



Infographic on

INFLATION

Why do policymakers filter out food and energy prices to get a read on where inflation is headed?

Policymakers at the Federal Reserve are responsible for meeting **two goals**: **maximum employment**, or the highest level of employment that the economy can sustain over time, and **price stability**, where inflation remains low and stable over the long run. Policymakers decide on what actions to take to meet these objectives.

The **challenge** is that it takes time for monetary policy to affect the economy, so **policy must be made** with an **understanding** of what **economic**

conditions may be **in the future**.

The Fed's policymakers look at many measures of inflation when assessing the inflation outlook. **Different measures** supply **different** kinds of **information**.

Short-term movements in inflation aren't always indicative of the inflation that will persist. **Energy and food**, in particular, are typically associated with **highly volatile prices** that **don't always reflect** longer-run **inflation prospects**. For example, a poultry cull because of avian flu raises poultry and

egg prices, but those prices are likely to return to more normal levels once the threat has passed.

One way to better see where inflation may be headed is to **exclude** items with highly **volatile price changes** that are less likely to persist.

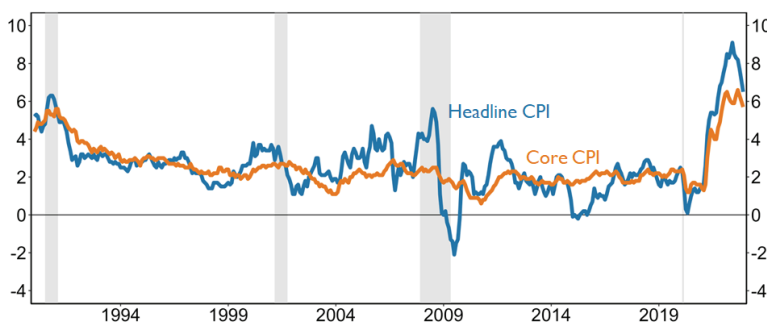
When policymakers do this, they are using a measure called **"core inflation"** to "look through" current inflation and **focus on** its **longer-run movements or trend**.

The chart below shows that, across decades, when headline inflation, which includes food and energy prices, moves above or below core inflation, which excludes these prices, the difference will dissipate, and headline inflation ultimately moves back toward **core inflation**. Core inflation thus provides a **signal of where headline inflation will eventually move**. This makes core inflation an **important indicator** for policymakers working to achieve price stability.

If current inflation rises but is expected to move lower, no monetary policy action may be needed. If current inflation rises and is expected to remain elevated, policy may need to respond to move inflation lower.

It's important to stress that policymakers need a measure of trend inflation to help them determine the actions to bring inflation in line with longer-term goals. Highly volatile prices mask the trend.

Inflation, 12-month percent change



Source: Bureau of Labor Statistics, Haver Analytics

THE BOTTOM LINE

Policymakers filter out parts of the current inflation picture that aren't likely to persist.

They do this because monetary policy affects inflation with lags, so policy must be made with an understanding of where inflation may be heading.

The fact that measures of core inflation exclude certain prices reflects policymakers' need to see the trend, not their lack of concern or interest in particular prices.

