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U.S. Inflation: Where and When?

There are two main issues that are worrying investors. The first is the future of the dollar as the numeraire—the key metric in the world economy. Recent Special FX pieces have argued that this concern is misplaced. The dollar's share of reported reserves remains fairly stable. Its use as an invoicing currency remains pervasive. Numerous commodities, including oil, foodstuffs and fibers, industrial goods, and even a wide range of raw materials, continue to be priced in dollars. We have looked at alternatives to the dollar, such as the IMF's Special Drawing Rights (SDRs) and gold and have found them wanting. Looking at the actions of the vast majority of countries, (yes, ignoring the rhetoric), the inescapable conclusion is that the dollar's role remains secure.

The second issue that worries investors is that the aggressive monetary and fiscal policies in the United States will create inflationary conditions that will undermine the value of the dollar. Yet a closer look at the situation will show why this concern is similarly misplaced for the coming quarters.

The FOMC decision in mid-March to purchase $300 bln of Treasuries fanned new inflation worries. Although the Fed has been cagey on how it was going buy not only Treasuries, but the Agency bonds and the mortgage-backed securities, the market assumed it would be by "printing money", which is really creating bank reserves. The Fed's balance sheet will explode. The Fed is hell-bent on creating inflation. Although many of the Fed's critics seem to think it can do no right, they assume the Fed will be successful in reigniting inflation.

Factor Markets First

Before turning to the monetary variables that the inflation fears are based on, it is important to first consider a few key macro-economic variables which are most certainly not inflationary or conducive to inflation. In fact, many of the newbie monetarists in the past warned that tight labor markets would fuel inflation.

Unemployment in the U.S., like in most countries, is rising. It stood at 8.5% at the end of Q1 and will likely be above 9% by the end of Q2. Over the past half year, the U.S. has recorded an average monthly job loss of more than 600k. This pace is the fastest since the mid-1940s. Even though weekly initial jobless claims appear to be stabilizing, there is no reason to expect that the April job loss will show any slackening of the pace (due May 8th).

Tight labor markets are regarded as inflationary because they exert upward pressure on wages and salaries. Now is the converse. The slack in the labor market means that employment costs are weak. In the first quarter, the Employment Cost Index (ECI), a broad measure of compensation, rose at a record low rate of 0.3%.

Compared to Q1 08, the ECI is now 2.1% higher, which is the lowest level since 1982, when the measure was first introduced. And even this seems to exaggerate the inflationary pressure. The ECI in the private sector rose a scant 0.2% in Q1 (by comparison the ECI for the public sector—the government--rose 0.8%).

The dramatic slowing of ECI may be helping many businesses report better than expected earnings. In this regard, it is interesting to note that the sector with the weakest ECI in Q1 was finance and insurance. The ECI contracted 0.9% in Q1 and were down 0.1% from the first quarter last year.

Not only is the labor market slack, but so is the goods market. U.S. industrial capacity usage stood at a lowly 69.3%. This is the lowest rate since the time series began in the late 1960s. Moreover, the pace of decline in the utilization rate in Q1 was the fastest thus far during this crisis.

Fed's Balance Sheet

Seemingly unbeknownst to many, the decline in the usage of various Fed facilities is more than offsetting the pace of the Fed's purchases of assets. This resulted in a $130 bln contraction in the Fed's balance sheet in last week. The cynics and critics do not appreciate that some of the Fed's programs are already producing such successful results that they are not needed as much as was previously the case.

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Consider programs such as the traditional discount window facility, the PDCF, AMLF, CPFF, MMIF, TAF and the swap lines with foreign central banks.[i] The usage of these facilities is off more than 50% from the peak late last year. TAF alone saw a $33 bln decline last week. That drop was twice the amount of securities the Fed bought during the period.

Of course the Federal Reserve is still in the middle of fulfilling its commitment to buy Agency bonds, mortgage-backed securities, and Treasuries. The Fed has bought slightly less than a third of the $1.75 trillion worth of securities it has indicated it would. At the same time, it is important to recognize that the Fed's latest statement indicated that the commitment is not air tight. Depending on conditions, the Fed seemed to suggest it could increase or decrease the amount of securities it will buy.

Cart Before the Horse

At the end of Q1 09, price pressures in the United States were among the weakest in the world, using headline CPI as the metric. From a year ago, US consumer prices were 0.4% lower. This is even weaker than Japan, where consumer prices are 0.3% below year ago levels. In contrast, headline inflation in the euro-zone was 0.7% above year ago levels and in the UK it was 2.9% above year ago levels. To round out the G7, Canada's consumer prices were 1.2% above the March 08 levels.

One major country has experienced a greater decline in consumer prices than the United States, namely China. In March, Chinese consumer prices were reportedly 1.2% below year ago levels. So, these two countries with the largest decline in headline CPI also have among the most aggressive policy responses.

The inflation narrative seems to put the cart before the horse. It begins with the inflationary risk of the monetary and fiscal policies, rather than with the conditions that elicited the policy response. Dire circumstances require a powerful response.

Moreover, despite the aggressiveness of the US policy response and the gallons of ink spilled claiming the contrary, inflation expectations remain anchored. There are of course numerous ways to try to gauge inflation expectations. One metric of inflation expectations that both the Federal Reserve and the European Central Bank have cited is the five-year, five-year forward. Essentially, this a five year forward of the second five years of a 10-year inflation-linked bond. In the US, it stands at 2.3%. The French five-year, five-year forward, a proxy for the euro zone, stands at 2.6% and 3.78% in the UK.

Of course there is a risk that when the economy recovers the Federal Reserve is too slow to unwind its accommodation, causing an inflation problem down the road. Yet given the self-liquidation feature of several of the Fed's facilities, and the discussions of an exit strategy, prior to the full entrance, a sharp increase in inflation is neither inevitable nor necessarily the most likely scenario.

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[i] Primary Dealer Credit Facility (PDCF), Asset-backed Commercial Paper Money Market Liquidity Facility (AMLF), Commercial Paper Funding Facility (CPFF), Money Market Investor Funding Facility (MMIFF), Term Action Facility (TAF).

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