

# Inflation Observatory

May 15<sup>th</sup> 2008

## Consumer Price Index (April 2008)

- In April, core inflation gave no signs of pass-through; yet, upside risks remain
- A decline in gasoline prices was more than compensated by an upsurge in food prices; however, headline inflation came lower than expected
- These trends are consistent with a pause in monetary policy

### No signs of pass-through

Inflation readings could be reflecting the effects of slower economic activity. In April, core CPI inflation remained contained at 0.1% down from 0.2% in March, while on a three-month annualized basis, prices rose 1.2%, the lowest reading since December 2003. The deceleration was driven by substantial declines in the indexes for lodging away from home, transportation, household furnishing and recreation. These developments were partially offset by an upsurge in the index for apparel. Meanwhile, the indexes for rent and owners' equivalent rent posted sustained gains, though they continued to exhibit a moderating trend on a year-over-year basis.

### Upward pressures persist

Headline CPI came below expectations at 0.2% from 0.3% in March. Energy prices were unaltered from a 1.9% increase in March. However, food prices rose 0.9% in April, posting the largest monthly change since January 1990. We expect headline inflation to rebound in May, mainly as a result of higher energy prices. So far this month, oil has averaged \$122 dpb up from \$112.6 in April, while gasoline has averaged \$3.7 per gallon up from \$3.4 in April.

Core inflation readings gave no signs of pass-through, though upside risks remain and pressures intensified. Concerns arise from the ongoing increases in food prices which rebounded strongly in 1Q08 after softening in 4Q07, suggesting that upward pressures could last several months. Not surprisingly, consumers seem to be discounting a higher inflation for the next year; 1-year-ahead inflation expectations –from the U. of Michigan– rose to 4.8% in April from a minimum of 3.1% in October 2007. Despite all these pressures, some factors will prevent core prices from getting out of control. So far, firms have been able to absorb higher production costs through a reduction in profit margins. In addition, productivity growth remains solid and labor compensations have eased. Economic slack will increase further as the economy slows down. Thus, we expect core inflation to remain stable in the next couple of months and to decelerate thereafter. Finally, in a context of downside risks to economic growth and rising inflationary pressures, Fed is likely to keep rates unchanged.

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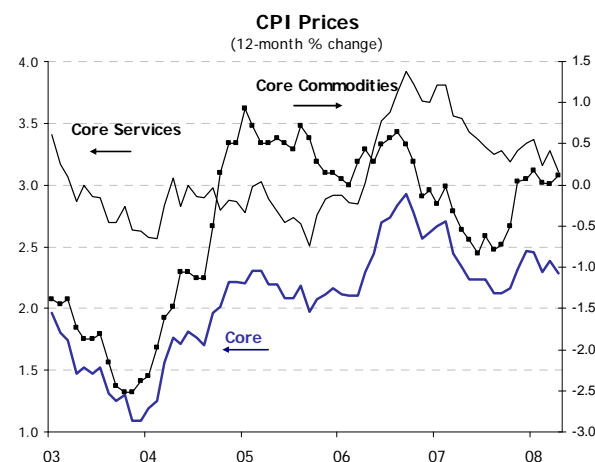
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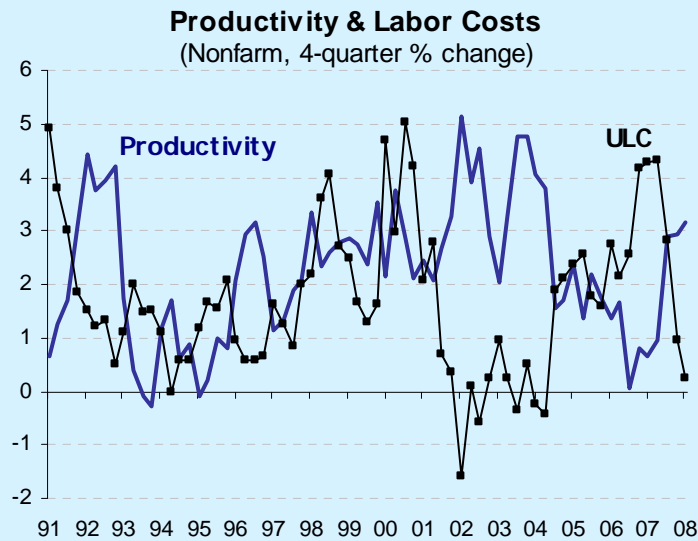
### Consumer prices (sa, %)

	Apr	Mar	Feb	3-month change	12-month change
<b>CPI</b>	0.2	0.3	0.0	2.3	3.9
<b>Core</b>	0.1	0.2	0.0	1.2	2.3
<b>Excl. shelter</b>	0.1	0.2	0.0	1.4	2.0
Energy	0.0	1.9	-0.5	5.6	15.9
Food	0.9	0.2	0.4	6.3	5.1
<b>By expenditure</b>					
Food & Beverages	0.9	0.2	0.4	6.1	5.0
Housing	0.3	0.4	0.2	3.7	3.0
Shelter	0.1	0.1	0.0	1.0	2.6
Rent of prim. resid.	0.3	0.3	0.2	2.9	3.6
Owners' eq. rent	0.2	0.2	0.1	2.3	2.6
Apparel	0.5	-1.3	-0.3	-4.6	-0.7
Transportation	-0.7	0.7	-0.7	-2.5	7.2
New vehicles	-0.2	-0.1	-0.3	-2.4	-1.3
Gasoline	-2.0	1.3	-2.0	-10.4	20.7
Medical Care	0.2	0.1	0.1	1.6	4.3
Recreation	-0.1	0.3	0.1	1.2	1.2
Education & Comm.	0.4	0.3	0.1	3.3	3.2
Other Goods & Serv.	0.5	0.4	0.2	4.8	3.5
Commodities	0.1	0.3	-0.2	0.8	4.8
Excl. food & energy	0.0	-0.1	-0.1	-0.7	0.1
Services	0.3	0.4	0.2	3.4	3.3
Excl. energy	0.1	0.2	0.1	1.9	3.1



# Trends

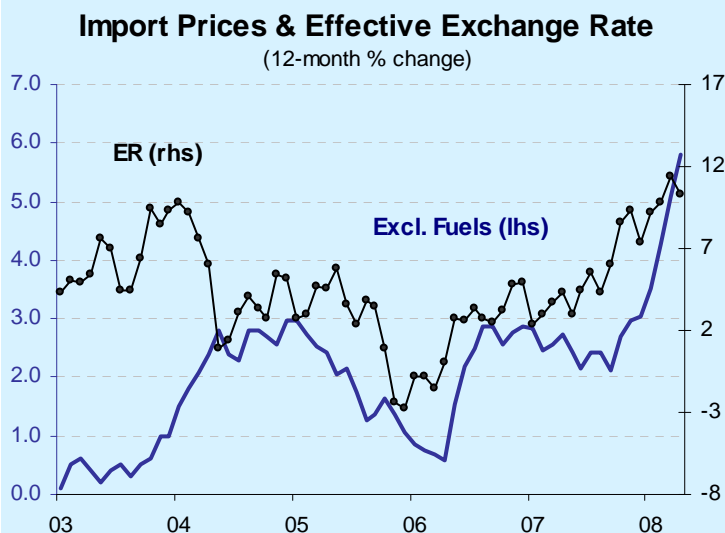
## Labor Compensations



### Labor compensations have eased

Pressures from the labor costs side remain contained. In 1Q08, unit labor costs, expanded by a modest 0.2 yoy, its lowest rate since 2Q04. Hourly compensations' growth moderated while that of productivity accelerated. Other indicators point to a slower growth of compensations. Average hourly earnings rose 3.4% in April from a maximum of 4.3% in December 2006. Moreover, the employment cost index increased 0.7% in 1Q08, the lowest quarterly increase since 1Q06.

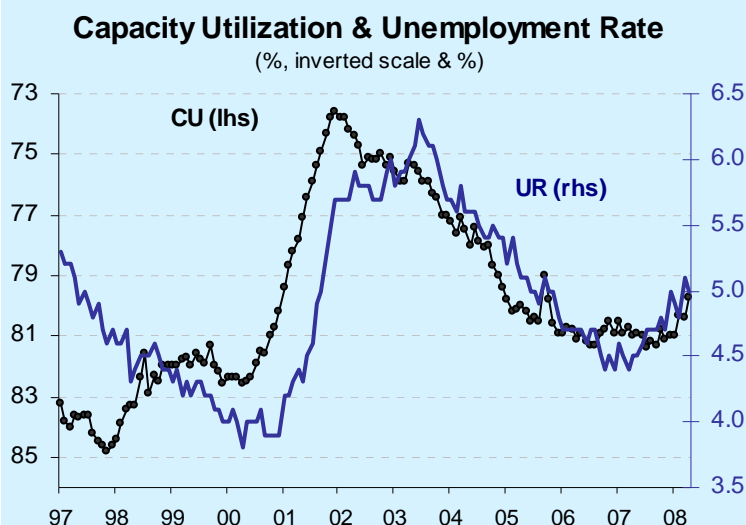
## Import prices



### Import prices continued on an upward trend

Excluding petroleum, import prices increased an additional 1.1% in April. This magnitude is as large as the record-high monthly increase observed in March. Accumulated inflation for imports (ex. Petroleum) was 6.2% yoy. Despite that the real exchange rate appreciated in April, the dollar remains extremely weak with respect to other currencies. This scenario is likely to continue in coming months, adding pressure to domestic inflation.

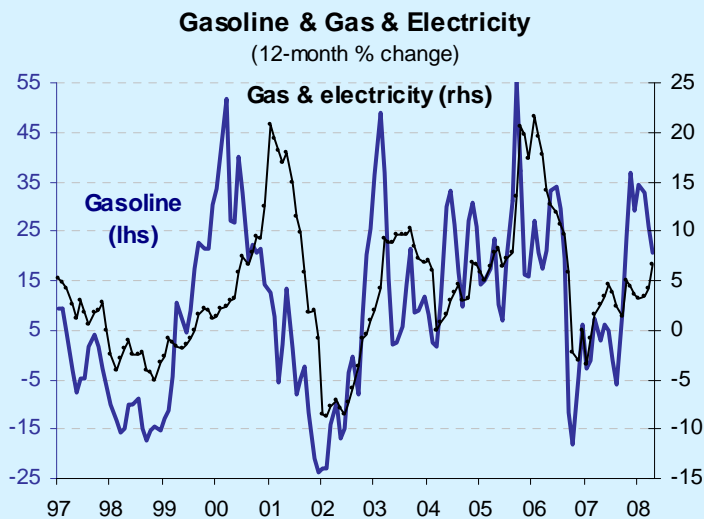
## Economic Slack



### More slack in the economy will help to contain inflationary pressures

Although the unemployment rate fell from 5.1% in March to 5.0% in April, the trend continues to be of ever higher unemployment. In addition, industrial capacity utilization has been moderating since November 2007. These trends are a clear indication of a slowing economy, which will help to contain inflation throughout this year. But these forces will not eliminate accumulated pressures, they will rather postpone "everything else equal" inflationary outcomes to 2009-10

## Energy Prices



### Energy prices continue to be risky

The price of oil keeps breaking new records, transmitting inflationary pressures to the rest of the economy. On May 13th, the price of oil reached a record high \$126.98 per barrel on the New York Mercantile Exchange. Although, prices have gone down since then, we think that oil prices will remain high for some time due to structural factors like strong economic growth in some emerging economies. However, as the global economy moves into a period of slower growth, oil prices should eventually stabilize.

## Inflation Expectations



### Short-term inflation expectations have climbed

Boosted by persistently high energy and food prices, consumer inflation expectations twelve-months ahead continued to climb to 4.8% in April from 4.3% in March and 3.6% in February. However, expectations in the mid- and long-term remained contained. Philadelphia-Fed 10-year inflation expectations stood at 2.5% in 2Q08. This is in line with inflation expectations as priced in the bonds market, which have not moved much.

## Forecasts

CPI Forecasts					
		CPI		Core	
		12-month	M/M*	12-month	M/M*
2007	Dec	4.1	0.4	2.5	0.2
2008	Jan	4.3	0.4	2.5	0.3
	Feb	4.0	0.0	2.3	0.0
	Mar	4.0	0.3	2.4	0.2
	Apr	3.9	0.2	2.3	0.1
	May	3.7	0.3	2.3	0.2
	Jun	3.8	0.3	2.3	0.2
	Jul	3.6	0.0	2.1	0.1
	Aug	3.8	0.3	2.1	0.2
	Sep	3.8	0.3	2.1	0.2
	Oct	3.8	0.3	2.1	0.2
	Nov	3.1	0.3	2.0	0.2
	Dec	3.0	0.3	2.0	0.2
2007		2.9		2.3	
2008		3.7		2.2	
2009		2.5		2.4	

\* Seasonally-adjusted

### Core Inflation Forecasts

