

# The Inflation Update

Stephen G. Cecchetti<sup>1</sup>

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By all accounts, yesterday's bond market drop was precipitated by the strong retail sales numbers. But wasn't this really expected? The consensus seems to be that fourth quarter U.S. growth will come in around 4.5% (at an annual rate), and yesterday's information did very little to change that. Looking to the inflation report, the common view is well reflected in today's *New York Times* Business Section headline "Once Again, Inflation is a No-Show." Was it really? What is the trend in inflation anyway?

The headline U.S. CPI 0.1% in November, 1.4% at an annual rate. Meanwhile the ex-food and energy core was up 0.2%, 2.7% at an annual rate. By contrast, the Median CPI, computed by the Federal Reserve Bank of Cleveland and known for its month to month stability, registered its biggest monthly increase since July 1996, rising a whopping 4.0% at an annual rate. Looking to the more stable twelve month changes, we see that the both core measures, the ex-food and energy and the median, have gone up 2.2% since November 1998. For the median, this represents a significant decline from the readings of just under 3

the methodological changes made by the BLS over the past two years to reduce the measurement bias. Estimates from the BLS suggest that these improvements have shaved half a percentage point off of measured inflation, accounting for much of the drop in the median. Even so, the record of 1999 suggests that inflation is largely under control.

But when we turn to the details of yesterday's CPI report, there is very little good news. Apparel prices, which went down last month, tend to be nearly as volatile as food and gas prices, suggesting that the traditional core measure can be very misleading. While the economics is a bit murky, the evidence suggests that services

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<sup>1</sup>Cecchetti is Professor of Economics, Ohio State University, as well as the former Director of Research at the Federal Reserve Bank of New York, and Associate Economist of the Federal Reserve's Federal Open Market Committee. Together with Michael F. Bryan, he is the creator of the Median CPI, now published monthly by the Federal Reserve Bank of Cleveland.

tend to be better predictors of the longer-term trend in the inflation. In this report, that leads me to focus on overlooked items: food away from home, which accounts for 5.7% of the overall CPI, and owner's equivalent rent, the single biggest item in the CPI with 20.5% of the weight. These two components of the price index have tended to be very good measures of the longer-term inflation trend, and are largely the ones that drive the median CPI. Looking at the first, we see that food away from home rose 0.2% last month, but has gone up at an annual rate of 5% over the past six months. Owner equivalent rent, which is based on a complex procedure that begins with a survey of rental units and involves estimation of the rent that homeowners in essence pay themselves, rose a significant 0.4% last month. This is a doubling of the 0.2% increase we saw over the past two months, and is somewhat disconcerting. If this trend continues, then we could be in for a rough ride.

As it stands today, trend inflation still seems to be in the range of 2 1/4%. But if the rental equivalence paid by homeowners continues to rise at rates even close to what we saw in November, the trend inflation will be well on its way back to 3%.