

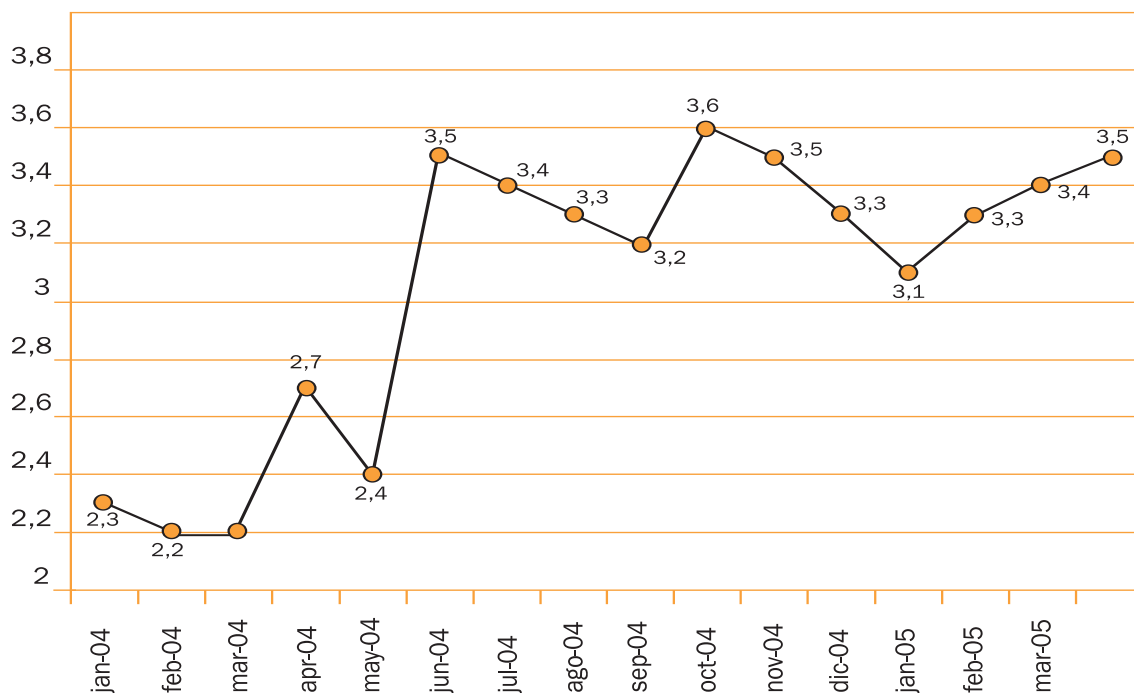


ECONOMICS

COSTS AND CAUSES OF EXCESSIVE INFLATION

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SPANISH INFLATION RATE 2004-2005



Source: Spanish National Statistics Institute (INE); The Spanish Index of Consumer Prices harmonized with the EU.

Over the last year, the rate of inflation has risen sharply in Spain. The consumer price index (CPI) has increased by 3.5%, compared to 2.2% a year ago; the GDP deflator has increased by almost 5%; and the underlying rate of inflation has risen by almost 3%. The inflation rate differential with regard to the eurozone comes to 1.4 points, compared to 0.5 points a year ago. This inflationary cancer reduces the competitiveness of Spanish industry and results in lower levels of growth and employment.

The main cause of this excessive inflation is not the impact of the oil supply, but the Government's own economic policy: a budgetary policy that is too expansive within the current monetary context of the eurozone, combined with a lack of structural reforms, which limit the growth potential of the Spanish economy.

Reading the Rate of Inflation

Inflation has become a deeply worrying source of macroeconomic imbalance for Spain. It has to be pointed out that it is not a good idea to read the rate of inflation on a month-by-month basis –the monthly figure is too volatile for that. Neither can we draw any particularly definitive conclusions by comparing one quarterly figure with another. The important factor is the inflation trend, i.e. the rate of inflation that produces long-term effects on the economy.

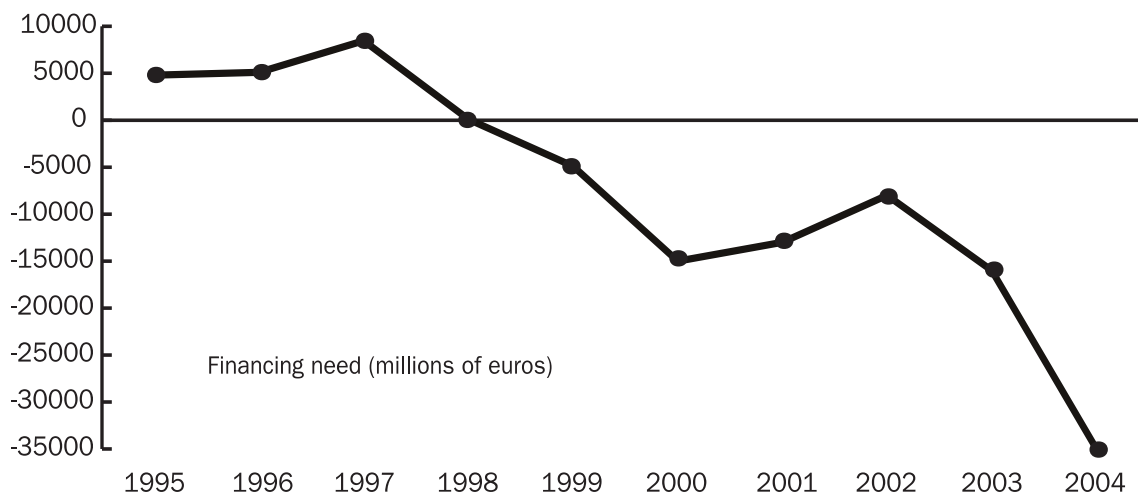
The last four quarters, plus the month of April, constitute a sufficiently long period for us to be able to conclude that the Spanish economy has witnessed a significant rise in inflation.

We can measure the rise in prices by using the CPI¹. In March 2004 the year-on-year inflation rate came to 2.2%; in March 2005 it was 3.4%. The European HICP² increased in March 2005 by 3.4% in year-on-year terms, a figure 1.2 points higher than the rate recorded in March 2004. In April it increased to 3.5% (National Statistics Institute INE). Furthermore, we have the GDP deflator³, which increased by 4.7% in 2004; and the deflator of domestic demand came to 5.2% in the fourth quarter of 2004. The industrial price index IPRI⁴ now stands at 5.1%. These figures speak for themselves.

Inflation has risen for the last thirteen months in Spain, an alarming trend that can be broken down into the following elements:

1. A significant rise in the underlying rate of inflation (which excludes products with the most volatile prices, such as energy and fresh food) from 2.2% in March 2004 to the current rate of 2.9%, the level at which it has remained over the last six months, which shows that there is some resistance to a return to former levels.
2. Prices rose in Spain at a significantly higher rate than in the eurozone and the rest of the EU (2.1% in both cases), which increased the Spanish inflation rate differential to 1.4 points (in terms of the HICP), 0.9 points higher than the average rate of the last quarter of 2003 and the first quarter of 2004. This differential is clearly excessive.
3. The appreciation of the euro, which makes imported goods and services cheaper and exerts deflationary pressures on the CPI. The euro has appreciated over the last year from \$1.20/euro to \$1.30-\$1.35/euro, in other words, between 8% and 13%.

THE SPANISH ECONOMY'S NEED FOR FINANCING, 1995-2004



Source: National Statistics Institute (INE)

¹ CPI: this index measures the prices of a specific basket of goods and services acquired by consumers, whether they are produced in Spain or imported. We shall ignore certain technical matters such as the handling of discounted prices when calculating the CPI.

² European HICP: a harmonized index of consumer prices for the entire EU that measures changes in consumer prices in Spain.

³ The GDP deflator: this indicator measures the prices of domestic output, which means that it measures the inflation of the Spanish system of production.

⁴ The IPRI, or industrial price index, shows the development of prices of industrial products.

4. The rapid *deterioration of Spain's foreign accounts*. The deficit presented by the goods and services account came to 6% of GDP in the year 2004 (Eurostat). The Spanish economy needed to finance itself from the foreign sector to the tune of 33,739 million euros in 2004, which represents 4.2% of GDP (INE), with a drastic deterioration of 100% compared to 2003 (2.1% of GDP). Using more recent figures, the deficit presented by the balance of payments on the current account and balance of payments on the capital account now stands at 5.2% of GDP, a horrifying figure. In January 2005 the Spanish economy's need for financing vis-à-vis the foreign sector came to 3,719 million euros, six times higher than the figure recorded in January 2004 (Bank of Spain).

It is also extremely worrying that the deterioration of the country's financing capacity vis-à-vis the rest of the world is, in large part, the fault of the public administrations. These negative figures are unparalleled in the EU.

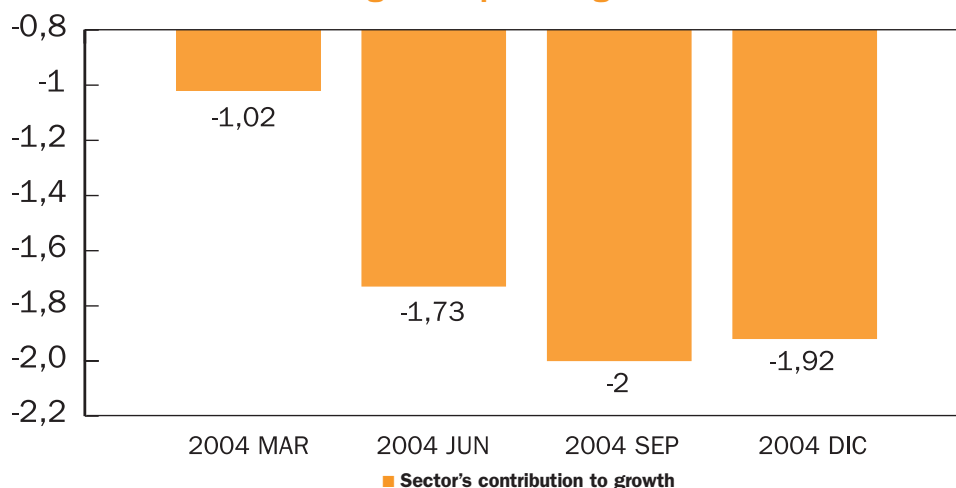
CAPACITY (+) OR NEED (-) OF FINANCE

SECTOR INSTITUCIONAL	2003	2004	DIFERENCIA
Sociedades no Financieras	-31.467	-38.424	-6.957
Instituciones Financieras	10.898	6.146	-4.752
Administraciones Públicas	3.024	-2.384	-5.408
Hogares e ISFLSH	1.992	923	-1.069
Total de economía	-15.553	-33.739	-18.186

Source: National Statistics Institute (INE).

Without overlooking the effects of the appreciation of the euro on the balance of payments, we must bear in mind that, in a common market such as that created by monetary union, macroeconomic imbalances are reflected rather more frequently in the balance of payments figures. It is within this context that the record negative figures of the foreign sector reflect their impact on economic growth.

THE FOREIGN SECTOR'S CONTRIBUTION TO GDP GROWTH IN 2004 (%) figures in percentages



In short, the rate of inflation is exacerbated by the balance of payments figures.

5. Coinciding with the rising inflation differential and adverse balance of payments figures, *the Spanish economy's differential of real growth compared to the European average has fallen* from 2 points in 2003 to a current figure of 0.8 points (as an average of all four quarters in 2004).

Some have claimed that inflation is the inevitable price to be paid for real convergence. This is a grave error. The evidence regarding the correlation between

convergence and differential inflation is conclusive. There is no trade-off between real inflation differential and convergence. Convergence does not entail having to systematically pay the price of higher inflation. The erroneous interpretation of the *Balassa-Samuelson* theorem in this context is quite frequent.

In fact, the lower relative growth recorded over the last four quarters represents a setback with regard to Spain's convergence with Europe. Thus, in terms of GDP per capita, adjusted for purchasing power parity, in 2004 convergence with the EU-15 was non-existent (87.4% of the Community average, the same figure as in 2003) and negative with regard to the EU-25 (95.0% compared to 95.3% in 2003).

The Cost of Excessive Inflation

Those who defend the erroneous 'real inflation differential/convergence trade-off' thesis tend to complement this idea with a second claim: that the inflation differential is harmless. This is once again based on an erroneous application of the *Balassa-Samuelson* theorem, since it necessarily considers the inflation differential to be a balancing phenomenon resulting from differential growth of total factor productivity (TFP) within the marketable goods sector of the country featuring the inflation differential.

“The most obvious consequence of a high rate of inflation, which translates into an increase in the inflation differential vis-à-vis trading partners, is an accumulated loss of competitiveness for national production”

The slump in productivity over the last year, combined with a steady rise in labour costs that was clearly higher than that of Spain's competitors, has led to a relative deterioration of Spanish unit labour costs.

All of this is reflected in general increases of the real effective exchange rate (REER), measured both through our calculation of the CPI, of unit labour costs (ULC) and unit value indexes⁵ (UVI) with regard to the Eurozone and the EU-15, not to mention the OECD.

In short, the Spanish economy is witnessing increasingly high losses in terms of competitiveness. In the short term, a loss of competitiveness does not tend to have drastic or immediate effects on activity and employment levels, because international trade links are able to resist price variations of a certain size and because domestic demand can replace waning net foreign demand in the short term when it comes to supporting production. However, the relative increase in national production costs inevitably has a real effect on the economy. In the short term, the social cost of excessive inflation can be measured in reduced employment and lower job creation levels.

When Spain was a sovereign monetary area, this loss of competitiveness was solved time and again by devaluation. The peseta was devalued against the German mark on four occasions within the period 1992-1995. Forming part of a monetary union changes the rules of the game entirely. Devaluation is not possible. Any loss of price competitiveness can only be recovered through price increases being lower than those of our trading partners. It is not enough to simply reduce the inflation differential to zero.

To place exclusive trust in factors other than price (such as quality and design, among others) in order to recover our competitive edge would be extremely imprudent. Conceding little importance to price competitiveness is a major error.

⁵ In the case of the REER-UVI, featuring some very specific temporary exceptions.

We can thus see the danger inherent in Spain's current high rate of inflation. The figures for 2004 will probably have eaten up the margin granted to Spain during the intelligent negotiations on the peseta-euro exchange rate which preceded our entry into the single currency. Now that this margin has disappeared, maintaining a positive inflation differential means entering the sphere of insufficient competitiveness. This is an extremely serious economic policy error.

Given that our main trading partners in the eurozone have inflation rates of 1.5%-2%, recovering the competitiveness we have lost as a result of an annual differential of 1.4 points would mean, *ceteris paribus*, securing inflation rates that are only possible at the cost of a recession.

The Inflationary Tax

Inflation has other pernicious effects, namely those that derive from its consequences as a tax. Inflation reduces real wages, increases tax revenues (levied on nominal amounts) and reduces the burden and real value of the public debt. It constitutes a regressive tax. And in a tax system such as the current one that does not deflate income, inflation leads to cold progressivity (it is worth remembering that the 'deflation' of personal income tax (IRPF) for 2005 represented less than a euro per month per taxpayer).

“The positive compensation for inflation in the short term is job creation. However, this effect is temporary. In the medium term, nominal wages will attempt to recover their purchasing power, leading to a contrary effect. Furthermore, the loss of competitiveness ends up producing lower real taxable bases”

Higher inflation reduces the real profitability of savings. It reduces the real cost of financing and, *ceteris paribus*, reduces real interest rates, whilst also reducing the real profitability of fixed-income assets after tax, the type of saving that makes up most of the average modest income earned. The aggregate result is lower levels of saving, greater spending and great indebtedness, thus exacerbating the vicious circle of excess demand-inflation and intensifying macroeconomic imbalances. The inflationary tax also leads to inefficiency and an excessive tax burden.

Now let's consider the seigniorage, i.e. the profits that derive from the currency that is issued. Inflation increases these payments, which swell the coffers of the European Central Bank (ECB), and this money only returns to the Spanish Treasury according to the percentage which Spain holds in ECB capital. Thus, a high inflation differential leads to a net transfer of resources to the rest of the eurozone. The most recent calculations estimate the effect of a differential of 1.3 points at no less than 1,100 million euros.

The ECB's Possible Raising of Interest Rates: Inflation and Mortgages

The rise of Spanish inflation to rates well above the level the ECB considers acceptable (2%) entails the risk that the ECB will react by raising interest rates in the short term.

Spain is the fourth largest economy of the EMU. A clearly excessive rate of inflation in Spain increases the average rate of the eurozone and increases the probability that the ECB will increase interest rates at some point in the future. If this happens, the cost of this increase for the Spanish economy will be significant, in view of the levels of indebtedness of Spanish families and companies, the very sector on which the growth in domestic demand also depends.

An unexpected and substantial increase in interest rates would have a considerable financial impact on many economic sectors, families and companies. The structure of

mortgage loans in Spain, which is very different from the European model, also increases the vulnerability of the Spanish economy.

The Causes of Inflation

Some commentators who do not share the thesis that differential inflation is harmless have been quick to place the entire blame for the sharp inflationary increase on oil. They are wrong. The oil supply shock has, indeed, exerted (and continues to exert) inflationary pressures on prices. However, this factor on its own is entirely insufficient when it comes to explaining the rise in inflation.

Observing the development of the CPI for special groups may not explain the causes of inflation, but it does give us some clues regarding the minimal importance of rising oil prices as a determining factor. Between the 1st quarter of 2004 and the 1st quarter of 2005, out of a total year-on-year inflation rate of 3.4%, foodstuffs accounted for 0.9 percentage points, services 1.6 points, non-energy industrial goods 0.1 points and energy 0.8 percentage points.

If we analyze Spain's inflation differential compared to the eurozone over the last year, the contribution to the 'Spanish HICP/Eurozone HICP' differential is as follows: fresh food, differential 0.3 points; services, 0.6 points; processed food, 0.4 points; and non-energy industrial goods, 0.1 points. The contribution of energy to the inflation differential was negative, coming to -0.1 points, although it came to +0.1 points for the fuels sub-basket. If we apply this analytical approach, we can see that if the prices of the rest of the goods and services that make up the HICP increased at the same rate in Spain as in the eurozone, the differential growth of fuel prices in Spain means that Spain would have a general inflation rate of only 2.2%. The remaining amount, up to 3.4%, cannot be explained by oil.

There are various reasons for this:

1. Oil is quoted and paid for in dollars. The euro has appreciated strongly over the last few months, which has enabled it (defraying other costs) to absorb a large part of the impact of the net inflationary effects resulting from the rising price of oil.
2. Our Community partners, whose productive structures are also strongly dependent on oil, have borne the shock with significantly lower rates of inflation. The substantial increase in the inflation differential is quite revealing.
3. Recent academic studies (such as those of the Lawrence J. Klein Institute at the Autónoma University in Madrid) have concluded that the direct effect of the rising price of oil in 2004 on Spanish inflation came to between 0.4 and 0.6 of one percentage point.

Excessive Inflation Cannot be Attributed to Wages or Lack of Competitiveness

The labour market is clearly not the source of rising inflation, neither in terms of its current structure nor with regard to recent collective bargaining negotiations. Wage indexing does not underlie the tendency for inflation to rise, either in Spain or in the rest of our neighbouring countries. Recent empirical evidence is quite conclusive: no correlation exists between wage indexing and levels of differential inflation within the EMU.

Besides, the relative moderation of wage rises in recent quarters also confirms the fact that wages are not responsible for the rise in inflation. Total wage costs per worker increased by an average of 2.8% in the year 2004, below the average rate of inflation and well below the average increase of 3.8% in the year 2003.

⁶ The approach employed by the Spanish Ministry of Economy and Finance in its "Synthesis of Economic Indicators".

Neither should we simply attribute this rising inflation to non-competitive structures within the commodity markets. Varying levels of competition within the markets for goods and services explain the varying rates with which changes in aggregate demand are transformed into prices. However, this does not explain variations in the rate of inflation.

“The main cause of rising prices and the increase in the inflation differential resides in the Government’s economic policy. An inadequate fiscal-monetary policy mix is the key to explaining excess inflation, in addition to the absence of structural reform policies that enhance potential economic growth”

The ECB is not to blame for this

Without necessarily adopting a pure monetarist approach, we can accept the idea that excessive liquidity is always behind the phenomenon of inflation. Does this mean that the ECB is to blame for Spanish inflation? No. Let us consider why.

Behind the Spanish inflationary trend and differential lies the differential growth of liquidity in Spain vis-à-vis the eurozone. The other side of the coin, of course, is differential growth in nominal expenditure.

Loans taken out by families and non-financial companies grew by 17.9% in Spain during 2004, almost three percentage points more than in 2003 (Bank of Spain). The growth in final consumption expenditure in 2004 at current prices came to 7.4% in Spain (INE), compared to 3.2% in the eurozone, 4% in the EU-15 and 4.1% in the EU-25 (Eurostat).

This spending gap goes beyond any reasonable difference in potential growth between Spain and the eurozone average. The result is a sustained increase in nominal expenditure per unit of output, which drives inflation up.

The growth of liquidity in Spain has two causes. The main cause is the ECB. The second, and one that is very often omitted from the analysis, is the Government’s fiscal policy, on which increases in liquidity and credit also depend⁷.

Inflation and the Excessive Growth of Public Expenditure

The main cause of excessive Spanish inflation is a highly expansive budgetary policy that places an excessive upward pressure on nominal expenditure. The figures show that the current Government is applying a clearly pro-cyclical fiscal policy. What is more, the growth in public spending in the Spanish regions is also excessive.

FINAL CONSUMPTION EXPENDITURE IN SPAIN 2004/2003

Current prices

Final consumption expenditure	7,4%
Household final consumption expenditure	6,6%
NPISH final consumption expenditure	5,2%
Public administration final consumption expenditure	9,8%

Source: Spanish National Quarterly Accounts. National Statistics Institute (INE).

⁷ The ECB’s criticisms of the reform of the Stability and Growth Pact that has recently been implemented has something to do with this.

The general state budget for 2005 is characterized by excessive growth in public expenditure (growth of non-financial public expenditure of 6.5%, clearly above nominal GDP), which translates into excessive growth in demand for credit within the private sector and a higher inflationary trend.

The Absence of Structural Economic Reform and Inflation

Structural supply factors also partly explain the behaviour of inflation. Reforms capable of enhancing potential economic growth enable us in general to reduce the pressure of nominal expenditure on output and, consequently, lessen the inflationary trend. Absence of reform worsens the inflationary effects of excess demand.

The recently approved Plan for Boosting the Spanish Economy is very poorly conceived. It contains very few liberalizing measures and a number of negative measures, such as those that relate to the energy sector. Measures such as the repeal of the Quality in Education Act, the cancellation of the transfer of water from the Ebro, the 11% increase in the minimum wage (which structurally reduces the level of stable employment among the least-skilled members of the labour force), the new restrictions contained in the Trading Hours Act (which reduces investment and the consequent increase in production capacity throughout the commercial sector) and measures relating to the audiovisual sector (which hold back the development of digital television in Spain) all curtail the potential growth of the Spanish economy.

Against the background of the budget for 2005, these economic ‘anti-reforms’ have become key factors that explain the excessive rate of inflation existing within the Spanish economy.

The Outlook

The outlook regarding Spanish inflation is not especially bright, because none of the causal factors seem likely to be addressed. A favourable development in oil prices does not seem very likely either. The inflation rate will continue to be excessive, given that no measures are in place to cut back on public spending and no far-reaching structural reforms appear on the political agenda.

Only a possible rise in interest rates imposed by the ECB could help to put out the inflationary fire, although this may have some very significant side-effects with regard to economic activity.