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What’s up with low inflation?

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To the surprise of some economists, inflation remains low 8 years after the end of the most recent recession. The Phillips curve, however, implies that the economy and inflation move in the same direction, rising during economic expansions and falling during contractions. In a recent study, “What's down with inflation?” (*Economic Letter,* Federal Reserve Bank of San Francisco, November 27, 2017), economists Tim Mahedy and Adam Shapiro examine the underlying cause of the persistently low inflation after the end of the recession.

Mahedy and Shapiro examined the factors that are keeping inflation low. The researchers looked at whether the inflation rate of various categories of personal spending was related to the strength of the overall economy. Next, the authors divided all sectors of the U.S. economy into two groups: procyclical, meaning inflation historically moves in tandem with the economic cycle, and acyclical, meaning inflation historically moves independent of the economic cycle.

The Phillips curve-like models they created showed that 42 percent of all personal expenditure categories (PCEs) were procyclical. The procyclical categories included housing, food services, recreational services, and some nondurable goods. The remaining 58 percent of PCEs were acyclical, including healthcare services, financial services, clothing, and transportation.

The researchers found that, during certain periods, procyclical and acyclical categories moved simultaneously, rising or falling together. However, after 2014, the two series moved in opposite directions. Recently, procyclical spending categories have responded to a tightening labor market and improved economic growth, and their inflation rates have risen close to the Federal Reserve’s 2-percent inflation target.

In examining the acyclical spending categories, Mahedy and Shapiro determined that healthcare lowered inflation the most. Healthcare services currently account for roughly 35 percent of cyclical inflation and about 20 percent of the entire core PCE index. The core PCE excludes food and energy prices, which are the most volatile PCEs.

The healthcare services inflation rate averaged 3.5 percent in the mid-2000s and only 1.1 percent over the past 5 years. The authors found that legislative changes to Medicare payments were likely the driving factor in the inflation decline. Because of the Affordable Care Act, the federal government has decreased the rate at which healthcare costs can rise. This lowered growth rate has resulted in reduced reimbursements to private insurers. The researchers pointed out that Medicare payments are scheduled to rise by 2.0 percent in 2018, compared with 0.9 percent in 2016 and 0.6 percent in 2017. Even with such a rise, the impact to overall core inflation will likely be minimal. To have a significant impact on core inflation, healthcare services inflation would need to near its precrisis levels of 3.5 percent.

In conclusion, procyclical components have largely returned to prerecession levels. Additionally, much of the persistent weakness in core PCE inflation is largely attributed to acyclical factors (specifically, cuts in the growth of Medicare payments), which have translated into slower inflation throughout the healthcare sector.