

The Inflation Update: May 2004
Stephen G. Cecchetti
15 June 2004

Waltham, Massachusetts

Inflation is right on target, so long as the target is 2½%. That what this morning's BLS release suggests. While the all-items CPI rose 8% (at an annual rate) for the month, core measures were more subdued. The CPI excluding food and energy increased 2½% (a.r.) and the Median CPI computed by the Federal Reserve Bank of Cleveland rose 2.7% (a.r.). While these readings are above the 12-month averages (1.8% for the CPI excluding food and energy, and 2.5% for the Median CPI), they are somewhat below the average inflation over the past three month.

Looking at the detail of the report, we see further evidence that CPI inflation is stabilizing at a 2½% trend. For the month of May, owner equivalent rent rose 2.7% (a.r.), the same as its 6-month average. And medical care cost inflation has moderated as well, rising at 3.6% (a.r.) in May, well off the average 5.2% (a.r.) of the past 6 months.

Then there is food away from home. As I pointed out in the April 2004 edition of the *Update*, this component of CPI is another useful predictor of long-term inflation trends. Last month, the cost of eating out rose 3.3% (a.r.), close to the six month average of 3.2% (a.r.) – again, things seem to be stabilizing.

Core goods and core services give the same sense that inflation has hit the new trend. Commodities, excluding food and energy commodities, rose 0.9% (a.r.) for the month, and are up 0.6% in the six months since November 2003. Services, excluding energy services, are up 2.1% (a.r.) in May, which is below the 3.2% (a.r.) average of the last 6 months.

Where does this leave the FOMC going into their end-of-June meeting? Assuming that their objective is in fact 2½% inflation, they are now in dangerous territory. The problem is that interest rate changes take 18 to 24 months to have an impact on inflation. The implication is that inflation will continue to rise for 2 years after the target federal funds rate returns to its long-run equilibrium level of 4 to 5%. Since the current policy seems unlikely to return the funds rate to these levels before late 2005, this means that inflation will continue to rise for the next 3 years!

The question we should be asking is not will the target up 25 or 50 basis points at the next meeting, but how high interest rates will have to go in 2006 in order to bring inflation back below 3 percent.

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

Previous	All Items CPI	CPI ex Food & Energy	Median CPI
1 Month	8.0	2.5	2.7
3 Months	5.5	3.3	3.4
6 Months	4.6	2.5	2.7
12 Months	3.0	1.8	2.5
12 Months ended May 2003	2.1	1.6	2.3

For previous updates, as well as my occasional essays on current policy issues,
Please visit my home page:

[Steve Cecchetti's Homepage](#)

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

[The Inflation Update: May 2004](#)

or you can download the pdf file

[The Inflation Update: May 2004 PDF Format](#)

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

Detail for Computation of the Median CPI			
<i>May 2004</i>			
Component	Annualized 1- month% change	Relative Importance	Cumulative Relative Importance
Motor fuel	151.5	3.8	3.8
Dairy and related products	120.3	0.9	4.6
Fuel oil and other fuels	43.5	0.2	4.9
Jewelry and watches	32.8	0.3	5.1
Meats, poultry, fish, and eggs	20.4	2.3	7.5
Processed fruits and vegetables	19.4	0.3	7.7
Gas (piped) and electricity	13.8	3.7	11.4
Fresh fruits and vegetables	10.8	0.9	12.3
Water and sewer and trash collection services	10.3	0.9	13.2
Women's and girls' apparel	7.7	1.7	14.9
Motor vehicle insurance	7.4	2.5	17.4
Education	7.0	2.9	20.3
Other food at home	5.2	1.8	22.1
Used cars and trucks	4.7	2.0	24.1
Nonalcoholic beverages and beverage materials	4.4	0.9	25.0
Tenants' and household insurance	4.2	0.4	25.4
Rent of primary residence	4.1	6.2	31.6
Medical care services	3.4	4.7	36.2
Food away from home	3.3	6.2	42.4
Personal care services	3.1	0.7	43.1
Men's and boys' apparel	3.1	1.0	44.1
Lodging away from home	2.9	3.1	47.2
Medical care commodities	2.7	1.5	48.7
Owners' equivalent rent of primary residence	2.7	23.5	72.2
Motor vehicle maintenance and repair	2.4	1.4	73.5
Cereals and bakery products	2.4	1.2	74.7
Household furnishings and operations	1.9	4.5	79.2
Miscellaneous personal services	1.7	1.5	80.6
Motor vehicle fees	0.9	0.5	81.1
New vehicles	0.9	4.8	85.9
Personal care products	0.8	0.6	86.5
Tobacco and smoking products	0.5	0.8	87.4
Motor vehicle parts and equipment	0.0	0.4	87.7
Alcoholic beverages	-0.6	1.0	88.7
Recreation	-2.2	5.9	94.6
Footwear	-3.0	0.8	95.4
Miscellaneous personal goods	-6.6	0.2	95.6
Communication	-6.7	3.1	98.6
Public transportation	-14.3	1.1	99.7
Infants' and toddlers' apparel	-17.5	0.2	99.9
Car and truck rental	-42.6	0.1	100.0

