# Market Insight



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## Does the U.S. Face an Inflation Threat?

Since the financial crisis reached its most acute phase in September 2008, the U.S. Federal Reserve has more than tripled the size of its balance sheet, from $900 billion to $2.9 trillion. It has kept its short-term interest rate target at just above zero since December 2008 and has taken further steps since then to keep monetary policy stimulative. For those who believe, along with conservative economist Milton Friedman, that "inflation is always and everywhere a monetary phenomenon", such aggressive Fed actions are troubling and portend a serious inflation threat. Investors who share these concerns have bid the price of gold to nearly $2,000 per ounce, while some advisers recommend that investors buy farmland or other "tangible" assets for inflation protection. How serious is today's inflation threat? Does the U.S. risk a period of high inflation such as it experienced in the 1970s? Or, worse still, a socially catastrophic hyperinflation such as Weimar Germany saw in the early 1920s?

Recent data suggest that inflation may indeed be rising, even if from low levels. Although U.S. economic activity remains weak, the consumer price index (CPI) rose 0.4% in August (which translates into an annual rate of just under 5%). Although increasing more slowly, "core" inflation, which excludes volatile food and energy prices, also looks to be moving higher; core CPI is up at a 2.9% rate over the last three months, compared to a 2.7% rate over the last six months and a 2.0% rate over the past year.

Nevertheless, we believe that inflation is unlikely to represent a serious problem in the U.S. for the next few years; however, as we discuss below, we recognize that some longer-term inflation risks do exist. Our current U.S. economic forecast calls for CPI inflation of below 2% through 2013. There are two main reasons for our relatively benign view: our understanding of the structure of the U.S. economy and our expectations for Federal Reserve policy.

### The Structure of the U.S. Economy: Services vs. Commodities

The first reason why we believe a serious inflation threat is improbable in the U.S. in the next few years is that broad-based inflation will require sustained increases in wages and unit labor costs. The U.S. is primarily a service economy; nearly 60% of the "basket" comprising the CPI consists of services. In service-oriented economies, labor is the main element of costs, and unit labor costs are thus the major inflation driver. There is a huge difference between inflation prospects in the U.S. and those in many emerging markets, where commodities — especially food and fuel — are a large part of inflation baskets. Rising commodity prices have led to a serious and continuing inflation problem in many emerging economies but have a much smaller influence on U.S. inflation. In today's U.S. economy, rising commodity prices tend to have a contractionary influence on GDP growth (by putting pressure on discretionary consumer spending, for example) rather than an inflationary influence on the general price level.

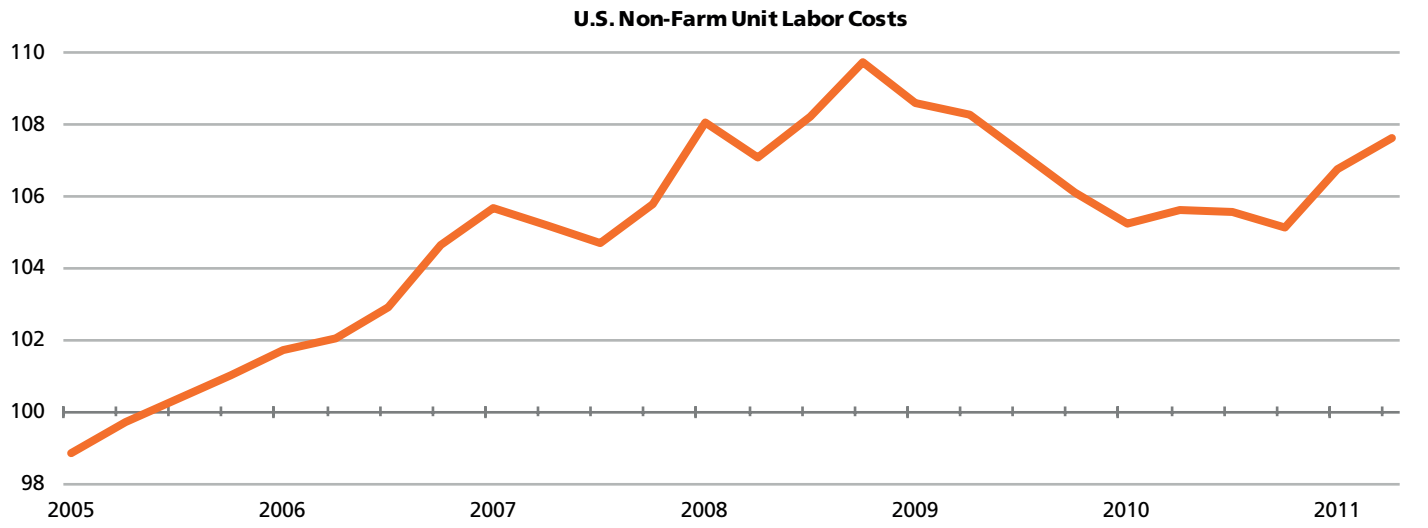
As Figure 1 on the next page shows, U.S. unit labor costs did rise in the first two quarters of this year (after falling a cumulative 4.2% in 2009 and 2010), though they have yet to recover to their 2008 level. Nevertheless, we believe that a sustained increase in unit labor costs is extremely unlikely because the U.S. labor market is far too weak to permit wage and benefit increases on anything but a very selective basis. Reported unemployment remains above 9% (total un- and underemployment is above 16%), and it is likely to remain materially above the "natural rate" consistent with structural conditions in the labor market for the next two years or longer. This is not an economic environment in which a "wage-price spiral" such as the U.S. experienced in the 1970s can occur.

### Is Today's Fed Policy Inflationary?

Yet if monetary policy is the ultimate driver of inflation, hasn't the Federal Reserve virtually guaranteed an eventual inflation problem by tripling the size of its asset base through successive quantitative easing programs? Not necessarily, in our view. The impact of the Fed's balance sheet expansion depends on several factors beyond the FOMC's decision to buy securities. Higher inflation is one possible impact, but it is far from guaranteed.

Thus far, most of the proceeds from the Fed's asset purchase programs have taken the form of reserves kept on deposit at the Federal Reserve by commercial banks. As Figure 2 shows, such reserves have grown from $11 billion in September 2008 to $1.6 trillion today. By contrast, the money supply — as measured by M2 — has grown at a 7% annual rate over the same period, modestly above the 5.5% rate seen over the past 20 years. Banks have preferred to keep these funds idle rather than lend them to households or firms for consumption or investment. Unless and until

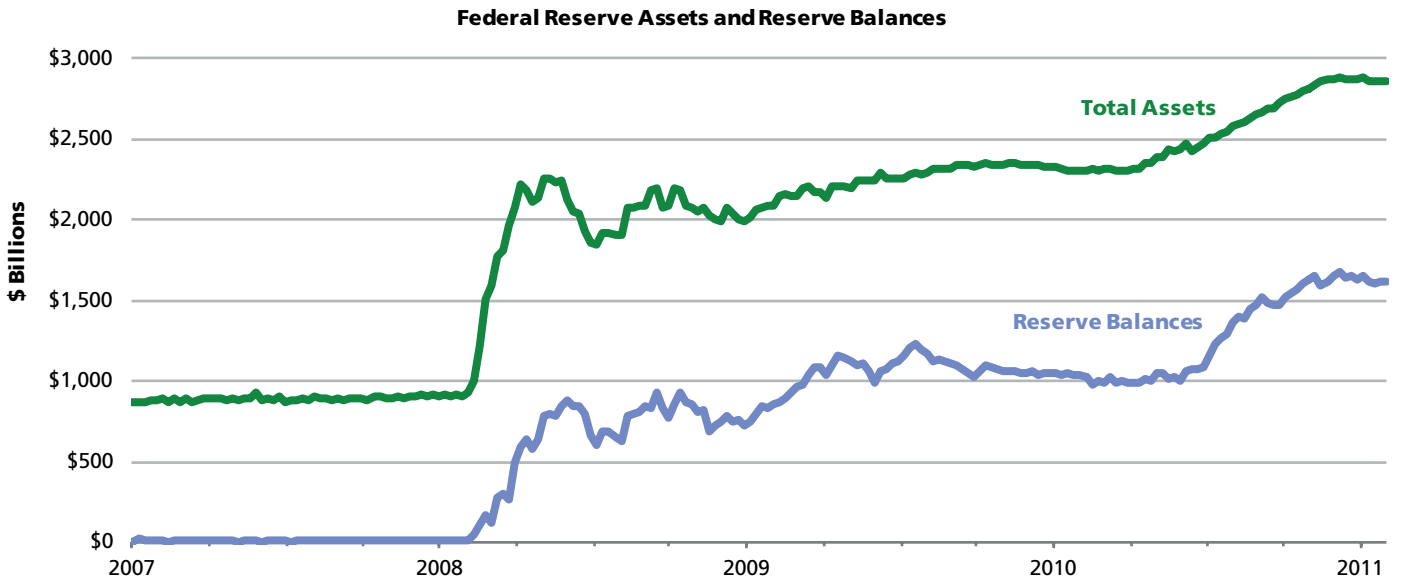
**Figure 1. Labor Costs in the U.S. Remain Contained**




Note: 2005 = 100

Source: U.S. Bureau of Labor Statistics

**Figure 2. Reserves Have Increased with the Expansion of the Fed's Balance Sheet**




Source: Board of Governors of the Federal Reserve System

these reserves translate into loans — and from there, into spending — they will have no direct impact on inflation.

Clearly, the Fed wants banks to begin lending some of these funds to businesses and consumers; some increase in lending is a necessary condition for real economic growth. As this happens, however, some risk of excessive money supply growth — and therefore inflation — may emerge. Yet the Fed can also use a new policy tool, the rate it pays banks on the reserves they deposit, to control money supply growth. The goal in this circumstance is to set an interest rate that gives banks the incentive to increase lending at a rate commensurate with moderate real growth, but not fast enough to reignite inflation. Setting this rate will certainly require judgment on the Fed's part, but the decision is not in and of itself more difficult than any of the other interest rate and policy decisions it has to make. There is a risk of somewhat higher inflation if, for example, the interest rate on reserves is kept too low once lending and economic activity revive, but this is not inherently different from the risk that the fed funds target is kept too low at the same stage of the business cycle. It is a normal cyclical inflation risk, if in a somewhat different guise.

One of the major lessons central banks worldwide have learned since the 1970s has been to recognize the importance of expectations. Businesses, households and investors all adjust their present economic behaviors based on what they expect to see in the future. The Federal Reserve thus pays close attention to a variety of measures of inflation expectations — from the yields on inflation-adjusted bonds to consumer surveys — so as to make sure that future inflation expectations are well contained (or "anchored" in its parlance). These measures of expectations provide the Fed with nearly real-time feedback on its policies and their effects, and will be a crucial element in its eventual decisions about raising the reserve interest rate and the fed funds target.

The Fed will ultimately wish to reverse its balance sheet expansion by selling back the securities it has purchased. Nevertheless, the ability to vary the rate it pays banks on their reserve deposits gives it an additional tool to manage money supply growth and thus forestall an increase in inflation even before it decides that reducing its balance sheet is appropriate. The balance sheet expansion by itself is not necessarily inflationary — it will only become inflationary if reserves currently held by banks are translated into loans and loan growth, and the resulting growth in the money supply and nominal demand for goods and services becomes excessive.

## Conclusion

All in all, we see little risk of a serious increase in U.S. inflation for the next two years at a minimum. Economic activity is likely to remain too weak and unemployment too high to provoke the kind of wage-price spiral that contributed to the inflation of the 1970s, while any commodity price spikes are more likely to depress real growth than to stoke inflation. Beyond 2013, inflation prospects will depend on how the Fed manages the huge increase in bank reserves that has resulted from its balance sheet expansion since 2008. There is a risk that policy mistakes could ignite somewhat higher inflation at this stage of the cycle. Yet we also believe that the Fed has the tools and the judgment required to prevent this outcome. ■