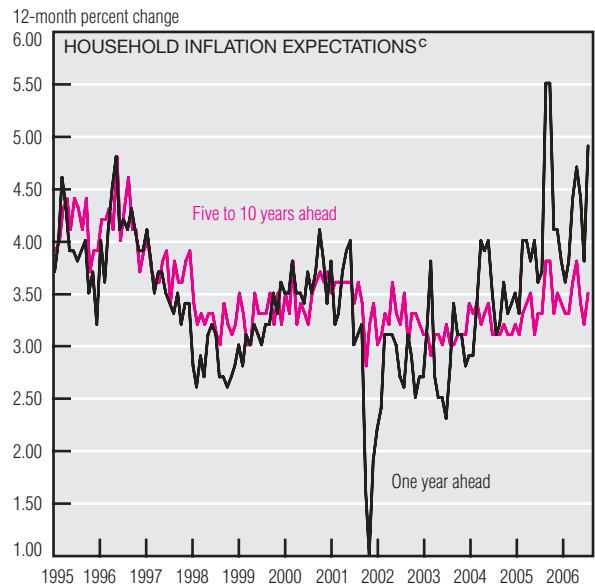
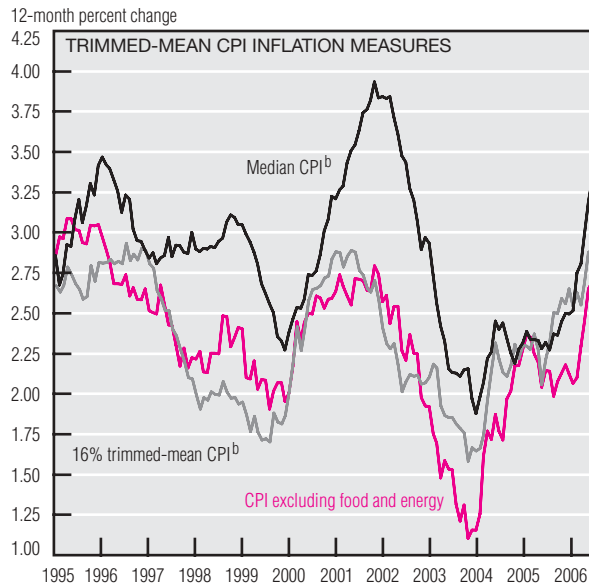
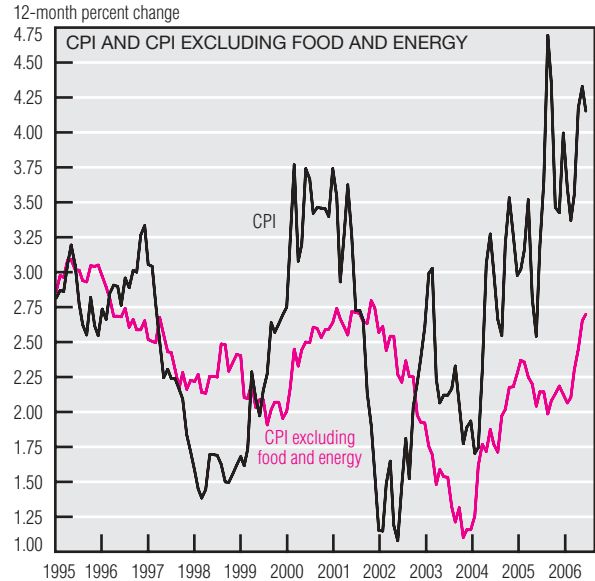


Inflation and Prices

	Percent change, last:				2005 avg.
	1 mo. ^a	3 mo. ^a	12 mo.	5 yr. ^a	
July Price Statistics					
Consumer Price Index					
All items	5.5	4.5	4.1	2.8	3.6
Less food and energy	2.4	3.2	2.7	2.1	2.2
Median ^b	4.4	4.4	3.3	2.7	2.5
Producer Price Index					
All items	1.5	3.3	4.2	2.9	5.7
Less food and energy	-3.0	0.8	1.3	1.1	1.5



a. Annualized.

b. Calculated by the Federal Reserve Bank of Cleveland.

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

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Bank of Cleveland; and University of Michigan.

The broad-based rise in retail prices, which began in March, was still evident in July. The Consumer Price Index (CPI) rose 5.5%; the core CPI, which excludes the presumably more volatile food and energy prices, rose a more modest 2.4% (annualized rate). The median CPI, which attempts to isolate inflation trends by focusing on the middle of the monthly price-change distribution, rose a brisk 4.4% (annualized rate).

Longer-term growth trends in the core retail price measures inched up a bit further in July and are now $\frac{1}{2}$ to 1 percentage point higher than in mid-2005. The 12-month growth rate in the CPI excluding food and energy and the median CPI ticked up to 2.7% and 3.3%, respectively. The 12-month growth rate in the 16% trimmed-mean CPI remained at 2.9%.

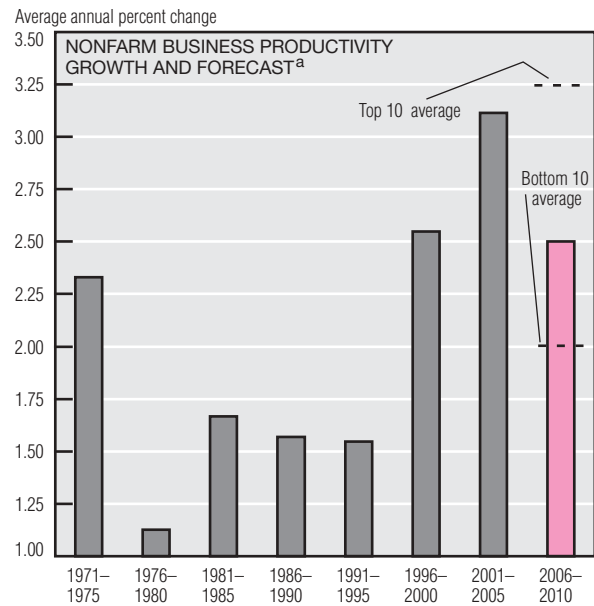
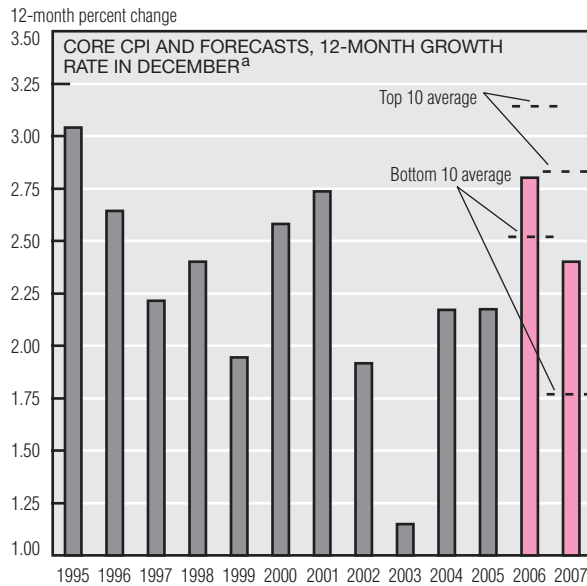
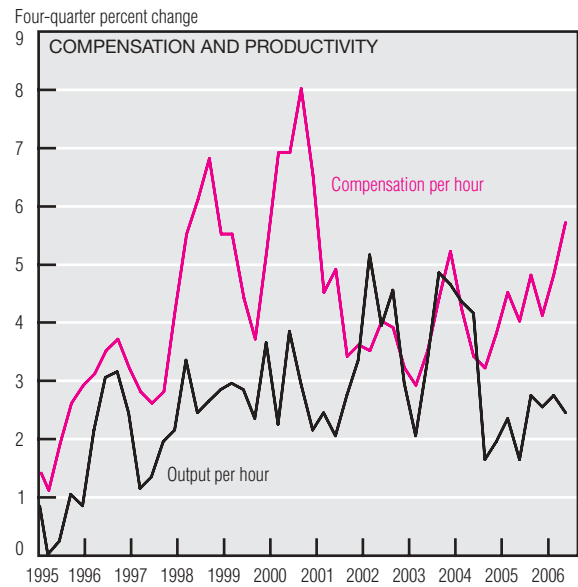
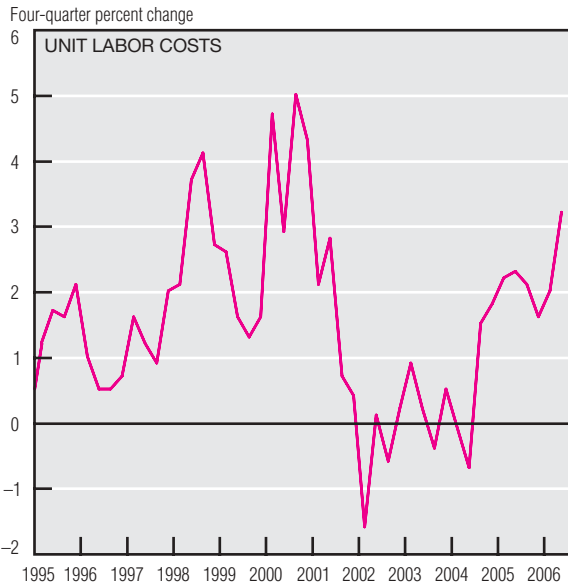
Meanwhile, short-term household inflation expectations have crept back to their highest levels since the

months after Hurricane Katrina. Survey data from U.S. households in early August indicate that retail prices over the next 12 months are expected to rise 4.9%. On the other hand, longer-term expectations remain fairly steady, with households anticipating that prices will rise 3.5% annually over the next five to 10 years.

One indicator of potential inflation pressure in the economy is unit labor costs: Higher labor costs, the theory goes, induce producers to raise

(continued on next page)

Inflation and Prices (cont.)



a. Blue Chip panel of economists.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and *Blue Chip Financial Forecasts*, September 1, 2006.

prices. Growth in unit labor costs, defined as compensation growth adjusted for productivity growth, doubled from 1.6% in December 2005 to 3.2% in June 2006. This jump resulted primarily from accelerated compensation growth (which recently hit 5.7%, its highest four-quarter growth rate in more than five years), not a slowdown in productivity gains.

The Blue Chip panel of economists anticipates that core CPI inflation will rise to about 2³/₄% this year—almost a

full percentage point above its 2002–05 average—before moderating to a 2.4% rate in 2007. One factor that is likely to weigh heavily in this outlook is the future behavior of unit labor costs. Economists expect nonfarm business productivity to remain relatively strong over the next five years, growing at an average annual rate of 2¹/₂%, which could help to keep unit labor costs in check. But the range of opinion concerning the core inflation outlook is pretty wide and

may depend on the performance of compensation growth relative to productivity growth. If labor compensation growth slows significantly, or productivity growth accelerates, the inflation outlook is likely to be much improved. But of course, should the opposite occur—if labor compensation growth were to accelerate further or productivity growth to wane—the more pessimistic inflation scenario would gain credibility.