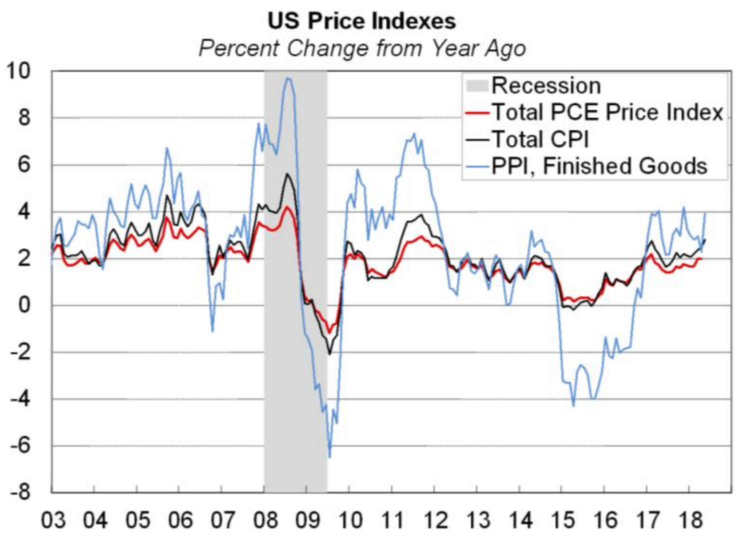
Current Economic Conditions

Robert C. Fry, Jr., Ph.D. June 20, 2018

INFLATION PICKING UP . . . FOR NOW

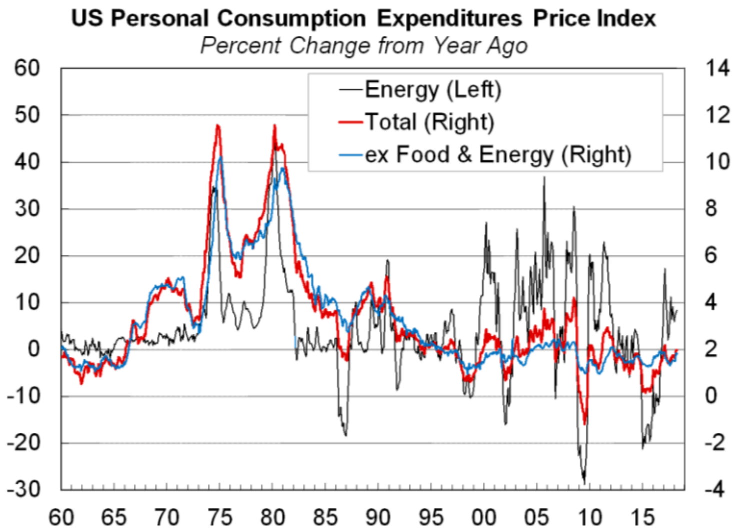
U.S. inflation, as measured by both the Consumer Price Index and the Producer Price Index, was higher-than-expected in May and has risen significantly since bottoming in early 2015. The Consumer Price Index was up 2.8% from year-earlier levels in May. CPI inflation briefly fell into negative territory in early 2015 and was at 1.6% as recently as last June. The "core" CPI, which excludes food and energy prices, was up 2.2% year-over-year. Until March, core CPI inflation had been in the 1.7-1.8% range for 10 straight months. The Producer Price Index for final demand, the headline PPI, also surprised on the upside, rising 0.5% month-to-month and 3.1% year-over-year. The PPI for Finished Goods, which was the headline PPI until a few years ago, rose 1.0% in May and was up 4.1% year-over-year. Traditionally, inflation in producer (i.e., wholesale) prices has been interpreted as inflation in pipeline, but there is little evidence that producer prices lead consumer prices, indicating that higher wholesale prices aren't always passed through to consumers.



The Personal Consumption Expenditures price index, which the Federal Reserve prefers, was up 2.0% year-over-year in April, up from 1.4% as recently as last August and exactly in line with the Fed's 2% target. The core PCE price index was up 1.8% year-over-year, near the upper end of the 1.3-1.9% range it has occupied for six years but still below 2%. (The 0.3% gap between core CPI inflation and core PCE inflation in April is in line with its historical average and reflects different weightings of items in the two indexes.

The May CPI and PPI readings and soft prior-year comparisons – inflation was low from May through August last year – make it likely that PCE inflation, both total and core, will rise above 2% in coming months. If this is just a temporary overshoot and the beginning of mild fluctuations around 2%, the Fed will declare victory, having hit its target after being below it for the last six years. However, if inflation remains above 2% on a persistent basis, the Fed will have let the inflation genie out of the bottle, by raising short-term interest rates too slowly and by increasing its holdings of long-term securities too much. And while the Fed considers 2% inflation a victory, savers who are taxed on nominal (not inflation-adjusted) interest and capital gains and pensioners whose pensions are fixed in nominal terms would beg to differ.

Several factors will determine whether inflation stabilizes round the Fed's 2% target or continues to rise. Much of the rise in inflation over the last three years is due to an increase in the price of crude oil and petroleum products. The price of Brent Blend crude oil has risen from below $30/barrel in early 2016 to around $75 today. Gasoline prices, which fell as low as $1.75/gallon in 2016, are now around $3. Saudi Arabia has successfully colluded with other OPEC countries and with Russia to limit supply at the same time that a synchronous global expansion has lifted demand. This has more than offset growth in U.S. oil production. But because cartel members are prone to cheat and because demand growth will slow if



prices get too high, oil prices are more likely to fall than to rise. To the extent the recent increase in core inflation reflects the pass-through of higher energy prices into prices of non-energy products, falling oil prices would bring down core inflation.

Many economists use a version of the Phillips Curve to forecast inflation. Older versions of the Phillips Curve showed a stable inverse relationship between inflation and the unemployment rate; newer versions imply that inflation rises when the unemployment rate is below its "natural rate." The unemployment rate fell in May to 3.8%, well below the Congressional Budget Office's 4.7% estimate for the natural rate. If the Phillips Curve relationship holds, inflation will continue to rise until the next recession causes unemployment to rise to (and likely above) its natural rate. I'm not a Phillips Curve adherent, and not just because it's hard to identify the natural rate, except in retrospect. A tight labor market should cause wages and salaries to rise more rapidly, but this won't translate into higher inflation if the acceleration in labor costs is matched by an acceleration in productivity or if product markets aren't tight enough to allow businesses to raise prices. Ultimately, it is tightness in goods and services markets, not tightness in labor markets, that causes inflation to rise. The Phillips Curve relationship only shows up in the data because, historically, labor markets have tended to tighten about the same time that product markets have tightened.

Markets for (labor-intensive) services are indeed tight. Goods markets are much less tight; capacity utilization in manufacturing is still well below the threshold that has historically signaled rising inflation. Accordingly, the CPI for services was up 2.9% year-over-year in May; the CPI for commodities excluding food and energy was **down** 0.3%. Whether markets will be tight enough for inflation to rise going forward depends on the impact of tax reform and on conditions in **global** markets. Tax reform has boosted both consumer spending and business investment. An increase in consumer spending is purely an increase in demand and puts upward pressure on inflation. Increased investment translates into more demand in the short run, but it boosts supply (via increased capacity and higher productivity) once plant and equipment has been put in place. To the extent investment rises in response to tax reform, it will put upward pressure on inflation this year, but will put downward pressure on inflation next year. And while tight U.S. markets might have been enough to cause inflation to rise in the distant past, global markets now provide a relief valve for U.S. inflation. For goods and, increasingly, for services, prices can't rise unless markets are tight everywhere. (Higher tariffs would clog this relief valve. Core PCE inflation has been below 2.5% every month since NAFTA was enacted in 1994; before NAFTA, it had been above 2.4% for 27 straight years.)

While I would have preferred an earlier tightening of monetary policy – mostly because I think the Fed's inflation target should be below 2% – there is little evidence **so far** that low interest rates and quantitative easing (bond purchases) earlier in this expansion will push inflation persistently above 2%. Demographics and inertia are working to hold inflation down. And if Milton Friedman taught us anything, it's that interest rates (relative to historical averages) are not a good guide to monetary policy and that we should focus on the M2 money supply, not on the size of the Fed's balance sheet. M2 growth is currently very slow. But the U.S. economy is too strong for a Federal Funds Rate between 1.75% and 2%. May was an especially strong month, with the unemployment rate down 0.3 percentage points, retail sales up 0.8%, housing starts at an 11-year high, and the NFIB's Small Business Optimism Index at a 35-year high. Growth in real Gross Domestic Product could exceed a 4% annual rate this quarter. Changes in Fed officials' "dot-plot" forecasts and more-frequent post-meeting press conferences by Chairman Powell suggest a willingness to raise rates more quickly and more frequently than markets expected even a few months ago. That increases the odds that inflation stays under control rather than spiraling higher.