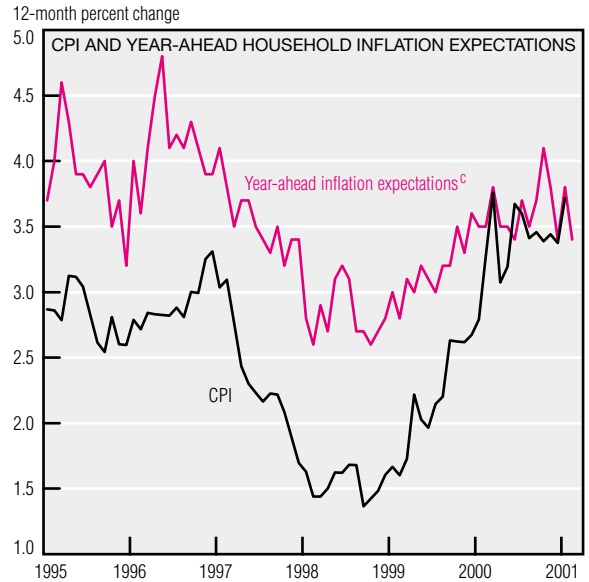
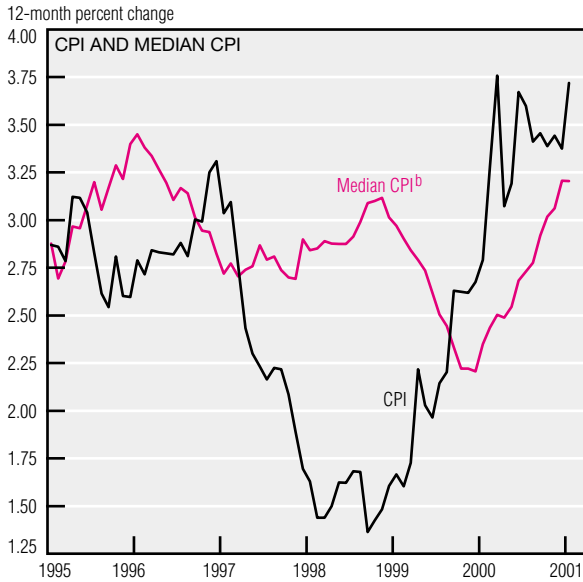
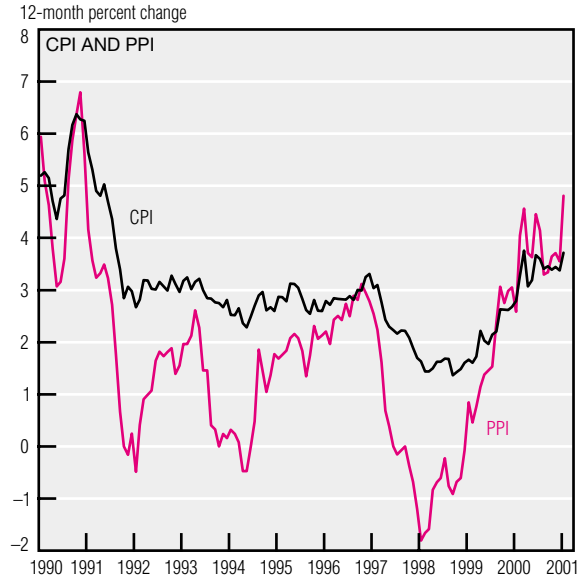


# Inflation and Prices

	Percent change, last:				2000 avg.
	1 mo. <sup>a</sup>	3 mo. <sup>a</sup>	12 mo.	5 yr. <sup>a</sup>	
<b>Consumer prices</b>					
All items	7.8	4.2	3.7	2.6	3.4
Less food and energy	4.0	2.9	2.6	2.4	2.5
Median <sup>b</sup>	3.6	3.6	3.2	2.8	3.2
<b>Producer prices</b>					
Finished goods	14.6	6.2	4.8	1.8	3.6
Less food and energy	8.4	3.3	2.0	1.1	1.2



a. Annualized.  
 b. Calculated by the Federal Reserve Bank of Cleveland.  
 c. Mean expected change in consumer prices 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.

Inflation worsened unexpectedly in January. The Consumer Price Index (CPI) rose at a decade-high 7.8% annual rate, helping to push its 12-month growth trend to 3.7%, the highest level in nearly nine years. Likewise, price increases at the factory level were much larger in January, up a whopping 14.6% (annual rate). Energy and tobacco price increases were especially prominent, building on a year-long sequence of large advances in these items.

Still, the breadth of recent price increases clearly has extended well beyond a few volatile components, as

shown by core measures of inflation. The CPI excluding food and energy, for instance, was up 4.0% (annual rate) in January, while the median CPI rose 3.6% (annual rate). The median CPI corresponds to the price increase in a consumer's market basket where half the items show larger price increases and half show smaller ones. The 12-month percent change in the median CPI has risen sharply since the beginning of 2000.

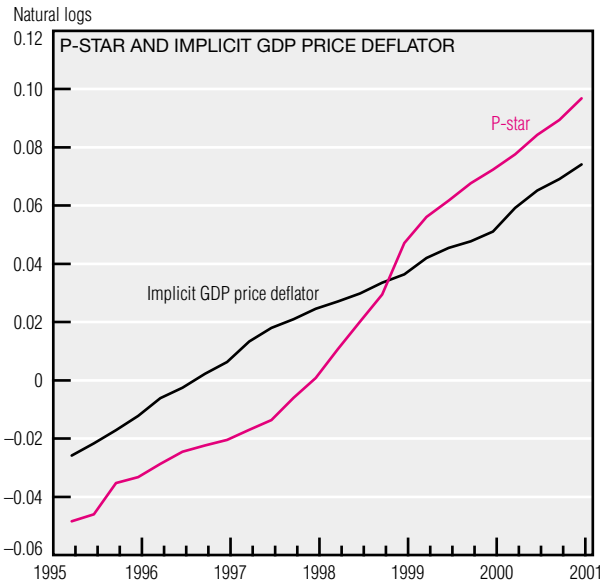
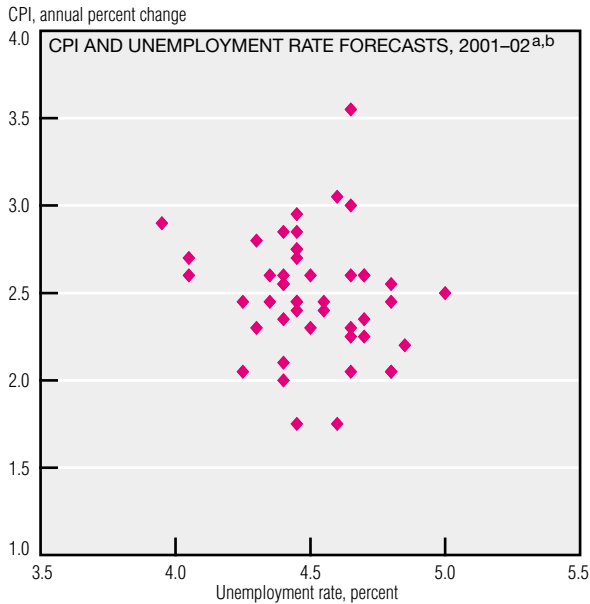
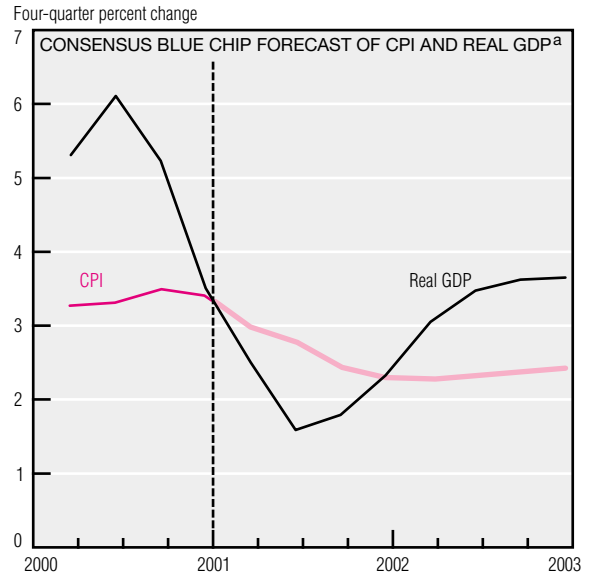
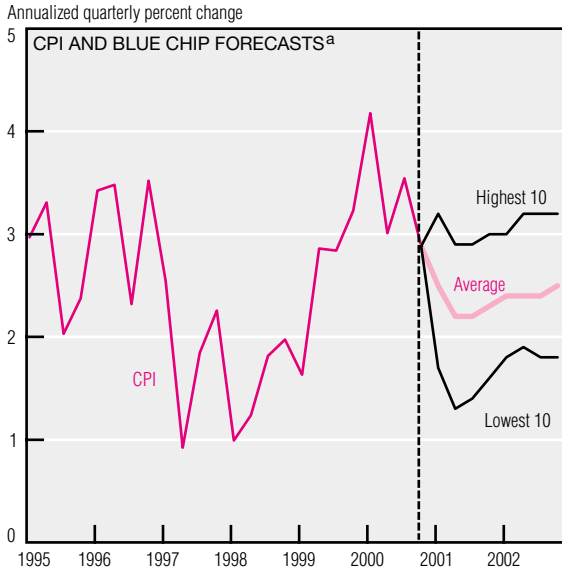
Nevertheless, while the recent upward inflation trend was accompanied by deteriorating household inflation expectations early in the process (1999), the pub-

lic's inflationary sentiments seemingly leveled off in 2000 and, so far, in 2001. In other words, the higher inflation rates recorded in recent months have apparently not fueled an inflation scare among U.S. households.

The central bank faces an especially difficult decision on how to respond to these higher inflation estimates, given the recent deceleration in the rate of economic growth. The Federal Reserve's stated ultimate objective is to eliminate inflation's corrosive influence on the economy. A key ques-

*(continued on next page)*

# Inflation and Prices (cont.)



a. Blue Chip Panel of economists.

b. Individual economists' forecasts, average for 2001 and 2002.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Blue Chip Economic Indicators, February 10, 2001.

tion, then, is whether recent data are an aberration or suggestive of a persistent upward trend in the inflation rate.

Economists are divided on the outlook for the next few years. Pessimists are projecting the rate of inflation to remain at or slightly above 3% through the end of 2002; optimists see it falling back below a fairly benign 2% during the same period.

An argument for the optimists' view is that energy prices, which doubtless are

being incorporated into a wide range of goods and services this year, will not keep rising indefinitely. Slower growth in economic activity might also relieve some of the price pressure. Indeed, the consensus forecast of economists shows a pattern in which inflation is projected to follow the economy's growth rate downward. But economists who use such models have been unable to measure precisely the connection between inflation and growth (witness the widely scattered unemployment and inflation rate expectations charted above).

The more pessimistic inflation outlook is buttressed by an above-average growth rate in the money supply (as measured by M2) relative to estimates of potential GDP, a model of future inflation that economists call P-star. When P-star exceeds the price level (as it has done since late 1998), inflation will likely accelerate. Unfortunately, this model of the inflation process has also proven highly imprecise in recent practice.