AIER

06|13 INFLATION REPORT

Modest Inflation Set to Emerge

by Steven Cunningham, PhD, Director of Research and Education

Cheaper energy kept a lid on inflation in the first quarter. With oil prices stabilizing, underlying pressures are coming to the fore.

A temporary decline in oil and gasoline prices became the dominant factor in the economic landscape in the first quarter.

For consumers, lower prices for gasoline and other energy products offset the payroll tax increase and higher non-energy prices, putting more cash in people's hands. This boosted demand for non-energy goods. For manufacturers, lower oil prices moderated price increases in other raw materials and helped contain price increases in manufactured goods.

All this spelled good news for the economy. But declining energy prices were a temporary result of high oil production and sluggish world demand. These kinds of declines are not likely to continue. In fact, prices are already firming up at the fuel pump as inflationary pressures, while limited, continue to build.

RETAIL PRICES

Retail prices, as measured by the government's Consumer Price Index for All Urban Consumers, decreased a seasonally adjusted 0.4 percent in April after falling 0.2 percent in March.

AIER's Everyday Price Index also fell, dropping 0.8 percent in April. (The EPI excludes fixed monthly expenditures.)

In both cases, the decrease was almost entirely the result of oil prices. The CPI Gasoline Index fell 8.1 percent in a single month, while the CPI Energy Index fell 4.3 percent in April after dropping 2.6 percent in March.

These short-term oil price declines are masking underlying inflationary pressures.

Food prices, for example, rose 0.2 percent on a seasonally adjusted basis. New vehicle prices rose a seasonally adjusted 0.3 percent, and used cars and trucks rose 0.6 percent. As a result, Core CPI, which measures consumer prices for goods other than food and energy, rose a seasonally adjusted 0.1 percent in April.

The way the Bureau of Labor Statistics measures price changes may also be masking inflationary pressure. The CPI and other government price indices don't measure the prices that people pay at the cash register. They measure the purchasing power of money rather than actual price increases.

In measuring purchasing power, economists are trying to compare how much people pay to how

OIL MASKS CORE INCREASES

	APRIL MONTHLY	ANNUALIZED
↓ CPI (SA)	-0.4%	-4.7%
↓ CPI Gasoline (SA)	-8.1%	-63.7%
↑ CPI Core (SA)	0.05%	0.63%
↑ CPI Core (NSA)	0.08%	0.95%
↓ EPI (NSA)	-0.8%	-9.2%

(SA) Seasonally adjusted (NSA) Not seasonally adjusted

Eventually, the increase in crude energy prices will raise the prices of retail goods.

much they get. The BLS attempts to account for quality improvements by adjusting downward. If a new computer is twice as fast as last year's model but costs the same amount, its quality-adjusted price will be half that of last year's model. But the consumer still pays the full price at the cash register.

While quality adjustment gives a more accurate picture of purchasing power, it distorts out-of-pocket expenses.

Recently, for example, the BLS estimated that 31.9 percent of the average annual retail increase for 2013 model vehicles was the result of quality improvements. As a result, they will not count that 31.9 percent as inflation and will adjust the CPI downward.

AIER's Everyday Price Index captures real-world, day-to-day prices that Americans experience by eliminating seasonal adjustments and most quality adjustments.

The EPI's April drop of 0.8 percent in the prices of frequently purchased goods and services came after a 0.3 percent increase in March. It follows a first quarter in which inflation as experienced by the average American was well over 12 percent annualized.

WHOLESALE PRICES

At first glance, prices at the earliest stages of production do not suggest inflationary pressure. For the single month of April, the Producer Price Index for Crude Materials for

CRUDE ENERGY PRICES SPIKE

	MONTHLY	ANNUALIZED
↓ PPI Crude (SA)	-0.4%	-4.7%
↑ PPI Crude Energy (SA)	3.7%	54.6%
↓ PPI Crude Food (SA)	-2.6%	-27.1%
↓ PPI Crude Nonfood less Energy (SA)	-2.8%	-28.9%
↓ PPI Intermediate (NSA)	-0.6%	-7.0%
↓ PPI Finished (SA)	-0.7%	-8.1%
↓ PPI Finished Energy (SA)	-2.5%	-26.2%
↓ PPI Food (SA)	-0.8%	-9.2%
↑ PPI Core (SA)	0.1%	1.2%

Further Processing fell a seasonally adjusted 0.4 percent. (If the PPI for Crude Materials continued falling at this rate for the next 12 months, it would result in an annualized decline of 4.7 percent.) This continues a longer-term downward trend in this index.

But unlike previous months, April's decline was not led by energy product prices.

Rather, the decline was led by a fall in crude foodstuffs and feedstuffs. Crude food prices fell 2.6 percent. Crude nonfood materials less energy fell 2.8 percent.

The upward bump in food prices in the first quarter, which was caused by crop problems last year, has substantially moved through grain and vegetable prices. But it is now showing up in livestock prices. Higher livestock feed prices have raised wholesale prices for meat, particularly beef. While this short-term aberration will result in some upward pressure, food prices will continue their return to trend over the course of the year.

In contrast, the PPI Index for Crude Energy Materials—mostly oil—actually rose 3.7 percent in April. Eventually, this increase in crude energy prices will result in higher consumer-level energy products and higher manufacturing and transportation costs. This will raise the prices of retail goods across the board.

Because price changes take a while to work through the stages of production, intermediate goods and final goods prices still reflect first-quarter energy declines. Overall, intermediate goods prices fell 0.6 percent in April.

The decline was led by energy products, which fell 2.1 percent. Finished goods prices fell by a seasonally adjusted 0.7 percent, driven by a 2.5 percent decline in the Finished Goods Index for Energy. Excluding food and energy prices, finished goods prices rose 0.1 percent (seasonally adjusted) in April.

Price changes in raw materials are typically moderated as producers apply labor, technology, and machines to create new output that ultimately reaches consumers. Consumers buy those goods in retail stores at consumer (CPI) prices. Right now, production

Right now, production costs aren't pushing prices. But that's only half the equation.

costs aren't pushing prices. But that's only half the equation. The other half is demand.

DEMAND

Demand backed by dollars is a typical source of inflation. There are signs of demand pressure now.

May estimates show that Real Gross Domestic Product (GDP), the broadest measure of total demand, increased by 2.4 percent in the first quarter.

GROWTH MAY PRESAGE INFLATION

		ANNUALIZED
↑ Real GDP (Q1)	+0.6%	+2.4%
↓ Real Disposable Personal Income (Q1)	-1.3%	-5.3%
↑ Real Disposable Personal Income (March)	+0.3%	+3.7%
↑ Consumer Spending (Q1)	+0.8%	+3.2%
↑ Consumer Spending—Durables (Q1)	+2.0%	+8.1%
↓ Consumer Spending (March)	-0.3%	-3.7%
↑ Gross Domestic Purchases (Q4)	+0.7%	+2.9%

Despite the drag created by public policy, including the weight of sequestration-related budget cuts and increases in income and payroll taxes, the economy's private sector is healthy enough to carry the recovery. As demand continues to rebound, prices are more likely to rebound too, especially when supported by the massive reserves sitting in banks.

Households increased their spending on consumer goods by an annualized rate of 3.2 percent.

A decline in another key indicator of demand, Real Disposable Personal Income (inflation-adjusted after-tax income), does not really change the picture. Disposable income fell at an annualized rate of 5.3 percent in the first quarter in the face of higher tax payments. By March, it was showing signs of life, rising 0.3 percent after an increase of 0.7 percent in February.

Even if the income numbers do not show it, a lot of households came into the quarter with additional cash in their accounts. They managed to get dividend payments, bonuses, and commissions paid early in anticipation of the higher tax rates in 2013. This moved a substantial proportion of early first-quarter income into the fourth quarter of 2012.

Consumers are also facing lower debt service burdens and adopting a lower personal saving rate. This has allowed households to increase their spending on consumer goods spending by an annualized rate of 3.2 percent, with durable goods spending posting the strongest gains at 8.1 percent annualized. (Often volatile, monthly consumer spending fell 0.3 percent in March, despite real after-tax income growing 0.3 percent.)

Americans do love their cars. Motor vehicle production alone added almost a quarter point to first-quarter GDP. Firms are rebuilding inventories they let fall in the fourth quarter, adding a full percentage point to GDP. The housing market continues to recover as both sales and prices rebound.

As demand increases, borrowing will likely expand, which will move money out of bank reserves and into circulation. This will foster more growth, but will also lead to accelerating inflation.

Second-quarter numbers could show some slowing growth in consumer demand as the private sector confronts the burdens of the public sector changes.

However, real average hourly earnings for all employees rose 0.5 percent in April, which suggests that stronger demand should return through the second half of the year. With swings in oil prices moderating and incomes slowly expanding, demand should continue to grow at a steady pace.

MANUFACTURING

Demand pressures are pushing production in a direction that eventually will be inflationary. But that direction is masked by month-to-month volatility in production measures. Industrial production fell 0.5 percent in April after rising 0.4 percent in March and 1.1 percent in February.

For the first quarter as a whole, production increased at an annualized rate of 5 percent, the largest gain since the first quarter of 2012. With the Index of

As demand continues to rebound, prices are more likely to rebound too.

Industrial Production at 99 percent of its 2007 average, we have almost recovered to levels before the recession.

CAPACITY NOT DRIVING PRICES

		ANNUALIZED
Industrial Production (April, SA)	-0.5%	-5.8%
Industrial Production (Q1, SA)	+1.2%	+5.0%
Capacity Utilization Rate (April, SA)	77.8%	

Another measure of manufacturing strength, the Capacity Utilization Rate, estimates the percentage of productive capability currently in use. If firms have substantial unused productive capacity, they are usually reluctant to increase prices and risk losing even more sales. As they reach full capacity, confidence grows, and price increases follow.

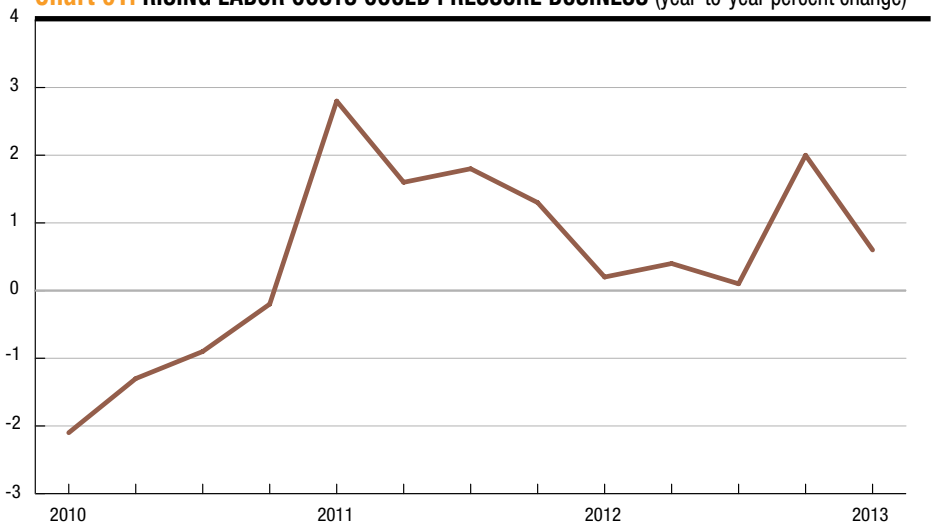
The rate of capacity utilization fell in April to 77.8 percent after rising to 78.5 percent in March. Still, April's rate is just 2.4 percent below the long-run (1972-2012) average of 80.2 percent.

April's rate of capacity utilization is a little on the weak side. But it also means that we are not in danger of inflation quite yet.

When the capacity utilization rate moves into the low-to-mid 80s, we near inflationary territory.

Another potential source of inflationary pressure is unit labor costs. As Chart 1 (above right) shows, nonfarm unit labor costs have been rising slowly year-to-year since mid-2010. They continued to rise 0.5 percent in the most recent quarter.

Chart 01. RISING LABOR COSTS COULD PRESSURE BUSINESS (year-to-year percent change)



Source: Federal Reserve Bank of St. Louis, Bureau of Labor Statistics, calculated by author.

WORLD ECONOMY

The world continues to suffer an economic slowdown. As the table on page 5 shows, the Euro Area has been in recession for over a year. Major exporters like Japan and Germany are struggling with near-zero growth. Although China's annual growth at 7.83 percent seems extraordinarily good to Americans, it is slow enough to be problematic to the Chinese. Sustaining China's massive industrialization and de-ruralization requires a very high growth rate. The silver lining to this unfortunate picture is that the weak world economy is helping to keep inflationary pressures in the U.S. in check.

Faced with weak demand at home, exporters in the Euro Area and China are not inclined to raise prices and risk losing foreign sales.

> The relative strength of the U.S. economy has worked in favor of a stronger rate of exchange for the dollar.

INTERNATIONAL WEAKNESS HELPS THE U.S.

	MONTHLY	ANNUALIZED
Trade-Weighted Dollar	0.04%	0.51%
Import Price Index	-0.5%	-5.8%

In addition, the relative strength of the U.S. economy has worked in favor of a stronger rate of exchange for the dollar. A stronger dollar means that it takes fewer dollars to buy each unit of foreign currency.

The Trade-Weighted Dollar captures the exchange rate of the dollar against a basket of leading currencies, weighted by the volume of trade we do with each country. The dollar has fluctuated considerably, but has been trending upward against major currencies since mid-2011.

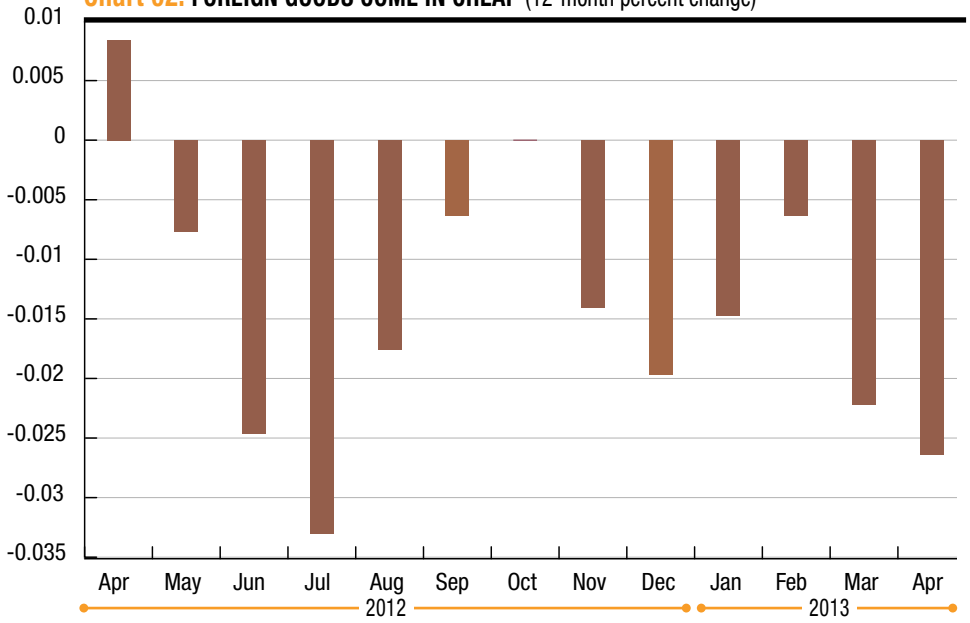
Both weak foreign demand and a strong dollar have led to falling import prices, as Chart 2 on page 5 shows. While prices have

Table. WORLD IN A SLUMP

Percent change from year ago	2012Q1	2012Q2	2012Q3	2012Q4
China*	.	.	.	7.83
Mexico	4.94	4.39	3.25	3.25
Russia	4.49	4.17	3.42	2.10**
United States	2.45	2.14	2.60	1.67
Korea	2.90	2.32	1.53	1.57
Brazil	0.74	0.42	0.91	1.40
Canada	2.03	2.75	1.49	1.09
Germany	1.18	1.00	0.86	0.42
United Kingdom	0.33	-0.17	0.25	0.25
Japan	3.28	3.92	0.40	0.15
India	5.16	3.88	3.22	.
France	0.20	0.07	0.00	-0.33
Euro Area	-0.08	-0.45	-0.61	-0.89
Italy	-1.32	-2.32	-2.41	-2.70

* Annual Data
Source: ** European Bank for Reconstruction and Development
Organization for Economic Cooperation and Development

Chart 02. FOREIGN GOODS COME IN CHEAP (12-month percent change)



Source: Federal Reserve Bank of St. Louis, Bureau of Labor Statistics, calculated by author.

From a sales and employment point of view, the trade balance is swinging our way.

been falling across the board for a variety of products, until recently the decline has been led by falling prices for oil and oil products.

Despite the changes in the oil market, import prices fell by 0.5 percent in April, helping to keep a lid on increases for domestic goods. U.S. domestic producers have been hard-pressed to raise prices and risk losing business to foreign producers.

This is slowly changing. From a sales and employment point of view, the trade balance is swinging our way. While China's economy is weakening somewhat, Europe is rallying. In April, the U.S. trade gap with China, our second-largest trading partner, fell to its lowest level in three years. Meanwhile demand from Germany, France, and Italy all rose by double digits. We are buying less and selling more to the Chinese and selling more to the Europeans.

Americans, on the other hand, have reduced their purchases of imports by nearly 3 percent, with the largest declines in consumer goods like computers and clothing.

Foreign producers are likely to fight back with lower prices, providing further downward pressure on U.S. prices.

MONEY

The rapid growth of bank reserves and currency in circulation is applying broad inflationary pressure that is starting to be felt.

THE FED GETS AGGRESSIVE

	MONTHLY	ANNUALIZED
↑ Monetary Base	2.4%	32.9%
↑ Money Supply	0.6%	7.4%

The massive injection of money is having a proportionately small effect on the money supply. Nonetheless, the M2 Money Supply has returned to near-trend growth. It expanded at an annualized rate of 7.4 percent in the most recent month.

When the Fed poured money into bank reserves in the first quarter, it was responding to the fourth-quarter slowdown and the sudden decline in loans and money supply. This continued in April, with the base expanding at an annualized rate of 32.9 percent. Without continued expansion of the money supply, the recovery would be in jeopardy.

Unfortunately, as the pace of the recovery improves, this latest expansion of an already enormous monetary base brings dangers. As bank lending grows, the money the Fed has injected into the system will begin to circulate more freely. That increases the likelihood that inflation rates will rise.

WHAT DOES IT ALL MEAN?

On the bright side, there are no signs of runaway inflation at present. While commodity prices will continue to be volatile, trends are likely to be broad-based and controlled. Because of downward price pressure from foreign imports and world demand that is only improving slowly, domestic consumer price increases will be neither steep nor fast. But continued upward pressure as the recovery proceeds is likely.

Rising inflation means the prices of most things will go up. This has a major influence on the attractiveness of economic choices.

You can bet that businesses are already nailing down prices at current levels by negotiating favorable supplier and labor contracts. We have seen evidence of some inventory accumulation as well.

Investors will also see common stocks rise with inflation, often moving in anticipation of future price increases. ■

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