

The Inflation Update: January 2005
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23 February 2005

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Lingering fears of deflation should be gone as goods prices are on the rise. After falling consistently for 2 ½ years, core goods (commodities excluding food and energy commodities) are up, rising 3.5% for the month (at an annual rate). This is even higher than the 2.6% annual rate increase registered by core service inflation.

Looking at the overall indices, while the all-items CPI is up a very modest 0.6% (a.r.) for the month, core measures increased much more. The traditional CPI excluding food and energy rose 2.4% (a.r.) while the median CPI computed by the Federal Reserve Bank of Cleveland was up 3.2% (a.r.). Over the past 12 months, core inflation is clearly over 2%.

The detail in this morning's report is somewhat worrying, as it suggests the inflation trend is up. As goods prices have started to rise more rapidly, service price inflation has not receded. If anything, it is the opposite. Owner equivalent rent increased 3.2% (a.r.) for the month, well above its 12-month trend of 2.3%.

Putting everything together, my current estimate of the inflation trend is slightly over 2.5%. Recall that services make up about 70% of the index, while goods accounting for the remaining 30%. Estimating the trend in services prices at 2.5% and the trend in goods now at 3% the estimate is $0.7 \times 2.5 + 0.3 \times 3 = 2.65\%$. This represents an increase of roughly one-half of one percent over the last year or so.

We are finally seeing the combined effects of 3 years of accommodative monetary policy, a 15% decline in the dollar (on a trade-weighted basis), and an improvement in business sentiment. People finally feel that they can raise prices, and they are doing it.

This is all consistent with the tone of Chairman Greenspan's twice-yearly comments on monetary policy, where he noted inflation risks and suggested that the FOMC is far from the end of its tightening cycle. As I have said before, my own view is that the long-term equilibrium or neutral real federal funds rate is in the neighborhood of 2%. When added to inflation of 2 to 2.5% this means that the neutral nominal funds rate is over 4%. We are still six 25 basis point increases away from even the bottom end of that range.

Finally, let me make few comments on the recent new reports that the FOMC may have moved closer to inflation targeting. The comments were based on the Economic Projections table on page 4 of the February 2005 Monetary Policy Report to Congress. (For those of you who really want to look you can find it at www.federalreserve.gov/boarddocs/hh/2005/february/fullreport.htm). That table has two interesting properties. First, it includes projections for 2006 – one year more than had been the norm in February. Second, the inflation projections are the same for 2005 and 2006. Since these projections are based on expected policy actions, the conclusion was that the FOMC intends adopt an interest rate path that will deliver the inflation in the projections. By the way, the numbers are 1.5 to 1.75% on the PCE price index excluding food and energy.

There are two things to say about this. First, the FOMC's primary attention is not focused on the CPI. Without getting into technical details, I will simply say that there is a consensus that the PCE index is a more accurate measure of inflation. (It has smaller upward bias, and covers more than just out-of-pocket costs.) Overall, the PCE tends to be about 0.4-0.5 percentage points lower than the CPI. So the FOMC's projection is equivalent to CPI inflation of roughly 2.0 to 2.25%.

Second, to understand if these projections imply that the FOMC has implicitly adopted an inflation target, it is important to look at the procedures used to generate these numbers. Some years ago I participated in this process, and I do not believe that it has changed. Here's how it works. Each Reserve Bank President (all 12) sends their projections to the Director of the Division of Research and Statistics. These projections are single numbers, not ranges, and there is no coordination or discussion among the Presidents. (I do not know the procedures for the Governors, but assume they each send in their own projections that are based on a common set of information they receive.) Next, the table is distributed. That's it!

If such a procedure happens to yield the same projection for two years running, should we label that the Committee's inflation target? I would not.

I will close by saying that we will know much more at 2pm today when the minutes of the February FOMC meeting are released. My hope is that these will include a summary of the debate over whether to adopt a long-term inflation objective.

Consumer Price Inflation, Various Measures
(Through January 2005, all data s.a. at an annual rate)

Previous	All Items CPI	CPI ex Food & Energy	Median CPI
1 Month	0.6	2.4	3.2
3 Months	1.3	2.0	2.2
6 Months	2.2	2.1	2.1
12 Months	3.0	2.2	2.4
12 Months ended January 2004	2.0	1.2	1.9

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(Note: If you have trouble viewing the tables, you may prefer looking at them in html at
[The Inflation Update: January 2005](#)
or you can download the pdf file
[The Inflation Update: January 2005 PDF Format](#)
These also include the table used to construct the Median CPI.)

Detail for Computation of the Median CPI			
<i>January 2005</i>			
Component	Annualized 1- month % change	Relative Importance	Cumulative Relative Importance
Processed fruits and vegetables	46.6	0.3	0.3
Dairy and related products	29.5	0.9	1.1
Tobacco and smoking products	25.0	0.8	1.9
Footwear	18.3	0.8	2.7
Infants' and toddlers' apparel	14.0	0.2	2.9
Men's and boys' apparel	13.1	1.0	3.9
Water and sewer and trash collection services	12.0	0.9	4.8
Other food at home	9.9	1.7	6.5
New vehicles	9.1	4.7	11.3
Motor vehicle parts and equipment	7.9	0.4	11.7
Motor vehicle fees	7.5	0.5	12.2
Food away from home	5.8	6.2	18.3
Medical care services	5.2	4.7	23.0
Motor vehicle insurance	5.2	2.5	25.5
Motor vehicle maintenance and repair	4.8	1.4	26.9
Nonalcoholic beverages and beverage materials	4.3	0.9	27.8
Personal care services	4.3	0.7	28.5
Medical care commodities	4.1	1.5	30.0
Rent of primary residence	3.4	6.2	36.2
Education	3.3	3.0	39.1
Owners' equivalent rent of primary residence	3.2	23.4	62.5
Alcoholic beverages	2.5	1.0	63.5
Meats, poultry, fish, and eggs	2.0	2.3	65.9
Used cars and trucks	1.8	2.1	67.9
Cereals and bakery products	1.2	1.2	69.1
Recreation	1.1	5.8	74.9
Household furnishings and operations	1.0	4.4	79.3
Gas (piped) and electricity	0.8	3.8	83.1
Communication	0.0	2.9	86.0
Miscellaneous personal services	0.0	1.5	87.5
Tenants' and household insurance	-2.0	0.4	87.9
Personal care products	-2.3	0.7	88.5
Women's and girls' apparel	-4.2	1.6	90.1
Car and truck rental	-4.6	0.1	90.2
Lodging away from home	-8.1	3.0	93.3
Public transportation	-8.8	1.0	94.3
Miscellaneous personal goods	-10.5	0.2	94.5
Jewelry and watches	-19.3	0.3	94.8
Motor fuel	-21.4	3.9	98.7
Fuel oil and other fuels	-45.4	0.3	99.0
Fresh fruits and vegetables	-53.1	1.0	100.0

