

The Inflation Update: December 2004

Stephen G. Cecchetti

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Waltham, Massachusetts

Big drops in gasoline and fuel oil prices caused a fall in the headline Consumer Price Index in December. Even though energy commodities account for only three-and-one-half percent of the CPI market basket, price declines in excess of 35% at an annual rate (a.r.) was large enough to drive the overall CPI down 0.6% (a.r.) for the month. By ignoring the high frequency fluctuations in oil prices, core measures show substantially less month-to-month volatility. The CPI excluding food and energy rose 1.8% (a.r.), while the Median CPI computed by the Federal Reserve Bank of Cleveland increased 2.1% (a.r.).

Looking over the entire year of 2004, the headline CPI rose 3.3%, while the core measures increased a more modest 2.3% and 2.4%. The first of these is important, since it is the basis for indexation provisions in government programs and things like Treasury Inflation Indexed Securities (so-called TIPS). To the extent that there is any sort of wage-price spiral left in the American economy, this is the number that would drive it. A high headline number could force up unit labor costs, posing an overall inflation risk, albeit a small one (even if you believe this stuff).

The detail in the report shows that inflation remains at a trend of slightly above 2%. Owner equivalent rent (OER) rose by 2.1% (a.r.) for the month, and is up 2.3% for the entire year. (Last month's extremely modest rise of 0.5% (a.r.) in OER was clearly an anomaly.) And we have to wonder when and how rents and home sale prices will converge. Will rents rise to match the recent double digit increases in housing prices; or will the residential real estate market collapse? It has to be one or the other, and regardless whether inflation rises or consumption falls, policymakers should be concerned.

As for monetary policy, this morning's inflation report is unlikely to have much net impact. The data provide balm for FOMC hawks—inflation doesn't appear to be increasing. At the same time these numbers give doves (the ones that are left) a reason to be slightly nervous—inflation doesn't seem to be returning to the very low levels of a year-ago. For Committee members more concerned with inflation, core goods prices (commodities excluding food and energy commodities) fell by nearly 1% for the month, well under their 12-month trend of 0.6%. And for those who felt inflation was steady or even falling, core services continue to rise at more than 2% per year, suggesting that the inflation trend is not improving. I expect 25 basis points per meeting increases in the federal funds rate for at least the next 4 meetings. At that point, with the policy-controlled interest rate at 3.5% we will be deep into a discussion about what level is neutral – is it 3.5%, 4%, or higher?

Consumer Price Inflation, Various Measures
(Through December 2004, all data s.a. at an annual rate)

Previous	All Items CPI	CPI ex Food & Energy	Median CPI
1 Month	-0.6	1.8	2.1
3 Months	3.0	2.0	1.8
6 Months	1.8	1.9	1.9
12 Months	3.3	2.3	2.4
12 Months ended December 2003	1.8	1.1	2.0

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(Note: If you have trouble viewing the tables, you may prefer looking at them in html at

[The Inflation Update: December 2004](#)

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These also include the table used to construct the Median CPI.)

Detail for Computation of the Median CPI			
<i>December 2004</i>			
Component	Annualized 1- month % change	Relative Importance	Cumulative Relative Importance
Jewelry and watches	33.6	0.3	0.3
Infants' and toddlers' apparel	11.8	0.2	0.5
Tenants' and household insurance	10.7	0.4	0.8
Tobacco and smoking products	8.0	0.8	1.6
Men's and boys' apparel	7.5	1.0	2.6
Personal care services	7.4	0.7	3.3
Footwear	7.2	0.8	4.0
Education	5.9	3.0	7.0
Miscellaneous personal services	5.8	1.5	8.5
Medical care services	5.7	4.7	13.1
Used cars and trucks	5.4	2.0	15.2
Nonalcoholic beverages and beverage materials	5.2	0.9	16.1
Motor vehicle insurance	4.9	2.5	18.6
Gas (piped) and electricity	4.8	3.7	22.3
Meats, poultry, fish, and eggs	4.7	2.3	24.6
Lodging away from home	3.8	3.1	27.7
Motor vehicle maintenance and repair	3.6	1.4	29.0
New vehicles	3.5	4.7	33.7
Motor vehicle fees	2.8	0.5	34.2
Rent of primary residence	2.3	6.2	40.4
Owners' equivalent rent of primary residence	2.1	23.3	63.7
Water and sewer and trash collection services	1.9	0.9	64.7
Food away from home	1.9	6.2	70.8
Motor vehicle parts and equipment	0.0	0.4	71.2
Alcoholic beverages	-0.6	1.0	72.2
Household furnishings and operations	-0.9	4.4	76.6
Recreation	-1.1	5.8	82.4
Cereals and bakery products	-2.3	1.2	83.6
Communication	-2.8	2.9	86.5
Personal care products	-3.1	0.6	87.1
Medical care commodities	-3.5	1.5	88.6
Dairy and related products	-5.2	0.9	89.5
Miscellaneous personal goods	-5.4	0.2	89.7
Other food at home	-6.4	1.7	91.4
Processed fruits and vegetables	-8.0	0.3	91.7
Car and truck rental	-9.9	0.1	91.8
Fresh fruits and vegetables	-11.3	1.0	92.8
Public transportation	-14.3	1.0	93.9
Women's and girls' apparel	-20.9	1.7	95.5
Fuel oil and other fuels	-35.5	0.3	95.8
Motor fuel	-36.2	4.2	100.0