

FED SHADOW

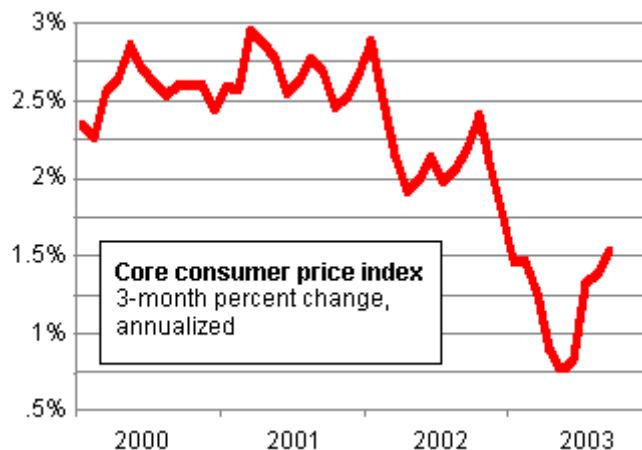
## Disinflation: Public Face vs Private Reality

Monday, October 20, 2003

David Gitlitz

**Surely the Fed must at least privately acknowledge the evidence that disinflation is over. Now -- will they act?**

At first blush, release late last week of September consumer price data seemed to bolster the consensus at **the Fed** and among the Wall Street economic fraternity that the "disinflation" trend is intact, and that pertinent inflation risks remain to the downside. As any number of analyses and press reports pointed out, on a year-over-year basis, the core CPI -- at rate of only 1.2% -- is now rising at the slowest pace in 37 years. That's down from a rate of 2% late last year and 1.5% just this past spring. If anything, it would *appear*, the rate of inflation deceleration is actually accelerating.



This ready-made interpretation of the data, however, should mostly serve as a cautionary reminder that appearances can be deceiving. During transitional periods, year-on-year analysis of the data can obscure significant turning points, and this is just such an occasion. Breaking down the data on a more compact three-month span provides a significantly more focused view of current trends. On that basis, as seen in the chart at left, core consumer price inflation bottomed last May at an annualized rate of about 0.75%, and is now rising at a three-month annualized

rate twice that, at 1.5%. We don't suggest that this amounts to evidence in itself of an imminent inflation breakout. But clearly, the directional trend is now pointing toward rising, rather than falling, inflation.

It's also important to bear in mind that the official government inflation indexes are all backward-looking, highly imprecise representations of real-time price-level impulses. At this point, the lagging statistical inflation measures are only beginning to reflect the easing of the dollar's deflationary appreciation that was first signaled by sensitive market price indicators such as gold and foreign exchange early last year. While the CPI is widely considered to overstate inflation, it could well be that its most telling defect in the current context is the methodological bias which leaves it especially slow to reflect changes in dollar purchasing power. On the same three-month annualized basis cited above, for example, the core personal consumption expenditures deflator, which is regarded as the most accurate of the official indicators, bottomed two months prior to the CPI -- also at about 0.75% -- but is now rising at an annual rate of some 2%.

Reluctant though they may be to acknowledge it, we don't doubt that Fed officials are mindful of all this. The Fed now uses the core PCE deflator as its main inflation indicator, and is assuredly aware of its recent turn higher. But while key officials may be cognizant of this directional shift, they seem content to ignore it, at least publicly. Despite a string of upbeat labor market indicators, **Fed Governor Ben Bernanke** -- who has emerged as leader of the apparent consensus favoring continuation of a super-easy policy posture -- continues to bemoan a lackluster employment recovery, equating slow job growth with the "risk" of a further decline in inflation. "In my view, monetary policy can afford to maintain its accommodative stance for a considerable period, certainly until a sustainable recovery in employment is under way and disinflationary risks have been correspondingly reduced," Bernanke told the **Senate Banking Committee** last week.

When the September jobs report came in surprisingly strong early this month, we viewed it as likely to encourage the Fed to begin backing away from its risky fixation on labor market stagnation (see ["Back from the Inflationary Brink"](#) October 6, 2003). Maintaining an excessively easy stance in the hope of spurring job growth would be an error equal and opposite to its earlier tightening campaign aimed in important part at stanching what it feared was an inflationary job market boom. Imposing a massively too-tight dollar scarcity against non-existent inflationary influences created the deflationary wipeout that culminated with the recent recession. Now, mistaking job market slack for non-existent deflationary pressures, the Fed risks engendering an inflationary liquidity surplus with consequences potentially just as damaging.

Bernanke's remarks would seem to represent a deepening of those risks, but there are signs suggesting the Fed consensus could be in some flux, at least at the margin. In this instance, it could be the regional reserve bank presidents -- informed by their networks of local ground-level contacts -- who take the lead in developing the rationale for a policy shift. **San Francisco Fed President Robert Parry** told a group at **UC Berkeley** last week that with GDP growth rates of 4% or more, "I just believe you cannot get through many more quarters without seeing growth rates in employment that are quite significant. It wouldn't surprise me if we saw it before year end." Parry also suggested the Fed could remain "accommodative" even while moving rates somewhat higher. "I think accommodative policy is not necessarily a time that interest rates are just kept flat," he said, noting that an accommodative stance is properly seen as one holding rates below equilibrium levels.

The significance of Parry's comments also were accentuated by the fact he dissented from the 25 basis point rate cut in favor of a more aggressive 50 bp cut at the June **FOMC** meeting. "Have I changed my views since then? Yes," Parry said at Berkeley. "I'm even more clear on the expansion today than I was a month ago."

In response to Parry, interest rate futures -- which had already upped the odds favoring out-month Fed rate hikes in response to the recent data releases -- were hammered, with the Euro-dollar futures market now priced for between 50 and 75 bps in hikes by next June. With a continued shift in expectations toward short rates moving higher sooner than had been anticipated, it seems only a matter of time before the 10-year Treasury note again breaches the 4.5% level. Obviously, the statement released after next Tuesday's FOMC meeting will be key to further shaping those expectations for the period ahead. Our view of the inflation risk environment will be particularly sensitive to whether the Fed chooses to repeat its claim that the "the risk of inflation becoming undesirably low remains the predominant concern for the foreseeable future." Should the Fed excise that unsupportable assertion, we will take some solace that the central bank is at least moving toward recognition of reality. If not, our assessment of the risk of the Fed remaining too easy for too long will rise considerably. **TM**