August 28, 2009

Is the output gap showing?

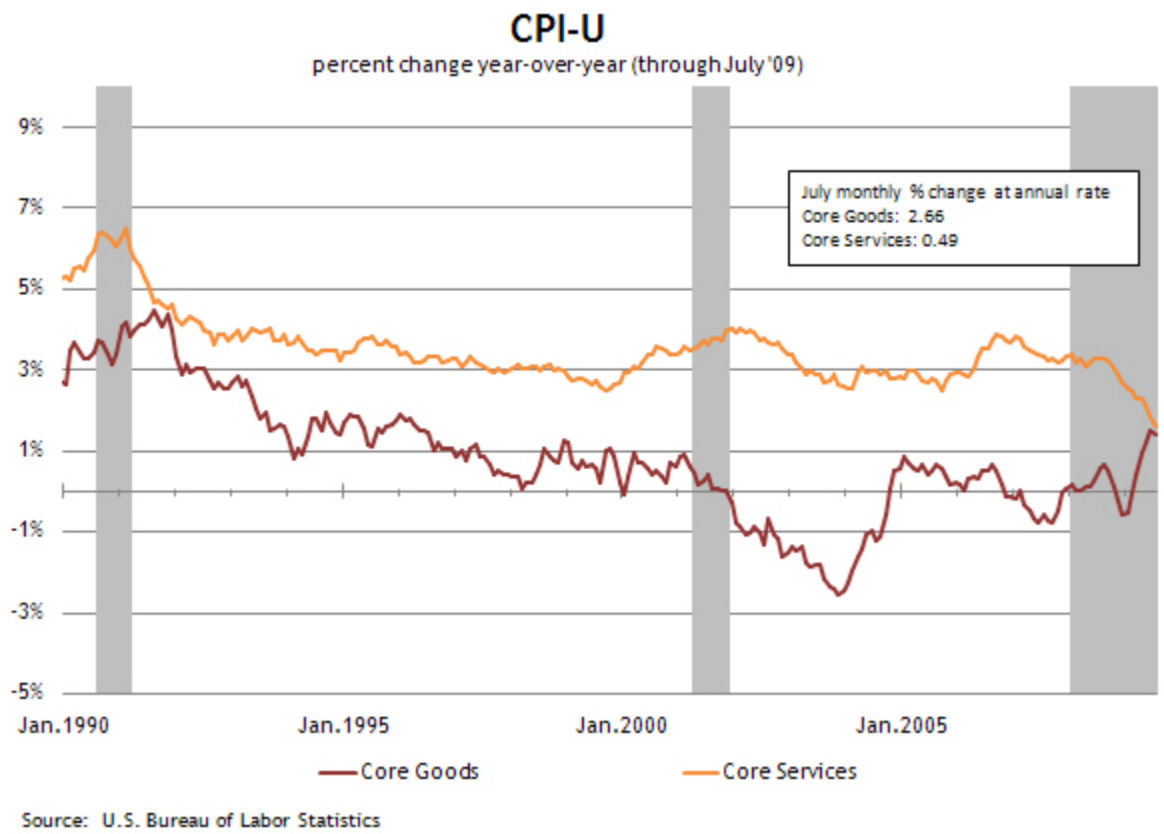
In a recent speech, Atlanta Fed President Dennis Lockhart laid out two competing risks to the inflation outlook. On one side, the usual measures of economic slack (output gap measures) suggest that there is so much excess production capacity that prices and wages are under great—and increasing—disinflationary pressure. All this is occurring at a time when inflation measures are trending below the FOMC's longer-term projection.

The other inflation risk is that the public may come to believe that the combined efforts of the monetary and fiscal authorities to prop up a sagging economy will ultimately lead to a familiar place—rising inflation—and if inflation expectations begin to move higher, so too will inflation.

So the risks to the inflation outlook seem to pivot on two, potentially opposing, forces: downward price pressure coming from a weak economy and upward price pressure resulting from a skeptical public.

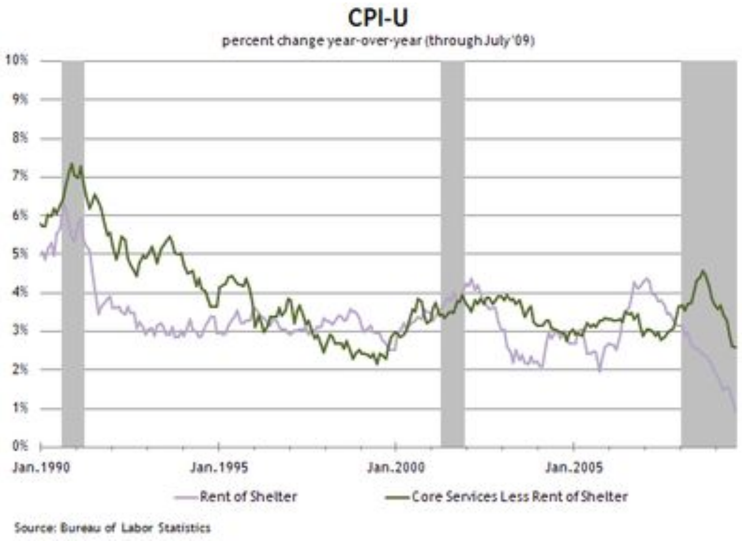
Lockhart's assessment is that these "inflationary and deflationary risks are roughly balanced." But in the end, the security of such an inflation outlook rests largely with the behavior of the inflation data. So it is important to continue watching carefully for any signs that the balance of these risks is tilting in one direction or the other.

This view brings us to a chart posted in last week's Economic Highlights showing recent trends in core goods and core services prices in the consumer price index (CPI).

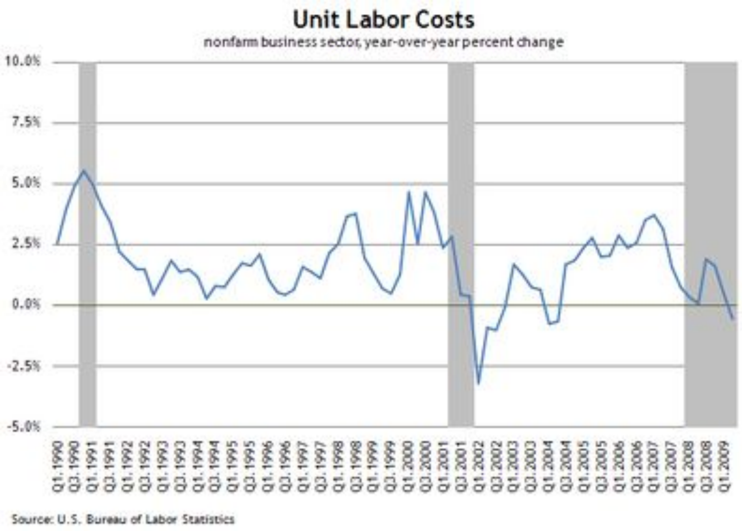


A key observation to take away from this picture isn't the recent acceleration in core goods prices. The highly volatile behavior of goods prices tends to make them an unreliable guide to underlying inflation trends. Rather, it is noteworthy to consider the significant downward trek of core services price growth. Indeed, the 12-month trend in core services prices was a shade under 1.6 percent in July—its lowest reading in the post-WWII era and roughly 1¾ percentage points lower than this time last year.

Some of the downward pressure on core services prices is a direct reflection of the housing crisis; a little more than half the core services price components are computed from housing rents. But that's not the whole story as a rather sharp disinflation was evident in core services excluding rents.



Likewise, productivity-adjusted labor costs—so-called "unit labor costs"—have also recently turned negative. These aren't record declines, but they are well off their prerecession growth rates.



Is this a sign that economic slack has begun to show through to the retail price numbers? It could be a bit early to bet the ranch on that one. Nonetheless, the evidence seems to offer a pretty compelling story at this time.

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