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Squawking about persistently higher inflation?

Thomas LAM
Singapore Management University, thomaslam@smu.edu.sg

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All signs point to an uncertain path for inflation in the future. While inflation is set to stay prospectively higher in the US in the near-term, it's unlikely to remain so.

THE eye-catching headlines on inflation, broadly and narrowly referenced, have been a source of anxiety, confusion and speculation of late. Typically, when economists and policy-makers discuss inflation, the emphasis is on a general rise in the overall price level of consumer goods and services. The evolution of individual price changes, along with producer and import-price inflation, is usually less relevant for estimating the broad future trends in consumer price inflation.

My discussion will first allude to inflation developments across advanced economies before zeroing in on the US experience for clues on the current and future inflation environment. Generally, I find that inflation waves in advanced economies have been less uniform in recent years than in prior years. While headline or overall inflation tends to fluctuate in sympathy, the co-movement on the standard core component (defined as total excluding food and energy) appears to have weakened on average since the last decade and a half or so.

The behaviour of core inflation, which is usually responsive to domestic factors, can differ from the more globally-sensitive headline. This implies that higher food and energy prices per se, while raising headline inflation, need not pass through broadly into price changes of other consumer goods and services.

Indeed, research suggests that when the gap between headline and core inflation opens up, headline inflation has tended to converge toward core inflation in recent years (that is, core is a better predictor of future inflation than headline).

So, the lofty headline and core inflation prints in recent months, as well as through this year on average, might imply a more ominous future backdrop. But it is less clear whether the increase in core is due to a shift in more stable or less stable categories of inflation. The other exclusion indicators of inflation (more rigorously constructed - such as trimmed-mean and median - to exclude noisy categories) on balance do not appear to have ratcheted up as much as the standard core measure, perhaps suggesting that future inflation is less likely to remain persistently high.

The aforementioned relationship between core and headline might also be distorted or diluted by a confluence of unprecedented shocks, along with other idiosyncratic effects in the current environment. Arguably, the observed behaviour in core inflation at this time could be disproportionately related to gyrations in less stable categories or irregular influences.

Although core inflation typically fluctuates around a longer-term trend level, our understanding of cyclical fluctuations in inflation remains hazy. This is partly because of the wavering responsiveness of inflation to supply and demand shocks, in addition to budding fundamental relationships resulting from the impact of digitalisation and global developments.

Perhaps another way to scrutinise the current backdrop is to decompose the outsized US consumer inflation readings of roughly 4 per cent to 5 per cent in recent months into ephemeral, persistent and technical (or one-off base effects) components. My rough dissection of the US data suggests that less than half of the contribution to the prevailing level of inflation could possibly be more enduring, while the remainder might be ephemeral and technical in nature.

More specifically, I conjecture that at least a quarter to approximately two-fifths (or around one to two percentage points) of the contribution to the current level of inflation would probably be reversed over time. Furthermore, my recent estimates of the persistent component of US inflation, which has not risen notably above the pre-pandemic average, seem to corroborate the evidence of a less menacing outcome on future inflation.

While the foregoing exercise provides an alternative snapshot of the inflation backdrop, our understanding of the dynamics of future inflation is only partial and at best evolving. Another approach to tease out the likely future path of inflation is to focus on the broad contour of longer-run trend inflation. The basic idea is that when core inflation rises above or falls below its longer-run level, it shall revert to its trend over time as cyclical and idiosyncratic disturbances fade.

Research suggests that future trend inflation tends to generally reflect the shape of longer-term inflation expectations. While inflation expectations are usually related to the central bank's inflation goal, expectations can vary and may not be appropriately anchored. The degree of anchoring of inflation expectations is conceptually related to the conduct of monetary policy, general mindset and economic developments. When inflation expectations are well-anchored, trend inflation tends to be more stable and predictable.

The Fed's outcome-based policy approach, coupled with the reduced sensitivity of inflation to activity-oriented indicators, also raises the importance of monitoring inflation expectations. Generally, US inflation expectations can be obtained from surveys (mostly households and professional forecasters, less commonly from firms), extracted from market-based proxies and estimated econometrically.

PROFESSIONAL FORECASTERS

Also, I discover that surveys of professional forecasters, to a lesser extent market-based proxies, tend to outperform household surveys in forecasting inflation over the last two decades. But the different indicators of inflation expectations are neither homogeneous nor fungible, each one conveying a nuanced perspective of expectations formation, with varied strengths and weaknesses. Therefore, an alternative approach is to combine different measures of US inflation expectations into a unique composite indicator.

My Composite Measure of Inflation Expectations (CMIE), which outranks the various indicators, tracks the Fed's rhetoric and assessment on its longer-run inflation goal of 2 per cent. The updrift in the CMIE to roughly 2 per cent in Q2 2021 implies that inflation expectations remain well-anchored at this time, broadly in line with the Fed's mantra that the recent jump in inflation mainly reflects "transitory factors". Still, it would be crucial to monitor the CMIE to gauge the intended progress and risks surrounding the Fed's new strategy of flexible average inflation targeting.

The evolving public health situation, ongoing economic adjustments, unsettled policy dynamics and possibility of hefty data revisions combined implies that the future inflation path is far from certain. Besides, the spectre of Arthur Burns reminds us in anguish that "price inflation does not wait for full employment". But in light of the evidence thus far, we are still inclined to lean with the view that future inflation in the US, while prospectively higher in the near-term, is unlikely to be persistently elevated over time.

- **The writer is a principal researcher of the Sim Kee Boon Institute for Financial Economics at Singapore Management University.**