



Inflation Observatory

December 18th 2008

Inflation declined sharply

- Declines in energy prices drive down headline inflation
- Core inflation remains in line with our forecasts
- Downside risk to the inflation outlook have increased

Downward pressures on inflation intensified

In November headline consumer prices declined 1.7%. Food prices moderated 0.2%, the lowest since January 2008. This was largely the result of a reduction in meat and fruits. Energy prices dropped 17%, the sharpest fall since the series was first recorded in 1957, strongly influenced by a -28.6% decline in motor fuel. In December, gasoline prices have averaged \$1.81 per gallon, a 7.3% decline from November and 41.7% below the previous 12 months. Therefore, the next release is likely to show a 1% decline in headline inflation. These trends could persist if sluggish economic growth continues to reduce demand for fuels. The 12-month change in headline CPI was 1.1% (after reaching 5.6% in July), the lowest rate since Jun-2002 and the second lowest since Mar-1965.

Core inflation was unchanged in November. Apparel rose 0.3% from -1% in the previous month, while the index for shelter picked up 0.2% due to a 0.3% increase in owners' equivalent rent. These trends were offset by a 0.9% reduction in vehicles and a 2.7% decline in public transportation. Prices of medical care, education and communication kept a sustained rate of growth, while those of recreation were unchanged. As a result, core commodity prices decreased 0.2%, the third consecutive decline while core services edged up 0.1%, well below the 0.2% average of the past twelve months. On a year-over-year basis, core inflation was 2%, the lowest rate since Sep-2005.

Risks increase to the downside

November's core inflation reading came in line with our scenario for 2008-09. Thus, we continue to expect core inflation to remain low for several more quarters, particularly as prices of core goods (autos, apparel, appliances, etc.) edge down further. However, core services will more than offset these pressures keeping core inflation away from a deflationary environment. Nonetheless, energy prices volatility increases the uncertainty surrounding the headline inflation outlook. The sharp fall in energy prices during December could result in a 1% decline in headline prices. This will imply an accumulated decline of 3.7% in the CPI between July and December. If energy prices decline further or even if they remain stable, there is a high probability that year-over-year headline inflation will be negative as soon as December and remain below zero for several months in 2009.

