MONTHLY Economic Review

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The data for this report is released on a rolling schedule. The presented numbers are current as of publication and are subject to revision.

SYNOPSIS | **Inflation is a Concern No Matter How You Measure It**

After decades of relatively low levels, inflation is on everyone's mind and has been making consumers and businesses miserable as prices have picked up dramatically over the past year. In January, the Consumer Price Index soared 7.5 percent from a year earlier, the highest rate of inflation since 1982. The Federal Reserve's preferred measure of inflation, the core Personal Consumption Expenditures Price Index, which excludes volatile food and energy costs, rose 5.2 percent for the biggest annual gain since 1983. How ever you measure it, inflation has become a powerful force and plays a key role in the nation's economic outlook.

Since both measures are signaling the biggest gains in inflation in decades, how do the two compare? Both price a basket of goods, but each captures different pools of spending. The CPI from the Bureau of Labor Statistics measures changes based on a survey of individuals' expenditures for a fixed basket of goods and services purchased by urban consumers. Alternatively, the PCE from the Bureau of Economic Analysis includes rural areas and encompasses a broader range of goods and services. Not only does it track what is being purchased, it also represents how consumers change their buying patterns when prices change, including substitutions between goods when one gets more expensive. If the price of beef goes up, for example, people buy less beef, a cheaper cut of beef or even chicken, and the PCE uses a new basket of goods to account for that. That approach leads to smoother price changes. Since the CPI uses the same basket each month, it is more likely to be affected by categories with wide price swings such as food and gasoline.

In addition, the PCE measures not just individuals' expenditures but what organizations spend on their behalf, such as medical care paid for by employer-provided insurance, Medicare and Medicaid. And because each index is calculated using a different mathematical formula and different pools of spending, each has different weighting. The PCE, for example, gives nearly three time as much weight to health care (23.1 percent) as the CPI (8.9 percent) while the CPI gives nearly twice as much weight to housing (42.4 percent) as the PCE (24 percent).

Headline inflation numbers may mask what is being faced by different consumers since spending patterns vary widely and lead to significantly different inflation experiences. What a person buys can have a tremendous effect on how severely the pain of inflation is felt. Older households, for example, spend more on health and medical services than younger households, which spend more on education and communications technology like smartphones or TV streaming services. In addition, some consumer purchases that drive inflation numbers are infrequent big-ticket purchases like a new car or new home. If a person doesn't buy a car or house, inflation might overstate what is going on and becomes a relative nonissue compared with those who do.

There is a very lively debate about the causes of the sharp rise in inflation and the extent to which it might persist. The rise has been larger and faster than in past recoveries. It is becoming clear, however, that neither demand nor supply alone is to blame. Instead, strong consumer demand coupled with restricted supply – both affected by the pandemic – have contributed to inflation.

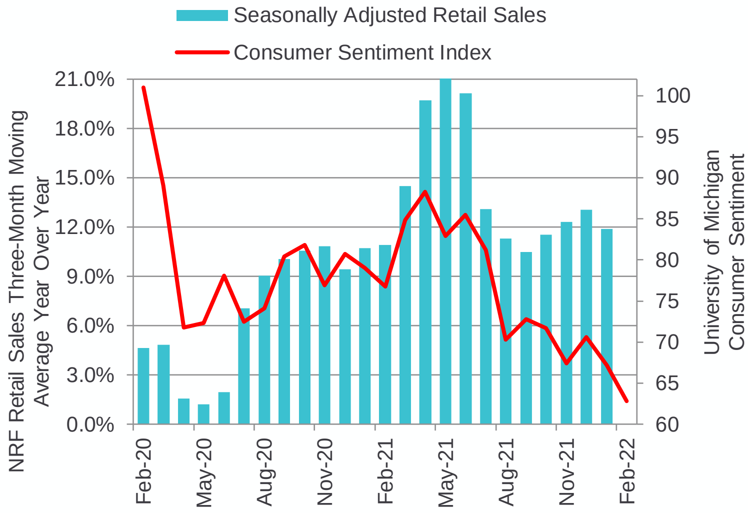
The surge in inflation is weighing on the collective psyche and gives the Federal Reserve good reason to accelerate its normalization of monetary policy by increasing interest rates from its current near-zero levels. Household expectations are important because as people get accustomed to higher inflation, they adjust their expectations about future costs and demand higher wages. Expectations are shaped not by the present but supposition about future changes to the economy and policy. Back when the country was in the jaws of the pandemic, inflation expectations fell off as the economy sank into a recession. But expectations for inflation are now above pre-pandemic levels, having increased as the economy has recovered.

There are many measures of what the public anticipates with future inflation and a clear picture is difficult to discern, but a good starting point is the New York Federal Reserve Bank's Survey of Consumer Expectations. Recent data shows that despite all the news about high inflation, U.S. consumers don't believe it will be long-lasting. The January survey showed consumers expect inflation to rise 5.8 percent over the next year but only 3.5 percent over the next three years. The study also found consumers expect inflation to behave differently than before the pandemic, with a smaller share of short-term changes anticipated in the future.

The next several months will be challenging for the Fed as it remains unclear how much inflation will slow on its own this year. The Fed's decision-making strategy is a matter of dealing with inflation expectations as much as the recent string of elevated actual inflation. While actual price gains are expected to slow down in the coming months as they lap relatively high readings from the year before, the Fed is concerned about the risk of an unwanted jump in inflation expectations. If consumers expect rampant inflation to continue, the possibility of a wage-price spiral could be unleashed as they demand to be paid more. In that scenario, the Fed would need to be even more aggressive with its rate hikes – a move that might stop inflation but at the risk of slowing the economy to the point of causing a recession.

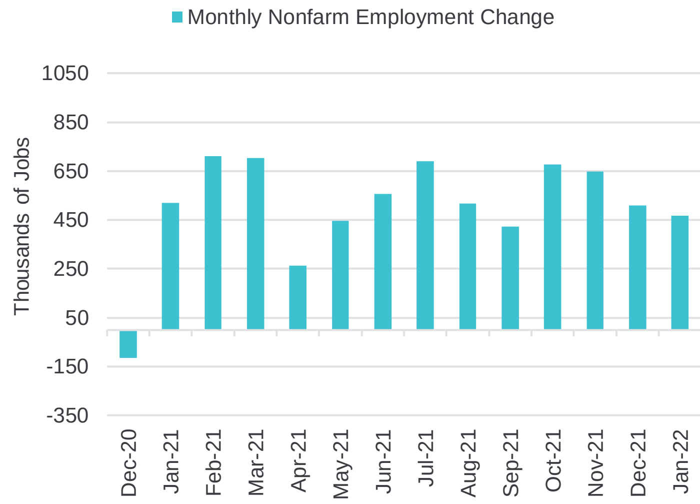
SALES AND SENTIMENT

Consumer spending remained solid at the beginning of 2022. January retail sales were expected to be strong but came in even higher than expected. University of Michigan sentiment data is being dragged down by rising inflation.



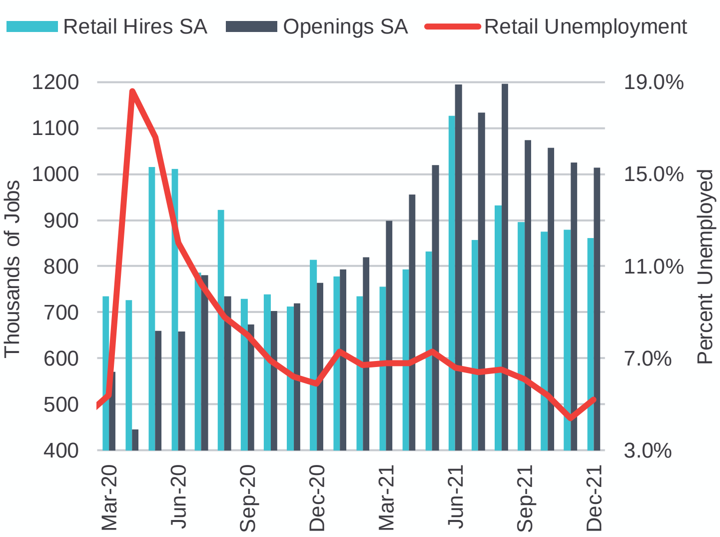
EMPLOYMENT

Payroll employment increased a seasonally adjusted 467,000 jobs in January, surprisingly high, and the unemployment rate was little changed at 4 percent.



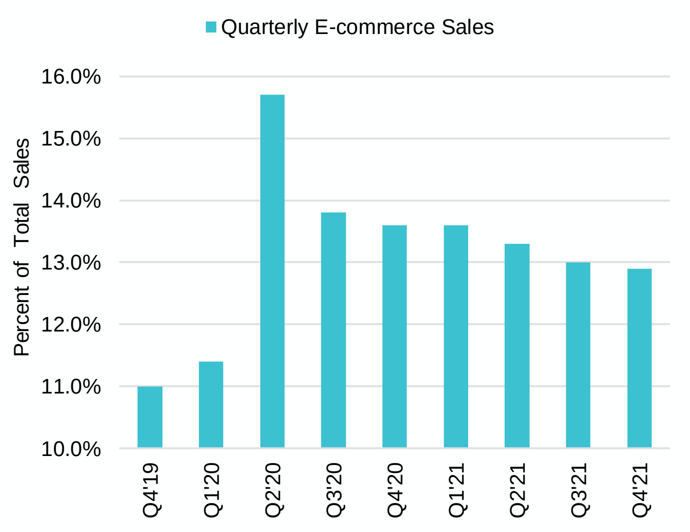
RETAIL LABOR MARKET

The retail labor market has remained tight, with December's 1 million job openings far exceeding 861,000 hires that month. Retail unemployment rose from 4.4 percent to 5.2 percent.



ECOMMERCE

Online sales in the fourth quarter increased 1.7 percent from the third quarter. Online's share of total retail sales held steady at 13 percent, which was still above pre-pandemic levels.



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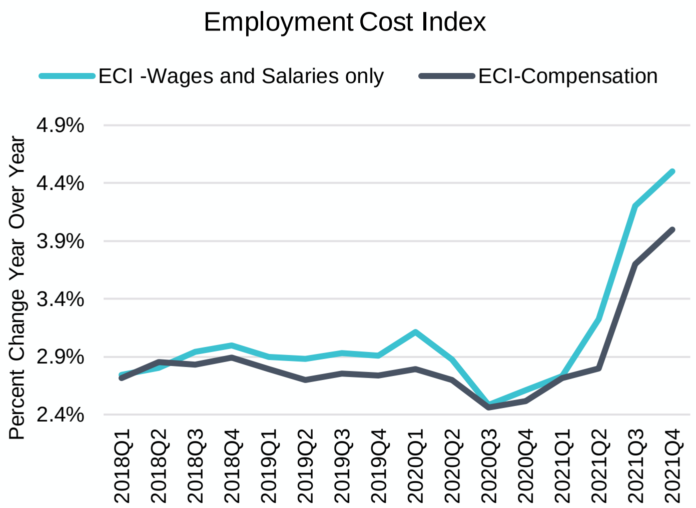
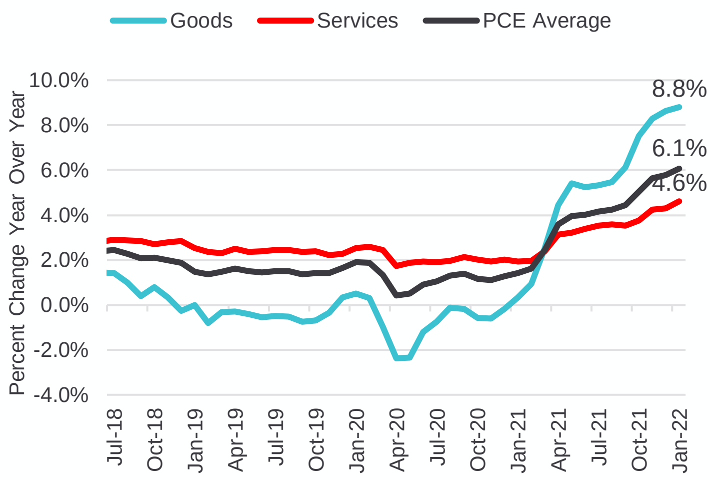
EMPLOYMENT COST INDEX

The tight labor market became even more costly for businesses in the fourth quarter. Over the past year, total compensation is up 4 percent while wages for private-sector workers are up 4.5 percent.



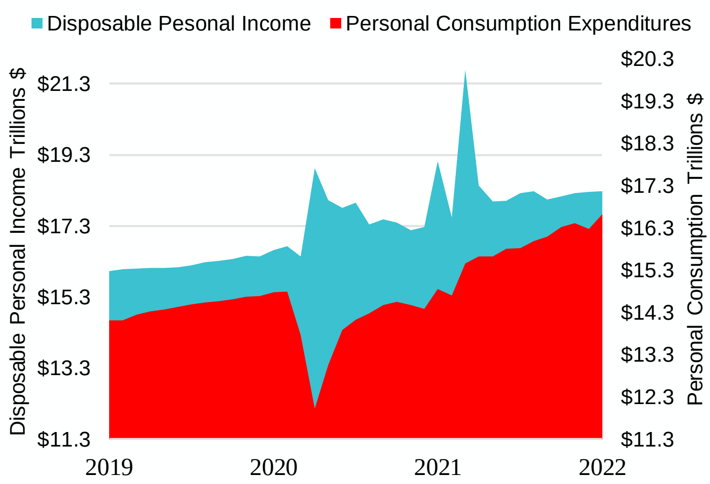
PERSONAL CONSUMPTION

The Personal Consumption Expenditures price index has risen 6.1 percent year-over-year, the largest increase since February 1982. Goods prices are a significant contributor.



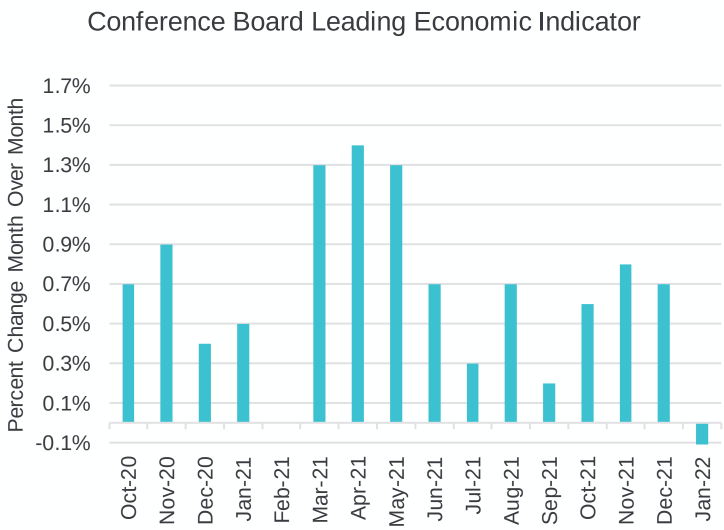
INCOME & EXPENDITURE

January's strong retail sales foreshadowed a solid and unexpected upturn in total monthly consumer spending that came even though personal income was flat for the month.



LEADING ECONOMIC INDEX

The Conference Board's Leading Economic Index ticked down in January, marking the first monthly decrease since the earliest days of the pandemic. The decline was caused by the omicron variant.



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