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A Deep Recession May Be Needed to Restore Price Stability

The San Francisco Fed created an inflation metric that breaks prices into two components. One is **acyclical**, meaning that its trend is not correlated with the business cycle. The other is **cyclical**, meaning its movements are highly correlated with changes in real GDP growth.

Acyclical prices account for 58% of the core PCE deflator with healthcare services the dominant subcomponent at 35%. Cyclical prices account for the remaining 42% and capture such spending categories as housing, recreational services, and restaurants.

As illustrated in the chart below, **both acyclical and cyclical prices are rising rapidly**. Over the past 12 months, acyclical prices are up 4.1%. While this is down from their cyclical peak of 5.5% last February, it is more than double its sub-2% trend that persisted for the two decades prior to the onset of the pandemic.

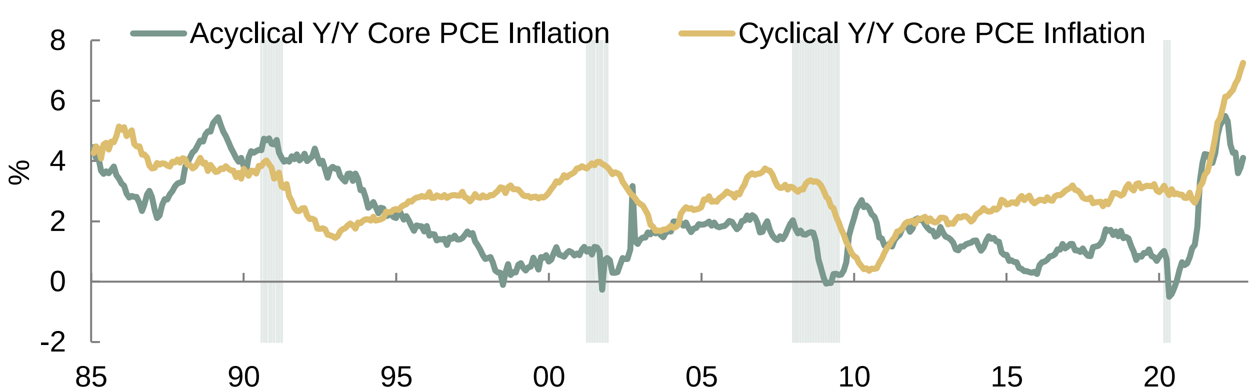
Meanwhile, cyclical prices continue to rise with the year-over-year rate up to 7.3% in September. This is the largest annual gain in record, and the series is showing no evidence of slowing, at least not yet.

Recessions cause inflation to slow, and cyclical prices tend to slow more as theory would predict. During the 1990-91 recession, they fell from 4.0% to 1.5%. In 2001, they also peaked at 4% and went down nearly as much to 1.7%. During the 2008 recession, cyclical prices were 3.4% and then fell to just 0.4% in 2010.

Acyclical prices went down sharply following the 1990-91 downturn but generally do not fall as much as cyclical prices do during recessions. If acyclical prices continue to grow at 4%, then **cyclical prices will have to decline by an annualized 1% rate to bring core inflation back to 2%**.

Since cyclical prices have never shown an annual decline, either the Fed may have to abandon its 2% inflation target or engineer a much deeper than anticipated recession. Stay tuned.

If acyclical prices do not slow, then cyclical prices will be need to decline to 2% to restore core inflation



Sources: Federal Reserve, Haver, SMBC

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