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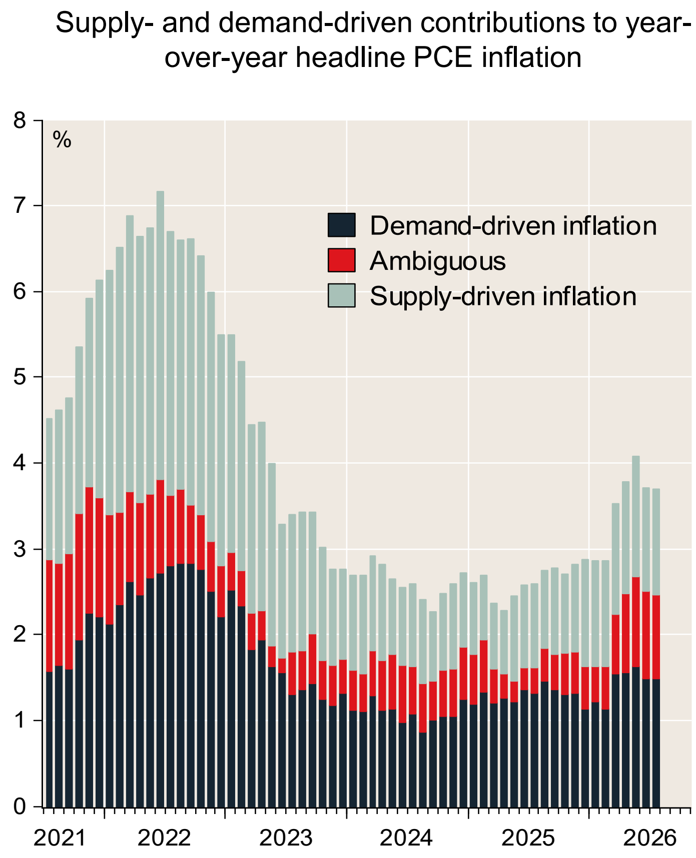
U.S. Watch

By Jocelyn Paquet

Most economists agree that, in the short term, central banks should look through a supply shock like the one we are currently experiencing. However, they usually add a major caveat to this recommendation. The shock must be limited in duration so that it does not affect core inflation components or lead to an increase in inflation expectations. But how can a central bank know precisely when such adverse effects will materialize? And how can it know when to act? In the case of market participants trying to anticipate the Federal Reserve's moves, the realization that it might be time to raise policy interest rates seems to have occurred in three stages. First came the August jobs reports, which were stronger than anticipated and hinted at a healthier labour market than the Fed expected. Next came the CPI and PPI reports for August, which showed core inflation slightly higher than expected and intensifying upstream price pressures. But the straw that likely broke the camel's back was the international developments *since* August. The price of a barrel of oil has indeed risen by nearly $20 since the beginning of September amid renewed tensions in the Middle East, raising the prospect of further bad news on the inflation front. Failing to raise rates in this context—especially when the central bank's full employment mandate appears to be fulfilled—would call into question the Fed's determination to meet its price stability goal, particularly as inflation has remained above the 2% target for more than five years now. The fact that excess demand remains a major source of inflation in the United States is another factor that, in our view, limits the Fed's flexibility at this stage. As today's Hot Chart shows, the portion of inflation driven by supply shortages has indeed increased since the start of the conflict in the Middle East (something that could be expected), but the portion driven by excess demand has risen even more, a phenomenon attributable to resilient consumption spending (see today's retail sales report) and, more importantly, to the AI investment boom. It is this combination of a supply shock from abroad *and* persistently strong domestic inflationary pressures that is now forcing the Fed to act. We believe it will raise its benchmark interest rates this afternoon.

U.S.: Fed faces double threat of supply shock and excess demand



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