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Industrial Price Signals Should Boost the Fed's Confidence in US Economic Recovery

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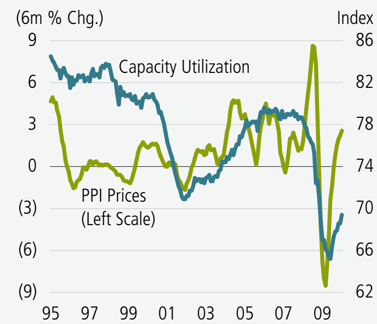
Price signals from the industrial sector indicate that the recovery is on firm footing, reducing the risk that low resource utilization will prompt further price weakness. As the sustainability of the economic recovery becomes more apparent, we believe the Fed must prepare markets for a lift in official rates later this year.

Display

Key Producer Prices Rise Despite Low Capacity Use

Core Intermediate PPI Prices vs. Capacity Utilization



Source: Bureau of Labor Statistics, Federal Reserve Board and Haver Analytics

When policymakers discuss the inflation outlook, they usually focus on the consumer price index. Less attention is paid to core intermediate producer prices, where important early signals on demand, new orders and rising costs surface long before they are visible at the consumer level.

Core intermediate prices of materials and supplies offer important early intelligence because many of these items are tied to cyclical industries such as basic manufacturing, motor vehicles and technology. Examples include paperboard, lumber and cement as well as steel products, electronic components, motors and generators.

Prices Rise for Sensitive Materials

Over the past six months, core intermediate producer prices rose by 2.6%, implying an annualized gain of 5.2%, according to the Bureau of Labor Statistics. In contrast, during the economic recovery of 2002, it took more than two years before core intermediate prices at the lower stage of processing increased at this pace.

Why are intermediate producer prices rising so rapidly today? In general, when economies begin to recover from recession, prices of crude commodities such as scrap metals tend to rise relatively fast. However, it usually takes time before these price increases pass through to core intermediate materials and supplies.

Of course, economic recoveries and price cycles are not identical. The speed that costs climb up the manufacturing chain has historically been linked to demand growth as well as slack in the industrial sector. Industrial capacity utilization has typically been a key factor because when operating rates are high, it is easier for firms to pass along cost increases flowing from various inputs. What is unusual today is that the rebound in core intermediate prices has occurred while US manufacturing operating rates are at a low level.

Last year, operating rates in the US manufacturing sector fell to a record low of 65.4% **(Display)**. Even though operating rates have climbed in recent months, reflecting the rebound in production, capacity utilization in January 2010 was still at a relatively low level of 69.4%. That's nearly 10 percentage points below its long-term average and well short of the threshold that usually prompts the pass-through of rising raw materials' prices to intermediate prices.

Greater Foreign Influence on Prices

One possible explanation for the accelerated pace of rising core intermediate prices today is that operating rates in the US are not as dominant as in the past. Perhaps price changes for intermediate materials and supplies are now being increasingly driven by global demand, as operating rates in some important emerging markets are running up faster than in the US. This suggests that the US has become more of a price follower than leader. In addition, the weak dollar may also facilitate a faster pass-through of prices, because it means that US-based companies are now paying more in dollar terms for many items that are sourced abroad.

Growing Confidence in Recovery

It's too early to tell how the trend in core intermediate prices will affect monetary policy in the short run. However, we think members of the Federal Open Market Committee (FOMC) should take notice as they prepare to discuss the economic outlook and assess whether the current targets on official rates are still appropriate at their meeting on Tuesday, March 16.

Back in November, the FOMC pledged to maintain a low federal funds rate for an "extended period", citing low levels of resource utilization as one of the reasons. At the time, policymakers lacked confidence in the pace of economic recovery and its sustainability, and were also concerned that prices could weaken further given the huge slack in labor and product markets. Now, with core intermediate prices rising and core consumer prices stabilizing in the desired 1.5% to 2.0% range, fears of a sharp deceleration in prices or even outright deflation should abate or disappear.

This does not imply that official rates must be raised at next week's meeting. We don't expect any change to the current target on the federal funds rate of 0% to 0.25%, in line with the consensus forecast.

Looking for Policy Signal on Rates

However, at Tuesday's meeting, policymakers will debate what signal to give about future policy decisions within the next three to six months. In recent weeks, several policymakers have indicated that they are uncomfortable with the promise of holding rates steady for the foreseeable future. According to some, the "extended period" phrase limits the Fed's flexibility, while at least one policymaker thinks that with the economy recovering, there is no need to keep policy rates at today's unprecedented low levels indefinitely.

In our view, the price signals from the industrial sector are not a sign of a quick rebound in consumer inflation, but rather of continued strength in demand, improved order flow for manufacturers and the need to start rebuilding inventory. Taken together, these trends indicate that the US economic recovery is exhibiting important signs of sustainability. As the endurance of the recovery becomes increasingly apparent, we believe the Fed must prepare the markets for the removal of the emergency rate cuts implemented in late 2008, since adjusting to changing developments is the hallmark of successful monetary policy.■