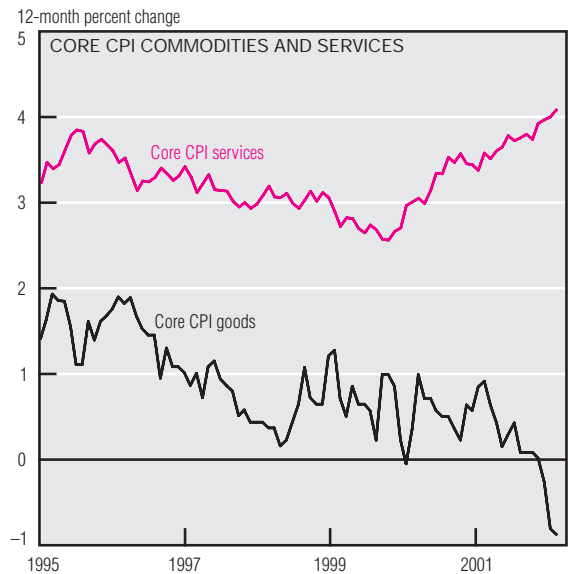
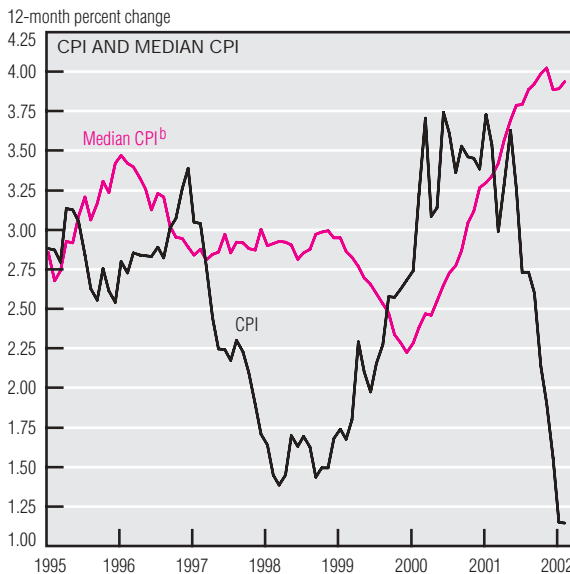
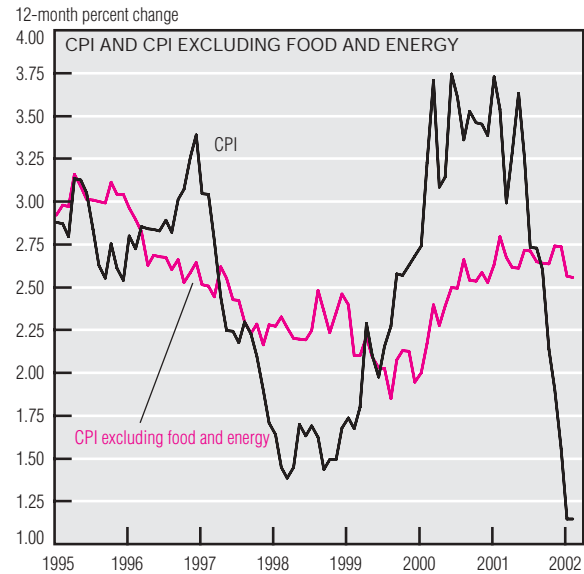


Inflation and Prices

	Percent change, last:				
	1 mo. ^a	3 mo. ^a	12 mo.	5 yr. ^a	2001 avg.
February Price Statistics					
Consumer prices					
All items	2.7	1.1	1.1	2.2	1.5
Less food and energy	3.2	2.1	2.5	2.4	2.7
Median ^b	4.2	3.3	3.9	3.1	3.9
Producer prices					
Finished goods	2.6	-0.9	-2.7	0.8	-1.9
Less food and energy	0.0	-0.3	0.5	1.0	0.7



a. Annualized.
 b. Calculated by the Federal Reserve Bank of Cleveland.
 SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Bank of Cleveland; and University of Michigan.

After three consecutive monthly declines, the Consumer Price Index (CPI) rose for the second straight month in February. The 0.2% increase the index registered in February (2.7% at an annual rate) was nearly identical to the increase it posted in January. Energy prices continued to demonstrate their characteristic volatility, falling in February after rising in January.

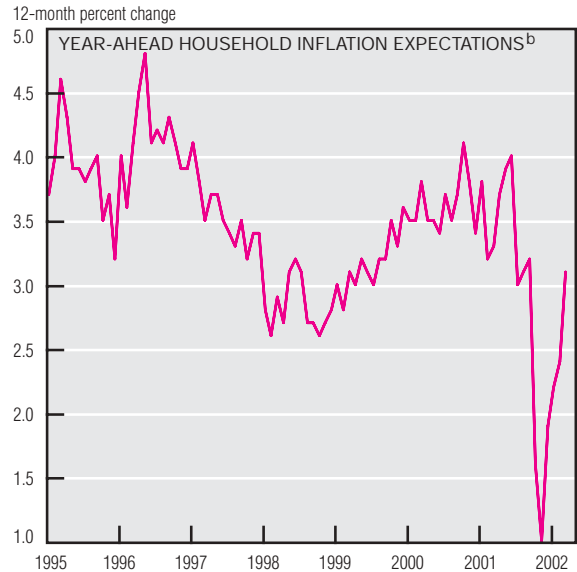
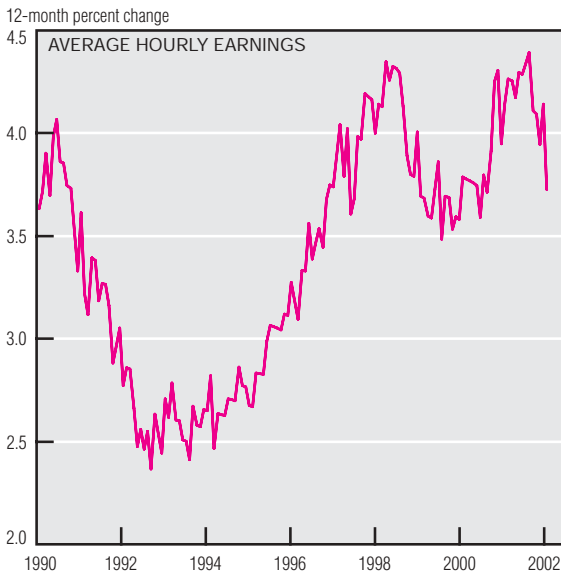
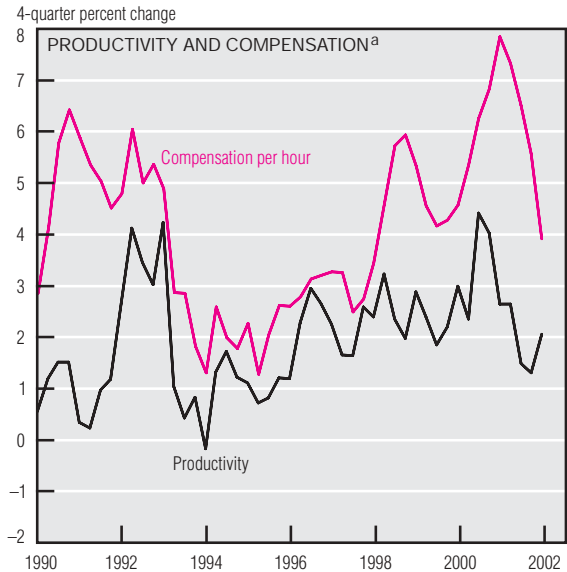
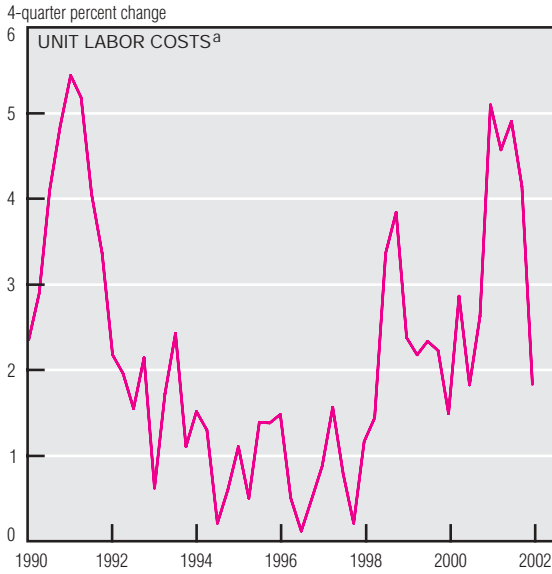
Excluding both food and energy, the CPI rose 0.3% in February (3.2% at an annual rate), higher than its increase of only 0.2% the previous

month. According to the Labor Department, an upturn in apparel prices, along with larger increases for shelter and for tobacco and smoking products, accounted for the greater advance in February. The median CPI, another measure of inflation, rose at a rate of 0.3% in February (4.2% at an annual rate). Over the last 12 months, the median CPI has increased by 3.9% and the CPI excluding food and energy by 2.5%. Over the same period, however, the total CPI rose at the much less rapid rate of 1.1%, its smallest 12-month rate of change in nearly 40 years.

What accounts for the divergence between the median CPI and these other inflation measures? Much of the difference may result from the growing gap in the inflation rates for goods and services in the CPI. Since 2000, the gap between non-food, non-energy ("core") goods and services prices has widened. Currently, CPI services prices are rising at about 4% per year, while core CPI goods prices are declining. The median CPI, because it excludes extreme price movements, may be filtering out the recent dramatic

(continued on next page)

Inflation and Prices (cont.)



a. Nonfarm business sector.

b. 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; U.S. Department of Commerce, Bureau of Economic Analysis; and University of Michigan.

declines in core goods prices; the CPI and the CPI excluding food and energy, because they are weighted means, are likely to be more sensitive to such movements.

It's difficult to know what precisely is driving apart core goods and services prices, but there may be a clue in labor costs, which represent a disproportionate share of services prices. Unit labor costs—the costs associated with producing a unit of output—spiked upward in 2000, and this may have been reflected in services prices.

The upward spike in unit labor costs in 2000 can be seen as the result of the divergence between compensation growth and productivity growth: Compensation growth continued to accelerate in 2000, but productivity growth began to diminish. As a consequence, firms were paying their workers more money for a unit of output. The year-over-year growth rate of unit labor costs, however, has since reversed course, falling consistently throughout 2001. This suggests that services prices may soon reverse their upward trend—and perhaps

the median CPI along with them. Indeed, assuming that productivity growth remains relatively stable in 2002, and given the recent downward trend in the growth rate of wages as measured by average hourly earnings, it looks as if unit labor costs may continue to fall.

U.S. households, however, don't foresee much of a change in the underlying inflation trend. Their expectation of the likely course of inflation over the next 12 months has returned to the levels that prevailed before September 11.