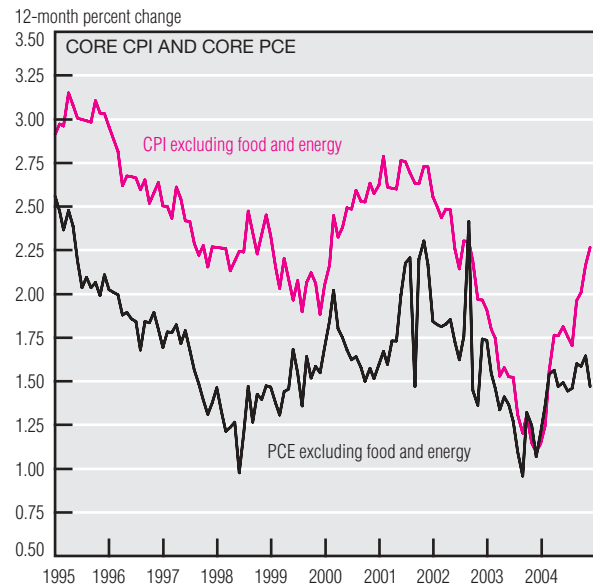
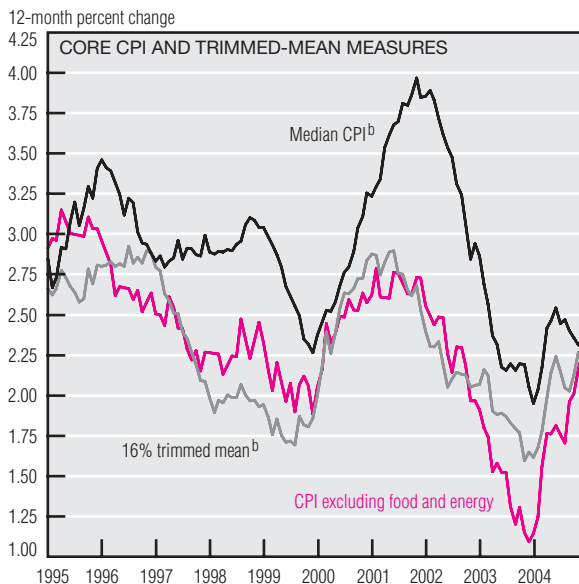
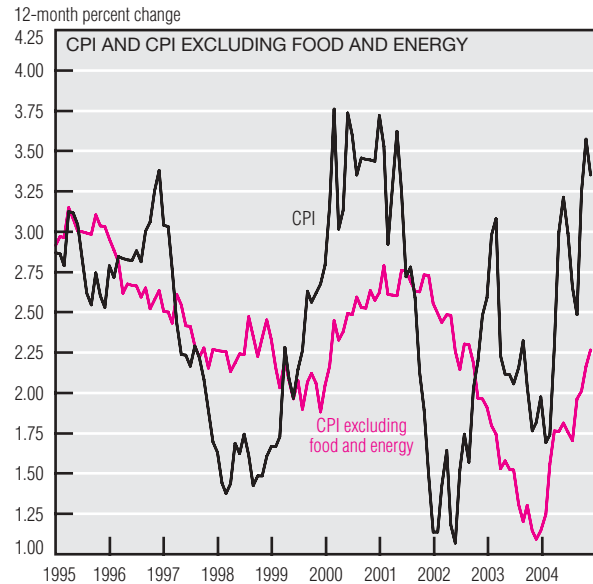


Inflation and Prices

	Percent change, last:				2004 avg.
	1 mo. ^a	3 mo. ^a	12 mo.	5 yr. ^a	
December Price Statistics					
Consumer prices					
All items	-0.6	3.0	3.3	2.5	3.4
Less food and energy	1.8	2.0	2.2	2.1	2.3
Median ^b	2.1	1.8	2.4	2.9	2.4
Producer prices					
Finished goods	-7.6	6.3	4.1	2.2	4.4
Less food and energy	1.6	2.6	2.2	1.0	2.2



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.

During December, the Consumer Price Index (CPI) declined at a 0.6% annualized rate, reflecting a 19.8% drop in energy prices. The core CPI rose 1.8% for the second straight month, while the median CPI increased 2.1%.

Growth in retail price measures accelerated in 2004; however, core measures, which exclude the more volatile food and energy prices, showed more modest growth (between 1.5% and 2.5%). After rising 1.9% in 2003, the CPI advanced 3.3% in 2004—its

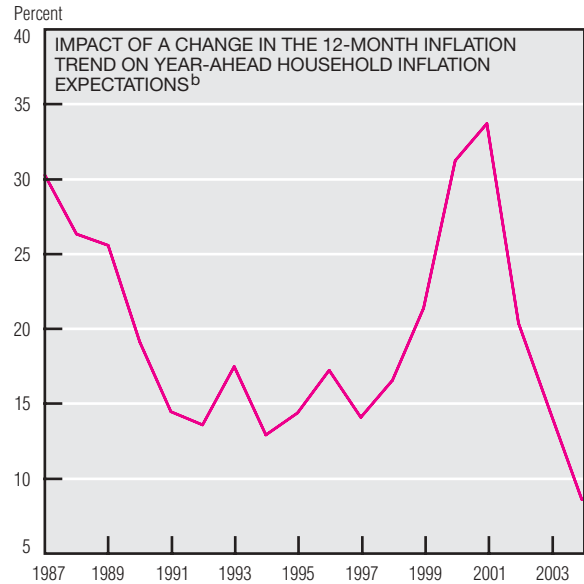
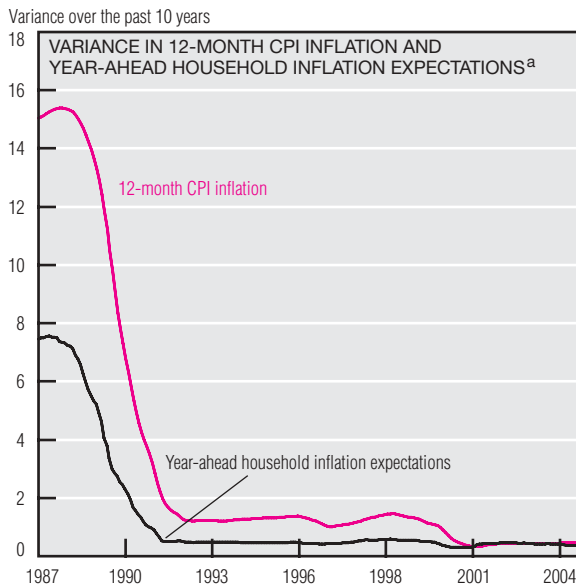
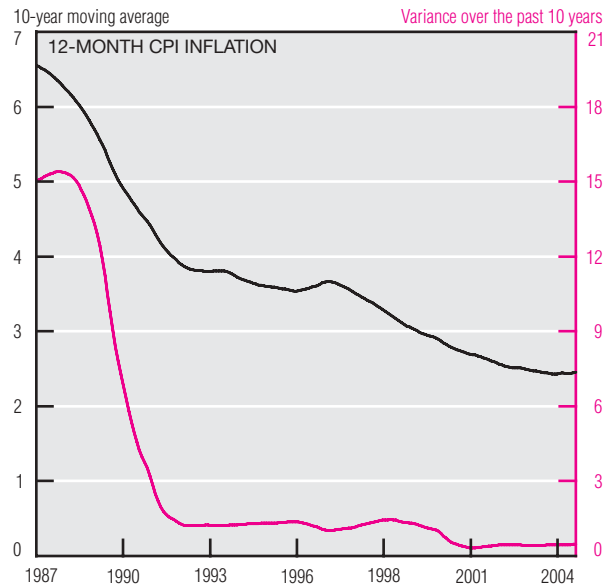
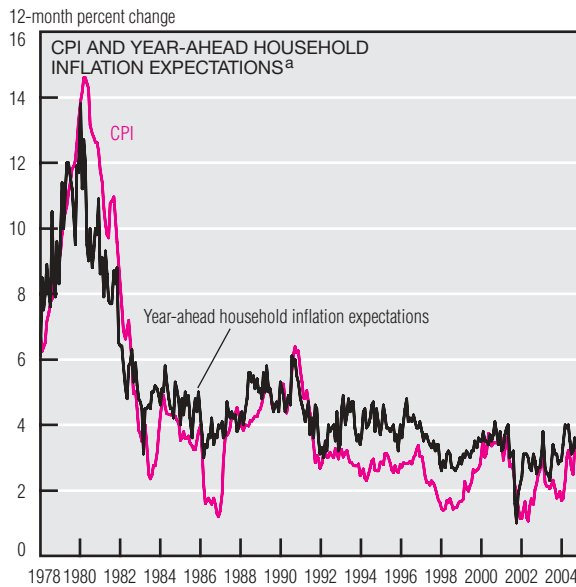
largest annual increase since 2000. The Bureau of Labor Statistics attributed about one-third of the rise to a 16.6% increase in energy prices over the year. Growth in retail prices was more subdued and consistent across the alternative retail price measures. The core CPI rose a more moderate 2.2% in 2004, but still doubled its 2003 growth rate of 1.1%. The Bureau of Labor Statistics attributed three-fourths of the acceleration to rising prices for new and used vehicles and shelter costs. In 2004, the median CPI

rose 2.4%, and the 16% trimmed-mean CPI rose 2.2%. The core Personal Consumption Expenditure (PCE) price index, which measures prices for an alternative consumer-goods market basket, rose a modest 1.5% over the year.

Looking ahead, survey data from U.S. households indicate that retail prices over the next 12 months are expected to rise 3½%—about the same inflation expectation that households have held over most of the past three years. In fact, if we exclude the sharp drop that followed

(continued on next page)

Inflation and Prices (cont.)



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

b. Estimated over 10-year intervals using an ordinary least-squares equation, which regressed the change in year-ahead household inflation expectations on the change in the 12-month inflation trend during the previous month.

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

September 11, 2001, household inflation expectations have fluctuated within a rather narrow range over much of the past 10 years. In other words, households seem to accept that inflation has been following a rather steady course and they expect moderate inflation to continue in the future.

Clearly, as the trend rate of inflation has moderated over time, so too has inflation's year-to-year volatility. Indeed, the trend's volatility, which decreased dramatically with the great

disinflation of the early 1980s, has been reduced further as inflation has moved even lower in the current decade. The more stable inflation environment has been accompanied by reduced volatility in household inflation expectations. That is, households' inflation sentiment appears to be more firmly "anchored" than in the past.

A crude way to gauge that steadiness is to consider what impact a change in the inflation trend has on household predictions for future

inflation—are they likely to perceive a change in the inflation trend as a passing event or a persistent phenomenon? In the late 1970s to early 1980s, about 30% of any change in the inflation trend stayed in household inflation predictions for the next year. Over the past 10 years, changes in the inflation trend seem to have had considerably less influence on the public's outlook; during that period, only about 9% of the change in an observed trend became embedded in year-ahead inflation expectations.