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Inflation: Some Important Technical Perspectives

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Concern about inflation these days seems to travel along two separate avenues. On the more technical side are the worries over recent food and fuel price spikes and the objections to Washington's practice of excluding such price moves from its analyses and policy decisions. The second, very different concern takes a much longer-term view and worries that federal budget deficits and the liquidity poured on markets during the past two years or so by the Federal Reserve will cause considerable inflationary pressure in 2012 and beyond. Since these concerns are so different, Lord Abbett will take them up separately in two consecutive columns. This first one addresses food and fuel prices and their role in policymaking.

Certainly, the recent path of food and fuel prices gives reason enough for concern. Energy prices generally are up more than 16.5% during the past six months, 36% stated at an annual rate. Gasoline prices have jumped more than 28% during this time, 65% at an annual rate. Food prices also have soared, with crude food prices rising some 22% during these past six months, though prices in supermarkets rose at a more moderate 5% annual rate. Since food and beverages amount to some 15% of the basket goods and services counted in the Consumer Price Index (CPI)[1] while gasoline amounts to a touch more than 5%, and other energy about 4%, these rapid increases have pushed up the overall CPI to an annual rate of 4.2% during these past six months, faster, many note, than in a long time and than the Fed officially considers acceptable.

Outside of food and fuel, however, the inflation picture looks much less pressing. The so-called "core" inflation measure—which excludes food and fuel prices from the calculation—shows only a 1.4% annualized rate of increase during these past six months. In large part, this moderation reflects the influence of housing prices, which amount to more than 40% of the overall basket of goods and services covered by the CPI and over half the core measure. Because housing prices are still suffering from the lingering effects of the 2008–09 housing collapse, prices have risen at a negligible 1.2% annual rate.

Against this background, many object to the Fed's exclusion of food and fuel prices in its inflation analyses. First, these critics note, reasonably, that food and fuel are essential, that they are definitely a part of their cost of living, and that policy makers should, therefore, not ignore them. Second, the group believes that the housing inflation relief is misleading. Noting that people do not buy a house or move from rental to rental frequently, these critics argue that shelter prices matter less than food and fuel prices to living costs. Adjusting the inflation measure for such a remixing would indicate a 6.3% annualized inflation rate for the past six months, much closer to the sense most people have of the rising cost of living, and a figure that would trouble any policy maker.

While such a counterpoint to the Fed's approach is understandable, it nonetheless mistakes the Fed's purpose. No policy maker means to imply that the core gauge captures month-to-month changes in living costs better than the overall CPI or even the CPI excluding shelter prices. All at the Fed are well aware that food and fuel are essential and that household budgets get squeezed, sometimes painfully, when these prices rise, especially when they rise as quickly as they have of late. But the Fed also recognizes that food and fuel prices are more volatile than most, both upward and downward. The members of the Federal Reserve Open Market Committee (FOMC) do not want policy distracted by temporary swings. On the contrary, the FOMC wants to set policy in response to fundamental inflation trends. The FMOC removes food and fuel price swings from its calculation not because the swings are insignificant but because their inclusion might from time to time disguise such basic trends.

Certainly, past price behavior supports the Fed's perspective. Table 1 illustrates such a perspective by tracking core and overall CPI inflation during critical past periods. The overall index, which remains sensitive to food and fuel price volatility, often overstated or understated the underlying inflationary trends, while the so-called core measure, which has little month-to-month sensitivity to food and energy price swings, came closer to that trend.

Thus, 10 years ago, in the spring of 2001, a surge in fuel prices drove up the overall CPI measure in May of that year to an annualized rate of 6.8%. Then, a downward adjustment in food and fuel prices in July caused the overall measure to register a 2.0% annualized deflation. Those shopping during that period no doubt felt the pinch in May and the relief in July, but it is also apparent that neither the spike up nor the spike down captured the trend that the core more closely tracked throughout.

A similar picture developed in 2003, when in January and February food and fuel prices caused an upward spike in the overall CPI, only to fall enough in April and May to create a temporary deflation. Neither spoke to the trends on which the Fed tries to make policy. Neither did the core measure, for that matter, but it came closer. Two years later, in September 2005, the overall CPI showed a terrifying 17.8% annualized rate of advance, largely because of a sudden, short-lived spike in fuel prices, only to see a sudden drop in fuel prices create a 5.9% annualized deflation the following November. Either month gave an accurate reflection of what happened to living costs in that brief period, but neither captured the trends that were more evident in the core measure. The same could be said for the sharp inflation recorded in May, June, and July 2008, as food and fuel prices soared, or the sharp deflation recorded later in that year, in October, November, and December, as food and fuel prices plummeted.

No one pretends that the Fed’s preferred core measure is a more accurate gauge of the cost of living in any month than is the overall CPI, or any other mix of its components, for that matter. But the Fed has no desire to make policy on the basis of month-to-month swings. It needs to tailor its policy to control lasting trends. Policy makers know that the core does a mediocre job of capturing those trends, but it is less misleading in any month than the overall measure owing to its susceptibility to the volatile up and down moves of food and fuel prices.

Table 1. Distortions Caused by Food and Fuel Price Fluctuations*

Dates		**Overall CPI (%)**	**"Core" CPI Total Food and Fuel (%)**
2001	January	7.1%	4.0%
	February	2.8	3.3
	March	0.7	2.0
	April	2.1	2.6
	May	6.3	1.3
	June	2.7	4.6
	July	(2.0)	2.6
	August	0.0	1.9
	September	4.8	2.6
	October	(3.3)	1.9
2003	January	5.4	1.9
	February	6.8	0.6
	March	2.0	0.0
	April	(4.5)	0.0
	May	(1.9)	2.5
	June	1.3	0.6
2004	September	3.9	3.7
	October	6.5	2.5
	November	5.8	2.5
	December	0.0	1.8
2005	January	(0.6)	2.4
	February	5.1	2.4
	March	4.5	4.3

	April	3.8	0.6
	May	(0.6)	1.8
	June	0.6	0.6
	July	7.7	1.8
	August	7.6	1.2
	September	17.8	1.2
	October	1.8	4.3
	November	(5.9)	3.0
2008	May	6.9	2.5
	June	11.3	3.1
	July	11.0	3.4
	August	(1.9)	2.3
	September	0.4	1.5
	October	(10.0)	0.1
	November	(19.7)	0.7
	December	(9.0)	-0.3
	January	3.3	2.3
	February	5.7	2.5
	March	(1.7)	2.2
2010	September	2.0	0.4
	October	3.0	0.2
	November	1.5	1.4
	December	5.3	0.8
2011	January	4.9	2.1
	February	6.8	2.4
	March	6.1	1.2

Source: Department of Labor, Bureau of Labor Statistics.
*Consecutive monthly percent charges expressed at an annual rate; seasonally adjusted.

[1]The Consumer Price Index (CPI) is a measure of the average change in prices over time of goods and services purchased by households. The index is published monthly by the Bureau of Labor Statistics (BLS). The CPI is based on prices of food, clothing, shelter, and fuels and other goods and services that people buy for day-to-day living.

Milton Ezrati, Partner and Senior Economist and Market Strategist, has been widely published in a wide variety of magazines, scholarly journals, and newspapers, including *The New York Times, Financial Times, The Wall Street Journal, The Christian Science Monitor,* and *Foreign Affairs*, on a broad spectrum of investment management topics. Prior to joining Lord Abbett, Mr. Ezrati was Senior Vice President and head of investing in the Americas for Nomura Asset Management, where he helped direct investment strategies for both equity and fixed-income investment management.

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