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ECONOMIC TALKING POINTS

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October 19, 2011

Inflation is Heating Up, Not Cooling Down.

"Inflation appears to have moderated since earlier in the year as prices of energy and some commodities have declined from their peaks."
FOMC Statement
September 21, 2011

"The substantial amount of resource slack that exists in U.S. labor and product markets should continue to have a moderating influence on inflationary pressures."
Federal Reserve Chairman Ben Bernanke
The Economic Club of Minnesota Luncheon, Minneapolis, Minnesota
September 8, 2011

For the better part of this year, Federal Reserve Chairman Ben Bernanke has argued that inflation will snap back to a more moderate pace once the effects of higher oil prices are dissipated and the emerging economies start to slow. The Fed chief might have been pleased with today's CPI report.

Consumer prices rose by 0.3% in September, slower than the 0.4% increase the previous month. Core CPI crept up only 0.1% last month.

But as the Fed chairman knows, the monthly series tends to bounce around a lot, which is why we prefer to look more closely at the less volatile annual pace. By following inflation on a 12-month moving basis, one can gain more insights on trends in real income and spending. Social security, wage contracts, home rental leases all make assumptions on how inflation will perform annually, not monthly.

If we examine how inflation behaved over the past year, the news is anything but positive for Bernanke. Consumer prices rose 3.9% in September from its year ago level, the fastest in three years! Indeed, the cost of living for Americans has been accelerating all year. It's now climbing at more than double the pace at the start of the 2011.

Nor has core inflation quieted down. Take out food and energy and the CPI is up 2% from a year ago, matching the rate of August. However, core CPI has been relentlessly marching upwards since October 2010.

Why isn't inflation behaving the way the Federal Reserve said it will? There many reasons for that.

(1) First of all, the global economy is not falling apart. We just saw China's economy continue to expand at a pace above 9%, a rate that will help sustain commodity prices and economic growth across Asia and Latin America. Secondly, European leaders appear more prepared to take bold steps to finally address the region's sovereign debt crisis and prevent a recession. Third, in the US, we have had a spate of positive economic news lately showing business activity picking up (e.g., housing starts, industrial production, exports). All this suggests that global demand for goods and services will continue to buoy prices for commodities and capital goods.

(2) The Federal Reserve, we believe has also mistakenly overestimated the "slack" in the U.S. economy. Let's begin with the Fed's perception of excess in labor markets.

The US economy has now successfully recovered all its lost output from the 2008- 2009 recession. Our current GDP is larger than its previous peak,

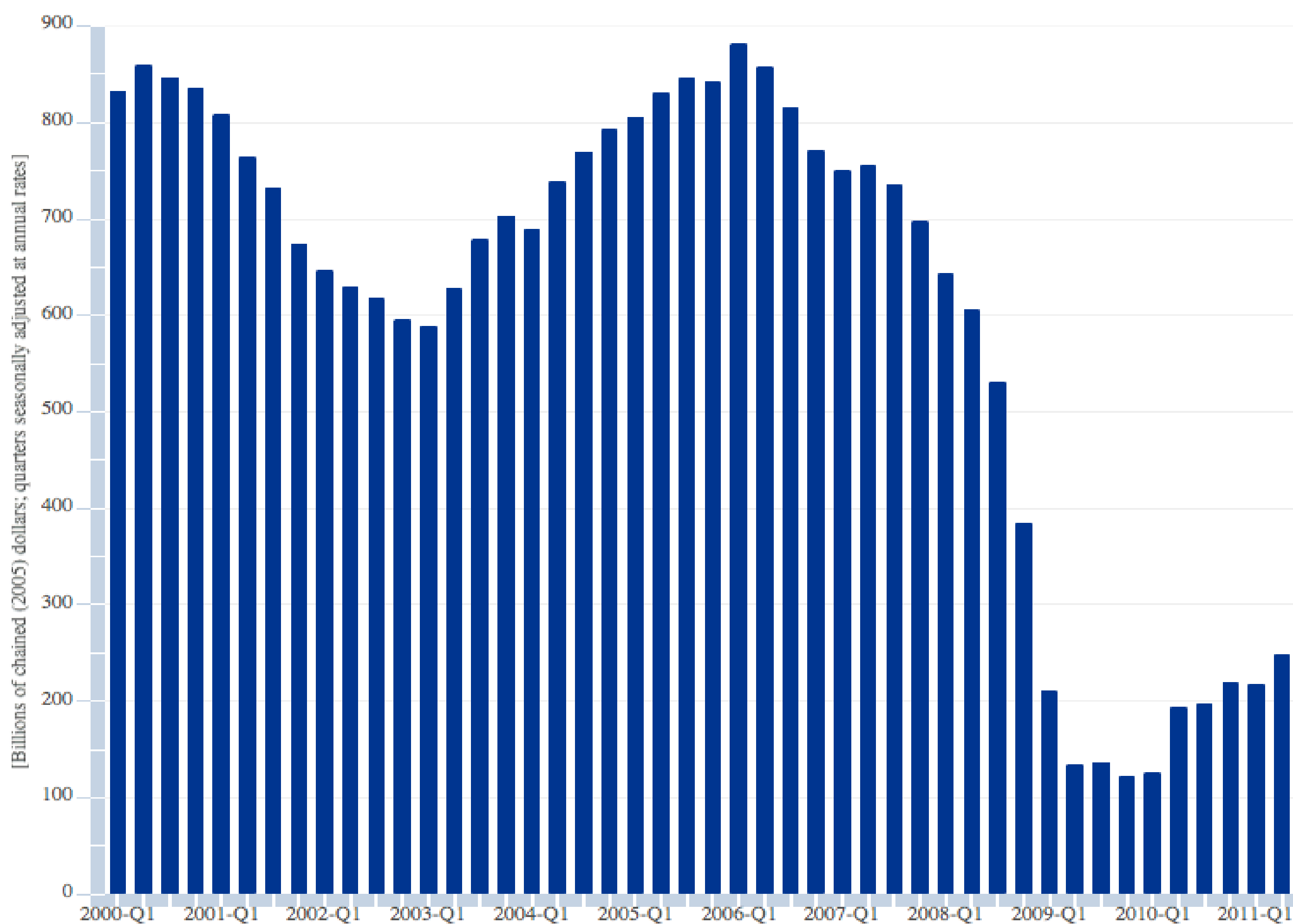
which means the economy is producing more than ever before. The downside is that it has achieved this with seven million fewer workers! Higher labor productivity and the more efficient use of capital have reduced the need for labor. Employment could pick up more dramatically if the economy achieves growth rates of 3.5% or better for a sustained period of time, but that is not yet on anyone's radar screen.

Secondly, there are still 14 million people in the labor force that are unemployed. Nearly half have been without a job for more than 6 months, and one in three have been out of work for at least a year! It stands to reason that the longer they are out, the more their skills atrophy. Simply put, the number of unemployed Americans equipped with the skills and knowledge to compete in the work force is growing smaller with each passing day that the country grows below its potential. From an economic standpoint, it also means that the non-inflationary rate of unemployment may be closer to 7% to 8%, and not the 5% to 6%.

Another frequent justification by the Fed that inflation will ease is the ongoing slack in capacity among U.S. industries. Again, we don't share this view. Capacity utilization rates are extremely difficult to compute on a national scale. Nevertheless, let's see the data as it is. This week the Federal Reserve reported that industrial capacity utilization has moved up to 77.4 and for manufacturing alone it rose to 75.1. Both are the highest in three years! Capacity in the mining sector has surged to 91.3, the most since 2005! So capacity utilization is clearly moving up.

Yet this doesn't tell the full story. These figures hardly account for the aging of our capital stock. Is all that unused capacity still working efficiently? It is certainly true that business investments have been strong since the recovery started. Gross private domestic investment (GPDI) has risen 17.9% in real terms in 2010 and increased further in the first and second quarter of this year. But there are two points to consider here. First, some of this spending is simply being used to replace aging capital, not add new capital. Second, the GPDI also includes spending on inventories, some of which doesn't get sold off. For a better understanding on how much U.S. productive capacity has grown, we need to look at net private domestic investments, which is business capital spending *beyond* that of simply replacing aging equipment and the purchases of inventories. As you can see from Figure 1, companies are not rushing to buy much more than what is needed to replace depreciating assets.

Figure 1. Net Private Domestic Investment by Business



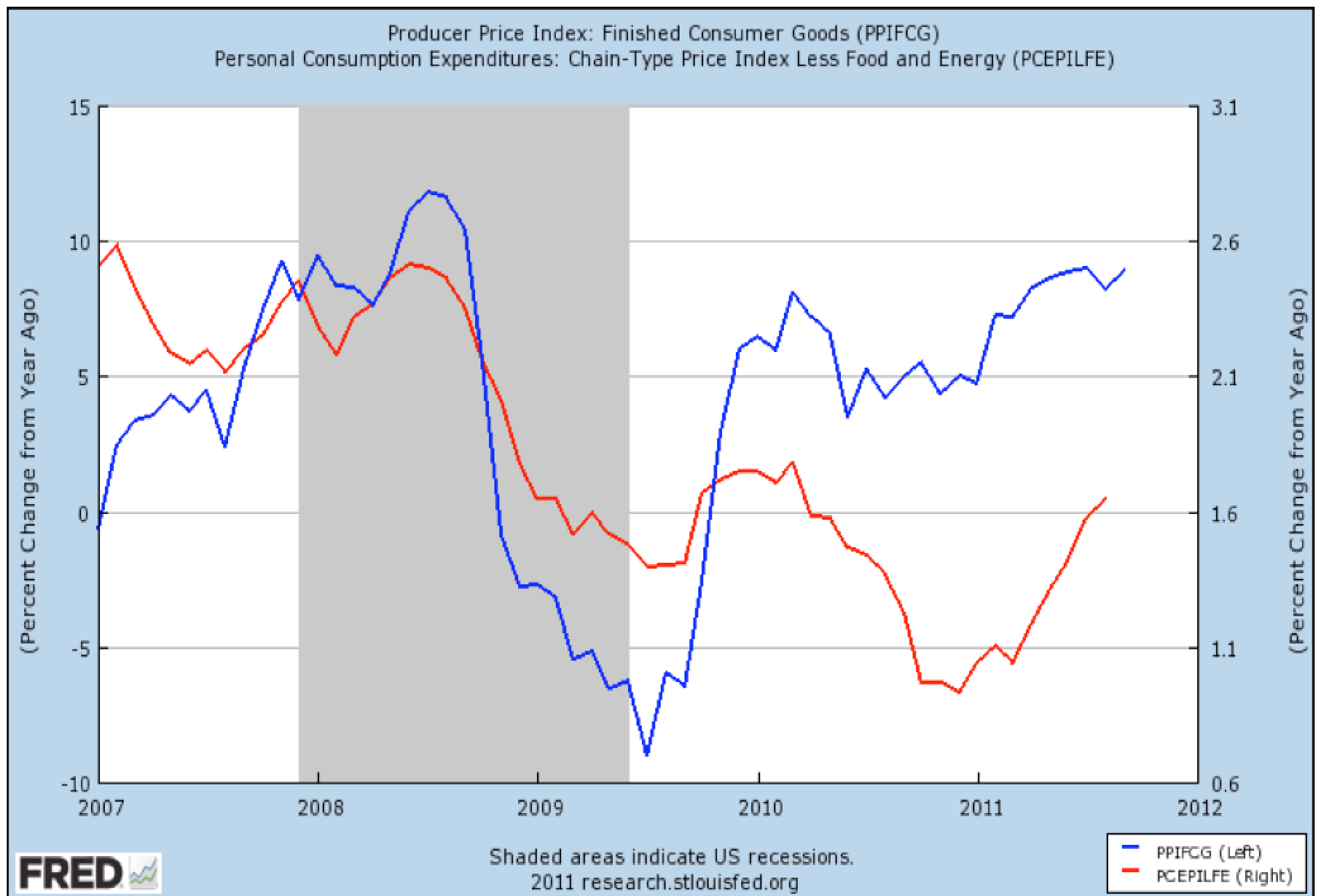
So we have to ask the question. Is there anything to suggest that the Federal Reserve may be right in that inflation will soon cool?

We can’t see it.

Producer prices, which reflect cost pressures in the production phase, took everyone by surprise when it shot up 0.8% last month, and brought the year over year rate to 6.9%. It is true that a rise in headline producer prices

itself will not necessarily translate into higher consumer prices. There is, however, a fairly good correlation between producer prices for finished consumer goods (essentially the price retailers pay for merchandise) --- and the Fed's preferred inflation gauge, the Personal Consumption Expenditure Price Index minus food and energy. In Graph 2 we see that directional changes in the core PCE price index often follows movements in PPI for finished consumer goods, which means that even the Fed's favorite inflation measure is likely to edge higher in coming months.

Graph 2. 12-month price changes in PPI for finished consumer goods and the core-PCE Price Index



Bottom line:

The Fed, especially Chairman Bernanke, has repeatedly said that inflation pressures will ease in coming months. We do not see such a moderation in

the making. The world economy is not static. China appears to be achieving a soft landing, with growth holding at around 9%. Europe seems intent on preventing a systemic financial crash and avoiding a deep recession. Middle East instability is likely to get worse this year and next and this will be transmitted in the form of higher oil prices. As for price pressures emanating in the U.S., we fear that structural unemployment is larger than commonly thought which means there is much less slack in the labor force. Nor are companies showing much enthusiasm about adding net new capital to their existing stock. So the effective capacity utilization rate is probably higher than what the Fed publishes in its monthly report.

Even investors are beginning to take another look at inflation. Yields on 10-year Treasuries have climbed 50 basis points in just two weeks. It's a reality check that the Fed should heed too.