US: THE COST OF DISINFLATION

With the return of elevated inflation, the debate on the output cost of bringing down inflation that was very lively in the early 80s has made a comeback. This debate is centered around the sacrifice ratio -the loss in output compared to its trend level for a given decline in inflation- and whether the landing of the economy will be hard or soft. Recently, the semantics have evolved and commentators now speak of the possibility of immaculate disinflation, whereby inflation is brought back to target by the Fed through a restrictive monetary policy but with a very small cost in terms of unemployment. For this to happen, labour tensions should ease and lead to a drop in wage growth. This will take time. In addition, the US economy should do a better job in filling vacancies. Clearly, the jury is still out on what will happen to the unemployment rate in this cycle.

Back in the early 80s, when central banks were trying to get a grip on elevated inflation, academics spent a lot of time discussing the output cost of bringing down inflation. The thinking was that aggressive monetary tightening would cause a drop in economic activity, an increase in the unemployment rate, a decline in wage growth and inflation.

A temporary increase in the unemployment rate above its natural rate and a loss in output compared to its trend level were considered as the price to be paid for lowering inflation to an acceptable level. This price is represented by the sacrifice ratio. In the numerator we find the sum of output losses -the deviations between actual output and its full employment or trend level- and in the denominator the change in trend inflation over a given period, between its peak and its trough[1].

In 1994, Laurence Ball, a professor of economics at Johns Hopkins University, stated that "*disinflations are a major cause of recessions in modern economies - perhaps the dominant cause.*"[2] This explains why rate hiking cycles give rise to heated discussions between market commentators whether the landing of the economy will be hard or soft. Historically, the latter has been the exception.

Since the Federal Reserve started raising the federal funds rate in this cycle, the debate has been ongoing but recently a new twist has appeared, that of 'immaculate disinflation' whereby inflation is brought back to target by the central bank through a restrictive monetary policy but with a very small cost in terms of unemployment.[3]

Historically, tightening cycles have seen a significant increase in the rate of unemployment, with the major exception of the 1994 episode during which the unemployment rate continued to decline (chart 1). The latest Summary of Economic Projections shows that the members of the FOMC expect real GDP growth below trend this year and next, but this should only cause a limited increase in the unemployment rate, to 4.5% (from 3.7% in May), which is only slightly higher than its projected level in the longer run (4.0%).

US : UNEMPLOYMENT RATE AND FEDERAL FUNDS RATE

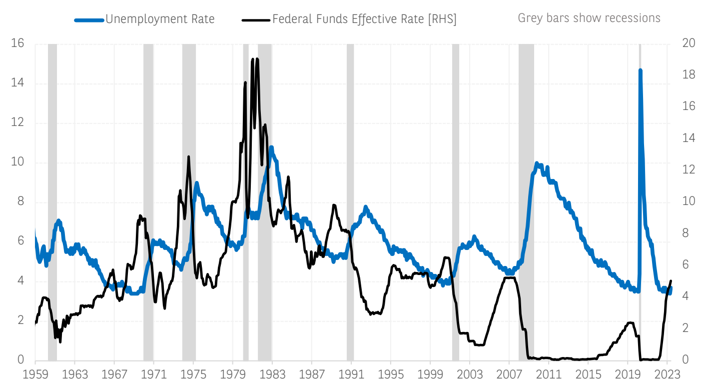

CHART 1 SOURCE: NBER, BLS, FEDERAL RESERVE BANK OF ST. LOUIS, BNP PARIBAS

This triggered a comment from a journalist during Jerome Powell's press conference that *"it seems like it's getting more immaculate rather than a little messy."*[4] It echoes the debate of last year whether a soft landing was a realistic assumption[5]. According to J. Powell, for goods price disinflation we need to see further improvement in supply conditions. This process is underway.

Another important source of inflation is coming from housing services, but new rents and new leases are coming in at low levels, which should contribute to lower inflation going forward. Finally and importantly, there is services sector inflation where *"we see only the earliest signs of disinflation."* Given its labour intensity, wage costs play a key role.

1 Source: Laurence Ball, What determines the sacrifice ratio, in Monetary Policy, edited by N. Gregory Mankiw, NBER, The University of Chicago Press, 1994.
2 Source: see footnote 1.
3 See: Tracy Alloway, So where does 'immaculate disinflation' come from anyway?, Bloomberg, 9 February 2023 and Paul Krugman, Wonking out: from stagflation to immaculate disinflation, New York Times, 10 February 2023.
4 Source: Transcript of Chair Powell's Press conference, Federal Reserve, 14 June 2023. The journalist who made the comment was Howard Schneider of Reuters.
5 See Félix Berte, Slowdown in the labour market and recession, EcoFlash, BNP Paribas, 10 February 2023.

> Labour market tensions can ease because of a reduction in hirings and/or an increase in layoffs. However, the impact on employment also depends on how easy vacancies will be filled.

According to the Fed Chair, to have inflation back to target, we need economic growth meaningfully below trend and a further loosening of the labour market. *"The things are in place that we need to see, but the process of that actually working on inflation is going to take some time."* Wage growth has declined, albeit at a very gradual pace. Powell refers in this respect to the recent paper of Bernanke and Blanchard –*"which is very consistent with what I would think"*- in which the authors conclude that *"although tight labor markets have thus far not been the primary driver of inflation, we find that the effects of overheated labour markets on nominal wage growth and inflation are more persistent"*[6].

Bringing inflation under control will require a reduction in labour market tightness, meaning a better balance between labour demand and supply. That is why the Fed has been raising its policy rate so swiftly and significantly. Labour market tensions can ease because of a reduction in hirings and/or an increase in layoffs. However, the impact on employment also depends on how easy vacancies will be filled. Clearly, the jury is still out on what will happen to the unemployment rate in this cycle.

William De Vijlder

6 Ben Bernanke and Olivier Blanchard, *What Caused the U.S. Pandemic-Era Inflation?*, Hutchins Center working paper 86, June 2023.

FOMC SUMMARY OF ECONOMIC PROJECTIONS

June projections	Median			
	2023	2024	2025	Longer run
Change in real GDP	1.0	1.1	1.8	1.8
Unemployment rate	4.1	4.5	4.5	4.0
PCE inflation	3.2	2.5	2.1	2.0
Core PCE inflation	3.9	2.6	2.2	
Federal funds rate (projected appropriate policy path)	5.6	4.6	3.4	2.5

TABLE 1

SOURCE: FEDERAL RESERVE, SUMMARY OF ECONOMIC PROJECTIONS, 14 JUNE 2023