

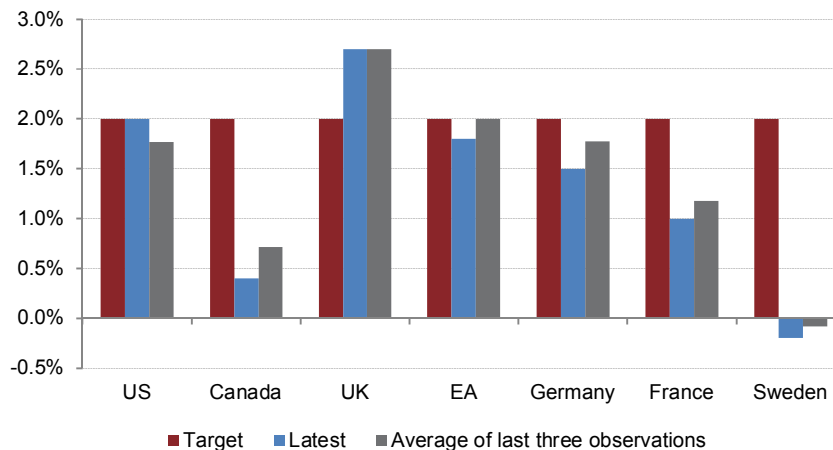
## Don't worry about inflation – for now

- **Some countries have seen an uptick in inflation in February**
- **But both headline and underlying – trimmed mean – inflation is generally easing**
- **Medium-term, there are some warning signs from the US**

Sir Mervyn King has expressed concerns that the fall of sterling may have gone too far and that this may have an impact on UK inflation. Zhou Xiaochuan was worried when Chinese inflation jumped to 3.5% in February and noted that the PBoC remains on 'high alert' against inflation. US inflation – headline and core – edged up in February. Is it time to start worrying about inflation again?

Emphatically – no! With the exception of the UK, where inflation has been above target for three years (partly because of the falling pound, which in itself is good news), there is no inflation problem anywhere among major economies. Yes, US inflation rose in February – primarily on higher oil prices – but inflation in the euro area and its major constituents slowed, as it did in Sweden. Canadian (January data) and Australian (Q4 2012) inflation are also if anything trending down. The chart below shows headline inflation in the most recent month available (February, except for UK and Canada where it is January); the average of the three most recent months; and the official or unofficial target.

**Inflation, latest, recent trends and targets, 12-month changes, %**



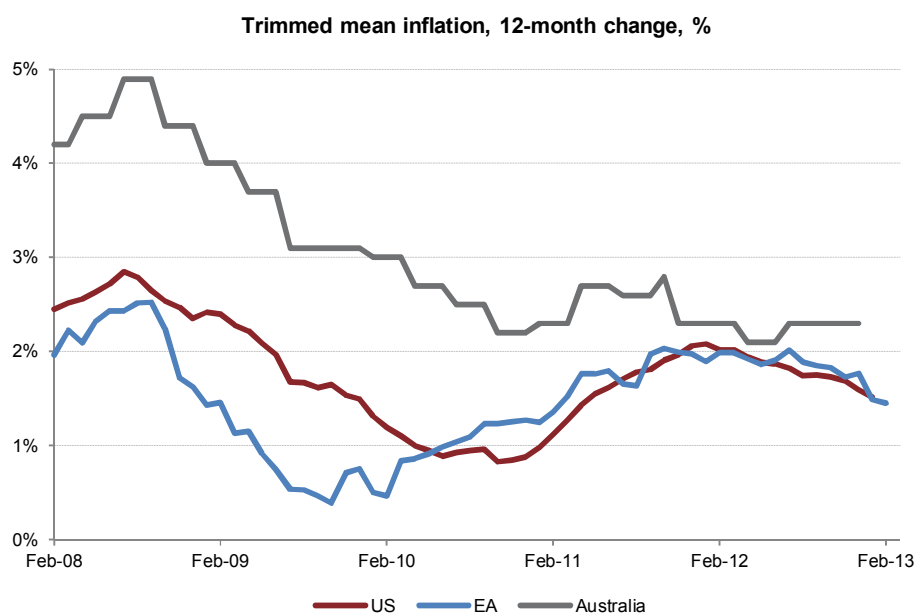
In most cases the most recent number is below the latest three-month average, implying that the trend is still down. The UK is an exception, but here too inflation should ease during the course of 2013. This will partly depend on what the new Governor of the Bank of England and the Chancellor will do. Once again the air is full of talk of the Bank's target changing, whether to a dual mandate like the Fed's, or to nominal GDP targeting. It has to be kept in mind that any change is going to be in the direction of allowing for and

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attempting to achieve higher inflation. If that were not the case, why bother changing the policy framework? But, absent a change, both activity and money trends point to inflation coming down.

The US is an exception to the point about the latest number being below the average of the last three observations. But underlying price pressures in the US are also coming down. The Federal Reserve Bank of Dallas publishes a trimmed mean inflation rate for the personal consumption expenditure deflator. While there is no February data for this (that will be published on the last day of the month, together with the personal income and spending data) the trend of US trimmed mean inflation is down. The trimmed mean is arguably a better guide to underlying inflation than a core rate. The core rate constantly excludes the same prices, be it food and/or energy, tobacco (France) or variable interest rates (Sweden). By contrast, the trimmed mean each month excludes the fastest and slowest changing price groups, providing a better picture of 'mid-stream' price movements. At the moment, the only countries using trimmed mean inflation are Australia and the US, although I have constructed a trimmed mean measure for the euro area as well (this is available on the Stein Brothers website).



Other indicators – weak broad money growth, continued below-trend output growth – confirm that inflation is not a problem for the near future. So too does recent data from the euro area which shows labour cost falling; while US labour costs, although rising, remain under control.

Near-term, there should therefore be no reason to worry about inflation, in spite of an odd monthly hiccup. Further out, however, it may again be prudent to raise a question mark over the US. The Federal Reserve has generally shown itself as the most inflation-friendly of major central banks over the past few decades.

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This is almost certainly due to its dual mandate (take heed, Messrs Osborne and Carney). Over the next few years, US inflation should remain subdued. But, if the Fed persists in keeping interest rates at ultra-low levels well into an upswing phase and beyond the achievement of full employment – and there is a clear risk that this will happen – there will ultimately be cause for concern. This is a topic that will no doubt be revisited many times.

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