



Is disinflation different this time around?

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Over the past year, the view that a recession would be needed to enable the Fed to achieve its firm target of returning inflation to 2% has gone from long shot to consensus view to, essentially, a coin toss. In their recent US Economic Perspectives report, Deutsche Bank Research attempts to answer the question: *Recession or soft landing: Is disinflation different this time?*

Here are some of the highlights:

- We have been in the recession camp from the start but recent developments in the US economy increase the possibility of a soft landing, even if this is not yet the most likely outcome. Hence, our baseline forecast remains for a mild US recession to begin in Q4. While timing is always tricky, the case for recession remains compelling, based on several considerations:
 1. Historical experience with central-bank induced disinflation has provided no precedent for a soft landing in relation to the current inflation backdrop;
 2. The extent to which elevated core price and wage inflation continues to be driven by excess demand and tight labor markets;
 3. Empirical evidence that the inflation process recently has looked more like it did during the Great Inflation period of the past;
 4. The strong signals of impending recession that have been sounding from historically reliable leading indicators.
- At the same time, the case for disinflation with a soft landing has gained considerable currency, given favorable developments of late. These include:
 1. The uniqueness of the pandemic shock, such as the significance of global supply chain disruptions, which touched off the current inflation episode and renders history an imperfect guide, at best;

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2. Structural changes in the labor market, such as the decline in unionization, which make it less prone to persistently elevated inflation;
 3. The benefits of the Fed's hard-won credibility, which has helped to anchor inflation expectations much lower than in the past, even in the face of some greater inflation persistence;
 4. Model-based evidence in light of those still well-anchored expectations that disinflation can occur at a much lower cost than in the past.
- On balance, these considerations make forecasting a mild recession versus a soft landing a much closer call, but not yet one that warrants a change. Inflation has been behaving better than expected recently, even in the face of an economy that has held up reasonably well. But there is still a way to go until the economy is close enough to the Fed's objectives. For this reason, the US central bank is still in tightening mode, as we believe it should be. Moreover, the long and variable lags in monetary policy suggest the economy may only now be entering the front edge of the period when the effects of significant policy tightening have peaked historically.

In conclusion, the research team sees the line between mild recession and soft landing as increasingly fine. If the coming months, indeed weeks, provide further evidence of soft-landing dynamics – resilient growth and labor market data meet with softening wage and price inflation as the economy comes into better balance – this could tip the scales in favor of the view that this time is different enough to warrant a soft landing.