TrendMacro

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Real Deflation

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January's core deflation report is accurate -- and it sets up for more inflation down the road.

We now know we were correct in our initial quick take on the Fed's motive for announcing a hike in the discount rate last week, rather than waiting for next month's FOMC meeting (see "On the Fed's Discount Rate Hike" February 18, 2010). An FOMC announcement might have been misunderstood by markets as positioning it as a shift in *monetary* policy, while the inter-meeting announcement made it more likely to be seen as only a change in *bank-relief* policy. Now with Friday's announcement of a *negative* change in core consumer prices -- *deflation* of 0.14% in January, or 1.64% on an annual basis -- we see the Fed having no reason whatsoever to seriously consider tightening policy anytime soon, at least as long as the unemployment rate stays high and bank credit continues to contract.

- We take as further confirmation this morning's announcement that the Treasury will bulk up it its Special Financing Program back to $200 billion. The SFP is the Treasury's issuance of short-term cash management bills, and the deposit of their proceeds with the Fed. We've heard it said that the expansion of SFP could be a form of tightening in the sense that it substitutes for excess reserves on the liability side of the Fed's balance sheet. But we don't see how such substitution *tightens*, as the excess reserves for which it substitutes would just be invested in the SFP bills themselves, at least notionally. More likely, this is a strategy for assuring the ongoing funding of the Fed's assets -- which wouldn't happen if the Fed intended to shrink its balance sheet anytime soon.

Several clients have asked us about claims that the reported deflation in January core CPI must be incorrect. One widely-followed economics blogger has accused the Bureau of Labor Statistics of deliberately falsifying the number. His reasoning is based on a simple reconstruction of the 0.5% deflation figure reported for the CPI's shelter sub-index, based on its component sub-sub-indices. He concludes that it should actually be only deflation of 0.1%, which would be sufficient to flip the core CPI reading from negative (deflation) to positive (inflation). The blogger is simply wrong, and the BLS's computations are in fact correct. Senior sources at BLS have explained to us that the disjunction is due to the BLS simultaneously introducing in January new weightings for elements in the

Update to strategic view

FED FUNDS: Neither last week's discount rate hike, nor this morning's announcement of an expanded Special Financing Program, portend Fed tightening anytime soon. We still see the Fed staying on hold for the rest of the year.

US BONDS: With no visible evidence of core inflation, with the Fed on hold for the rest of the year, with crowded short-side speculation -- and especially with Europe's problems driving a flight to quality -- we see 10-year Treasuries trapped in a trading range between 3.50% and 4.00%.

GOLD, COMMODITIES, OIL, US RESOURCE STOCKS: Statistical evidence showing deflation only strengthens the case for "inflation plays," because it assures that the Fed will stay easy longer. Even with the money-multiplier at new lows, commodity inflation is already observable at the bottom of the supply chain.

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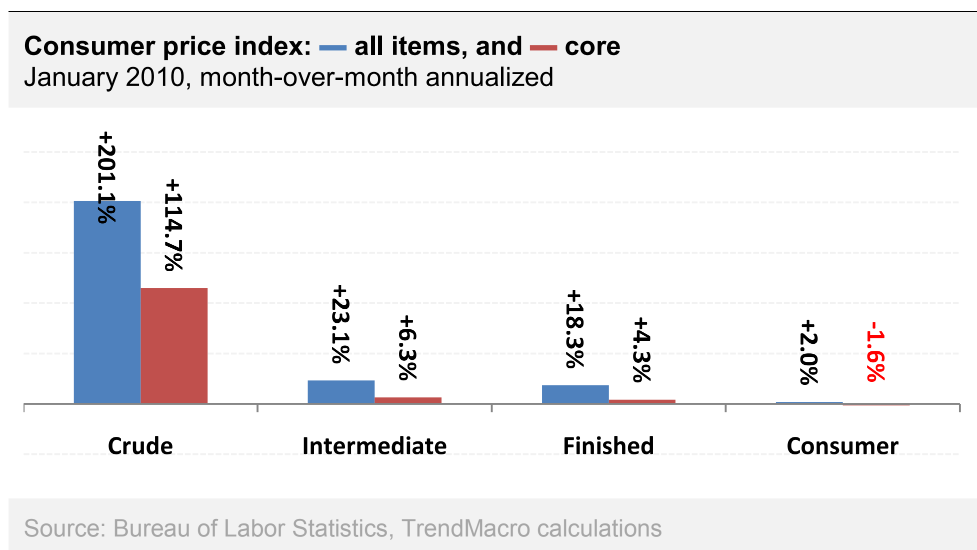
CPI consumption basket, new aggregation conventions for what is included in sub-indices and sub-sub-indices, *and* new seasonal adjustment factors for those aggregations.

The reported core deflation was indeed real -- or at least *accurate*, leaving aside how *real* over-specified statistics like CPI are in the first place. Incidentally, the culprit behind the deflation is *not* just owner's equivalent rent, although OER fell 0.08% in January, or 0.93% on an annual basis. Obviously, since OER fell less than overall core inflation, it has to be the case that core inflation *ex-OER* must have fallen *even more*. And so it did -- twice as much in fact, with deflation of 0.16%, or 1.96% on an annual basis. Without any help from OER, it was dragged down by drops in apparel, recreation and non-energy transportation prices.

So where's the inflation we've been forecasting? In one sense it's already here, gradually working its way up the supply chain. If you work down from consumer inflation at the top of the supply chain, back to finished goods, then intermediate goods, and finally crude goods at the bottom, we see a monotonic increase in inflation rates with each step, whether we look at all items or core (see the chart below).



We have no idea how many months or years it might take for the inflation already evident at the crude level to work its way up the chain to the consumer level. That depends in large part on the Fed. For now, with bank credit contracting, the Fed's enormous balance sheet remains perfectly sterilized -- that is, the base money the Fed has created remains trapped on its own balance sheet in the form of excess reserves. Thus we see new lows in the "money multiplier," the ratio of monetary aggregates such as M1 to base money. Crunch time for inflation will come when the banks start lending again, and the money multiplier starts to rise -- will the Fed dare to start tightening then, just when the string it's been pushing on for the last two years finally starts to move? We are betting that the Fed will tighten too slowly -- and *that's* when we'll start to see some real consumer inflation.

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[About us]

Recommended Reading

Capital Inflows: The Role of Controls
Jonathan D. Ostry, Atish R. Ghosh, Karl Habermeier, Marcos Chamon, Mahvash S. Qureshi, and Dennis B.S. Reinhardt
IMF Staff Position Note
February 19, 2010

Rethinking Macroeconomic Policy
Olivier Blanchard, Giovanni Dell'Ariccia, and Paolo Mauro
IMF Staff Position Note
February 12, 2010

[Recommended Reading home]

In the meantime, the Fed's extremely easy posture funds "carry trades" of all kinds. This, in turn, supports commodity prices -- which is why we already see measurable inflation at the base of the supply chain. You can think of this subterranean inflation as an ever-growing pressure, putting more and more stress on inflation at each step up the supply chain, and raising the stakes on a serious consumer inflation break-out at some point. That will happen when, as we expect, the Fed ultimately errs by failing to tighten promptly -- or not as sharply as required -- when lending and labor markets finally heal.

Bottom line

Neither last week's discount rate hike, nor this morning's announcement of an expanded Special Financing Program, portend Fed tightening anytime soon. We still see the Fed staying on hold for the rest of the year. With no visible evidence of core inflation, with the Fed on hold for the rest of the year, with crowded short-side speculation -- and especially with Europe's problems driving a flight to quality -- we see 10-year Treasuries trapped in a trading range between 3.50% and 4.00%. Statistical evidence showing deflation only strengthens the case for "inflation plays," because it assures that the Fed will stay easy longer. Even with the money-multiplier at new lows, commodity inflation is already observable at the bottom of the supply chain.