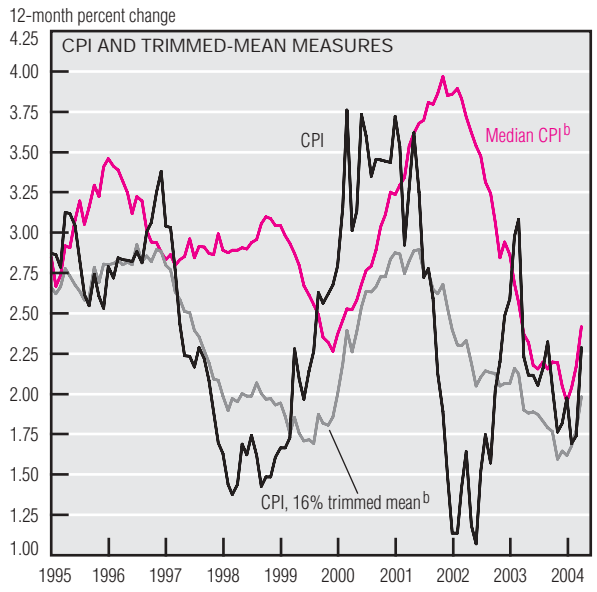
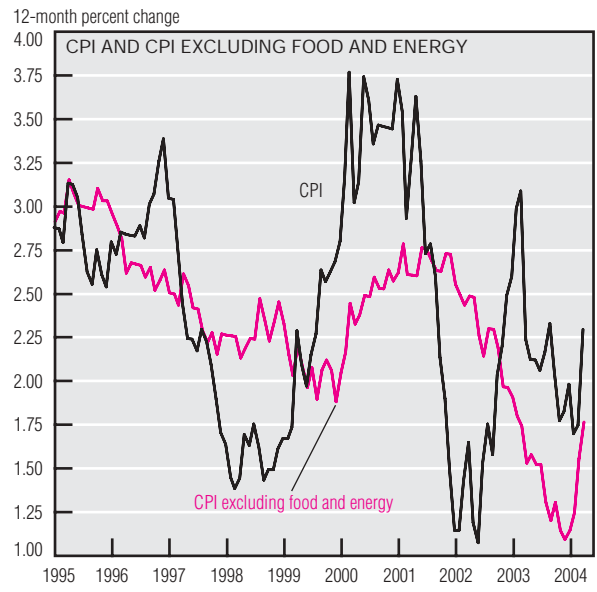
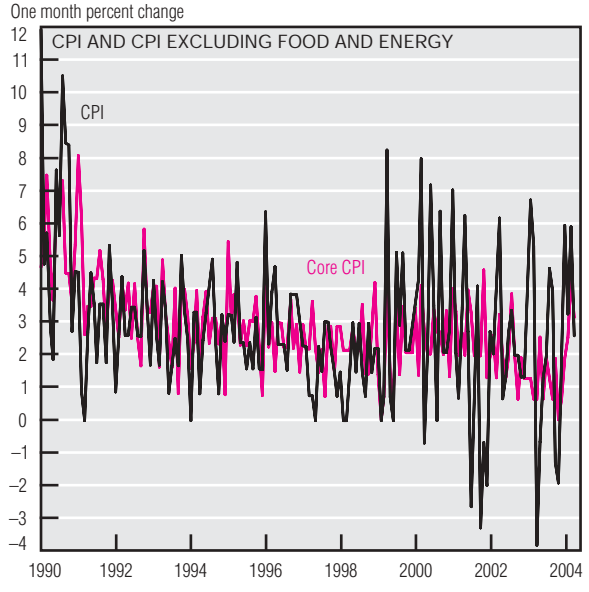


Inflation and Prices

	Percent change, last:				2003 avg.
	1 mo. ^a	3 mo. ^a	12 mo.	5 yr. ^a	
Consumer prices					
All items	2.6	3.9	2.3	2.5	1.9
Less food and energy	3.1	3.3	1.8	2.1	1.1
Median ^b	4.1	3.4	2.4	2.9	2.1
Producer prices					
Finished goods	8.5	5.3	3.6	2.3	4.4
Less food and energy	2.4	1.9	1.4	0.9	1.1



a. Annualized.
 b. Calculated by the Federal Reserve Bank of Cleveland.
 SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Federal Reserve Bank of Cleveland.

The recent broad-based rise in retail prices continues: The volatile Consumer Price Index (CPI) increased at a 2.6% annualized rate in April after surging 6.0% in March. Interestingly, the core CPI, which excludes volatile food and energy prices, increased at a faster rate than the overall index, advancing 3.1% (annualized rate) in April. The median CPI rose at a 4.1% annualized rate, its largest monthly increase since November 2001.

Year-over-year inflation rates continue to rise. The CPI has increased 2.3% since last April, while the core

CPI, median CPI, and 16% trimmed-mean CPI posted their highest 12-month growth rates in a year or more, rising by 1.8%, 2.4%, and 2.0%, respectively.

The Blue Chip panel of economists has increased its CPI inflation forecasts. They predict inflation will average 2.1% over the next three quarters, up from their 1.8% estimate last month. The range of inflation forecasts has widened, but both optimists and pessimists have increased their quarterly forecasts for 2004. Optimists anticipate that inflation will

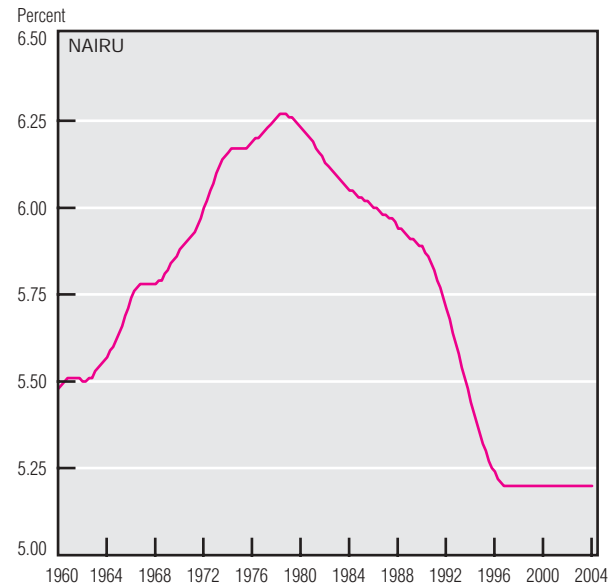
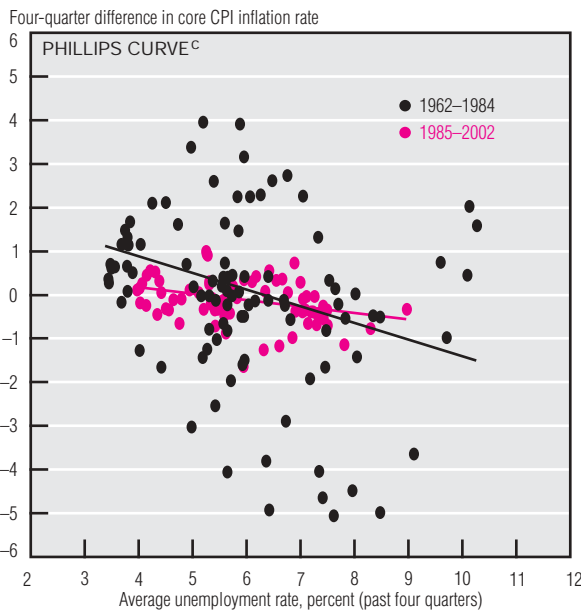
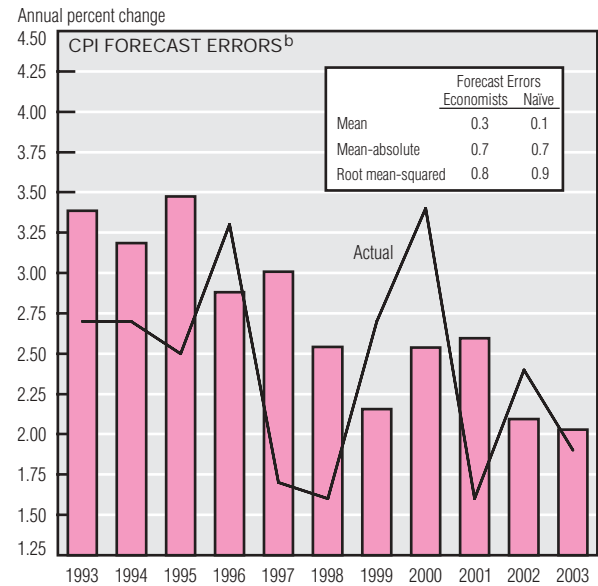
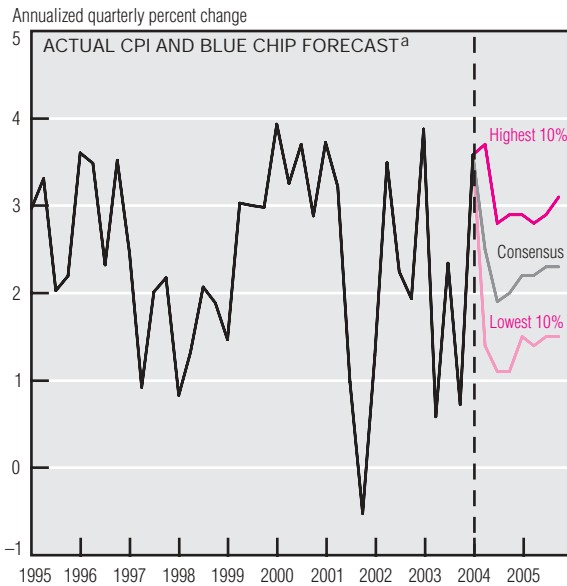
register 1.1% by the end of 2004, while pessimists expect a 2.9% inflation rate.

Some economists question the ability of our economic models to predict inflation. Since 1993, economists' year-ahead inflation predictions have had an average error of 0.3 percentage point and 0.7 percentage point in absolute terms. This is no better than a naïve forecast, in which next year's inflation rate is assumed to be the same as this year's.

One particularly contentious issue is how useful measures of economic

(continued on next page)

Inflation and Prices (cont.)



a. Blue Chip panel of economists.

b. CPI forecasts from the *Livingston Survey*.

c. Core CPI inflation rate calculated as the four quarter percent change of the Core CPI Price Index.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Congressional Budget Office; Federal Reserve Bank of Philadelphia, *Livingston Survey*; and *Blue Chip Economic Indicators*, May 10, 2004.

slack are in predicting inflation rate changes. The idea that inflation accelerates as the economy's resources become strained is a key assumption in most forecasts, but gauging the amount of slack in the economy is a daunting task.

Several alternative measures of economic slack have been suggested such as the gap between potential and actual GDP, and capacity utilization. Another popular approach, sometimes termed the Phillips curve, suggests that inflation will increase

when labor markets are tight, that is, when the rate of unemployment falls below the NAIRU (non-accelerating inflation rate of unemployment).

If we assume that NAIRU is constant, the relationship between unemployment and inflation changes has deteriorated since the mid-1980s. One reason for this may be that the economy's potential, as embodied by measures like NAIRU, is not constant; it fluctuates over time. According to the Congressional Budget Office, NAIRU peaked at around 6¹/₄% in the

late 1970s, falling below 5¹/₄% sometime in the last decade. Perhaps inflation has picked up recently because there is less slack in the economy than these measures suggest. That is, NAIRU may now be higher than 5¹/₄%. Most economists, however, do not believe NAIRU has increased so much that the economy has begun straining against its capacity or that the recent rise in inflation will persist for long. But, of course, only time and more research will tell.