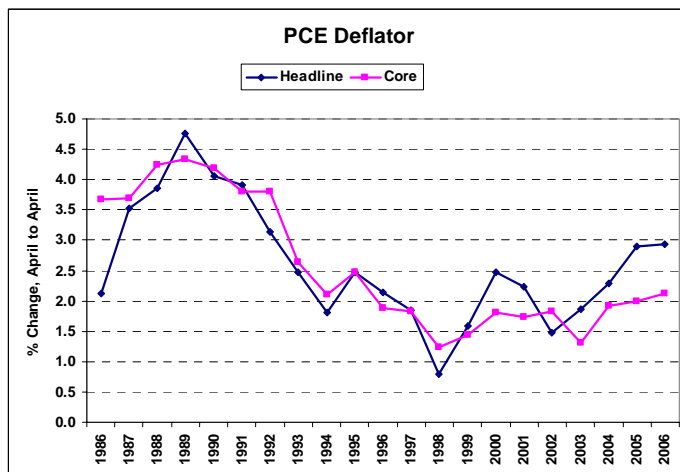


## Headline Versus Core Inflation

For the typical household, the total or headline rate of inflation is what matters. It is headline inflation that measures the rate at which the cost of living is rising. It is headline inflation relative to income growth that determines whether a household's standard of living is rising or falling.

For the purpose of calibrating monetary policy, however, the Fed and many economists focus more intently on the core rate of inflation: the total excluding food and energy prices. In part, that is because the core is less volatile and a better reflection of the interplay of supply and demand in domestic product markets. Thus, the core usually is a better gauge of the underlying rate of inflation that will tend to emerge in the absence of supply shocks.

By contrast, food and energy prices are sometimes extremely volatile from month to month due to temporary supply disruptions related to weather or to political crises. In those instances, the headline rate of inflation, which includes the volatile food and energy price components, tends to be less representative of the underlying rate of inflation.



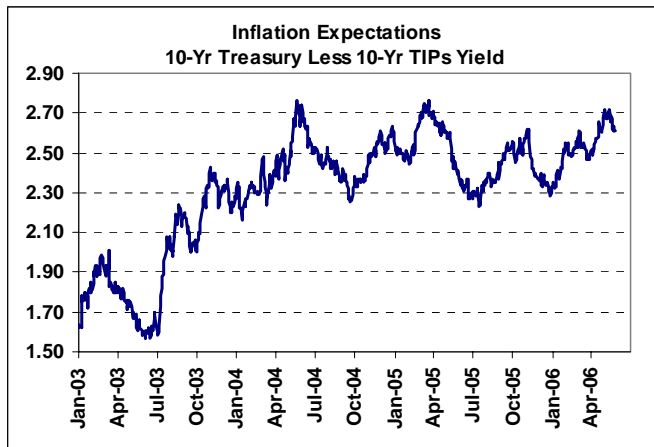
The historical record in the United States is that headline and core inflation have averaged about the same over the long run. For example, over the past 20 years, annual inflation as measured by the Personal Consumption Expenditure (PCE) deflator averaged 2.6 percent, while price increases as measured by the core PCE deflator averaged 2.5 percent. As the chart confirms, however, headline and core inflation sometimes diverge quite substantially over shorter intervals. Since 1986, headline inflation measured over 12-month spans has been as much as 1.8 percentage points higher and 1.7 percentage points lower than core inflation.

The experience of the past four years poses a challenge to the rationale for focusing on the core. Over that period, crude oil prices have soared, rising from \$20 per barrel in early 2002 to around \$70 currently. At times, the rise in crude oil prices was related to supply disruptions such as the Iraq war and hurricanes. But predominantly, the upward trend in crude oil prices reflects surging global demands for energy. In any case, the outcome is that headline inflation has run hotter than core inflation for four consecutive years. As measured by the PCE deflator, prices have risen at a 2.5 percent compound annual rate over the past 48 months, while the core PCE deflator has increased at only a 1.8 percent compound annual rate. So is it appropriate for the Fed to continue to focus on the core rate of inflation in such circumstances?

In my judgment, the practical test for whether the Fed has been doing the right thing is whether the tendency for headline inflation to run above core inflation has boosted the underlying rate of inflation or undermined confidence in the Fed's anti-inflation resolve. So far the evidence is that not much of either has occurred.

Returning to the first chart, the core rate of inflation in the latest 12 months was 2.1 percent, an acceleration of only 0.2 percentage points compared to two years earlier. While that represents a remarkably small

pass-through of energy cost increases, it does place core inflation slightly outside the Fed's comfort zone of 1 to 2 percent. And that is the highest rate of core inflation measured from April to April in eleven years. All in all, core inflation is still quite subdued but is subtly creeping higher.



The second chart shows a good proxy for inflation expectations. It portrays the difference between the yield on 10-year Treasury notes and 10-year inflation-linked Treasury notes. A conventional 10-year note pays a fixed coupon. The inflation-linked notes pay a lower fixed coupon plus a variable component that equals the actual rate of headline inflation as measured by the consumer price index. The premise is that yields will adjust on these two Treasury instruments until investors are indifferent between owning a conventional or an inflation-linked note. If that is true, the difference in the two yields will be a good proxy for the expected rate of inflation over the 10-year maturity of these Treasury notes.

What the second chart shows is that inflation expectations returned to the 2 ½ percent area as the economy began to grow strongly in 2004. But in 2005 and 2006, this proxy has continued to fluctuate in a relatively narrow band between 2.3 and 2.7 percent, even as energy prices trended higher. So far, most investors remain relatively confident that the Fed will keep headline inflation subdued, even though it has been running significantly above core inflation for four straight years.

The evidence, then, is that core inflation and inflation expectations have edged up in reaction to the more rapid trend in headline inflation. But both remain relatively subdued and well contained so far. Still with the economy growing in a relatively healthy fashion, the main risk is that core inflation and inflation expectations will continue to move subtly higher. Resource utilization in product and labor markets has increased. The dollar has weakened recently giving US companies a bit more leeway to raise prices. Commodity prices, while off their recent peaks, remain high; and producers will attempt to pass along those cost increases.

In sum, the predominant risk in the period ahead is that the core rate of inflation will accelerate to around a 2 ½ percent annual rate for awhile. In effect, the gradual but relentless Fed tightening of the past two years may have accommodated a bit of a cyclical rebound in the underlying rate of inflation. If so, I have no doubt that the Fed under Bernanke's leadership will reverse that cyclical rise of inflation by putting in place an appropriately restrictive monetary policy.

The key take away is that the core rate of inflation in the United States is not going to accelerate in a persistent and lasting fashion. There is no controversy in Washington about the basic premise that the Fed contributes most to the growth prospects of the country by keeping inflation low. Bernanke will have no trouble leading the Fed to tighten further if that is what it takes to keep core inflation subdued.

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# Economic Brief

## Comerica Forecast Worksheet (May 31, 2006)

	<b>Federal Funds*</b> %	<b>Bank Prime</b> %	<b>3-Month Treas. Bill**</b> %	<b>3-Month Libor</b> %	<b>2-Year Treasury</b> %
<b>Actual</b>					
2005Q2	2.94	5.91	2.93	3.21	3.64
2005Q3	3.46	6.43	3.43	3.71	3.95
2005Q4	3.98	6.97	3.91	4.31	4.36
2006Q1	4.46	7.43	4.50	4.75	4.60
<b>Forecast</b>					
2006Q2	4.95	7.93	4.82	5.12	4.94
2006Q3	5.00	8.00	4.90	5.15	5.00
2006Q4	5.00	8.00	4.90	5.15	5.00
2007Q1	5.00	8.00	4.95	5.20	5.13
	<b>10-Year Treasury</b> %	<b>Conventional Mortgage</b> %	<b>Fed Major Currency Index Mar73=100</b>	<b>Real GDP SAAR</b>	<b>Unemploy. Rate</b> %
<b>Actual</b>					
2005Q2	4.16	5.72	83.5	3.3	5.1
2005Q3	4.21	5.76	84.6	4.1	5.0
2005Q4	4.49	6.22	85.9	1.6	5.0
2006Q1	4.57	6.24	84.9	4.8	4.7
<b>Forecast</b>					
2006Q2	5.06	6.62	81.1	2.8	4.7
2006Q3	5.07	6.57	80.5	3.0	4.6
2006Q4	5.20	6.70	79.7	3.0	4.6
2007Q1	5.30	6.80	78.3	3.2	4.5
	<b>CPI SAAR</b>	<b>Core CPI SAAR</b>	<b>Light Veh. Sales Units</b>	<b>Housing Starts Units</b>	<b>Trade Deficit \$ BN</b>
<b>Actual</b>					
2005Q2	3.7	1.9	17.2	2.04	691
2005Q3	5.4	1.6	17.9	2.10	734
2005Q4	3.2	2.4	15.8	2.03	789
2006Q1	2.2	2.4	16.8	2.13	803
<b>Forecast</b>					
2006Q2	4.4	2.9	16.6	1.91	790
2006Q3	2.2	2.2	17.0	1.91	800
2006Q4	1.9	2.4	17.0	1.88	805
2007Q1	2.1	2.4	17.2	1.85	810

\*The federal funds rate is projected to be 5% at the end of 2006. We are forecasting that the Fed will resume tightening in the second half of 2007.

\*\*Coupon Equivalent Yield