Inflation Expectations

Tatiana Bailey, Ph.D.

This week, the consumer price index was released, and it showed prices increasing from 3.2% year-over-year in July to 3.7% year-over-year in August. Month-over-month, from just July to August, prices rose 0.6%, which is the largest monthly increase since June of last year when inflation peaked in the double digits.

The biggest contributor to inflation in August was gasoline, with a 10.6% increase over the month. "Core" inflation, which strips out more volatile food and energy prices, moved in the opposite direction of headline inflation declining from 4.7% year-over-year in July to 4.3% year-over-year in August. Core inflation is what the Federal Reserve looks at more carefully, but the news overall for the Fed and the average consumer still isn't good. New vehicles, shelter costs, car insurance costs, medical and personal care costs all increased, and those components impact everyone.

As part of this inflation conversation, I'd like to address inflation expectations. One of the primary worries economists and the Federal Reserve have in terms of inflation is elevated price expectations on the consumer side. Basically, if consumers expect prices to increase, it can cause them to buy now instead of later because they expect prices to be higher in the future. This can further constrict supply causing prices to stay high or even increase further.

But I think perhaps the bigger issue especially in this cycle is high price expectations by producers. If manufacturers and other businesses expect their costs to be higher in coming months, they are likely to increase prices today to protect the profit margins of tomorrow.

And this isn't only true for physical, material inputs. It's also true for labor. Even with a modest cooling in the U.S. labor market, wage pressures persist as evidenced by the slew of union wage demands that I talked about in last week's article. If businesses assume that wages will stay high, which they will as no one is likely to take a pay cut, or that wages may even increase further, they may build these cost increases into their price structure moving forward. This is especially true for labor that is hard to get like in hospitality, health care, and very specialized fields like software engineering. This is especially true in the demographic reality of more retirees and proportionately fewer working-age people.

Volatile energy prices further exacerbate this scenario. Again, if businesses want to protect themselves, they may assume energy prices will be high prospectively or at a minimum, energy prices will be volatile, and they build that assumption into their pricing models. Geek economists like me have a term for this called "second order effects." Businesses might call it projecting costs and protecting the bottom line. Consumers might call it price gouging.

Regardless of the terminology, this all feeds on itself and the Federal Reserve knows it, which is part of the reason they are so dogged about reining in inflation. Now, the recent data shouldn't overshadow that progress has indeed been made in terms of the overall direction of lower inflation rates (see chart). But right now, it's a tossup whether the Fed will be concerned enough about August's increase to raise interest rates one more time or wait to see new data to ascertain whether the recent increase is a blip on the radar. Next week, I'll talk about how inflation plays into our local sales and use tax and the implications for local governments.

Tatiana Bailey is Executive Director of the nonprofit, Data-Driven Economic Strategies (DDES). An abridged video with this information recently aired on The Economic Update with Tatiana Bailey on Fox21 and can be found on their website or at ddestrategies.org. Other articles and DDES monthly economic progress reports (EPRs) can also be found on their website.