TD Bank Financial Group

TD Economics

Topic Paper

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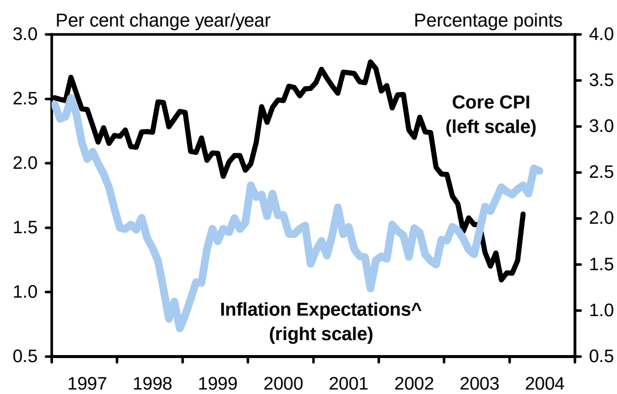
HAS THE FED LEFT RATES TOO LOW FOR TOO LONG?

After a three-year moratorium, the resurgence of more than 860,000 new jobs in the first four months of this year alongside an economy roaring ahead at a 5-per-cent clip has left market pundits fretting that the Fed might have to aggressively tighten monetary policy in order to head off percolating inflationary pressures. In response, inflation expectations have been on the rise, though they remain anchored at about 2.5 per cent (as measured by the difference between U.S. Treasuries and inflation-adjusted notes). Certainly, there has been a tight focus on the recent spike in gasoline prices, but there is more at play in the U.S. inflation picture than elevated energy costs. Recent movements in the core consumer price index (CPI), while not alarming, do indicate that inflation has turned the corner. As a result, there is a risk that the Fed has left rates too low for too long, and is falling behind the inflation curve.

Disillusioned with disinflation

It wasn't so long ago that concern over disinflationary pressures dominated market headlines. As recently as October of last year, the Fed believed that "the risk of inflation becoming undesirably low was the predominant concern for the foreseeable future". Even by mid-March, the Fed clung to the belief that the risks were still ever so slightly tilted towards disinflationary pressures when it stated that "the probability of an unwelcome fall in inflation [is] *almost* equal to that of a rise in inflation". By May, however, the Fed had changed its tune, voicing the opinion that "the risks to the goal of price stability have moved into balance". Some Committee members also have pointed to rising prices for "energy, other commodities, and non-oil imports", and reports from some business contacts that higher costs were increasingly being passed through to prices. And to some extent, that is true but it is not enough to ring the inflation alarm bells. The chart on page 2 does illustrate that there is a link between core consumer and producer prices, but it is not an overwhelmingly strong one. Sharp downward movements in the annual growth rate of core PPI lead to much more muted movements in the core CPI. In other words, consumer prices are more stable over time and do not reflect each and every gyration in producer prices. By the same token, firms do not readily pass along the full upswing in production costs to consumers.

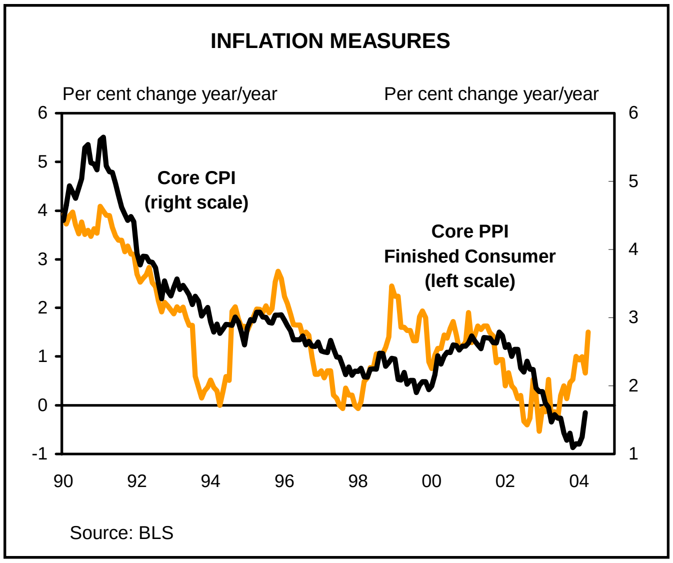
U.S. INFLATION EXPECTATIONS



^ Nominal 10-year U.S. Note less inflation-adjusted 10-year U.S. Note
Source: U.S. Federal Reserve Board, U.S. Department of Labor

Goods prices stop sinking

That said, core consumer inflation has been creeping higher since February, suggesting that some firms have indeed regained the ability to pass along higher prices to consumers. Prices for goods often provide an accurate signal of turning points in inflation because service price

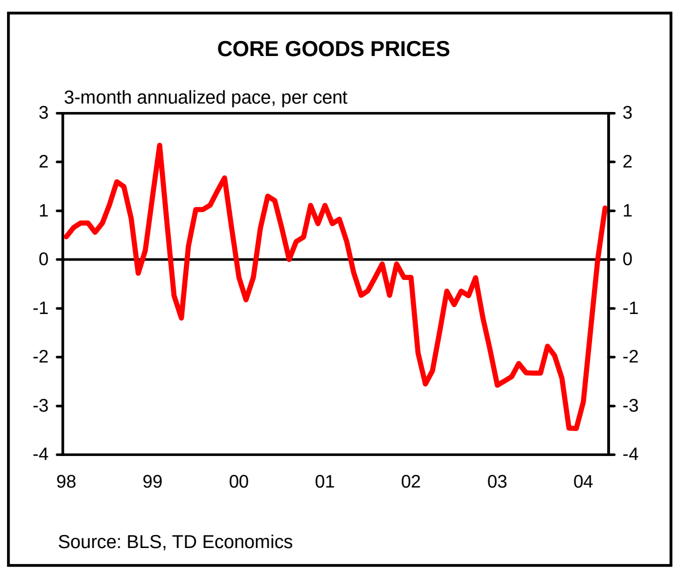


inflation tends to be more stable than goods price inflation. On this front, goods prices – which had been held down by global competition in the past two years – now appear to be recovering some lost ground. For instance, core goods prices were on a downward trajectory for sixteen straight months, sinking the annual rate of change to -2.6 per cent. Remarkably, this was the slowest pace ever recorded, which dates back to 1958. But January brought an end to the monthly slide and February and March even registered price gains in step with long-term averages. By April, the annual rate of change stood at –1.4 per cent, more than a full percentage point off its low. More importantly, the three-month annualized pace is running at +1.1 per cent, which is the first time this measure has registered a gain in three years. So there is good reason to believe pricing power is returning to firms in the goods producing industries, though admittedly some of this may also be reflective of import price increases from a much-depreciated U.S. dollar.

Business-as-usual for services

As for the service side of the CPI equation, corporate America never did lose its ability to pass on higher prices to consumers, even when a recession washed up on U.S. shores in 2000-2001. The service component encompasses more than two-thirds of the total core CPI measure and therefore represents a wild card in terms of its potential to exert the biggest influence on the total measure. Up until February, the annual growth rate for non-energy related services had been on a modest downtrend towards 2.5 per cent, but outsized monthly gains in both March (+0.5 per cent) and April (+0.4 per cent) quickly pushed the annual rate back up to 3.1 per cent. What caused it? Medical services and education have been long-standing culprits, offering upward pressure on the core service measure for over a year, and both March and April produced even more forceful gains. But, since intensified price pressures were largely contained to these two components in the past two years, it was not sufficient, until now, to materially drive the broader index higher. Lately, however, there's been a new kid on the block – shelter. This is the largest component of core services – representing more than half its weight – and up until recently shelter has registered mild month-to-month gains that have helped to temper growth in the overall services index. But that came to an end in March and April, which produced hefty gains that tipped the scale at 0.6 per cent and 0.5 per cent, respectively. The price increases were uniquely attributed to two subcomponents: homeowner's equivalent rent (HOE) and lodging away from home. The rise in the latter is reflective of a rebounding tourism industry following the 9-11 terrorist attacks. Not to mention that a lower valued U.S. dollar relative to other major global currencies now makes the U.S. a more enticing holiday destination.

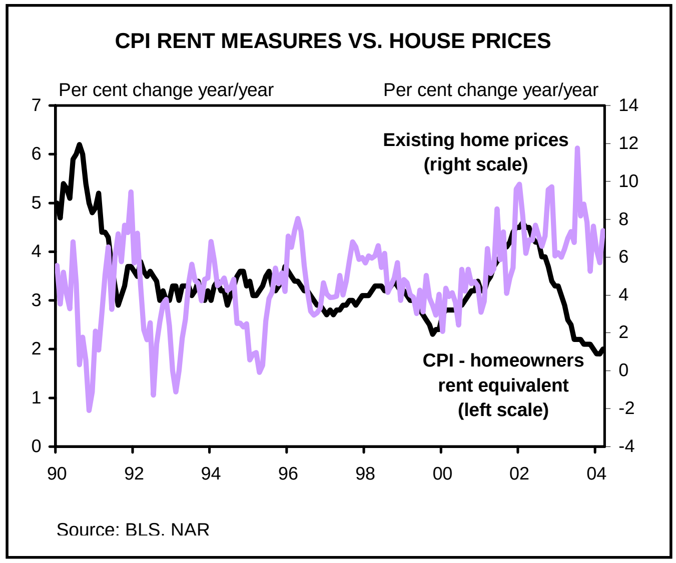
The explanation behind the increase in homeowner's equivalent rent is less obvious. This component reflects the change in implicit rent, which is the amount homeowners would pay to rent, or would earn from renting, their home in a competitive market. The measure is cal-



culated from a direct question posed to survey respondents that does not in any way prompt respondents to consider potentially related factors, such as movements in either house prices or rental vacancy rates. In fact, it is left completely up to the discretion of the respondent to determine the equivalent rental prices based on whatever they determine to be relevant benchmarks, and therefore there is a fair bit of ambiguity embedded in this measure. Nevertheless, the adjacent chart suggests that respondents implicitly take into account movements in house prices and interest rates – not surprising since homeowners would likely equate the rental value of their home to their mortgage carrying costs. If this relationship continues to hold, as one would expect, the HOE index may be in for a period of catch-up, with the growth in house prices running well ahead of that in HOE. In fact, HOE is expanding at an annual rate that is well below (half to be exact) its long-term norm of nearly 4 per cent, suggesting that the current level is unsustainable. Putting it all together, it's hard to ignore the possibility that the recent increase in the overall shelter measure is not just a one-time blip, and could materially underpin increases in core consumer prices moving ahead.

No need to hit the panic button

With the disinflationary influence from goods prices abating and with service prices holding firm does this mean that inflation is about to blast above the Fed's comfort level? Not necessarily, because the existence of ample slack in both product and labour markets suggest that inflationary pressures within the goods-producing sector will remain modest. First of all, industrial capacity utilization rates remain well below their long-term averages, indicative of ongoing economic slack. And, even though firms are regaining pricing power, it is not broadly represented across industries. The year-over-year rates of growth for vehicle and household furnishing prices are still deeply rooted in negative territory, while most goods components have yet to display consistent price gains on a monthly basis. Second, productivity growth has been sprinting at a 5.0 per cent quarterly clip over the past two years, constraining growth in unit labour costs to a -2.0-per-cent pace. This means that wage-push inflation is definitely not a problem in the near-term – an aspect some Fed members have touched upon in recent speeches.



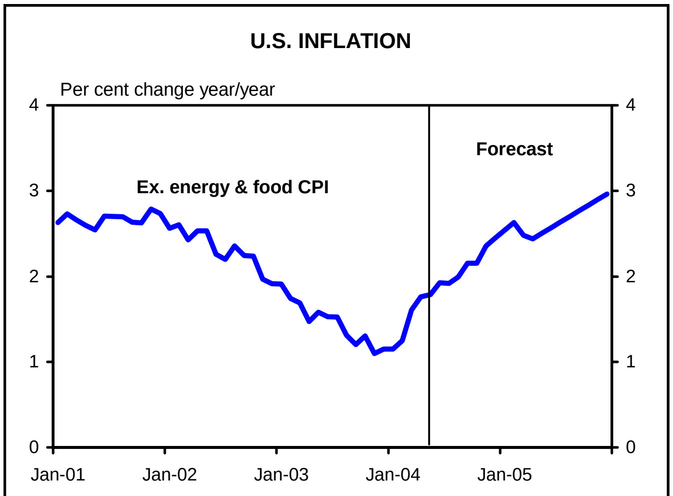
Keep your eyes on the storm clouds in the horizon

However, there are several risks lurking on the horizon, which, if they materialize, could intensify inflationary pressures rather easily. First and foremost, we cannot dismiss the possibility that increased production costs from elevated oil prices may be passed on to consumers, especially now that there is evidence that some firms are regaining pricing power. So far, the impact has been contained to first-round effects, such as added fuel surcharges on airplane tickets. But the longer that energy prices remain at inflated levels, the greater the risk that it will eventually place upward pressure on wages and spread to other sectors. In addition, as some Fed members have aptly pointed out, there is also the risk that if productivity growth slowed as employment picked up, the result could be reductions in slack accompanied by higher unit labor costs and associated pressures on prices. And lastly, lest we forget about the possibility for the U.S. to import inflation through a much-depreciated greenback.

Fed must not waiver in commitment to raise rates

Even if these risks do not play out, it is clear that the disinflation/deflation story is dead, and as a result, the Fed must start tightening soon in order to mitigate the threat that it will have to act more aggressively down the road. A 1-per-cent Fed funds rate is simply providing an unnecessary degree of monetary stimulus, especially with the real (inflation-adjusted) Fed funds rate sitting 50 to 80 basis points into negative territory. What's more, even if none of the above risks materialize, and there is absolutely no change in goods prices through the remaining of the year, the annual growth rate in core CPI would likely still rise to 2.5 per cent by year-end and push upwards of 3 per cent by the end of 2005. Unlike the Bank of Canada, the Fed does not explicitly state a target range for core inflation, but we can probably safely assume that 3 per cent would be broaching the top end of its comfort zone. In fact, core inflation hasn't been above the 3-per-cent mark since May 1995.

Although we have stood in the camp that the Fed will start raising rates in August, the risks of a June kick-off date have increased dramatically. In any event, the Fed will make every attempt to raise rates in measured 25 basis points increments, thereby normalizing the Fed funds rate at 4.00 to 4.25 per cent by the end of 2005 – the level that is consistent with trend economic growth and stable inflationary pressures. Indeed, tighter monetary policy is already at work. In anticipation of Fed hikes, the yield curve along the 2- through 10-year maturities has already risen by about 100 basis points since the end of March. And, American consumers are already feeling this impact, with the 15-year mortgage rate climbing by an equivalent amount and with the 1-year mortgage rate rising by about 50 basis points. Nonetheless, the Fed must not waiver in its commitment to tighten monetary settings, as the margin for error is indeed slim.



Forecast by TD Economics
Source: Bureau of Labor Statistics

Beata Caranci, Economist
416-982-8067