

The Economy in Perspective

It's all relative ... For 10 years, inflation as measured by the Consumer Price Index has ranged between 1% and 3³/₄%, and inflation as measured by the CPI excluding food and energy (core inflation) has moved in a very similar zone, bounded by 1% and 3%. Many people have come to expect future CPI inflation to fluctuate in ranges similar to these, and to average something close to 2% over time.

Recently, headline inflation has been at the high end of this range, although core inflation remains closer to 2% than 3%. Today's inflation dynamics echo an earlier event: In early 1999, headline CPI inflation accelerated from 2% and stayed near 3³/₄% for most of 2000 and into early 2001; at the same time, core inflation drifted up from 2% to 2³/₄%. Rates dropped considerably after those peaks, but concerns about a resurgence of inflation have once again come to the fore. Headline CPI inflation accelerated from 2% in early 2004 to 3³/₄% currently, while core inflation advanced from about 1% to 2%.

One key difference between the previous experience and the current one is the level of core inflation. Today, core inflation lies about 75 basis points below its 2001 peak and, being near 2%, could be regarded as less worrisome than in 2000–01. Whether to be more or less worried about inflation today depends on your reading of the inflation fundamentals and your view of monetary policy.

Let's start with the inflation fundamentals. Because energy (and food) prices become quite volatile at times, many analysts exclude them from the CPI to see inflation trends more clearly. Whether or not that adjustment makes sense depends on energy prices' return to some "stable trend" level within a reasonable time. In the past 10 years, for example, the monthly CPI energy index has fluctuated at annual rates between -10% and +20%. Between 2000 and early 2004, crude oil prices rose and fell within a range of \$20 to \$35 per barrel.

Aside from energy prices, other specialized factors occasionally exert strong but transient pressures on the total CPI. Exchange rate movements have the potential to temporarily alter import prices—in both directions. For example, take CPI movements since 2000, when the price indexes for core CPI goods and core CPI services began to follow disparate trends. Global competition affects goods prices significantly more than service prices. Changes in core services have stayed primarily in

the range of 3%–4% from 2000 until now. Core goods prices disinflated from an initial band of 0%–1% to a low of -3% in 2003, then reinflated to its initial 2004 range, where it has stayed since. The disinflation of core goods prices occurred when a strengthening in the dollar made imported goods less expensive. The subsequent return to trend of small, positive price changes came after a period of considerable dollar depreciation, which raised import prices. During the entire 2000–2005 period, these two movements in import prices roughly cancelled one another out, but CPI inflation measures were first retarded and then boosted, temporarily obscuring the true inflation trend.

When import prices, energy prices, or another special category follows a different pattern than all other retail prices, we ought to think of the situation as a change in *relative* prices—not necessarily a change in the trend inflation rate. Crude oil prices have roughly doubled in the last three years. Supposing that they do not decline, the economy will have experienced a change in the price of oil relative to other prices, and CPI inflation will temporarily rise as a result. But assuming no spillover to the prices of other goods and services, the change in relative prices will have no permanent effect on future CPI inflation.

Changes in relative prices are not the same as inflation, which is more commonly thought of as a persistent and broad-based increase in the prices of goods and services. By their nature, relative price changes are self-limiting in their effect on the trend rate of inflation. True, one-time price level jumps (or declines) do reduce (or increase) the purchasing power of money, but once relative prices have adjusted, the jumps or declines will have no impact on inflation in the future. A persistent increase in the prices of a broad range of goods and services requires that monetary policy be set on an accommodative course.

During the last 10 years, the FOMC has found it necessary to move its federal funds rate target as high as 6%, and as low as 1%, to contain the inflation trend within a range of 1%–3%. Although the FOMC's goal has been constant, its strategies and tactics might have changed to meet the challenges of each episode. In the present case, it is worth considering a twist on an old adage: You can pick your inflation targets, but you can't pick your relatives.