Why the Fed Worries Inflation Is too Low

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The Federal Reserve's rate-setters announced on Wednesday that they are forging ahead with ultra-easy money, in part because inflation is running "somewhat below" the Fed's target of 2 percent. The Federal Open Market Committee said it will leave the funds rate where it is, just above zero, and keep buying bonds at a pace of $85 billion a month.

This might strike some readers as odd. Why does the Fed want prices to go up? Isn't inflation bad? And even if you buy the idea that a little inflation is good, who *says* inflation is running under 2 percent? It certainly doesn't feel that way to families that are having trouble making ends meet.

First, the Fed's policymakers want prices to go up because they believe that a little bit of inflation is good for growth. The Fed wants interest rates to be below the rate of inflation to give homeowners and businesses a strong incentive to borrow and spend, generating jobs. The Fed can't do that if there's no inflation because interest rates can't be lower than zero.

Second, inflation really is below 2 percent. Over the past year through March, consumer prices rose just 1.5 percent. Excluding food and energy, which jump around a lot, consumer prices rose 1.9 percent. That's according to the Consumer Price Index of the U.S. Labor Department's Bureau of Labor Statistics.

The Federal Reserve prefers to use a separate measure of inflation that shows even lower inflation—namely, the price index used by the U.S. Commerce Department in calculating personal consumption expenditures (PCE) for its reports on gross domestic product. A report on Wednesday by economists at JPMorgan Chase delves into the differences between the CPI of the Labor Department and Commerce's so-called PCE deflator .

In the first quarter of 2013, says JPMorgan, the CPI grew 1.7 percent from a year earlier, while the PCE deflator grew just 1.2 percent. The CPI has outpaced the PCE price index by an average of 0.4 percentage points per quarter since 2011.

Why does this matter? Because the Fed will keep its foot on the accelerator pedal harder and longer if it considers inflation to be much lower than 2 percent than if it thinks inflation is pretty close to its target rate.

JPMorgan cites three main reasons for differences between the two inflation measures.

• **Formula:** The PCE deflator captures shifts in the pattern of consumers' spending much sooner than the CPI does. So when consumers shift away from expensive items to cheaper ones, it shows up as lower inflation in the PCE, but not the CPI.

• **Weights:** Housing counts for 31 percent of the CPI but only 16 percent of the PCE. So the recent big rise in rents has boosted the CPI more than the PCE.

• **Scope:** Medical care, whose costs are largely covered by Medicare, Medicaid, and private insurance, weighs more heavily in the PCE. Since medical inflation tends to run high, this factor usually works in the other direction, boosting the PCE vs. the CPI. But not enough to offset the other two factors.