Northern Trust

DAILY GLOBAL COMMENTARY

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Yellen on Budget Deficit and Inflation

November 10, 2009

Janet Yellen, President of the San Francisco Federal Reserve Bank, and a voting member of the FOMC had this to say about budget deficits and inflation in this morning's speech:

> "*Persistent large budget deficits may be harmful once the economy recovers because they are apt to boost interest rates and absorb private savings that would otherwise finance productive investments. But experience teaches us that budget deficits do not cause inflation in advanced economies with independent central banks that pursue appropriate monetary policies. As for the Fed, you can be 100 percent certain that price stability will remain our objective, regardless of the stance of fiscal policy.*"

President Yellen presents a reassuring case to the camp that is concerned about the link between budget deficits and inflation in the U.S. economy.

Inflation Expectations – An Update

Inflation expectations (as measured by the spread between the nominal Treasury security yield and TIP rate) have moved up 22 bps in six business days ended November 9 if the 10-year time span is considered, while the 5-year time span shows 18 bps increase in the same period (see chart 1). It is well known that inflation expectations are important in the formulation of Fed policy and this aspect is stressed in official policy statements and Fed rhetoric. Inflation expectations as of November 9 (222 bps using the 10-year span) is the highest since August 2008. After the collapse of Lehman Brothers, inflation expectations, much like other market indicators, moved to worrisome territory with a possibility of deflation being priced in. This situation has undergone a significant change with improving financial market and economic conditions in place at the present time. Consistent with more bullish economic data, inflation expectations have moved up to reflect the change in business conditions (see chart 1).

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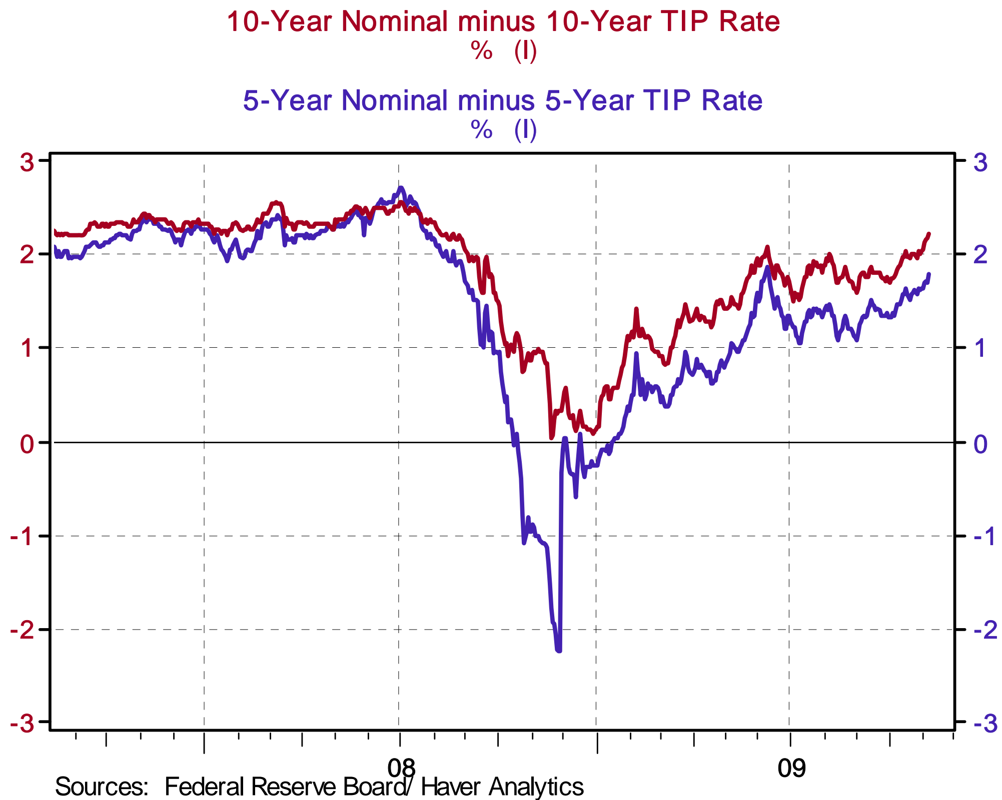
Chart 1



How does the current situation compare with 2004 just prior to the Fed tightening phase which commenced in June 2004? Inflation expectations (see chart 2) were closer to 2.0% in the second half of 2003. The advancing trend commenced in the fourth quarter of 2003 and reached a high of 2.63% in May 2004. Inflation expectations move gradually and it appears there is an implicit threshold. Readings outside of this threshold set off alarm bells. Chart 2 indicates that the implicit threshold was possibly around 2.5% in 2004. The Fed applied the monetary policy breaks in June 2004 by which time inflation expectations exceeded this implicit threshold. From chart 2, it also appears that inflation expectations moved down as the Fed continued to tighten monetary policy. Inflation expectations have risen in the past few days but there is an exaggerated concern about inflation evolving despite the fact that there is an enormous level of unused capacity across the economy. Inflation should not be problematic in 2010.

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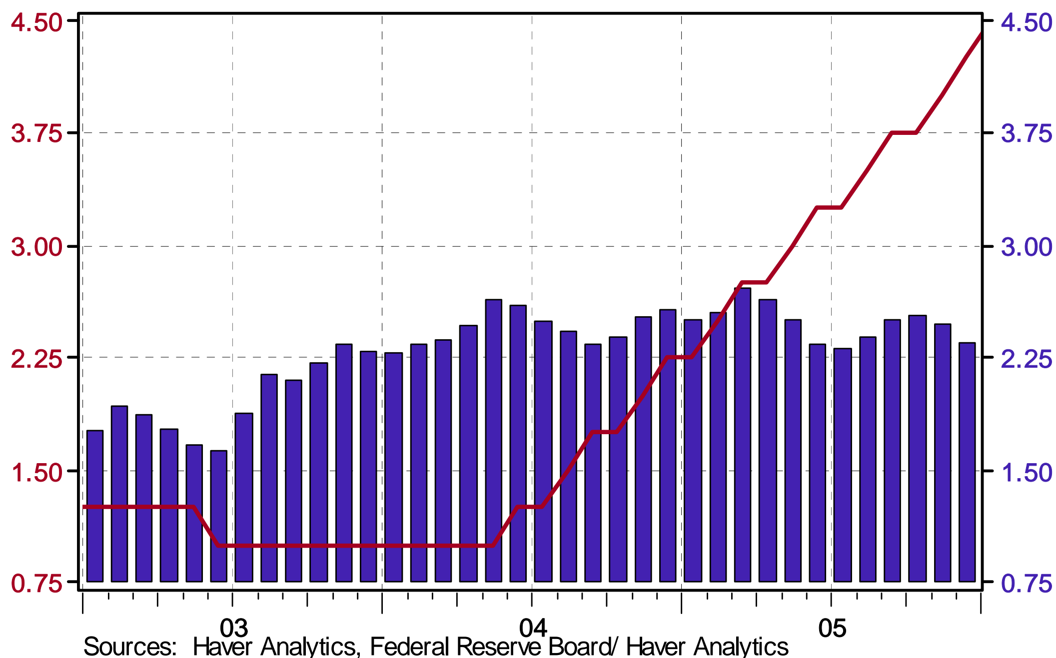
Chart 2



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