Inflation holds steady during the first half

Increase in Consumer Price Index remains unchanged at 4.4 percent, as a downturn in energy component is offset by acceleration in prices for food and apparel

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During the first 6 months of 1988, the Consumer Price Index for All Urban Consumers rose at a seasonally adjusted annual rate of 4.4 percent, the same as that for the 12 months ended in December 1987. While overall rates for the two periods were identical, the composition of price change was different. The energy component turned down slightly in the first half, after partially rebounding in 1987 from the effect of the 1986 oil glut. Shelter costs advanced at virtually the same rate as in 1986 and 1987. But food prices surged in the second quarter, pushing their year-to-date annual rate above 4 percent.

The index for all items excluding food, shelter, and energy rose at an annual rate of 4.9 percent in the first half, the largest increase since the first half of 1984. Within this group, prices for both commodities and services accelerated. The sharp increase in apparel prices accounted for more than 40 percent of the 1988 increase, but most other commodity components also rose faster than in 1987. All service groups other than apparel services accelerated in the first half of 1988. (See table 1.)

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Current developments

Food. Effects of the drought of '88 in the Nation's Farm Belt have evoked comparisons to the Dust Bowl of the 1930's, or to the 1970's when double-digit inflation was preceded by commodity-price shocks. The comparisons are illustrative but not necessarily predictive. Through the first half of 1988, at least, the hot and dry weather has had a minimal effect on food prices.

During the first 6 months of 1988, grocery store food prices increased at an annual rate of 3.9 percent. Although the increase was slightly higher than the 3.5-percent increase in 1987, the composition of the change was different. For example, prices of fresh fruit and vegetables increased a strong 12.8 percent in 1987 because of a combination of strong demand, erratic weather, and a virus which seriously damaged the winter lettuce crop, causing prices to double. In contrast, over the first 6 months of 1988, fresh fruit and vegetable prices declined at a 13.6-percent rate as there were no major disruptions of supplies of potatoes, tomatoes, and seasonal fruits such as peaches, melons, and cherries. Lettuce production rebounded substantially from levels of late 1987 and prices plummeted. However, prices for selected fruits in short supply, such as apples, bananas, and oranges, jumped in the first half of

1988. Prices for processed fruits rose mainly because of production shortfalls of orange concentrate in Brazil.

The index for meats, poultry, fish, and eggs also displayed a wide year-to-year disparity—climbing at a brisk 10.7-percent rate in the first half of 1988 compared with a modest 1.1-percent increase in 1987. Beef and veal prices rose sharply because, early in the year, ranchers held cattle from slaughter in an attempt to build up depleted herds. But, as a direct result of the drought, grazing pastures became parched and feed grain supplies tightened and rose abruptly in price. Cattlemen without the financial wherewithal to survive these conditions were forced to cull their herds by sending beef cows and steers to slaughter. At the Producer Price Index (PPI) level, cattle prices declined sharply in June; lower prices at the meat market counter are likely to follow. But meat prices eventually are expected to turn higher, as supplies are reduced while ranchers rebuild their culled herds.

Prices for pork rose during the first 6 months of 1988, partially in sympathy with beef prices. Higher feed grain prices, because of the drought, were depleting breeding-hog inventories. Fewer hogs for slaughter in the future will result in higher retail prices. Poultry prices soared 24.1 percent in the first half because of increased exports, production cutbacks, and strong incremental demand. For fish and seafood, as with poultry, increased per-capita consumption by health-conscious consumers at a time of relatively static supply resulted in higher prices. The hot weather and rising feed costs led to decreased egg production, causing prices to shoot up at a 29.6-percent annual rate.

Several other food groups contributed to the acceleration in the food index during the 6-month period ending June. Prices for cereals and bakery products rose at a 7.0-percent annual rate with anticipatory price increases for drought-impacted grains partly responsible. The index for alcoholic beverages rose at a 5.8-percent annual rate, while food away from home rose at a 4.4-percent rate. Finally, two groups that helped to moderate the food price increase were nonalcoholic beverages and dairy products—up 1.5 and 0.9 percent, respectively.

Table 1. Percentage changes for major categories of the Consumer Price Index, 1982–June 1988

Expenditure category	Percent changes, 12 months ended December						6 months ended June 1988[1]
	1982	1983	1984	1985	1986	1987	
All Items	3.8	3.8	3.9	3.8	1.1	4.4	4.4
Energy	1.3	-.5	.2	1.8	-19.7	8.2	-.4
Energy commodities	-5.0	-3.2	-1.8	3.4	-30.5	17.8	-1.2
Energy services	14.1	4.1	3.5	-.6	-3.3	.2	.2
All Items less energy	4.2	4.5	4.4	4.0	3.8	4.1	4.7
Food	3.1	2.7	3.8	2.6	3.8	3.5	4.2
Shelter	2.4	4.7	5.2	6.0	4.6	4.8	4.7
All Items less food, shelter, and energy	6.1	5.0	4.3	3.7	3.3	3.8	4.9
Commodities less food, shelter, and energy	5.5	5.0	3.1	2.2	1.4	3.5	4.3
Services less food, shelter, and energy	7.3	4.9	6.0	5.4	5.6	4.3	5.6

[1]Seasonally adjusted annual rates.

Shelter. Shelter costs increased at an annual rate of 4.7 percent during the first half of 1988, about the same as in all of 1987. Renters' costs rose at a 6.0-percent annual rate during the 6-month period after moving up 3.9 percent during 1987. The acceleration in renters' costs resulted from large increases in the index for out-of-town lodging, which advanced at a 12.0-percent annual rate in the first 6 months of 1988, dramatically higher than the 3.9-percent rise in 1987. The 3.4-percent rate of increase for house or apartment rents during the first 6 months of 1988 followed a 4.0-percent rise for 1987. Similarly, the index for homeowners' equivalent rent, up at a 4.4-percent rate during the first half of 1988, rose less than in 1987 when prices increased 4.8 percent. The index for household maintenance and repairs advanced at an annual rate of 2.5 percent in the first 6 months of 1988, compared with a 3.3-percent increase in 1987.

Energy. During the first half, energy prices declined at an annual rate of 0.4 percent, in contrast to the 8.2-percent rise in the index during 1987. The drop in the index can be linked to the continuing disarray within the Organization of Petroleum Exporting Countries (OPEC). Despite short-lived price surges resulting from attempts by OPEC to curb overproduction, the Producer Price Index for crude petroleum fell at an annual rate of 12.2 percent in the first 6 months of 1988. The index had soared 28.8 percent in 1987.

The drop in crude oil prices resulted in moderate 6-month index changes for fuel oil and gasoline in the CPI. Fuel oil rose at a modest annual rate of 1.8 percent, after advancing 17.9 percent in 1987. Gasoline prices dropped at an annual rate of 2.2 percent, after an 18.7-percent increase in 1987. The current surge in fuel consumption has restrained any additional decrease in gasoline prices; there are more cars on the road, being driven longer distances, more often. Both indexes remained below the peak levels reached in early 1981. Energy services (gas and electricity) advanced at the same rate as in 1987, up 0.2 percent. Charges for natural gas dropped at a rate of 0.4 percent, partially offsetting a 0.7-percent increase in the index for electricity.

Services less food, shelter, and energy. The index for services excluding food, shelter, and energy rose at an annual rate of 5.6 percent in the first half of 1988, compared with a 4.3-percent increase in all of 1987. (See table 2.) Most ser-

Table 2. Price changes for consumer services other than food, shelter, and energy, December 1982–June 1988
[In percent]

Consumer service category	December 1982 to December 1983	December 1983 to December 1984	December 1984 to December 1985	December 1985 to December 1986	December 1986 to December 1987	December 1987 to June 1988[1]
Services less food, shelter, and energy	4.9	6.0	5.4	5.6	4.3	5.6
Other utilities and public services	4.8	8.1	5.0	3.7	1.9	2.3
Telephone services	3.6	9.2	4.7	2.7	-1.3	.2
Water and sewerage maintenance	8.5	5.5	5.5	5.4	5.2	7.2
Cable television	(2)	6.1	6.0	3.8	9.5	3.2
Refuse collection	(2)	3.2	6.4	9.4	10.2	8.1
Housekeeping services	2.5	2.4	3.9	1.8	1.8	6.2
Apparel services	5.0	4.9	4.9	3.9	3.9	2.1
Transportation services	3.8	6.2	4.9	5.8	4.3	4.9
Automobile maintenance and repair	3.8	3.2	3.3	3.7	3.8	4.8
Other private transportation services	3.8	7.6	5.3	6.8	5.4	6.1
Automobile insurance	9.1	7.9	12.0	11.8	5.8	9.2
Automobile finance charges	-7.9	6.8	-8.3	-7.3	5.9	-2.6
Automobile registration, licensing, and inspection fees	7.8	8.5	2.1	3.4	1.7	10.8
Public transportation	3.8	6.4	5.1	6.0	1.8	1.8
Airline fares	4.8	6.5	6.3	5.3	1.6	.2
Other intercity public transportation	7.0	10.7	6.4	4.9	2.0	10.9
Intracity public transportation	2.1	5.9	3.6	6.8	2.4	2.0
Medical care services	6.2	5.8	6.8	7.9	5.6	7.5
Professional medical services	7.6	6.3	6.5	6.3	6.3	7.7
Hospital and related services	10.4	7.6	5.0	7.2	7.0	10.9
Entertainment services	5.4	5.7	4.4	5.4	4.3	4.9
Personal and educational services	9.9	9.2	8.1	8.0	6.5	8.5
Tuition and other school fees	9.4	10.1	8.4	7.9	7.6	9.1
Personal expenses (legal, financial, and funeral)	12.2	6.5	6.1	9.0	4.4	6.3

[1] Seasonally adjusted annual rates.
[2] Data not available.

vice categories experienced more rapid price increases in the first half of 1988. The medical care services component advanced at an annual rate of 7.5 percent in the first half, following a 5.6-percent increase during 1987. The acceleration reflected larger increases for both professional medical services and hospital and related services.

Transportation services increased at a 4.9-percent rate during the first 6 months of 1988, after advancing 4.3 percent in 1987. Automobile insurance costs rose at a 9.2-percent annual rate during the first 6 months, up from the 5.8-percent rise in 1987, but still slightly below the double-digit increases of both 1985 and 1986. The index for automobile registration, licensing, and inspection, which had increased only 1.7 percent in 1987, moved up at an annual rate of 10.8 percent in the first half. Partially offsetting these larger increases was a decline at an annual rate of 2.6 percent in automobile finance charges. Public transportation costs rose at a 1.8-percent rate in 1988, the same as in 1987. Increases in fares for airlines and intracity mass transit slowed in 1988 but were offset by a sharp advance in other intercity transportation costs, up at a 10.9-percent annual rate.

The index for personal and educational services advanced at an 8.6-percent rate in the first 6 months of 1988. Charges for tuition and other fees continued to advance sharply—up at a 9.1-percent rate. The index for personal expenses accelerated, reflecting a jump in charges for personal financial services, which include banking and accounting expenses.

Among the non-shelter housing services, the index for housekeeping services accelerated, largely as a result of the April increase in postage rates by the U.S. Postal Service—the first increase since February 1985. Charges for other utilities and public services continued to register moderate increases despite a 7.2-percent rise in the water and sewerage maintenance index. This advance reflected general sewer rate increases and special "drought rates" to promote water conservation.

Within the entertainment services component, which rose at an annual rate of 4.9 percent, the index for club membership fees jumped 10.9 percent in the first half, after rising only 1.7 percent in 1987. The only major service group to decelerate, apparel services, increased at a 2.1-percent rate, after advancing 3.9 percent in 1987. Smaller increases in charges for laundry and drycleaning services were responsible for the slowdown.

Commodities less food, shelter, and energy. Several groups of commodities have a high proportion of imports in market sales. (See table 3.) It follows that these groups are susceptible to price acceleration after a sustained period of decline in the value of the dollar exchange rate such as occurred between early 1985 and the end of 1987. For example, prices for apparel commodities rose at an accelerated clip during the first half, 7.6 percent, compared with 7.4 percent for the same period last year and 4.9 percent for all of 1987. The introduction of substantially higher-priced spring and summer merchandise was consistent throughout the apparel group. Especially sharp rates of increase were displayed by women's and girls' apparel (10.5 percent) and men's and boys' apparel (5.7 percent). It is probable that for all of 1988 the increase in apparel commodities will surpass the gain for 1987 (the largest on record). Major clothing manufacturers have already indicated that, due to sharp increases in their costs for imported wool and other fabrics, prices will be commensurately higher when the fall and winter merchandise is unveiled.

Another import-sensitive commodity, new cars, provides an example of market conditions overriding the effects of exchange rate movements. The index for new cars increased at a modest 1.6-percent annual rate during the first half of 1988, compared with a 1.8-percent increase in 1987. While new cars sold at a slightly higher rate this year as opposed to 1987, the manufacturers and dealers had a difficult time weaning consumers from incentive packages. Although prices of imported cars increased more than prices of domestic models, the rise was below expectations based on the lengthy appreciation of the currencies of the exporters. There are several explanations. First, manufacturers of foreign cars displayed a willingness to sacrifice profit margins in the short run rather than experience an erosion of market share. Second, dealers, who had previously added substantial surcharges to the sticker price of imports in short supply, were cutting or eliminating entirely these markups. Indeed, some imports, especially the luxury European models, were marketed with incentive packages comparable to those of their domestic counterparts. Finally, the distinction between an import and a domestic automobile was becoming blurred as several "foreign" model nameplates are now wholly or partially manufactured in the United States.

Among groups of commodities insulated from the gyrations of the dollar and imports, price movements were disparate. Tobacco and smoking products rose at a 9.9-percent annual rate in the first 6 months of 1988 compared with a 7.9-percent increase in 1987. Late last year, the manufacturers of tobacco products raised wholesale prices which the retailers quickly passed on to the consumer. And the prospect is for more increases in the price of tobacco products for the remainder of 1988 because the manufacturers again raised their wholesale prices in June. The index for medical care commodities, consisting of both prescription and nonprescription drugs, rose at a slightly slower pace during the first half of 1988 than during 1987—5.7 percent versus 7.1 percent. Finally, the index for used cars displayed a complete turnaround from 1987, when prices rose 8.9 percent. In contrast, in the first half of 1988, used car prices declined at a 1.5-percent annual rate. The surprisingly good pattern of new car sales this year resulted in a surfeit of late-model used cars on dealer lots. Hence there was dealer reluctance to bid aggressively at the wholesale auto auctions for anything but clean, ready-to-sell cars.

Current outlook

During the past 6 years, particularly if the volatile energy component is excluded, the movement of consumer prices has been relatively stable. Recent concerns, how-

Table 3. Seasonally adjusted annual rates of change for Consumer Price Indexes for certain commodities with higher-than-average import proportions, selected periods, December 1982–June 1988
[In percent]

Category	December 1982 to December 1983	December 1983 to March 1985	March 1985 to June 1986	June 1986 to December 1986	December 1986 to December 1987	December 1987 to June 1988
Commodities less food, shelter, and energy	5.0	3.5	0.7	2.0	3.5	4.3
Wine at home	-1.5	.7	2.6	-1.3	3.8	3.8
Whiskey at home	1.5	1.3	7.8	.2	1.3	2.1
Alcoholic spirits, excluding whiskey	1.0	2.0	9.7	-.3	.9	2.1
TV and sound equipment	-2.2	-4.1	-5.1	-3.0	-3.7	-.5
Clocks, lamps, and decor items	2.4	1.0	1.6	-5.8	1.7	6.1
Tableware, serving pieces, and nonelectric kitchenware	1.6	.5	2.2	.9	1.3	5.3
Lawn equipment, power tools, other hardware	2.3	1.9	-1.9	1.8	1.3	-2.9
Men's and boys' apparel	2.3	2.3	1.3	.9	3.1	5.7
Women's and girls' apparel	3.3	2.5	-2.3	5.0	5.9	10.5
Infants' and toddlers' apparel	3.5	5.5	4.6	-4.3	2.4	3.5
Jewelry and luggage	3.4	.3	-1.1	5.1	[1]11.5	[1]6.4
Footwear	1.0	2.0	-1.4	3.9	3.8	3.8
New vehicles	3.3	3.0	4.1	5.8	1.8	1.4

[1]Jewelry only.

ever, are that the rate of inflation is accelerating. Most private and public sector estimates of consumer price change for the second half of 1988 and for 1989 show an upward drift. We will examine some of the factors on which these forecasts are based.

The most direct, and highly publicized, influence on prices in the next 18 months will come from this summer's heat and drought. While the economic consequences of the drought will be serious, particularly for farm incomes, the effect on the overall CPI is not generally anticipated to be that large. The consensus forecast, after consideration of the drought, has added 0.1 percentage point to the 1988 estimate of the change in the CPI and 0.2 to 0.3 percentage point to the 1989 estimate. The shortages of crops have both a direct and an indirect effect on the food component of the CPI. The crop failure of durum wheat (for which there are no carryover reserves) used to make pasta is an example of a food component which will be directly affected. More important to food prices, however, are the indirect effects of the failure of the feed grain crops. As noted, higher priced feed is pressuring ranchers to send their livestock to slaughter sooner. The temporary oversupply will lead to lower meat prices. However, the need to rebuild the herds will likely result in higher prices next year.

A second inflationary factor cited revolves around the delayed impact of the long decline in the exchange value of the dollar, that is, the prices of imports will inevitably rise further. The recent U.S. experience was discussed above in the section on commodities less food, shelter, and energy. The evidence suggested that recent exchange rate movements did not consistently portend the magnitude or duration of price movements. Other competitive forces such as the desire to retain market share or the availability of substitute products often mitigated the effects of currency gyrations. Barring a further substantial decline in the value of the dollar (the dollar appreciated slightly over the first half of 1988), there is no reason to believe that any future impact will be significant.

Of greater concern are the inflationary implications of the current stage of the business cycle, typified by high industrial capacity utilization, low unemployment, and accelerating material costs. Through June, the current expansion had lasted 68 months, which exceeded in length 7 out of the 8 post-World War II expansions—the exception being the 106-month period from February 1961 to December 1969. It is usually during the advanced stage of an economic recovery that prices begin to accelerate.[1] Although fears of impending recession persist, the current expansion does not yet appear to have run its course. And the behavior of several statistical series do seem to harbinger upward pressure on prices in the months ahead.

The 14-year low in the civilian unemployment rate achieved during the first half of 1988 has stirred concern about rising wages and their impact on prices. Civilian worker compensation is measured by the Employment Cost Index. During the second quarter of 1988, the annual rate of change in this index rose above 4 percent for the first time since early 1986. But, while rising wage costs usually correlate to rising prices in the long run, advances in productivity can offset this upward pressure. Another indicator influenced by rising wages is the index of unit labor costs, which are the labor compensation costs incurred in the production of a unit of output (and are derived by dividing compensation by output). The unit labor cost index has averaged an annual increase of 2.2 percent during the current expansion. The index rose 3.0 percent, however, between the second quarters of 1987 and 1988. Nevertheless, this should be contrasted to the last 2 years of the 1961–69 business cycle, when unit labor costs rose at a 7.1-percent rate.

An additional characteristic of the latter stages of an expansion is an acceleration of material costs. In good part this can be tied to the fact that the U.S. factory utilization rate during the second quarter rose to its highest level in more than 8 years. The best measure of accelerating material costs is the finished goods component of the Producer Price Index, which rose at a 3.6-percent annual rate in the first half of 1988, following a 2.2-percent increase for all of 1987. While some of the acceleration in the PPI was because of rising food prices, this was partially offset by the downturn in energy prices. Finished goods less food and energy rose at a 3.9-percent annual rate over the first half, almost twice the 2.1-percent rate of last year.

In summary, the drought and the delayed impact of the deterioration of the exchange value of the dollar are likely to have only a small effect on the CPI in the next 18 months. The recent acceleration in labor and material costs will probably put the most pressure on consumer prices. However, even these cost increases, when viewed with a historical perspective, are consistent only with a gradual drift upwards from the 4-percent inflation level of the past 6 years. □

FOOTNOTE

[1]See John F. Early, Mary Lynn Schmidt, and Thomas J. Mosimann, "Inflation and the business cycle during the postwar period," *Monthly Labor Review*, November 1984, pp. 3–7.