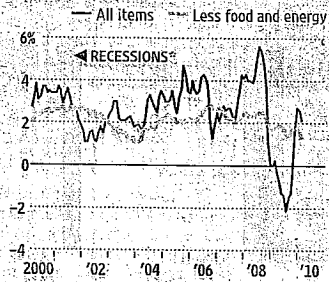


Economy's Excess Capacity Reins In Prices

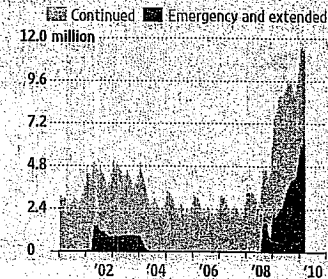
Latest Data Give Fed Room to Maintain Rock-Bottom Interest Rates; Initial Jobless Claims Decline for Third Straight Week

Inflation Remains in the Background

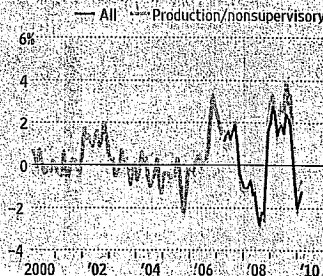
Consumer-price gains are modest. Change from a year earlier in consumer-price indexes



and with so many out of work. Claims for unemployment insurance benefits



wage growth is trailing inflation. Change from a year earlier in real weekly earnings of private industry workers



*WSJ survey of economists forecasts that the most recent recession ended in June. †Adjusted for inflation and the seasons

Source: Labor Department



People wait in line to attend a job fair in Brooklyn, N.Y., on March 10.

By CONOR DOUGHERTY

The vast economic slack left over from the recession continues to keep inflation in check, leaving companies and workers with little leeway to ask for price or wage increases.

Consumer prices were flat in February—and even with volatile food and energy removed from the equation, the needle barely moved: Prices ticked up a scant 0.1%, the Labor Department said Thursday. Over the past year, prices have increased 2.1%, or 1.3% omitting food and energy, the smallest rise in six years.

Behind these numbers stands a huge excess—of workers, factory space and homes. Until more of the nation's productive capacity comes into use and starts pulling workers off the unemployment line, the sellers of everything from golf clubs to paving machines have little ability to raise prices. The problem is exacerbated by continued

tightness in credit, which makes it harder to rev up economic growth through bank lending to soak up the economy's lingering slack.

"Everybody's talking about inflation, but we're not seeing anything yet, at least not in any major or consistent way," said Dyke Messinger, chief executive of Power Curbers Inc. of Salisbury, N.C., which makes equipment that lays curbs and sidewalks. Power Curbers' business is off some 65% from pre-recession levels, Mr. Messinger said. The firm hasn't raised prices in three years and still relies on discounting to make sales.

Thursday's report showed weakness across a range of categories. Owner's equivalent rent, a measure of home costs that is by far the CPI's largest component, was flat in February. Weak home prices and a glut of homes for sale have held down shelter costs. Apparel fell 0.7% last month and personal computers

fell 0.5%.

Low inflation is a global phenomenon. Euro-zone inflation, excluding food and energy, is up 0.8% from a year ago, the lowest reading since at least 1991, according to J.P. Morgan Chase & Co. Japan, meanwhile, has seen prices excluding food and energy fall 1.1% over the past year.

Inflation trends are closely watched by the Fed, which has said it will keep short-term interest rates near zero for an "extended period," meaning at least several more months. But the central bank's stance holds only as long as inflation stays low, inflation expectations remain stable and the economy is burdened by lots of slack.

The inflation data come at a crucial moment, too: Fed officials have intensified an internal debate in recent weeks about when and how to change its terminology to signal that interest rate might be boosted down the road. Soft inflation readings

strengthen the hand of those arguing that it is too early to shift the stance.

"There is still a lot of unemployment and excess capacity all over the place," said Kenneth Rogoff, an economics professor at Harvard University. "In the short term, deflation is much more the risk."

Some analysts and investors see inflation as inevitable in the longer run, the result of huge government budget deficits and the Fed's lax credit policies. There also are concerns—both inside and outside the Fed—that the economy may have less surplus capacity than seems apparent, since some unused capacity will never be brought back online. In addition, wages aren't keeping pace even with this tame inflation: Real average weekly earnings fell 0.2% in February from January. Over the past six months, average weekly earnings have been essentially unchanged.

The combination of weak prices today and a fear of high prices tomorrow has sowed uncertainty at many businesses. Robinson Helicopter in Los Angeles spends about \$250,000 a year on thin aluminum sheets that are fashioned into the company's four-seat helicopters. Prices are about where they were last year, but Kurt Robinson, the company's vice president of product support, said he has been unable to get a supply contract going out more than three years. In the past the company signed five-year contracts.

"The concern is that inflation will take off and they get locked into a low price," he said. "People don't want to go as far out."

One incentive for Washington to tolerate a little more inflation: The White House budget office estimates a one-percentage-point increase in the inflation rate above its current estimates, sustained for 10 years, would reduce the federal budget deficit by

\$462 billion over 10 years even if interest rates rose one percentage point over the same period. Higher inflation raises government receipts more than it increases government spending.

A separate report Thursday showed the number of workers filing new claims for jobless benefits fell slightly for the third consecutive week. The Labor Department said initial claims fell 5,000 to 457,000 in the week ended March 13. The previous week's level was left unrevised at 462,000. The four-week moving average—which aims to smooth volatility in the data—fell 4,250 to 471,250 from the previous week's unrevised average of 475,500.

Finally, the Conference Board's Leading Economic Index increased 0.1% in February, following a 0.3 percent gain in January, pointing toward a slow economic recovery.

—Jon Hilsenrath contributed to this article.