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Economics Group

Special Commentary

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Is Inflation Really as Low as the Fed Fears?

Executive Summary

Fed officials have been concerned about inflation's ongoing shortfall from the FOMC's 2% target. Core PCE inflation has averaged only 1.6% over the current expansion, and has weakened more recently. The undershoot and handwringing over the miss come as a surprise to many of the clients to whom we speak, who feel their own costs have been rising more rapidly.

The perception that inflation is higher than official figures comes as prices for many items are indeed rising faster than 2% and have picked up more recently. Of course other items offset these gains, but often garner less attention. Moreover, a number of statistical practices, like quality adjustment, depress inflation readings relative to transaction prices, although other practices may overstate inflation. These methods have been little changed in recent years, however, meaning that they are unlikely to bias inflation today relative to previous periods.

While inflation has picked up for many items over the past couple of years, it still remains low compared to the prior expansion. The upshot is that real household income and spending continue to benefit from low inflation, while monetary policy has no glaring need to become restrictive.

There is a common perception that inflation is higher than official figures.

Wide-Ranging Perspectives

As far as the Fed is concerned, inflation is largely absent. In March, the core PCE deflator slipped to 1.6%, year-over-year. While recent weakness may have been exaggerated by a number of temporary factors, there is no getting around the fact that inflation has struggled to reach the FOMC's target for the vast majority of the expansion (Figure 1). In the 10 years since the recession, both headline and core PCE inflation have increased at an average annualized rate of 1.6% compared to the FOMC's 2.0% goal. The prolonged shortfall has generated a rethink of the underlying drivers of inflation and the Fed's approach to its price-stability mandate.[1] More immediately, it has spurred debate about the FOMC cutting the fed funds rate this year to support inflation.

Figure 1

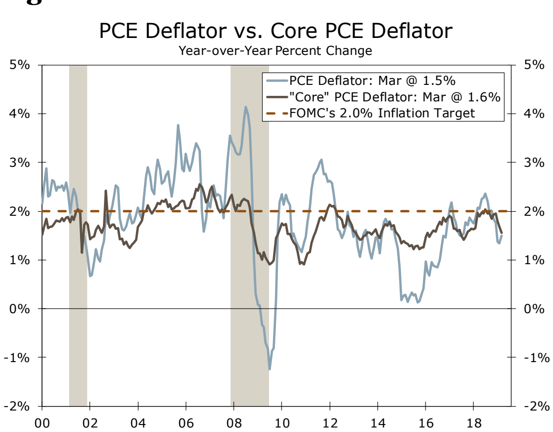
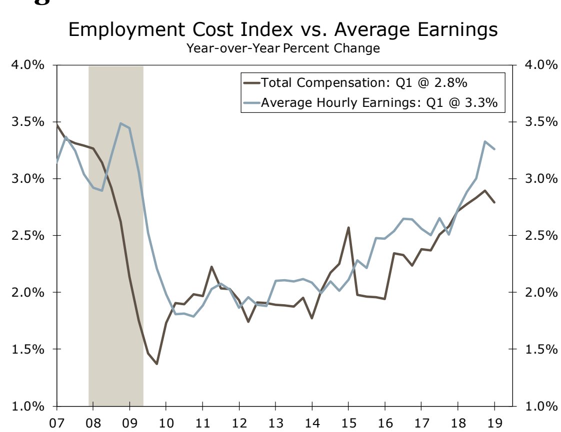


Figure 2



Source: U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities

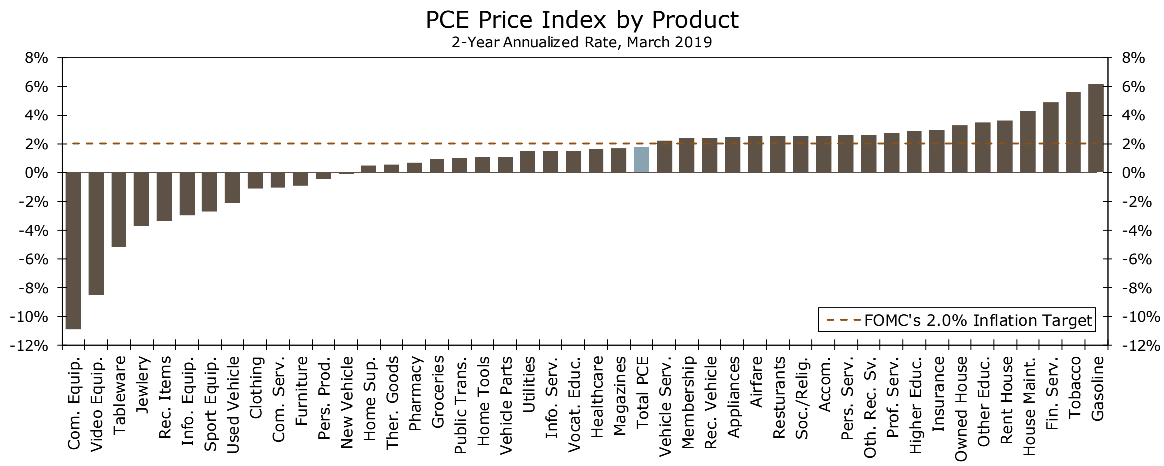
[1] **See "Two Thine Own Inflation Target Be True?" (Mar. 4, 2019).**

The Fed's handwringing about low inflation may seem odd to businesses and households.

The handwringing about low inflation may seem odd to businesses and households at the moment. Businesses have seen their own costs pick up over the past few years, especially for labor (Figure 2). At the same time, "low" inflation in the official sense may not jibe with consumers' views when seeing prices pick up for everyday items, or the sticker-shock from less frequent purchases that have been outstripping broader inflation for years, like college education or a hospital stay.

The reality is that the low rate of headline or core inflation masks wide variance in price changes. Declining prices for some goods and services are offsetting price hikes elsewhere. Figure 3 illustrates the spectrum of inflation across goods and services.[2] We show the two-year annualized inflation rate in order to filter through some of the short-term noise that inevitably comes from surveys. While overall prices rose at a 1.8% pace over this period, that does not capture everyone's experience or perception of inflation.

Figure 3



Source: U.S. Department of Commerce and Wells Fargo Securities

Are We Really Struggling to Reach 2%?

Some frequently purchased and/or large budget items have seen prices rise faster than overall inflation.

The public's perception of inflation has more often than not been higher than measured inflation this expansion, as indicated by the surveys of inflation expectations (Figure 4). More recently, for a number of frequent purchases, like gasoline and eating out, prices have risen faster than overall inflation. Major budget line items, like housing, have also seen prices rise more markedly than aggregate inflation. Conversely, less frequent purchases like televisions, phones, computers and cars have seen prices decline. The infrequency of such purchases may influence consumers' perception of inflation, where many "feel" inflation is higher than official estimates indicate.

The scope and methodology used to measure prices may also lead to official inflation coming in lower than the rate at which households feel their cost of living is changing. Take healthcare costs for example. In the PCE deflator, healthcare is based on the prices paid by all payers, including the government and private insurers. Healthcare inflation, which accounts for almost one-fifth of the PCE deflator, therefore is subject to the government-determined reimbursement rates. Consumers' out-of-pocket medical costs, better reflected by the CPI, have continued to increase faster than what has been indicated in the Fed's benchmark (Figure 5).

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[2] **We exclude the inflation rates for a number of small categories, which together account for only 1.4% of total personal consumption expenditures.**

Figure 4

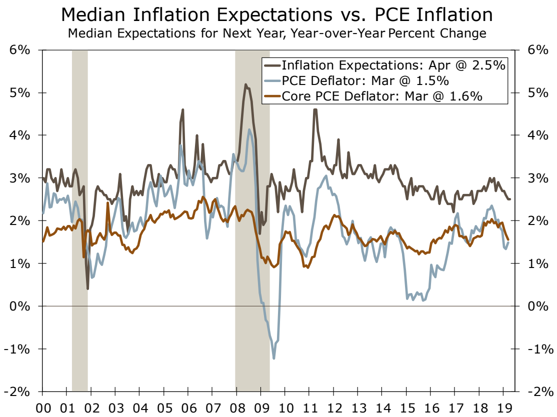
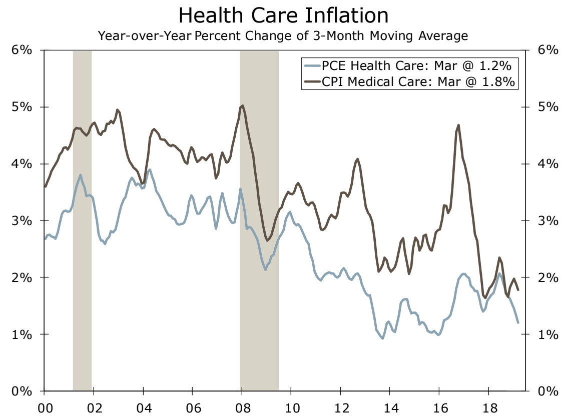


Figure 5



Source: University of Michigan, U.S. Dept. of Commerce, U.S. Dept. of Labor and Wells Fargo Securities

Transaction prices may rise faster than official price measures due to quality adjustments.

Attempts to control for the changing quality of items is also likely to make it feel as though living expenses are rising faster than official inflation figures indicate. Inflation is meant to capture how the cost of the *same* good or service changes over time. If a good or service today does more or works better—like a smartphone versus a basic cell phone, or faster internet services—it is not exactly the same product. Statisticians therefore try to strip out the value of quality improvements, making changes in transaction prices diverge from the official rate. Some of the items to see the steepest declines in prices in recent years are subject to such quality adjustments, including smartphones (communication equipment), TVs (video equipment), computers (info processing equipment), clothing, and internet and phone services (communication services). Similarly, while the transaction prices for new vehicles have climbed to record highs, the PCE measure of new cars and light trucks has largely treaded water.

Further holding down official inflation, at least when using the Fed's preferred PCE measure, are substitution effects. For example, if pork prices rise rapidly, consumers may choose to eat more chicken, limiting the impact of the price increase on their overall cost of living. Nonetheless, the increase in pork prices still looks and feels like inflation to shoppers.

There are also ways in which official inflation indices overstate inflation.

But there are ways in which official inflation indices may also overstate some consumers' inflation experiences as well. Take housing. Owned housing accounts for a sizeable weight in the PCE deflator (12%) and the CPI (24%). For most homeowners, however, mortgage payments are fixed. As a result, their costs are not changing with the equivalent rental value of the home, which is the way owner-occupied housing costs are captured in the PCE and CPI.

Consumers are also prone to shift purchases to establishments offering lower prices faster than government surveyors. The rise of e-commerce—and the lower overhead and prices it entails—is the latest example of such "outlet bias". Research shows online prices are on average 6% lower than "offline" prices, although prices tend to *change* closely in line with offline prices, limiting the impact to overall inflation.[3] Many internet-based services, like search and email, are already free to consumers and therefore not included in official inflation measures.

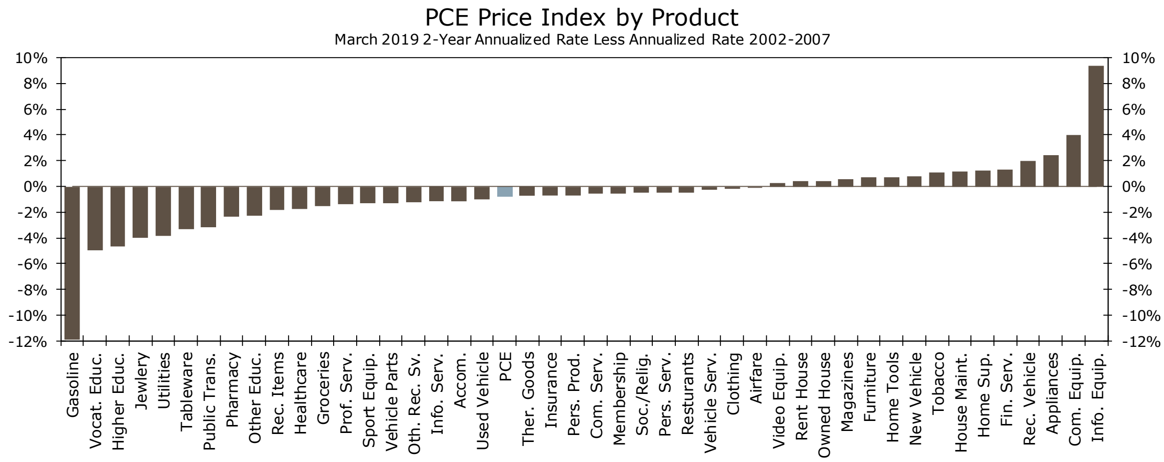
At the End of the Day, Still Low

Measurement issues like quality adjustment and outlet bias have long been a challenge for capturing inflation. At the same time, households' undue focus on prices that are rising quickly versus items that are little changed, is not new. Regardless of the range of inflation among items or the overall fit of official indices and households' perceptions of inflation, price growth remains modest compared to the prior expansion. Over the past two years, with arguably little if any slack left, inflation has run nearly a point below its annual pace over the entirety of the 2002-2007

[3] See "The Weight of the World (Wide Web) on Inflation" (Feb. 13 2018), for a more detailed discussion.

expansion. Most sub-categories have experienced lower inflation compared to the last expansion (Figure 6). Among those where "inflation" has been higher, about half have merely registered less deflation (i.e., prices for these items have been declining, just not as quickly as previously).

Figure 6



Source: U.S. Department of Commerce and Wells Fargo Securities

Even as many businesses and households feel prices are rising faster than official figures, inflation remains low.

The upshot is that even as many businesses and households feel the general price level is rising faster than official figures indicate, inflation remains rather low. The subdued trend is not completely lost on consumers, as overall inflation expectations remain on the low side of their historic range. The modest pace of inflation has kept *real* income growth rising and supported consumer spending. And while the Fed's concern about inflation running too-low may seem misplaced to households, inflation's continued undershoot has allowed the FOMC to scale back its plans to tighten policy and helped to elongate the expansion.

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