

Inflation Outlook Remains Stable

By Jia Liu, PhD, Research Fellow

A range of indicators point to dampening domestic prices for the months ahead.

In September, the headline Consumer Price Index (CPI) increased by 0.09 percent after falling 0.20 percent in August. Rising domestic demand in August helped push up the Consumer Price Index Core by 0.14 percent in September, compared to last months' 0.01 percent increase. However, industrial production has caught up and consumer demand has cooled, suggesting a moderating inflationary climate in coming months. Slowing global economic growth and falling oil prices provide further support for that outlook.

CONSUMER PRICES

After adjusting for normal seasonal

fluctuations, the overall consumer price level, measured by the CPI for All Urban Consumers, rose 0.09 percent in September, after falling 0.20 percent in August (see Table 1). The CPI Core, which excludes food and energy, grew by 0.14 percent from last month, consistent with our prediction for acceleration of CPI Core in the October *Inflation Report*. The higher aggregate demand and lower aggregate supply that appeared last month contributed to an increase in the CPI Core this month.

Energy prices continued their three-month slide, falling 0.70 percent for the month. This more than offset the 0.30 percent increase in food prices, resulting

TABLE 1. OVERALL CONSUMER PRICES SHOW SLIGHT INCREASES IN SEPTEMBER 2014

	MONTHLY CHANGE	12-MONTH CHANGE (YEAR-OVER-YEAR)
↑ Consumer Price Index (CPI)	+0.09%	+1.66%
↑ CPI Core	+0.14%	+1.74%
↑ CPI-Food and Beverage	+0.30%	+2.87%
↓ CPI-Energy	-0.70%	-0.65%
↓ CPI-Transportation	-0.31%	-0.75%
↑ CPI-Rent	+0.33%	+3.29%
↑ CPI-New Vehicles	+0.04%	+0.29%
↓ Everyday Price Index (EPI)	-0.22%	+1.63%
↓ Personal Consumption Expenditure Price Index (August, 2014)	-0.05%	+1.46%

Notes: All data are for September 2014 unless noted otherwise, seasonally adjusted.

Data sources: Bureau of Labor Statistics, Bureau of Economic Analysis, Haver Analytics, Federal Reserve Economic Data, AIER.

in slower growth in the broader CPI than the growth in CPI Core. However, on a year-over-year basis, the CPI and the CPI Core grew at similar rates, 1.66 percent and 1.74 percent, respectively.

Among the components of the CPI two stand out. One is food and beverage prices, which trended up by 2.87 percent from a year earlier—a record high since April 2012. The other is rent, rising 3.29 percent—the biggest increase since February 2009.

Whereas the CPI measures the price of a relatively fixed market basket of goods and services, the Personal Consumption Expenditure (PCE) price index more closely reflects actual consumer spending behavior. For example, consumers might choose cheaper in-season fruit or more expensive newly released electronics. In each of these cases, CPI would fluctuate more than the PCE price index. Although the PCE price index dropped in the last month, over the past 12 months it increased by 1.46 percent, less than the CPI increase.

AIER's Everyday Price Index (EPI) decreased by 0.22 percent in September, the third straight monthly decline in day-to-day consumer prices. The EPI decline this month is mainly due to the continuing decline in energy prices; energy prices carry more weight in the EPI than in the CPI. For a more detailed discussion of the EPI, go to www.aier.org/research/everyday-price-index.

WHOLESALE PRICES

Overall, producers experienced lower finished goods prices in September, a decrease of 0.25 percent over last month. But

TABLE 2. ENERGY PRICE DROPS OVERSHADOW OTHER PRODUCER PRICES IN SEPTEMBER 2014

	MONTHLY CHANGE	12-MONTH CHANGE (YEAR-OVER-YEAR)
↓ Producer Price Index (PPI) Finished	-0.25%	+2.13%
↑ PPI Finished Core	+0.16%	+2.05%
↑ PPI Intermediate	+0.10%	+1.24%
↑ PPI Crude	+0.57%	-0.08%
↓ PPI Crude Energy	-1.49%	-7.94%

Notes: All data are for September 2014, seasonally adjusted.

Data sources: Bureau of Labor Statistics, Federal Reserve Economic Data.

Finished Core, Intermediate and Crude prices all trended upward in September, even as the Producer Price Index (PPI) Crude Energy price fell by 1.49 percent (see Table 2).

It takes time for goods to move through the production process. This month's lower prices at the final stage of production are the result of lower prices for intermediate and crude goods in the *prior* month. Because intermediate and crude goods prices trended up this month, finished goods prices should rise *next* month and beyond. The lower finished goods prices *this* month are only a transitory price change, and therefore they are not expected to transfer to lower consumer prices in the coming months.

Since March 2014, however, the producer price increases have outpaced consumer prices—from March through September 2014, the average 12-month growth of the PPI was 2.49 percent, compared to an average of 1.87 percent for the CPI.

Producers are reluctant to immediately pass along changes in production costs to consumers. But given the price gap between

retail and wholesale levels for seven consecutive months, there is a good chance that rising producer prices will eventually drive up retail prices in the coming months.

DEMAND

After demonstrating strong demand last month, consumers seemed to slow their spending in September (see Table 3). Retail sales, corrected for inflation, actually fell 0.41 percent from last month, the first decline since January 2014. Falling retail sales, as an important leading indicator for near-term inflation, suggests that the inflation rate will remain low, likely ranging from 1.5 to 2.0 percent for at least the next several months.

Falling retail sales were not caused by a lack of consumer funds. In fact, real disposable personal income and consumer credit—measures of how much cash and credit consumers have to spend—both grew for the month. Real disposable personal income advanced 0.32 percent over last month, and consumer credit rose 0.42 percent, month-to-month. These measures point to increased consumer buying

TABLE 3. RETAIL SALES FALL WHILE INCOME AND CREDIT RISE

	COMPOUNDED ANNUAL RATE	MONTHLY CHANGE	12-MONTH CHANGE (YEAR-OVER-YEAR)
Real GDP (Q3)	+3.5%	–	–
Real Retail Sales (September)	–	-0.41%	+2.61%
Real Disposable Personal Income (August)	–	+0.32%	+2.66%
Consumer Credit (August)	–	+0.42%	+6.81%

Notes: All data are seasonally adjusted.

Data sources: U.S. Bureau of Economic Analysis, Federal Reserve Economic Data, Board of Governors of the Federal Reserve System.

power, which may be felt in higher demand in the months ahead.

Besides the impact of domestic demand on prices, the global economy has played an important role in the U.S. economic landscape. Slower overseas economic growth has weakened international demand for U.S. goods and services. Table 4 presents real GDP growth rates of U.S. major trading partners in the past three years.

Compared to three years earlier, most major U.S. trading partners are suffering slower economic growth, especially the Euro area and China, indicating lower demand in those countries for U.S.

goods and services, thus hurting U.S. exports (see Table 4). A decline in U.S. exports could increase the supply of domestic goods and services, putting downward pressure on domestic prices.

Moreover, relatively strong U.S. economic growth has made U.S. capital markets more favorable for international investors. As a result, the U.S. dollar has appreciated. The real trade-weighted U.S. Dollar Index to major currencies trended up by 1.33 percent in August and 2.70 percent in September. A stronger U.S. dollar resulted in lower imported goods prices. The U.S. Import Price Index fell 0.50 percent in

September over last month, after falling 0.57 percent in August. Consequently, cheaper imported goods dampened domestic prices.

All in all, weak global economic growth is imposing downward pressure on the U.S. inflationary climate, both through exports and imports.

SUPPLY

Spurred by strong demand last month, production caught up in September. Industrial production increased by 1.01 percent from the previous month, and 4.32 percent over the past 12 months (see Table 5.)

Since the U.S. economy produced more in September, the capacity utilization rate—a measure of the extent to which the nation's production capacity is used—rose 0.76 percent, the biggest monthly increase since December 2012. This indicates that production reacted quickly to meet the strong demand of the previous month, but it was a one-time push. In September demand decreased, which may create a surplus, thereby putting downward pressure on

TABLE 4. REAL GDP GROWTH OF MAJOR U.S. TRADING PARTNERS

	2011			2012				2013				2014	
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q1	Q4	Q1	Q2
Canada	1.9	3.0	2.4	2.0	2.6	1.2	1.0	1.6	1.6	2.2	2.7	2.1	2.5
Mexico	3.7	4.2	4.2	3.8	4.5	3.2	3.3	2.9	0.5	1.4	0.6	0.7	2.7
Euro Area	1.8	1.5	0.7	-0.2	-0.5	-0.7	-1.0	-1.1	-0.6	-0.3	0.5	1.0	0.7
Japan	-1.6	-0.5	0.2	3.1	3.2	-0.1	-0.3	-0.1	1.3	2.4	2.4	2.7	0.0
China	9.6	9.7	9.1	8.1	7.6	7.4	7.9	7.7	7.5	7.8	7.7	7.4	7.5

Notes: All data are real GDP growth rates compared to the same quarter of previous year, seasonally adjusted.

Data source: Organization for Economic Cooperation and Development.

TABLE 5. INDUSTRIAL PRODUCTION GROWTH REBOUNDS IN SEPTEMBER 2014

	MONTHLY CHANGE	12-MONTH CHANGE (YEAR-OVER-YEAR)
↑ Industrial Production	+1.01%	+4.32%
↑ Industrial Production: Manufacturing	+0.47%	+4.11%
↑ Capacity Utilization	+0.76%	+1.28%

Notes: All data are for September 2014, seasonally adjusted.

Data source: Board of Governors of the Federal Reserve System.

consumer prices going forward.

Because it takes time for prices to react to changes in demand and supply, current sluggish demand and increased production both point to a near-term modest price environment in the foreseeable future. In addition, slowing global economic growth and continuously falling oil prices are contributing to moderating prices.

MONEY

When money supply growth outpaces real output growth, inflation occurs. A centuries old cornerstone of responsible monetary policy posits that the ratio between money supply and nominal GDP should remain constant. In the long run, money supply growth should equal the sum of real GDP growth and inflation. But in the short run, this is not always true. Table 6 presents recent growth rates of the U.S. Money Supply M2, real GDP and inflation (as measured by the GDP price deflator).

TABLE 6. GROWTH IN MONEY SUPPLY OUTPACES GROWTH IN REAL GDP PLUS INFLATION IN THREE OUT OF FIVE QUARTERS (Q2 2013 TO Q2 2014)

	2013			2014	
	Q2	Q3	Q4	Q1	Q2
M2	4.5%	5.7%	6.9%	7.4%	6.2%
Real GDP	1.8%	4.5%	3.5%	-2.1%	4.6%
GDP price deflator	1.1%	1.6%	1.4%	1.3%	2.1%

Notes: All data are compounded annual rates of change, seasonally adjusted.

Data source: Federal Reserve Economic Data.

Over the past five quarters, the above-mentioned relationship only holds for the third quarter of 2013 and the second quarter of 2014. In the other three quarters, the money supply growth rate far exceeded real GDP growth plus inflation. Yet, despite abundant money in circulation, we are not experiencing inflation. How can this be?

One possible explanation is that a part of the newly created money flowed to capital markets instead of chasing consumer goods and then being reflected in prices. This would explain why the yields on government bonds have remained low as the Federal Reserve tapers its asset purchases. For instance, the 10-year Treasury bond interest rate has been declining since the beginning of 2014 until August when it reached its new low of 2.4 percent.

However, the change in how the money supply affects prices and real GDP might be caused by the current economy with its anemic recovery. As the economy continues to improve, it is possible that money creation will outgrow output and then cause inflation. Despite this possibility,

we don't see a sign of runaway inflation in the near future.

To sum up, prices trended up in September from the previous month, but over the past 12 months the inflation rate is still below 2 percent. Going forward, September's sluggish consumer demand and increased goods supply, falling oil prices, and weakening foreign trade point to a moderate inflationary climate in coming months. ■

About AIER:

The American Institute for Economic Research provides factual, unbiased research and critical analysis on economic and financial topics that people can act on. We educate individuals on how to protect their interests, and to make informed decisions for a better America. AIER is supported by Annual Sustaining Members. To become a member, visit www.aier.org or call us at 413.528.1216.

The *Inflation Report* is published by American Institute for Economic Research, a nonprofit, scientific, educational, and charitable organization.

To contact AIER by mail, write to:

American Institute for Economic Research
PO Box 1000
Great Barrington, MA 01230

Find us on:

Facebook
facebook.com/AmericanInstituteForEconomicResearch

Twitter
twitter.com/aier

LinkedIn
linkedin.com/company/american-institute-for-economic-research

For more information or to donate, visit:
www.aier.org