TrendMacrolytics

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TRENDMACRO LIVE!

On March CPI

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Now what will they say? After staking their credibility and prestige on the highly dubious proposition that inflation was virtually impossible with their models showing “slack” resource use and plentiful spare capacity, **Fed** officials surely are stunned by today’s data, with core CPI jumping 0.4%, double the expected rate. Today’s news should finally mark the end of the ill-advised exercise under which the Fed has pledged either to remain ultra-easy for a “considerable period” or to be “patient” in shifting from its highly accommodative posture so as to root out supposedly “disinflationary” forces. As we have detailed over the past eight months, the central bank’s stubborn adherence to output-gap rationalizations for its stance became increasingly inappropriate in the face of growing signs of incipient inflation. Now, the pertinent questions become how much inflation has already been embedded by the Fed remaining too easy for too long, and whether the central bank can correct its error without doing significant economic damage.

Of course, one month does not a trend make. But today’s inflation news will not easily be dismissed as an isolated event. In fact, though it has gone largely unnoticed, the data started showing a subtle turn in the first months of the year, with the core rate rising at a three-month annualized rate of 1.7% through February, up from 0.8% last December. After this morning’s release of the March CPI, however, no analytical subtlety is required to spot the shift. In the first thee months of the year, core consumer prices are up at a 2.9% annual rate, the highest in nearly three years. Even using the year-over-year calculation that the Fed and many Wall Street analysts prefer to capture underlying trends, core CPI is now rising at a rate of 1.6%, nearly 50% faster than the 1.09% posted at the end of last year.

The rapidity of this turn higher in the statistical price data underscores the inherent flaws in the Fed model which views inflation as a consequence of real factors such as rising capacity use, faster job growth or higher wages. Inflation is caused by a decline in the unit of account, which can only result from an excess supply of monetary liquidity relative to demand, and which shows up first in sensitive commodities, foreign exchange, and other forward-looking market price indicators. We are under no illusions, however, that the Fed will acknowledge the error of its ways and convert to this classical view (to which **Alan Greenspan** himself once subscribed). The most that can be hoped for is that the Fed is sensitive enough to its inevitable errors that it can move to correct them without causing serious dislocation.

Whether or not this will prove to be such an occasion remains to be seen. Fed funds futures are now fully priced for a first 25 basis-point rate hike in August, and another 50 bp before year end. While a 1.75% overnight rate would put the Fed in a less accommodative posture than it is now, by any objective standard it would continue to be easy. It would be premature to rule out the possibility that monetary policy could continue to impart further inflationary impulses even as it ostensibly moves toward restraint. TM

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