	5.8	-0.2	2.6	3.5	
	2003	3.0	2.0	3.7	2.9	6.0	1.4	3.6	3.0	
	2004	3.6	0.9	3.7	2.7	4.6	4.8	4.7	3.0	
	2005	3.5	1.1	3.7	2.7	3.6	0.1	1.8	2.5	
	2006	2.7	1.2	4.1	2.8	4.5	-0.5	2.0	2.6	
ANNUAL RATES (growth of the month over the same month of the previous year)	2004	January	2.5	0.7	3.6	2.3	6.5	-1.7	2.2	2.3
		February	2.4	0.5	3.6	2.3	6.1	-2.5	1.5	2.1
		March	2.4	0.5	3.6	2.2	6.5	-2.5	1.6	2.1
		April	2.9	0.7	3.7	2.4	6.8	1.4	3.9	2.7
		May	3.7	0.9	3.8	2.7	7.0	6.6	6.8	3.4
		June	4.0	1.0	3.8	2.8	6.2	7.2	6.8	3.5
		July	4.2	0.8	3.7	2.8	5.5	6.6	6.1	3.4
		August	4.2	1.0	3.7	2.9	3.8	7.0	5.5	3.3
		September	4.3	1.0	3.8	2.9	1.4	7.5	4.6	3.2
		October	4.0	1.3	3.6	2.9	1.8	11.6	6.8	3.6
		November	4.1	1.2	3.8	2.9	2.3	9.9	6.3	3.5
		December	4.1	1.2	3.8	2.9	1.8	7.6	4.8	3.2
	2005	January	4.2	1.2	3.7	2.9	1.4	5.6	3.6	3.0
		February	4.2	1.3	3.8	2.9	2.9	5.1	4.1	3.1
		March	4.2	1.3	3.8	3.0	2.9	3.9	3.4	3.1
		April	4.2	1.1	3.5	2.8	3.1	2.5	2.8	2.8
		May	3.3	1.1	3.7	2.7	2.6	0.0	1.2	2.4
		June	3.1	1.0	3.6	2.6	2.8	0.0	1.3	2.4
		July	3.1	1.1	3.7	2.6	2.8	-0.4	1.1	2.3
		August	3.1	1.1	3.6	2.6	3.6	-2.2	0.6	2.2
		September	3.1	1.1	3.7	2.6	5.0	-2.3	1.1	2.3
		October	3.1	1.1	3.7	2.6	5.2	-4.9	-0.2	2.1
		November	3.0	1.1	3.7	2.6	5.2	-3.8	0.5	2.2
		December	3.0	1.1	3.8	2.7	5.7	-1.4	2.0	2.6
	2006	January	3.0	1.2	4.1	2.8	5.5	-0.3	2.5	2.8
		February	2.9	1.2	4.0	2.8	5.2	-0.4	2.3	2.7
		March	2.9	1.2	4.0	2.8	4.8	-0.7	2.0	2.6
		April	2.6	1.2	4.1	2.7	4.6	-0.7	1.9	2.6
		May	2.7	1.2	4.1	2.7	4.5	-0.6	1.9	2.6
		June	2.7	1.2	4.1	2.7	4.6	-0.6	2.0	2.6
		July	2.7	1.2	4.1	2.8	4.7	-0.5	2.0	2.6
		August	2.7	1.2	4.1	2.8	4.6	-0.5	2.0	2.6
		September	2.7	1.2	4.1	2.8	4.2	-0.5	1.8	2.6
		October	2.7	1.2	4.1	2.8	4.0	-0.5	1.7	2.6
		November	2.7	1.2	4.1	2.8	3.9	-0.5	1.7	2.6
		December	2.6	1.3	4.1	2.8	4.1	-0.5	1.7	2.6

Source : INE & IFL (UC3M)

Date: January 28, 2005



CPI MONTHLY GROWTH BY SECTORS IN SPAIN

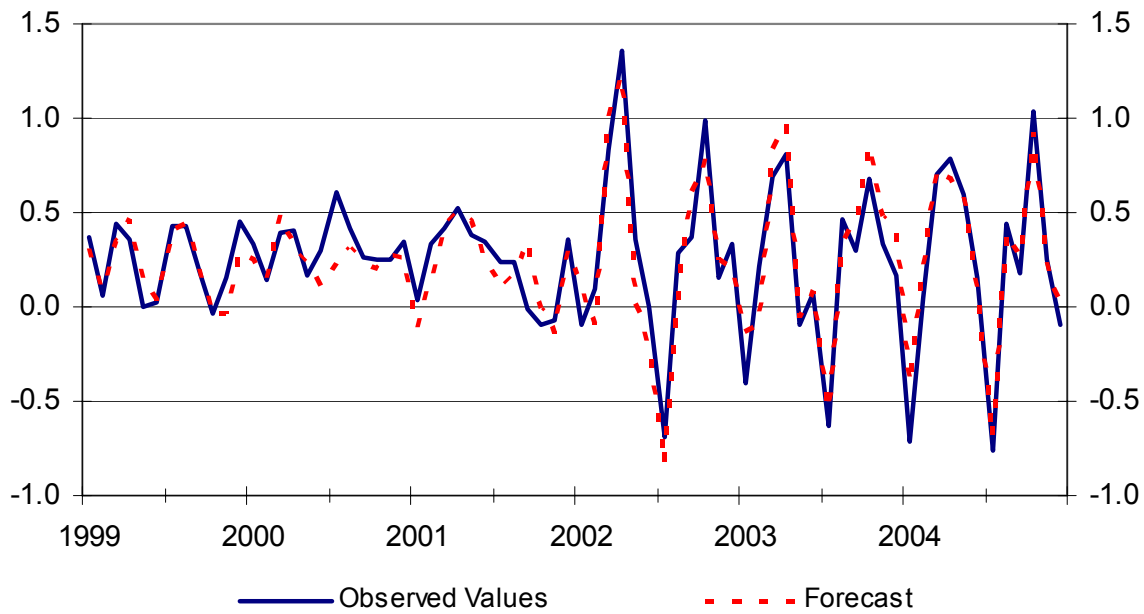
		Consumer Prices Index							TOTAL 100%	
		Core				Residual				
		Processed food	Non energy industrial goods	Services	TOTAL	Non processed food	Energy	TOTAL		
Weights 2004		17.2%	30.1%	35.1%	82.3%	8.6%	9.1%	17.7%		
MONTHLY RATES (Growth of the month over the previous month)	January	2003	0.5	-3.1	0.6	-0.8	0.4	2.2	1.4	-0.4
		2004	0.4	-3.6	0.6	-1.0	0.6	0.6	0.6	-0.7
		2005	0.5	-3.6	0.5	-1.0	0.1	-1.2	-0.5	-0.9
		2006	0.5	-3.5	0.8	-0.8	-0.1	-0.1	-0.1	-0.7
	February	2003	0.6	0.0	0.4	0.3	-1.5	1.3	0.0	0.2
		2004	0.5	-0.2	0.4	0.2	-1.9	0.4	-0.7	0.0
		2005	0.4	-0.1	0.4	0.2	-0.4	0.0	-0.2	0.2
		2006	0.3	-0.1	0.4	0.2	-0.7	-0.1	-0.4	0.1
	March	2003	0.3	1.0	0.5	0.6	0.5	1.4	1.0	0.7
		2004	0.3	0.9	0.5	0.6	0.8	1.5	1.2	0.7
		2005	0.3	1.0	0.5	0.6	0.8	0.3	0.5	0.6
		2006	0.3	1.0	0.5	0.6	0.5	-0.1	0.2	0.6
	April	2003	0.1	2.7	0.7	1.3	0.0	-2.6	-1.4	0.8
		2004	0.5	3.0	0.7	1.5	0.3	1.3	0.8	1.4
		2005	0.5	2.8	0.4	1.3	0.5	-0.1	0.2	1.1
		2006	0.2	2.8	0.5	1.2	0.2	-0.1	0.1	1.0
	May	2003	0.1	0.5	-0.2	0.1	0.6	-2.5	-1.1	-0.1
		2004	1.0	0.6	-0.1	0.4	0.8	2.5	1.7	0.6
		2005	0.2	0.6	0.0	0.3	0.3	-0.1	0.1	0.2
		2006	0.2	0.6	0.1	0.3	0.2	0.0	0.1	0.2
	June	2003	0.1	-0.2	0.4	0.1	0.3	-0.6	-0.2	0.1
		2004	0.4	-0.1	0.4	0.2	-0.5	0.0	-0.2	0.2
		2005	0.2	-0.1	0.4	0.2	-0.2	0.0	-0.1	0.1
		2006	0.2	-0.1	0.4	0.2	-0.1	0.0	0.0	0.1
	July	2003	0.1	-3.5	0.7	-1.0	1.5	0.9	1.2	-0.6
		2004	0.2	-3.7	0.6	-1.1	0.8	0.3	0.5	-0.8
		2005	0.2	-3.6	0.6	-1.0	0.8	-0.1	0.3	-0.8
		2006	0.2	-3.6	0.6	-1.0	0.9	0.0	0.4	-0.7
	August	2003	0.2	-0.3	0.7	0.2	1.9	1.4	1.6	0.5
		2004	0.2	-0.1	0.6	0.3	0.3	1.8	1.1	0.4
		2005	0.2	-0.1	0.6	0.3	1.1	0.0	0.5	0.3
		2006	0.2	-0.1	0.6	0.3	1.0	0.0	0.5	0.3
	September	2003	0.1	1.0	-0.5	0.2	2.2	-0.4	0.8	0.3
		2004	0.2	1.1	-0.4	0.2	-0.2	0.1	-0.1	0.2
		2005	0.1	1.1	-0.4	0.2	1.1	0.0	0.5	0.3
		2006	0.1	1.1	-0.4	0.2	0.7	0.0	0.3	0.3
	October	2003	0.3	2.3	0.2	1.0	-0.4	-1.1	-0.8	0.7
		2004	0.1	2.6	0.0	0.9	0.0	2.6	1.4	1.0
		2005	0.1	2.6	0.1	1.0	0.2	0.0	0.1	0.8
		2006	0.0	2.6	0.1	1.0	0.0	0.0	0.0	0.8
	November	2003	0.2	1.1	-0.2	0.4	0.0	0.3	0.1	0.3
		2004	0.2	1.0	0.0	0.4	0.6	-1.2	-0.4	0.2
		2005	0.2	1.0	0.0	0.4	0.5	0.0	0.3	0.4
		2006	0.1	1.0	0.0	0.4	0.5	0.0	0.2	0.4
	December	2003	0.1	-0.1	0.4	0.1	0.9	-0.3	0.3	0.2
		2004	0.2	-0.2	0.4	0.1	0.4	-2.5	-1.2	-0.1
		2005	0.2	-0.1	0.4	0.2	0.8	-0.1	0.4	0.2
		2006	0.1	-0.1	0.4	0.2	1.0	-0.1	0.5	0.2

Source : INE & IFL (UC3M)

Date: January 28, 2005

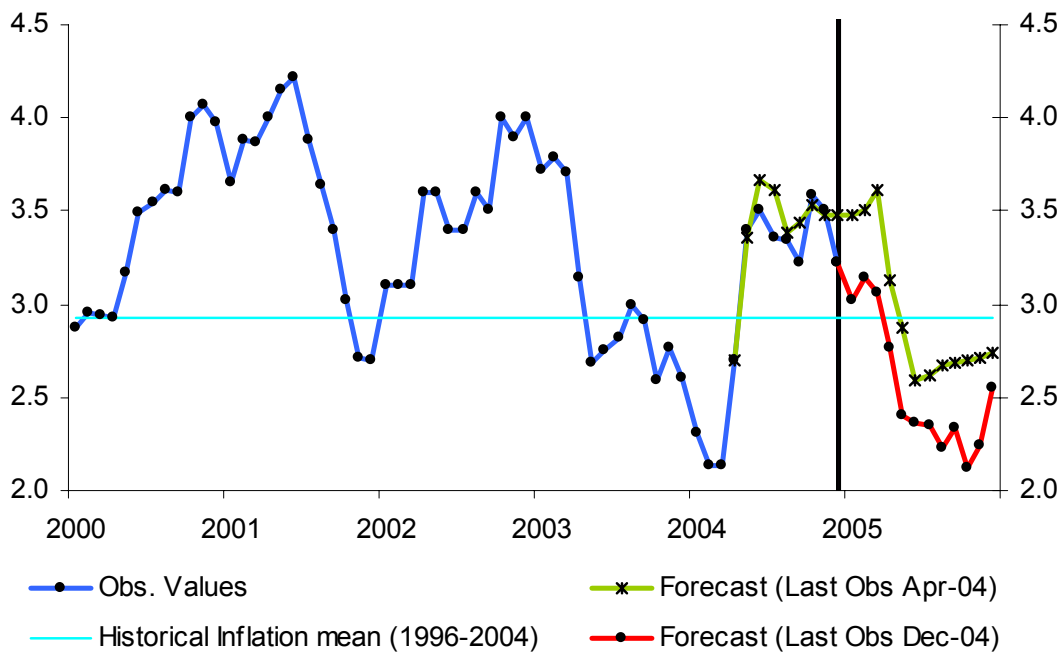


CPI MONTH-ON-MONTH RATES OF GROWTH IN SPAIN



Source : INE & IFL (UC3M)
Date: January 28, 2005

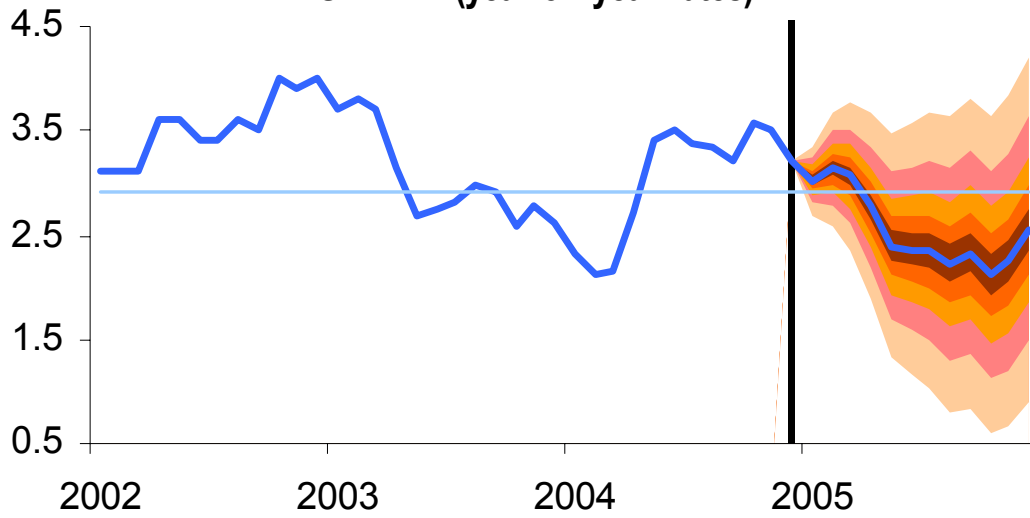
ANNUAL FORECASTS FOR TOTAL INFLATION IN SPAIN (year-on-year rates)



Source : INE & IFL (UC3M)
Date: January 28, 2005



ANNUAL FORECASTS FOR TOTAL INFLATION IN SPAIN (year-on-year rates)

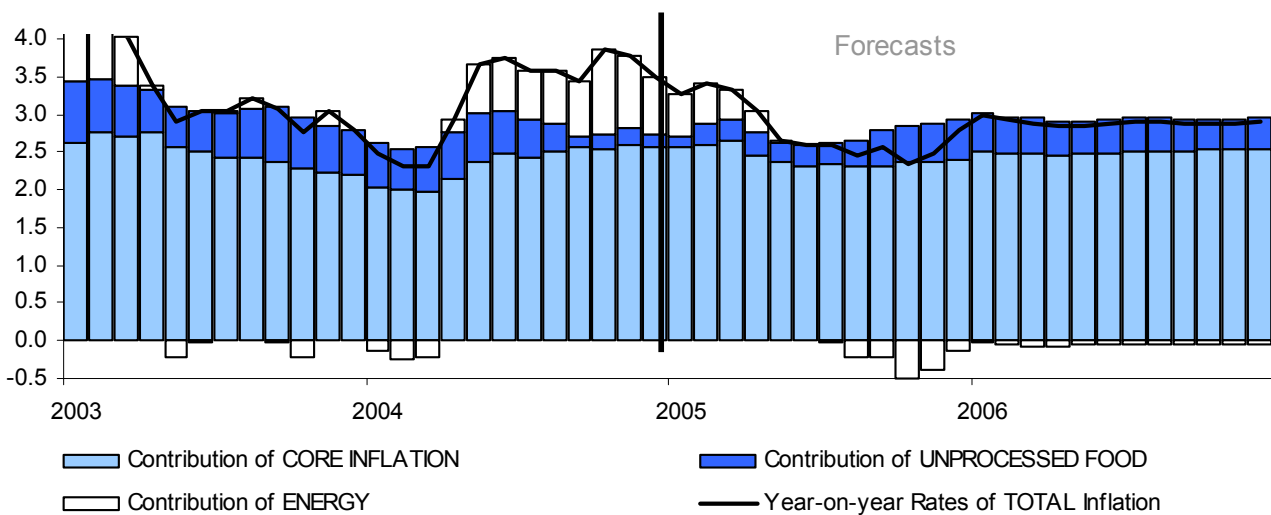


Confidence intervals 95% 80% 60% 40% 20%

Historical Inflation mean (1996-2004) —

Source : INE & IFL (UC3M)
Date: January 28, 2005

YEAR-ON-YEAR RATE OF INFLATION IN SPAIN AND CONTRIBUTIONS OF MAIN COMPONENTS



Source : INE & IFL (UC3M)
Date: January 28, 2005



III.2. MACROECONOMIC TABLE OF SPANISH ECONOMY

MACROECONOMIC TABLE AND INDICATORS (*)					
	2003	Annual Rates			
		Forecasts BIMA(*)			Budget
		2004	2005	2006	2005
Private Final Consumption Expenditure	2.9	3.4	3.3	3.3	3.2
Public Final Consumption Expenditure	3.9	4.4	4.2	4.2	3.5
Gross Fixed Capital Formation	3.2	4.2	4.1	3.4	4.0
Equipment	1.0	4.4	6.3	5.4	(3)
Building	4.3	4.3	2.9	2.1	3.2
Other products	3.0	3.2	4.1	4.4	(3)
Inventory change (1)	0.1	0.2	-0.1	-0.1	0.0
Domestic Demand	3.2	3.9	3.6	3.4	3.4
Exports of Goods and Services	2.6	4.5	5.9	7.4	6.4
Imports of Goods and Services	4.8	8.5	8.2	8.2	7.3
Net Exports (1)	-0.8	-1.5	-1.1	-0.7	-0.6
GDP	2.5	2.6	2.7	2.9	3.0
GDP, current prices	6.6	6.4	6.5	6.1	6.3
Prices and Costs					
CPI, annual average	3.0	3.0	2.5	2.6	
CPI, dec./dec.	2.6	3.2	2.6	2.6	
Average earning per worker	4.2	3.8	3.9	4.0	
Unit labour cost	3.5	3.2	3.3	3.4	
Labour Market (Data poll labour force)					
Labour Force (% variation)	2.6	1.9	1.7	1.8	
Employment (EPA)					
Annual average variation in %	2.7	2.4	2.3	2.3	
Annual average variation in thousands	436.8	400.7	393.2	402.2	
Unemployment rate	11.3	10.9	10.3	9.9	10.8
Basic balances					
Foreign sector					
Current Account (m. €.)	-24.634	-35.270	-28.937	-26.500	
Net lending or borrowing (% GDP) (2)	-3.3	-4.4	-3.4	-2.9	
AA.PP. (Total) / Public Administration					
Net lending or borrowing (% GDP) (2)	0.0	-0.8	-1.2	-1.0	
Other Economic Indicators					
Industrial Production Index	1.6	1.9	1.0	2.1	

(1) Contributions to GDP growth

(2) In term of national accounts

(3) Equipment goods and other goods: Forecast PGE, 5.1; Forecast BIAM, 5.5.

Source: INE & IFL(UC3M)

Date: January 20, 2005.

(*) Bulletin EU & US Inflation and Macroeconomic Analysis.

Section Sponsorship:
Cátedra Fundación Universidad Carlos III de Predicción y Análisis Macroeconómico.





IV. FORECAST SUMMARY

IV.1. EURO AREA AND USA

INFLATION FORECASTS AND EVOLUTION IN THE EURO AREA AND USA								
	1999	2000	2001	2002	2003	2004	Forecasts	
							2005	2006
TOTAL INFLATION								
Euro-area (100%).	1.1	2.1	2.3	2.3	2.1	2.1	2.0	1.8
USA (81.5%). ⁽¹⁾	2.1	3.5	2.6	0.9	2.2	2.8	2.4	2.1
A HOMOGENEOUS MEASURE OF CORE INFLATION⁽²⁾								
Services and Non-energy industrial goods excluding food and tobacco.								
Euro- area (72.34%).	1.1	1.0	1.8	2.4	1.8	1.8	1.8	1.8
USA (55.6%). ⁽¹⁾	1.4	2.1	2.1	1.6	1.1	1.6	2.3	2.3
DIFFERENT COMPONENTS OF THE HOMOGENEOUS MEASURE OF CORE INFLATION								
(1) Services.								
Euro- area (41.33%).	1.5	1.5	2.5	3.1	2.6	2.6	2.6	2.6
USA (27.4%). ⁽¹⁾	2.7	3.5	3.6	3.6	3.2	3.3	3.2	3.2
(2) Non-energy industrial goods excluding food and tobacco.								
Euro- area (31.01%).	0.7	0.4	0.9	1.5	0.8	0.8	0.7	0.8
USA (29.0%).	-0.5	-0.1	-0.2	-1.5	-2.1	-1.0	0.8	0.9
INFLATION IN EXCLUDED COMPONENTS FROM THE HOMOGENEOUS MEASURE OF CORE INFLATION								
(1) Food.								
Euro- area (19.53%).	0.6	1.4	4.5	3.1	2.8	2.4	2.4	2.5
USA (14.9%).	2.1	2.3	3.1	1.8	2.1	3.4	2.5	2.4
(2) Energy.								
Euro- area (8.13%).	2.4	13.0	2.3	-0.6	3.0	4.5	2.1	0.2
USA (9.90%).	3.6	16.9	3.8	-5.9	12.2	10.9	3.0	-0.1

⁽¹⁾ less owner's equivalent rent of primary residence.

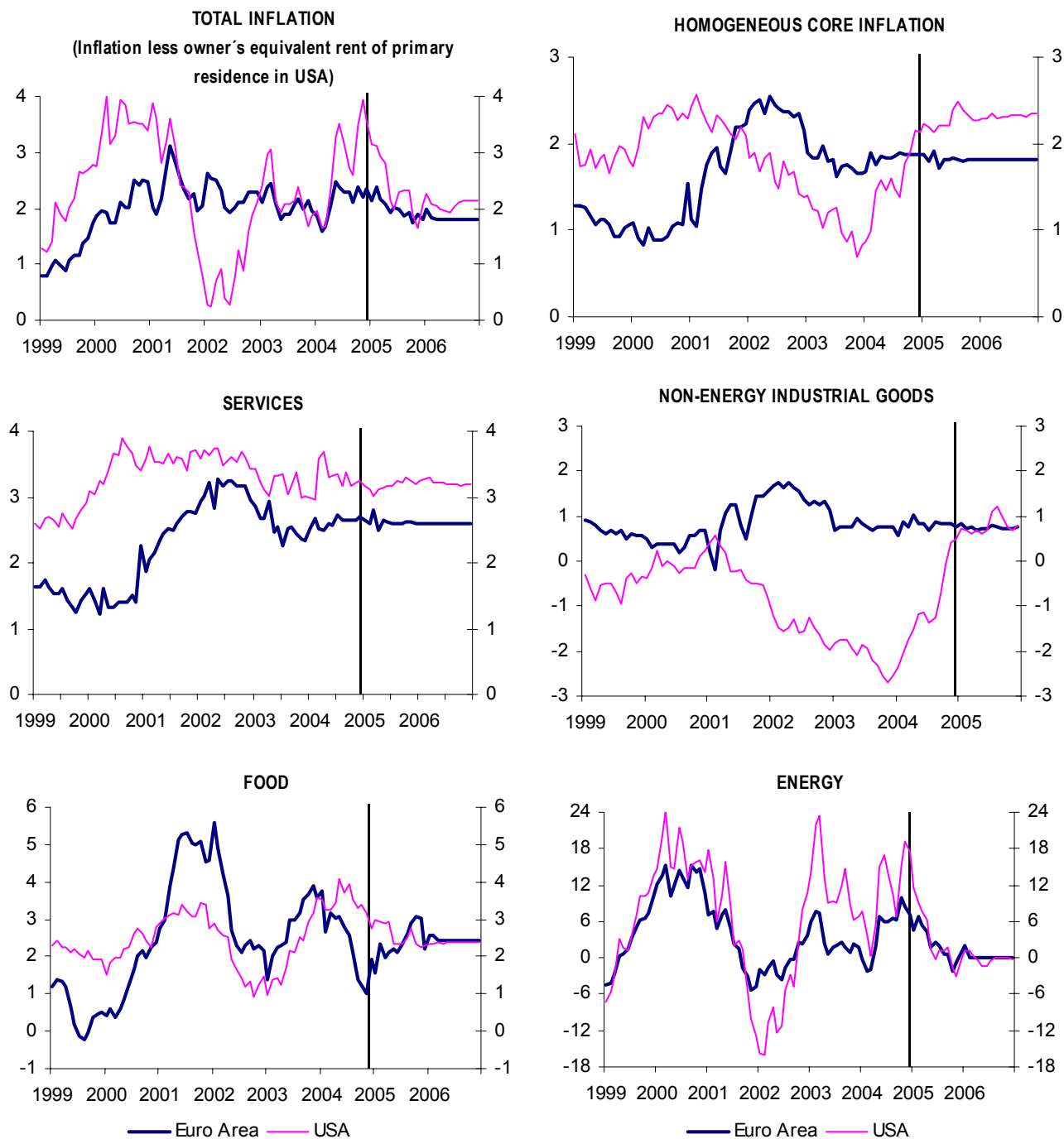
⁽²⁾ This homogeneous measure of underlying inflation does not coincide with the usual measure of core inflation for the EMU nor for the USA. It has been constructed in order to compare the data in the EMU and in the USA.

Source: EUROSTAT, BLS & IFL (UC3M)

Date: January 20, 2005



YEAR-ON-YEAR RATES OF INFLATION IN THE EURO AREA AND USA



Source: EUROSTAT, BLS & IFL

Date: January 20, 2005

Total inflation is less owner's equivalent rent of primary residence. The core inflation has been constructed in order to compare the data in the EMU and in the USA.



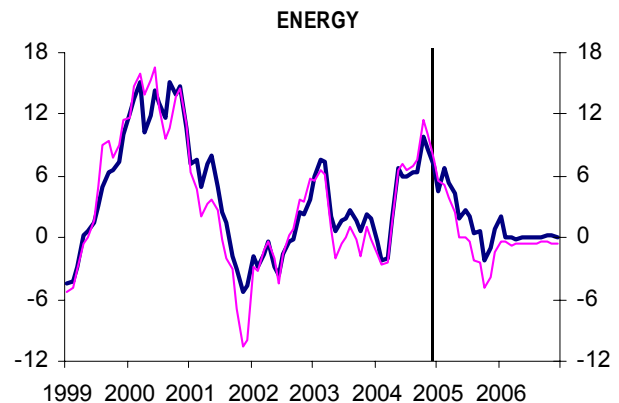
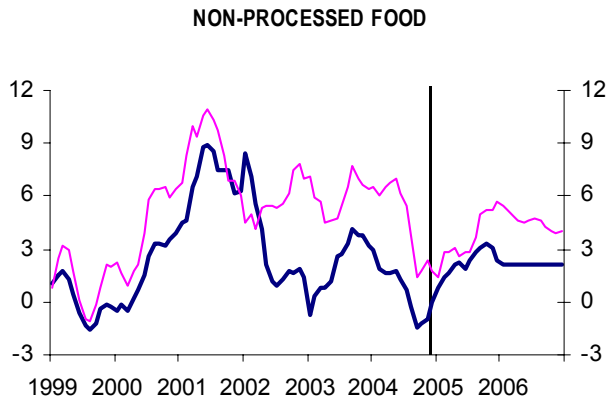
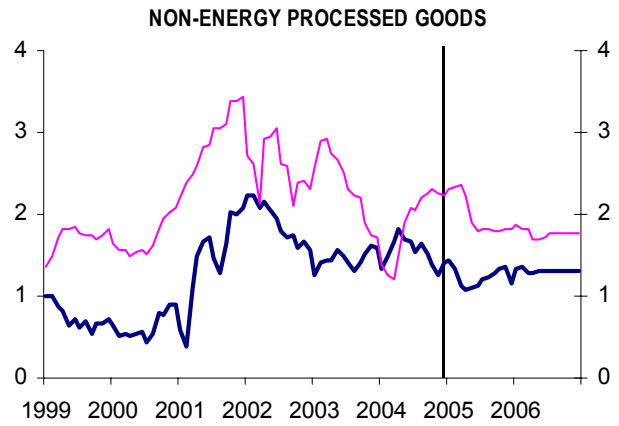
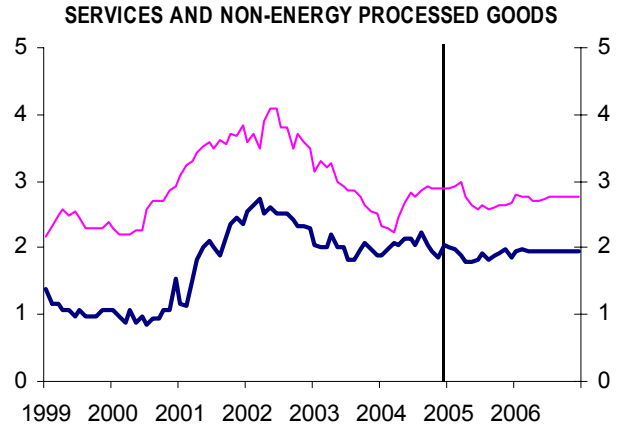
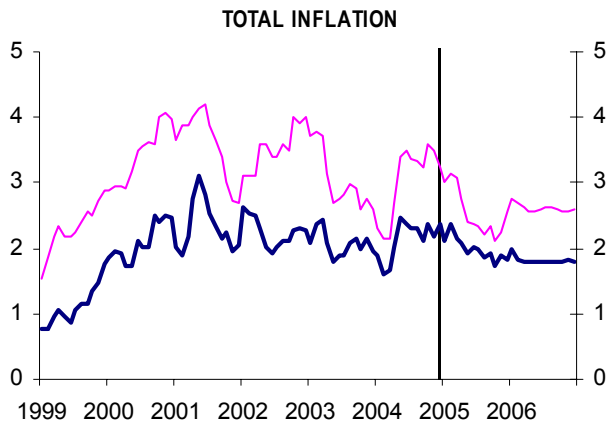
IV.2. EURO AREA AND SPAIN

INFLATION FORECASTS AND EVOLUTION IN THE EURO AREA AND SPAIN								
	1999	2000	2001	2002	2003	2004	Forecasts	
							2005	2006
TOTAL INFLATION								
Spain (100%).	1.4	2.3	3.4	3.6	3.5	3.0	3.1	2.8
Euro-area (100%).	1.1	1.1	2.1	2.3	2.3	2.1	2.1	1.9
CORE INFLATION								
Services and Non-energy processed goods.								
Spain (81.40%).	2.2	2.2	2.5	3.4	3.7	2.9	2.7	2.8
Euro-area (84.18%).	1.4	1.1	1.0	1.9	2.5	2.0	2.1	2.0
DIFFERENT COMPONENTS OF CORE INFLATION								
(1) Services.								
Spain (34.87%).	3.6	3.4	3.7	4.2	4.6	3.7	3.7	4.0
Euro- area (41.33%).	1.9	1.5	1.5	2.5	3.1	2.6	2.6	2.6
(2) Non-energy processed goods.								
Spain (46.53%).	1.4	1.7	1.7	2.9	3.1	2.4	2.2	2.0
Euro- area (43.26%).	1.1	0.7	0.6	1.5	1.9	1.5	1.6	1.3
INFLATION IN EXCLUDED COMPONENTS FROM CORE INFLATION								
1) Non-processed food.								
Spain (9.40%).	2.1	1.2	4.2	8.7	5.6	5.6	4.5	3.5
Euro- area (7.69%).	2.0	0.0	1.7	7.0	3.1	2.2	0.4	1.2
(2) Energy.								
Spain (9.14%).	-3.8	3.2	13.3	-1.0	-0.2	1.4	5.0	2.1
Euro- area (8.13%).	-2.6	2.4	13.0	2.3	-0.6	3.0	4.5	1.9

Source: EUROSTAT, INE & IFL
Date January 28, 2005



YEAR-ON-YEAR RATES OF INFLATION IN THE EURO AREA AND SPAIN



— Euro area — Spain

— Euro area — Spain

Source: EUROSTAT, BEA & IFL

Date: January 28, 2005



V. INFLATION FORECASTS OF DIFFERENT INSTITUTIONS

INFLATION FORECASTS OF DIFFERENT INSTITUTIONS ¹										
	BIAM ²		CONSENSUS FORECASTS ³		IMF ⁴		ECB ⁵		OCDE ⁶	
	2005	2006	2005	2006	2005	2006	2005	2006	2005	2006
EURO AREA	2.0	1.8	1.8	1.7	2.1	1.9	2.1	1.9	1.7	1.8
EE.UU.	2.3	2.1	2.5	2.4	3.0	3.0	-	-	1.8	1.7
ESPAÑA	2.5	2.6	2.8	2.6	2.6	2.7	-	-	3.2	2.7

1 The forecasts are based on CPI in USA and Spain and on HICP in the Euro area

2 Bulletin EU & US Inflation and Macroeconomic Analysis , January 2005.

3 January 10, 2005.

4 IMF. World Economic Outlook. September 2004.

5 ECB. Monthly Bulletin. Survey of Professional Forecasters. November 2004

6 OECD Economic Outlook 76. November 2005. For Euro area and USA measured by the increase in the GDP deflator. For Spain, the forecasts are based on HICP inflation.

Our forecasts for total inflation in the euro area and Spain are slightly greater than the previsions derived from other institutions because with the methodology applied in our Bulletin, total inflation is breaking down in core and residual inflation. Last one is composed by inflation in non-processed food and energy prices.

The innovations come in different components are transferred in future through different multipliers. The innovations derived from residual inflation are less persistent.

Our expectation about total inflation in the euro area in 2005 is 2.0% slightly higher in relation the published in the previous bulletin, 1.8%. In Spain, the expectations for 2005 are lower in relation to the forecasts of our previous bulletin (2.3%). Energy prices are expected to increase due to the evolution of crude prices although the better evolutions of euro/dolar exchange rates counteract this negative evolution. The expected average inflation rate for 2005 in energy prices is 0.1% in Spain and 2.1% in the euro area.



THE CAPITALISM TO COME:

Juan Urrutia Elejalde
Professor of Economics

January 2005

CHAPTER III.3.: ESTATE

III.3.2. THE SCOPE OF THE STATE

III.3.2.A. The third sector

- a. The third sector
- b. Patronage, foundations and market

III.3.2.B. The dismantling of the State

- a. Privatisations
- b. Independent regulatory agencies
- c. Minimum State

Summary

SUMMARY

In this second section of chapter III.3, which is presented as its second part, we start by attempting to track the trends that appear to lead to a reduction in the scope of the State and continue by speculating how these trends are influenced by the new technologies (ICTs) and the availability of information in the information society. What is said in this section has nothing to do with the size of the State, to which we will be referring in the next, and it is therefore unrelated to globalisation.

In the first part we approach the immediate problem of whether the emergence of a third sector between the public sector, controlled by the government on behalf of the State, and a private sector driven by profit, affects the scope of the State or, in other words, the ratio between the public and private sectors. The answer is not initially obvious because the third sector can move within the scope of the other two. However, the text shows that it can be expected for the activities of this third sector to reduce the scope of the public sector and for its ratio to be reduced in the private sector. First, because the third sector should become responsible (for reasons provided in the relevant section and already used when referring to ownership and sovereignty) for the provision of some public services; secondly, because the most sensible way of understanding patronage and foundations is to consider them as activities aimed at the creation of markets and subject to competition among them, so what we find here is the principle of the aligning virtues of private initiative which, in this case, would correspond to the initiative of true patrons.

This trend is strengthened for three reasons related to the factors whose impact on capitalism we are attempting to discover. In the first place, it would be expected that, in as much as the private sector sees possibilities of profit in the activities related to the Information Society, it will be interested in the cultural activities that form part of such an



Information Society. Secondly, the ICTs will significantly help to reduce the value of the public sector as it reduces its added value by introducing a digital administration which will simplify things considerably. Finally, the ICTs will help to speed up the changeover of culture from being “sacred” to being a commodity.

The second part of this section shows that the scope of the State will become radically smaller; so much so that we will be referring to a dismantling of the State that will not end until the State is minimal. According to texts published earlier, we studied how privatisations and what are known as independent regulatory agencies work in that direction. Two levels of ideas are now added to these recent texts. The first is related to the creativity of individual initiative, which is strengthened with privatisations. The second level comprises ideas alerting about the possibility of the capture of the State and the creation of a crony capitalism which acts as a dead weight for the creation of wealth. This capture of the State can be by means of the government, on behalf of the State, delivering these independent regulatory agencies to its friends, thus becoming strong and performing the same operation with privatisations, strengthening a dangerous connivance between the government and the business community. This second part ends, somewhat unashamedly, with a shaky description of what would be the minimal State, sufficient not to block the sources of wealth, and with a hypothesis on the social class that will eventually create a small, but strong, State.

The only way in which such a State cannot be captured is by citizen participation in the decision-making process, a participation that can only be effective by means of the proliferation of interactive media which are technologically accessible and already cornering the traditional mass media at the extremes of the ideological spectrum. This polarisation is precisely what leaves space for interactive media.

III.3.2. THE SCOPE OF THE STATE

According to the general ideas of this part of THE CAPITALISM TO COME, we can see a gradual reduction in the scope of the State in economic activities, together with the subsequent enlargement of the scope of the market. In this section, we will be insisting on this from two perspectives corresponding to recent phenomena. In the first part, I will be referring to the emergence of a third sector, which remarkably helps to reduce the scope of the State. In the second, I will be considering the undesired consequences of other ways of reducing the scope of the State, such as the privatisation of public enterprise and the emergence of independent regulatory agencies (IRAs). In my analysis of these three phenomena, I will attempt to clarify that the reduction in the scope of the State does not only lead to the growth of the scope of the market, but also that private initiative, which is inseparable from competition, effectively helps to reduce the scope of the State¹.

III.3.2.A. The third sector

It is traditional to classify economic activities as belonging to the private sector and the public sector, although it would analytically be clearer to classify them according to whether allocations are achieved through the market or other mechanisms. And the two classifications are not exactly the same. On the one hand there are private sector activities such as charities which produce allocations by means of a mechanism that has nothing to do with the market and does not use prices. On the other, there are public sector activities which take place on the market and by means of the price system, such as cigarette production in Spain, for instance.

The important question is, therefore, why some activities take place on the market and others do not. The following elementary analytical framework will help us find the answer. Let E be a class of economic environments and let $e \in E$. A resource allocating mechanism, β , gives us, for each e , a sub-set in R^{ln^2} where l is the number of goods and n is the number of individuals. In other words, the mechanism tells us who



gives what to whom: $\beta(e) = A \subseteq R^{\ln^2}$. We request a mechanism to have certain specific properties, some of which I will be mentioning here, but without describing them because they are either well known or of no interest at the moment. A resource allocation mechanism must be consistent, unbiased, efficient, compatible in incentives, fair, core-selecting, etc. Although, in certain classes of environment, E , the price mechanism complies with “all” the desired properties, this is not the case in another class of environment, E' , say. The characteristics of these environments E' in which the market does not perform its functions as cleanly as we desire, always refer to notions to which we have paid attention in the previous chapters or we will be doing so in the chapters to come: transaction costs, uncertainty, information problems (incompleteness and asymmetry), non-convexities (or increasing returns to scale), externalities and public goods.

There are many cases in which this explains the generation of private institutions which exclude the market from their operations. As we have seen in a previous chapter, this is how firms appear. But it also gives rise to, for instance, joint ventures, vertical integrations or cooperatives as special forms of enterprise. Here, resources are allocated by mechanisms that we can call β' , which have nothing to do with the market and which are not always the same: $\beta'_1 \dots \beta'_k$. In general, these mechanisms are not anonymous and they exhibit both authority and control.

There are other cases (generally associated to public goods and non-convexities) in which there are no private institutions, with its corresponding β' , which solve the problem and what are generated are public institutions which allocate resources with mechanisms β'' which do not necessarily have anything to do with the market. These public institutions either allocate goods directly (education, defence, etc) or by means of the market (shipbuilding today in Spain); but in any case the β'' , $\beta''_1 \dots \beta''_h$, are not necessarily the same as the β s.

a. The third sector

In this analytical framework it is easy to express a conclusion reached earlier with the help of H. Simon's visitor to the earth from Mars: most of the allocations (in quantity or value) do not pass through the market. Therefore, concern for non-market resource allocating mechanisms, β' or β'' , is far from trivial. Part of this concern is reflected in the business literature. The other part is related to the study of public institutions or curious forms of enterprise. This general concern involves two aspects. First, which mechanisms are appropriate, β' or β'' ? Secondly: are these institutions sufficient to eliminate the characteristics of the environment which made the market system fail? In general, they are not, and we are therefore concerned with the Pareto ranking of possible allocations. But, as we shall see in the next part of this section, private institutions (better than their public counterparts) sometimes appear when the private initiative is given enough room to manoeuvre.

But above and beyond the distinction between private and public sector, between market and State, I am interested here in what is known as the third sectorⁱⁱ. The apparent crisis of the welfare State to which we will be referring in part IV of this book, and the recent emergence of so-called civil society, have created unprecedented interest in the third sector as an intermediate position between the private and public sectors. News bulletins are increasingly full of references to the activities performed by NGOs (non-governmental organisations) which, as their name implies, cannot belong to the public sector, or by some non-profit making foundations.

It seems appropriate at this point to have a description of the organisations now handling enormous unidirectional transfers and an assessment of the quantitative importance of their income and expenditure. Fortunately, progress has been made in this direction. Indeed, in May 1990, Johns Hopkins University, and specifically its Institute for Policy Studies, launched an ambitious international project to attempt to describe and analyse the comparative status of the non-profit sector in twelve significant countries: six of them developed, five of them developing and one previously belonging to Eastern



Europeⁱⁱⁱ. Professor Salamon, the Institute's director, coordinated the work of hundreds of specialists for 3 years and has finally published the results obtained, together with Professor Anheier from Rutgers University, in The Emerging Sector. An Overview.

Although more recent work has been published, this book provides us with an idea that is sufficient for our purpose. According to Salamon and Anheier, this emerging sector would consist of organisations (neither political nor religious) which share the following characteristics: (i) they have been formally established (whatever their legal status), (ii) they are independent from the government from an organisational perspective (even though they may execute its decisions), (iii) they are non-profit making, (iv) they are under independent management, and (v) they depend on volunteer work to a significant degree.

From this viewpoint, the sector starts to be describable. It does not include, for example, governmental agencies, mutual insurance companies, savings banks, cooperatives, political parties or religious congregations. However, it does include educational institutions, healthcare dispensaries, research and professional associations, social service agencies, recreational clubs and cultural foundations. We can even progress in the quantitative determination of such a third sector. According to the aforementioned study, in the seven countries^{iv} for which complete data are available, this sector is remarkably large. In terms of employment, it represents 11.8 million jobs and 4.7 million volunteers, and in terms of expenditure, it represents 600 billion dollars of current expenses, a 5% of the GDP of these seven countries. This expenditure is unequally distributed by activity. There are four activities covering nearly 80% of this expenditure. They are education and research (24%), health (22%), social services (16%) and culture and leisure (16%). We are also provided with information about the sources of funding for the different activities. For the mean of the seven countries considered, 47% of the revenue comes from sales in the sector itself, 43% from public grants and 10% from private donations (including foundations). However, this financing structure differs a great deal from one activity to another. Sales are particularly important in education and research (50%), government grants are important in health (51%) or social services (59%), and private donations in international aid (35%). Spending on culture and leisure is financed as follows: 65% from sales, 21% from public grants and 14% from private donations.

The interesting question in relation to this third sector is whether it helps to reduce the scope of the other two or increases the scope of one of them in detriment to the other. This is no innocent question and the answer is not obvious. For some, many of the activities of this third sector represent a further burden for the public sector which, as we have seen, often supplement the funds that institutions in this emerging sector attract from other sources, paying out amounts that without NGOs would have remained unspent. For others, however, NGOs and other institutions help to relieve the State of some of its functions, which now depend on civil society. For most of us, this new sector has nothing to do with the private sector; but for a few, it could be the start of a new way to allocate resources not guided by profit.

It is my opinion that the emergence of this third sector reduces the scope of the State or public sector, and it acts like an initiation ceremony towards the enlargement of the private sector. This viewpoint is based on two ideas. We have already mentioned the first one, which would be particularly applicable to NGOs, twice. The first time was in chapter I.2 in relation to the possible privatisation of science, and the second was in this chapter in reference to sovereignty; it concerned the idea of Besley and Ghatak according to which, if a public good is produced by the State as an investor together with technical experts and is only appreciated by the latter, the ownership of the means of production for the manufacture of such a public good should lie with the technical experts. I will not repeat the argument here; but Besley and Ghatak are precisely thinking about NGOs. This transfer of private ownership to civil society reduces the scope of the public sector, although there is no evidence that this improves allocations or even the personal autonomy of individuals, since the third sector may have its own shortcomings or become exceedingly bureaucratic.



The second idea justifying my assertion that the emergence of the third sector reduces the scope of the State or public sector, increasing that of the private sector, is no less intriguing and can be explained more easily if we refer to the narrower field of patronage. I have already considered the advantages or disadvantages of such patronage in relation to the public sector when there are market failures in the cultural sector. I talked about this in chapter II.1; but we now need to show clearly how true patronage should be considered as market creating and we will therefore be focusing on the figure of a foundation.

b. Patronage, foundations and market

We will begin with the obvious explanation of patronage presented in the work I have referred to. The State, incapable of supporting the growing fiscal cost of maintaining the cultural output, provides fiscal incentives for patronage which, as the economy develops, are used by social initiative. Our explanation is not yet complete, however, because it is not clear why social initiative chooses these fiscal incentives instead of other incentives related with other fields. What does culture have that housing lacks, for instance, making patronage flourish in the former but not in the latter?

The first thing we have to note is that culture is a magnificent candidate to be a signal. Not all activities can act as signals. If a builder develops new small apartments for young people of marriageable age is not a signal that the builder is a patron of marriage, since that would be his rational activity in any event. However, if the builder gives the apartments away he is indeed more than a mere builder because, for such an economic agent, it is irrational to give apartments away. The signal is often more illustrative. For example, if I am studying for a doctorate, this is a sign that I am intelligent because otherwise the cost of obtaining it would be rationally prohibitive. Well, a firm's unidirectional expenditure on culture is an intermediate case. It is a signal that it is more than a mere firm operating in, say, the financial sector. But that "more" is related to its taste for what we know as culture, which is only appreciated with use. It is thus issuing a signal that it has a special status; it is a culture lover.

We see, then, that spending on culture and being a patron has to do with status and, ultimately, one's reputation. But why should a firm want a reputation as a patron? The simplest answer is that such a reputation is a magnificent support for advertising, something like the marble operating floors of ancient banks and which, like advertising in general, is largely used because it is used by the competitors. We thus find ourselves in a situation known by economists as a signal equilibrium, which can have the remarkable characteristic consisting of the fact that, in fact, patron firms are spending too much on cultural patronage. In other words, they spend more than they would if patronage did not act as a signal. This is possibly an example of patronage failure which could not arise in the public sector, since the Ministry of Culture has no concern for its reputation as a regulator of culture and has no competitor to emulate.

For better or worse, we have provided some kind of explanation of patronage, but it may be possible to put forward some additional ideas and a risky hypothesis. The explanation provided above does not explain why business (or individual) patronage very often adopts the form of a foundation. We here have to make an elementary distinction between foundations with an initial capital and foundations who live on regular contributions. There are different reasons for one and the other. The former is very easy to rationalise in the context of the ideas we have just put forward. Indeed, a signal equilibrium may not be stable because the signals may not be credible, in which case one firm or another will cease to issue the signal, and cease to act as a patron. Therefore, a firm which really wishes to signal that it is a true patron has an incentive to commit to a long-term contribution to culture. It therefore creates an irreversible foundation based on initial capital. Of course a kind of foundations equilibrium may arise as a particular case of the aforementioned signal equilibrium in which, as in this case, there may also be an excess of investment in foundations. The second case, a foundation with periodical contributions, is not the same. There is no commitment to continue to act as a patron and the signal equilibrium either does not arise or is not very stable. Therefore, we would



expect to see a considerable rotation of this type of foundation, appearing with one purpose and then disappearing to appear again with another.

It is worthwhile continuing by saying that there are other foundations, of either of these two classes, which could be described in a caricaturesque manner as visionary foundations. The visionary would be someone who immobilises a small capital, or commits to a small annual contribution, aimed at putting a praiseworthy principle into practice. This someone is not issuing relevant signals but feels that he can legitimately obtain funds for his foundation and very often does so.

This reference to visionary foundations leads us to continue to examine what we could call patronage failures in the same way as we refer to market or State failures. In all these cases, there would be incentives to pervert the original purpose of each institution. We have already mentioned the tendency to overinvest in patronage as a signal, but visionary foundations alert us to a different failure. They are a very clear example of "rent seekers". Visionaries would attempt to supplement the small amount of money provided by themselves with contributions from the public sector and other foundations. Visionaries not only appear to do good work (they sometimes do such work) but also make a living. All too often, visionaries become clever intermediaries, thus running the risk of creating a profession of their work. This "rent seeking" activity which not only threatens the State but also other patrons and foundations, is not only performed by the developers of visionary foundations. Indeed, any individual familiar with the supply of one collective good or another, has incentives to mobilise resources to obtain the broad resources that the State, patrons and foundations spend on the good's provision. For example, artists or theatre groups would have an incentive to invest more than necessary to be prepared to win calls for ideas or obtain grants available in their field.

This danger of falling into the trap of "rent seekers" is a veritable plague against which it is impossible to vaccinate the State, or a patron or a foundation. The only way to mitigate its harmful effects would possibly be to establish true competition between patrons or foundations (this is not applicable to the State, obviously) in an initial application of the principle of the virtues of incentive alignment. In sponsorship this should be easy because in this case there is a firm concerned with making a profit which hopes that its sponsorship expenditure will improve its image and ultimately help its profits grow. We hence find the paradox that for apparently altruistic activities to really have a positive impact, they must be subject to market discipline, and more specifically competition and private initiative, in order to avoid the "income seeking" plague. But who could exercise such discipline in the case not of sponsorship, but patronage proper?

There is only one answer to this question: the true patron or founder. The figures of Cosme de Medicis or Pope Julius II have, with their stature, heavily distorted the image of patronage. It is difficult to see them as the creators of the market for "Cellinis" or "Michelangelos" because it is practically impossible to see them in the same light as Renoir saw Vollard the art dealer: *He was the impressionists' first protector. He did not buy our work to speculate. His only idea was to help his friends as much as possible and he did so in an admirable fashion, since he only kept what he was unable to sell*'. The difference between great patrons and this dealer is that while the former decorated their homes with marvellous cultural goods, the dealer traded them, converting them into "commodities". Without the latter, a sculpture would not be a cultural asset. Patrons are creators of markets.

This characteristic of patronage may seem too simple for those who have a sacred conception of culture, but I believe it has some advantages. Firstly, it brings the patron close to the figure of a Schumpeterian businessman who, instead of taking resources from their current use and using them to generate new products or processes, uses resources to create a market (as we imagined in the previous chapter), in order to transform a "good" into a "commodity". If the social value of a businessman is due to the fact that he is a vehicle for technical progress, the social value of a patron is due to the fact that he is a vehicle for cultural progress. Secondly, from this perspective, patrons, and the foundations they use for their commitments, must inevitably be avant garde in nature, just like Vollard. Otherwise they would not be patrons but something else:



collectors, special customers, warehouse owners, art market regulators or even speculators. A third advantage of conceiving patrons as creators of markets is that they are thus classified as part of today's liberal trend. But does this make sense from a historic perspective?

To end these remarks, it may be worthwhile to establish a historic hypothesis. Analytical economists often reason as if the market was a natural phenomenon which has been patched up over the years by the State, due to failures which in time became intolerable. Indeed, history appears to have been travelling in the other direction. Initially, resources were allocated by the sovereign and the market arose gradually, being a cultural and not a natural phenomenon. For analytical economists, the horizon of thought would paradoxically be patronage, whereas for observers of history it would take us to the market realm. The historic function of patronage varies from one conception to the other. For some, patronage would represent the predominance of civil society which would be organised according to a principle of generosity other than profit. For others, the only function of patronage would be to create markets where there are none. In my opinion, the latter conception is more in line with history. The patrons of the renaissance were State. Today's patrons are bound to introduce goods in the trading process which are not presently acting as commodities, thus leading to their widespread use, no less!

To end this section it is convenient to mention the interest of the new information and communication technologies (ICTs) for the public and the third sector, together with the growing significance of the information society. Three brush strokes are sufficient. The first is that in as much as the third sector is highly focused on cultural activities, it forms part of the information society and, in as much as the latter represents the future for private business initiative, we can expect the private sector to take over these cultural activities from the State. The second has to do with enhanced administration, not only of firms but also of the public sector, which will necessarily occur with the ICTs. This improvement is already becoming noticeable and will make a significant contribution to transparency and the sensation of a broad field of free decision which Hayek has always associated to the market. The last brush stroke is more speculative. But it seems evident that the use of ICTs will significantly reduce the time required for culture to cease to be seen as sacred and to be seen as a commodity to be provided by the market. This may have a not very noticeable side effect (such as the trivialisation of a museum), but it helps to broaden the private sector and intensify the competition spirit, thus enlarging the scope of our freedom.

II.3.2.B The dismantling of the State^{vi}

At the present time, it is impossible not to be aware of two complementary criticisms of the State, to which we have been referring since the introduction to this chapter. The first is of liberal origin and questions the diameter of the scope of the State. This diameter might be too large to enable individual freedom to be fruitfully deployed, since there might be too many decisions made by the State and we will each gradually give up our use of individual freedom. As we have attributed to Hayek, liberals consider that this state of things reduces individual responsibility and fosters the degradation of citizens into mere impoverished subjects. There is also another criticism of the State, this time of a communitarian origin. In this case what is questioned is not so much the scope as the size of the State. Although historically the State arose as a national State, this type of criticism maintains that what we now know as the State is not always the same as a national community and is eventually too broad for the affairs affecting the political community that sustains it, and too narrow to handle the relations that are inevitably established between the national communities of different States.

Both criticisms seem useful and, in fact, form part of conventional thinking that questions not only the scope of the State, but also how to determine the size and number of the States on the planet. We refer to these two criticisms in this and the following section, respectively. In what remains of the present one, we will be studying a relevant aspect of the scope of the State, beginning by considering a technical question and its implications. We already know that if a government is not capable of a reliable



commitment to do something, because that something is not credible (it is not a government strategy forming part of a sub-game perfect equilibrium or it is not intertemporally consistent for the government, in the terms of game theory or dynamic programming, respectively), we commission that something from an independent institution governed by someone for whom it is, indeed, credible. However simple this may seem, it is the conceptual basis for the autonomy of central banks, and it justifies the flourishing of the endless independent regulatory agencies (IRAs) to which we will be referring in this section. This argument is so familiar for economists aware of the development of their discipline that we fail to notice a possible technical problem. The credibility problem certainly exists, but it is a problem for the government, not for the State; and a solution also exists: the State itself, which should not be mistaken for the government. If we have to resort to an independent agency in order to mitigate the effects of a government problem, we have forgotten the State completely and we believe that State and government are one and the same thing. Evidence of this mistake is, for example, the change of the situation that State lawyers and economists. They used to be great professionals who also worked for the State in technical sections protected from the winds of the political cycle and political changeovers. Today, however, many of the members of this elite community work for consultancy firms who do the work that the State used to do. State and government were not one and the same. If they are now mistaken for each other, it must be because the State is either dead or ailing. We will also consider this in this section.

At the start of this section we referred, when talking about the diameter of the scope of the State, to its possible excess contrary to the deployment of individual autonomy, and I have just mentioned the possibility of mistaking the State for the government. We will now see how privatisations may be a solution to the excess of such a diameter, and what is meant by the proliferation of independent regulatory agencies (IRAs). Both of these issues will help us to define what we could consider as a minimal State.

a. Privatisations

We will begin by remembering and ruling out something elementary that was pointed out by Emilio Albi in his book Público y Privado. If business privatisation is aimed at reducing indebtedness, the burden of debt and, finally, the public deficit, this attempt may not be successful. If the rate of return of the debt is the same as the rate of return on business capital, the favourable effect of reducing indebtedness is compensated by the unfavourable effect of not collecting the surplus from the public enterprise. Therefore, a privatisation programme only makes sense, from this first perspective, if an imminent increase in business productivity is expected, and this expectation has an impact on selling prices.

This viewpoint, however, is neither decisive nor even the most important. What is really relevant from the socioeconomic perspective, as Albi also announces, is the change in the agency relation, with the principal changing from the State to the shareholder or his representative. This change brings about a renewal of the incentive system, which will now have to aim at creating value for the shareholder. What we need to know is whether this improves business efficiency, because the assumed gains in productivity could merely disguise price increases or reductions in salary costs due, respectively, to residual monopolistic elements and staff or salary adjustments. La Porta and López de Silanes^{vii} have conducted a detailed study of the programme of non-financial privatisations in Mexico from 1983 to 1991. Using the ratio between operative revenue and sales as an indicator of enhanced business efficiency, they show how privatisations increased this ratio by 24%. However, of this increase, 5% is due to price increases and 31% to the redundancy programmes applied after privatisation. Only 64% can be attributed to improved productivity.

There is no similar study for Spain, but we may find something in the book by Nicolás Hernández and Lucía López de Castro, Privatizaciones, Liberalización y Bienestar, to which the reader will have to resort for later precisions on the aspects we are now going to consider. It is a paper rich in data, which analyses the effects of the



privatisations carried out by the PP (Telefónica, Repsol-YPF, Endesa and Gas Natural) in relation to consumers' capacity for choice, prices, investment, employment, shareholders structure and tax revenue. This is not the place to summarise all their conclusions, but we can include some of these conclusions to align them with the study on Mexican privatisations.

What we want to underline here is that prices appear to have fallen, and there are reasons for believing that salary costs have not diminished. Let's start with prices. Between 1998 and 1999, the costs of international calls fell by nearly 38% and the costs of interprovincial calls fell by nearly 43%. In the electric sector, the fall in rates for "unqualified" consumers between 1997 and 1999 was 10.6% in nominal terms and 17% in real terms. The situation in hydrocarbons and natural gas is not as clear but, considering the increase in oil prices at the time and the limited development of the gas market (which continues today), it can be argued that fuel prices after tax and gas prices in some segments are among the lowest in Europe. These considerations enable us to venture the opinion that if prices have risen, privatisations have not been to blame. With regards to salary costs, the data available does not fully clarify the situation, but the following remarks lead us to believe that they do not appear to have fallen. Indeed, Spanish salaries did not fall in the 96-99 period and the employment generated by privatised companies did not diminish. Indeed, in the sectors affected, net employment appears to have increased, with more staff working for the firms considered (although largely through the acquisition of other firms). These results concerning prices and salary costs certainly do not imply a final conclusion on the effects on productivity, in view of the lack of revenue and sales figures, but these company's increased stock market value – in relation to the general index – leads us to believe that their productivity improved. This impression seems clear enough to transfer the burden of proof to condemn privatisations to whoever carries it out. But privatisations involve other problems to which Hernández and López de Castro make no reference whatsoever.

Indeed, one unavoidable problem is that privatisations can be carried out in such a way as to constitute a transfer of income to the friends of the government who decides to apply them, and that therefore, regardless of the subsequent increase in productivity, they can form part of the crony capitalism to which we referred in the second part of the first section of this chapter, and which Parentte and Prescott considered in 1999 to be the true hindrance to the creative force of the market. The privatisations to which the paper on the Spanish ones refers to were carried out in a peculiar manner, inverting the logical order. Instead of selling the control package owned by the government, allowing the final shareholders to elect the chairman of the board, the opposite was the case. The chairmen were removed from office using control of shares and friends of the government were appointed in their place and expected to sell the public share. This ensured their initial easy success and the government was guaranteed their loyalty to a certain extent. It is perfectly possible that this improper movement was intentional, with the government pursuing control of a regenerative economic movement in favour of large groups which were like the embryos of veritable Spanish multinational corporations. It is possible, but this is not recommended or required by the idea of competition to which we referred in the first section of this chapter. As we shall see in the following section, this beneficial competition includes not only competition in the sale of commodities, but also competition between individuals or groups for the implantation of institutions and, as an example of this, competition for power and control in business enterprise. Ignoring this demand for competition in favour of an apparently respectable or heroic objective cannot lead capitalism to a safe end. I do not believe that I am much mistaken if I see this as a particularly roughshod way of capturing the State by the government's capture of the principal State or public enterprises. Here is a paradigmatic example of the mixture of the criticism of the excessive diameter of the scope of the State for liberal reasons, not only respectable but also correct, with the previously mentioned technical problem of continuously mistaking the government for the State. But we shall soon see that this is not the only one.



a) Independent regulatory agencies (IRAs)

The proliferation of IRAs is, indeed, a highly complex example of mistaking government and State which, however, although it is related to the scope of the State, has much greater and more important significance. Here in Spain, agencies like the National Energy Commission (*Comisión Nacional de la Energía* - CNE) or the Telecommunications Market Commission (*Comisión del Mercado de Telecomunicaciones* - CMT), certainly the Bank of Spain and, in a way, the Competition Court, are well known examples of IRAs in the broadest sense. In each case, the agency concerned performs functions that a government is unable to perform in a credible fashion. The case of monetary policy is paradigmatic: the impossibility of a government (which would like to inflate the economy) applying an anti-inflationary policy that is consistent over time, makes it advisable for this policy to be the responsibility of a central bank which is known to be free of inflationary bias^{viii}. This same logic is behind the creation of each new IRA, and however correct it may be, it is leading to a dismantling of the State which is superimposed over the liberal criticism of the scope of the State and the communitarian criticism of the size of the State. This dismantling of the State is a surprising tangle, since the logic that sustains it appears not to distinguish between government and State, since it seems natural to think that what the government wants the IRAs to do should be done by the State by means of chosen, highly qualified and incorruptible officials. I will now attempt to undo the tangle. On the way, we will again be coming up against capture problems and the idea of competition that I have used when criticising the privatisations that have taken place in Spain for the time sequence in which they were made.

To start with, there are several functions to be performed by the IRAs we have mentioned. There are two alternative approaches to this. In alternative 1, the State as the principal and the government as the agent, sign a contract (constitutional?) for the latter, the government, to perform several functions, a contract that will supposedly induce a practice maximising general welfare subject to a so-called incentive constraint preventing the government-agent from refusing to perform the function established in the contract. The problem with this way of performing the functions of interest is that this contract could be very fragile (and unacceptable for the government) because the State is, by definition, the only social-economic agent which does not have to keep its promises, the only one incapable of credibly making a commitment, because initially, there is no one capable of forcing it to do anything. We should therefore be thinking of a more realistic alternative 2 in which the government, now acting as the principal, signs a contract with several IRAs for the performance of certain functions as agents. Each of these contracts would be designed to maximise social welfare (otherwise, they would not be socially acceptable), complying with the incentive constraint of each IRA to accept it. The problem related to the dismantling of the State derived from the proliferation of IRAs can now be approached in operative terms by means of an obvious question: which alternative is best, 1 or 2? To start to answer this question, we will concentrate on a stereotype but simple example. Consider a State, a government and two IRAs. The first would be a central bank, which has to maintain the monetary supply within limits that are compatible with the desired level of inflation, and the second could be a tax agency charged with maintaining the public deficit within limits that are compatible with the desired growth rate. We will refer to this scenario at length in Part IV; but we will now merely use it as an example. Many voices are being heard demanding a fiscal arrangement like the one we have mentioned^{ix}, especially in Europe since the failure of the Stability and Growth Pact, and we have admitted for years that a really independent central bank is a useful instrument for controlling inflation. On this scenario, the alternatives to which the question refers are evident. In alternative 1, the State would be responsible for both the monetary and the fiscal functions and instruct the government by contract to (within the possibilities enabled by its incentive constraints) choose the inflation and growth rates which maximise social welfare (a sum of the welfare derived respectively from inflation and growth) subject to the strong constraint that inevitably links the public deficit to the monetary supply. In alternative 2, the government would sign two contracts, one with each agency, each of which specifies that, always respecting the relevant incentive constraint, each agency will choose the variable it controls (inflation rate or unemployment rate) so that it maximises the relevant component of social welfare subject to its own constraint, or one band for the M3 and another for the public deficit. We would appear to be close to solving the



problem because the question about which alternative is best is apparently answered immediately, since it is evident that two independent constraints are never less restrictive than the combination of the two. We would consequently say that alternative 1 is preferable, since it would generate a combination of inflation and growth that we would call optimal, whereas alternative 2 would generate a Nash equilibrium in the game played by the two agencies which would only be the same as the optimal situation by chance.

However, this answer, to our surprise, does not solve the problem, but makes it worse, because it is now even more evident that the State should not be dismantled in favour of IRAs. To finally solve the problem, we have to introduce another factor to which we have already indirectly referred: the possibility of the friends of power capturing the State or the IRAs. The temptation to do so is immense, precisely because the sovereignty we studied in the first part of this chapter III.3 has been delegated by what we referred to as the people in the State, and then by the State in the IRAs when they were given independence. Therefore, in either of the two alternatives considered, we have to take into account the possibility of the State and the IRAs being captured by lobbies and associations of different kinds, leading to the dangers of crony capitalism. In the spirit of the ideas of J. J. Laffont and D. Martimort, we could say that it is much easier to capture a single social operator in alternative 1 than two in alternative 2, something that is quite intuitive. Consequently, and as always in economics, we have to decide between an angelical optimum threatened by the ease with which the State can be captured, and a sub-optimum with its feet firmly on the ground because it is more difficult to capture several IRAs at the same time. If we choose alternative 2, the State is dismantled just as feared, but at least it will not be an instrument in someone's hands. If we choose alternative 1, the State is maintained but it may fall into the hands of those who wish to use it as an instrument in their own favour.

The problem now appears to be solved. And not only that, but it also appears that this way of solving it provides us with a characterisation of what we could expect the right and the left to do in this respect. The latter, we would think, prefers to maintain the State with the possibility of reaching an optimum, even running the risk of others obtaining power over the State. The right, on the other hand, would be expected to prefer the dismantling of the State, and its replacement by IRAs, which are more difficult to capture and the activities of which would lead to a possibly sub-optimal Nash equilibrium, but an equilibrium after all. Looking at the horizon or with one's feet on the ground: the usual alternative. We would therefore conclude that the right would reveal a greater credible desire to reduce the scope of the State, as we would have expected. But we still haven't finished with the problem of the IRAs. I can think of one further objection and of another question.

The objection to the justification of reducing the scope of the State by delegating its functions in these IRAs consists of the fact that their supposedly greater resistance to being captured is not clear. I said that it would be more difficult for lobbies or groups; but what I did not say is that the government now has it easier thanks to suitable appointments to be in charge of the IRAs, and that this capture by the government means that it can make more decisions with less democratic control. And there is no doubt that this corresponds to a stronger crony capitalism. And here, as in the case of the privatisations, the trap, although hidden, is easy to discover and reveal. Once again, as we shall see and however strange it may seem, the trap consists of preventing competition from existing between persons or groups to occupy these regulatory agencies. If the liberalism that presides over our conception of the State – as opposed to an authoritarian conception – leads us to denounce crony capitalism and defend a State with a smaller scope, that same liberalism will lead us to argue in the next section that the traditional argument in favour of the provision of public goods by the State can be corrected because this competition to obtain the power over public institutions can align individual incentives with social interests. When we clarify this question, I hope it will be quite clear that both privatisations and delegation in IRAs can betray the initial good intentions (or, to be blunt, can become alibis for capture) by eliminating competition where we do not usually seek it, but where a true liberal should.



And a final question in this sub-section. It has to do with the limits of delegation. Can an IRA refuse to make some changes in the terms of the delegation? This question arises when the CMT (Telecommunications Market Commission) strongly objects to moving from Madrid to Barcelona, following the government's instructions. How independent is it? Could the Bank of Spain decide to move to Alsasua, for instance? In the age of the new technologies, physical location would not appear to condition the residence of the employees or their effectiveness, but who decides?

b. Minimal State

To complete my remarks on what I have called the scope of the State, and before I go on in the next section to talk about the size and number of States, I will describe what would be an acceptable minimal State today, and the social class or political or social group that could be considered as the supporter of such a minimal State. In any case, it will not be until the next part of THE CAPITALISM TO COME when I will be seriously discussing the distributive problems that will benefit from the remarks in this chapter; but for the time being, they are not included in the functions of a minimal State. It is better to be clear and concise than exhaustive.

The desirable minimal State (since the necessary State is different and probably even smaller) consists of the performance of basic functions: security and defence of competition^x. Providing that individuals have legal and physical security, it is sufficient to allow the free private initiative implicit in the idea of competition to work for society to prosper and for each individual to be able to undertake his own life project. I will be referring to both these things in the next part of this chapter, but I now wish to include some remarks expressing precisely the social circumstances that would justify my hope that something like the minimal State can be achieved, if only approximately.

I will attempt to identify more or less who defends different types of State, and why, and in particular a minimal but strong State^{x1}. I will start by those who prefer a State with a generous scope. Those who are initially the owners of a generous allocation, those who do not appreciate diversity and those who have no identity to maintain would also prefer the broad State to be strong so that it can perform its liberal functions of preserving private ownership and guaranteeing the freedom to facilitate the capture of the State to benefit its class. In this case I am referring to the conservative bourgeoisie, providing it is liberal, which is not necessarily the case. On the other hand, those who do not have a great initial allocation, appreciate diversity or believe in the preservation of different identities, that is social democrats, would prefer the State, although large for redistributive purposes, to be weak, precisely in order not to threaten such diversity or different identities. I will now continue with those who defend a small State. Right-wing anarchists would want the State to be weak as well as small, and thus prefer its classic functions to be performed by independent agencies which are presumably less easily corruptible. Finally, those who have a good starting point in terms of wealth (wealth that they would prefer to maintain, although without taking too much trouble to increase it), like diversity and hate uniformity would prefer a small but strong State. They are the small bourgeoisie who believe in private ownership, but who are also aware of their identity as a class (of traders, possibly) and appreciate by experience the diversity on which their business is based.

Once we have established these types of possible States and associated each of the types to a certain social class, it is not difficult, with a simple exercise typical of the Public Choice approach, to identify the only one that can be sustained by sensible liberalism. Social-democrats will lose their desired weak State with a large diameter in the hands of a *haute bourgeoisie* which, although it will initially want a large, but weak State, in order to continue to obtain undeserved income by occupying it, but which, when there is no more income to be obtained, will continue to want it weak, but smaller, so that it will not trouble them with calls for justice or for solidarity, thus moving towards a form of State typical of right-wing anarchy. This is the State that the neoconservatives who appear to control the world want. Since, according to ideas we have included here and there in this text, the neo-con attempt is unsustainable, we will have to hope that the next political movement is in favour of a small and strong State, precisely as desired by the *petite*



bourgeoisie. It seems easy to obtain a small State, because both the ideology and the facts appear to confirm the reduction in its scope. However, to obtain a strong State implies that it should not be dismantled, separating its functions and delegating them in committees or independent agencies. For this not to happen, the only solution is to confront the possibility of capturing the State, to which we have previously alerted.

It is with regards to this last point, and to end this second part of the Chapter on the State, that we should question the influence of the availability of information due to the information society and the information and communication technologies (ICTs) on this general phenomenon of the dismantling of the State and privatisations and IRAs, and on the sustenance of a small and strong State. The key to understanding this influence lies in participation as a necessary ingredient of democracy. In my opinion, participation is to politics what private initiative is to economics. A concrete economy can lead to efficient allocations in a static sense, but if they do not result from private initiative they are not appreciated (because imposed) or do not guarantee dynamic efficiency (since they inhibit innovation). Similarly, a specific political system can be legislating and correctly administering by means of the relevant institutions, but if there is no participative public debate, I neither appreciate the legislation or the administration as my own, and nor do I expect my genuine concerns to become part of the political agenda. This participative public debate, which I would dare to associate to the small and strong State that I can see in the future, can only take place by means of the media, which thus start to form part of the fabric of freedom. We will later be forced to question the future of the media in a world in which information is available at zero cost and where the ICTs enable a new way of conceiving them. If crony capitalism is to survive, it has to obtain power over the media. This can be conceived with the traditional unidirectional media in which there is a transmitter and a receiver, but when technology enables interaction and the mixture of roles between transmitters and receivers, the control of opinion is impossible unless freedom is hindered in the development of the Internet, or in the production of the necessary software. Let us see, then, how participation and free competition meet again and how the only way of failing to limit the latter's creativity is, once again, to allow the aligning virtues of free competition to do their job. Specifically, if we allow participative communication to develop via the Internet in the form of a large number of personalised newspapers, or radios or televisions, we will have engineered a mortal blow to the possibilities of crony capitalism. It would follow to believe that these personalised media could also be captured; but as we will be seeing in the next section, this does not appear to be plausible. Consequently, free interaction via the ICTs creates a true public opinion which it is impossible to manipulate, and which is clearly revealed without the packaging of the mass-media whose owners still control information, but in an increasingly polarised way, as instruments of crony capitalism.



NOTES

ⁱ This part of chapter III does not intend in any way to summarise all the problems associated to the role, or roles, of the State in the economy. A comprehensive summary of the situation can be found in Estado y Economía. Elementos para un debate which was published in 1995 by the BBV Foundation, under the editorial guidelines of S. Barberá.

ⁱⁱ The description of the third sector provided in the text, both in this and the following sub-section, is based on my paper in Revista de Occidente (Urrutia 1996) which, in turn, was inspired by my paper in Economía Industrial (Urrutia 1989)

ⁱⁱⁱ The twelve countries are: United Kingdom, U. S., France, Germany, Italy, Japan, Brazil, Ghana, Egypt, Thailand, India and Hungary.

^{iv} These seven countries are: United Kingdom, U. S., France, Germany, Japan, Italy and Hungary.

^v Quoted by Grampp (1989)

^{vi} Practically all this section is based on three of my papers. Two of them are included in the book Economía en Porciones (see Urrutia 2003b and 2003c) and the third is Urrutia (2004)

^{vii} See references.

^{viii} Concerning this problem, here merely summarised, we will be speaking at length in the last part of THE CAPITALISM TO COME. However, it is inevitable to mention here, and in view of the last Nobel prize in Economics, the seminal work by Kydland and Prescott on the possible inconsistency over time of economic policies.

^{ix} Bradford de Long referred to this is his article in the business section of El País on Sunday, November 28, 2004.

^x Not to mention explicitly the private ownership that can be included in the idea of security that does not only refer to physical but also to legal security. However, the idea of ownership can be blurred when we consider the intellectual property to which we also refer in the following section of this chapter.

^{xi} See Urrutia (2003 d)



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ECONOMIC MONETARY UNION							
Total Inflation	-0.4	2.1	2.3	2.1	2.1	2.0	1.8
Core Inflation	-0.5	2.0	2.5	2.0	2.0	1.9	1.9
Goods	-1.5	0.8	1.5	0.8	0.8	0.7	0.8
Services	-0.1	2.6	3.1	2.6	2.6	2.6	2.6
GDP							
Private Final Consumption Expenditure			0.9	0.5	1.9	2.0	2.2
Gross Fixed Capital Formation			1.3	1.1	1.4	2.2	2.2
Exports of Goods and Services			-2.7	-0.5	1.4	2.3	2.0
Imports of Goods and Services			1.9	0.2	6.1	5.4	5.4
Gross Value Added Total			0.5	2.0	6.6	5.8	5.2
Gross Value Added Agriculture			0.9	0.5	1.9	2.0	2.2
Gross Value Added Industry			0.8	-3.9	3.4	-0.4	0.5
Gross Value Added Construction			0.2	0.0	2.5	2.6	2.4
Gross Value Added Services			-0.6	-0.6	0.5	-0.7	-0.1
			1.3	1.0	1.9	2.4	2.4
OTHER ECONOMIC INDICATOR							
Industrial Production Index (excluding construction)			-0.5	0.3	2.0	1.2	1.8
UNITED STATES							
Total Inflation	0.2	2.9	1.6	2.3	2.7	2.4	2.2
Core Inflation	0.3	2.2	2.3	1.5	1.8	2.3	2.4
Goods	-0.2	0.8	-1.1	-2.0	-0.9	0.9	0.9
Services	0.4	2.8	3.8	2.9	2.9	2.8	3.0

SPANISH ECONOMY FORECASTS

	JANUARY 2005		AVERAGE ANNUAL RATES				
	Monthly Rate	Annual Rate	2002	2003	2004	2005	2006
Total Inflation	-0.9	3.0	3.5	3.0	3.0	2.5	2.6
Core Inflation	-1.0	2.9	3.7	2.9	2.7	2.7	2.8
Goods	-3.6	1.2	2.5	2.0	0.9	1.1	1.2
Services	0.5	3.7	4.6	3.7	3.7	3.7	4.1

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