Consumer prices in 1994

Inflation remained stable in 1994, as the index for all items less food and energy, which is considered the underlying rate of inflation, posted its smallest annual rise since the mid-1960's

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As measured by the Consumer Price Index for All Urban Consumers (CPI-U), inflation was moderate in 1994. The CPI-U increased by 2.7 percent, the same as in 1993, keeping inflation below the 3-percent level for 3 consecutive years. This is the first time since December 1965 the index has remained stable for such an extended period.

The CPI for all items less food and energy, often referred to as the core index, or underlying rate of inflation, increased 2.6 percent in 1994. This was its smallest annual increase since 1965, when the index rose just 1.5 percent. The deceleration in the index for all items less food and energy, which has continued since 1990, has contributed to moderate retail inflation over the past 4 years. (See table 1.)

The economy continued to expand in 1994. Consumer spending and real disposable income rose, and unemployment fell. The Federal Reserve Board maintained its goal of noninflationary price stability by raising the discount rate and Federal fund rate three times each in 1994. (The discount rate is the interest rate the Fed charges for loans to banks.[1]) The Federal Reserve Board's Open Market Committee cited increases in commodity prices and capacity utilization rates, a measure of plant stress in manufacturing, mining, and utilities. Utilization rates rose to 84.9 percent of total capacity in December, the highest since May 1989.

Despite the economy's growth, pressure on wages was modest, with private industry wages and salaries increasing only 2.8 percent in 1994. Even accounting for increases in interest rates, which alter borrowing costs and saving incentives, personal consumption increased 3.4 percent during the year. As increases in the Nation's aggregate demand continued, prices also continued to increase. However, with retail competition intensifying and wage pressures abating, prices paid by consumers did not increase. Overall, price inflation was tamed by downward pressure on wages and competition among retailers, despite the surge in the Nation's output.[2]

Food. In 1994, consumer prices for food climbed 2.9 percent for the second consecutive year, remaining less than 3 percent for the fourth consecutive year. Except for fresh vegetable prices, increases for most food categories were fairly moderate in 1994.

Tropical storm Gordon, which hit the eastern coast in November, prompted a 21.6-percent increase in prices for fresh vegetables, the second-highest increase since 1971. Lettuce prices were up 79.8 percent, its highest since 1987, when prices rose 136.9 percent. For other fresh vegetables, prices rose by 21.1 percent, attributable to excessive rain and acreage reductions in 1994.

The index for meats, poultry, fish, and eggs decreased 0.5 percent in 1994. Beef and veal prices fell 2.2 percent, its largest decline since 1976. Production for herding and slaughtering increased by 6 percent in 1994 over levels that were pushed down by weather-related problems

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during the previous year. In addition, profitable feed margins, an input cost to farmers and ranchers, accelerated production, helping to reverse the effects of reducing herds late in the year to limit overextended meat supplies. In the fourth quarter, prices for future contracts, a hedging device used by farmers and cattlers to guarantee specific delivery prices, remained steady in commodity trading markets with greater availability of beef and veal. On the other hand, fish and seafood prices rose 5.2 percent, reflecting tight supplies most of the year in salmon, shrimp, cod, and haddock.

A frost in Brazil was largely responsible for a 55.4-percent increase in coffee prices, a record since the index was started in 1967. Despite a drop of 0.3 percent in the index for carbonated drinks, its largest since the index began in 1978, the surge in coffee prices caused the index for nonalcoholic beverages to increase 14.7 percent. Because of increased competition between restaurants, the food-away-from-home index increased only 1.9 percent in 1994.

Energy. After falling 1.4 percent in 1993, energy prices increased 2.2 percent in 1994. The household fuels index, which makes up more than half of the energy component, fell 0.5 percent, after increasing 1.7 percent a year earlier. Within the fuels index, fuel oil remained unchanged, electricity rose 0.6 percent, and natural gas fell 3.2 percent. The decline in the household fuels index was the first 12-month decrease in December for this index since 1986. A colder-than-usual winter in early 1994 pushed household fuel oil prices above the 6-percent mark in the first quarter. However, the harsh winter was tempered by mild temperatures in the fall. Electricity and natural gas also were affected by the cold weather. As with fuel oil, natural gas rose during the first two quarters of the year, only to turn down again during the last half of 1994.

The continuation of cold weather into the first few months of 1994 not only kept up prices for fuel oil, but also delayed the spring decline in natural gas prices until April, after the cold snap. The additional costs incurred by the gas utilities to meet the unforeseen excess in demand caused by the unseasonably long winter were passed on to consumers. These higher charges, or "purchase adjustments," kept the gas index at a high winter level through March. More favorable weather in the fall of 1994 kept expected price increases in check for fuel oil and natural gas. Refunds in the electricity sample in April and September, and in the natural gas sample in June, also contributed to this year's decline in the household fuels index.

Gasoline prices increased by 6.4 percent in 1994 after falling 5.9 percent the previous year. This turnaround was due primarily to a drop in exports by oil-producing countries, higher demand associated with the expanding economy, leaks in North Sea pipelines, and a strike by Nigerian oil workers. Crude oil prices, as reported in the Producer Price Index, rose 21.3 percent in 1994, with price increases occurring during most of the first 8 months of the year before tailing off. Also, summer travel and increased tourism helped fuel demand.

Prices in 1994 were not much affected by new legislation that requires reformulated gasoline to be sold in selected cities to comply with the Clean Air Act. Instead, the impact of

Table 1. Annual percent change in the Consumer Price Index for All Urban Consumers (CPI-U), selected expenditure categories, 12 months ended December, 1985–94

Expenditure category	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
All items	3.8	1.1	4.4	4.4	4.6	6.1	3.1	2.9	2.7	2.7
Food	2.6	3.8	3.5	5.2	5.6	5.3	1.9	1.5	2.9	2.9
Energy	1.8	–19.7	8.2	.5	5.1	18.1	–7.4	2.0	–1.4	2.2
Electricity	2.7	–1.5	1.8	2.8	2.8	1.4	5.0	1.7	.6	0.6
Natural gas	–4.7	–5.8	–2.9	3.6	2.7	1.8	.3	5.1	5.8	–3.2
Fuel oil	5.4	–33.3	17.9	–6.3	19.5	29.9	–19.9	–3.4	–4.6	.0
Motor fuel	3.1	–30.7	18.7	–2.1	6.8	36.5	–16.0	1.8	–5.4	5.9
All items less food and energy	4.3	3.8	4.2	4.7	4.4	5.2	4.4	3.3	3.2	2.6
Medical care	6.8	7.7	5.8	6.9	8.5	9.6	7.9	6.6	5.4	4.9
Medical care commodities	6.3	6.8	7.1	6.9	8.2	8.4	7.5	5.2	3.1	3.0
Medical care services	6.8	7.9	5.6	6.9	8.6	9.9	8.0	7.0	5.9	5.4
Apparel and upkeep	2.8	.9	4.8	4.7	1.0	5.1	3.4	1.4	.9	–1.6
Shelter	6.0	4.6	4.8	4.5	4.9	5.2	3.9	2.9	3.0	3.0
College tuition	8.6	7.4	7.0	7.7	8.1	8.2	12.1	10.0	7.9	6.3
Alcoholic beverages	5.5	2.0	3.3	3.9	4.8	4.2	9.9	2.9	1.5	1.0
Tobacco products	7.2	5.9	7.9	9.4	14.7	10.8	11.1	8.1	–5.9	3.0

NOTE: Data are not seasonally adjusted.

most of the law's provisions will be felt in 1995. The legislation required gas stations to use only this new gasoline as of January 1, 1995. The Federal Environmental Protection Administration calculates that production costs associated with reformulated gasoline range from 4 cents to 6 cents per gallon. December was the only month in 1994 that was affected by the law. On a seasonally adjusted basis, the index was unchanged; however, without factoring out productions costs to refine this gasoline, the index rose 0.9 percent.

Core indexes

Inflation for most other consumer goods and services was modest in 1994. The 2.6-percent increase in the CPI for all items less food and energy was due primarily to declining inflation for medical care and falling prices for apparel.

Medical care. Medical care costs rose 4.9 percent in 1994, its lowest increase since a 3.3-percent rise in 1972. Although medical care costs have risen faster than the overall index since 1980, medical care commodities and medical care services were at their lowest levels in 20 years. Price competition between brand name and generic prescription drugs and patients' increasing reliance on health maintenance organizations has helped keep down inflation in medical care costs.

Although the service component of the medical care index (doctors' and hospital fees), represents about 80 percent of this index, the decrease in inflation for medical care commodities has been more significant. The rise in medical care commodity prices was just 3.0 percent, the lowest since a 0.6-percent increase in 1973. Over-the-counter drugs increased 0.8 percent, as new therapeutically equivalent generic drugs continue to push down prices on their brand-name counterparts.

Prices for medical care services rose 5.4 percent. Uncertainty in health care reform contributed to a moderation in the index for physicians' services, which rose 4.4 percent in 1994. Dental services rose 5.4 percent in 1994, the lowest increase since 1973. The index for hospital and related services increased a modest 5.5 percent, due in part to hospital mergers, consolidation among hospitals in eliminating duplicative services, and an increase in negotiated rates.

Apparel. Apparel prices fell 1.9 percent, the first time this index has fallen since 1954 and its biggest drop since a 2.9-percent decline in 1952. Manufacturers continue to increase imported apparel from lower-wage countries, keeping down costs. Men's and boys' clothing prices fell 1.7 percent. Women's apparel, which is slightly more volatile than menswear, fell 4.4 percent, contributing to the 3.8-percent decline in women's and girls' apparel. On the other hand, prices for infants' and toddlers' clothing, and watches and jewelry, were up 3.3 percent and 5.0 percent respectively.

Apparel indexes over the last 10 years have increased only 2.5 percent on average from December to December. A long winter delayed introduction of spring clothing, forcing apparel manufacturers to discount spring clothing longer than usual. In addition, retailers cut prices to encourage consumers. Although some prices increased since last year, analysts had never before witnessed such reductions continue for an entire season. Also, the fall weather was unseasonably warm, perpetuating discounting for a new fall line of clothing.

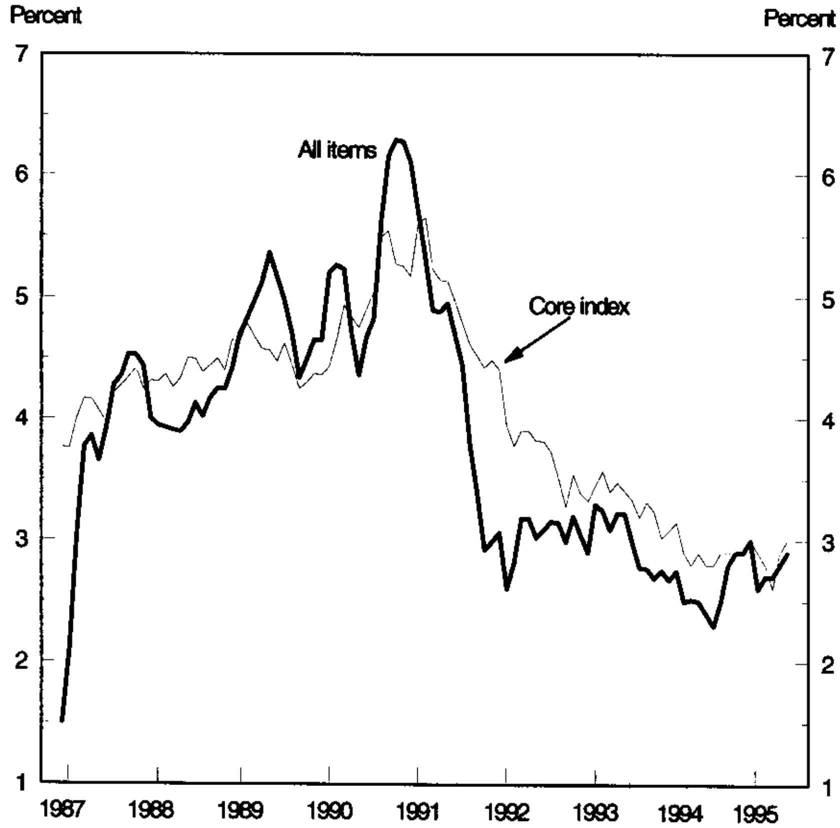
Consumer concern seems to have shifted toward value as measured by price rather than different characteristics in quality in apparel. Retailers are fueling competition and lowering prices for consumers as their costs for goods have dropped. Similar in style and quality, apparel manufactured in lower wage countries has been cheaper for U.S. retailers. As a result, prices have declined, and manufactures will employ third world labor to maintain profit margins as long as U.S. consumers continue to buy their products.

Shelter. Inflation for shelter also has been modest for the past few years. Within the shelter component of the CPI, the owners' equivalent rent index was up 3.3 percent, while the residential rent index rose 2.5 percent. Housing starts reached their highest level since 1988. Starts and sales of single-family homes recorded their largest annual rise in more than 15 years. The index for out-of-town lodging was up 1.3 percent, its smallest increase since the index was started in 1967.

Furthermore, since the excess capacity of residential rental property construction during the 1980's, an oversupply of units continues in the 1990's. Because supply exceeds demand, rent prices are flat. In addition, the return of young adults to their parents' homes and the increase in more affordable group homes help explain the rise in availability in rental units. Both choices lead to more affordable housing, have reduced demand for rental units, and has indirectly kept down rental price increases.

Household furnishings and equipment. In 1994, a portion of the 8.1-percent increase in consumer durable spending included housing expenditures for furnishings and household equipment. However, the CPI for this remained low. Consumer home equity loan rates were lower than fixed rate mortgages at the end of the year. At the same time, reduced loan principles and lower interest debt in household income reflected cheaper financing for home improvement and furnishings. This gave consumers more discretionary income to spend on such items. However, as spending increased, prices for household furnishings and operations rose by only 0.4 percent because discount specialty stores offer furniture and bedding, floor and window coverings, and lawn equip-

Chart 1 **Changes in the Consumer Price Index for All Urban Consumers for all items and all items less food and energy (core index), 1987–95**



The Federal Reserve Board's decision to raise interest rates has had a significant impact on the automobile finance charge index, which rose 23.0 percent for the year. This was the biggest increase in the index since 1980, when auto finance charges rose 25.3 percent. The index for automobile finance charges is affected by price increases for new vehicles and auto finance rates. For example, rates correlated with prime lending rates charged by banks rose between 5 percent and 30 percent on consumer-secured loans such as automobiles. These rate increases were not limited to banks; auto manufacturing credit companies and credit unions also increased borrowing costs. On the other hand, automobile insurance went up a modest 3.4 percent in 1994, the smallest increase since 1974, when the index rose 0.7 percent for the year. Automobile maintenance and repair prices rose only 2.8 percent, its lowest jump since 1966, when these prices grew 2.4 percent.

ment, sparking a price competition with traditional chain retail stores.

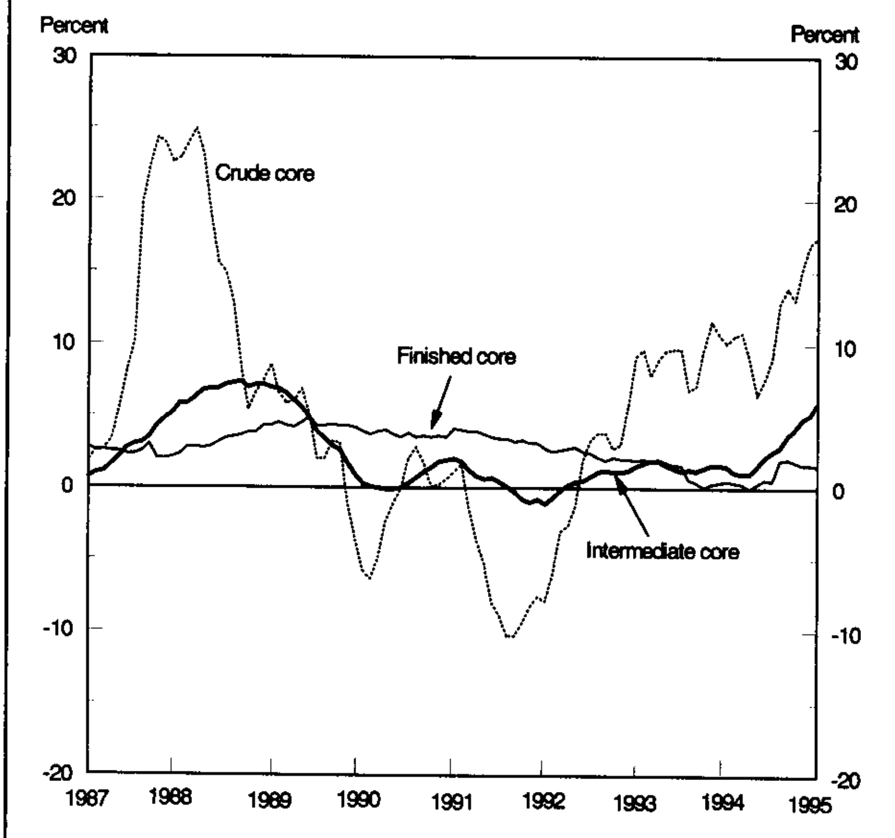
Motor vehicles. Prices rose 3.2 percent for new cars and 3.7 percent for new trucks in 1994. The "Big Three" auto manufacturers—General Motors, Ford, and Chrysler—posted record earnings or returned to positive balance sheets for their domestic sales. The new vehicle index, which incudes new cars, trucks and motorcycles, rose steadily in the first three quarters of the year, as consumer confidence in the economy lifted factory demand. Prices abated in the fourth quarter due to a combination of larger incentives on the 1994 models and smaller price increases on the 1995 models.

Sales of new cars and light-duty trucks were up 8.2 percent for the year. Light trucks and sport-utility vehicles were in particularly high demand, up 12.9 percent in 1994. In 1994, pressures from quality upgrades by domestic manufactures caused import prices to fall below U.S. prices for the first time in the 1990's. This occurred despite a favorable yen-to-dollar exchange rate.

Tobacco products. Tobacco and smoking products rose 3.0 percent in 1994, compared to a 5.9-percent decrease in 1993. Prices for tobacco and smoking products had risen by about 10 percent annually from 1990–92. Increases occurred in various State excise taxes; cigarette price increases at the wholesale level in late 1993 reached consumers in early 1994. Wholesale cigarette prices were unchanged in 1994, the first year since 1980 that cigarette manufacturers did not raise prices. The possibility of a large Federal excise tax increase on cigarettes—as much as $2.00 per pack—to finance health care reform never materialized. With health care reform on the back burner, and the different priorities of the new Congress, the likelihood of a Federal excise tax increase is slimmer.

Other price indexes. In 1994, intense competition among airline carriers led to a drop in fares of 9.5 percent. This was the biggest drop since the index for airline fares was published in 1963. College tuition rose 6.3 percent in 1994, and increases have been smaller each year since 1990. Private universities have been cutting tuition price increases, hoping to draw more students from less expensive State universities. This strategy has increased revenues for some private

Chart 2. Annual percent changes for the core index of the three major stage-of-processing categories, January 1987–94



universities and has helped them avoid shortfalls in enrollment.

Other indexes to note in 1994 included entertainment, which rose 2.3 percent, its lowest price rise since its inception in 1967. Entertainment services rose 2.7 percent, its lowest gain since an increase of 2.5 percent in 1972. Video and audio products fell for the 13th consecutive year, down 2.1 percent. In part due to regulations imposed by the Cable Act of 1992, cable TV prices fell 2.6 percent, the first drop in this index since it began in 1983. Water and sewer prices were up 4.2 percent, its lowest since a 2.6-percent increase in 1979. And the 5.0-percent advance in 1994 was the smallest since the inception of the refuse collection index in 1983. Finally, alcoholic beverages were up only 1.0 percent, their lowest increase since a 0.5-percent rise in 1964.

In sum, consumer price inflation for 1994 has been quite modest as it has been since 1990, the year Iraq invaded Kuwait and, for a time, ran up world oil prices. This should not be surprising: retail stores are experiencing intense competition, consumers are becoming increasingly price conscious, and wages are rising only modestly. Indexes that are less transient, representing those other than food and energy price measures, have risen only modestly over the past 2 years or in some instances have declined.

The outlook for inflation in 1995 is mixed. Those who predict an uptick in inflation in 1995 point to the economy's overall performance in 1994, with robust growth in real output, jobs, consumer spending, disposable income, and capacity utilization. In addition, inflation is increasing for commodities at the intermediate stage; the PPI for intermediate goods rose 4.4 percent in 1994. When and whether this will be passed on to consumers remains to be seen.

However, observers who believe inflation in 1995 will continue to be modest look to the continued competitive strength of U.S. firms. In addition, the effect of last year's increases in short-term interest rates may stabilize prices and increase U.S. dollar reserves with larger foreign holdings of our securities. Also, the PPI for finished goods rose a mere 1.7 percent and inventory buildup in 1994, particularly in the retail trade sector, was matched by steady sales. This may prompt companies to keep production levels up and retain their work force, rather than continue accumulating inventory. Finally, as tariffs fall and global competition increases—a result of legislation such as NAFTA and GATT—and with employment costs showing little sign of wage pressure, price inflation could well remain in check in the coming year. □

Footnotes

[1] This was the first time the discount rate had increased since it reached a nominal level of 3 percent in July 1990.

[2] Most economists agree that a lag of up to 1 year occurs for a change in rates to affect consumer inflation and bring the economy to a soft landing.