MSCI Thematic Insight

Subject Area: **Inflation**

Immaculate Disinflation?
Is a soft landing possible after the inflation shock?

Enter

This is an **interactive brochure**

Contents

This is an **interactive brochure**

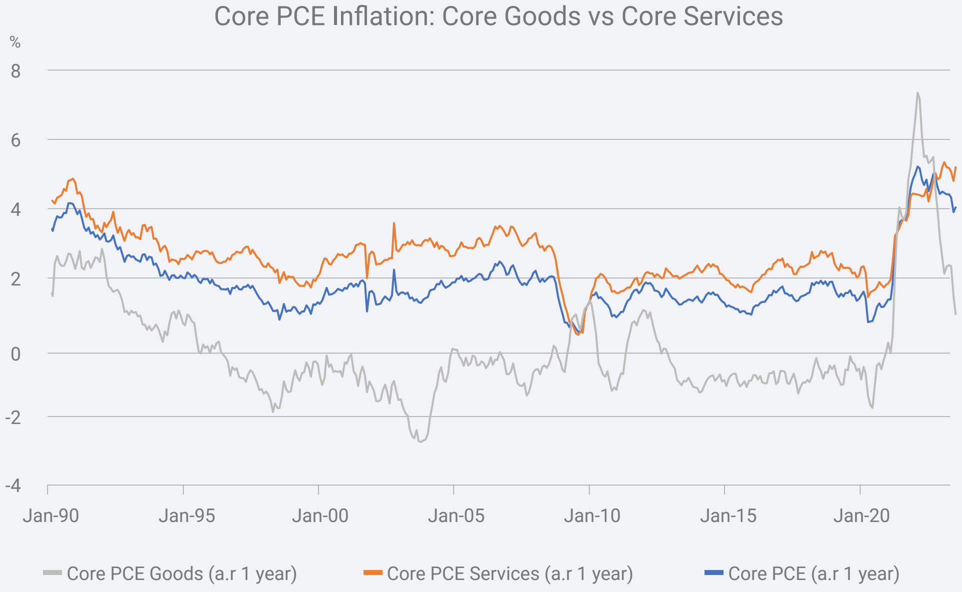
Introduction

Could US inflation be heading back towards the Fed's target level without too much damage to the labour market? If it were to, it would amount to quite a victory for the central bank.

Both of the mandated objectives of its monetary policy (high employment and stable prices[1]) would have been achieved, despite a widely criticized delay in responding to the initial inflation surge in 2021[2]. Headline CPI inflation in the US has fallen from a peak of 9.1% in June 2022 to 3% in June , and rising to 3.7% in August reflecting higher oil prices. Labour markets, in the meantime, are looser via lower job openings and lower quit rates, but remain tight on the critical basis of an unemployment rate of 3.8% in August that is very close to the cycle-low of 3.4% reached in April.

Despite this sharp fall, the path of disinflation has not been smooth thus far. Towards the end of 2022, inflation first started to fall, but two problems soon became apparent. First, both policy-makers and markets quickly noted that much of the disinflation was coming from goods, and little from domestically-generated services[3] (See Exhibit 1). Second, as a result, the optimistic disinflation projections that the market had espoused towards the end of 2022 had to be revised to a slower disinflation profile.

Figure 1: Only a small amount of disinflation has been driven by change in domestic services inflation



Source: Bureau of Economic Analysis

The performance of equity markets since and the message from monetary policy-makers at the Fed and ECB (among others) now project disinflation to proceed at a more measured pace, but still without too much cost to the labour market and the economy[4]. The scale of the cost, however, remains the subject of much debate. Many believe that it will be difficult to bring inflation down and keep it low without much damage to the economy (see comments by Summers, Blanchard or Furman at the Brookings event referenced earlier), others believe far more in the robustness of the relatively costless disinflation we have seen thus far.[5]

In this thematic insight, we distinguish four "recession camps": first split into a soft- vs. a hard-landing, and then each further divided into demand- and supply-oriented views. Each camp has a proponent we identify, but we also comment on those market participants, forecasters and policy-makers who are not easily classified in this way or seem to be shifting camps.

1 The Fed Explained: What the Central Bank Does (federalreserve.gov)
2 The Fed: Lessons learned from the past three years | Brookings
3 Transcript of Chair Powell's Press Conference -- February 1, 2023 (federalreserve.gov)
4 Speech by Chair Powell on the economic outlook - Federal Reserve Board
5 Christopher J Waller: Hike, skip, or pause? (bis.org)

The **demand-driven** soft-landing camp

Reducing job vacancies without raising unemployment too much

In July 2022, FOMC voting member Chris Waller co-authored a Fed note[6] with Andrew Figura that argues "something unprecedented can occur because the labor market is in an unprecedented situation". The vacancy ratio (the ratio of job vacancies to the number of unemployed workers) has risen strongly in the post-pandemic period. They argued that, because the ratio has risen almost exclusively because of a sharp rise in job openings, seeking to lower the ratio by weakening demand for workers, i.e., lowering the vacancy rate, should be a potent strategy. Their calculations showed that falling vacancies could bring the vacancy ratio down from 7 to 4.6 (which brings the ratio down to historically average levels) while raising the unemployment rate by only 1%.

Implicit to their argument is that a better balance between labour demand (i.e. vacancies) and labour supply (proxied by the unemployment rate) would be enough to keep wage growth under control and hence avoid further upward pressure on inflation.

To date, this argument has played out. Vacancies have fallen without much of a pickup in unemployment (Exhibit 2a), while both inflation and wage growth (Exhibit 2b) have moderated since the start of 2022.

Figure 2a:
Job openings have fallen with little change in the unemployment rate

Source: Federal Reserve Bank of St. Louis

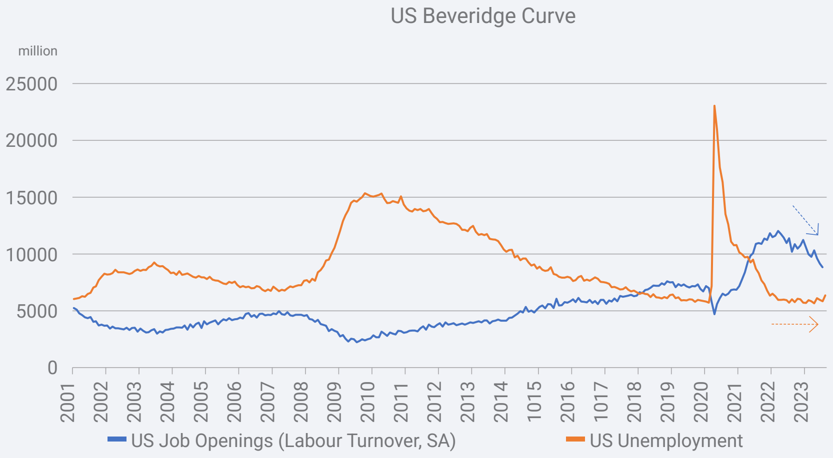
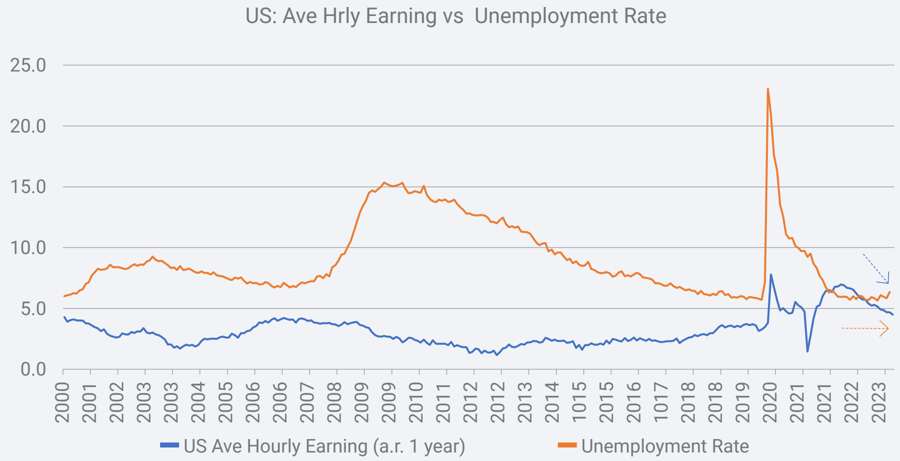


Figure 2b:
Average hourly earnings growth has moderated along with labour demand (unemployment rate)

Source: Federal Reserve Bank of St. Louis



There are, however, two concerns worth highlighting. First, the reasoning may work well in for early-stage disinflation but could be difficult to sustain once the frothiest labour market activity has cooled. The second is what happens after the vacancy rate returns to more normal levels? If the Fed then eases the monetary stance, labour demand is likely to rise again.

6 "What does the Beveridge curve tell us about the likelihood of a soft landing?", A. Figura and C. Waller, 29 July 2022,

The **supply-driven** soft-landing model

Supply chains and commodity prices

In mid-2023, Bernanke and Blanchard[7] estimated that most of the increase in inflation has been driven by commodities and supply chain issues, and hence the supply side of the economic problem. Encouragingly, the supply-side has been improving consistently for more than a year now[8]. The ongoing reversal of the shocks would then continue to deliver rapid disinflation. While their model did not show that wages have boosted inflation too much so far, they did caution that labour markets were likely to be a more difficult hurdle for sustained disinflation. Overall, their model offered an econometric path to "immaculate disinflation": while supply conditions improve, disinflation is largely assured. Oil prices, however, have been rising since early May, and those price increases have directly contributed to the recent upticks in CPI inflation.

Their concerns on labour market tightness are more subjective. Labour market tightness became apparent from 2022 onwards, towards the end of their sample period, and hence their model, even if well-posed, will not likely capture any renewed importance of the labour market over longer horizons. Equally, within their model, how are shocks 'identified', how are they 'allocated' and do the supply shocks subside too quickly?

Identifying shocks: Supply chains and commodity prices may have pushed inflation higher, but what created the supply shortages and higher commodity prices? Demand for goods surged during the pandemic as services could not be consumed and the level of consumption was boosted by highly accommodative monetary and fiscal policies. Should inflation be attributed to supply chain and commodity price shocks, or to the underlying demand surge?

Allocating the shock: The pickup in inflation was preceded by large local aggregate demand shocks (expansionary monetary and fiscal policies) and aggregate supply shocks (supply chain dislocations, commodity price shocks, labour shortages). How can we allocate these shocks? Supply chain dislocations, commodity price surges and initial demand for goods can be linked to goods price inflation (Exhibit 3a). As the chart shows, all three have been easing, which helps explains why goods price inflation has fallen globally. Services inflation may be understood as an allocation of demand shifting to services amid labour supply shortages (Exhibit 3b). Both dynamics remain in place, consistent with services inflation stubbornly high levels prevailing in many economies – above 5% in the US, the euro area, UK, Australia, Brazil, and Mexico in August.

Figure 3a:

US core goods PCE inflation correlates well with the Cleveland Fed's measure of supply-driven inflation and the San Francisco Fed's measure of acyclical inflation

Source: Source: Federal Reserve Bank of San Francisco

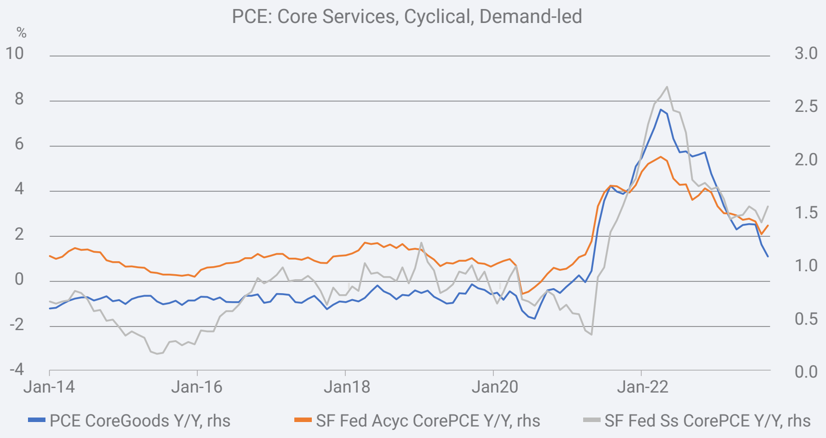
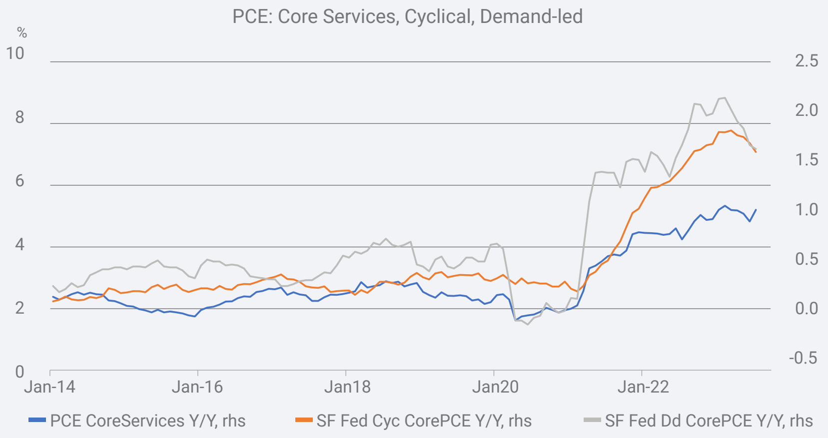


Figure 3b:

While core services PCE inflation shares the dynamics of demand-driven inflation (Cleveland Fed) and cyclically-driven inflation (San Francisco Fed)

Source: Source: Federal Reserve Bank of San Francisco



Shock longevity: Bernanke and Blanchard do not distinguish between the longevity of different supply shocks. Supply chain disruptions (measured by the New York Fed's disruption index referenced above) and commodity price shocks (seen through the sharp rise and fall in energy prices) have been largely resolved over the last year or two. But the same does not seem true of labour shortages and, demographically, in an ageing global economy, labour shortages are a structural decadal problem.[9]

7 "What Caused Pandemic-Era Inflation?" B. Bernanke and O. Blanchard, 23 May 2023, conference draft for "The Fed: Lessons learned from the past three years," Hutchins Center on Fiscal & Monetary Policy, Brookings Institution.
8 Global Supply Chain Pressure Index (GSCPI) - FEDERAL RESERVE BANK of NEW YORK (newyorkfed.org)
9 "The Great Demographic Reversal: Ageing Societies, Waning Inequality, and an Inflation Revival", C. Goodhart and M. Pradhan, 2020, Palgrave Macmillan.

The **hard landing** scenarios

Demand- and supply-led medium-term inflation threats

In the same week in March 2023 that the collapse of Silicon Valley Bank was raising concerns about the US banking sector, Larry Summers surprised academic economists and monetary policy committees when he performed a sharp U-turn from his previously resolute views on secular stagnation[10]. Despite significant hikes in the policy rate by the Fed and many other central banks, he observed that demand has remained strong. That suggested an interest rate-insensitive component in spending, e.g. from forced savings accumulated during lockdowns. Over the medium-term, Summers argued that green investment and geopolitically-driven defence spending could play a similar role, creating interest-insensitive spending in the medium term. To Summers, this could have two results: (i) a higher medium-term real interest rate to support financing this spending and (ii) higher medium-term inflation.

Those two outcomes echo those presented by Charles Goodhart and Manoj Pradhan in "The Great Demographic Reversal" cited earlier. Goodhart and Pradhan reach similar conclusions but from the perspective of labour markets (the supply side). If either, or both, perspectives are valid, then bringing inflation down to central bank targets will be easier than keeping it there.

This then suggests a hard landing is needed because otherwise disinflation and a soft landing could risk policy committees leaving demand a little too strong and labour markets a little too tight at the end of the current episode.

For example, the Federal Reserve's latest forecasts project a rise in the US unemployment rate to 4.1% by the end of 2023 and 4.5% a year later. Over this period, and following sustained disinflation, the Fed would expect to ease policy rates by approximately 200 bps. Any suggestion that a new cycle can start once inflation is lower and the unemployment rate is so modestly higher does not sit well with history since not a single new cycle over the last 75 years has started from an unemployment rate as low as 4.5% (Exhibit 4). However, if monetary easing were to start then labour markets could tighten again. Exhibit 5 shows how when labour markets have tightened, services inflation has tended to rise. For the Fed intends to keep inflation close to its target, a tight labour market is a very real headwind. Proponents of a hard landing believe that is the only mechanism to sufficiently softens the labour market.

Figure 4:
No cycle over the last 75 years has started from an unemployment rate as low as 4.5%

Source: Bureau of Economic Analysis

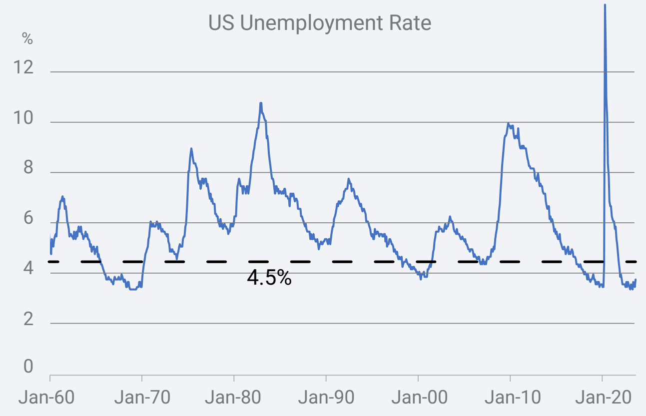
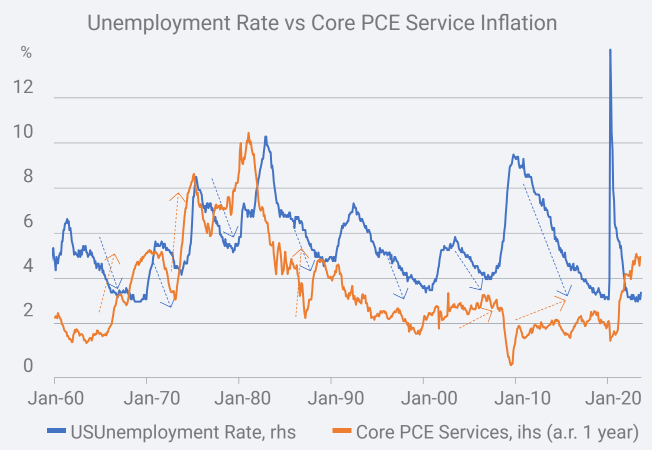


Figure 5:
When labour markets become quite tight, services inflation tends to rise

Source: Bureau of Economic Analysis



10 "Summers and Blanchard Debate the Future of Interest Rates", March 2023, Peterson Institute of International Economics.

Conclusion

If the medium-term concerns outlined by Summers and by Goodhart and Pradhan turn out to be even partly validated, then inflation will likely resurface again.

The “hard landing” camps would argue that it is to prevent such economic dangers that come with such a recurrence that a hard landing is necessary. Significantly softer demand and looser labour markets could push an inflation rebound materially into the future, and most importantly help anchor inflation and wage growth expectations to sustainable levels. Based on their actions and communications central banks do not seem minded to agree.

MSCI would like to thank Manoj Pradhan, founder of Talking Head Macroeconomics, for discussions and insightful analysis of this megatrend that have facilitated the preparation of this document.

Pradhan is the co-author of the bestseller, “The Great Demographic Reversal.” He founded the independent research firm Talking Head Macroeconomics in 2016 and was previously a managing director at Morgan Stanley, where he led the Global Economics team. He joined Morgan Stanley in 2005 after serving on the faculty of the George Washington University and the State University of New York. Pradhan works on thematic global macroeconomics. He has a Ph.D. in economics from the George Washington University and a master’s degree in Finance from the London Business School.

Contact us

AMERICAS

US	+1 888 588 4567 (toll free)
Canada	+1 416 628 1007
Brazil	+55 11 4040 7830
Mexico	+52 81 1253 4020

ASIA PACIFIC

China	North: 10800 852 1032 (toll free) South: 10800 152 1032 (toll free)
Hong Kong	+852 2844 9333
India	+91 22 6784 9160
Malaysia	1800818185 (toll free)
South Korea	00798 8521 3392 (toll free)
Singapore	800 852 3749 (toll free)
Australia	+612 9033 9333
Taiwan	008 0112 7513 (toll free)
Thailand	0018 0015 6207 7181 (toll free)
Japan	+81 3 4579 0333

EUROPE, MIDDLE EAST & AFRICA

South Africa	+27 21 673 0103
Germany	+49 69 133 859 00
Switzerland	+41 22 817 9400
United Kingdom	+44 20 7618 2222
Italy	+39 025 849 0415
France	+33 17 6769 810

About MSCI

MSCI is a leading provider of critical decision support tools and services for the global investment community. With over 50 years of expertise in research, data and technology, we power better investment decisions by enabling clients to understand and analyze key drivers of risk and return and confidently build more effective portfolios. We create industry-leading research-enhanced solutions that clients use to gain insight into and improve transparency across the investment process.

To learn more, please visit **www.msci.com**

The process for submitting a formal index complaint can be found on the index regulation page of MSCI's website at: **https://www.msci.com/index-regulation.**