Summer 7-1-2021

Why Inflation Numbers are Running High

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Hibbs Brief

Hibbs Institute for Business & Economic Research

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In this issue of the ***Hibbs Brief***, we discuss the concept of inflation, the Consumer Price Index and some of its subcategories at the national level.

The concept of inflation refers to the change of prices of goods and services overtime in a given economy, such as a country, state or city. The most commonly used measure of inflation is the Consumer Price Index (CPI).[1] The CPI is produced by the Bureau of Labor Statistics (BLS) every month using 80,000 items in a basket of goods and services consumed by Americans during their daily activities. The items receive a weight according to their relative importance to the average consumer, which is determined based on a survey of American families called the Consumer Expenditures Survey.[2] Although this survey is administered nationwide, we only have CPI estimates for a few regions and some large metro areas in the nation; Tyler is not one of them.

The inflation rate is the percentage increase or decrease in prices during a specified period, which is usually a month or year. Since inflation increases our cost of living by reducing our purchasing capacity (as prices rise, our money buys less), its control is one of the priorities of the Federal Reserve Bank (Fed). The Fed uses monetary policy to control inflation, aiming at an annual inflation rate around 2%.[3] However, higher rates may be acceptable during certain periods of time, such as when the Fed uses its tools to end a recession and move the economy forward.

Figure 1 shows the US city average CPI for all items from January 2018 to September 2021 (the most recent available). We can observe inflation rates growing consistently for 26 months, then falling in March 2020, when business activities decreased while some shutdown for several months because of the pandemic. Inflation rates start growing in June 2020, with the recovery efforts.

After years with a controlled inflation (1.9% in 2018 and 2.2% in 2019), we are currently experiencing inflation rates reaching 5.3% in 12 months (4.8% January–September 2021).[4] See **Figure 2**. These higher rates are, at large, a result of the Fed's efforts to recover from the recession caused by the COVID-19 pandemic. Deciding how intense the efforts should be (monetary policy tools) and how long they should last is not easy. The Fed has to find the correct balance between stimulating the economy to reach full recovery and managing inflation. Furthermore, this task became even more difficult over the summer with the surge of the delta variant of the COVID-19 virus.

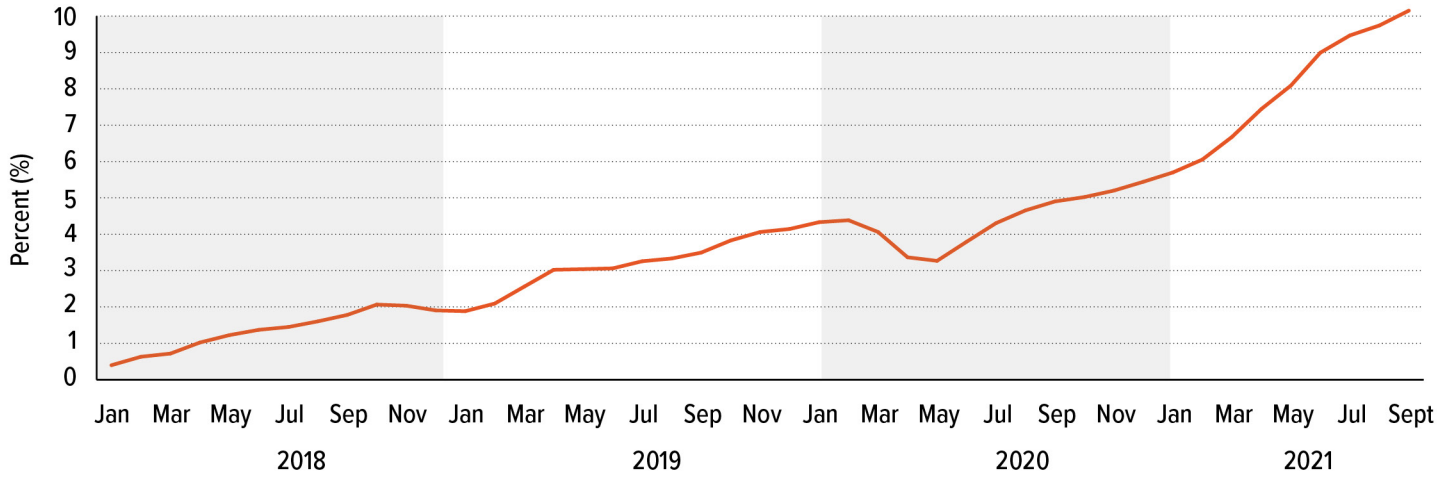
While inflation rates show a relative change in prices for a comprehensive group of products and services, it does not necessarily mean that all the items on the list follow the same pattern or trend. Sometimes, a highly-weighted item experiences a significant and/or sudden change compared to other items on the list, which pulls the overall rate in a certain direction. **Figure 3** depicts six categories of items used by the BLS: Housing, Transportation, Apparel, Food/Beverages, Medical Care and Durable Goods. For the reader's convenience, each category is graphed separately, alongside the blue trendline for the overall list of items (CPI).

The Housing prices category reflects the current housing market boom, showing a consistent increase over the past few years (**Figure 3a**). Oil prices plunged in the second quarter of 2020, which is shown by a substantial drop in the Transportation prices category in **Figure 3b**. After February 2020, the shortage of electronic chips caused a rise in the price of new and used vehicles, resulting in a steep increase in the Transportation prices category. After the pandemic hit the economy in April–May 2020, apparel

prices fell (**Figure 3c**), while food and beverage prices increased (**Figure 3d**). Since November 2018, Medical Care prices increased well above average (CPI) but stabilized after August 2020 (**Figure 3e**). After March 2021, Durable Goods prices (i.e. appliances and electronics) rose dramatically (**Figure 3f**).

The Fed believes that the substantial increase in prices that we are experiencing these days is transitional. This means that the prices of many items should eventually level down, such as the price of lumber and steel, which experienced a considerable drop in the past few weeks. Nevertheless, the Fed recently announced (November 3 meeting) that will start to reduce the volume of their expansion tools (tapering)[5] in December 2021 as a measure to contain (mitigate) inflation.[6] Things are changing every day amid our way to economic recovery after the pandemic effects. We are experiencing some external factors that may also impact domestic prices in the next few months. Some more unexpected events are to come in the last days of this unique year. We will discuss some of these events in our next Hibbs Brief.

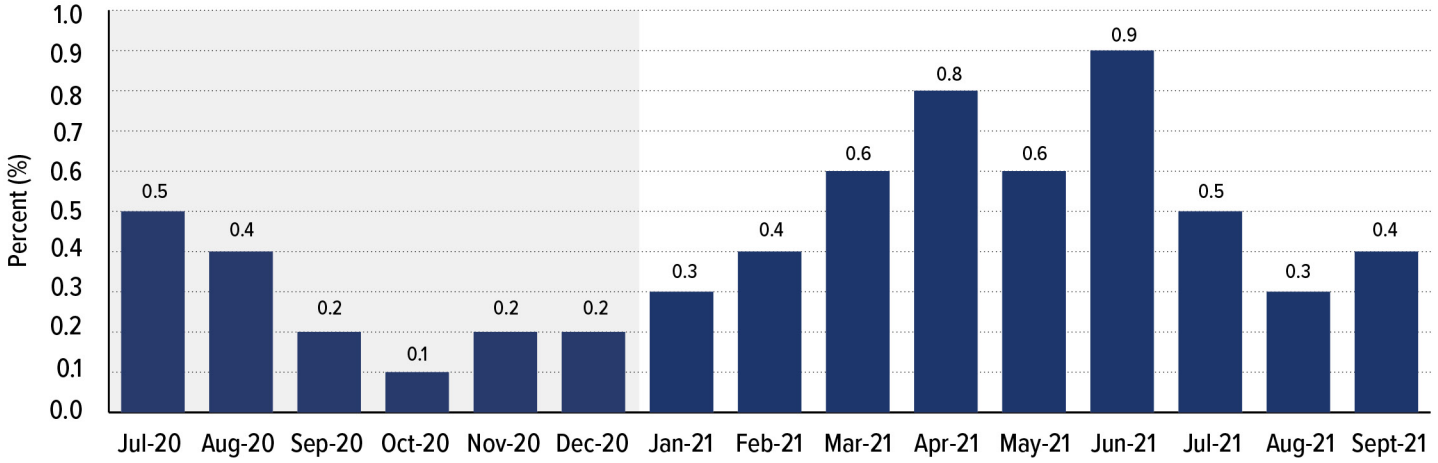
Figure 1. Consumer Price Index: All Items in US City Average Seasonally Adjusted Accumulated Percent Change (January 2018–September 2021)



Note: Consumer Price Index for All Urban Consumers (CPI-U).

Source: US Bureau of Labor Statistics.

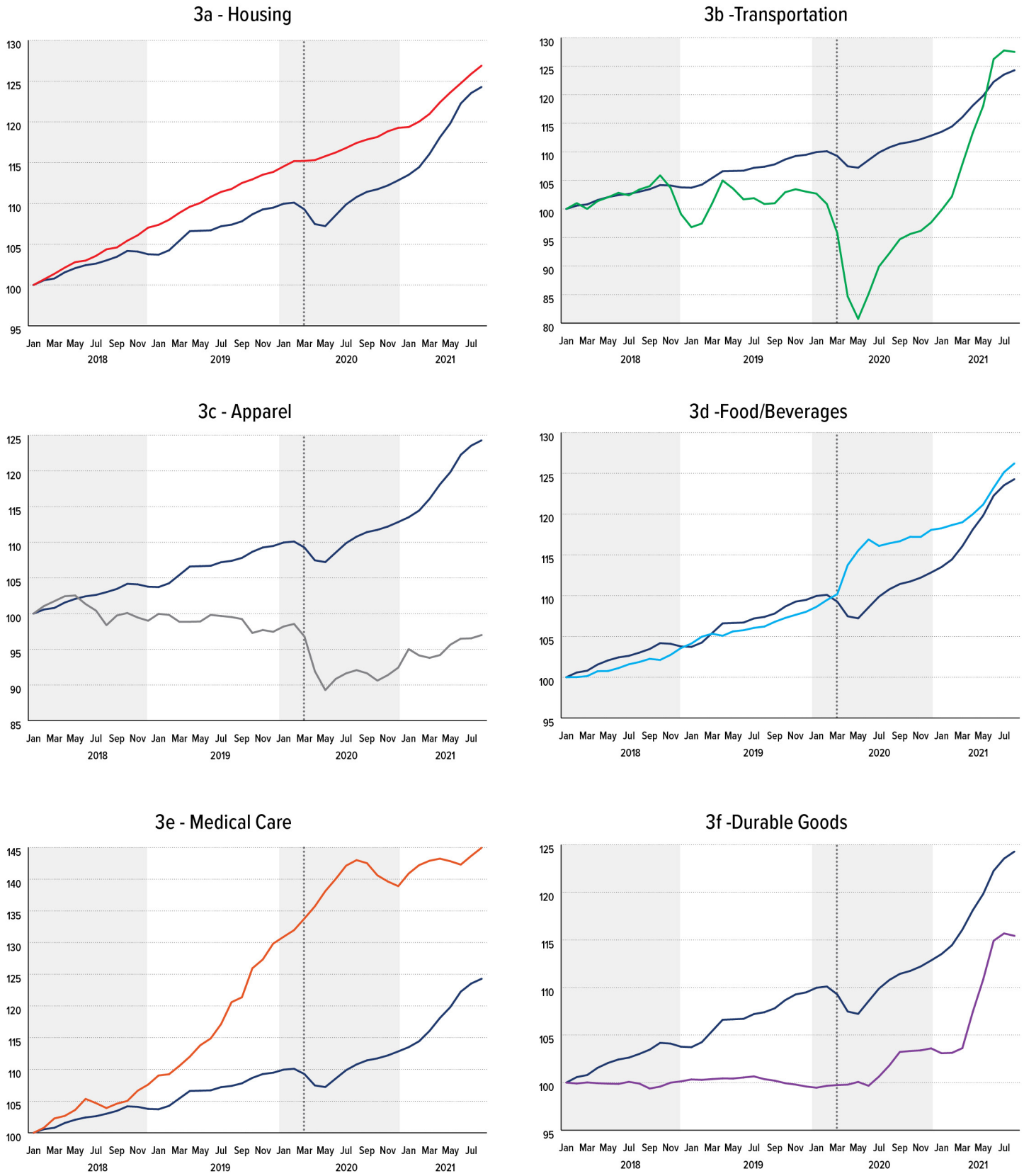
Figure 2. One-Month Percent Change in Consumer Price Index Seasonally Adjusted (July 2020–September 2021)



Note: Consumer Price Index for All Urban Consumers (CPI-U).

Source: News Release, Consumer Price Index – September 2021; US Bureau of Labor Statistics.

Figure 3. Consumer Price Index: All Items, Housing, Transportation, Apparel, Food/Beverages, Medical Care and Durable Goods
Seasonally Adjusted, January 2018 =100 (January 2018–August 2021)



Note: Consumer Price Index for All Urban Consumers (CPI-U). The dotted vertical line illustrates were the pandemic effects began.

Source: U.S. Bureau of Labor Statistics.

[1] For simplicity, this piece refers to the Consumer Price Index while discussing its "All Urban Consumers" version, or CPI-U.

[2] "How Does the Government Measure Inflation?" Salwati, N. and Wessel, D.; The Brookings Institute, Monday, June 28, 2021.
https://www.brookings.edu/blog/up-front/2021/06/28/how-does-the-government-measure-inflation/

[3] "How the Federal Reserve Controls Inflation; The Way the Fed Uses Its Tools to Manage Prices," Amadeo, K. and Kelly, R.C.; The Balance, December 1, 2020.
https://www.thebalance.com/what-is-being-done-to-control-inflation-3306095

[4] "News Release, Consumer Price Index – August 2021; Bureau of Labor Statistics, US Department of Labor.
https://www.bls.gov/news.release/pdf/cpi.pdf

[5] "Tapering refers to policies that modify traditional central bank activities. Tapering efforts are primarily aimed at interest rates and at controlling investor perceptions of the future direction of interest rates. Tapering efforts may include changing the discount rate or reserve requirements. Tapering may also involve the slowing of asset purchases, which, theoretically, leads to the reversal of quantitative easing (QE) policies implemented by a central bank". Monetary Policy; What is Tapering"; Investopedia.
https://www.investopedia.com/terms/t/tapering.asp

[6] "Fed Will Start Tapering in December 2021", Kolakowski,M.; Market News, Investopedia, November 3, 2021.
https://www.investopedia.com/fed-will-start-tapering-in-december-2021-5208392