

## **“Americans’ Inflation Fears Reach a Fever Pitch as Consumer Prices Rise”**

by

Manfred W. Keil and Robert A. Kleinhenz

There is much talk lately about the fear of inflation as shown in the headline scare title above, borrowed from a June CNBC story. The percentage change in the overall level of prices (inflation) is considered one of the central indicators of economic well-being. And just like a doctor, who checks a patient’s health by looking initially at her temperature, and blood pressure, the Fed monitors the inflation rate. Similar to temperature, the doctor must ask, is this currently observed increase transitory or will it become sustained if left untreated? If it is transitory, then you just let the fever run its course. But if it becomes sustained, then you have to administer medicine (increase interest rates).

The Federal Reserve’s dual economic policy mandate is to achieve full employment and to minimize the inflation rate. While human vital signs must fall within certain ranges to be considered normal, economic targets are not absolute, and in fact, will change over time depending on economic fundamentals. Moreover, some of the most widely cited economic indicators have known complications. For example, you might think the Fed should strive for price stability or 0% inflation. Wrong for two reasons. First, the Consumer Price Index (CPI) actually overstates inflation by 1% for technical reasons (don’t worry, boring stuff) and therefore an inflation rate of 1% represents actual price stability. Second, in some situations, the Fed will want to see inflation adjusted wages to decrease in order to increase employment. That is much harder to achieve in a 0% inflation environment where take-home wages would have to fall, but is more palatable if there were a little more inflation while wages stay the same, i.e. are not cut. For these two reasons, the Fed is aiming for 2% inflation, not as a ceiling but as an average.

Since March, the CPI has averaged closer to 5% than the target of 2%, causing concerns about the future direction of inflation. Specifically, the question is whether inflation is likely to be elevated on a sustained basis or whether the sources of higher prices are transitory and therefore will eventually subside, thereby resulting in a lower inflation rate. The answer to this question is more complicated.

For one thing, there is more than one inflation gauge, each having its own strengths and weaknesses. The published CPI contains two volatile components: food and energy prices. These components account for a considerable share of the “consumer market basket” upon which the CPI is based, and occasionally they exhibit wide swings (think of a missile hitting a Saudi oil refinery or a ship being stuck in the Suez Canal). Another version of the CPI backs out food and energy prices, resulting in an index that is referred to as “core inflation.” The core rate of inflation is about one percentage point lower than the overall CPI, and while both have decreased over the last two months, the core CPI has fallen more quickly.

The Fed actually relies less on the CPI and core CPI, and instead looks at another inflation index, “Trimmed Mean Inflation,” which eliminates goods and services with the largest price variation.

This measure currently shows an inflation rate of only 2%. Using this metric suggests that there is no need to pull the emergency break by increasing in the Federal Funds Rate.

There are three more price gauges, each offering a different view of inflation in the economy: the GDP price deflator, the producer price index (PPI), and finally, the personal consumption expenditure (PCE) index. The GDP deflator looks at all U.S. output (hence it includes exports but not imports) to determine how the prices in all sectors of the economy have changed, not just those for consumers. The PPI contains price changes before they reach the consumer, namely for producers. And finally, the PCE (its trimmed mean version) is what the Fed really pays attention to. The numbers here are 4% for the GDP Deflator in the second quarter of 2021 after surpassing 2% for the first time in recent data during the first quarter; 19.9% for the PPI after being elevated at 19% since May 2021; and 4.2% (PCE) after being at the elevated level of 4% since May 2021, but before getting rid of the extreme components.

The bottom line is we do not expect the inflation rate to become permanently higher than 2% in the near future. Surveys by the Federal Reserve of New York show that Americans expect inflation rates of 4% for 2022 and 3.6% for 2023. We believe those numbers will come back down to 2% over the next several months. These are a far cry from the Great Inflation year's rates of 15% during the '70s and early '80s. For inflation to be permanently higher, three factors have to be in place: supply shocks (like oil price hikes), an economy that is operating above its full employment level, or higher expectations by people. We don't see any of these persisting for any length of time. Even the large one-time fiscal stimulus will not result in demand being consistently above supply. Our final advice for those of you who worry a lot about inflation comes from the two words inscribed on the cover of the Hitchhiker's Guide to the Galaxy: "DON'T PANIC."