INFOCUS

MACRO COMMENT

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How worried should we be about US inflation?

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HIGHLIGHTED IN THIS PUBLICATION:

In this issue of *Infocus*, EFG Chief Economist Stefan Gerlach looks at the behaviour of US inflation as measured by the deflator for personal consumption expenditures (PCE). Recent rates are compared with a forecast to assess the behaviour of inflation.

There has been much concern about US inflation recently. The latest data showed the CPI rose in May, by 0.6% month-on-month and 5.0% year-on-year, the highest annual inflation rate since 2008. The index of the deflator for personal consumption expenditures that was released on 25 June was also strong, with a monthly inflation rate of 0.4% and annual inflation of 3.9%.

One view that attracts considerable support among some financial market commentators is that inflation will stay persistently and uncomfortably high, reflecting a fundamental change in the economic environment that the Fed has yet to understand. These commentators worry about the Fed "falling behind the curve", being too late to withdraw stimulus. Under this view, the Fed may suddenly change tack and sharply tighten monetary policy, potentially leading to a negative financial market shock. The other view, which appears to be held by many Fed policy makers, is that recent increases in inflation are very much what one would have expected given the decline in prices during the start of the covid pandemic last year. While inflation is likely to remain high for a few months, proponents of this view believe that inflation will decline towards the Fed's 2% target in the second half of 2021.

1. Base effect

	Monthly inflation		Annual inflation	
	New data	Data dropping out	Change	Level
Jan-20	0.15%	-0.08%	0.23%	1.86%
Feb-20	0.09%	0.12%	-0.03%	1.83%
Mar-20	-0.27%	0.23%	-0.50%	1.33%
Apr-20	-0.53%	0.33%	-0.86%	0.48%
May-20	0.17%	0.10%	0.06%	0.54%
Jun-20	0.49%	0.12%	0.38%	0.92%
Jul-20	0.26%	0.18%	0.09%	1.00%
Aug-20	0.30%	0.07%	0.23%	1.23%
Sep-20	0.16%	0.05%	0.11%	1.34%
Oct-20	0.03%	0.19%	-0.16%	1.19%
Nov-20	0.00%	0.08%	-0.07%	1.12%
Dec-20	0.37%	0.26%	0.10%	1.22%
Jan-21	0.29%	0.15%	0.14%	1.36%
Feb-21	0.29%	0.09%	0.20%	1.56%
Mar-21	0.56%	-0.27%	0.83%	2.39%
Apr-21	0.64%	-0.53%	1.17%	3.56%
May-21	0.45%	0.17%	0.28%	3.84%

Source: FRED. Data as at 26 June 2021.

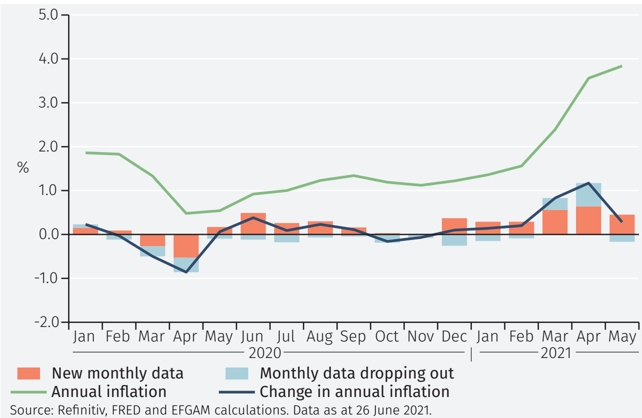
Recent inflation data

To understand the recent behaviour of PCE inflation, it is useful to consider the base effect. To do so, it is easiest to use inflation computed using compounded growth rates.[1] In this case, annual inflation in May 2021 is the sum of the 12 monthly inflation rates between June 2020 and May 2021.[2] Similarly, inflation in April 2021 is the sum of the monthly inflation rates between May 2020 and April 2021. The change in annual inflation between April and May 2021 of 1.17% equals the difference between the new monthly inflation data in April 2021 (+0.64%) and the monthly inflation rate for April 2020 (-0.53%) that dropped out of the calculation (see Figure 1). This latter effect is referred to as the base effect.

These calculations make the important point that changes in 12-month inflation depend both on the new data and the old data point that drops out of the calculation. The recent pattern has seen the new data pushing up 12-month inflation and the old data that drops out pushing it down. One reason inflation has risen so sharply recently is that the price level fell as Covid struck in March (-0.27%) and April (-0.53%) 2020, reducing 12-month inflation at that time. But this decline in the PCE index pushed up inflation in March and April 2021 by the same amount as these data points dropped out of the calculations. To illustrate this, Figure 2 shows annual inflation and the change in annual inflation, which equals the difference between the new monthly inflation rate (orange pillars) entering the calculation of annual inflation, and monthly inflation rate (blue pillars) from a year ago that drops out from the calculation. The chart illustrates how the price falls in the spring of 2020 lead to sharp increases in inflation a year later. Since monthly inflation in May 2020 was 0.17%, the base effect lowered inflation by this amount in May 2021.

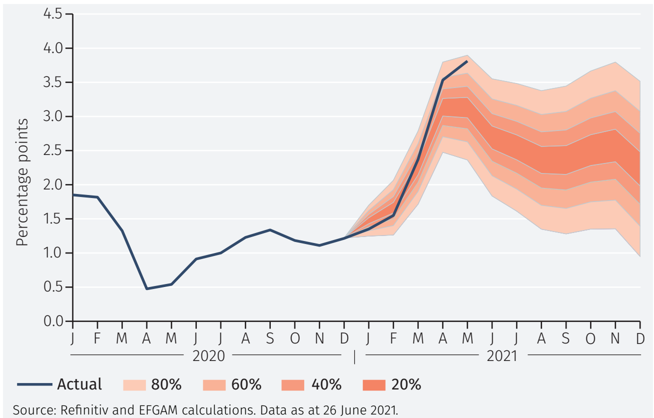
[1] The difference between these and ordinary growth rates is generally negligible, except for higher inflation rates. For instance, the annual inflation rate in April is 3.52% if compounded growth rates are used and 3.58% if it is calculated in the standard way.
[2] This holds only approximately if standard growth rates are used.

2. US PCE inflation



Source: Refinitiv, FRED and EFGAM calculations. Data as at 26 June 2021.

3. US PCE inflation and model forecasts



Source: Refinitiv and EFGAM calculations. Data as at 26 June 2021.

The outlook for inflation

While recent inflation data has been strong, the Fed is insisting that its outlook for inflation has not changed. Apparently, the recent data do not appear to be at odds with the Fed's view of the likely evolution of inflation in 2021.

To explore this issue, we estimate a simple forecasting model for PCE inflation on data for 2000-2020. The idea is that the model may produce forecasts similar to the Fed's own forecasts of inflation. Next, we compare inflation from January to May 2021 with the forecasts. If the observed and forecasted inflation rates are substantively different, we must conclude that the model fails to explain the data, and that the behaviour of inflation has changed.

Figure 3 shows annual US PCE inflation and compares it with model forecasts from January 2021 onward. While the actual inflation rate in May was 3.84%, the forecasted inflation rate was 3.13%. The likelihood that actual inflation and the forecasts will be identical is of course nil. To judge whether this difference is so large as to suggest that the behaviour of inflation has changed, we use a 'fan chart' that shows the range of possible inflation rates that are compatible with the model.

The fan chart is constructed in such a way that the likelihood that actual inflation will fall in the lightest orange-coloured area is 80%, the likelihood that it will fall in the slightly darker area 60% and so on. The likelihood that actual inflation will fall in the darkest area is 20%. If actual inflation falls outside the forecasted range, we conclude that the inflation process, as captured by the forecasting model, has changed.

As can be seen, it never does. While inflation is a little high, it is not so high as to call the forecasting model into question.[3] Looking ahead, the forecasting model suggests that inflation will decline over the summer months.

Conclusions

Investors worry that the recent rise in US inflation will continue, that the Fed has fundamentally underestimated the strength of price pressures, and that its delay in tightening policy will require a larger and more dramatic policy response when the Fed comes to realise the severity of the situation. Of course, there is always potential for the inflation process to shift, but the analysis here indicates that recent inflation data provide little evidence that a shift has occurred. Indeed, it is not surprising that Fed officials have reiterated their view that inflation is only high temporarily and will soon revert to more normal levels. Nevertheless, the risk of such a shift taking place has risen recently and we remain vigilant to its possibility, although that is only likely to become apparent - if it occurs at all - as the second half of the year progresses. In the meantime, the framework presented in this report provides useful guidelines to help us assess whether reported inflation data lies within expected norms or is cause for greater concern.

[3] Statistically, the likelihood of observing a forecast error of the size of the May error is about 24%.

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