

CHART OF THE WEEK

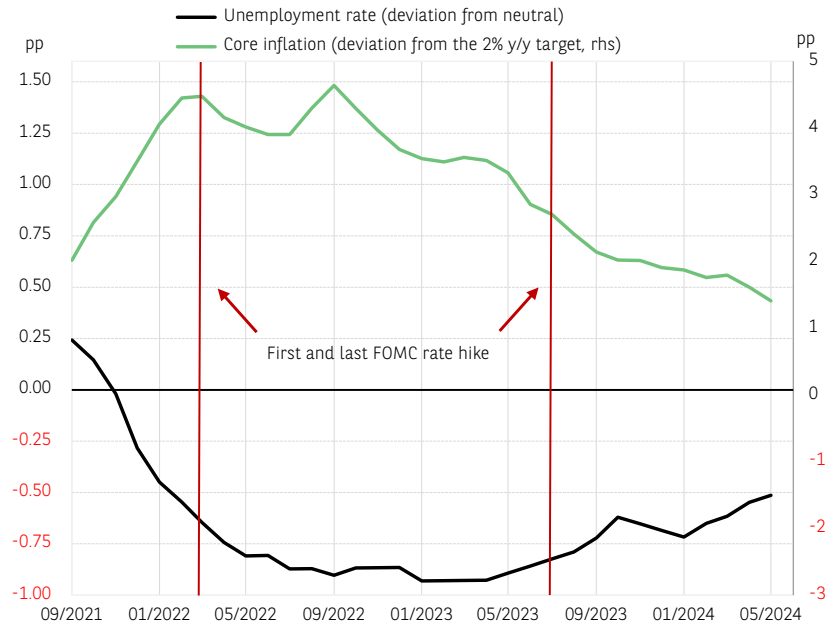


3 July 2024

DISINFLATION IN THE UNITED STATES: THE SCALE OF THE SACRIFICE ON THE LABOUR MARKET

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The cost of disinflation for households: focus on unemployment



Source : BLS, CBO, BNP Paribas

Since a 1977 act, the dual mandate of the Federal Reserve (Fed) has de jure entrusted it with the objectives of maximum employment and price stability (the latter being expected to favour the former in the long term). However, these objectives can come into conflict and, as has been the case since March 2022, the Fed may have to give clear priority to reducing inflation at the risk of damaging employment and output. This refers to the concept of sacrifice ratio¹ or trade-off², i.e. the expected cumulative deterioration of the latter to help bring inflation back to its target (2%).

So far, the fall in inflation (-5.2 percentage points between March 2022, the start of monetary tightening, and May 2024, the latest point available) and core inflation (-3.1 pp), measured by the CPI, have gone hand in hand with a fairly contained rise in the unemployment rate (+0.4 pp over the same period, still below its neutral level according to the Congressional Budget Office). At the same time, growth remained at a robust rate of +2.5% in 2023 as an annual average and +1.3% at an annualised rate in Q1 2024.

However, changes in the unemployment rate alone provide only fragmentary information about the state of the labour market. Another relevant indicator is the participation rate of 25-54-year-olds (prime age), which has been at its highest level since 2001 (as of May 2024), while the employment rate has remained above 60% since the start of monetary tightening, despite the deterioration in the unemployment rate. The rebalancing of the labour market (in the sense of reduced hiring difficulties) has been made possible by an improvement in the supply component – which was not the Fed's central scenario – which has so far prevented the labour market and the economy from experiencing a hard landing. However, the trend in the unemployment rate is tending towards the trigger point for the Sahm Rule. The Sahm Rule links an increase of +0.5 pp in the three-month moving average of the unemployment rate at its 12-month low to a recession.

Furthermore, in a research paper³, Robert J. Tetlow, economist and adviser to the Board of the central bank, highlights the downward pressure exerted by the anchoring of inflation expectations and the credibility of monetary policy on the level of the sacrifice ratio. However, the sacrifice ratio is still difficult to estimate and is thought to have increased over time. Yet, we have not seen any slippage in long-term (10-year) inflation expectations, as measured by the Cleveland Fed (+2.5% in May 2024), during the current cycle, despite a definite appreciation. This could be related to the firmness shown by the Federal Reserve on the need to maintain its policy at a restrictive level, even when there was a consensus within the economic community in 2023 on the upcoming occurrence of a recession.

¹ Speech by Isabel Schnabel, Member of the Executive Board of the ECB, at the Jackson Hole Economic Policy Symposium organised by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, European Central Bank, 2022
² The Inflation/Output Variability Trade-off Revisited, John B. Taylor, 1994
³ How Large is the Output Cost of Disinflation? (Federal Reserve, 2022)

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Head office: 16 boulevard des Italiens - 75009 Paris France / Phone : +33 (0) 1.42.98.12.34
Internet: group.bnpparibas - www.economic-research.bnpparibas.com
Head of publication : Jean Lemierre / Chief editor: William De Vijlder