AIER

06|14 INFLATION REPORT

Strong Dollar Dampens Inflation

By Robert Hughes, Senior Research Fellow

A strong dollar helps hold down the prices of imported consumer goods, partially offsetting core consumer services inflation.

In the debate over the risks associated with quantitative easing, inflation hawks point to the massive build-up of reserves in the banking system as a potential source of inflationary pressure. Inflation doves counter that despite the massive build-up of reserves over the past few years, inflation has remained below the Fed's target of two percent a year, a somewhat unexpected result.

Similarly, economic theory suggests that substantial reserve creation should push the dollar's value downward versus other currencies. Yet the dollar has strengthened generally over the past few years, another unexpected result. Surprising or not, the stronger dollar is an important factor in keeping a lid on inflation.

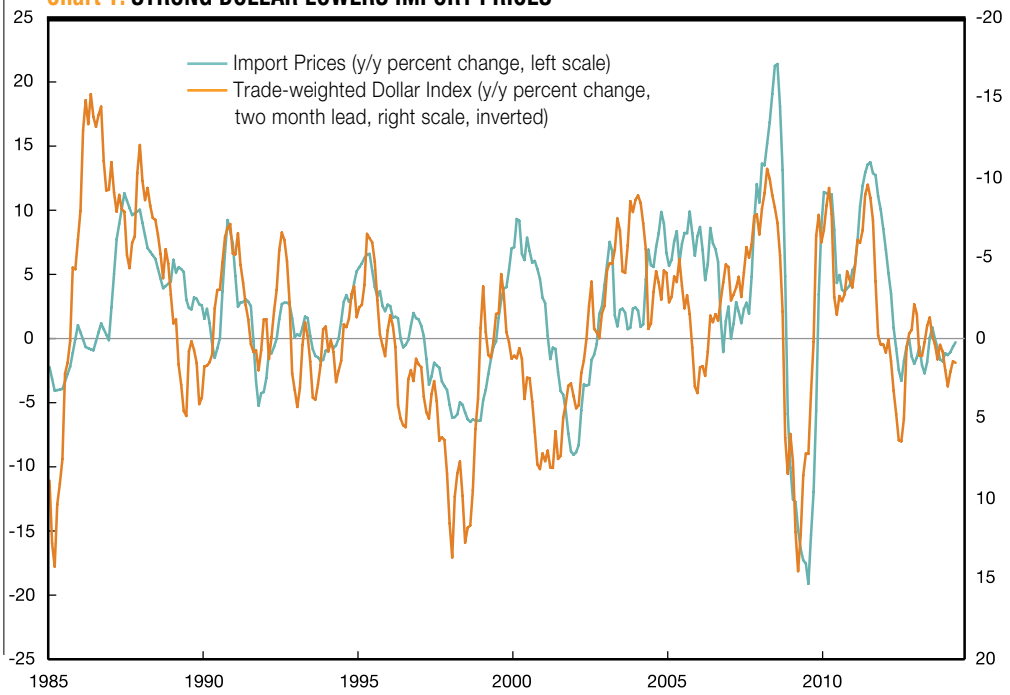
STRONG DOLLAR BENEFITS

As the U.S. dollar strengthens against the currencies of its trading partners, it takes fewer dollars to purchase imported goods, and the prices of imported goods into the U.S. tend to fall.[1] The lower-priced imported goods then tend to put downward pressure on the prices of competing domestically-produced goods.

Over the past twelve months, the U.S. dollar has risen by about one and a half percent against a broad, inflation-adjusted,

1 The inverse relationship between the U.S. dollar and import prices has been well established. The coefficient of determination, or R-squared, between the real, broad trade-weighted U.S. dollar index from the Federal Reserve and the U.S. import price index from the Bureau of Labor Statistics (BLS) is approximately -0.65 over the last 30 years.

Chart 1. STRONG DOLLAR LOWERS IMPORT PRICES



Source: Federal Reserve Board, Bureau of Labor Statistics

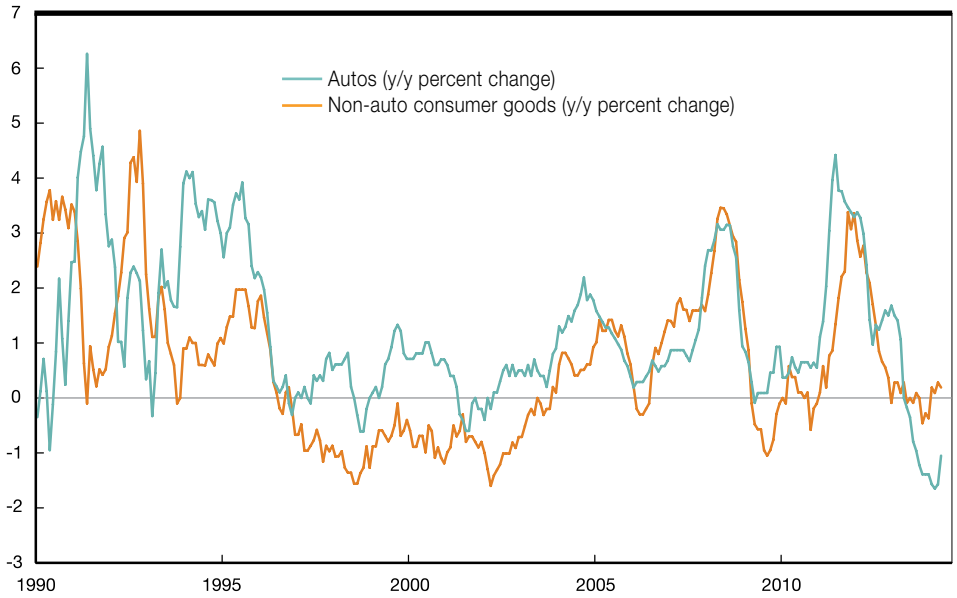
trade-weighted basket of foreign currencies. Over that same period, the U.S. import price index has declined about 0.3 percent. Since movements in the dollar tend to lead movements in import prices by about two months, the dollar's recent rise suggests flat-to-lower import prices in the coming months (Chart 1).

While the broad economy benefits from lower-priced imports in general, the Consumer Price Index (CPI) is most affected by imported consumer goods, both autos and non-auto goods. Like the broader import price index, the import price indexes for autos and non-auto consumer goods are strongly and inversely correlated with the value of the dollar—that is, they are sensitive to dollar movements.[2] As a result, we know that import prices for autos and non-auto consumer goods, in particular, are likely to be very tame over coming months (Chart 2).

IMPORTS AND CONSUMERS

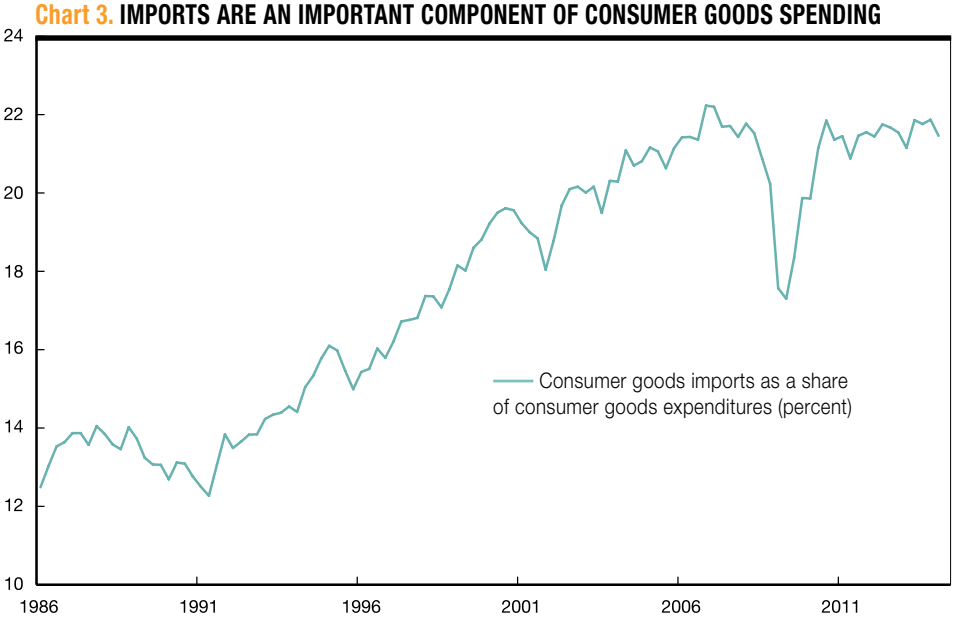
Consumer spending totaled about $11.8 trillion at an annual rate in the first quarter of 2014, accounting for roughly 68 percent of total gross domestic product (GDP) of $17.1 trillion, in nominal terms. Within consumer spending, outlays on goods totaled $3.9 trillion at an annual rate, or approximately one-third of total consumer expenditures. During the same period, imports of autos and non-auto consumer goods totaled $843 billion at an annual rate, the equivalent of around 22 percent of total consumer spending on goods (Chart 3).

Chart 2. CONSUMER GOODS IMPORT PRICES ARE FLAT OR FALLING



Source: Bureau of Labor Statistics

Chart 3. IMPORTS ARE AN IMPORTANT COMPONENT OF CONSUMER GOODS SPENDING



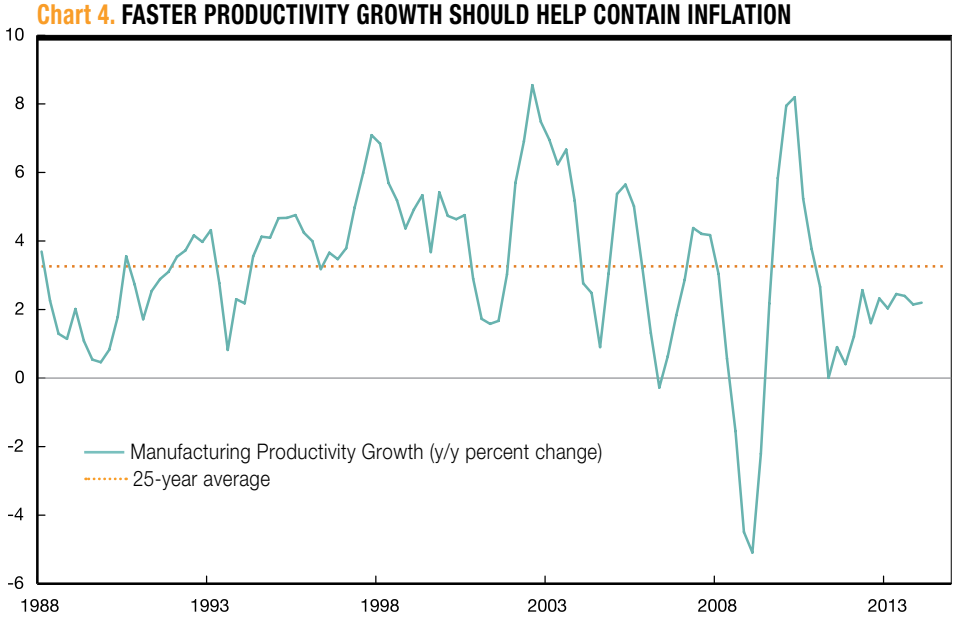
Source: Census Bureau, Bureau of Economic Analysis

COMPETITION AND PRODUCTIVITY

The net effect of a strengthening dollar and lower-cost imports of consumer goods is downward

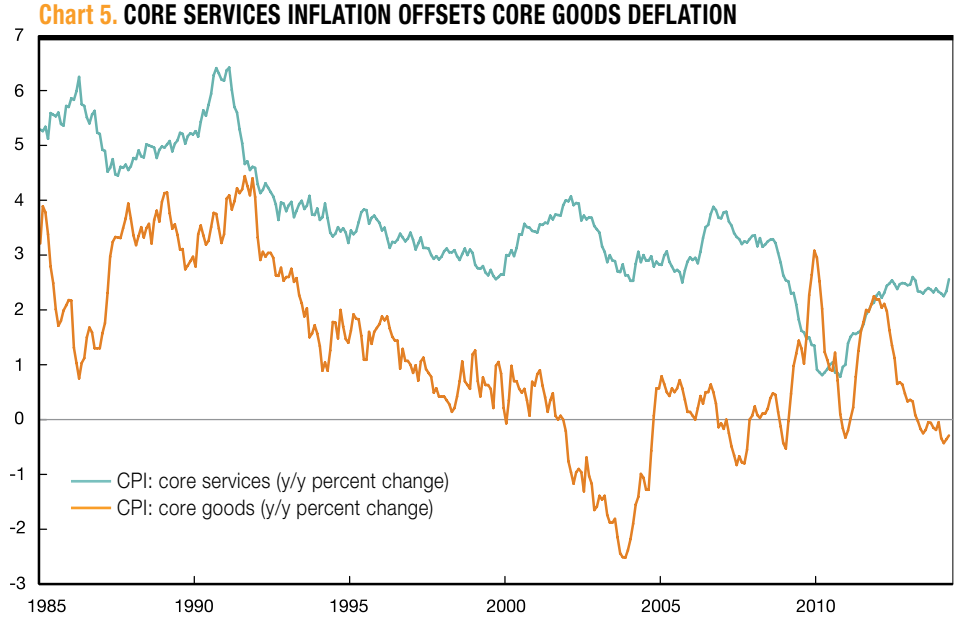
2 The R-squared values for the import price index for autos and for non-auto consumer goods are -0.62 and -0.66, respectively.

Chart 4. FASTER PRODUCTIVITY GROWTH SHOULD HELP CONTAIN INFLATION



Source: Bureau of Labor Statistics

Chart 5. CORE SERVICES INFLATION OFFSETS CORE GOODS DEFLATION



Source: Bureau of Labor Statistics

pressure on core consumer goods prices. Domestic manufacturers are pushed to respond to the lower-cost imports by restraining their own costs of production in order to remain competitive. Slow wage gains over the past several years have helped domestic manufacturers remain competitive, but as labor markets tighten, that influence may wane.

On a positive note, while labor costs may begin to see upward pressure, productivity gains could also accelerate, keeping unit labor costs in check. Over the past two years, productivity gains have slowed to around 2.2 percent, a percentage point below the longer-term trend growth of about 3.3 percent (Chart 4). As output growth slowly accelerates—and as competition intensifies, technological innovation continues, and capital spending rises—it's likely that productivity growth will move higher. Higher productivity growth will help to restrain costs and keep price increases moderate.

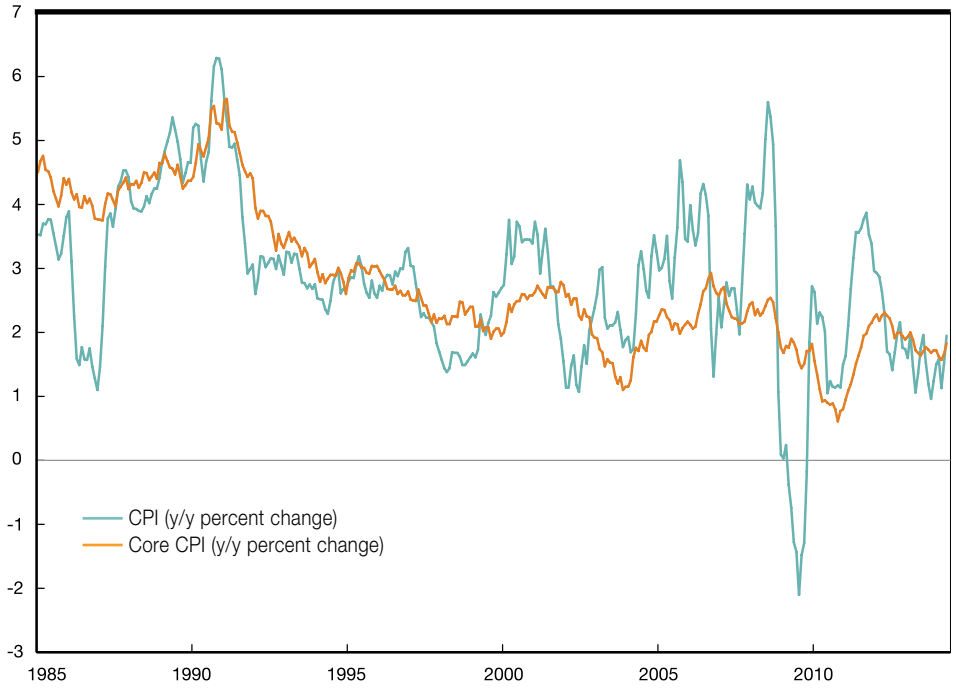
SHARP DIVERGENCE

Lower-cost imports and relative productivity gains are two key reasons for a sharp divergence in the price behavior of core consumer goods and core consumer services. Over the last twenty years, the two major components of core consumer prices show very different patterns. While both categories have seen decelerating price increases, called "disinflation," the pattern has been much more pronounced in core goods prices. In fact, core goods prices have experienced periods of outright price decreases, or "deflation." Core goods price inflation currently is trending about flat, while core services price inflation remains above the Fed's two percent target for overall inflation (Chart 5).

MONTHLY INFLATION MEASURES

The CPI rose 0.3 percent in April,

Chart 6. INFLATION IS FIRMING BUT RISKS OF A SURGE ARE LOW



Source: Bureau of Labor Statistics

the largest monthly increase since June 2013. Over the past twelve months, the total CPI has risen 2.0 percent, in line with the Fed's long-run target. Food and energy were among the main contributors to the April gain, rising 0.4 percent and 0.3 percent, respectively. Over the 12-month period through April, food prices have gone up 1.9 percent while energy prices have jumped 3.3 percent. The year-over-year rise in energy prices over the past year is largely due to a 77 percent annualized increase in gas utility prices over the January-to-March 2014 period.

The CPI excluding food and energy rose 0.2 percent in April and has increased 1.8 percent over the past year (Chart 6). As already discussed, the primary sources of inflationary pressure have come from core consumer services. The largest contributors to core services price increases in April were: housing, up 0.2 percent in April and 2.8 percent over the past year; hospital services, up 0.5 percent in April and 6.1 percent over the past twelve months; motor vehicle insurance, up 0.9 percent in April and 4.4 percent year over year; and college tuition, up 0.4% in April and 4.0 percent for the year.

Among core goods, weak pricing power was evident in: household furnishings, down 0.3 percent for the month and down 2.3 percent for the year; apparel, flat for April and up just 0.6 percent for the year; transportation-related goods, up 0.3 percent for the month but up just 0.1 percent for the last twelve months; recreational goods, unchanged in April and down 2.3 percent over the past year; and information technology goods,

INFLATION MEASURES APRIL 2014

	M/M CHANGE %	YEAR-OVER-YEAR CHANGE %
CPI		
▲ CPI	0.3	2.0
▼ CPI Food	0.4	1.9
▲ CPI Energy	0.3	3.3
▲ CPI ex. Food & Energy (Core CPI)	0.2	1.8
▲ CPI Core Goods	0.1	-0.3
▲ CPI Core Services	0.3	2.6
▼ CPI Shelter	0.2	2.8
▼ CPI Medical Care Services	0.3	2.7
▼ CPI Hospital Services	0.5	6.1
▲ CPI Transportation Services	0.7	2.3
▲ CPI Auto Insurance	0.9	4.4
▲ CPI Education & Communication	0.2	1.9
▲ CPI College Tuition	0.4	4.0
PPI		
▲ Final Demand	0.6	2.1
▲ Final Demand Foods	2.7	4.9
▲ Final Demand Energy	0.1	3.8
▲ Final Demand Goods Less Food & Energy	0.3	1.4
▼ Final Demand Services	0.6	2.0
Import Prices		
▼ Import Price Index	-1.0	0.3
▲ Import Price Index Autos	0.3	-1.0
▼ Import Price Index Consumer Goods ex. Autos	0.3	0.2

Source: Bureau of Labor Statistics, Haver Analytics.
Monthly changes are seasonally adjusted.

down 0.1 percent in April and down 5.9 percent for the year.

DEMAND AND SUPPLY

Demand for consumer goods continues to be supported by ongoing modest gains in jobs, wages, and total personal income. Average hourly earnings have risen 1.9 percent over the past year; when combined with an increase in payrolls and lengthening average workweek, the wages and salaries portion of personal income has been rising at a 3.7 percent annual rate.

Consumer credit growth has rebounded from the period of sharp contraction that began in early 2009. Overall consumer credit has been growing at greater than a five percent rate, on a year over year basis, since August 2012, a run of 20 consecutive months. However, nearly all the gains have come from non-revolving credit, particularly auto and education loans. Revolving consumer credit, primarily credit cards, has been growing at a very meager 0.8 percent annualized rate over the past two and a quarter years (Chart 7).

The income and credit gains have translated into rising retail sales in general and rising auto sales in particular. Retail sales have gained 4.0 percent over the past twelve months, while unit auto sales have held above the 15 million-annual-rate mark for 18 consecutive months.

On the supply side, industrial production is up 3.4 percent for the twelve months through April, though the gain for manufacturing is a milder 2.9 percent. Consumer goods manufacturing has gained a modest 2.4 percent over the past year.

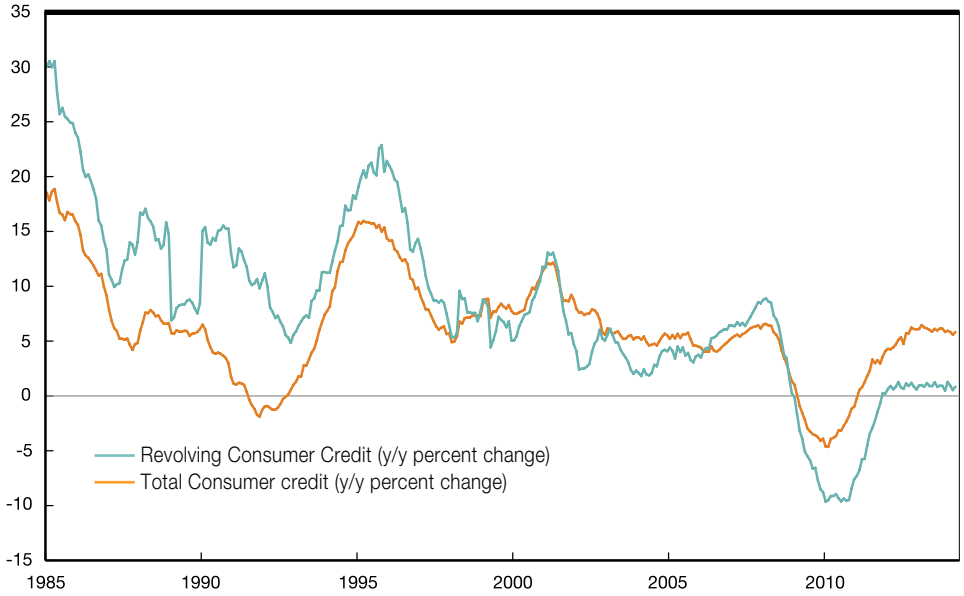
Total business inventories have increased 4.7 percent over the past year, while retailers have grown stocks by 6.1 percent. When compared to current selling rates, the total business inventory-to-sales ratio came in at 1.30 months—equal to the average of the prior three months, though up from a low of 1.25 months hit in April 2011. Retailers' inventory-to-sales ratio has moved up to 1.42 months in March from a low of 1.34 months in February 2012, though the March reading was down from 1.45 months in January. In general, a falling inventory-to-sales ratio suggests tighter supplies of goods.

DEMAND & SUPPLY

	M/M CHANGE %	YEAR-OVER-YEAR CHANGE %
Demand Measures		
↓ Average Hourly Earnings (Apr 2014)	0.0	1.9
↓ Average Weekly Hours (Apr 2014)	0.0	0.3
↑ Nonfarm Payrolls (Apr 2014)	288	197
↑ Personal Income (Mar 2014)	0.5	3.4
↑ Wages & Salaries (Mar 2014)	0.6	3.7
↓ Retail Sales (Apr 2014)	0.1	4.0
↑ Unit Auto Sales (Apr 2014)	16.0	15.7
↑ Consumer Credit (Mar 2014)	0.6	5.8
↑ Consumer Credit-Revolving (Mar 2014)	0.1	0.9
Supply Measures		
↓ Industrial Production (Apr 2014)	-0.6	3.4
↓ IP: Manufacturing (Apr 2014)	-0.4	2.9
↓ IP: Consumer Goods (Apr 2014)	-1.3	2.4
↓ Total Business Inventories (Mar 2014)	0.4	4.7
↑ Retail Inventories (Mar 2014)	0.0	6.1
↓ Total Business Inventory/Sales Ratio (Mar 2014)	1.30	1.29
↓ Retail Inventory/Sales Ratio (Mar 2014)	1.42	1.41

Source: Bureau of Labor Statistics, Bureau of Economic Analysis, Haver Analytics.

Chart 7. CREDIT CARD DEBT GROWTH IS WEAK



Source: Federal Reserve Board

FINAL WORD

Consumer prices overall are firming in response to improving economic fundamentals. However, the strong dollar promotes lower-priced imported consumer goods, which in turn foster competition that helps to restrain goods price increases. But offsetting inflationary pressures continue, emanating from food, energy, and certain areas of core services.

Looking ahead, the build-up of reserves in the banking system presents the risk of upward inflation pressure. But other factors—including soft credit demand, restrictive lending practices, and the slow-growth economic environment—seem unlikely to support a sustained inflation surge over either the short- or intermediate-term time horizons.

Taken together, these countervailing forces suggest continued modest inflation ahead. ■

Offsetting inflationary pressures continue, emanating from food, energy, and certain areas of core services.

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