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Economic INSIGHT

Myriad of Inflation Indicators Offer Varying Assessments of Improvement

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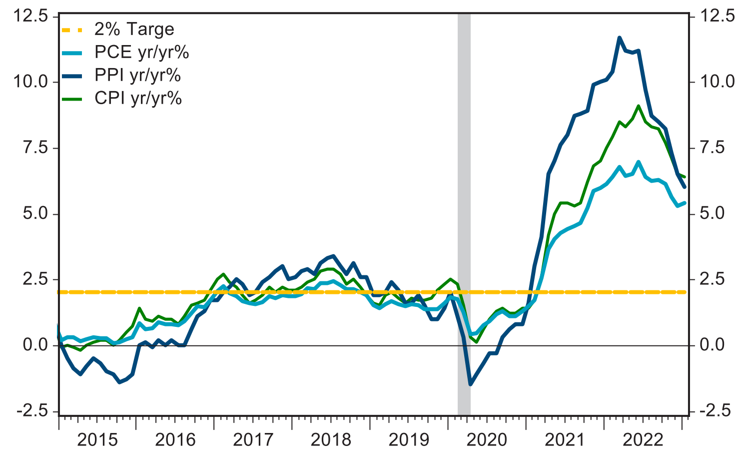
Inflation appears to be cooling in the United States, but the level of progress varies based on the inflation measure used. Some calculations indicate *"less"* improvement in price pressures than the headline retreat would suggest, and others may be skewed by the lingering impact of the pandemic. At this point, with the Federal Reserve (Fed) hyper-focused on taming the inflation beast and the health and soundness of the broader economy at stake, it matters more than ever exactly what measure is used to properly gauge inflation.

Overstating inflation could lead the Fed to tighten unnecessarily, potentially causing recession, while an understatement could prompt the Fed to pull back before the war against inflation is won, potentially undermining progress already made and forcing the Committee to reengage in a second round of even more painful policy adjustments. Ideally, the Fed would thread the proverbial needle between reinstating price stability whilst avoiding a prolonged period of pain and weakness in domestic activity. The Committee's ability to achieve a soft landing depends not only on the successful impact of policy measures, but also accurately accounting for improvement.

HIGHER PRICES HERE, THERE, BUT NOT EVERYWHERE

The debate over accurately measuring inflation is nothing new. For decades, economists have struggled to fully capture the level of price growth across an increasingly complicated and ever-changing economy. And, this challenge arguably prevails in a post-pandemic world more than ever before.

There are three primary metrics used to gauge inflation. The Producer Price Index, or the PPI, measures the average change in prices charged by businesses (domestic producers). On the consumer side, the Consumer Price Index, or the CPI, and the Personal Consumption Expenditures Index, or the PCE, measure the cost of a basket of goods and services



Sources: BEA, BLS/Haver

being purchased by the end user. Both the CPI and the PCE aim to capture the costs incurred by the consumer, although the CPI is based on what households are buying (including foreign-made goods). The PCE is the Fed's preferred measure of inflation and is based on what businesses are selling (including capital goods).

Each metric – PPI, CPI, and PCE – varies in weighting, methodology, how to account for changes in purchasing behaviors, the scope of coverage, and seasonal effects. And each of them come in two variations – a headline and a core measure. The headline captures overall inflation across goods and services in the economy. The core excludes food and energy costs.

Of course, consumers and businesses pay for both food and energy, and the proportion of the household balance sheet designated to these categories is not insignificant. In fact, arguably the fastest way to derail the American consumer is by sustained heightened energy costs. So why are they excluded from the core measure? Quite simply because while they are key components of the household budget, they are also the two most volatile elements of inflation and often do not reflect the underlying trend of price pressures in the broader economy.

HIGHER GOODS COSTS? SERVICES?

In the quest to finely tune measurements of inflation, some economists have proposed alternative methods to try to account for anomalies in the data or special circumstances in the economy. After all, food and energy are not the only components that can face extreme volatility in a short period of time and at least temporarily skew the read on price pressures. The Dallas Fed, for example, proposed an alternative measure of core inflation in 2005 called the Trimmed Mean PCE. Rather than focusing on excluding particular categories, the metric attempts to eliminate the *"noise"* in the data itself by excluding the most extreme upside and downside price changes each month. While the measure does not eliminate all variability, it attempts to offset one-off events or factors that may not be indicative of the "real" level of inflation.

More recently, given the unprecedented impact of the global pandemic and the increasingly complicated nature of inflation, officials have taken further steps to isolate the *"true"* measure of price pressures independent of COVID disruptions. One such measure, dubbed the *"supercore,"* removes not only food and energy, but also strips out housing costs and the price of goods. While these components account for a substantial portion of household spending, they are also the ones most distorted by the pandemic and may be skewing the broader measure of prices.

From the Fed's point of view, the key concern surrounding inflation is the wage-price spiral, rather than product limitations caused by global trade disruptions. In the former, labor demand far outpaces labor supply, forcing businesses to pay higher wages, which leads to higher prices and longer lasting inflation. In other words, monetary policy officials are increasingly interested in the demand side of the inflation equation rather than the supply side, which is largely influenced by factors outside the Fed's control.

Labor costs account for the largest proportion of expenses for business services – as opposed to parts and materials for goods production. Therefore, wages are the primary driver of services sector inflation, and by extension, they act as a proxy for the wage-price spiral that officials so greatly fear.

"Finally, we come to core services other than housing. This spending category covers a wide range of services from health care and education to haircuts and hospitality.

GLOSSARY

CEA – Council of Economic Advisors

CPI – Consumer Price Index

PCE – Personal Consumption Expenditures

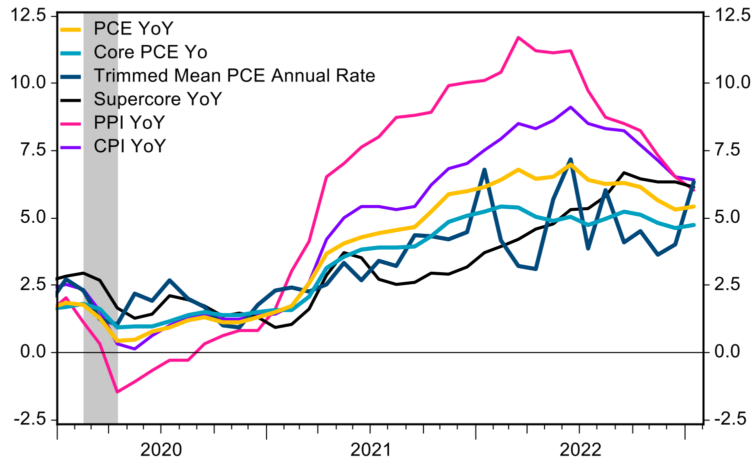
PPI – Producer Price Index

YoY – Year over Year

This is the largest of our three categories, constituting more than half of the core PCE index. Thus, ***this may be the most important category for understanding the future evolution of core inflation****. Because wages make up the largest cost in delivering these services, the labor market holds the key to understanding inflation in this category."*
– Federal Reserve Chairman Jerome Powell, Speech at Brookings Institution, November 30, 2022

In order to isolate the costs of services, such as going out to eat, visiting the doctor, or getting a haircut and manicure, wages – wage growth – in these specific sectors need to be isolated. Such specifications are not provided by the Labor Department, which reports the monthly figures on employment and earnings. The Council of Economic Advisors (CEA), however, has recently constructed a wage series that tracks only the labor costs of the industries that go into the *"supercore"* inflation measure.

While undoubtedly imperfect at best, such additional breakdowns of inflation data offer further insight into the underlying forces and directional momentum of price pressures that could serve to aid monetary policy officials to best direct policy.



Sources: BEA, FRBDAL, BLS/H, BLS/Haver

SO, WHAT IS THE DATA SAYING?

The data show price pressures in the United States, which at one point were higher than most anywhere else in the developed world, have slowed. The degree of improvement and the momentum of further reprieve, of course, is debatable depending on an individuals' preferred measure of inflation.

The headline PCE, for example, peaked in June at 7.0%, and has since slowed to 5.4%. The core PCE, meanwhile, has shown less improvement, off *"only"* 50 basis points (bps) from a second-round peak in September, and rising 4.7% as of January. Separately, the Trimmed Mean PCE reversed course at the start of the year, rising 6.3% in January, up from the 4.0% gain in December and only modestly below the 7.2% peak reached in 2022.

The latest reading of the *"supercore"* showed a 6.1% rise at the start of this year, down slightly from the 6.3% annual gain in December and further below the 6.7% September peak. Similarly, supercore wage growth also continued to slow in January dropping from a high of 8.0% in early 2022 to 5.2% as of late. Of course, while the drop or the change in the pace of supercore wage growth is significant at 280 bps (albeit it less than the 370 bps decline to 4.4% reported for all private-sector workers), the nominal level of growth remains elevated.

BOTTOM LINE

While labor costs have slowed from peak levels in 2020, suggesting a heightened level of normalization, wage growth remains well above what the Fed would consider sustainable. Furthermore, while inflation – by any measure – has come off earlier highs, the underlying components and core services paint a more complicated picture of minimal improvement, reinforcing the need for the Fed to remain focused on its goal of reinstating price stability.

No measure of inflation is perfect. However, since the risk of curtailing inflation-taming action too soon far outweighs the risk of overshooting or raising rates beyond what would be the *"precise"* target level, the Fed may be well advised to err on the side of caution regarding the more massaged or nuanced measures of prices and instead use the more egregious readings of inflation as a guide to just how high rates should climb.

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