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Inflation Metrics to Change at Crucial Time

THE OUTLOOK|

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PCE

An acceleration in the Federal Reserve's preferred measure of inflation has some officials warning that higher interest rates might be in order.

A bit of relief, though, is on its way—not from prices themselves, but the way they are measured. The agency responsible for publishing the Fed's preferred measure, the price index of personal-consumption expenditures, plans to revamp how it handles three components.

The effect, according to economists, will be to lower core PCE inflation. The core rate excludes food and energy to gauge underlying price pressures better. Economists estimate that when the revised approach is rolled out in the August data set to be published Sept. 30, core PCE inflation will be about two-tenths of a percentage point lower than under the old formula.

Note Note

That will eliminate some of the unusual discrepancy that has opened up between the PCE rate and the betterknown consumer-price index. Annual core CPI inflation was 2.6% in June. Economists estimate core PCE was 3.3%.

Usually, CPI inflation runs slightly above PCE inflation. The latter is higher now in part because of software and investment-management readings, which will likely show lower increases after revisions.

Statistical agencies regularly tweak their indicators.

Note

This makeover is getting added attention because it comes at a crucial time for monetary policy. Though the likely effect is small, it could, at the margin, weaken the case for a rate hike.

It's also coming as economists and investors are on high alert for any sign of political interference in economic data from President Trump or his appointees. While there is no evidence such interference played a role in the changes, the opacity regarding them has raised some eyebrows.

The Bureau of Economic Analysis is tweaking its measurement of the cost of investment management, software and legal services, and it will apply changes retroactively to the past five years.

The BEA, part of the Commerce Department, doesn't gather much price data itself. Instead, it mostly uses prices collected by another federal statistics agency, the Bureau of Labor Statistics, part of the Labor Department, and then recombines them using its own formulas. Frictions can arise when the two agencies' approaches differ.

For example, to measure prices for software, the BEA takes data from a BLS index of computing costs. But the BLS's numbers include some items such as flash drives. Their prices have soared because of roaring artificial-intelligence demand. So the BEA's software index has shown significant price increases that are actually at tributable to hardware.

The new formula aims to address that problem by blending additional BLS data on videogame software and web-hosting prices into the BEA's software index. This will likely lower the PCE inflation rate by about a tenth of a percentage point, Alan Detmeister of UBS estimates.

The BEA is also changing how the PCE index measures the cost of investment advice. Investors usually pay money managers a fee based on a percentage of assets. Under the BEA's current formula, this price rises when the stock market is on an upswing, as it has been for most of this year.

Some have argued that this shouldn't really count as inflation. When advisers are --managing more assets, rising fees represent a greater volume of services provided, not a higher cost for the same service, then-Fed governor Stephen Miran said in a speech last year.

To address this, the BEA is switching to a more complicated method that involves comparing financial firms' income with the amount of work performed in the industry. This approach will also lower inflation, by about two-tenths of a percentage point, Detmeister estimates.

On legal services, the BEA has mostly taken the cost from the BLS's CPI—even though data-collection challenges have led the BLS to stop releasing legal-services figures publicly. The BEA will now swap out that data for numbers from a different BLS survey, the producerprice index. This will likely push up inflation.

The downward effect of the investment and computing changes will probably outweigh the upward effect from legal services and on net reduce PCE inflation, says Vikas Patel, a program manager at Employ America, an economic-policy think tank.

A few tenths of a percentage point won't alter the big picture. Inflation has run well above the Fed's 2% target for more than five years. The new Fed chairman, Kevin Warsh, has said he isn't interested in splitting hairs, adding that he prefers to focus on how the inflation rate looks "to the left of the decimal point."

But at a moment when Fed officials are torn over whether higher interest rates are needed, even a slightly cooler inflation rate could sway their thinking.

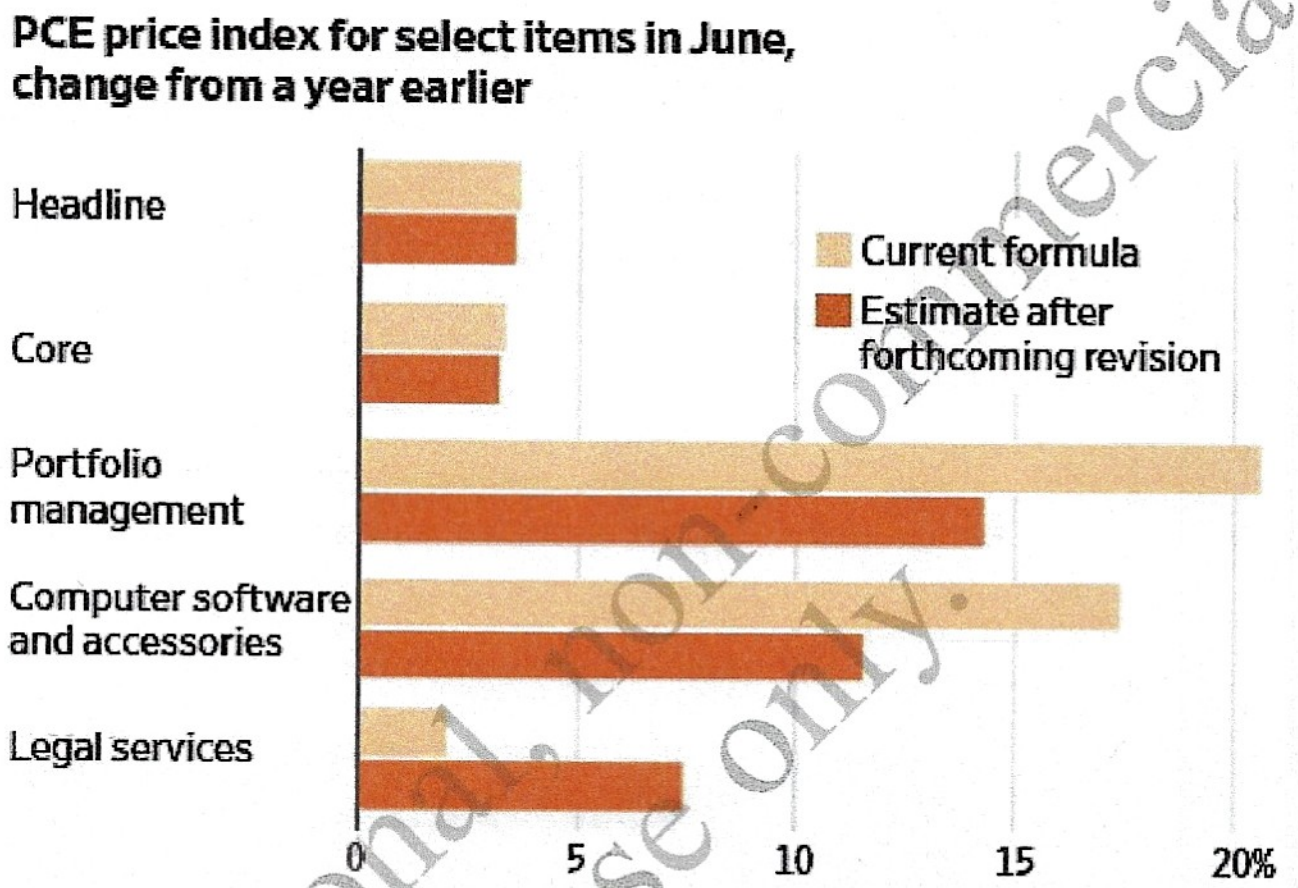
When the BEA tweaks its approach, it usually does so in September, when it annually revises the past five years of data. It is following that protocol here.

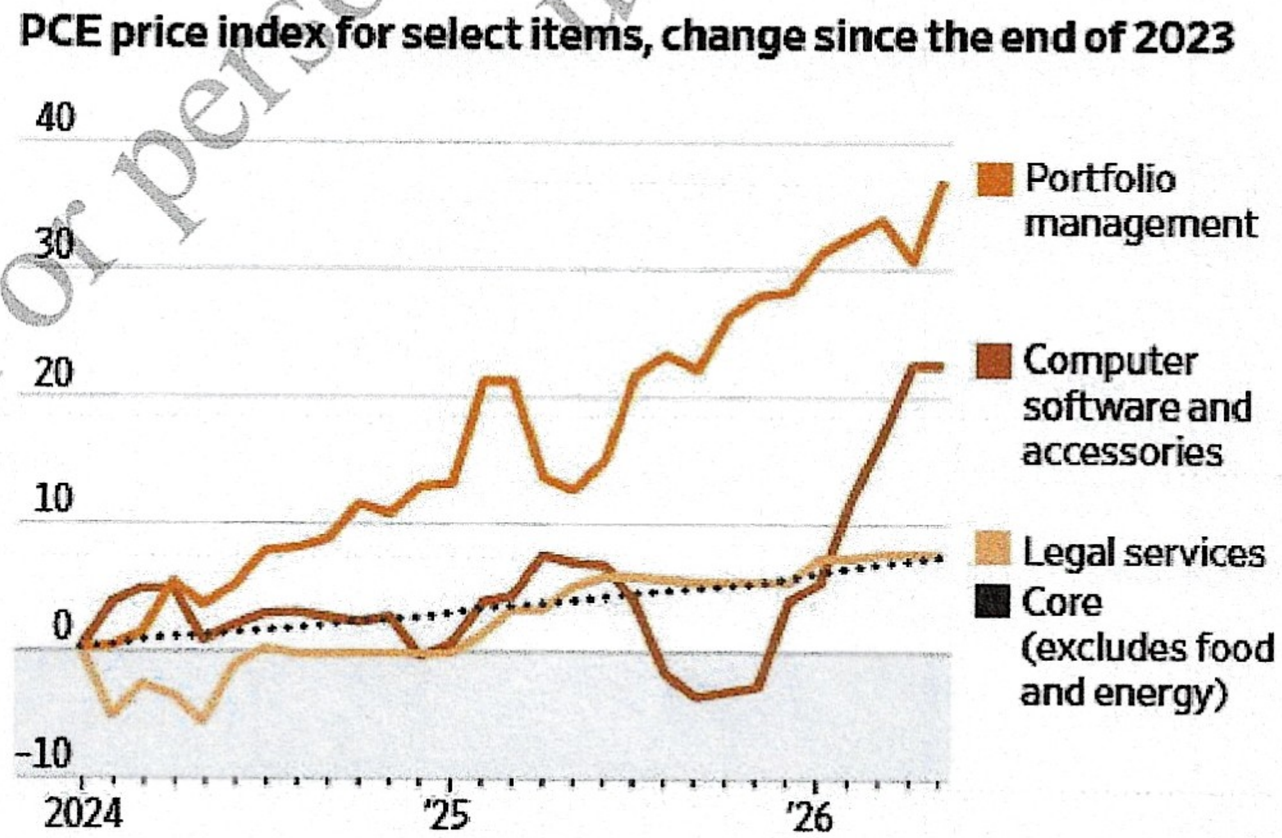
Some economists who track the government's statistics closely would have liked more clarity. Some are frustrated that the agency hasn't specified the exact formula it will now use in the software calculation. Others are wary of the new approach to investment-management prices, which relies on labor-market numbers that are subject to large revisions.

"Any of the changes that you're making to any of these three categories don't themselves seem out of line," Detmeister says. But he adds that the selection of categories has left him wondering, "Why did they choose these?"

The BEA has described the coming changes as routine adjustments necessary to make the statistics as faithful as possible.

"These decisions are made by BEA career staff to maintain the accuracy and reliability of BEA's estimates, without other considerations," Connie O'Connell, the agency's head of public affairs, says.





Source: Commerce Department (PCE actuals); Employ America (estimated revision impact)