Munk Advisory Services

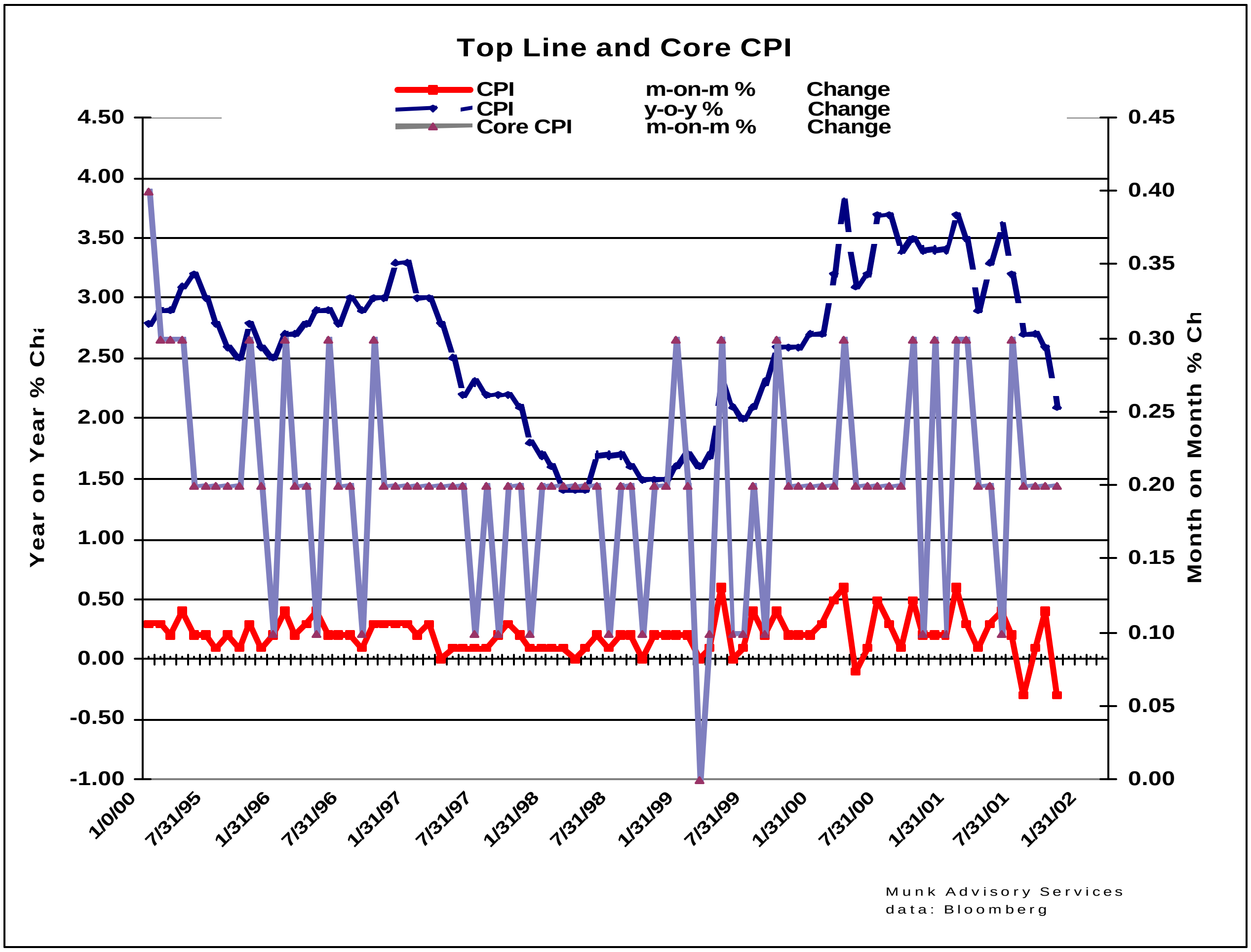
ECOMENTARY™

MAS111601

CPI Changes Are An Energy Story: more good news coming?

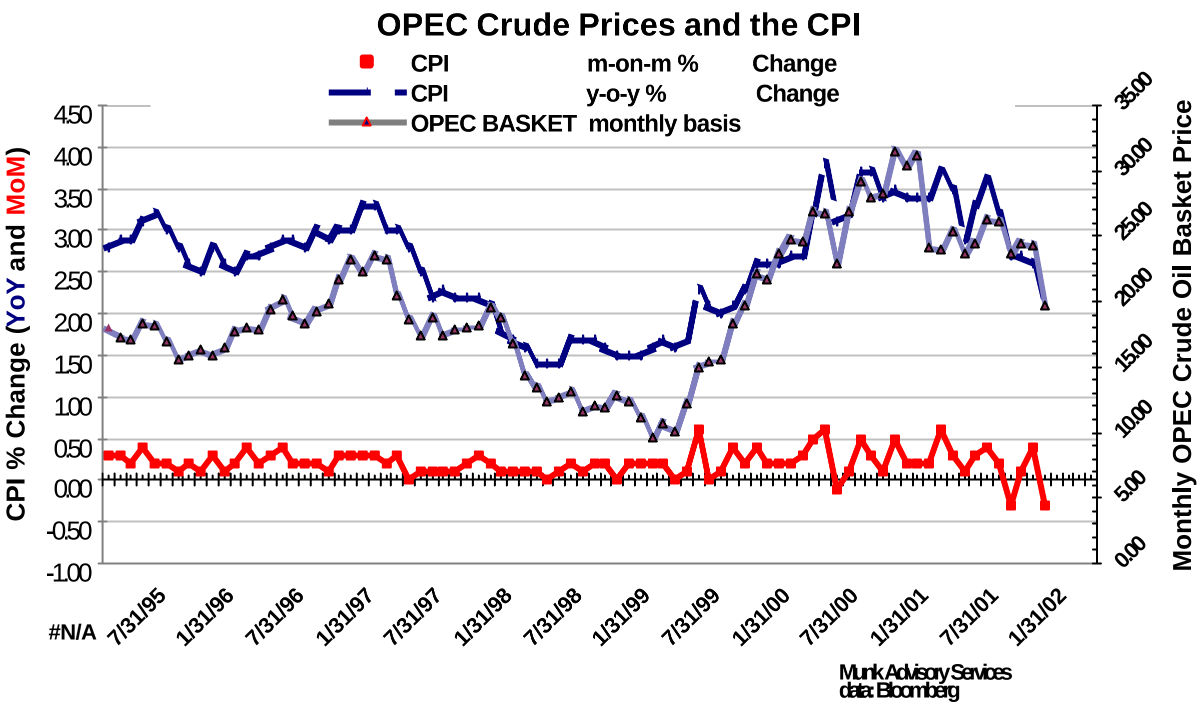
The collapse in energy prices dominates the CPI data released today with energy prices falling **6.3%** for the month or at an annual rate of **54.6%** (It should only happen!) Rising prices were seen in food and beverages (0.5), medical care (0.4) and education and communication (0.6).

Underlying the collapse in oil prices are two factors: the terror-induced reduction in air transportation and the effect of aggregate demand reductions on the use of energy in all forms. As a result, the price of crude oil and petroleum product prices have fallen sharply. The gasoline price index has fallen 20.8% since peaking in May.



The effects of the oil price drop can also be seen in the fall in the transportation component of the CPI for the month (2.2%) as compared to the prior month's rise of 1.6%. While the top line CPI fell, the CPI adjusted for energy and food **did not change its monthly growth rate of .2%.**

Year on year top line inflation has not been as low as this (2.1%) since July 1999. Interestingly enough, with the inability of OPEC to agree on a production cut, and the lack of cooperation from significant non-OPEC producers such as Russia and Norway, some optimists think crude oil may revisit the **collapse** scenario of 1998. Today's recovery on the Merc suggested that some 'cuts' will still come out of the discussions, even if delayed until January.



Crude prices have fallen dramatically and with the U.S. economy trying to get out of recession, and a further reduction in crude and product prices to the levels of 1998 or first half 1999 would create a huge transfer of income from oil producers to oil consumers. In the fall and winter of 2000, the OPEC crude price basket varied between a low of $28 and a high of over $34 per barrel. In the week following the **Attack,** the OPEC crude price exceeded $27 per barrel, but had fallen this week between $16 and $19.70 per barrel. If the current prices prevailed for the next year, that would be a drop of between $10 and $15 per barrel. A $12.50 per barrel reduction in the price of crude puts some 50 Billion of purchasing power (net of production income lost to domestic producers) in the hands of business and consumers. If prices returned to end 1998 levels, that number would increase to more than 75 Billion. Furthermore, a reduction in the price of crude would impact other sources of energy, although the benefits come only from the quantities of imported natural gas. Needless to say, however, 50-75 Billion dollars of purchasing power is like an extra tax cut---without the incessant wrangling of the two parties in Congress.

In fact, much of the top-line CPI behavior over the last year has been dominated by the petroleum story. A cartel of state-run oil companies can hurt! Non-competitive pressure influenced by geopolitics is a volatile mixture. The top line CPI numbers quite strikingly mirror the crude price (with hardly a lag) while the monthly CPI data show that rising crude plays a role month-to- month.