U.S. Inflation Flash

New and Improved Methodology for Measuring Producer Prices

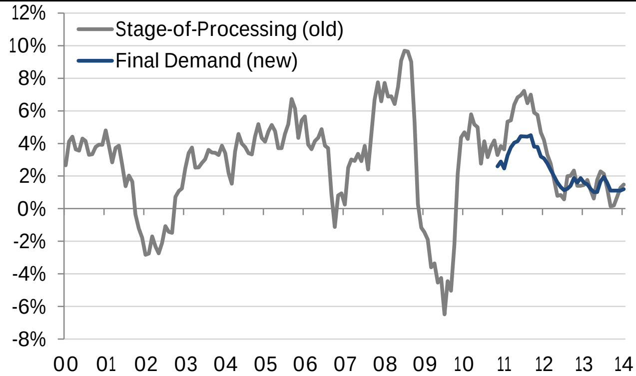
- **Finished goods PPI replaced with final demand for goods and services**
- **Inclusion of services, construction, government purchases, and exports expands PPI coverage to 75% of domestic production**
- **Despite the short historical series, the new index will improve the accuracy of measuring producer prices**

The producer price index has never warranted significant market attention compared to its consumer price counterpart. Much of the reasoning for this has been the methodology used to calculate prices received by the producer, categorized into simple groupings for finished, intermediate, and crude goods only. Today, the BLS released an updated PPI methodology based on price changes for final demand, which on top of goods also includes services, construction, government purchases, and exports. Goods producing industries only account for about 18% of GDP in the U.S., so the old system, known as the stage-of-processing method, accounted for only a small fraction of domestic production. On the contrary, this new final demand PPI covers prices received for nearly 75% of domestic production, including 72% of all services and 34% of construction. In terms of relative importance, price changes for services contribute more than 60% to the index. With these other industries included, the overall series should be much less volatile than the old index as it will not be so dependent on swings in commodity goods prices.

According to this new final demand index, producer prices increased 0.2% in January, compared to a 0.6% jump in the stage-of-processing index. Most of the monthly increase for the new PPI was driven by final demand for goods, which increased 0.4% for the month on top of a modest 0.1% gain from the services side. On a YoY basis, the new PPI came in slightly lower to start off 2014, at 1.2% compared to 1.5% via the old index. Moving forward, we will follow the BLS in reporting the new methodology as the main measurement for PPI.

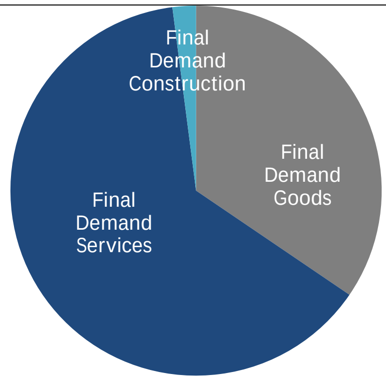
The downside to the new final demand index is that the series only dates back to November 2009, so we cannot yet use it to assess long-term business cycle trends. Furthermore, it may take some time to evaluate the consistency between this new PPI and other price indices, such as the GDP deflator. Still, this PPI adaptation marks a significant improvement in measuring producer prices and will provide for a more accurate analysis, especially as inflation remains a hot topic for the Fed's monetary policy strategy.

Chart 1
Stage-of-Processing (old) and Final Demand (new) PPI (YoY % Change)



Source: Bureau of Labor Statistics & BBVA Research

Chart 2
Final Demand PPI Relative Importance, 2013 (%)



Source: Bureau of Labor Statistics & BBVA Research

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