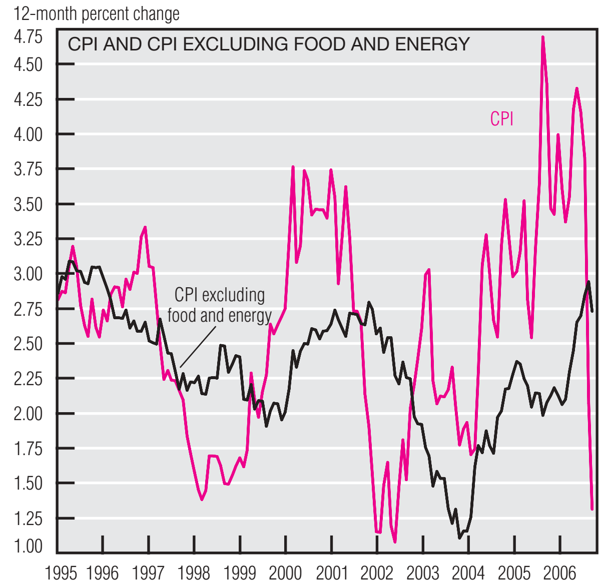
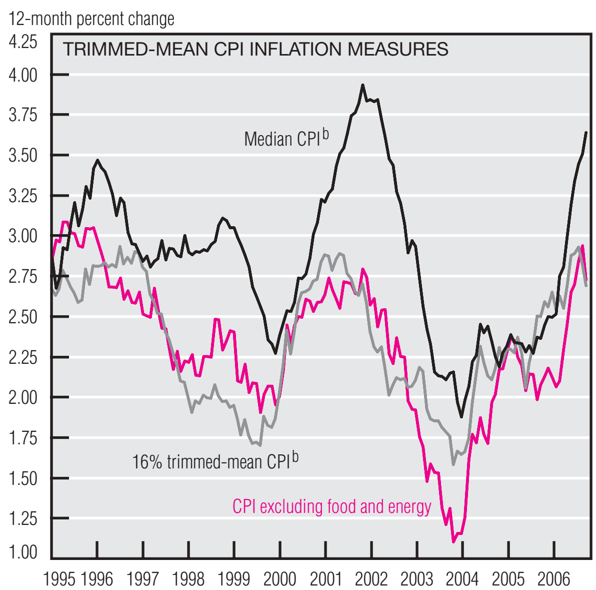
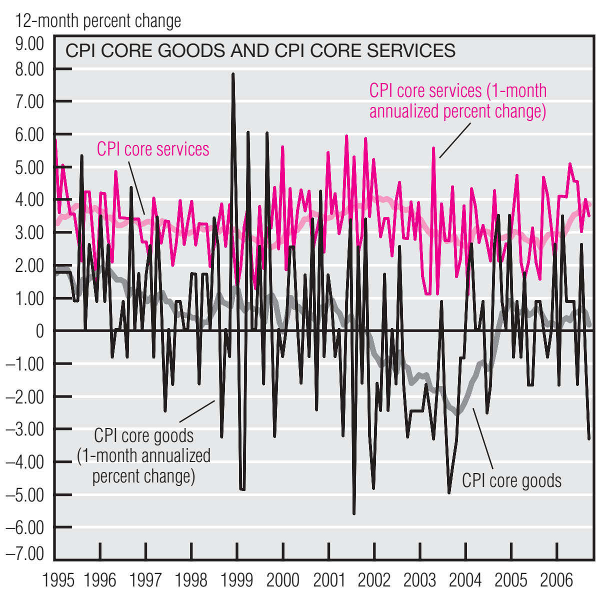
Inflation and Prices

October Price Statistics

	Percent change, last: 1 mo.[a]	3 mo.[a]	6 mo.[a]	12 mo.	5 yr.[a]	2005 avg.
Consumer Price Index						
All items	–5.8	–2.9	0.7	1.3	2.6	3.6
Less food and energy	1.2	2.3	2.8	2.7	2.1	2.2
Median[b]	3.7	3.5	4.0	3.6	2.7	2.5
16% trimmed mean	0.9	2.1	2.7	2.7	2.2	2.6
Producer Price Index						
All items	–17.9	–10.9	–4.2	–1.6	2.5	5.7
Less food and energy	–10.1	–2.7	–0.9	0.6	1.0	1.5







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 Consumer Price Index (CPI) declined sharply in October for the second straight month, falling at a 5.8% annualized rate. However, the core inflation measures continued to hold steady, with monthly growth rates about the same as—or lower than—their longer-term trends. The CPI excluding food and energy rose a moderate 1.2%, while the median CPI climbed 3.7%.

Longer-term growth trends in the core retail price measures remained elevated. Whereas the CPI's 12-month growth rate dropped sharply (to 1.3%, its four-year low), rates for the CPI excluding food and energy and the 16% trimmed-mean CPI came down only slightly to about 2.7%; both retail price measures remain well above the range generally associated with price stability.

Deceleration in the core inflation measures seems to be heavily influenced by recent softness in prices for core goods (which exclude food and energy). Core services prices, however, remain stubbornly high, contributing to the persistently high readings of the Cleveland Fed's median CPI. This measure, which examines the component in the middle of the monthly price-change distribution, rose a brisk 3.6% over the 12 months that ended in October.

The discrepancy in the behavior of goods versus services prices is clearly reflected in the monthly price-change distribution of the CPI components: Large shares of the consumers' market basket showed either large price increases (above 3%) or price softness (below 1%); only a very small proportion of the CPI components

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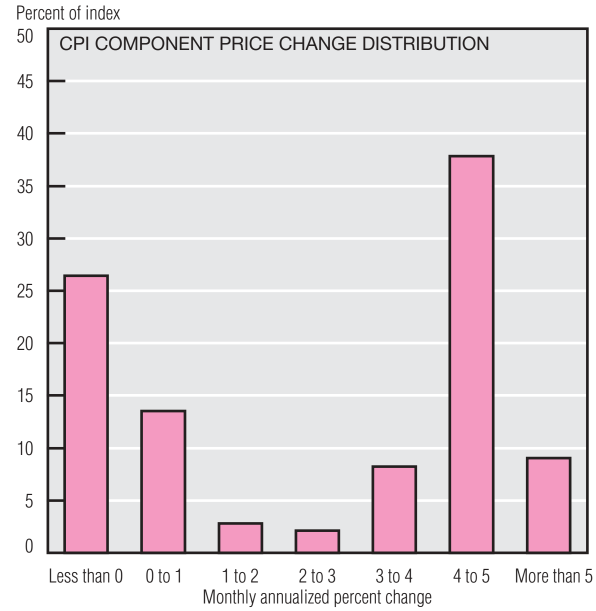
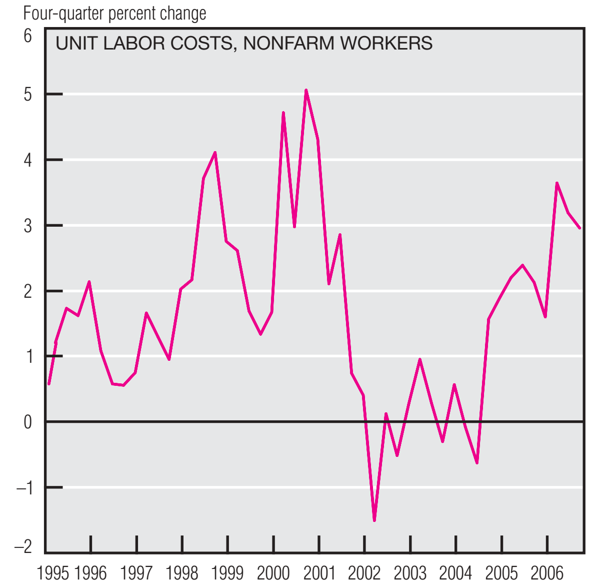
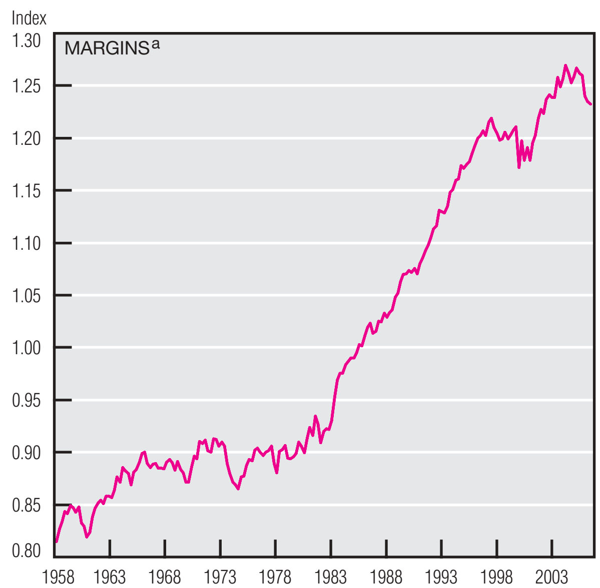
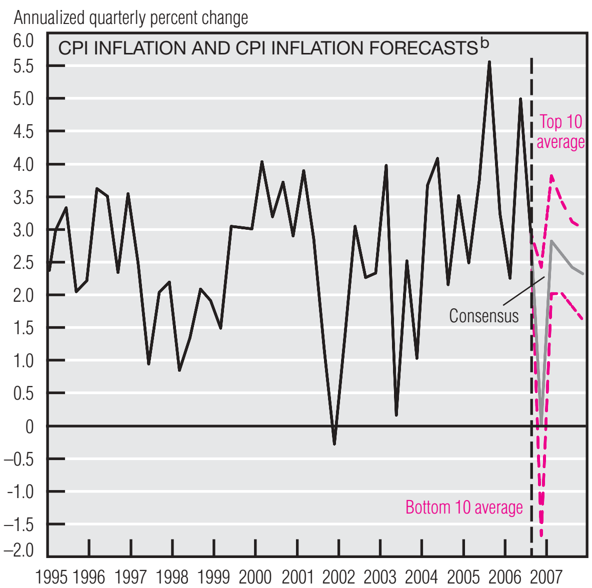
Inflation and Prices (cont.)









a. Ratio of the core CPI to unit labor costs, indexed to the average ratio for the entire period.
b. Blue Chip panel of economists.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and *Blue Chip Economic Indicators*, November 10, 2006.

(about 5%) showed price increases in the moderate 1%–3% range.

In a recent speech, Federal Reserve Chairman Ben Bernanke stated that "there are substantial uncertainties about the inflation forecast… One factor that we are watching carefully is labor costs…[which] have been rising more quickly of late. Some part of this acceleration no doubt reflects the current tightness in labor markets." Indeed, in 2006:IIIQ, the four-quarter growth rate of unit labor costs was 2.9%, as compensation growth outpaced decelerating productivity growth.

Chairman Bernanke suggested that accelerating growth in unit labor costs would not affect price inflation if firms were to absorb rising labor costs by sacrificing some portion of their profit margins. Margins, as measured by the ratio of prices to unit labor costs, do indeed seem unusually high. But what firms' responses to rising labor costs would be and whether firms' margins are really as high as this measure would indicate are highly speculative matters. Chairman Bernanke also suggested that "the more worrisome possibility is that tight product markets might allow firms to pass all or part of their higher labor costs through to prices, adding to inflation pressures."

Despite these concerns, economists don't anticipate that the recent acceleration in the growth rate of unit labor costs will have a lasting impact on inflation. The consensus estimate of the Blue Chip panel of economists is that retail prices will hold steady in 2006:IVQ and will rise between 2¼% and 2½% by the end of 2007.