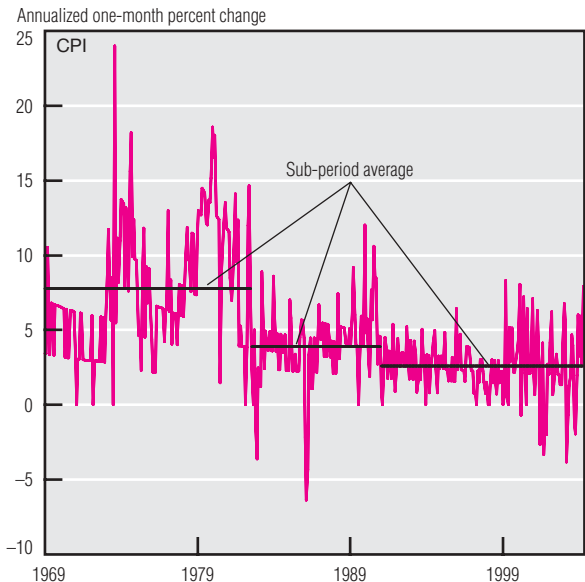
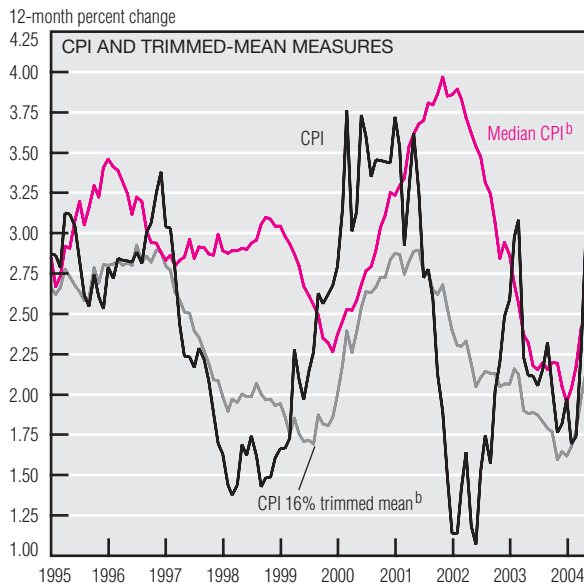
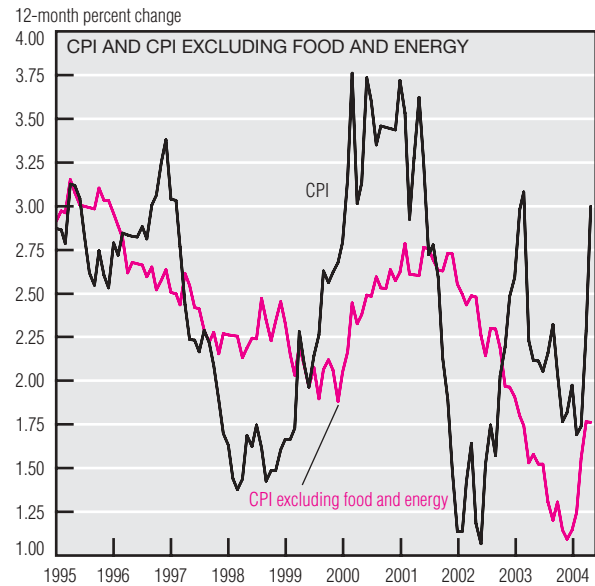


Inflation and Prices

	Percent change, last:				2003 avg.
	1 mo. ^a	3 mo. ^a	12 mo.	5 yr. ^a	
Consumer prices					
All items	8.0	5.5	3.0	2.6	1.9
Less food and energy	2.5	3.3	1.8	2.2	1.1
Median ^b	2.7	3.4	2.5	2.9	2.1
Producer prices					
Finished goods	10.2	8.5	4.9	2.4	4.4
Less food and energy	4.0	2.9	1.7	1.0	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.

In May, the Consumer Price Index (CPI) surged 0.6% (8.0% annualized rate)—the largest monthly advance in more than four years. Energy prices, which have continued to rise since the end of last year, jumped 4.6% after increasing only 0.1% in April. However, the inflation measures that exclude the volatile food and energy components suggest more moderate pricing pressures in May: Both the core CPI and the median CPI rose 0.2% (annualized rates of 2.5% and 2.7%, respectively).

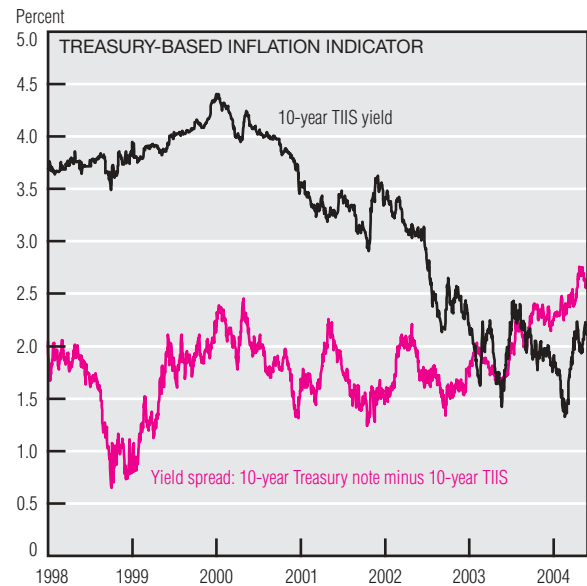
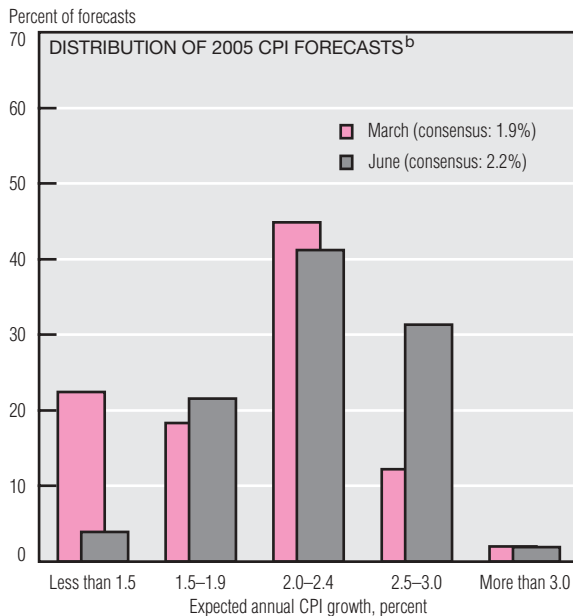
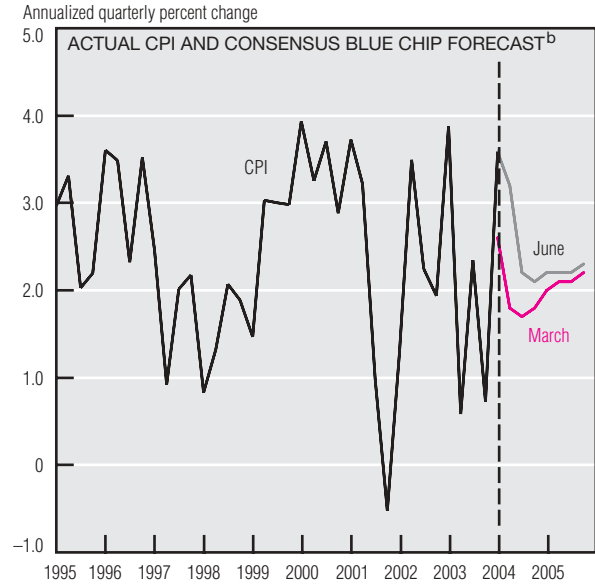
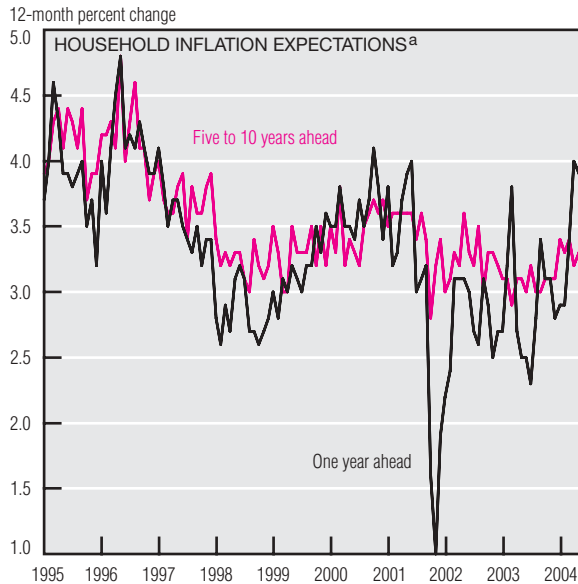
The 12-month growth rate of the CPI, median CPI, and 16% trimmed-mean CPI continued to rise, with prices increasing 3.0%, 2.5%, and 2.1%, respectively, in the last year. The core CPI's 12-month growth rate held steady at 1.8% in May. The CPI growth rate for the past year was more than 1 percentage point higher than it was at the end of 2003. While food and energy prices alone explain about half the difference, core CPI inflation in the past year was still more than half a percentage point higher than it was at the end of 2003.

Does the recent surge in prices suggest that the longer-run inflation trend has changed? May's increase in consumer prices is greater than the average monthly price increases of recent years, but over a longer period, average monthly price increases have still declined. It is difficult to extrapolate a change in the underlying inflation trend from monthly CPI data because monthly price changes are so volatile.

Inflation expectations are also rising: Households included in the

(continued on next page)

Inflation and Prices (cont.)



a. Mean expected change in consumer prices as measured by the University of Michigan's *Survey of Consumers*.

b. Blue Chip panel of economists.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; University of Michigan; Bloomberg Financial Information Services; and *Blue Chip Economic Indicators*, March 10, 2004 and June 10, 2004.

University of Michigan's *Survey of Consumers* increased their year-ahead inflation forecast from 3.9% in May to 4.0% in June. Long-run inflation expectations are more stable but have also inched upward over the past three months, rising from 3.3% in May to 3.4% in June.

The Blue Chip panel of economists has increased its CPI inflation forecasts since March. In the most recent Blue Chip survey, economists predicted that inflation would average 2.5% in the last three quarters of

2004, up from their 1.8% estimate in March. For 2005, the same consensus inflation forecast rose from 1.9% in March to 2.2% in June. These increases reflect a significant shift in the distribution of economists' forecasts. In the June survey, more economists—roughly one-third—predicted that 2005 inflation would be in the 2.5%–3.0% range, far higher than in the March survey. Also in the most recent survey, far fewer economists anticipated that 2005 inflation would be lower than 1.5%.

Financial markets provide an additional tool to gauge inflation expectations: Market participants' expectation of average annual inflation (over the next 10 years) is reflected by the yield spread between 10-year Treasury notes and 10-year inflation-indexed securities (TIIS). This yield spread is trending upward and suggests that market participants anticipate a 2.6% average annual inflation rate over the next 10 years.