QNB Economics
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Low inflation worries continue to challenge Fed tightening

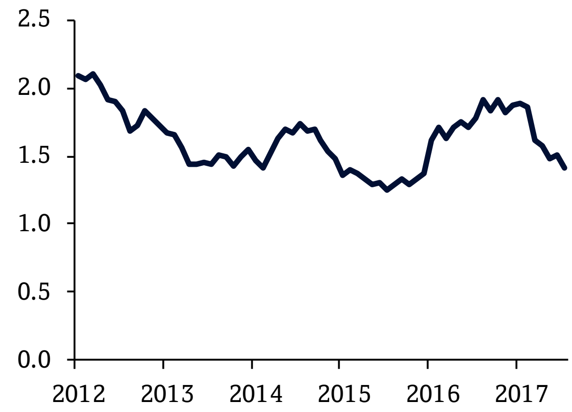
The US Federal Open Market Committee (FOMC) surprised markets two weeks ago when it maintained its projection for another rate hike in 2017 and three additional hikes in 2018. In contrast, the market was predicting just one more hike over both the remainder of 2017 and all of 2018. The discrepancy between the Fed and the market rests on diverging views of inflation which has been on a downward trend for most of 2017. The Fed believes weak inflation is temporary and will to rebound to its 2% target in 2018. On the other hand, market sceptics view subdued inflation more as a product of long-term structural trends which are unlikely to be so quickly overcome. We expect the Fed to hike three times between now and the end of 2018 as structural factors continue to keep inflation below target while the temporary factors currently supressing inflation unwind.

There are three main structural explanations for low inflation. First, increased globalisation has resulted in greater competition and integrated production of goods and services which has pushed down costs and retail prices for global consumers. Research from the Bank of International Settlements has shown that the impact of globalisation on domestic inflation is gradual and can last for several years. This implies that although the pace of globalisation has abated in recent years, the pass through of cheap foreign labour costs, greater competition and more efficient production could still be weighing on inflation in the US today.

Second, the emergence of e-commerce has increased retail competition through greater transparency and lower costs. An estimated 8% of US retail sales are conducted online and digital price indices reveal lower prices across a wide range of goods categories in comparison to equivalent categories in official consumer price indices. Therefore, prices are also likely being depressed by increasing online retail sales.

Third, wage growth has been dampened by declining bargaining power of workers resulting in lower inflation. This has been driven by the consolidation of firms into ever larger ones, the decline of unionisation and slower productivity growth. In the past, workers value added grew at faster rate and were more effective in bargaining through unionisation with smaller firms, resulting in faster wage growth, and therefore higher inflation.

Core PCE Inflation
(% year on year)



Sources: Bureau of Economic Analysis and QNB Economics

However, the Fed has generally rejected all of these explanations for the current spell of subdued inflation. Arguing instead that most of the weakness in inflation is attributable to one-time events. More specifically, this involves methodological changes to the way cell phone costs are calculated and base year effects from a jump in pharmaceutical costs in 2016. But the general theme of the Fed's view is heavily anchored on the premise that the labour market strength will eventually result in inflationary pressures.

The Fed is right to highlight some of the temporary factors currently depressing inflation. However, given the long-term downward pressures on inflation, the Fed's expectation for inflation to rebound to the 2% target so quickly in 2018 seems optimistic. Inflation has undershot its 2% target for the past five years and the presence of the aforementioned structural factors are key reasons for that. We don't expect those structural influences to fade so suddenly.

The temporary factors weighing on inflation will come off in 2018, which should add about 0.2 percentage points to core inflation and bring it to 1.7%-1.8% in 2018. Plugging this inflation rate into the Taylor-Rule (the Fed's standard equation for estimating the appropriate policy rate) rather than the 2.0% forecast of the Fed suggests that three rate hikes between now and the end of 2018 would be appropriate.

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