Who’s to blame for the good news on inflation?

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What a difference a year makes.

Around this time last year there was a lot of debate, some of it ill tempered, about who deserved blame for soaring inflation. Now most of that is gone, replaced by a debate, some of it ill tempered, about who deserves credit for the rapid decline in inflation.

The one nice thing one might say about the current debate is that it doesn’t seem to involve nearly as much partisanship. Unfortunately, the reason it’s fairly nonpartisan is that many ardent Republicans appear to live in the Fox Cinematic Universe and either haven’t noticed or refuse to acknowledge that inflation is, in fact, way down.

What remains is an argument between those who credit the Federal Reserve, which has certainly been trying to reduce inflation by rapidly increasing interest rates, and those who attribute disinflation to Long Transitory — a term I think I coined. That is, they argue that inflation is falling because the economy is finally unsnarling the kinks created by the Covid-19 pandemic and its aftereffects.

Here's the reason for the argument: As I documented the other day, as of late last year most economists expected Fed rate hikes — which have driven mortgage rates to a 21-year high — to reduce inflation. But they expected this disinflation to come at the cost of a substantial rise in unemployment. After all, that's how it works in standard economic models.

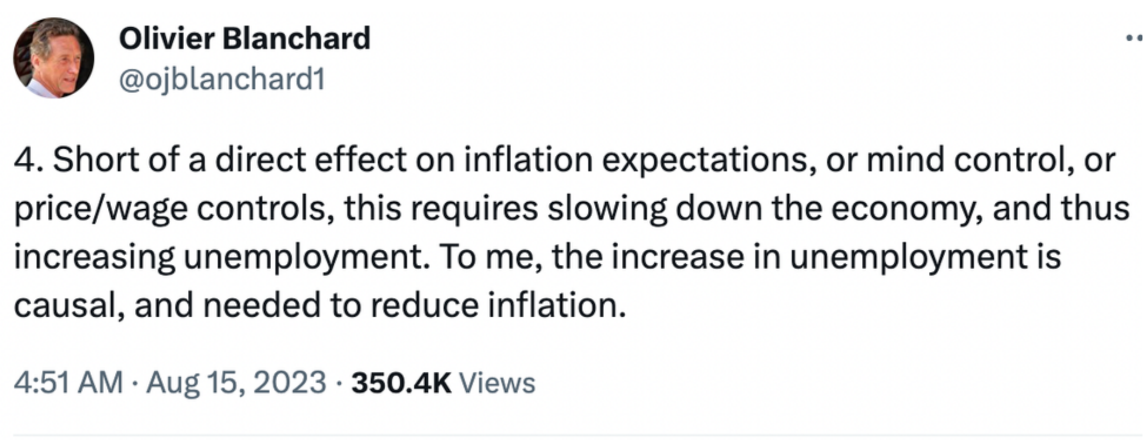
But while the disinflation came, the rise in unemployment hasn't, at least so far. And other measures of labor market strength, like the employed share of prime-age adults, have improved to levels not seen in decades. So how can we give credit to the Fed for disinflation when the mechanism through which monetary policy is supposed to reduce inflation doesn't seem to be operating?

One possible answer is that this mechanism actually is operating but is basically invisible in the fog of imperfect data. Lately quite a few economists have become converts to the idea of a nonlinear Phillips curve. What this means in something resembling plain English is that inflation isn't very sensitive to unemployment when the labor market isn't tight but becomes very sensitive when jobs are abundant and workers scarce. Since we've had very tight labor markets recently, this view argues that the Fed wouldn't have to raise unemployment by much to get inflation down — and given the imprecision with which we measure unemployment, a small rise in true unemployment might get lost in the official data.

I have been sympathetic to this view but have become less so recently, for reasons I’ll explain in a minute.

Some economists giving the Fed credit for lower inflation have been making a different argument, which I think of as “contactless” monetary policy — the claim that monetary tightening can directly reduce inflation, without having to cause unemployment along the way. For example, Ricardo Reis of the London School of Economics argues that while inflation-reducing rate hikes may sometimes lead to higher unemployment, “that is a side effect, not the causal channel.”

This argument provoked an acerbic response from Olivier Blanchard of the Peterson Institute for International Economics, who, you should know, isn’t just one of the world’s most respected macroeconomists but also normally a very even-tempered kind of guy:



Olivier Blanchard
@ojblanchard1

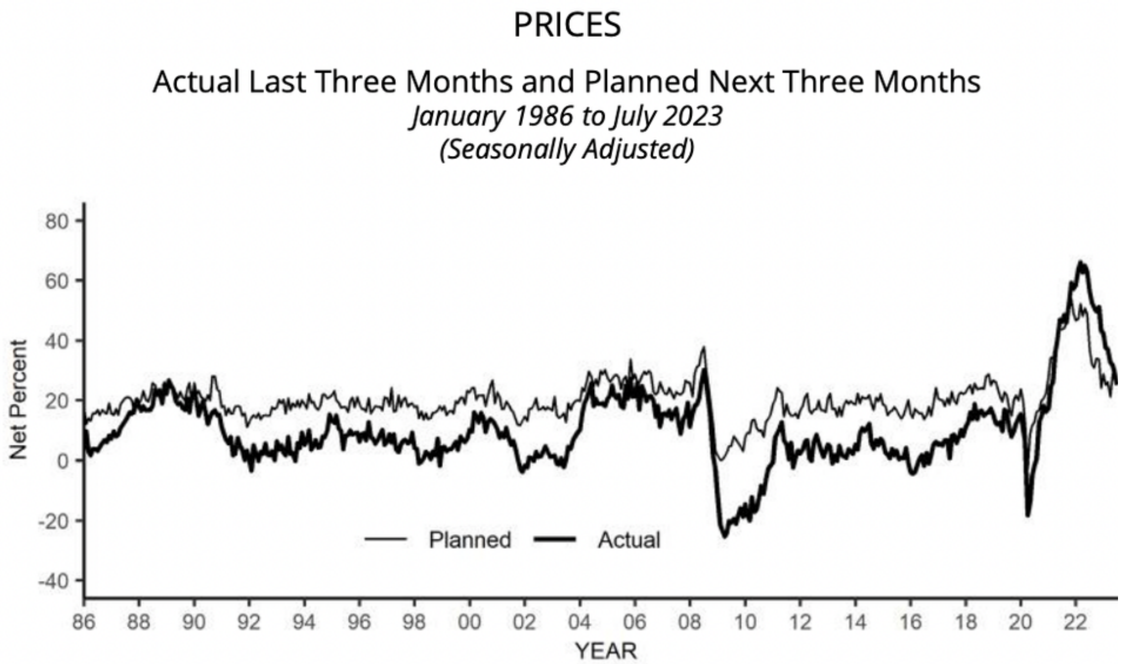
4. Short of a direct effect on inflation expectations, or mind control, or price/wage controls, this requires slowing down the economy, and thus increasing unemployment. To me, the increase in unemployment is causal, and needed to reduce inflation.

4:51 AM · Aug 15, 2023 · **350.4K** Views

I'm with Blanchard here. It's always important to remember that economics is about what people do and that when you make an argument about the effects of economic policy, you should have at least some plausible story about how the policy affects the behavior of specific people.

In this context, I find it especially helpful to focus on small businesses, not out of any special affection for the little guys but because (a) we have regular surveys of small-business perceptions and intentions from the National Federation of Independent Business and (b) we can be reasonably sure that small-business owners aren't watching Fed press conferences and carefully parsing Jerome Powell's words to guide their pricing decisions.

Now, the N.F.I.B. survey doesn't directly ask respondents about the rate of inflation. Instead, it asks whether they are increasing or reducing prices and reports the resulting "diffusion index," the difference in number between those increasing and those reducing. Such diffusion indexes tend, however, to track economic data quite well. So here's the resulting inflation index:



National Federation of Independent Business

As you can see, the N.F.I.B. survey looks a lot like official inflation data: It shows a sharp rise in 2021-22, then a steep fall that has brought us most, but not quite all, of the way back to prepandemic inflation.

This result is useful for several reasons. One is that it serves as a rebuttal to inflation truthers who claim that the government is faking the price numbers — yes, they're back. Well, here's a private survey that tells the same story as the government numbers. (And for what it's worth, small-business owners lean Republican.) Another reason is, as I've already pointed out, small businesses are unlikely to be parsing Fed statements and making pricing decisions based on their perceptions of Fed credibility.

Finally, if you reject contactless disinflation but believe, nonetheless, that the Fed is driving inflation down by weakening the economy, albeit in ways that aren't showing in official data, well, that weakness isn't showing in business perceptions either. Here's how the N.F.I.B. puts it:

> Waiting for Gadot: The long anticipated, predicted, recession is nowhere to be seen (almost). Recessions can start quickly (2020 shutdown) and end quickly (2020 reopening). Or they can start slowly, for example, due to opposing forces like expansionary fiscal policy vs. contractionary monetary policy. The Fed staff (not F.O.M.C.) has changed their recession forecast to a "slowdown." There is more talk about a "soft landing" and less of a recession. The shifting outlook is often confusing but even less clear is, can the Fed reach its 2% inflation target (P.C.E. deflator) without a significant slowdown in economic activity (e.g., slower wage cost growth)? The manufacturing sector is clearly slowing, soft all year (I.S.M.) but services are doing well (I.S.M.). Business investment is solid (lots of government incentives), and housing is ignoring 7% mortgage rates.

OK, I don't think businesses are waiting for Wonder Woman. But typo aside, this really doesn't sound like an economy in which businesses are forgoing price hikes because of weak demand, in such a way that that we're currently sliding down the steep part of the Phillips curve. It sounds like an economy in which inflation is coming down because of improved supply, not reduced demand.

Does this mean that the Fed was wrong to raise rates? Not necessarily. If it hadn't raised rates, the economy might be running really, really hot. The Atlanta Fed's GDPNow tracker currently shows the economy growing at 5.8 percent (!!!), which isn't really plausible but does suggest a lot of heat; so the Fed may not have caused disinflation, but rate hikes may have been necessary to permit disinflation caused by other forces. Or, if you like, the Fed may have done the right thing for the wrong reasons.

In any case, I'd urge economists to look up from their models now and then and remember that they're talking about people. Oh, and let's celebrate the good inflation news, whoever we think should get the credit.