Exchanges at Goldman Sachs

Will Slaying Inflation Require Recession?

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Allison Nathan: In the fight to combat high inflation, the Fed has tightened aggressively, which seems all but guaranteed to continue in the near term, especially given recent higher than expected US inflation numbers. But how much damage to economic growth will the Fed ultimately have to inflict to win this fight? I'm Allison Nathan, and this is Exchanges at Goldman Sachs.

On this episode, we're breaking down my most recent Top of Mind report. The gap between the number of jobs firms are looking to fill and the number of workers looking for jobs remains unusually large in the United States, a clear sign of an overheated labor market. A heated debate has emerged about whether the Fed can alleviate this overheating, which is critical to taming inflation, without a sharp rise in unemployment and its recessionary consequences. That's something that's never happened before.

We speak with the Peterson Institute's Olivier Blanchard and Jan Hatzius, our head of Global Investment Research and chief economist, who are on opposite sides of this debate. Blanchard sees no chance of job openings declining without a large increase in unemployment. He believes that the current difficulty in matching workers with jobs will persist.

Olivier Blanchard: There seems to be a hope of some immaculate conception outcome which basically job openings decrease, and unemployment doesn't increase. It will not happen. There are two reasons. That has never happened. We've had many turnarounds, and each time, vacancies decreased, and unemployment increased. No exception, right? So that's fairly strong evidence.

Now, the issue is that we're at the level of vacancies or job openings which we've never seen before, so we're outside the realm of what we've seen in the past. So anything can happen, by definition. But either side the math and the graphs and everything else, when firms have lower sales, what do they do? They do both, right? First, they stop hiring or they slow down hiring and they lay off.

Now, it may be that they start by decreasing hiring because it's easier to cancel job interviews than lay off people. But you do it at both margins. There are some firms which are going to do it mostly one way. Other firms which are going to do it mostly the other way. The firms which were not hiring to start have no choice. But if you think about what a firm does, it is absolutely obvious that in general it's going to do both, which means, yes, there is going to be a decrease in vacancies and there is going to be an increase in unemployment.

Again, it is such basic evidence and basic logic that I wish it was more widely shared.

Allison Nathan: There's been some observations that people were just looking less for a job because of the pandemic, and those factors should diminish how much weight we put on observations of labor market mismatch right now. What is your view on that?

Olivier Blanchard: So if you'd asked me a year and a half ago, I would have said, yeah, almost surely there are strange things happening in the labor market. You have a need for very sharp relocations of labor due to Covid, due to lockdowns, and so on. And people have very generous unemployment benefits. And so all this together may explain why it's both hard to find people and people are not eager to take the jobs.

I thought at the time that we'd come and go when unemployment benefits came to an end or the checks were spent. The fact is we have not seen that at all. And my sense is we still are in a world where people have changed the way they consider jobs. So you have a job interview, the firm loves you, but you don't love the firm. Then you just don't take the job. There are still a lot of intersectoral relocation. We all know the stories about West France and their inability to find workers. And presumably the workers are working somewhere else. I would not be surprised if there was a bit of a shift back, but so far we haven't seen much. And it seems to me that the shift is there for some time.

In the past, the big shifts have gone and stayed. It took 10-20 years before they went back to something else.

Allison Nathan: We have seen, though, this big decline in job openings and the unemployment rate not rising as much. What do you make from that?

Olivier Blanchard: I think what we're seeing is something which is well known, which is that, when things turn around, when typically vacancies decrease first and then unemployment increases later, so you have a few months typically in which it looks good. Vacancies come down. Unemployment may not move much. But eventually -- and again, for the reasons we discussed -- at some stage, some firms who were not hiring in the first place are going to start laying off. So I think what we've seen the last two or three months is that.

Now, the issue is that we keep seeing the same numbers, meaning job vacancies decrease and unemployment does not increase. Would I worry? I would if I saw that for another three months. I would very much worry that I'm wrong. So we have to accept the fact that it takes a little bit of time, but within six months I have no doubt that we'll have an increase in unemployment if the Fed does what I expect it to do.

Allison Nathan: Hatzius is more optimistic that the labor market can rebalance without a sharp rise in unemployment, even if this would be unprecedented.

Jan Hatzius: At a broad level, I would say that we had an incredibly unusual environment in 2021. We had the fastest GDP growth rate relative to potential in at last four decades. Extremely rapid recovery and output. Still a lot of constraints on supply, labor supply in particular, because of the pandemic, because of the unemployment benefits, and obviously a lot of supply issues more broadly and in global supply chains. So it became a very tight environment, and firms I think scrambled to post job openings because they felt that they were just not going to get enough workers to deal with all the work that was coming in the door.

And so now we're in a post pandemic environment in which a lot of these things are reversing. Demand has slowed very significantly, and supply is improving, probably will continue to improve somewhat. And I think that, in that environment, this really unusual increase in job openings as the labor market moves to a lower level of utilization can unwind in a way that is very tilted towards job openings and not as tilted towards an increase in the unemployment rate.

And there are some early indications that things are improving. The job openings rate is down four tenths of a percentage point even after the somewhat surprising increase that we saw in the July numbers. Four tenths decline in the job openings rate is actually the biggest we've ever seen outside of a recession. We've seen a decline in the quits rate. And employment growth has decelerated in a smooth fashion. So I think we're on a path that is certainly consistent with the idea that we're going to be able to bring down job openings without a massive increase in the unemployment rate.

Allison Nathan: How much comfort can we really take from these recent developments in the data? Just because you would expect that companies would first stop hiring and then start laying off.

Jan Hatzius: It depends on how deep the downturn in growth and in demand is going to be. If where we are now, which is modest positive growth of, say, 1% or so, if that is only an intermediate stop on the path to -2%, then I agree. Then you probably would see more significant layoffs. But I don't think there's any law of nature that says, once you've gone to a 1% growth pace we're going to have to see -2%. I don't really see that as something that has to happen. I don't think it necessarily follows.

Allison Nathan: If we think that a lot of what we're seeing here is just a nature of the pandemic-related effects playing out that are set to unwind, are you at all concerned that at this point we aren't seeing more improvement?

Jan Hatzius: Not really that concerned. I think these things happen in stages, and the deceleration in growth only happened really over the last couple of quarters. Q4 2021 was still very strong, and it takes a while for these things to show up, in part because of data reporting lags. I think it's very hard to be confident of what the timeline is going to be on this, but I wouldn't say that we should have seen a lot more.

Allison Nathan: Blanchard and Hatzius also disagree on whether inflation more broadly can be tamed without a meaningful rise in unemployment. Blanchard doesn't believe it's possible. Here he is again.

Olivier Blanchard: I wish. My answer is “I wish” but it actually is no. So I think there are three factors behind the inflation that we have. The first one is, if matching is worse in the labor market, this means the natural rate is higher, right? Because basically mean no unemployed and more job vacancies to match. I think it's safe to say that pre COVID we were probably at the natural rate, right? So, we were at 3.5 say, right? And if the computations that I've done with [UNINTEL] are right, then presumably the natural rate is probably a point higher. So say 4.5/5. Today, we're at 3.7, which means that the economy is overheating. So that's the first factor that's putting pressure on inflation.

The second factor is commodity prices, energy prices. And I think it's useful to think about why it is that it generates inflation. Why it does because, when this happens, overall pie for workers and firms to share becomes smaller. And so none of the two sides really want this to happen. So the firms increase prices in order to reflect the fact that some of the intermediate inputs are higher. The workers see that and either are in a strong position to bargain, and they say our wages are lagging behind and we want an increase in wages. And then the firms say, sure, we'll give them to you but we're going to reflect that in our prices. And then it keeps going. And as long as either the commodity prices or the energy prices remain high, then that fight is fair and inflation is the outcome. If no side wants to give in and is trying enough not to, then it goes on forever. And what has to happen is unemployment has to increase. So that second factor clearly has played a major role. It says that the unemployment rate that we would need today to avoid that would be even higher than the 4.5% that I gave you.

The third factor is inflation expectations. If for some reason people say, “We don't believe the target of 2% anymore,” but given what has happened [UNINTEL] then you'll have to have higher unemployment in order to convince them that, no, it's 2.

So if you add all these factors, the first one implies that we have to increase unemployment to get to a natural rate. And the other two say that, on unless there is a sharp decline in commodity prices, energy prices, we need to go above that. When above is “I don't know,” but I wouldn't be surprised if it was 6%, for example. If you asked me what probabilities I would put on 7, I would feel bad saying that it's probably positive, but it might well be positive. But if I had to make a median forecast, 6.

Allison Nathan: So if we're looking at unemployment at 6-7%, do you think recession is inevitable?

Olivier Blanchard: I don't think any of us knows what one can do back of the envelope. So take the optimistic assumption that basically we have to go to 5%. We're at 3.7, so we need 1.3 more. So then in terms of output growth, we have to use the so-called opens coefficient, too. Which means that, in order to increase unemployment by 1.3%, you have to decrease growth relative to normal by around 3%. So if you think normal is a bit on the low side of 3, then you get the result that if you want to do this in a year then you probably have to have a recession.

Now, what the Fed has is some leeway in how long, how slowly it fights, right? It can be a really strong fight right away, tries to get to 5% unemployment within a few months. Or it can say we get 5% in a year and a half. My guess is, because commodity and energy prices have stabilized, sometimes decreased, the numbers on inflation are going to be quite good in the next few months. Now, the Fed knows that's not enough. That's not going to get you to 2%, but it can say, look, we've started. We've done a good job. We're now at maybe 4 or 5% at the end of the year. We've no need to basically kill the economy. We're just going to do it more slowly.

And if they can do this and not lose credibility, then, if they give up on the target of 2% and they're willing to go to 3, then these are parameters we can use trying to get where we are to get to such that maybe they avoid a recession. But suppose that we actually have to go to 6 or 7, then you do the same computation and the only way to avoid a recession would be to decrease inflation over three or four years, which the Fed is not going to be willing to do because of credibility.

So if it turns out that what we need to do is 6%, then I just don't see how the Fed will be able to avoid a recession.

Allison Nathan: I would say a fairly severe recession in that case, given the numbers.

Olivier Blanchard: Yes.

Allison Nathan: Hatzius, however, believes that inflation can ultimately be tamed even as he forecasts that unemployment will rise to only 4.2% by the end of 2024. Here he is again.

Can inflation be tamed without unemployment arising a lot?

Jan Hatzius: Yes, because a large part of the inflation that we did see was driven by forces that are temporary in nature and that are now abating. Goods inflation is clearly abating at the moment. Could obviously pick back up again if we saw another surge in energy prices, but the supply constraint part, I think that is behind us for good.

Dollar appreciation probably could be with us for a while longer. And then on the rent side and service side, I think we're also seeing early signs of encouragement. And all that is still with a sub 4% unemployment rate. Is that going to bring us down to 2% or 2.5% or 3%? There are important differences between 2.5 and 3. At 3, I think the

Fed would still be probably inclined to tighten somewhat more. At 2.5, I think they'd probably be fine. If the trend still looks like it's not reaccelerating, that's taming inflation, in my view, even if you're not all the way back down to 2%.

Allison Nathan: Together with the early signs of progress he sees in rebalancing the labor markets and the slower pace of economic growth, Hatzius is a little more confident that the US is heading towards a soft landing.

If you think about our mainline scenario of avoidance of recession, soft landing, have you got more confident, less confident that we're heading in that direction?

Jan Hatzius: Our recession probability is about 30% over the next 12 months can close to 50 over the next 24 months, but I've become a little more confident that we'll manage to pull off a soft landing just because we're seeing some signs of progress in a number of places and I'd say in three categories. One, the slowdown in growth to a clearly below trend but still positive pace is much more of a fact and less of a forecast than it was earlier in the year. And I would say our other indicators would also say slow but still positive growth. Obviously there is the question how long that persists. We need a longer period of low-trend growth, so it will be important to maintain that. But at least we've made that transition.

Number two, at a much earlier stage, we have seen some signs of labor market adjustment. And then lastly, we've seen some improvement in the inflation indicators. A lot of declines in commodity prices, which have yet to feed fully through to CPI. Big dollar appreciation that has yet to fully show up in import prices and then ultimately in consumer goods prices. And a lot of improvement in supply constraints. And I think we're seeing that in measures like supply deliveries and the PMIs but also, more anecdotally, if I go around and talk to corporates, there is definitely a lot more sense that a lot of this has unclogged.

Still less clear on the service side. Probably we're seeing some deceleration in rent inflation. But in part, for statistical reasons because of the way that these numbers are constructed, it's probably going to take a lot longer to bring rent or its equivalent rent to more normal levels.

There are some tentative signs of deceleration in wage growth. There are some wage surveys that the Federal Reserve banks and other organizations like the National Federation of Independent Business run that point to some deceleration, but at the moment it's way too high. A lot of these things are pretty tentative, but it's more visible than it was three or six months ago. So, yeah, I would say I have gotten a little more confident that we'll manage to pull off a soft landing or softish landing. Doesn't mean I'm confident, but a little more confident.

Allison Nathan: With questions about how much the Fed will have to tighten to combat inflation and the implications for growth sure to remain in focus, we'll continue to keep a close eye on the fight from here. I'll leave it there for now. If you enjoyed this show, we hope you follow on your platform of choice and tune in next week for another episode of Exchanges at Goldman Sachs. Make sure to like, share, and leave a comment on Apple Podcasts, Spotify, Stitcher, Google, or wherever you listen to your podcasts.

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