



U.S. Inflation and Its Components

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In January 2012, the Federal Open Market Committee (FOMC) began to explicitly interpret its price stability mandate as meaning 2 percent annual inflation, as measured by the personal consumption expenditures (PCE) price index. This target matches average inflation over the preceding two decades. However, as the first chart shows, annual inflation has trended below 2 percent since the end of the last recession (June 2009, as dated by the National Bureau of Economic Research) and has fallen steadily since the adoption of the inflation target. Note that these observations are not fundamentally altered with the exclusion of food and energy prices, which are typically more volatile than other components of the PCE price index.

The recent divergence between targeted and actual inflation prompts a closer inspection of price behavior. Even though average consumption prices have increased 2 percent annually from January 1991 to September 2013, dramatic differences exist across the three major categories of the PCE price index: durables, nondurables, and services (see the second chart).

The average price of consumer durables has declined steadily since the mid-1990s, to 30 percent below its 1991 level. Consumer electronics (e.g., televisions and personal computers) are an important driver of this decline. Over the January 1991–September 2013 period, the price of nondurable goods typically lagged the average PCE price index but has caught up since 2011. Food and energy, major components of this category, account for about half of the expenditures. Thus, much of the convergence of the price of nondurables to the average price level can be explained by the commodity price boom of the 2000s. In particular, the energy component of this category has increased 1.9 percent annually from 1991 to 2001 and 8.0 percent annually since 2002—a 5.0 percent annual average over the 1991–2013 period. Energy prices also explain most of the high-frequency volatility in the average price of nondurables. With food and energy excluded, the price of nondurables over the same period has increased more

modestly, 0.9 percent annually. Interestingly, this pace has picked up significantly, averaging 2.0 percent annually since 2009.

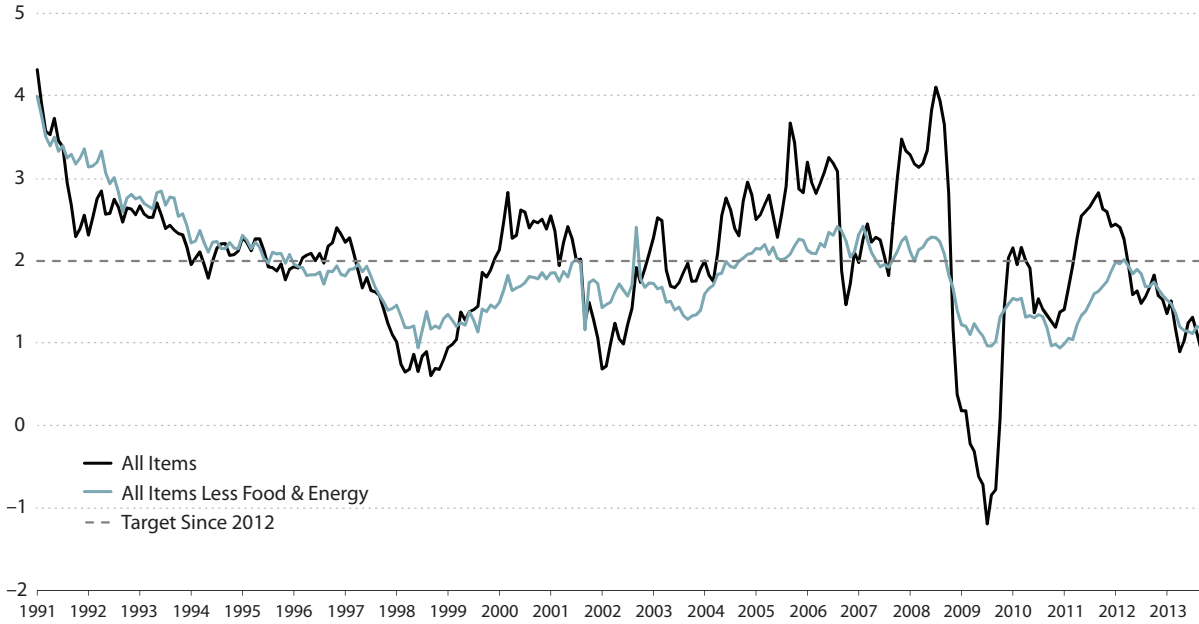
Services account for roughly two-thirds of total PCE, and prices for services have grown significantly faster than other categories over the same period, although the pace has decelerated since mid-2008. About half of services expenditures pertain to housing and health care, components heavily influenced by government intervention. Since 1991, their annual costs have increased an average of 2.7 percent and 3.2 percent, respectively, while the price of other services has increased an average of 2.3 percent.

The short-term volatility of the price of nondurable goods, especially energy, may explain why inflation occasionally appears off target. The recent decline in average inflation may be partially attributable to the ongoing reduction in the cost of durable goods and a significant deceleration in the inflation rate of services expenditures.

Long-run trends in prices are determined by the combined effects of the supply of and demand for money. In the short run, however, the idiosyncratic behavior of certain expenditure categories may affect average consumer prices such that observed inflation appears inconsistent with the stated monetary policy. For example, the short-term volatility of the price of nondurable goods, especially energy, may explain why inflation occasionally appears off target. In addition, the recent decline in average inflation may be partially attributable to the ongoing reduction in the cost of durable goods and a significant deceleration in the inflation rate of services expenditures. ■

Annual Inflation Rate

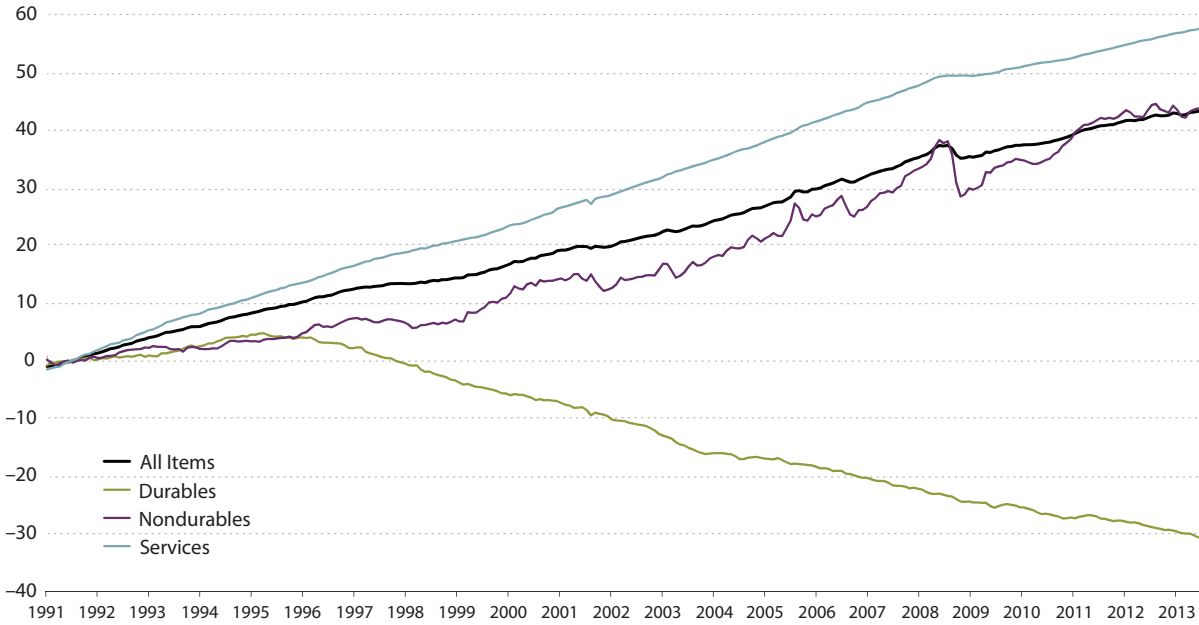
Percent



SOURCE: Haver Analytics.

PCE Price Index Changes Since 1991

Percent



SOURCE: Haver Analytics.

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Views expressed do not necessarily reflect official positions of the Federal Reserve System.