Those of us who have a vested interest in the level and direction of Fed Funds know the new Federal Reserve Chairman Ben Bernanke is going to have his every word carefully scrutinized, and his every move closely watched, as we try to get a grasp on the nuances of his administrative style.

Will the chairman be an inflation hawk as some Fed watchers suspect? Will he attempt to perform a very public ballet in balancing the economic expansion versus price stability issue at which his predecessor, Alan Greenspan, proved to be so proficient?

At the very heart of this debate is the measurement of inflation—both historic and anticipated. And, as we shall see, the various measurements of price level changes have been experiencing a departure from their historical patterns. It would therefore be instructive to review the more popular inflation indices, and their current levels, to get a grasp on some of the most important data which the Federal Open Market Committee has at its disposal when making monetary policy decisions.

Traditional Yardstick
If someone asks you, “Where is inflation running?” what would be the most likely basis for your answer? I would most likely use the Consumer Price Index (CPI) year-over-year change—the “overall” rate—for several reasons.

One, it is a very easy-to-find index; the monthly announcement is usually prominently displayed in any number of market letters, newspapers or business-related Web sites.

Two, CPI takes into account a basket of goods and services which the Bureau of Labor Statistics tells us represents the American consumer’s likely buying activities. The index should therefore be fairly true to the change in costs for the goods and services being measured.

Three, year-over-year annualizing takes out monthly aberrations. And four, it is a very popular measurement for cost-of-living adjustments for numerous private-sector employers, and is the designated index the Social Security Administration uses for changes in its monthly payments to retirees.

Normally, the overall rate and the “core” rate (which excludes the volatile food and energy components) run very closely to one another. The bond market pays close attention to the core rate. Over the last 20 years, the overall and core CPI have averaged an annual increase of 3.1 percent and 3.0 percent,
respectively. One could reasonably argue that ignoring food and energy was appropriate from a long-term perspective.

More recently, however, there has been a disconnect in the relationship between the two. For example, in 2005 the overall and core rates rose 3.4 percent and 2.2 percent, respectively (see Table 1). Ignoring the more volatile sectors has become very difficult as we’ve noticed that it takes a fifty to fill up the family Hummer.

Wholesale Measures
Another commonly referred-to inflation gauge is the Producer Price Index (PPI). Like its cousin CPI, PPI is released monthly by the BLS in both an overall and core form. It does have some differences (e.g., it measures only input prices of goods), which could cause it to not track consumer prices very well.

Globalization, excess capacity and improved productivity all conspired to push the PPI into negative territory on a year-over-year basis between October 2001 and October 2002. This, at least temporarily, caused some alarm at the Fed, and was partly responsible for the drop in Fed Funds to 1 percent in 2003. Today, of course, the Fed is much more focused on inflationary issues.

PPI appears to have some impact on monetary policy, albeit less so than CPI. The fact that consumer spending accounts for 70 percent of gross domestic product tells us why. Continued globalization has also made PPI less relevant. PPI (like CPI) has seen a departure from historic norms in its overall and core rates. For all of 2005, the wholesale-level price changes were 5.4 percent and 1.7 percent, respectively.

The Preferred Measurement
The Consumer Price Index, while easily the most visible index measuring price-level changes, has a characteristic that is widely criticized by inflation watchers. It measures the change in price for a fixed basket of goods and services, and the weightings of this basket change very infrequently over time. So, if the average consumer gradually buys more chicken and less beef, the relative prices of the two are not very quickly imputed in the CPI.

The Personal Consumption Expenditures (PCE) reading, on the other hand, is a chain-weighted index that is periodically revised to take into account two aspects of consumer preferences: a
changing basket of goods and services, and a changing weighting of expenditures for the basket. As a result, if in our example chicken becomes a greater factor in the consumer’s grocery basket relative to beef, and if the price of chicken rises less than that of beef, the PCE index will report a lower year-over-year increase than does CPI for that segment.

This improvement in flexibility is what makes core PCE, on a year-over-year basis, the preferred inflation measurement for the Fed. In fact, within the past 12 months, the Fed has stopped projecting CPI and has begun using PCE in its forecasts. Core PCE over the last 12 months has risen 1.8 percent.

Where This Leads Us
This is not to say CPI and PCE are not highly correlated. Table 2 shows how the two have performed over the last 16 years. What remains to be seen is how the Bernanke Fed will react to changes in the PCE in the future. Fed Funds have averaged about 170 basis points over core CPI, and 225 basis points over core PCE, since 1989. As of February 2006, the gaps are 240 and 270, respectively, which would seem to suggest that the Fed has moved into neutral territory. As a result, the near-future path for monetary policy will be highly dependent on the release of economic data, including inflation.

The Federal Open Market Committee’s words and actions have gradually become more transparent. As its personality under the new chairman comes more into focus, we will have a better grasp on the evolving link between inflation, by any definition, and Fed Funds.

Jim Reber is president and CEO of ICBA Securities, a broker dealer in Memphis and a member of NASD and SIPC. Reach him at jreber@icbasecurities.com.