ECONOMIC VIEWPOINT

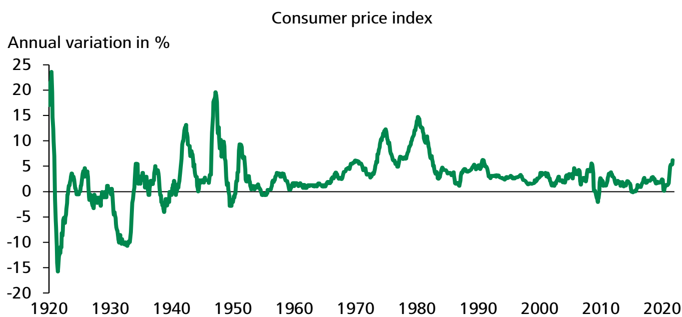
Is Higher Inflation Widespread in the United States?

By Francis Généreux, Senior Economist

The 12-month increase in the U.S. consumer price index (CPI) recently reached rates not seen since the summer of 1990. Inflation is now more than the triple of the Federal Reserve's (Fed) traditional target of 2%, and more than 85% of the basket of goods and services shows an increase above this rate. The disruptions caused by the pandemic are clearly at the root of the higher inflation. Factors like the pressure on the cost of housing and on wages threaten to make the price surge more persistent.

It has been a while since the United States saw inflation surge like this, with the CPI's annual variation hitting 6.2% in October. The last time inflation was higher than this was in October and November 1990 when it reached 6.3% (graph 1), and before that, July 1982. Today's inflationary landscape stands in stark contrast to the weaker price growth trend of recent decades. That said, the United States is still far from seeing inflation soar like it did in the 1970s and 1980s, when annual variations in CPI often exceeded 10%.

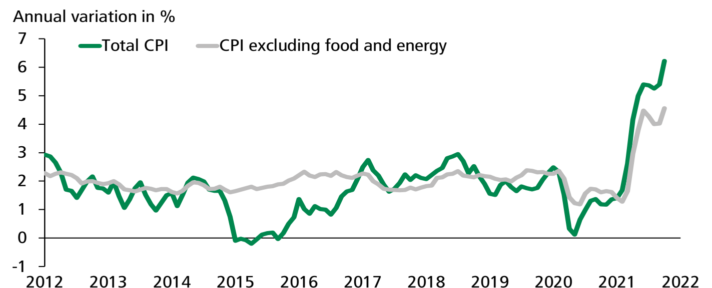
GRAPH 1
Inflation reached its highest point since 2008, but remains well below that of the 1980s



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

The effect of COVID-19 can be seen in the stunning price hikes in recent quarters. The annual variation in total CPI was no more than 1.4% at the beginning of 2021. It even fell to a mere 0.1% in May 2020 (graph 2), its lowest level since September 2015. Core inflation—the annual variation in CPI excluding food and energy—saw fluctuations like those of total CPI, albeit less pronounced. Summer 1991 was the last time core inflation outstripped the 4.6% recorded in October.

GRAPH 2
U.S. inflation clearly rose in 2021



CPI: Consumer price index
Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

The Composition of the CPI Basket

Like household consumption, the basket that makes up the CPI in the United States is made up mainly of services. These represent more than 60% of the composition of the index (graph 3 on page 2). A large part of the services come from the housing components (32.6% of total CPI). Among goods (38.7% of the total), the largest share goes to food. The auto sector is another important component with a major impact on the recent surge in inflation.

Energy behind Recent Hike in Inflation

The pandemic is playing a major role in how consumer prices are changing. This is mostly evident in the way energy prices are fluctuating, especially for oil and gasoline. The price for a barrel

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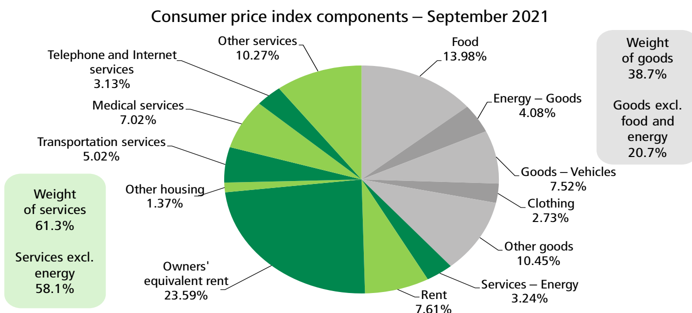
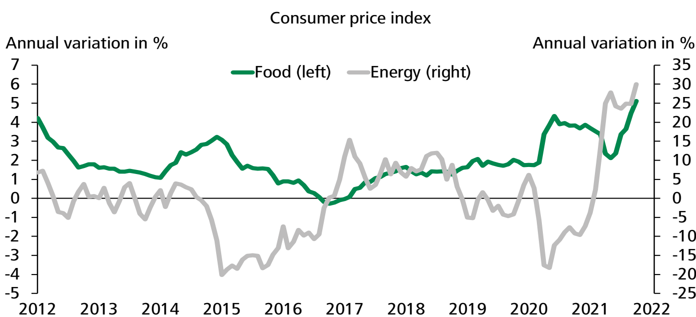
GRAPH 3
Services, especially housing, make up the biggest share of the consumer price index



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

of crude oil collapsed at the beginning of the pandemic. For example, the WTI (West Texas Intermediate) index went from more than US$63 per barrel in the first few days of 2020 to an average of US$17 per barrel in April that same year. Because of this plunge, monthly CPI variations were negative between March and May 2020, and inflation came within a hair's breadth of 0%. Since then, the opposite has been happening, and higher oil prices (the WTI is now over US$80 per barrel) have contributed significantly to inflation (graph 4).

GRAPH 4
Energy and food helped drive up the consumer price index



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

The food industry has also contributed, although not as dramatically as energy. Food prices were up significantly when the pandemic first began, contrary to other goods and services, which saw prices fall. After a lull that lasted until spring 2021, food prices have risen once again, with meat (annual variation of 14.5% in October) and restaurant meals (+5.9%) up sharply.

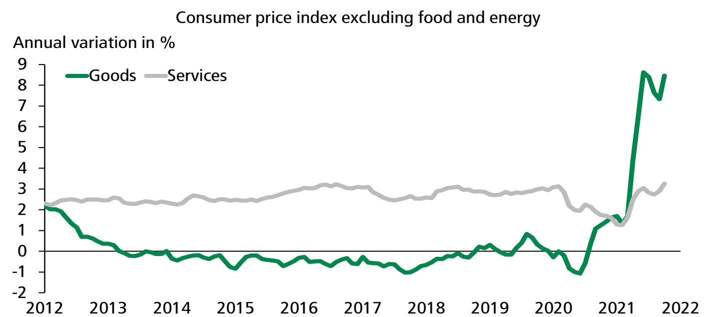
Together, the weights for energy and food represent 21.3% of the basket of goods and services that make up the CPI. In September, components linked to energy were responsible for 2.0 percentage points of inflation, which was 6.2%, whereas food added 0.7 percentage points.

Goods Jump in Price

The biggest change in consumption habits caused by the pandemic was the strong interest in goods, while services experienced more disruptions because of the public health measures. Helped by a sharp rise in disposable income and low interest rates, real consumption of goods exceeded its February level as soon as June 2020. At the same time, the consumption of services was still down roughly 10.7% from the pre-pandemic peak.

The increased demand for goods quickly put pressure on prices, especially during summer 2020. Supply chain problems only made the situation worse, pushing prices up again starting in spring 2021. As a result, the annual variation in CPI for goods (excluding food and energy) went from -1.1% in June 2020 to a high of 8.6% a year later (graph 5), the highest annual variation since February 1981. At the same time, the annual variation in prices for services remained modest, barely going back on its medium-term trend.

GRAPH 5
Goods are at the core of the post-pandemic inflationary surge



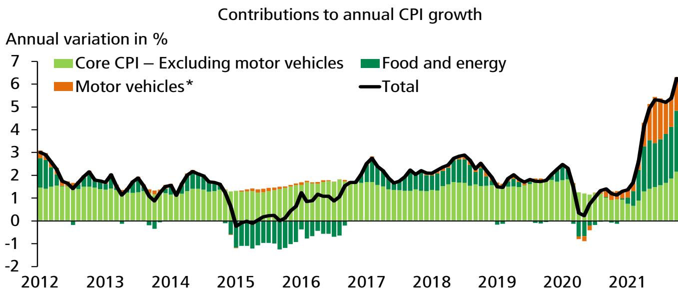
Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

Auto Sector Problems Made the Situation Worse

One of the main reasons behind the surge in total inflation and prices for goods was the price increases in the auto sector (which represents nearly 11% of total CPI). First noticed in 2020, the impact increased significantly starting in April 2021 (graph 6 on page 3) because of a poor assessment of how many vehicles needed to be produced to meet demand and the lack of electronic parts.[1] Last June, the annual variation in the prices for goods associated with the auto sector (new and used vehicles as well as parts) reached 22.6%, whereas the annual variation in services (rental, repair and fees) climbed to 15.0% in May. First prize goes to the cost to rent a car, which more than doubled

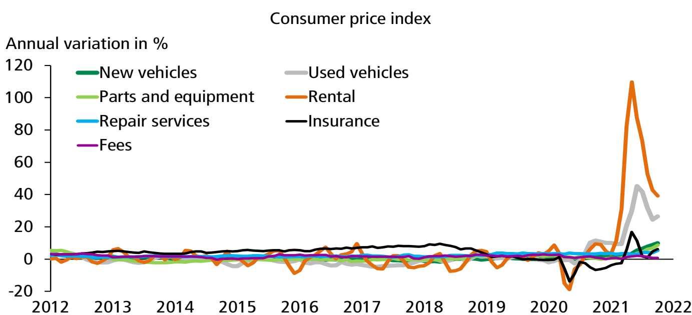
[1] For more information, see: The U.S. Auto Industry's Problems, Desjardins, Economic Studies, *Economic Viewpoint*, June 3, 2021, 6 p.

GRAPH 6
The U.S. auto sector contributed significantly to the variation in consumer prices



CPI: Consumer price index; * New vehicles, used vehicles, parts and equipment, rental, repair services, insurance and fees.
Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

GRAPH 7
Some classifications of goods and services associated with the auto sector saw spectacular price hikes



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

between May 2020 and May 2021 (graph 7). The increase was also especially high for used vehicles. The auto sector generally is not known for experiencing major price increases; between 2013 and 2019, the average annual variation in this sector was only 0.9%.

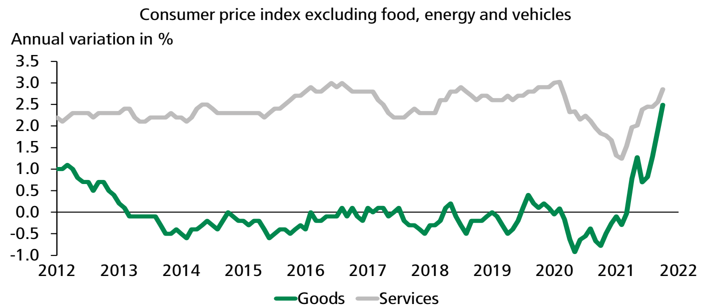
Steep price increases in the auto sector are having a significant impact. If we leave out the components in the CPI basket that relate to this sector, the CPI for goods (excluding food and energy) would have risen no more than 2.5% in October instead of 8.5% (graph 8). The difference in services is less striking (2.9% instead of 3.3%).

Is Deflation Over for Some Goods and Services?

It may seem less serious, but the recent rise in the price of goods excluding food, energy and the auto sector still stands out in contrast to the pre-pandemic situation. From 2013 to 2019, the average annual variation was -0.2%. Therefore, prices tended to decline for the better part of the last economic cycle. Inflation of more than 2% is a significant change.

Globalization as well as domestic and international competition largely explain the downward trajectory of the prices for

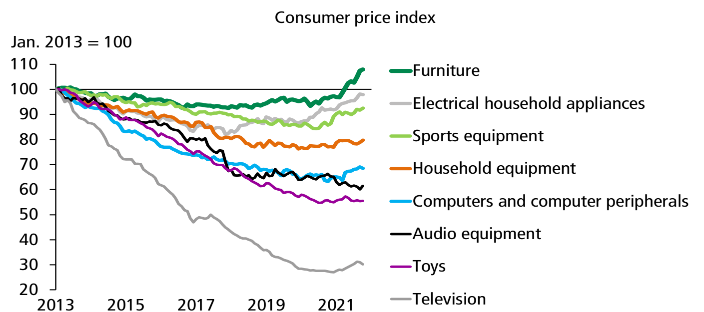
GRAPH 8
Even excluding motor vehicles, the price increases for goods were unusually high



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

goods. Furthermore, the method used by the Bureau of Labor Statistics (BLS) to compile the CPI is an important factor, especially when it comes to goods subject to technological progress. The BLS takes into account product improvements. So, an improved or better performing product at the same retail price is going to be considered less expensive than before. On the other hand, a decrease in quality (or quantity) will be perceived as a price increase.

GRAPH 9
Prices for goods that usually decline have increased in the last year



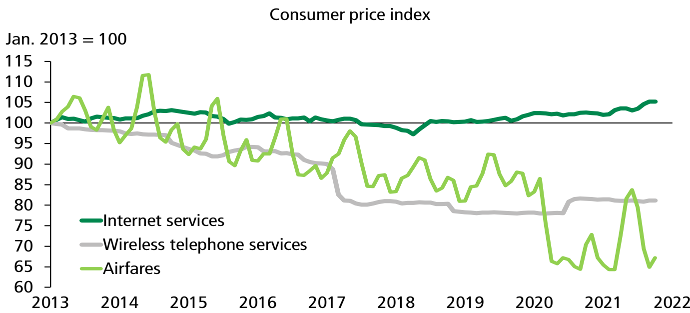
Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

Because of these factors, some goods have significantly dropped in price over the last decade (graph 9). For many though, the pandemic has halted the downward trend, with negative contributions being replaced by neutral or positive contributions.

A similar situation applies to some services, where prices usually decline from year to year. This is still rare, and the trend has changed little until now (graph 10 on page 4).

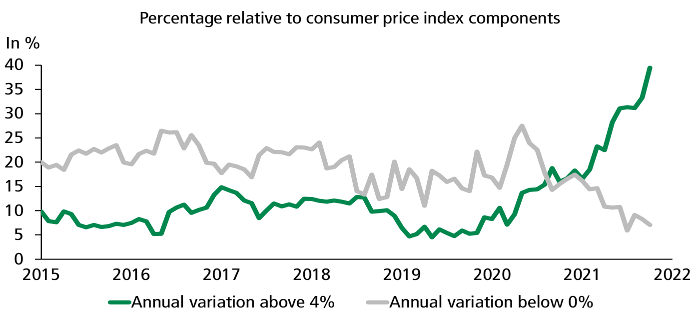
When it comes to the CPI, approximately 20% of the total basket consisted of goods and services that usually recorded negative annual variations before the pandemic. This proportion has now

GRAPH 10
Prices for services that usually decline have deviated less from the pre-pandemic trend



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

GRAPH 11
The weight of goods and services whose prices decline is currently very low



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

fallen to less than 10% (graph 11). In contrast, the proportion of goods and services in the CPI posting bigger hikes, that is, more than 4%, has increased substantially from 10% of the index to near 40%. Therefore, deflation is less present with a larger share of CPI components showing price increases twice as high as the Fed's target.

Inflation Is Clearly More Widespread

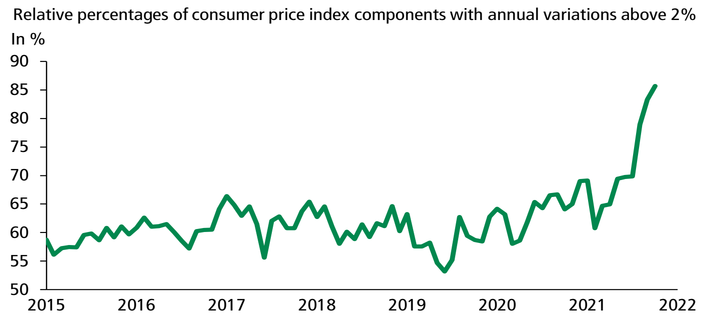
So, inflation is up but also more widespread. In October, 85.7% of the CPI basket surpassed 2% (graph 12). Between 2011 and 2019, this proportion was 58.6% on average. Therefore, more than four fifths of the basket of consumer goods and services used to calculate the CPI are now driving inflation higher than the Fed's target.

The Weight of Housing

In October, 72.6% of the CPI basket has surpass the 3% mark in terms of annual growth (graph 13).

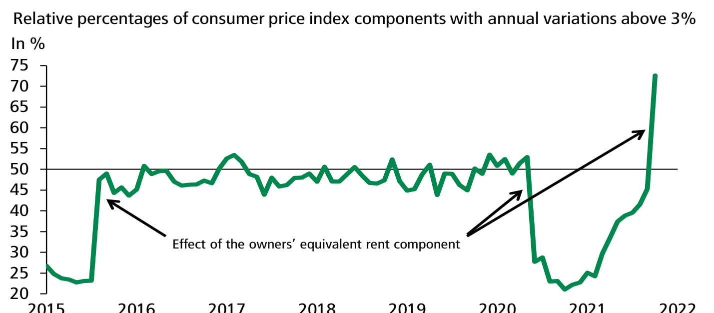
One component, the owner's equivalent rent, has a considerable influence on the fact that the bar of 50%, then 70% of the basket, is now growing at more than 3% annually. This component alone accounts for nearly 24% of the CPI. Its annual

GRAPH 12
More than 85% of the basket of goods and services saw price hikes in excess of the Federal Reserve's target



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

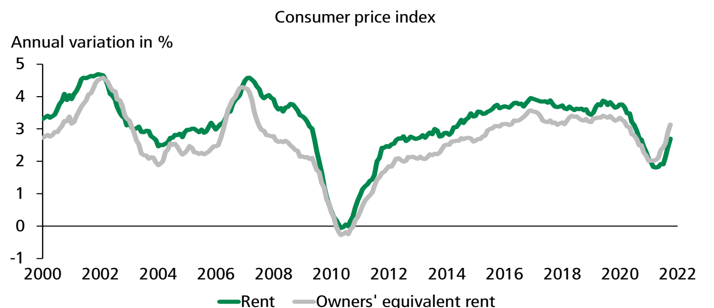
GRAPH 13
There are more and more components whose prices varied more than 3%



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

change was 2.9% in September and 3.1% in October. The (tenant) rent component, which represents 7.6% of the basket, posted a more modest 2.6% annual increase in October. These two CPI components began to follow an upward trajectory in recent months after an notable deceleration in 2020. Still, their

GRAPH 14
Prices linked to shelter have risen sharply, but their growth remains below pre-pandemic trends

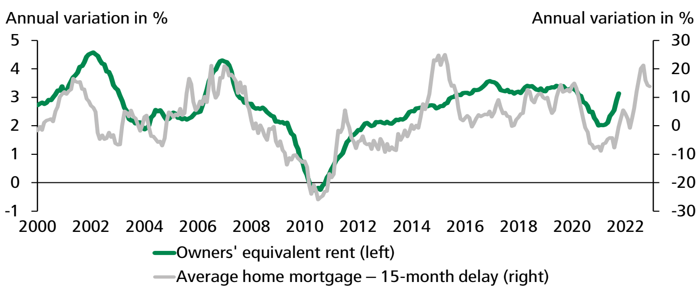


Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

recent annual variations remain lower than those recorded before the pandemic (graph 14 on page 4).

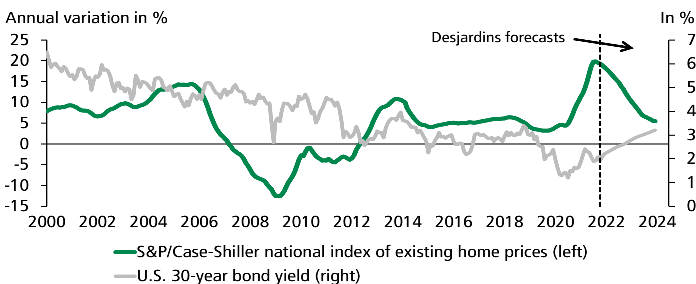
Given that its weight within the CPI is considerable and that it is generally edging above the 3% mark, owners' equivalent rent is having a huge impact. As we saw in October, any rapid increase or decrease heavily influences the way the CPI changes. In addition, it is important to understand that this component is not calculated based on a precise measurement of changes in home prices or expenditures relating to a property. Its index is based on asking consumers who own their principal residence the following question: "If someone were to rent your home today, how much do you think it would rent for monthly, unfurnished and without utilities?" Still, the assumption is that some factors, like the cost of a house and mortgage rates, are influencing the way owners answer this question. Moreover, there is a certain relationship between the CPI's owners' equivalent rent component and the variation in monthly household mortgage payments (including principal and interest) (graph 15). Consequently, recent rapid hikes in house prices and the anticipated change in interest rates in the United States (graph 16) suggest that there will be more and more upward pressure on mortgage payments and indirectly on owner perception about the amount they could receive if they were to rent their home to someone else. Therefore, expectations are that this important component should continue to contribute positively to the change in the CPI for a certain time.

GRAPH 15
The recent rise in shelter prices is expected to continue



Sources: Bureau of Labor Statistics, National Association of Realtors and Desjardins, Economic Studies

GRAPH 16
Housing price and interest rate increases suggest that the pressure caused by rents will continue

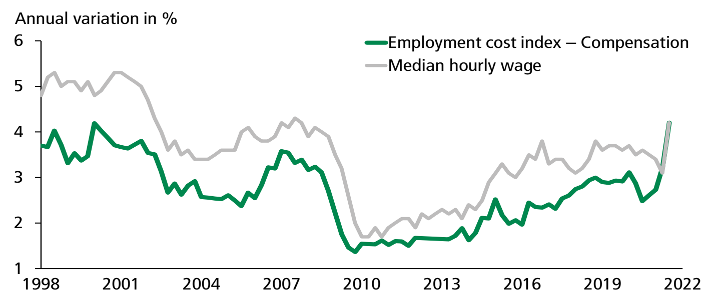


Sources: Standard & Poor's, Datastream and Desjardins, Economic Studies

Inflation Will Remain High in the Short Term

In the United States, inflation is both high and widespread. But will this situation last? Some factors should continue to boost prices and cause inflation excluding food and energy to stay higher than we typically saw in the 2010s for a certain period of time. One example would be the pressure on housing prices, including owners' equivalent rent. Wage hikes (graph 17), especially if they continue, could also cause some persistence of pressure on consumer prices. That said, some factors will fade. We can already see that the price surge associated with the auto sector has eased a little since the beginning of last summer. The 12-month comparisons for vehicles and for goods in other sectors (including energy costs) will also flatten in 2022. In addition, better control of the health situation with vaccination is already leading to a reorientation of consumption towards services, which will sooner or later reduce the pressure on the prices of goods. It will then remain to be seen if the disruptions caused by the pandemic, especially those affecting supply chains, will go on for a long time to come. If the problems relating to the lack of parts, labour shortages and shipping goods internationally persist, inflation will probably remain high. Still, if, as our scenarios predict—and the Fed's officials expect—these pressures ease, inflation will gradually go back to about 2%. The tapering of quantitative easing measures and the start of interest rate hikes expected in 2022 will also help moderate inflation expectations.

GRAPH 17
Wages are rising in the United States



Sources: Bureau of Labor Statistics, Federal Reserve Bank of Atlanta and Desjardins, Economic Studies