BEIGE BOOK REPORT

Upbeat Fed Sees U.S. Economy Improving and Inflation Tame

Interest Rates Are Likely To Be Kept Low for Now; Producer Prices Inch Up

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In a generally upbeat assessment of the economy's performance in recent weeks, the U.S. Federal Reserve said anecdotal reports from its 12 district banks showed that the nation's economy is continuing to improve, and that holiday sales were "positive across the country."

The Fed report, known as the "beige book," also said that prices charged by retailers and manufacturers were "generally steady," despite increases in raw-materials costs. The point seemed to suggest that Fed officials believe inflation remains tame enough to keep interest rates low for now. The Fed's next policy meeting is Jan. 27 and 28.

Touching on a similar point, the Labor Department said in a separate report that producer prices, which are the prices charged by manufacturers, increased in December after declining the month before. But there were few signs in the price index that the improving economy had given manufacturers much leverage to raise prices.

Producer prices rose 0.3% on a seasonally adjusted basis in December after a 0.3% decline in November. The increase was driven largely by a 1.8% gain in energy prices, which rebounded after three straight monthly declines. Excluding the volatile food and energy sectors -- which economists believe gives a more reliable indication of inflation trends at the wholesale level -- prices fell by a seasonally adjusted 0.1% for the second straight month, largely because of a drop in light-truck prices.

The government's latest inflation figures showed that the risk of deflation, or persistently falling prices, has subsided in recent months. Wholesale prices were up 4% in December from a year earlier, largely because of increases in energy prices. With food and energy prices excluded, prices were up 0.9% in

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December from a year earlier, after registering declines early last year.

Yet manufacturers have been severely limited in their ability to pass on sharp increases in raw-materials prices. Input prices on materials ranging from natural gas to wastepaper to iron have each risen by 8% or more in the past 12 months. However, output prices on products ranging from cars to footwear to paper machines have each risen by less than 2%.

This puts some pressure on profit margins. But David Greenlaw, an economist with Morgan Stanley, said that many manufacturers have been able to offset this squeeze by keeping a tight grip on labor costs, which are a much bigger component of their overall cost structures. He added the inability to raise prices means "the focus on efficiency gains and cost cutting, and trying to focus on the cost side of the equation, will continue."

Underscoring that point, the Fed's beige-book report noted that "wage pressures remained generally subdued."

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