

Daily Note

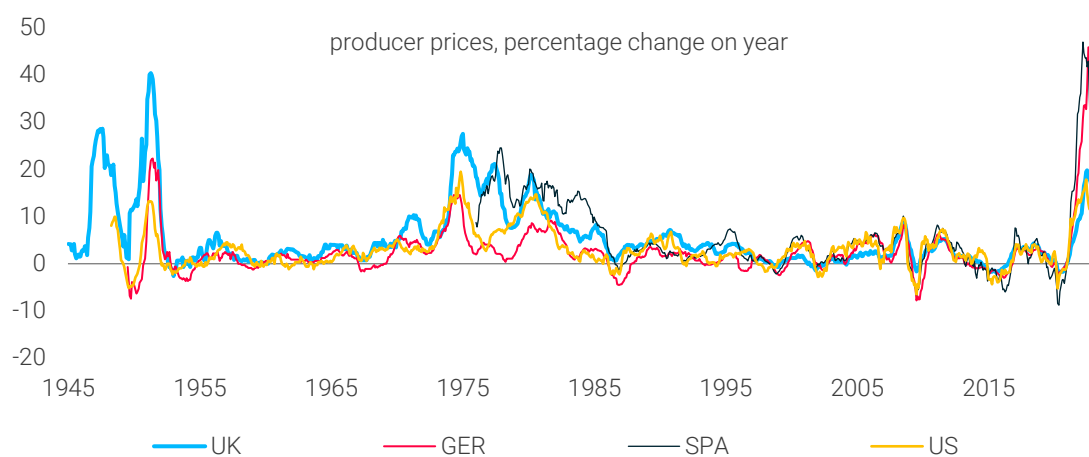
THE MYSTERY OF IMMACULATE DISINFLATION

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- Clear disinflation trend is now undeniable, even with unemployment at historical lows
- Mainstream economics is confused – the consensus is getting everything wrong
- We do not “need” a recession, the question is whether we will get one anyway

Mainstream economics is in a state of confusion because inflation seems to be going away even with unemployment at record lows and no sign of the recession that consensus thought was “necessary” (even “inevitable”) six months ago. More impressive still, this “immaculate disinflation” is not just a story about base effects or food and energy prices. In the US, which is probably six months ahead of Europe in the disinflationary process, we are even seeing clear moderation in the Fed’s specially selected “core services excluding housing” index, a measure of inflation that is supposed to capture underlying pressures from the domestic labour market (i.e., wage dynamics). For economists who still believe in the Phillips curve (which, unfortunately, means most central bankers) this is a riddle, wrapped in a mystery, inside an enigma. How could immaculate disinflation happen? Things have got really bad: we have [Nobel laureate Paul Krugman crowdfunding the answer by appealing to the collective wisdom of #fintwit](#).

Chart 1: A huge one-off shock to global goods prices



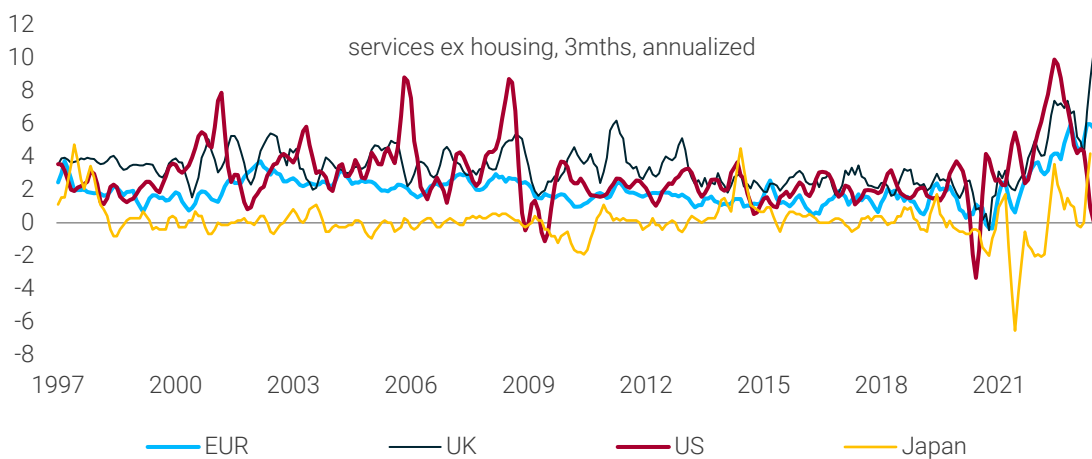
Source: OECD, national sources, TS Lombard

Immaculate disinflation does not surprise me in the slightest. Ever since the “recovery” from COVID, I’ve been warning that this is no ordinary business cycle. And with fake cycles, there are likely to be unusual endings. [Where we were headed, we did not need the Phillips curve to guide us](#). But to address Krugman’s question more specifically, here is my list of contributing factors:

- 1 **Post-COVID inflation was weird:** A big part of the inflation we have seen since 2021 was the result of [a one-off increase in prices, not the start of an inflationary spiral](#). Enormous cost

pressures – stemming first from the pandemic and later from the war in Ukraine – made their way through the global goods sector before entering services activity. Central bankers panicked in 2022 because they assumed that the evident “broadening” of price pressures was the result of a shift in “inflationary psychology”. But broader does not necessarily mean persistent – and perhaps Team Transitory had just been too optimistic about how long it would take the global economy to adjust. I have always liked the comparison with the period after WW2: while inflationary was ultimately transitory – in the sense that it went away without a monetary response – it took the better part of two years for consumer prices to settle back onto the pre-war trend. Two related points: first, it is important to remember that core services prices are not a clean measure of labour-market developments (because they include a lot of passthrough from goods). Second, a big part of the post-COVID acceleration in wages may also have been a “levels effect”, as companies tried to entice workers back to jobs they did not want to do anymore.

Chart 2: Fed’s special metric of underlying inflation has eased

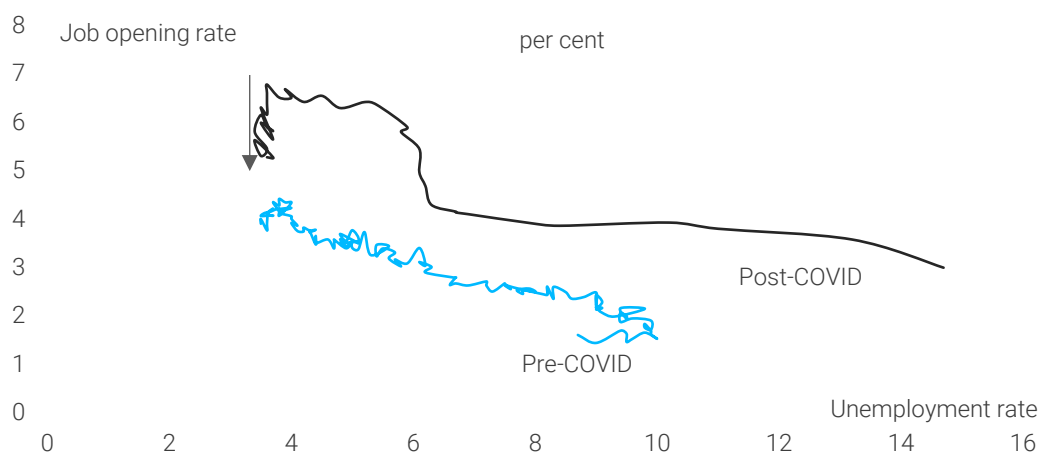


Source: National sources, TS Lombard estimates

- 2 **Running out of excuses:** There has been a big debate about “greedflation” in recent years, a topic that has typically divided economists according to political persuasion. But regardless of the underlying causes – uncompetitive markets, excess demand, supply shortages or whatever – it is clear that the unique circumstances of the past three years made it easier for companies to raise their prices. They always had a convenient excuse, with the media full of stories about broken supply chains and the “cost of living crisis”. Now, as the global economy returns to normal, the public are becoming less tolerant of stinging price hikes (especially when they have already suffered such a serious squeeze on their real wages). To the extent “greedflation” was an actual thing, perhaps it was just a temporary phenomenon. Companies enjoyed a brief period of pricing power, which has now evaporated. (Admittedly, thinking about the issue like this does not really add anything to the debate, since this is just another way of respecifying my first explanation – that post-COVID inflation had similar dynamics to what happened after WW2, when many economists also accused “greedy” corporations of exploiting a difficult situation.)
- 3 **Silent demand destruction:** The transitory debate died as soon as central banks started raising rates aggressively – because it was no longer possible to distinguish between those pure transitory effects and the authorities’ own contribution to disinflation (the whole argument from Team Transitory was that the authorities did not need to respond!). And my

[own research suggests monetary policy has made an important contribution](#). Yet the demand destruction from central banks' aggressive rate hikes has – so far – been happening in a subtle and unusual way. Normally, when we think of policymakers trying to rebalance demand and supply in the labour market, we imagine them raising rates to reduce output and put people out of work – the classic recession. This time, however, a lot of excess demand was “unrealized”, in the sense that there were huge numbers of unfilled job vacancies. Companies wanted to hire workers and expand their businesses, but they were unable to find people with the necessary skills/interests. The crucial point about this dynamic is that central banks have been able to reduce labour demand and rebalance the market simply by destroying those unfilled job openings. Turnover has slowed (people have stopped quitting their jobs for higher wages), which has cured some of the “overheating” we were seeing 12 months ago. The big question – the true recession risk we face today – is whether monetary tightening can be calibrated to achieve such a perfect outcome. Since interest rates are a blunt tool, there is no guarantee the authorities can stay on this narrow path, which seems to be leading to an historically rare “soft landing”. But – we must acknowledge – so far, so good...

Chart 3: US labour market rebalancing – without job losses



Source: BLS, TS Lombard

- 4 **The Phillips curve is bogus:** I started out as an economist in 1998. My first job was to estimate the UK NAIRU for the Treasury. Our estimate – close to the consensus – put the equilibrium unemployment rate at around 8%. Unemployment eventually got to 4%, and there was no sign of a wage-price spiral. It is not an exaggeration, in fact, to say the Phillips curve has failed to “work” throughout my entire professional career. Sometimes the relationship between inflation and unemployment is flat, sometimes it is steep, sometimes it is inverted, and sometimes it does the loop-to-loop. Perhaps the Phillips curve is a figment of economists’ imagination or, worse, a phony way to reconcile the competing demands we have placed on central bankers. Put it this way: if you are a policymaker tasked with delivering both full employment and low inflation with only one policy instrument (interest rates), you must believe those objectives are related in some way or you face an impossible task. It is amazing that the Phillips curve is not illegal, but I guess central bankers – and macroeconomics in general – cannot think of an alternative.
- 5 **The BIS view:** The BIS believes central banks have been lucky so far but that their luck is about to run out. Getting from 9% inflation to 4% was easy but moving from 4% to 2% is going to be an entirely different ball game. Politicians will push back, and financial instability risks

will grow. The problem with this view – apart from the obvious point that it assumes an implicit Phillips curve – is that it is much too fixated on what happened in the 1970s, which is not a good template for the modern economy. But if you want to read more, see my other Daily Notes on the BIS view ([here](#) and [here](#)).

So where do we end up? Obviously, I find immaculate disinflation much less extraordinary than do most economists, who cannot seem to operate without their weird fetish for the Phillips curve. We can debate whether these price dynamics would have happened without such aggressive monetary tightening, but that is mostly a dispute for academics rather than anyone involved in financial markets. (FWIW, my own sense is that a large part of inflation would have been transitory but the response from central banks has helped to guarantee that outcome today – something for which [they will obviously want to take full credit.](#)) The good news is that, so far, the collateral damage from monetary tightening has been much less than feared. We are on the path to a soft landing. [The bad news is that the threat of recession has not completely gone away.](#) It is clear, however, that we have never “needed” a recession to get inflation back down to tolerable levels. There was nothing “inevitable” about it, and [all that analysis based on “sacrifice ratios” was deeply flawed.](#) The only question now is whether we will end up with a recession anyway.