Observation
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# WILL INFLATION STICK?

## HIGHLIGHTS

- **Core CPI can sometimes give off misleading signals about inflation.**
- **A CPI of "sticky" prices that change relatively infrequently can help gauge whether inflationary pressures are broadening.**
- **Sticky prices have fallen in recent months, suggesting a more benign inflationary environment than core CPI lets on.**
- **The Fed can thus afford to remain accomodative for a time as the labor market struggles to make a comeback.**

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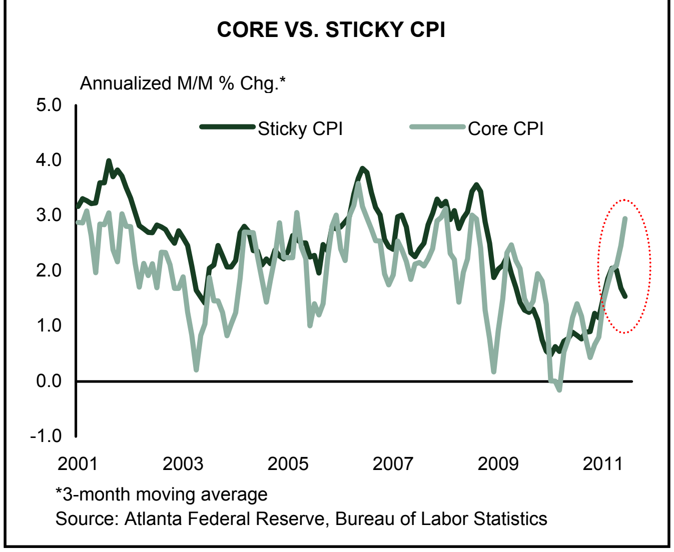
U.S. core consumer price inflation rose to 1.6% in June from a low of just 0.6% in October of last year. The upswing has led to concerns that quantitative easing worked too well; that now instead of deflation the risk is of the Fed falling behind the inflation curve. The Fed, for its part, has acknowledged that inflation may no longer be "subdued", yet continues to signal its intent to keep monetary policy accommodative in light of the labor market's frustratingly slow recovery. Is the Fed shirking its commitment to price stability? Or could inflationary fears be overstated?

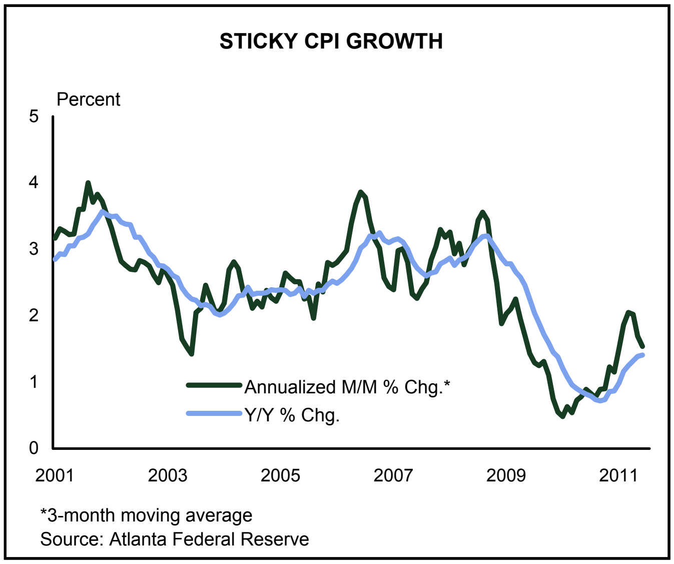
One way to gauge whether inflationary pressures are broadening is to compare indices of prices that change relatively infrequently with those that change more often – call these "sticky" and "flexible" prices. Sticky price growth has slowed in recent months, even though core CPI, which includes elements of both, has continued to rise. This suggests that price pressures driven by the CPI's more volatile components have not yet spilled into other prices in the economy. The Fed, it seems, still has time on its side.




### The trouble with CPI

In the first four months of this year, global food and energy prices surged on the back of poor harvests and political unrest in the oil-rich Middle East. Growth in headline CPI accelerated as a result, even though other prices in the economy remained stable. Fortunately, energy prices have come off their April highs, and headline CPI has peaked.

Because frequent relative price changes can distort the inflationary picture, a core measure of CPI that strips away volatile food and energy components is typically a more reliable gauge of price pressures. Sometimes, though, even core CPI can send misleading signals about inflation. Motor vehicle, apparel, and jewelry prices are all included in core CPI, but are susceptible to the same frequent relative-price shocks as the excluded food and energy components. Core CPI can thus yield many clues about underlying inflation, but not all of them.





### Sticky vs. flexible prices

As a useful check on core CPI, the Atlanta Fed publishes indices of sticky and flexible prices that provide another angle from which to gauge inflationary pressures. Approximately two-thirds of the overall CPI basket is comprised of sticky prices – those that change less often than once every four months – while one-third of prices are flexible and change much more frequently. If the overall price level of the economy were rising, not only would we expect to see a persistent upward trend in prices that change frequently, but in those that change less frequently as well.

It turns out that sticky prices have indeed been rising for the last year, coming off historic lows reached in 2010. In fact, they are still accelerating on a year-over-year basis. However, the last few months have seen a change in the direction of sticky price growth that should eventually be captured in the year-over-year reading.

When measured on a 3-month moving average basis, June's movement in sticky prices was more benign than the movement in core CPI lets on. The 3-month average monthly growth rate in core CPI came in at an annualized rate of 3% – it's fastest pace in almost three years. But sticky prices fell on the month, decelerating to an annualized rate of 1.5%. This is far below its 10-year average rate of 2.4%, and well within the Fed's comfort zone. If we strip out the energy and food components to get a "core" sticky measure, the inflation picture is even less threatening. At a 3-month annualized rate, core sticky CPI rose 1.4% in June.

### Clueing in on inflation expectations

Sticky prices can also tell us something about the direction of inflation expectations, arguably the most important determinant of sustained inflationary pressures in the economy. Persistent upward movements in sticky prices would suggest that businesses are expecting higher future price growth, and this should worry the central bank.

That sticky CPI has reached an inflection point suggests inflation expectations may actually be falling. We see this downturn mirrored in a number of consumer surveys. In June, the Conference Board reported that the number of respondents expecting income gains over the next six months fell to its lowest level since October 2010.

The Cleveland Fed's model of inflation expectations, which accounts for a variety of consumer surveys and movements in treasury inflation-protected securities (TIPS), tells a similar story. Although one-year inflation expectations rose in July, they are a noisy indicator as they tend to track, with a lag, movements in gasoline prices. Longer term expectations still remain stable and low by historical standards – further evidence that consumers and investors view recent price pressures as temporary.

### The bottom line

Last year's fears of deflation are certainly behind us, but so far there isn't any worrisome evidence of broadening inflationary pressures. The bottom line is that the Fed can afford to remain accommodative for a time as the labor market struggles to make a comeback.