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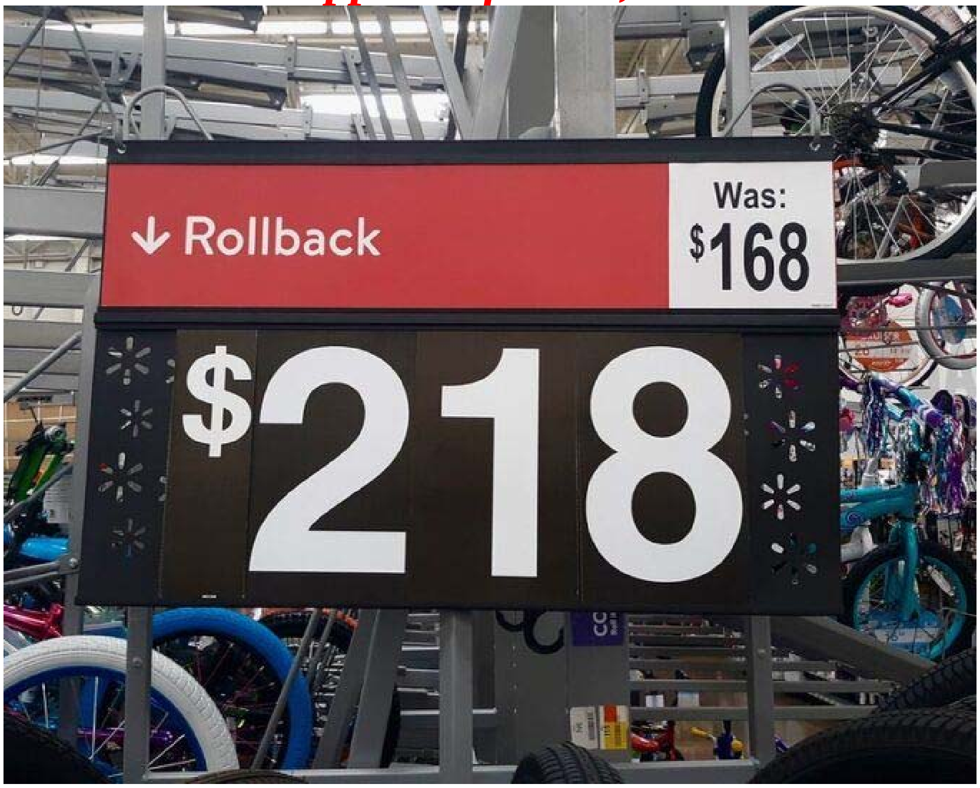
Whipped Inflation, Now



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The December Consumer Price Index (CPI), following a great December jobs report, shows the economy has turned the corner and seems on a path to stable growth with moderate inflation. The CPI showed prices actually fell by 0.1 percent for the month. This brought the annualized rate of inflation over the last three months in the overall index to just 1.8 percent.

With the drop in prices reported in December, the real average hourly wage for all workers is now 0.3 percent above its pre-pandemic level. For production and non-supervisory workers it is 0.8 percent higher. And, for production and non-supervisory workers in the low-paying hotel and restaurant sector it is up 5.7 percent.

The overall index for December was held down by a 4.5 percent plunge in energy prices, but the 0.3 percent rise in the core index should not be terribly troubling. The biggest factor pushing the core index higher was a 0.8 percent rise in both the rent proper index and the owners equivalent rent index, which together comprise almost 40 percent of the core index. The core index, excluding shelter, fell by 0.1 percent in December.

We know the rent indexes will be showing much lower inflation in 2023, and possibly even deflation, based on private indexes of rents in marketed units. Research from the Bureau of Labor Statistics shows that these private indexes lead the CPI rent indexes by six months to a year. With inflation in these indexes having turned downward in the summer, we know that in the not distant future, the inflation rate shown in the CPI rent indexes will fall sharply.

After leading the surge in inflation in 2021 and the first half of this year, due to supply chain problems, most goods are now seeing flat or falling prices. New vehicle prices fell 0.1 percent, the first drop since January of 2021. With demand for vehicles slowing, and most production largely back to normal, we should be seeing more drops in vehicle prices going forward.

Used vehicle prices fell by 2.5 percent in December, continuing a decline that began in July, but with prices still almost 40 percent higher than their pre-pandemic level, they have much further to fall. Prices of other items driven up by supply chain issues, like apparel, furniture, and appliances, were mixed in December, but there is little doubt that the direction in 2023 will be flat or downward.

With goods inflation clearly under control, the Fed has said that it wanted to focus on non-rent services. Here also the picture was largely positive in December. The index for medical services rose just 0.1 percent, although it was held down by an anomalous 3.4 percent decline in the health insurance index. But even pulling this out the picture is mixed at worst. The index for professional medical services rose just 0.1 percent, putting the year over year increase at 3.0 percent. The index for hospital services rose a more concerning 1.5 percent, but that followed declines in the prior two months. It is up 4.6 percent year over year.

The picture in other services is mixed. Recreation services rose 0.3 percent, well below the rates in recent months. The index is up 5.7 percent over the year. College tuition rose 0.3 percent in December, putting the year over year increase at 2.3 percent. Transportation services rose 0.2 percent, but the year over year increase is a still a double-digit 14.6 percent.

A big factor in the year over year rise is a 28.5 percent jump in air fares, which was reversing the decline earlier in the pandemic. Air fares actually fell by 3.1 percent in December.

But there also have been sharp increases in other components of transportation services. Car repairs rose 1.0 percent in December and are up 13.0 percent year over year. The auto insurance index rose 0.6 percent in the month and 14.2 percent over the last year.

These sharp increases show how the supply chain goods problems are intertwined with the service indexes. The index for motor vehicle parts and equipment rose 9.9 percent over the last year. These increases get passed on the price of the services. With the supply chain problems now largely under control, these price pressures will lessen in the months ahead, but some of the price increase in these services is reflecting price hikes in inputs from earlier in the year. As the prices of these inputs level off, or even fall, we should see slower inflation in these services.

This is similar to the story with restaurant prices. These rose 0.4 percent in December and are up 8.3 percent over the last year. Some of this rise is due to the reduction in government subsidies for school lunches, the price of which rose 305.2 percent over the last year. But inflation in the larger category was driven to a substantial extent by an 11.8 percent rise in the price of store-bought food.

We actually got some very good news in that category in December, as grocery prices rose just 0.2 percent, the smallest increase since March of 2021. Chicken prices actually fell by 0.6 percent in the month and milk prices dropped by 1.0 percent, although the indexes for both are still up by double digit amounts year over year.

It is likely that we will see more good news on food prices going forward. The price of many commodities, like wheat, corn, and coffee, have fallen sharply from pandemic peaks. With shipping costs also having reversed the vast majority of their pandemic increases, we should be seeing lower prices for many food items in stores.

We always need caution when looking at a single month's report, but the good December CPI report follows several months in which inflation has slowed sharply from the pace earlier in the year. All the evidence suggests that the economy is still growing at solid pace. (The latest projection for the fourth quarter from the Atlanta Fed's GDPNow is 4.1 percent.)

It looks like the Fed has largely accomplished its mission of taming inflation, without bringing on a recession. Plenty of things can mess up this picture, like another surge of Covid or an escalation of the war in Ukraine, but for now, the economy is looking very good.

This first appeared on Dean Baker's Beat the Press blog.

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