Economic Research Department

BBVA

Inflation Observatory

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Headline inflation remains unchanged in July

- Food and energy prices depressed headline inflation
- Core price increases are modest but widespread
- Inflation will remain low, with no upward pressure

Core component price increases are widespread

July's headline consumer prices exhibited no change after jumping up 0.7% in June. In total, food and energy subtracted 0.1pp from headline inflation. While surging gasoline prices added 0.7pp to the total index in the prior month, July's 0.9% drop in prices had a negligible effect. Furthermore, prices of household fuels fell 0.3% for the twelfth month in a row and food prices dropped 0.2% for the fifth time in the past six months. On a year-over-year basis, food prices are still 1.0% above those of last year, but energy prices are 28.1% below those of twelve months ago. As a result, headline inflation has fallen 2.1% yoy, the largest decline since October 1949.

Excluding food and energy, core inflation rose 0.1%, down from 0.2% in June. Price increases were fairly widespread across the major components. Core commodities rose 0.2% as apparel increased 0.6% driven by price increases in women's and girl's apparel and footwear. Prices of new and used cars also rose 0.2% along with a 2.1% increase in tobacco and smoking products, a 1.3% rise in educational books and supplies and a 0.4% increase in personal care products. Core services, on the other hand, exhibited no change as increases in medical care, transportation, household operations and water and sewer trash collection services were compensated for by a 0.1% drop in shelter. Shelter was brought down by the 1.6% decrease in lodging away from home, while rent and owner's equivalent rent did not change. Core inflation fell 1.6% yoy in July and has averaged 1.7% yoy thus far in 2009, which is in line with our baseline scenario.

Falling wages could keep inflation low

Although headline inflation has been persistently decreasing compared to last year, the effect could be transitory because it is primarily due to energy prices. Core inflation, on the other hand, is in line with our scenario of low but positive inflation for 2009. In addition, there are not any indications that core inflation will increase. It has been exhibiting a downward trend for the past eleven months and downside risks remain, such as signs that wages could be falling as exhibited by the declining trend in the employee compensation component of the BEA's personal income report. This effect, along with steady inflation expectations will keep core inflation low and contain potential pressures that could arise from fiscal and monetary stimuli. Furthermore, economic slack is expected to persist for some time, leading us to believe that the Fed will not raise interest rates for a prolonged period.

CPI Forecasts

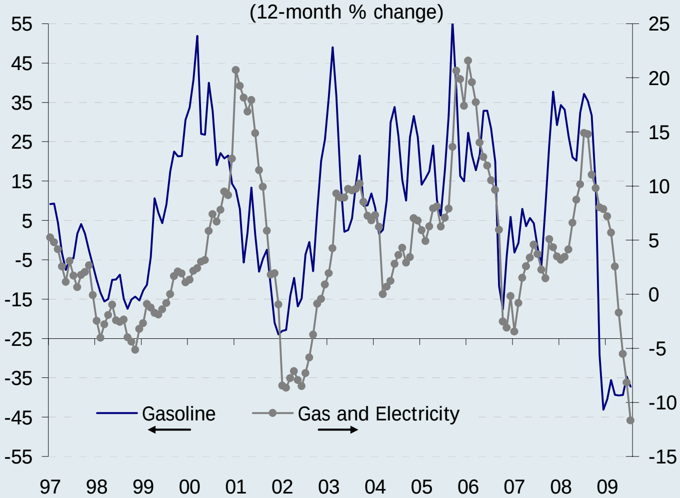
	Headline		Core	
Date	mom	yoy	mom	yoy
Jan 09	0.3	0.0	0.2	1.7
Feb 09	0.4	0.2	0.2	1.8
Mar 09	-0.1	-0.4	0.2	1.7
Apr 09	0.0	-0.7	0.3	1.9
May 09	0.1	-1.3	0.1	1.8
Jun 09	0.7	-1.4	0.2	1.7
Jul 09	0.0	-2.1	0.1	1.6
Aug 09	**0.0**	**-1.9**	**-0.3**	**1.0**
Sep 09	**0.1**	**-1.8**	**0.0**	**1.0**
Oct 09	**0.0**	**-1.0**	**0.1**	**1.0**
Nov 09	**0.1**	**0.8**	**0.1**	**1.1**
Dec 09	**-0.7**	**0.9**	**0.1**	**1.1**
2008		3.8		1.4
2009		**-0.7**		**0.9**
2010		**1.1**		**1.2**

*Forecasts are in bold

Headline CPI is declining due to steep drops in energy prices compared to 2008, but the effects should only be transitory.

Gasoline and Gas & Electricity

(12-month % change)

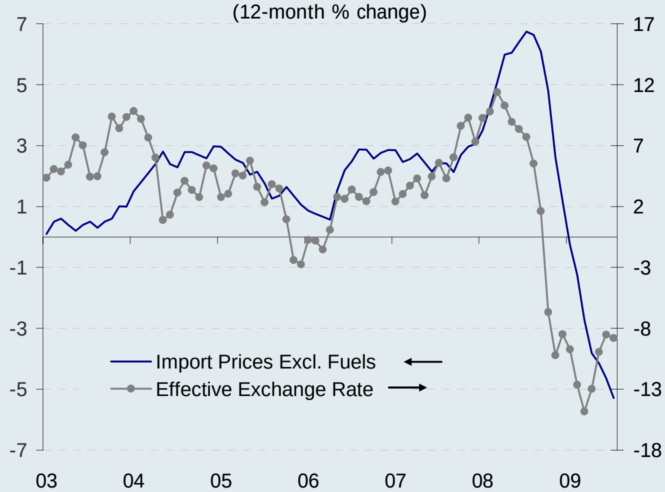


Source: BLS

The discounted exchange rate will help to keep import prices low, curbing any inflationary pressures.

Import Prices & Effective Exchange Rate

(12-month % change)

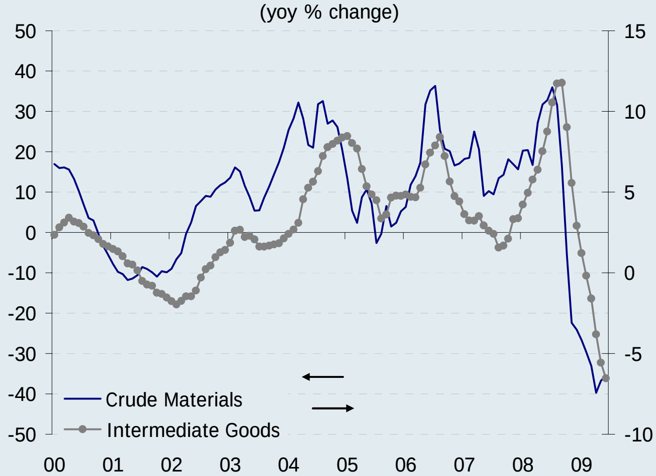


Source: BLS

Falling non-wage production costs will allow producers to maintain profits without raising consumer prices.

Core Producer Price Indices

(yoy % change)

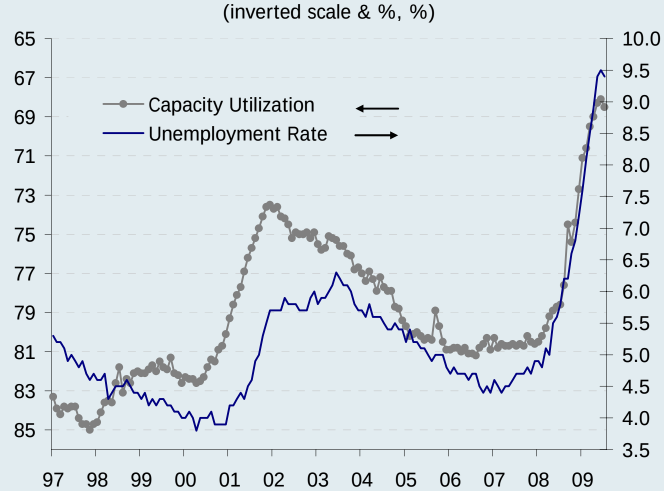


Source: BLS

Persistent economic slack will keep inflation low and justify maintaining the target Fed Funds rate for a prolonged period.

Capacity Utilization & Unemployment Rate

(inverted scale & %, %)

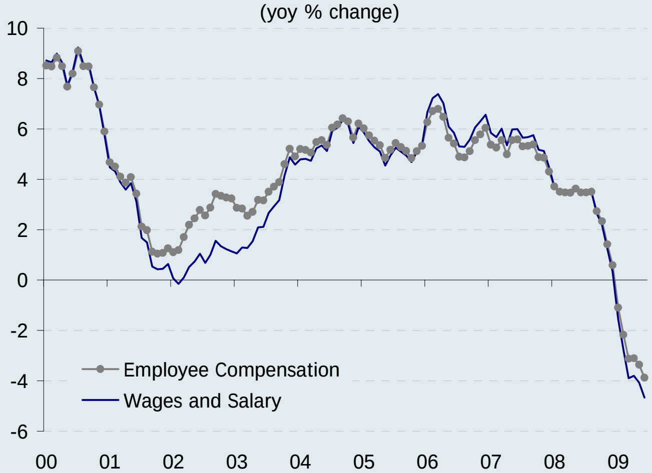


Source: BLS & Federal Reserve

Falling wages, producers' primary cost, are declining, which could eventually put downward pressure on inflation

Employee Compensation

(yoy % change)

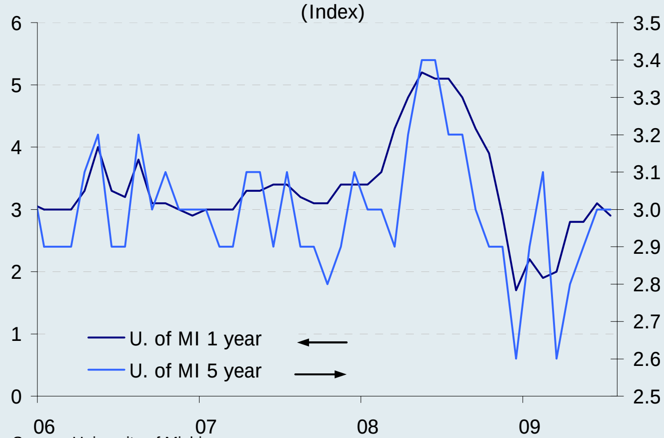


Source: BEA

Inflation expectations remain stable, counteracting downward pressures from wages.

University of Michigan Inflation Expectations

(Index)



Source: University of Michigan