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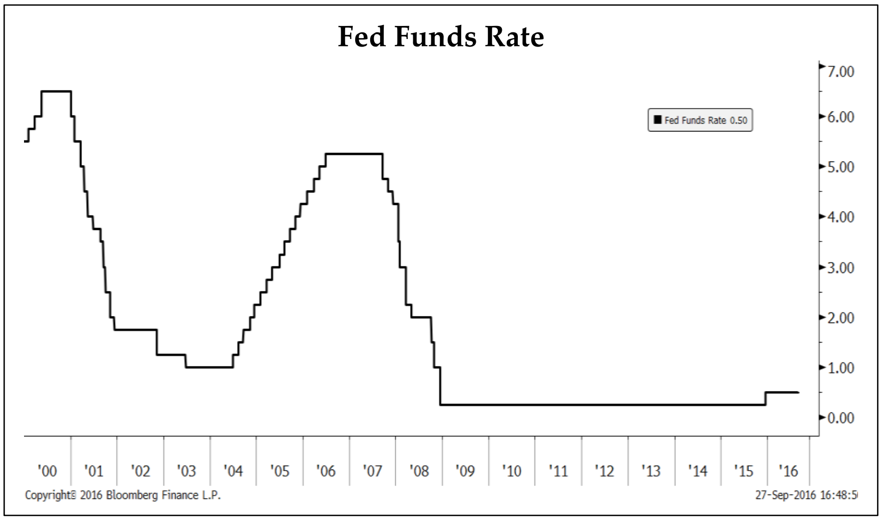
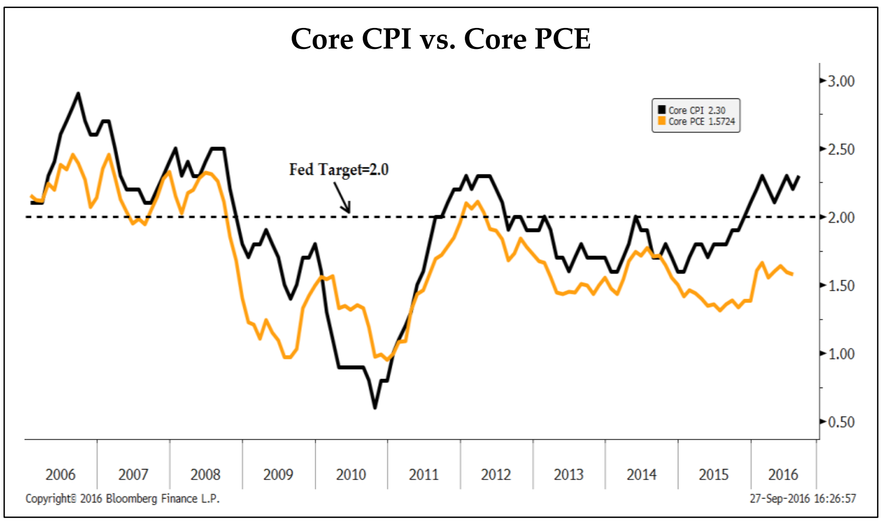
Is the Fed Underestimating Inflation?

October 17, 2016

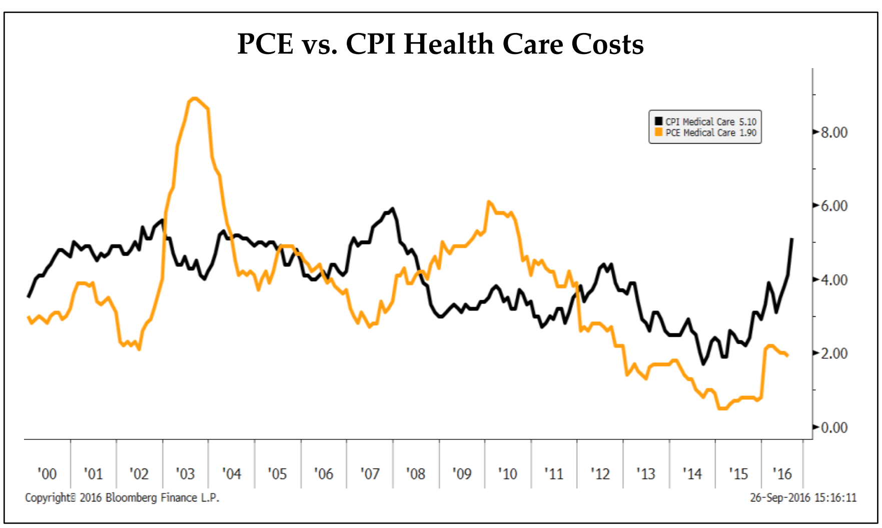
By: Luke Nicholas



- The Fed left the benchmark Federal Funds Rate unchanged at their September meeting, despite acknowledging continued improvement in the economy.
- Citing low inflation as a main determinant, the Fed is seeking further evidence of a strengthening economy before the next rate hike.
- However, if inflation accelerates above the Fed's two percent target, the committee may be inclined to raise rates more rapidly.



- The Fed's preferred measure of inflation, Personal Consumption Expenditures (PCE), remains below the committee's two percent inflation target.
- However, another popular inflation measure, the Consumer Price Index (CPI), is now well above the Fed's target, at 2.3%.
- The gap between the two indicators is at its widest level of the last ten years.



- The divergence stems from differences in how health care costs are calculated.
- CPI includes only out of pocket health care expenses, while PCE includes medical expenses paid by employers, which are being depressed by administered Medicare prices set by Congress.
- If PCE only included out of pocket expenses, it would be above the two percent target and the Fed would likely raise rates more aggressively.

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