

Feeling the heat

American inflation

Balancing growth and inflation

America's Federal Reserve gets a touch of the vapours. CENTRAL bankers are supposed to be calm, even a little boring. But the governors of America's Federal Reserve seem to have been seized by a sudden panic about inflation. Virtually every Fed official has been worrying aloud about rising prices. [Ben Bernanke](#), the Fed's chairman, warned about "unwelcome" inflation on June 5th. Since then his colleagues have declared it to be "troubling", beyond their "comfort level" and even "corrosive".

This hawkish talk has not been lost on financial markets, which now take for granted that the federal funds rate will be pushed up by a quarter of a percentage point, to 5.25%, at the end of the central bankers' next meeting on June 28th and 29th. Judging by the price of futures contracts, markets see a better than even chance of another quarter-point rise in August. Several forecasters believe that short-term rates will reach 6% by early 2007.

Less than two months ago, Wall Street was worried that Mr [Bernanke](#)'s Fed would be too soft on inflation. Now the opposite fear has taken hold. A rising chorus wails that Fed officials have become obsessed with monthly inflation figures and that their fixation will cause them to push interest rates too high and tip the economy into recession. David Rosenberg, chief economist at Merrill Lynch, puts the odds of a recession in 2007 above 40%.

The idea that the Fed worries too much about inflation comes from several quarters. Statistical boffins point out that recent jumps in consumer prices are due to an acceleration in the imputed cost of home ownership, an artificial figure that is calculated from rental prices. Since nobody pays this price, the argument goes, the inflation it causes should be discounted. Other economists reckon that with productivity high and wages muted, a pernicious wage-price spiral of the kind that lay behind soaring inflation in the 1970s is unlikely. Higher energy prices may temporarily push up inflation, but with labour costs so low, this one-off rise cannot last.

These critics make some good points. The central bankers have clearly been spooked by the recent jump in the "core" consumer price index (CPI). The core measure excludes the volatile prices of energy and food. Over the past three months this index has risen at an annual rate of 3.8%, the fastest in more than a decade.

But much of that jump is thanks to a sharp rise in the cost of housing (which makes up almost 40% of core CPI), particularly the category of "owners' equivalent rent" which estimates the cost of living in a house by looking at rents charged on similar properties. Although this measure makes sense in theory (by living in your house you forgo rental income), it may now be overstating inflationary pressure.

As the housing market has slowed, fewer people are buying property, choosing to rent instead. That has pushed up rents. In turn, owners' equivalent rent has risen too, even though homeowners have seen no change in the actual costs of owning their house. Because owners' equivalent rent is estimated net of utility prices, recent falls in gas and electricity bills have paradoxically made matters worse.

Statistical quirks, in short, are distorting the picture. But what should central bankers do about it? Some suggest that owners' equivalent rent should simply be dropped from the inflation index. That is what European statisticians have done. But credible central bankers cannot suddenly ignore an inflation component when it starts behaving in ways they do not like. That was the mistake made in the 1970s, when officials deluded themselves that inflation was under control by excluding ever more prices from their indices.

The bigger point is that even if you take out housing costs the recent acceleration in core consumer prices does not disappear (see chart overleaf). And a variety of other gauges suggest that underlying inflation is on the high side and rising. The deflator for core personal-consumption expenditure (PCE), Fed officials' favoured index, was up 2.1% in the year to April. The "trimmed-mean PCE deflator", calculated by the Dallas Fed, which excludes those prices that have risen and fallen the most before taking a weighted average of the rest, is up 2.4%. The "median consumer-price index", calculated by the Cleveland Fed, is up 3%. Look at these figures and the surprise is less that the central bankers are now so jumpy about inflation than that they sounded so sanguine earlier this year.

One reason is that Fed officials, as much as their sceptics, were comforted by the lack of wage pressure. Thanks to strong productivity growth and fairly modest pay rises, the cost of workers relative to their output has slowed, rising only 0.3% over the past year, even as the jobless rate has fallen to 4.6%. It is hard to see how prices could spiral out of control while labour costs remain so subdued.

So why are the central bankers suddenly worried now? One explanation is that other determinants of short-term inflation, particularly inflation expectations, have been flashing. Survey-based estimates of consumers' inflation expectations have all risen since last year. The hawkish talk was doubtless designed to put a lid on them and put paid to the idea that the [Bernanke](#) Fed was a soft touch.

Some central bankers are also wary of the most popular explanation for tepid wage growth, namely that the integration of China and India into the world economy has put pressure on workers elsewhere. In recent speeches, both Don Kohn, the Fed's vice-chairman, and Janet Yellen, president of the San Francisco Fed, argued that globalisation had had only a modest effect on American inflation. Much of China's price-dampening impact might prove temporary (see next story). Both pointed out that if globalisation had made America's inflation rate less sensitive to conditions at home, then it also made policy mistakes more costly. Once inflation gets out of control it will be harder to wring out of the system.

These are all fair points and, on balance, the central bankers' concern about inflation seems prudent more than phobic. After all, monetary policy is still not restrictive. Interest rates are only just positive in real terms. And although growth is slowing, there is little sign that the economy has stalled.

The problem is that the Fed's stern talk may backfire. The statistical nuances of owners' equivalent rent suggest that core inflation may rise further and will remain above Mr [Bernanke](#)'s boundaries for the rest of the year, even as the economy slows. If they are to avoid pushing up interest rates too far, Fed officials may soon have to explain why figures they now regard as "troubling" and "corrosive" are not so worrying after all. That task would be easier if their rhetoric had been more boring in the first place.