

## Economics Group

### Special Commentary

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# Will “Insurance” Cuts Solve Inflation’s Shortfall?

Despite the current expansion being only weeks away from becoming the longest on record, inflation continues to underperform relative to the FOMC’s 2% target. The year-over-year rate of core PCE inflation briefly brushed 2% a few months last year, but has subsequently fallen back to 1.6%—the average of the current cycle (Figure 1). The persistent shortfall has encouraged speculation that the FOMC may cut interest rates in order to help spur inflation. Our own forecast now looks for the FOMC to cut the fed funds rate 50 bps in the second half of this year, but not because the economy is about to fall into a recession. Rather, ongoing trade tensions are expected to weigh on business investment and slow GDP growth, while less scope to cut the fed funds rate than in prior cycles is likely to make the FOMC more proactive in trying to fend off a slowdown. At the same time, easing would be consistent with the Fed making efforts to meet the price stability side of its mandate. But would such “insurance” cuts fully solve the FOMC’s low inflation problem, and bring core inflation back to 2% on a sustained basis?

Figure 1

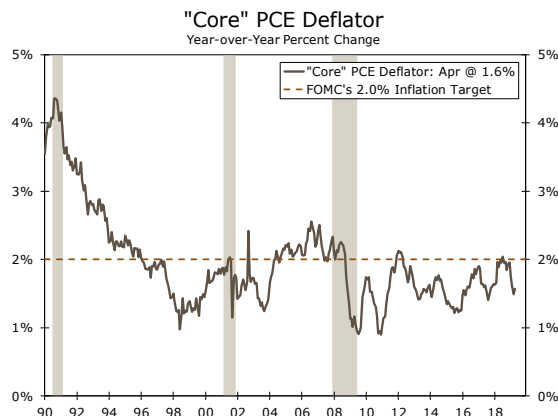
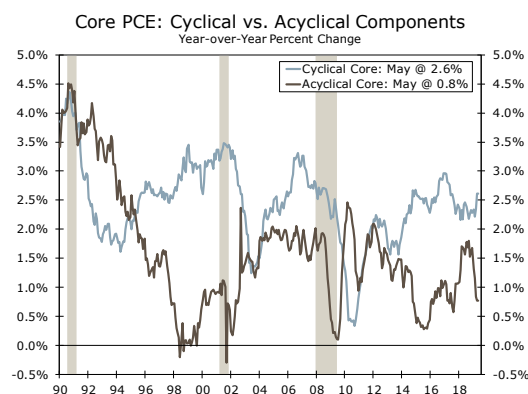


Figure 2



*Fed easing would be consistent with it making efforts to meet the price stability side of its mandate.*

Source: U.S. Department of Commerce, Federal Reserve Bank of San Francisco and Wells Fargo Securities

### Rate Cuts Would Support the Cyclically Sensitive Areas of Inflation

More accommodative policy would help support growth and hiring, putting pressure on remaining resource capacity in the economy and leading firms to raise prices. Inflation in areas most sensitive to slack, which include housing, food & accommodation services, recreation services and some nondurable goods, has in recent years run higher than areas where industry-specific factors are more influential (Figure 2).<sup>1</sup> Cyclical inflation has been contained within a range of 2.2-3.0% since mid-2014, even as the unemployment rate has fallen to a five-decade low and labor costs have

<sup>1</sup> Cyclically sensitive categories are defined as categories in which the difference between unemployment and the natural rate of unemployment has a negative and statistically significant relationship with inflation at the 1% level from 1985-2007. Remaining categories are considered acyclical. See Mahedy, Tim, and Adam Shapiro. 2017. “What’s Down with Inflation?” FRBSF Economic Letter 2017-35 (November 27) for more detail.



**Cyclical sensitive inflation categories would rise with Fed easing.**

picked up. Yet, with slack a significant determinant of inflation in these categories, easier Fed policy that supports further tightening in the labor market will generate faster price growth in these categories, all else equal, and help to chip away at core inflation's current shortfall.

The sideways move in the cyclically sensitive categories, however, is a reminder that slack is hardly the only driver of inflation, and a relatively small one at that. Inflation expectations bear significantly greater explanatory power in models of inflation. Here rate cuts by the Fed may go some way in supporting higher inflation, by signaling it is not willing to tolerate the status quo. The willingness to ease could also be construed by businesses and consumers as evidence that the economy is materially weakening, however, so communicating the "just in case" nature of rate cuts will be key.

### Slack Isn't Low Inflation's Main Problem

At issue for the FOMC is that slack is the part of the inflation equation that the committee can influence in the short term. Secular trends in technology, globalization and public policy are also influential for inflation, but are outside the Fed's purview. The undershoot in inflation remains centered in goods and services largely unaffected by slack.

Prices in acyclical inflation categories have been running lower than cyclical areas in recent years, and are materially weaker compared to historic trends. Relative to each category's average since 1990 (how far back you need to go for total core inflation to average 2.0%), cyclical core inflation is just a tick below its historic average (Figure 3). Most of the shortfall from the Fed's 2% target can be traced to acyclical categories, which is more than a full percentage point below its long-run trend. While acyclical categories like motor vehicles, clothing and miscellaneous services have all averaged less than their historical trend this cycle, healthcare accounts for the majority of inflation's undershoot due to acyclical factors (Figure 4).

Figure 3

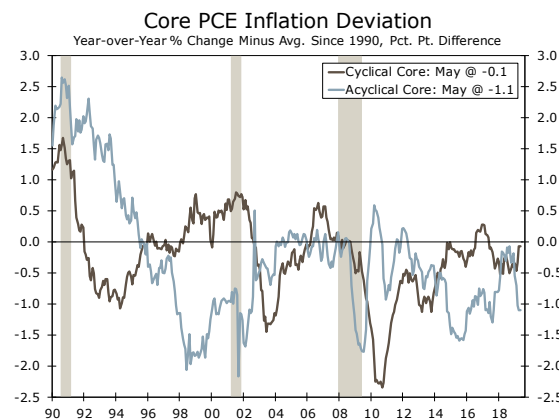
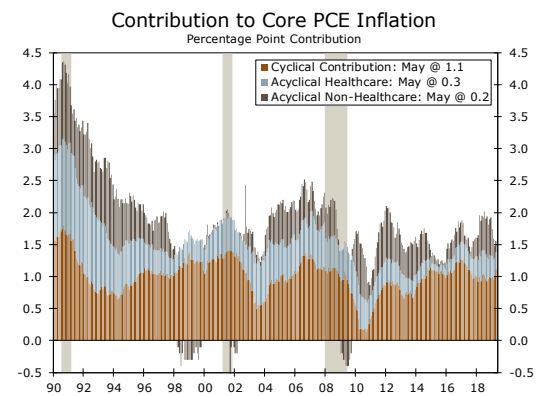


Figure 4



Source: U.S. Department of Commerce, Federal Reserve Bank of San Francisco and Wells Fargo Securities

The fact that a product category has been dominated by industry-specific factors in the past does not necessarily mean it is wholly immune to cyclical influences. For example, the labor-intensive nature of healthcare lends scope for prices to push higher, but the sector still contends with a shifting health policy landscape and administered prices—factors well outside the Fed's influence.

On net, we would expect Fed easing in the coming months to support higher inflation by driving the cyclically sensitive areas of inflation higher. With core inflation running below the FOMC's target for almost all of the current cycle and inflation expectations drifting lower, the price stability side of the FOMC's mandate needs all the help it can get. Yet, with acyclical inflation categories responsible for the bulk of the underperformance, rate cuts are unlikely to solve inflation's persistent shortfall on their own. We look for core inflation to continue to run below 2% through the second half of the year, even as the Fed likely provides some additional policy support.

**Rate cuts should support higher inflation, but not solve inflation's shortfall on its own.**

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