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ECONOMICS: US PERSPECTIVES—MARCH 4, 2011

Fed Needs Better Barometer to Detect Inflation

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According to the Fed, a sustained rise in US inflation is unlikely while the economy has substantial idle capacity. We think the Fed's output gap framework relies too much on domestic conditions, and overlooks important changing dynamics in the global economy that may eventually create new inflationary pressures.

The Federal Reserve has grown increasingly bullish on the prospects for the US economic recovery. In testimony before the Senate Banking Committee this week, Fed Chairman Ben S. Bernanke said the US economy has started to exhibit signs of a self-sustaining expansion. The Federal Open Market Committee raised its real GDP forecasts for 2011 to between 3.5% and 4%, about half a percentage point higher than its projections in November.

Despite Bernanke's optimism on growth, there seems to be little concern at the Fed that the faster pace of recovery may also trigger a rebound in prices sooner than expected. Policymakers argue that relatively high levels of labor market slack **(Display 1)**, along with generally stable long-term inflation expectations, indicate that core inflation will remain contained for some time. Indeed, the Fed expects overall inflation to remain stable over the next three years at 1% to 2% **(Display 2)**. Their outlook hasn't budged despite dramatic increases of oil, food and other commodity prices in recent months.

The Fed's view on inflation is rooted in an output gap framework, which argues that a sustained rise in inflation is unlikely to develop as long as underutilized resources and idle capacity exist in the economy. It's always been difficult to reliably estimate an output gap that effectively translates slack in the economy into actual price trends. These days, it's perhaps even more difficult to do so, as the main drivers of US economic growth are changing and emerging markets are playing a more dominant role in the global growth cycle.

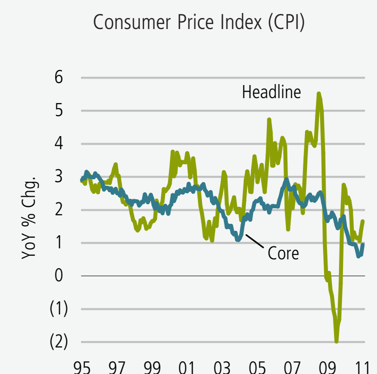
Will New Mix Affect Inflation?

For example, for the first time in the postwar era, the US economic recovery is being driven by exports and investment rather than by consumption and housing. It's too early to determine whether this shift in the sources of US economic growth will have different ramifications on capacity and inflation trends. In other words, we still don't know whether the US has enough flexibility in its labor and capital resources to ensure that this new mix of growth can occur without creating

Display 1
Slack Labor Markets Expected to Keep Inflation Tame

As of January 2011
Source: Bureau of Labor Statistics and Haver Analytics

Display 2
Fed Still Focuses on Core CPI Inflation



As of January 2011
Source: Bureau of Labor Statistics and Haver Analytics

cyclical price pressures well before what an output-gap framework would suggest.

In addition, a simple output gap framework, based on domestic economic conditions, may not be applicable when the global growth cycle is increasingly driven by emerging-market economies, which are much more commodity intensive than developed economies.

Commodity Costs May Fuel Inflation

In the past, rapid gains in commodity prices have been a late stage event in the US business cycle. Now, because of emerging market demand, we're seeing commodity prices rise much earlier in the economic recovery **(Display 3)**. This may render the output gap framework obsolete, as it doesn't incorporate the cost pressures emanating outside the US. Even if the rise in commodity prices does not immediately feed through into higher US consumer prices, the higher costs of commodities may lift inflation expectations. Over time, this could transmit the price gains to other segments of the economy, making it more difficult to reverse inflation later.

Even when the US economy led the global economic cycle, the output gap model had a mixed record on predicting inflation. Indeed, not only did it fail to predict the high of inflation of the 1970s, but it anticipated inflation in the 1990s that never materialized. In September 1994, then Fed Chairman Alan Greenspan raised doubts about the output gap, questioning whether inflation was a product of slack in the economy or a phenomenon driven by monetary conditions. Based on the lack of slack in the industrial sector at the time, he argued that the US economy was possibly on the verge of severe inflationary pressure. However, if inflation was a monetary phenomenon, prices should have remained tame because there was no financial tinder—money and credit growth—to trigger inflation. In hindsight, his doubts were justified—consumer price inflation didn't accelerate in 1995.

Broader View on Prices Is Crucial

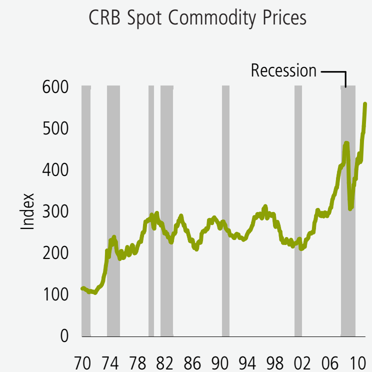
Perhaps the biggest flaw in the output-gap framework is the notion that the only inflation that matters for macroeconomic stability is core consumer price inflation, which excludes food and energy prices. In fact, this standard price measure has been an extremely unreliable barometer for identifying dangerous price imbalances, most notably those that triggered the mild recession of 2001 and the severe recession of 2008/09. These bubbles were created by price inflation of financial and real assets prices, which are not included in the core consumer price measure.

Our inflation outlook for 2011 isn't particularly hawkish, as we expect consumer prices to rise 2.5%. However, we do think that it's mistaken to dismiss the recent rise in commodity prices simply because it conflicts with the Fed's theoretical framework on the inflation process.

It's time for policymakers to broaden their horizons by focusing on a variety of prices. The global economy is too complex today for inflation to be gauged by a single price measure. Our broad price index, which includes commodity prices, indicates that US inflation is currently running at nearly 3.5% **(Display 4)**—more than triple the core CPI.

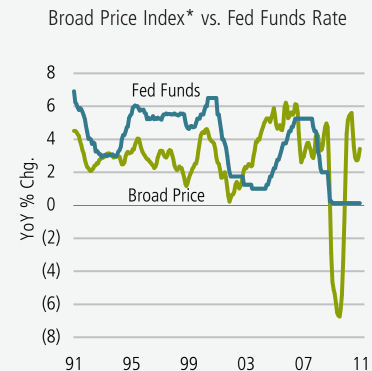
Even in relatively small sectors or markets, price misalignments can trigger imbalances that jeopardize the economic growth cycle. Without a comprehensive set of prices on its radar, we're concerned that the Fed's current monetary policy—with interest rates near record lows and an unprecedented balance sheet—risks fostering a new inflation cycle, with unknown consequences for the US economic recovery. ■

Display 3
Early Rise in Commodity Prices



As of February 2011
Source: Commodity Research Bureau and Haver Analytics

Display 4
Broad Prices Show Higher US Inflation



As of January 31, 2011
*3-month moving average
Source: Haver Analytics, National Association of Realtors and AllianceBernstein

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