

Don't I Buy Food or Gasoline?

Recent increases in commodity and energy prices mean that Americans are paying more at the grocery store and at the gas pump — at the same time that many families are still trying to regain their footing after the recession. In this environment, it is understandable to ask why many economists, including those within the Federal Reserve System, frequently seem to focus on “core” inflation, which excludes often volatile food and energy prices, rather than on “headline” inflation, which does include those items that are so important to households. In fact, from time to time I get asked, don't I buy food or gasoline?

The answer is yes, indeed, I do. And I, as well as others within the Federal Reserve System, pay attention to the prices of those goods — both when we purchase them and also when we consider monetary policy. In fact, the Fed's mandate is to ensure the long-term stability of the overall price level, which means that headline inflation is our ultimate concern.

But in the short term, we must be careful that the tools of monetary policy — which have a lagged effect on the economy — are not applied in reaction to temporary price changes. The level of core inflation is not a goal in and of itself; rather, it is a means to the end of determining the most appropriate policies for the long run.

That said, core inflation is not a perfect predictor of underlying inflation trends, and its correlation with overall inflation may depend on how it is measured. Moreover, recent research suggests that looking only at core inflation may understate the decline in purchasing power actually experienced by households during previous periods.

The two most common measures of inflation are the consumer price index (CPI) and the personal consumption expenditures (PCE) price index. I tend to prefer the PCE measure, which is based on data from the CPI but includes different weighting methods that make it more consistent over time. Since 2000, the PCE has also been the preferred measure used by the Federal Open Market Committee (FOMC).

Because inflation numbers often run hot or cold for several months at a time, the Richmond Fed looks closely at year-over-year headline PCE inflation to evaluate economic conditions in the Fifth District and the nation. Headline inflation is also an important component of the longer-term economic forecast each Reserve Bank president prepares prior to FOMC meetings. That does not mean, however, that core projections aren't useful too. All members of the Committee evaluate those measures as well, especially when looking at more near-term conditions.

Currently, inflation forecasts are consistent with our

price stability mandate, and the market's expectations reflect that commitment. But as I noted in my last column in *Region Focus*, signs that the recovery is strengthening may mean that we will need to exit from our current accommodative monetary policy in the near future. And upward pressure on energy and commodity prices must be monitored carefully. Monetary policymakers cannot influence the relative price of oil, of course, but we can and must keep a close eye on whether distributors begin passing along higher input prices to consumers. If headline changes prove to be more persistent than previously expected, we must be vigilant that they not become embedded in expectations.

The lesson to be drawn from this discussion is that no single measure of inflation is “wrong.” The Fed's mandate means that we should choose the best tools available to determine the appropriate policies to achieve long-term stability of the overall price level. In short, we are committed to fostering an economic environment in which households and businesses can make the investment and savings decisions that will promote their well-being and the well-being of the nation's economy as a whole. That means taking into account the prices of all goods — including food and energy — when considering the likely path of inflation and which policies we should pursue as a result of that evaluation.

RF



A handwritten signature in black ink, appearing to read 'J M Lacker'.

JEFFREY M. LACKER
PRESIDENT
FEDERAL RESERVE BANK OF RICHMOND