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Economics Group

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Assessing Where the FOMC Stands on Inflation Confidence

The road to the Fed's inflation target seems longer since July following another drop in energy prices and rise in the dollar. The Fed's focus on longer-term drivers, however, suggests a September rate rise is still in play.

A Slightly Longer Road to Target Inflation

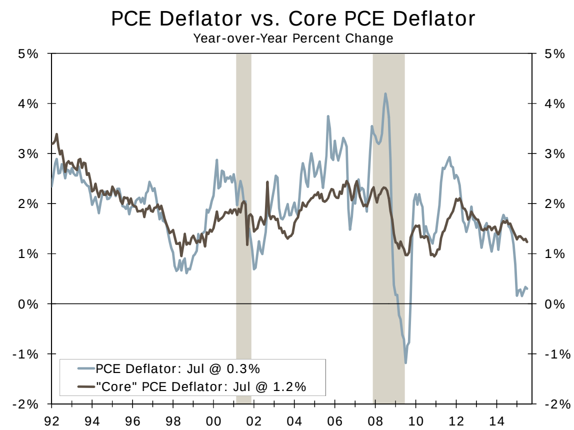
Heading into the September FOMC meeting, inflation continues to run well below the committee's 2 percent target. Inflation measured by the PCE deflator was only 0.3 percent on a year-over-year basis, while core inflation is up just 1.2 percent (top graph). The Fed has made clear it only needs to be confident inflation is moving back to target over the medium term, typically viewed as around two to three years. Minutes from the July FOMC meeting showed "almost all" members needed to see further evidence before the inflation confidence threshold was met.

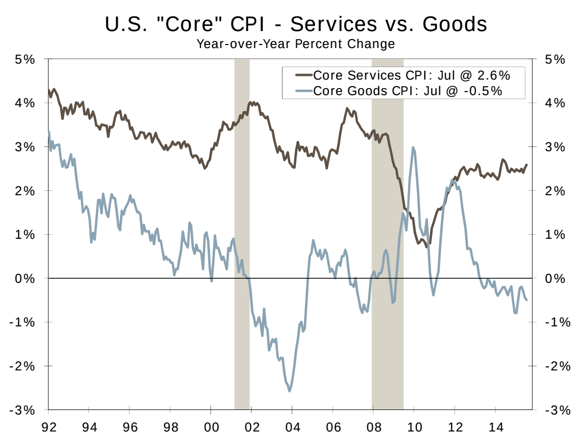
If not quite confident as of July, will FOMC members be ready in September? Near-term inflation prospects have only diminished since the Fed's previous meeting. Oil prices have fallen another 6 percent and the dollar has appreciated an additional 2.1 percent. Global economic conditions also appear more tenuous, leading to erosion in market-based measures of inflation compensation.

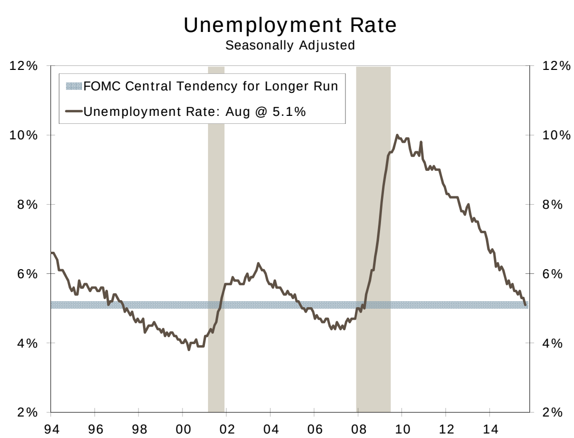
In a speech at the Kansas City Fed's annual conference at Jackson Hole, Fed Vice Chair Stanley Fischer highlighted how these largely global dynamics have weighed on domestic inflation. Fischer did not appear terribly concerned with the recent inflation downdrafts from lower commodity prices and the stronger dollar, as oil prices cannot fall indefinitely and the effects of the stronger dollar on inflation are "likely already starting to fade." Moreover, softness in inflation continues to be concentrated in the goods sector, which is more closely linked to the global environment and accounts for only one quarter of core CPI. Core services inflation, more indicative of domestic demand, has remained steady (middle graph). However, all else equal, the recent moves in the dollar and commodity prices would lengthen the journey back to 2 percent inflation.

For the Fed, Resource Slack Still Matters

Therefore greater confidence that inflation will return to 2.0 percent over the medium term hinges on a continued reduction in resource slack. Despite the weaker ties between slack and inflation since the financial crisis, most Fed officials still believe slack remains an important determinant of inflation. According to the July FOMC minutes, "Many participants indicated that their outlook for sustained economic growth and further improvement in labor markets was key in supporting their expectations that inflation would move up." Although recent moves in the dollar and commodity prices will keep near-term inflation tepid, the labor market continues to make strides. The 209,000 average gain in payrolls the past two months and decline in the unempl0yment rate to 5.1 percent—consistent with the Fed's estimate for full employment (middle graph)—may be enough to qualify as "some" improvement as well as make Fed officials more confident in the path of inflation.







Source: U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities, LLC

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