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"INFLATION – WHERE IS IT GOING? DOES IT EXIST?"

Over the past few weeks, we have witnessed a remarkable tug of war between a number of spokesmen for the Federal Reserve Board and investors in the stock markets. The causes of the to and fro are plain – inflation and what the Fed intends to do about it. Beyond that, not much is clear, and that lack of clarity is troublesome.

To begin with what we all know, the prices of energy have soared over the last year. It didn't take an economic genius to predict that those increases would result in a hike in the Consumer Price Index, since energy is an element in the bundle of costs going into the CPI. What was not known was how much of an effect higher energy prices would have on other ingredients in the CPI bundle, the so-called "core" prices, which exclude energy and food.

The answer to that question was delivered, at least in part, when the CPI data for May, 2006 were released earlier this month. They showed that the core index increased 0.3% for the month and 2.4% for the last 12 months. For the five months of 2006, the increase was 3.1%, compared with 2.2% for all of 2005.

None of this was too surprising, given the almost inevitable pass through of higher energy prices (and, as we in the steel industry know well, the increase in the costs of other commodities, like scrap, coke and alloying metals). What was surprising is what we heard from the Fed over the following few days:

- Fed Chairman Bernanke stated that high energy prices had not unduly increased expectations of inflation and had not significantly adversely affected the economy or the costs of other goods. While he added that "developments bear watching," his remarks sent the stock markets soaring. (In contrast, his statement ten days earlier that the Fed would take all necessary action to prevent inflation from spreading through the economy sent the markets reeling.)

- Fed Governor Randall Kroszner stated that inflation was "within manageable ranges" and that growth would be less robust during the rest of 2006. Cooling of the economy could ease inflationary pressures. (The Fed's business climate survey showed signs of deceleration and noted that retailers had been able to raise prices in only three of the twelve districts surveyed.)

- Fed Governor Susan Bries stated that core inflation was above her comfort range.

- President of the St. Louis Fed Bank, William Poole, said that the present situation was "absolutely not dangerous" and that pass-through statistics had not shown "significant effects in U.S. price data." But he also suggested that the statistics were understating actual inflation, as pressure from high energy prices percolated through the economy.

- President of the Dallas Fed Bank, Richard Fisher, stated that the current rate of core inflation was "unacceptable" and that the fight against inflation should be "relentless."

- President of the Boston Fed, Cathy Minehan, pointed out that globalization was working to keep U.S. inflation low and may be more effective than monetary policy.

- New Fed Vice Chairman Fred Kohn stated that "inflation expectations have come a little bit unhinged." He suggested that the Fed would need some way of "anchor[ing] expectations" within the general public.

None of these comments is particularly remarkable, and the fact that they show some divergence of views within the Fed is not surprising. But taken together, they suggest that the Fed might do better with a policy of actions rather than words, or at least speaking through fewer voices. Many of the comments address a perception that the public is beginning to assume the inevitability of inflation, which could be a self-fulfilling prophecy. Whatever the chances of that occurring, the greater peril could come from lack of confidence in the Fed. Certainly, the gyrations in the stock market seem less concerned with actual inflation than about the uncertainties of the Fed's tactics.

Of course, bellicosity on inflation is a good thing if there are serious dangers abroad. But many economists suggest that the relatively insignificant effect of energy increases on other prices, coupled with the absence of much evidence of the wage and price spiral we saw in the 1970's, make the true problem a possible overreaction by the Fed to imagined inflation.

Some specifics from last month:

- <u>Scrap, Pig Iron and Ore</u>. Scrap prices continued their rise and are getting back to the nose bleed levels of late 2004. Number 1 dealer bundles are at $355 per mt and #1 busheling (Chicago) reached $345 per mt. These prices represent increases of about 50% since last January and are uncomfortably close to the $400 plus levels we saw 18 months ago. High export demand appears to be playing an important role in the climb.

Meanwhile, pig iron prices are back to the bad old days. The spot price for Brazilian pig iron (cif New Orleans) reached $355 per mt, the highest price ever with the exception of November, 2004. Brazilian iron ore producers have entered into deals with European, Japanese and Korean steel makers calling for 19% price increases. The Chinese have been holding out for no increase, but they are under pressure to relent because of the success the Brazilians have had with other buyers.

- Ocean Freight. The Baltic Capesize Index was up a tick last month to 3176, but it continues to be well below earlier levels.

- Natural Gas. The Nymex contract price slipped a bit to $6.48 per mcf. This is the lowest price since February, 2004 and appears to result from substantial inventories due to last winter's mild temperatures.

- Exchange Rates. At this writing, the dollar has strengthened since last month. The euro declined from $1.28 to $1.26, and the pound from $1.88 to $1.84. The Canadian dollar remained unchanged at 89¢.

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