

ECONOMICS: US PERSPECTIVES—OCTOBER 1, 2010

Is US Inflation Too Low?

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The ongoing slowdown in the core rate of consumer prices has become an area of concern for policymakers. Although there is no doubt that inflation is low, we believe traditional consumer price measures are not the best gauge of inflation trends across the US economy.

Federal Reserve policymakers are fretting about inflation being too low. On September 21, the Federal Open Market Committee (FOMC) explicitly said that US inflation is running below optimal levels. Although these comments echoed remarks by Federal Reserve Chairman Ben S. Bernanke from late August, it was the first time that an official statement by the committee responsible for setting interest rates explicitly pointed to low inflation as a potential problem for the US economy.

According to the statement, “measures of underlying inflation are currently at levels below those the Committee judges most consistent, over the longer run, with its mandate to promote maximum employment and price stability.” The implication is clear: policymakers are likely to cite low inflation to justify another round of quantitative easing measures, aimed at engineering even lower market rates, when the FOMC next meets on November 2 and 3. But we think a closer look at the inflation metrics is warranted before the Fed rushes to shift monetary policy at a

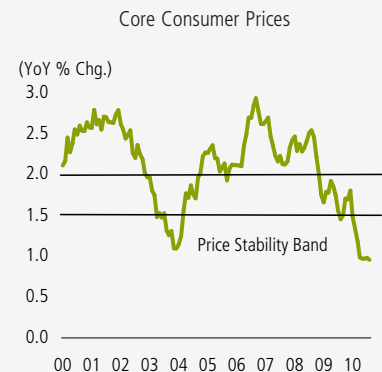
sensitive moment for the US economic recovery.

Understanding Inflation Metrics

When the Fed comments on the inflation environment, the metrics that shape their views are the core consumer price index (CPI), or its sister index, the core personal consumption deflator (PCE), which is derived from the CPI series. The core CPI has risen 0.9% (**Display 1**), year on year, the weakest twelve-month change since 2004, and well below the 1.5% to 2.0% band that policymakers consider to be consistent with price stability.

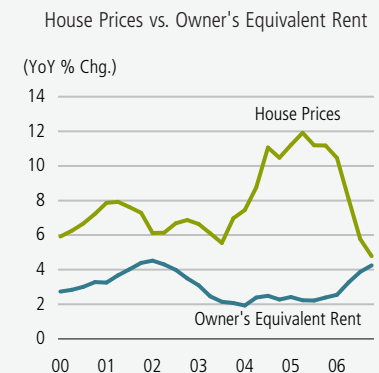
Based on the core CPI, inflation is undeniably low. But it’s not quite so clear how low inflation is in historical context, or what is the best data series to monitor price trends. We have long argued that following a single price series is problematic because a single measure cannot capture all of the important price signals in the economy. In addition, we believe the CPI may not be the best series to monitor for several reasons.

Display 1
CPI Inflation Looks Extremely Low



As of August 2010
Source: Bureau of Labor Statistics and Haver Analytics

Display 2
Rent Index Distorts CPI Inflation



As of December 2006
Source: Bureau of Labor Statistics, Federal Housing Finance Agency and Haver Analytics

Two Problems with CPI

First, the CPI series is not a continuous series. Since 1998, the Bureau of Labor Statistics (BLS) has made adjustments every month for product substitution, quality changes and new store outlet bias. BLS estimates suggest that these changes subtract roughly 0.8% per year off the core rate of inflation, but nobody knows whether these changes increase or decrease over time. Still, when accounting for these statistical adjustments, a core rate of inflation today of 0.7% to 1.5% is consistent with CPI gains of 1.5% to 2.3% before 1998.

Second—and perhaps most importantly—the core CPI is dominated by the owners' equivalent rent index (**Display 2, previous page**), which makes up about 30% of the core index. This index is not based on actual market prices, but represents an estimate of what homeowners could receive in rent for their house. This house-based price series has received plenty of attention and criticism from economists and analysts over the years. In our view, the house price series is an appropriate component of a cost-of-living index, but it should not be included in a price series used by policymakers to monitor underlying price trends in the economy.

In fact, as it is today, the CPI has more in common with a cost-of-living index than a price series, which is why we think it is not the right index for the Fed to use as a compass for monetary policy. Core consumer prices—excluding the owners' equivalent rent index—are a better gauge of underlying inflation trends. This measure is running 1.5% on a year-on-year basis (**Display 3**), which is still low, but within the Fed's so-called price stability band even if we don't make the statistical adjustment made by BLS over at least a decade.

Beyond the statistical issues, we think the core CPI, or its sister index the core personal consumption deflator, has even bigger credibility issues as a guide for

monetary policy. The problem is that stability in these two price measures has not been accompanied by general price stability in other parts of the economy. Indeed, in the most recent business cycle, despite stability in the traditional price series (core CPI and PCE) from 2003 to 2006, house prices were increasing at double-digit rates.

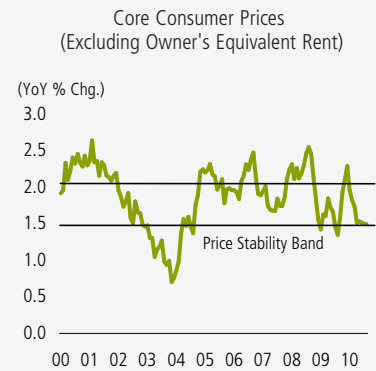
According to our analysis, if housing costs were measured based on prices and interest rates, as they were before 1982, the peak rate of increase in the core CPI in late 2005 and early 2006 would have been nearly double the published inflation gains (**Display 2** on OER vs. house prices). At the time, the Fed was gradually tightening monetary policy, moving interest rates up in increments of 25 basis points at every official meeting. Would policymakers have reacted differently if core inflation had been running at a rate of between 6% and 6.5% instead of the actual published CPI of 2% to 2.5%? We think they probably would have tightened monetary policy much more aggressively.

That point is not simply academic. Today, with the core CPI relatively low, the Fed is likely to put forward a strong case for a new round of quantitative easing. We think, however, that current broad inflation readings provide limited insight as guides to the future direction of prices and the appropriate monetary policy.

Keep Watch on Commodity Prices

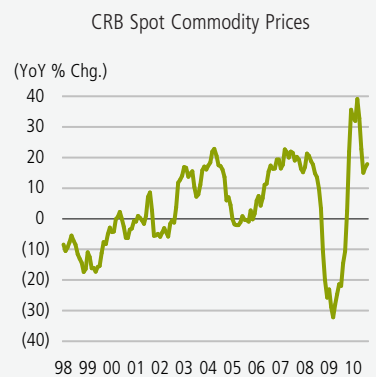
History shows that there is a significant lag between monetary policy changes and the effect on inflation. At this writing, all of the import and commodity price series that usually trigger consumer inflation cycles are rising, in some cases at a brisk pace (**Display 4**). Yet, we think policymakers are not paying enough attention to these crucial leading indicators of inflation. We have no doubt that additional quantitative easing measures are likely to fuel even larger gains in these sensitive price measures, and may lead to destabilizing price imbalances in the months ahead.

Display 3
CPI Is More Reliable Without Rent Index



As of August 2010
Source: Bureau of Labor Statistics and Haver Analytics

Display 4
Commodity Prices Are Rising Fast



As of August 2010
Source: Commodity Research Bureau and Haver Analytics

There's also a fiscal angle that must be considered in the Fed's deliberations. In our view, monetary policy moves must be weighed against the potential impact of fiscal policy changes on the economic environment. Monetary policy is not the reason that consumers and businesses remain hesitant to take risky decisions on spending, rather, it's the uncertainty surrounding tax policy in January 2011 that's holding them back. Since the full Congress will only decide on tax rates after the November 2 election, we think it would be prudent for policymakers to adopt a wait-and-see attitude before endorsing additional quantitative easing moves. ■

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