ECONOMIC VIEWPOINT

FOCUS ECONOMICS ANALYST FORECAST AWARDS 2017 #1 BEST OVERALL FORECASTER - CANADA

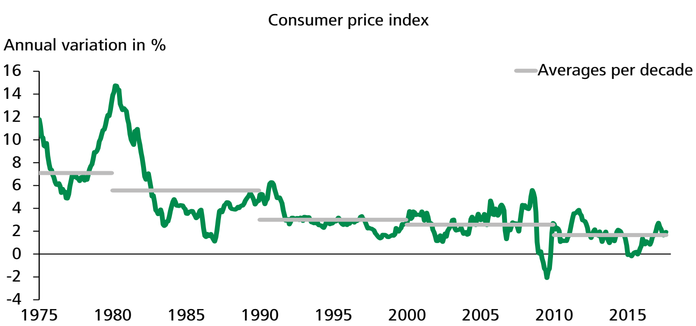
Is the Period of Lacklustre U.S. Inflation Winding Down?

In the United States, relatively soft inflation persists, something that has characterized almost all of the current economic growth cycle. Despite the livelier economy, inflation's recent movement is making the Federal Reserve's (Fed) job harder, as it is taking a while for price growth to reach its target. However, of the factors that may explain the fluctuations in inflation, several are starting to edge a little higher. We can therefore expect inflation to strengthen somewhat in the coming quarters, although that will not be enough for Fed leaders to abandon the current gradual pace for monetary policy normalization.

Cycle of Weak Inflation

The very long-term trend for consumer prices is slowing nearly constantly. In March 1980, the annual change in the consumer price index (CPI) peaked at 14.8%. The 1980 and 1982 recessions, the drop in oil prices and tight Fed monetary policy took inflation down considerably, to just under 2.5% in mid-1983. Core inflation—the annual change in the CPI excluding food and energy—followed the same trajectory, going from 13.6% to 4.0%. Total inflation has continued to moderate since then. It averaged 5.6% in the 1980s, then dropped to 3.0% in the 1990s, 2.6% in the 2000s, and has fallen to 1.7% since 2010 (graph 1).

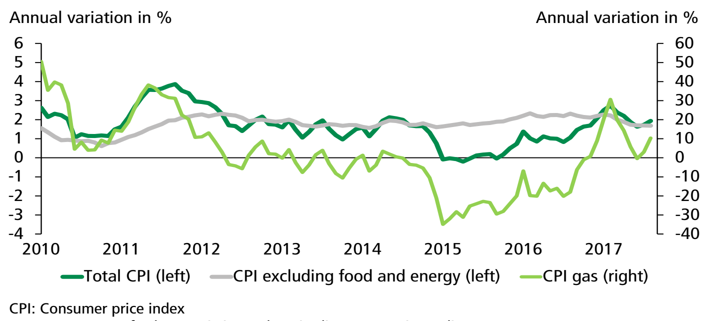
GRAPH 1
A long deflationary trend



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

Inflation has occasionally moved substantially away from its 1.7% average in this decade (graph 2). These gaps usually result from major fluctuations in energy prices, especially oil and gas. This did not affect core inflation, as it excludes energy and food. This measure was very low at the start of the decade as it was still influenced by the problems of the 2008–2009 recession. Since then, however, it has been highly stable, with a standard deviation of 0.3 percentage points around a 1.8% average.

GRAPH 2
Fluctuations in energy prices, gas in particular, triggered the main movements by total inflation



CPI: Consumer price index
Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

These averages are still relatively low. Since 2012, the Fed has officially been aiming for an inflation target of 2%, so it clearly has not achieved its goal satisfactorily. During this period, total CPI inflation has spent only 12 months at or above target.

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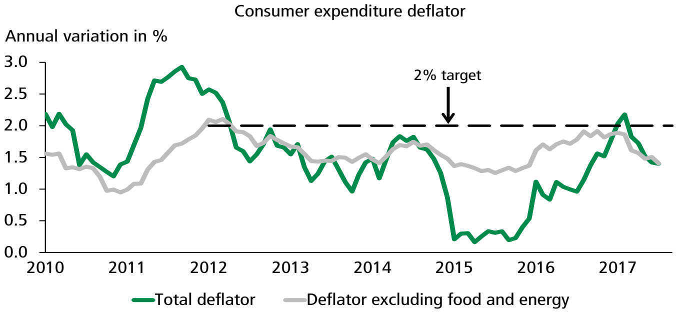
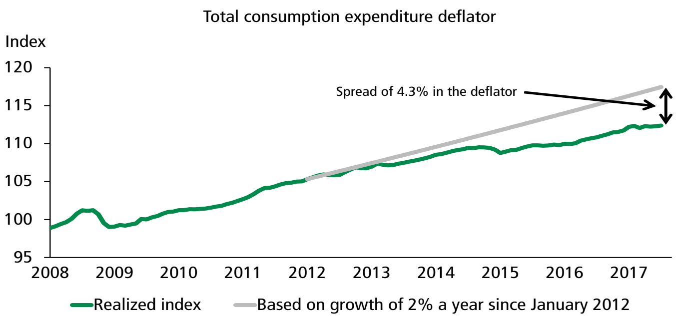
However, if we use the annual change in the consumption expenditure deflator instead—the index on which the Fed's target is based—inflation spent only six months at or above the 2% target (four months, if we exclude food and energy) (graph 3). The price level is therefore much lower than it would have been if the Fed had hit its target of steady 2% inflation (graph 4). This situation could also give the monetary authorities some leeway if inflation should accelerate to more than 2% for a period.

GRAPH 3
Inflation has generally been below the Federal Reserve's official target



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

GRAPH 4
The string of weak inflation figures means that prices are relatively low

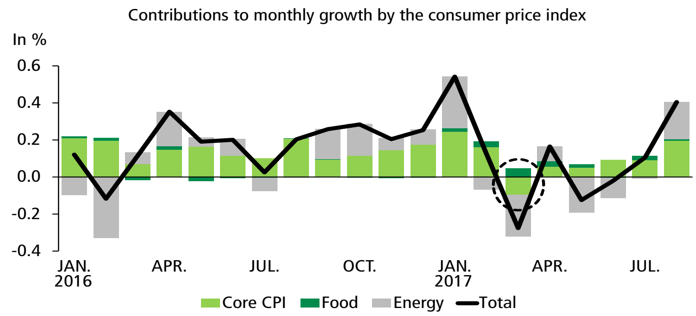


Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

What About the Recent Price Fluctuations?

Inflation has been on a descending slope since the start of 2017. In February, the annual change in total CPI hit a peak of 2.7%. It then plunged to 1.6% in June, the lowest rate since September 2016. Energy prices triggered a slight acceleration in July and August; the latest result is 1.9%. Core inflation, for its part, went from 2.3% in January to 1.7% in August, its lowest level since January 2015. During this time, the March 2017 monthly contraction of 0.1% in the core CPI is especially noteworthy (graph 5). This is quite unusual: the previous drop dates back to January 2010, and the core CPI has posted only

GRAPH 5
March 2017: Rare monthly drop by the core CPI

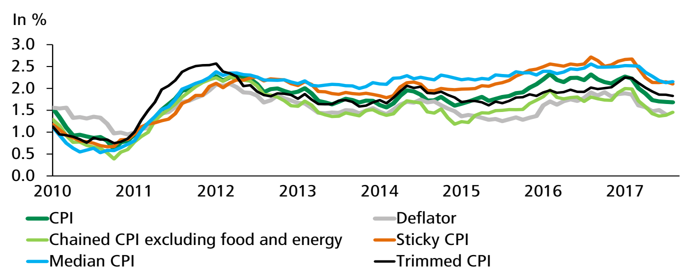


CPI: Consumer price index
Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

nine monthly contractions since 1960. Several components saw prices contract in March 2017, including clothing (-0.7%), wireless telephone services (-7.0%), hotels (-2.8%), eyeglasses and eye care (-0.7%), recreational goods (-0.3%) and motor vehicles (-0.4%).

The March hit had an impact that is still affecting the movement by core inflation. Its reach goes beyond the CPI; the consumption expenditure deflator and an array of other indicators of underlying inflation are showing the same weak growth (graph 6).

GRAPH 6
Several measures of core inflation slowed in 2017

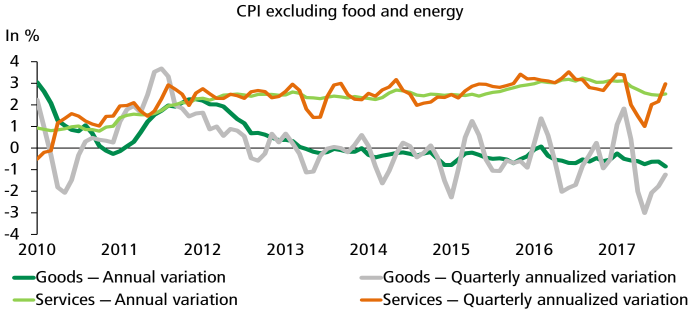


CPI: Consumer price index
Sources: Bureau of Labor Statistics, Bureau of Labor Statistics, Atlanta Federal Reserve, Cleveland Federal Reserve and Desjardins, Economic Studies

There is a steady divergence between core inflation that is sustained in services and very slow, even negative for goods (graph 7 on page 3). Except for a single point in February 2016, the annual change in the CPI for goods excluding food and energy has been negative since March 2013. Four and a half years of deflation!

Core inflation's stronger trend in services essentially comes from shelter. In August, the annual change in the shelter CPI was 3.3%, which is also its average since the start of 2015. The

GRAPH 7
Price growth is higher in services while goods are deflating



CPI: Consumer price index
Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

weight of shelter—a component that does not move much—within total CPI (33.8%) and core CPI (42.7%) is a major source of stability. Excluding shelter and energy, the services CPI is posting an annual increase of 1.5%. This is down from the average of 2.2% since January 2015. The tumble by wireless telephone services and a slowdown by medical care are partially responsible for the slower pace.

What Factors Explain Inflation's Movement?

Several micro- and macroeconomic factors can influence inflation trends. The major factors include:

- Commodity prices, especially energy
- The level of production capacity utilization
- Wage growth
- Currency movements
- Factors that affect productivity and competition
- Inflation expectations
- Factors specific to certain components, like shelter, or regulations

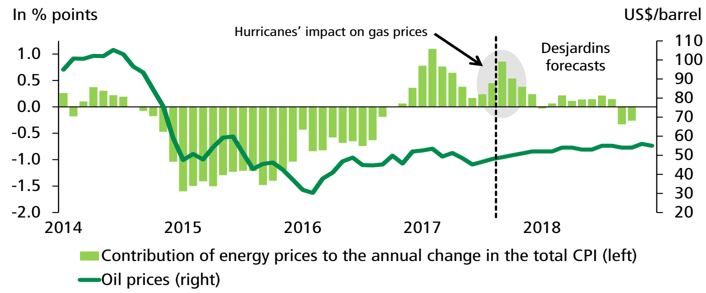
The recent movement by these factors can help us understand why inflation has been below expectations in recent years. Moreover, their trends, and the forecasts we can derive from them, can also yield some conclusions on future price movements.

Oil and Gas Prices

After the carnage of 2014, which lasted into 2016, oil prices are now more stable. This stability, with the slight increase recorded in 2016, provided for a neutral and then positive contribution to the total annual CPI (graph 8). This contribution had started to decline in the last few months. However, the gas price increase triggered by hurricanes Harvey and Irma will cause a temporary jump in total CPI's monthly and annual changes. In 2018, the contribution should head towards zero.

- Recent effect: downward between 2014 and mid-2016. Upward in 2017
- Future effect: upward at the end of 2017 and stable in 2018

GRAPH 8
The recent oil price stability is leading to fewer fluctuations in the total CPI



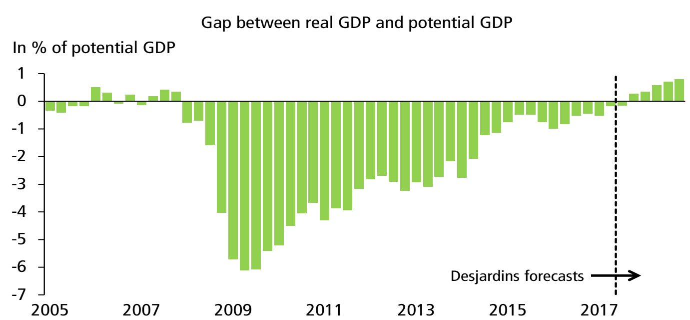
CPI: Consumer price index
Sources: Datastream, Bureau of Labor Statistics and Desjardins, Economic Studies

Production Capacity Utilization

The economy has shown slow but sustained growth since the recession. Excess production capacity has declined little by little, to the point that real GDP growth has outstripped potential GDP growth fairly often; the Congressional Budget Office (CBO) estimates the latter to be around 1.7%. The gap between these two metrics, called the output gap, should soon be back in positive territory for the first time since 2007 (graph 9). Scarcer production capacity should bring on greater inflationary pressures.

- Recent effect: downward
- Future effect: neutral to slightly upward

GRAPH 9
The output gap is closing



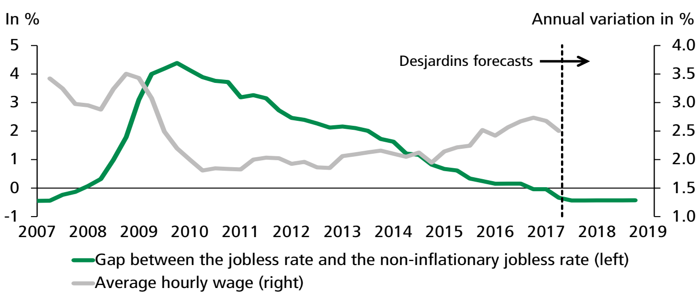
Sources: Bureau of Economic Analysis, Congressional Budget Office and Desjardins, Economic Studies

Wage Growth

In addition to being marked by weak inflation, the current cycle is also showing modest wage growth. This situation is especially disappointing as certain wage metrics recently posted slowdowns, while the jobless rate is at a very low point. The U.S. jobless rate (4.3% in August) recently dropped below the level that is deemed to be non-inflationary, which the CBO puts at 4.7%. While the situation should eventually support wages, we are not seeing it yet (graph 10). However, the game is not over, and certain factors are more encouraging (business surveys, situation for permanent full-time employees, etc.).

- Recent effect: downward to neutral
- Future effect: neutral to slightly upward

GRAPH 10
Wages are not accelerating much despite improvement in labour market



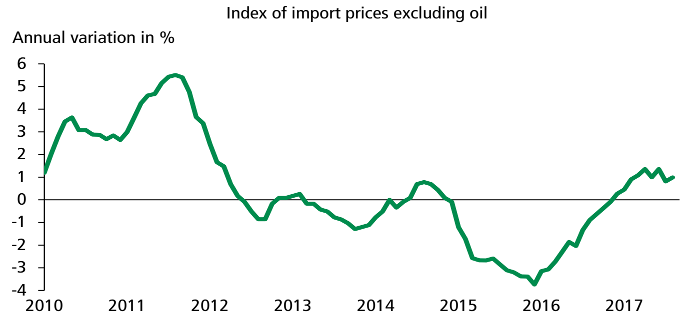
Sources: Bureau of Labor Statistics, Congressional Budget Office and Desjardins, Economic Studies

The Dollar and Import Prices

Although in some ways it is the world's economic powerhouse, the United States is not isolated. Fluctuations in prices abroad and currency movements can therefore influence prices in the U.S. market. The index of import prices excluding oil has been declining almost non-stop since 2012 (graph 11). The U.S. dollar's rise was one factor that helped moderate import prices and inflation in the United States. However, the greenback has been depreciating since the start of the year, which should help fuel upside pressure (graph 12). This is already showing in import prices, where the trend has changed. However, the U.S. dollar is expected to stabilize shortly, as the markets start to price in further key rate hikes from the Fed.

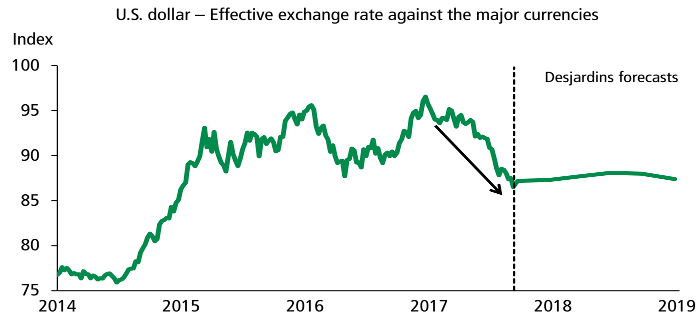
- Recent effect: downward
- Future effect: upward then neutral

GRAPH 11
The movement by import prices is no longer so weak



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

GRAPH 12
The greenback has been falling since the start of the year, but should stabilize



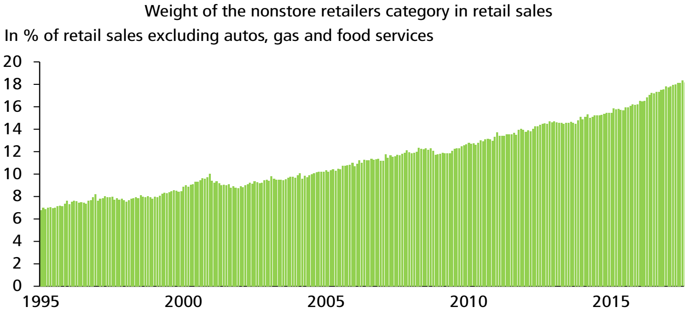
Sources: Federal Reserve Board and Desjardins, Economic Studies

Productivity, Competition, Technology, E-Commerce and Globalization

Aside from productivity, which has been fairly sluggish in the United States in recent years, nearly all of these elements are among the factors that fuel the disinflationary trend. By favouring international competition and the search for less expensive processes and equipment, the greater importance of foreign trade and globalization contribute to downside pressures. Whether the winds of protectionism now blowing in Washington will have real repercussions for price movements remains to be seen. E-commerce, which is becoming increasingly important in consumers' buying habits (graph 13 on page 5), also fosters competition, particularly by making it easy to compare prices and by offering economies of scale that have changed the overall picture of retailing. Furthermore, new technologies are making it possible to develop and implement much more efficient and less expensive production and marketing processes.

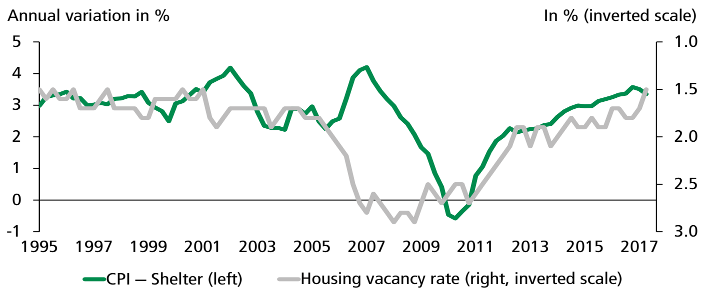
- Recent effect: downward
- Future effect: probably downward failing a surge in protectionism

GRAPH 13
The magnitude of e-commerce may be one source of price weakness



Sources: U.S. Census Bureau and Desjardins, Economic Studies

GRAPH 15
Housing demand should continue to fuel price increases



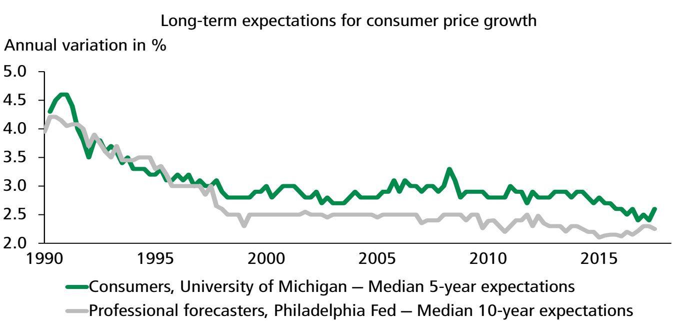
Sources: Bureau of Labor Statistics, U.S. Census Bureau and Desjardins, Economic Studies

Inflation Expectations

Inflation expectations have been relatively stable throughout the last decade. Some of the credit goes to the Fed, which has been able to anchor long-term consumer and professional inflation expectations since the second half of the 1990s (graph 14).

- Recent effect: stable
- Future effect: stable

GRAPH 14
Inflation expectations are still very stable



Sources: University of Michigan, Philadelphia Federal Reserve and Desjardins, Economic Studies

Shelter Prices

In the 2000s, during the height of the real estate bubble, shelter prices were making a sustained positive contribution to inflation. Since then, the whole thing collapsed. The CPI for shelter even fell in 2009 and 2010. The housing market's recovery, characterized by a dropping vacancy rate for housing units, finally put stronger pressure on home prices, the CPI for shelter, and then core inflation (graph 15). We expect this pressure to persist without accelerating.

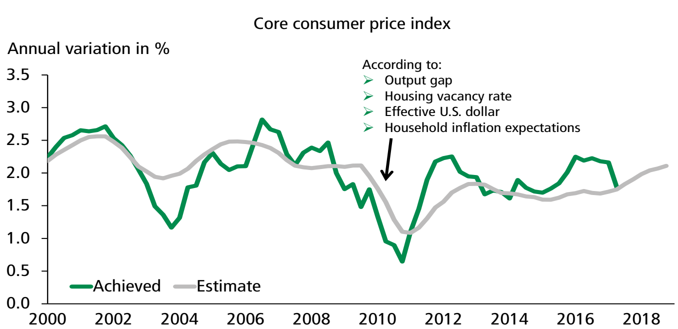
- Recent effect: upward since 2012
- Future effect: upward

Where Is U.S. Inflation Heading?

Most of these factors had a hand in inflation's weakness in recent years. Thus, while the economy was doing better, the production capacity utilization level, combined with currency effects, the drop in energy prices, new technologies and the underlying trend stemming from globalization and e-commerce, made total and core inflation underperform.

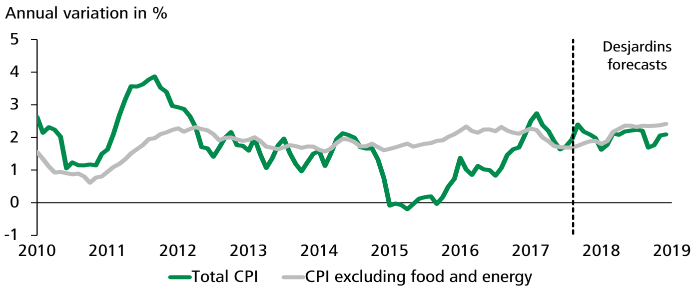
However, things could change soon. These downside factors are waning and should even reverse. The undeniable impacts of international competition and e-commerce should persist, of course, but the other components will no longer be a drag. An estimate based on the output gap, housing vacancy rate, the currency and consumer expectations points to core inflation that is faster than that seen in the United States in summer 2017 (graph 16). It could even go above 2% in the next year. Affected by energy prices, total inflation could accelerate further, starting within the next few months. However, it should continue to oscillate around 2% in 2018 (graph 17 on page 6). Over the medium term, inflation should remain fairly sustained at just over 2% until the economic cycle eventually wanes, triggering another slowdown.

GRAPH 16
Growth by core inflation should accelerate a little in 2018



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

GRAPH 17
Core inflation should remain stable in 2017 and 2018



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Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

As in March 2017, unexpected factors could skew the outlook, but the underlying trend should still show price growth that will be as satisfying to Fed's members. Here, key interest rates should continue to rise gradually. As this economic cycle is starting to age, the Fed's key interest rates should peak at about 2.5%, a level much lower than seen in previous monetary firming episodes.

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