NATIONAL BANK
FINANCIAL MARKETS
A division of National Bank of Canada

SPECIAL REPORT
Economics and Strategy

March 13, 2017

HOW CONCERNED SHOULD THE FED BE ABOUT U.S. INFLATION?

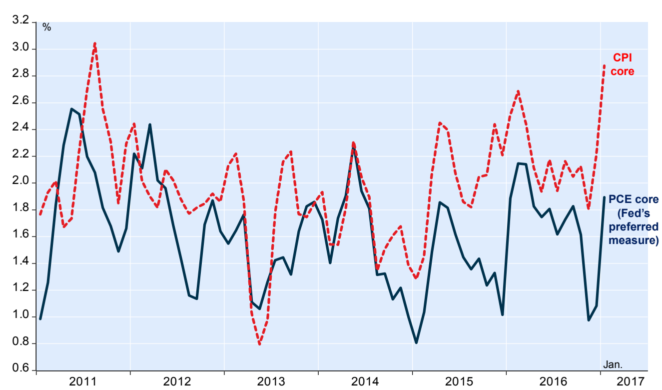
Summary

- **The Federal Reserve is poised to resume interest rate hikes this week. While it hasn't hit its inflation target in five years, the Fed will nonetheless be encouraged by improving data and have more confidence that the recent uptick in prices can be sustained, more so considering upcoming fiscal stimulus.**
- **But such optimism about inflation assumes the type of fiscal stimulus implemented is pro-growth and that the economy is at full-employment, neither of which is clear at this point.**
- **Measures favoured by the new Washington such as tax cuts for corporations and wealthy individuals and government spending on defense all have fiscal multipliers that are less than one, meaning the positive impact on economic growth (and hence inflation) may not be as good as advertised.**
- **While the labour market is booming and the jobless rate is at multi-year lows, it's unclear if wage growth can be sustained. If, as we expect, the participation rate for the age group 25-54 continues to rise, wage inflation will be curtailed.**
- **Even if wage growth does pick up, there's no guarantee that would spill to overall inflation. The pass-through of wage growth to actual inflation has diminished over the last few decades. In other words, the Phillips curve has become flatter, meaning that a bigger drop in the unemployment rate is now needed to generate the same inflation pressures as say a few decades ago.**
- **While protectionist policies such as a border tax or tariffs could temporarily lift inflation, a reversal is likely over the longer-term as economic growth is negatively affected.**

Market excitement about the return of inflation

U.S. consumer prices have been on a tear lately. Part of that is due to the recovery in energy prices, but core prices (i.e. excluding food and energy) have also been rising as evidenced by the annual core CPI inflation rate of 2.3% in January, the highest since August last year. More impressive is the 3-month annualized print of 2.9% for the core CPI, the highest since August 2011. True, the Fed's preferred measure, the core PCE deflator, is running at a much milder 1.9% on a 3-month annualized basis. But based on hawkish talk by Fed Governors in recent weeks, improving economic data coupled with upcoming fiscal stimulus seem to have given the FOMC enough confidence that rising prices can be sustained as to push up the annual core inflation rate towards its 2% target.

U.S.: Core inflation on the rise
Core consumer price index versus Core PCE deflator, 3-month annualized change



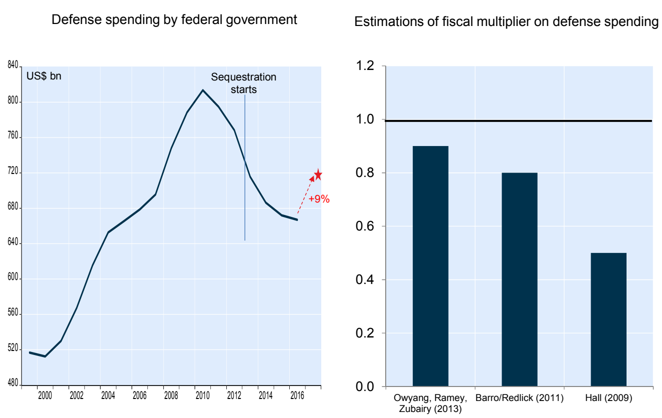
NBF Economics and Strategy (data via Datastream)

But such optimism about inflation assumes the type of fiscal stimulus implemented is pro-growth and that the economy is at full-employment, neither of which is clear at this point.

Fiscal stimulus could be a dud

The expected fiscal stimulus should indeed lift U.S. growth, although the extent of the boost will depend on the type of measures implemented. To be sure, not all types of current expenditures are created equal. The Trump administration reportedly aims to boost defense spending by US$54 bn this year, while seeking compensating cuts in non-defense spending. But fiscal multipliers for defense spending have typically been estimated at less than 1, meaning that such outlays are likely to crowd out private spending, restraining growth as a result. One can only hope compensating cuts to non-defense spending does not include infrastructure whose fiscal multiplier is well above 1 according to the Congressional Budget Office.

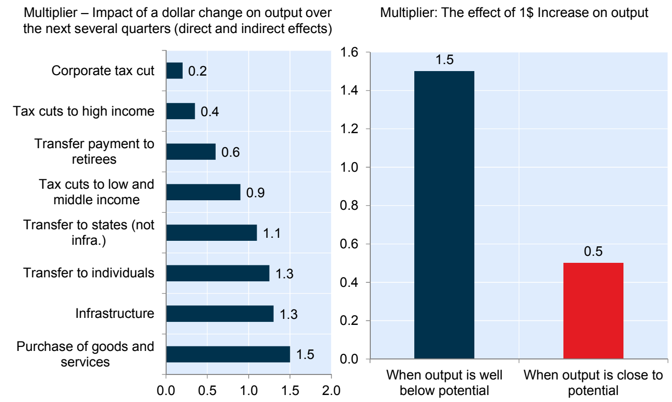
U.S.: How effective is defense spending?



NBF Economics and Strategy (data via BEA)

The benefits of upcoming tax policy are also unclear — the CBO suggests fiscal multipliers are much lower than 1 when there are tax cuts for corporations and wealthy individuals, both measures seemingly favoured by the new Washington. Multipliers are also the smallest when the economy is close to potential, as is currently the case. So, don't hold your breath for the 4% U.S. GDP growth that was promised during the election campaign. A more realistic target for U.S. GDP growth is arguably in the 2-3% range, but under such scenario inflation is unlikely to spin out of control.

U.S.: Impacts of fiscal stimulus may vary

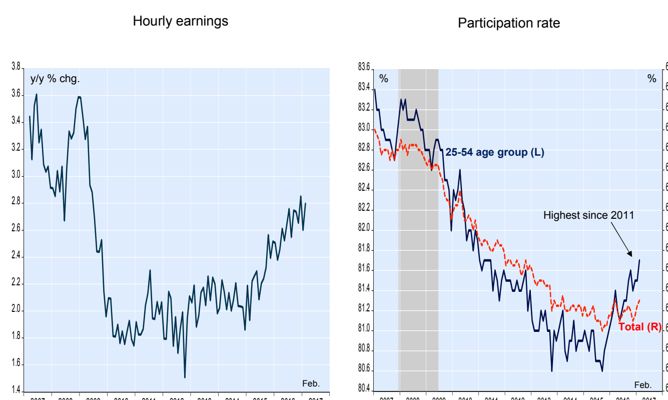


NBF Economics and Strategy (data via Congressional Budget Office)

Wage inflation will likely remain tame

Those who expect an inflation surge often assume the labour market is at full employment and wage growth will jump as a result. While there's no denying the U.S. labour market is booming, with the jobless rate at multi-year lows and rising wages, that's not a confirmation we're at full employment. There are still millions of individuals who are out of the labour force and poised to join as they feel more confident about landing a job. Note that the participation rate for the age group 25-54 (the most cyclical cohort of the labour market) hit 81.7% in February, the highest since 2011. If, as we expect, the participation rate for that age group rises further (and it has plenty of room to do so), that should keep wage growth in check as prime-age workers enter the labour force.

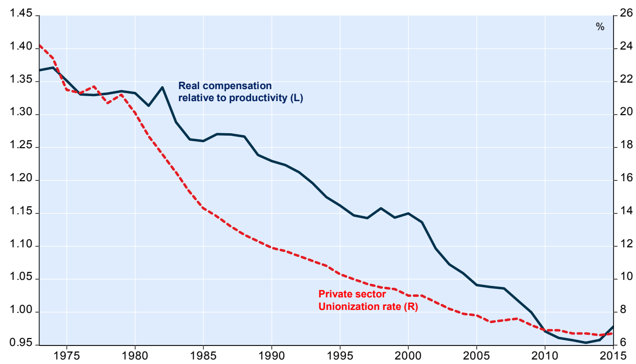
U.S.: Wage inflation restrained by rising participation rate



NBF Economics and Strategy (data via Datastream)

Also putting on lid on wage growth is the trend of the past few decades that has reduced bargaining power for workers. Diminished union power has led to a decline in real compensation relative to productivity. As a result, labour income as a share of the economy has fallen to an all-time low. There are no signs of improvement on that front considering the spread of "right to work" legislation — earlier this year Kentucky and Missouri became the 27th and 28th U.S. states respectively adopting such legislation.

U.S.: Declining bargaining power for workers
Real compensation relative to productivity versus Union membership as % of employed

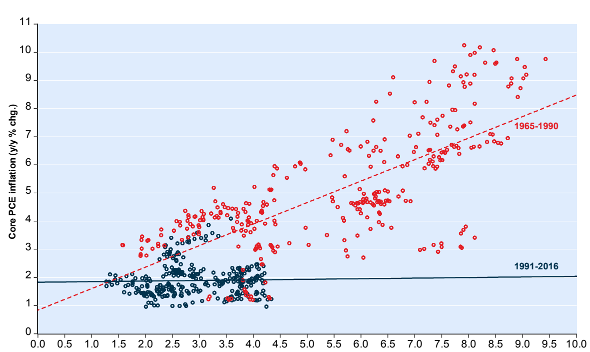


NBF Economics and Strategy (data via Bureau of Economic Analysis, ILO, US Census Bureau)

No pass-through from wages to PCE

Even assuming wage growth eventually picks up, there's no guarantee that would spill to overall inflation. The pass-through of wage growth to actual inflation has diminished over the last few decades. On the supply side, producers are controlling costs with technology and automation, thereby negating the need to raise prices aggressively. On, the demand side, an aging population translates into more savers, cushioning the positive impact of higher wages on spending. All in all, it seems the Phillips curve has become flatter, meaning that a bigger drop in the unemployment rate is now needed to generate the same inflation pressures as say a few decades ago.

U.S.: Pass-through of wage inflation has diminished significantly
Core PCE deflator versus Hourly earnings of production and nonsupervisory employees



NBF Economics and Strategy (data via Datastream)

Strong dollar caps inflation

The surging dollar is another drag on U.S. inflation given its negative impacts on exports and hence economic growth. The Federal Reserve is now raising interest rates at a time when other major central banks, including the European Central Bank, the Bank of Japan and Bank of England are still involved in quantitative easing. Diverging monetary policies suggest the greenback has room for further gains. The world's reserve currency could appreciate even more and potentially hit all-time highs in trade-weighted terms if protectionist policies implemented by the Trump administration have the desired effects of improving the U.S. trade balance and the undesired effects of increasing safe haven flows by spooking world markets — a trade war between the U.S. and say China, which accounted for roughly 40% of the U.S. trade deficit last year, would not be welcome news for investors worldwide.

Greenback not far from all-time high
Trade-weighted US dollar

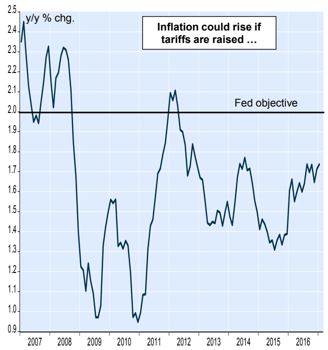
NBF Economics and Strategy (data via Datastream)

How will protectionist policies (if any) affect inflation?

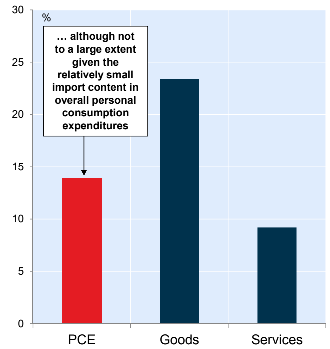
Could protectionism cause a surge in U.S. inflation? A tariff or border adjustment tax on imports would indeed raise the price of imported goods for American consumers. But the impact on annual inflation would be temporary because the annual price increase due to the tariff would vanish after a year (unless tariffs are raised every year). Moreover, the inflation impact would also be restricted considering the share of imports in U.S. personal consumption expenditures is less than 15%.

U.S.: Will protectionist policies prop up inflation?

Core PCE deflator



Share of imports in consumption expenditures

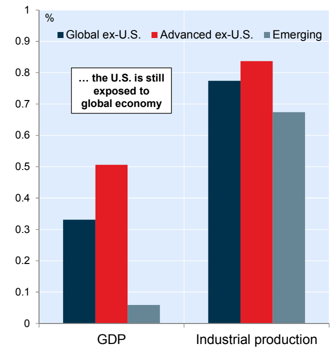


NBF Economics and Strategy (data via Datastream, FRBSF)

Global slowdown will have repercussions on U.S.

Exports as a share of GDP

Spillover to U.S. from 1% increase in GDP growth for global, advanced and emerging economies



NBF Economics and Strategy (data via Datastream, World Bank)

Moreover, a reversal in prices is likely over the longer-term as economic growth is negatively affected. Indeed, the damaging impact of a trade war should not be underestimated. Under that scenario, world GDP growth would slow down from already-mediocre levels, hurting not only oil prices but also U.S. growth. According to the World Bank's Global Economic Prospects, a 1% increase in global GDP growth helps lift U.S. growth by about 0.3% while a 1% increase in growth for advanced economies (other than the U.S.) helps boost U.S. GDP growth by about half a percentage point. Clearly, protectionist policies from Washington could come back and bite U.S. economic growth and hence inflation.

All told, whether or not protectionist policies are implemented by Washington, inflation is unlikely to run riot. Cost cutting measures such as automation by producers, restrained demand due to unfavourable demographics, a strong dollar and tighter monetary policy by the Fed should keep inflation under wraps. But we're cognizant of upside risks to our inflation call should upcoming fiscal policy be more effective than what we're currently assuming.

Krishen Rangasamy
514-879-3140

SPECIAL REPORT

ECONOMICS AND STRATEGY

Montreal Office
514-879-2529

Stéfane Marion
Chief Economist & Strategist
stefane.marion@nbc.ca

Paul-André Pinsonnault
Senior Fixed Income Economist
paulandre.pinsonnault@nbc.ca

Krishen Rangasamy
Senior Economist
krishen.rangasamy@nbc.ca

Marc Pinsonneault
Senior Economist
marc.pinsonneault@nbc.ca

Matthieu Arseneau
Senior Economist
matthieu.arseneau@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@nbc.ca

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Toronto Office
416-869-8598

Warren Lovely
MD, Public Sector Research and Strategy
warren.lovely@nbc.ca

NATIONAL BANK
FINANCIAL MARKETS
A division of National Bank of Canada