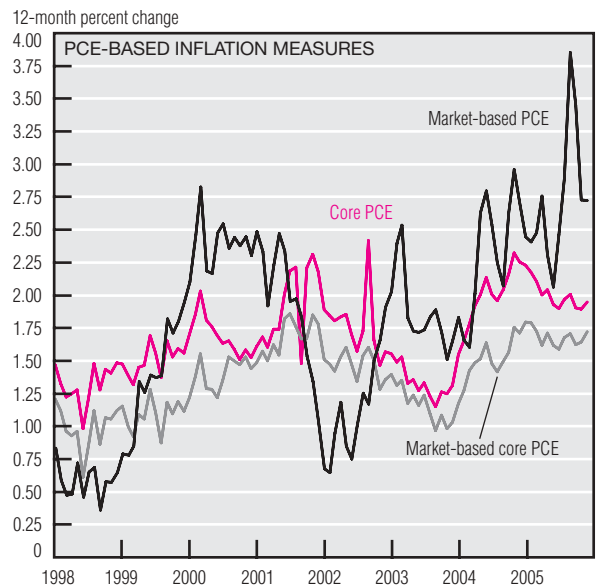
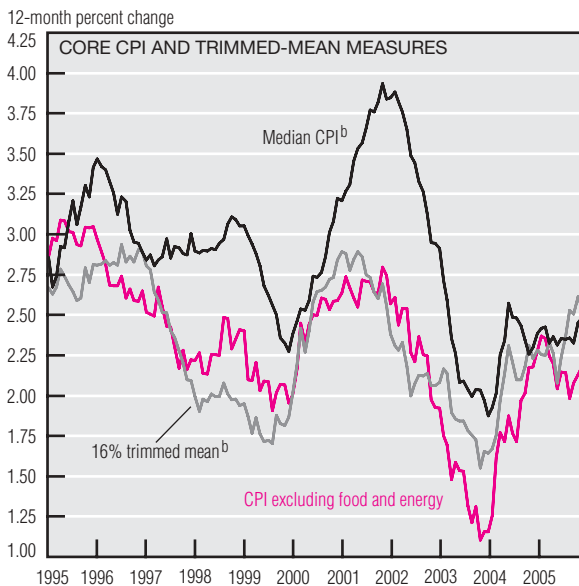
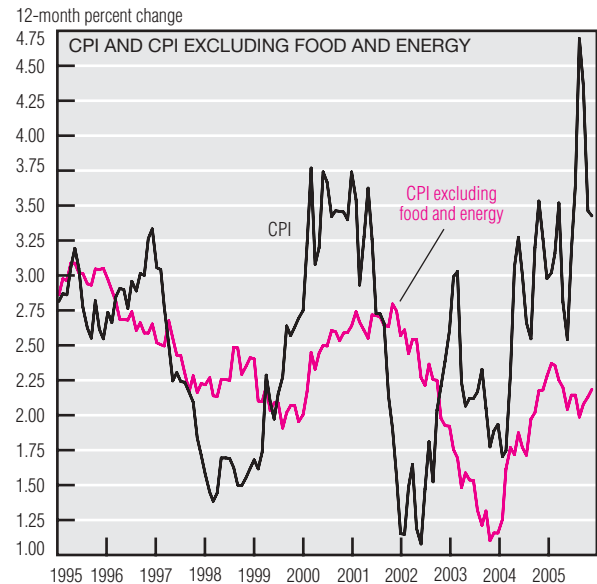


Inflation and Prices

December Price Statistics

	Percent change, last:				2005 avg.
	1 mo. ^a	3 mo. ^a	12 mo.	5 yr. ^a	
Consumer prices					
All items	-0.6	-1.6	3.4	2.5	3.5
Less food and energy	2.4	2.8	2.2	2.0	2.2
Median ^b	2.5	2.3	2.5	2.7	2.5
Producer prices					
Finished goods	11.1	3.6	5.4	2.6	6.0
Less food and energy	1.5	0.0	1.7	1.1	1.8



a. Annualized.

b. Calculated by the Federal Reserve Bank of Cleveland.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; and Federal Reserve Bank of Cleveland.

The Consumer Price Index (CPI) continued its decline in December, falling at a 0.6% annualized rate, after plummeting 6.4% (annualized) in November. Growth in the core CPI measures moderated somewhat: The CPI excluding food and energy rose 2.4% (annualized), and the median CPI increased 2.5% (annualized).

The longer-term trends of underlying inflation inched higher in December but remain between 2.0% and 2.5%. The 12-month growth rate in the core CPI ticked up to 2.2%, while the

median CPI's 12-month growth rate rose from 2.4% to 2.5%. The growth rate of the 16% trimmed mean, which has accelerated from 2.1% since June 2005, was also 2.5% during the month. Other core inflation measures that use a slightly modified consumer goods market basket, which encompasses the PCE excluding food and energy, as well as the market-based core PCE (which excludes certain imputed items that cannot be observed directly from the marketplace) also suggest that inflation is holding steady but at a

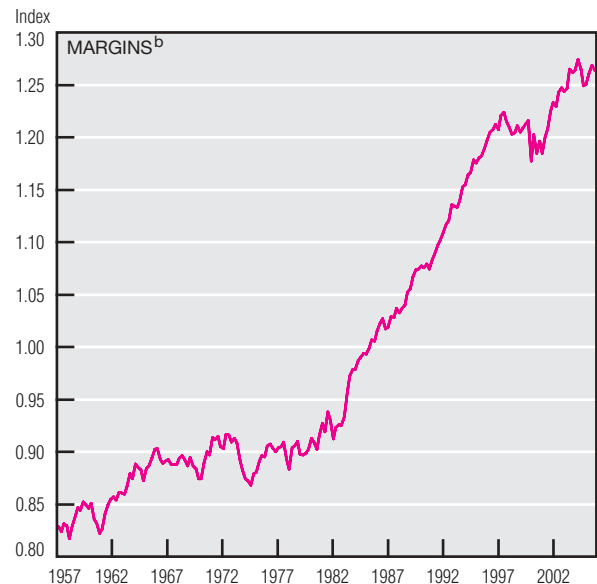
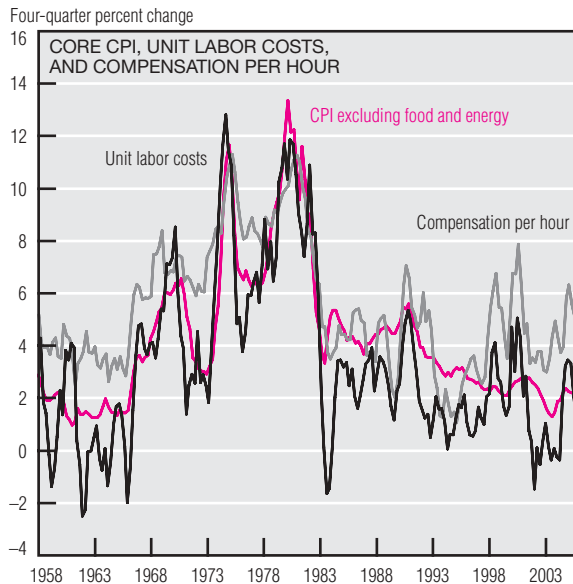
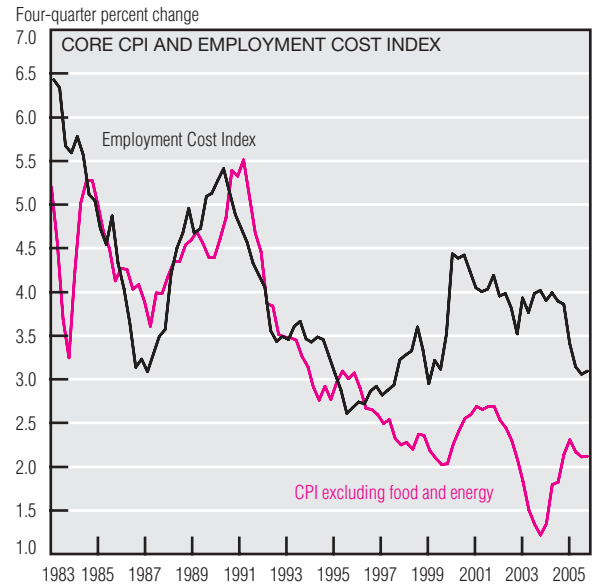
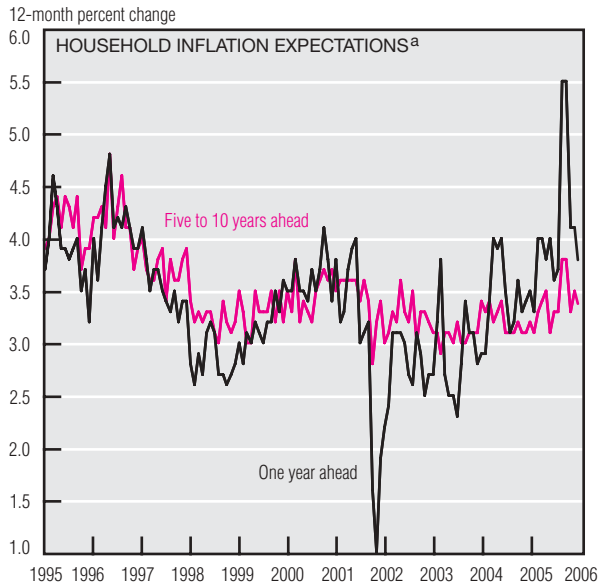
lower rate, remaining in the 1.5% to 2.0% range.

Indeed, the inflation anxieties that households reported in the aftermath of last summer's hurricanes have continued to dissipate: Survey data show household inflation expectations at 3.8% one year ahead. Long-term inflation expectations, at 3.4%, marked a return to the 3.0% to 3.5% range in which they had remained for nearly a decade.

One indicator of potential inflation pressure in the economy is the cost of

(continued on next page)

Inflation and Prices (cont.)



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

b. Ratio of the core CPI to unit labor cost, indexed to the average ratio over the entire period.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and University of Michigan.

labor. Higher wage costs, the theory goes, mean that firms will soon boost prices. The change in employment costs, as measured by the Employment Cost Index, has averaged about 3.7% over the past 15 years but slowed in 2005. However, the historical link between employment cost pressures and inflation, which was strong throughout the higher-inflation era of the 1970s, is otherwise weak. It is possible that productivity growth, which has remained high and less volatile over the

past decade, has weakened this link. But the productivity-adjusted measure of compensation—unit labor costs—has also proved to be a comparatively poor indicator of changing inflation rates in recent years.

Some argue that the relationship between labor costs and inflation is weak because firms may be experiencing higher-than-usual profit margins, which could allow them to hold the line on prices despite rising labor costs. That is, firms could reduce these margins as competition for

workers heats up. Perhaps. Margins, as measured by the ratio of prices to unit labor costs, would indeed seem unusually high. But what firms' responses to rising labor costs would be, should they occur, and whether firm margins are really as high as this measure would indicate, are highly speculative matters. One thing is clear, however: Current readings from the labor market do not provide very compelling evidence about changes in the economy's inflationary potential.