President's Perspective

We cannot simply base our inflation outlook on what seemed true just a few years ago.

I once had a neighbor in Dallas who kept a python named Julius Squeezer. That snake was an efficient processor of most anything he swallowed, although there were times when he had to be taken to the vet to be treated for indigestion.

The python might serve as a metaphor for the inflationary predicament now facing the U.S. economy. This summer's easing of energy and commodity prices has raised hopes that the recent burst of cost-push inflation might simply pass through the U.S. economy as a one-and-done episode.

Unfortunately, this felicitous scenario is not guaranteed to play out. Rather than moving through the python, the higher costs of inputs may give the beast digestion problems, leading to lingering inflationary fever.

The inflation picture is far from clear. A return to stronger growth may revive some of the price pressures that have recently abated. New worries may arise. In the first half of this year, for example, wages in China's urban areas, where most U.S. and foreign firms operating in China make or assemble products, rose 18 percent.

Nobody fully understands how Chinese labor impacts cost structures here at home. But this much is clear: We cannot simply base our inflation outlook on what seemed true just a few years ago.

Back then, a flood of cheap labor, low-cost goods and outsourced services from places like China, India, Brazil and the former Soviet satellites provided our economy with the most pleasant of tailwinds, propelling it forward while restraining inflation. Now that these countries are consuming more of what we consume as they climb up the income ladder, we have been facing a bracing inflationary headwind from the very same sources that previously helped our economy sail along.

The noble python may digest and dispatch the recent inflation bulge, or he might gag on it. It is too early to tell. And until we have a clear sense of what will prevail, monetary policy makers must remain poised to act if slowing growth fails to contain inflationary pressures. We cannot allow the Fed's credibility to be compromised by expectations of rising prices.

At times like these, it is important to know as much as we can about inflationary developments. Dallas Fed economist Jim Dolmas discusses some important measurement topics in this issue's On the Record interview (page 8). Reading it will help put recent trends into perspective.

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