Inflation Jump Poses Dilemma for Rate Setters

Fed Officials Balance Slowdown, Elevated Prices

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WASHINGTON -- U.S. consumer prices increased across the board last month and the housing downturn deepened, a worrisome sign for Federal Reserve officials who must balance a sharp slowdown in economic activity with stubbornly elevated price pressures.

The inflation data likely won't deter Fed officials from lowering official interest rates again next month, as guarding against housing-induced recessionary risks remains their top priority. But the figures could limit the size of future rate cuts or spur officials -- once the economy stabilizes -- to raise rates sooner than they otherwise would in order to maintain the public's confidence that they will keep inflation under wraps.

The consumer price index rose 0.4% in January, the Labor Department said Wednesday. The core CPI, which excludes volatile food and energy prices, advanced 0.3%. The data exceeded Wall Street forecasts. Unrounded, the CPI rose 0.395% last month. The core CPI advanced 0.311% unrounded.

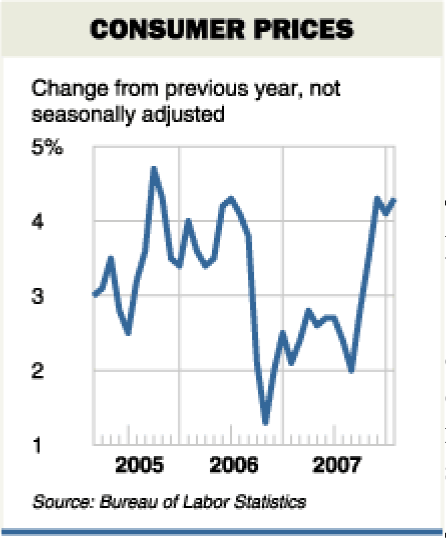
In a separate report, the government said housing starts eked out a 0.8% gain to a seasonally adjusted 1.012 million annual rate in January, after plummeting 14.8% in December to 1.004 million, the Commerce Department said Wednesday. Single-family starts and permits fell to 16-year lows, a sign of more pain ahead.

Wednesday's data "reflect the [Federal Open Market Committee's] disturbing dilemma -- further signs of weak growth coupled with persistent inflation pressures," said Richard Moody, chief economist at Mission Residential, in a research note.

Consumer prices rose 4.3% on a year-over-year basis, matching the biggest increase since September 2005. The core CPI grew a more modest 2.5% compared to January 2007, but that was still the highest annual rate since last March. Over the past three months, core inflation has risen at a 3.1% annual rate.

That's well above the top end of the Fed's presumed comfort zone of around 1.5% to 2%. The Fed's preferred gauge, the core price index for personal consumption expenditures, is closer to that range at 2.2% annual growth through December.

Amid growing evidence that housing and credit strains are filtering through the broader economy, the Fed is expected to lower the fed funds rate at which banks lend to each other by one-half percentage point to 2.5% at next month's Federal Open Market Committee meeting.



The CPI data should at a minimum slam the door on any hopes for a larger cut and put a smaller 25-basis-point reduction in play.

"The Fed will retain its forecast of a gradual decline in inflation and will continue to ease monetary policy," said Roger Kubarych, chief U.S. economist at UniCredit Markets and Investment Banking, in a research note. "But a more cautious policy approach may be in the offing," he said.

The FOMC has lowered the fed funds rate by 225 basis points since September even as inflation has climbed steadily higher.

In Congressional testimony last week, Fed Chairman Ben Bernanke said he expects sluggish economic growth ahead and moderating inflation. But the latter scenario may not unfold even if the economy slows. Import prices have soared in recent months, especially from China, once a source of cheap imports. Oil prices, meanwhile, closed above $100 per barrel for the first time on Tuesday, suggesting risks to both headline and core inflation in coming months.

As Fed Governor Frederic Mishkin noted in a speech last week, "careful monitoring of the incoming data on inflation and inflation expectations will continue to be necessary, especially given the potential risks to price stability that are associated with the rapid increase in energy prices and the depreciation of the dollar."

If higher inflation feeds significantly into the public's expectations for future trends, then the Fed "must be ready to hold steady or even raise" interest rates, Mishkin said.

Energy prices last month increased 0.7% compared to December, according to Wednesday's report. Gasoline prices advanced 1.2%, and electricity prices fell slightly. Food prices rose 0.7% on the month and 4.9% versus one year ago.

Medical-care prices, meanwhile, increased 0.5%, while clothing prices were up 0.4%. Transportation prices jumped 0.5% on the month, and airline prices soared 0.8% reflecting the secondary effects of higher energy prices. New vehicle prices were down 0.3%.

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Housing, which accounts for 40% of the CPI, was up a modest 0.2%. Rent increased by 0.3%, as did owners' equivalent rent. Lodging away from home rose 1.1%. Household energy prices fell slightly.

In a separate report, the Labor Department said the average weekly earnings of U.S. workers, adjusted for inflation, fell 0.5% in January, suggesting worker paychecks aren't keeping pace with inflation, which could in turn drag down spending. Average hourly earnings increased 0.2%, and average weekly hours were down 0.3%.

Housing Starts Rose in January

The increase in housing starts -- the first since October -- was a little smaller than Wall Street expected. The median forecast of economists surveyed by Dow Jones Newswires was a 1.4% climb to an annual rate of 1.020 million. Year over year, housing starts during January were 27.9% below the level of construction in January 2007.

Builders are restrained by plunging sales. The latest government report on new-home sales in the U.S. showed demand in December tumbled by 4.7% to a seasonally adjusted annual rate of 604,000, the lowest pace in 12 years. Year over year, new-home sales were 40.7% lower than the level in December 2006.

A report Tuesday showed builders gained a little confidence about the market this month -- yet still remain wary. The National Association of Home Builders' index for sales of new, single-family homes rose in February, up to 20 from 19 in January, yet far below a reading of 39 in February 2007. The index surveys builders about sales prospects now and in the near term.

Building permits decreased 3.0% to a 1.048 million annual rate in December, the Commerce Department said Wednesday. Economists had expected a permits rate of 1.040 million. December permits fell 7.1% to 1.080 million. The rate of 1.048 million was the lowest since 984,000 in November 1991.

January single-family housing starts decreased 5.2% to 743,000. Construction of housing with two or more units rose 22.3% to 269,000; within that category, groundbreakings of homes with five or more units -- or multifamily -- were 17.6% higher.

Regionally, housing starts rose 12.0% in the Midwest and 18.9% in the Northeast. Starts fell by 6.2% in the West and 2.9% in the South. Nationwide, an estimated 64,500 houses were actually started in January, based on figures not seasonally adjusted. An estimated 74,900 building permits were issued last month, also based on unadjusted figures.

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