

Core inflation is an unreliable guide

Print

By Stephen Cecchetti

Published: September 11 2006 19:42 | Last updated: September 11 2006 19:42

To the casual observer it must appear as if economic statistics are primarily weapons in a public relations war waged by politicians. Is US growth really benefiting everyone? The answer depends on whether you focus on the average or the median, and on wages or compensation that includes benefits. Political supporters of current economic policies tend to focus on one combination and critics on the other.

What about inflation? How much has it gone up in the past year or two? Again, it depends on which data you choose. Headline inflation as measured by the consumer price index is running at about 4 per cent, two percentage points above its 2004 level. That is high by anyone's standard. If, instead, you remove food and energy to get to core inflation, the increase is less than 1 percentage point and the level of inflation is a more tolerable 2.5 per cent.

Should we exclude food and energy prices when computing the inflation rate? We do buy food and energy so, in my view, we should not ignore their prices. The appropriate policy focus is on headline inflation.

Over the past 20 years or so, monetary policy has increasingly focused on price stability. For the Bank of England, there is an explicit numerical target; for the European Central Bank, it is the primary objective; and for the US Federal Reserve it is the path to maximum sustainable growth.

By focusing on price stability, central bankers around the world have succeeded in bringing inflation down to low single digit numbers. As a result, it has become important how inflation is measured. If a central bank targets the level of a specific inflation index, it will tighten when that index rises above the target and ease when inflation falls below the target.

The basics of inflation are straightforward: it is the extent to which prices are rising on average. If all prices were to go up in equal proportion, measuring inflation would be easy. But since some prices go up more than others, getting an accurate reading requires averaging across all of them. If you were to leave out the price of a good or service that was rising persistently less or more than average, you would get a measure that was too high or too low.

Returning to core inflation, these measures are designed to remove the elements of the index that are more volatile in order to get at the core trend. Floods or droughts might drive prices of raw food temporarily higher, only to have those increases quickly reversed when the weather improves. The same was thought to be true of energy prices.

Conventional core inflation indices that exclude food and energy were born in the 1970s during the heyday of the Organisation of Petroleum Exporting Countries as oil prices rose from \$3.50 to \$10 a barrel in 1974 and then to \$40 in 1980. I saw the impact on inflation measurement close up. As a young economist on the staff of the White House Council of Economic Advisers in 1980, I saw US consumer price inflation hit its modern peak of nearly 20 per cent. In an attempt to improve appearances, we started computing various alternative measures of inflation. Half jokingly, one of my colleagues noted that our job was to remove all the components of the price index that rose by more than the average. What was left was the core and it was clearly a weapon in the American political battles of the early 1980s.

But in recent years core measures have become misleading. Since 1995 energy prices have been increasing at rates that are consistently faster than those of other prices. As a result, the consumer price index excluding food and energy has been a biased measure of headline inflation, running at roughly ½ a percentage point below the headline measure.

This sort of evidence has led people such as Charles Bean, chief economist at the Bank of England, to criticise central bankers' use of core inflation measures as objectives for their policy. He did not mention the US Federal Reserve by name but his implication was clear. Both the Bank of England and the ECB put greater emphasis on headline inflation.

In comments last month at the Fed's annual Jackson Hole symposium, Mr Bean suggested "that the rise in oil prices is the flip side of the globalisation shock". Raw numbers bear this out. As prices of goods, excluding energy, have fallen, energy prices have risen so that the average roughly mirrors what has happened to service prices.

Economists (including me) have expended countless hours constructing alternative core inflation measures. Our objective was to provide policymakers with measures that remove the noise from conventional price indices and that provide more accurate forecasts of headline inflation two to three years hence. The techniques rely on various statistical methods, but in the end all we are doing is forecasting – and not terribly good forecasting at that.

Since the goal of policymakers is stable prices overall, including those of food and energy, they should turn their attention to

forecasts of headline inflation and stop focusing on core measures.

The writer is the Rosenberg professor of global finance at the International Business School, Brandeis University

Copyright The Financial Times Limited 2006

"FT" and "Financial Times" are trademarks of the Financial Times. [Privacy policy](#) | [Terms](#)
© Copyright The Financial Times Ltd 2006.