Should the Fed be worried about inflation?

- For some time, Fed policymakers have been concerned about inflation running below the 2% target.
- This has been reflected in the repeated markdowns of the Fed’s inflation forecasts.
- We think that the balance of inflation pressures are changing and expect inflation to start rising albeit at a slow pace.
- Higher oil prices and a flatter US dollar effective exchange rate are likely to support inflation in the coming time.
- Moreover, we expect that modestly rising unit labour costs, together with a stronger demand for services will slowly drive up services prices.
- We expect the core Personal Consumption Expenditure (PCE) deflator, the preferred inflation measure of the Fed, to rise by 0.2pp to 1.8% by end-2016 and a further 0.2pp to 2.0% by end-2017.
- This inflation scenario is benign and consistent with a slow pace of rate hikes in the US in the coming year.

Recent inflation measures have been mixed, with some measures still supporting the more dovish Fed policymakers who have for some time been concerned about inflation running below the 2% target and disinflationary forces building up. This note looks at the drivers of inflation and the inflation outlook.

Preferred inflation measures
Measures of core inflation, which exclude the volatile categories of food and energy prices have been stable for some time. The Core Personal Consumption Expenditure Index (core- PCE), which is the preferred measure of the Fed, jumped in January and has subsequently been stable. This measure is based on goods and services purchased by households from the national accounts. Meanwhile inflation measured by the core Consumer Prices Index (core CPI) has been higher than core PCE and increased...
gradually throughout 2015. But it has stabilised since January. The CPI measures direct outlays of households for a representative basket of goods.

The major differences between core PCE and core CPI are the weights of the different components and coverage. Reconciliations made of these two variables in the past quarters suggest that the main differences are housing rental and medical prices, which have been lifting both measures of inflation, but to a larger extent the core CPI. Indeed, the weight of shelter in the core CPI is much larger (more than 30%), than the PCE (around 15%). The contribution of shelter CPI to total CPI (2.3%) is now around 1ppt. Shelter CPI includes rent of primary residence and owner’s equivalent rent. Both have accelerated rapidly in recent years. Owner’s equivalent rent is an imputed measure of the rent homeowners would have to be charged to rent the homes they own. Measuring this is tricky, but this category has a little over three times the weight of the rent of primary residence. Moreover, it is unclear how rising owner’s equivalent rent limits consumers ability to spend, given that this is not actually paid by households.

Meanwhile, as already mentioned, weight differences in health care prices also explain the gap between core PCE and core CPI. Weights in core PCE (29%) are almost twice as high as in core CPI (14%). But the main difference is the items covered. For instance, health insurance, which has been rising considerably is excluded in core-PCE. Currently, the year on year rise in health care services CPI is almost 4pp above the equivalent measure of PCE.
Drivers of core inflation: some upside in services and goods
The breakdown of core - PCE suggests that most of the acceleration has come from services, where each major category has increased. The largest increase remains health care services, which reflects that price cuts related to the Affordable Care Act are starting to wane. Indeed year on year changes in medical costs are now at their highest level since 2008. Meanwhile core goods inflation has fallen significantly throughout 2015 as a result of lower import prices for vehicles and other imported goods, reflecting the stronger US dollar. We are forecasting a flatter trade weighted dollar versus year end (0.5%) and then in 2017 a small depreciation (-0.8%), which will eliminate downward pressure on goods inflation. The key question is whether and for how long lagged effects will still put some downside. Finally, shelter inflation will likely remain a firm component of core inflation at its current level. The labour market remains solid and the rental vacancy rate is at a 30-year low. It will take time before the pressure on rental prices fades as a result of additional supply of rental homes.

Limited upside from rising labour costs
We find that changes in unit labour costs tend to explain movements in services inflation the best. Clearly, unit labour costs tend to be volatile, even when expressed in year-on-year terms. However, we see lately that modestly rising unit labour costs at slightly above 2.5%, together with a stronger demand for services, are driving up services prices. The question is whether there is room for a further increase in unit labour costs. In the past months the labour market gains seems to have levelled off. The unemployment rate has stabilised since the beginning of the year and other measures of labour utilisation have barely changed. Our analysis of the labour market and labour underutilisation is signalling a slow improvement in the coming months given the near trend GDP growth in the coming quarters and modest growth in business investment. This suggests that wage growth will remain modest. Meanwhile labour productivity growth has been weak and there is no reason to think that this will change in the near term. So there is limited room for a rebound in unit labour costs, given the pace of growth of the US economy and the labour utilisation.

Inflation expectations mixed, but some room for upside pressure
Inflation expectations measures are mixed. Market measures of inflation expectations, the 5y5Y inflation forward inflation rate, has been picking up recently, after having declined noticeably in the past two years, partly as a result of lower oil prices. However, this
measure remains well under the 2% target. As actual core and headline inflation rise, we would not be surprised to see a pick-up in long-run inflation expectations. Meanwhile, consumer-based inflation expectations, both 1-year ahead and 5-year ahead have been relatively stable in the past few years. We think that falling gasoline prices have maintained consumer-based inflation expectations stable. However, a steady increase in gasoline prices could put some upward pressure to consumer-based inflation expectations.

Fed cautious on inflation forecasts
The Fed has actually been downgrading the inflation forecasts in the Summary of Economic Projections, since 2012 and it has pushed out the timing to reach the inflation target to 2018. The more dovish Fed policymakers are concerned about the persistent undershooting of inflation relative to the target. The “most direct attack,” on the inflation target came from San Francisco’s Fed President Williams, who suggested considering the costs and benefits of a somewhat higher inflation target. These proposals are not entirely new (Blanchard 2012). Chair Janet Yellen expressed in September 2015 that changes in the inflation target could ruin the central bank’s credibility because it may be seen as opportunistic.

Meanwhile the hawks in the FOMC, who are in minority, suggest that the recovery of the labour market could lead to an unwanted increase in inflationary pressures. They see the remaining slack in the labour market as mainly the result of structural factors. They fear...
that nearing full employment could lead to a steady pick up in wage growth, which will contribute to higher core PCE. The more hawkish members think that the Fed could be falling behind the curve. As already mentioned, we think that there is still some room for further improvement in the labour market without this putting significant upward pressure on wage growth.

**Our view**

Over the past year, there was an ongoing debate in the Fed whether disinflationary pressures were only temporary. We think that the balance of inflation pressures are changing and expect inflation to start rising albeit at a slow pace. We think that our forecast of higher oil prices and a weaker exchange rate will support inflation in the coming time. On top of this, we expect that modestly rising unit labour costs, together with a stronger demand for services will slowly drive up services prices. Components, including shelter and health care will continue to contribute to inflation, but at a slower pace. We expect core PCE inflation to rise by 0.2pp to 1.8% by end-2016 and a further 0.2pp to 2.0% by end-2017. This inflation scenario which is consistent with a rate hike in December and a slow pace of rate hikes in the US in the coming year (two hikes).

### Inflation more pressure up than down

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<td>Reduced slack labour market</td>
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Source: ABN AMRO Group Economics