Monetary Tightening, the Likelihood of a 'Soft Landing' and the Beveridge Curve in the US and the UK

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This short article reviews the current phase of monetary tightening in the US and the UK, summarises some differing opinions on the likelihood of a 'soft landing', and examines how these differences can be characterised, in large part, by differing views on the Beveridge curve.

Monetary tightening

The UK and US Central banks are now well into the current phase of tightening monetary policy, deemed necessary to bring inflation back under control. The Bank of England's Monetary Policy Committee (MPC) enacted the tenth successive hike on February 2nd, the day after the US Federal Reserve's Federal Open Market Committee (FOMC) raised the target range for the Federal Funds rate for the eighth time.

Table 1: The current phase of monetary tightening in the US and the UK

FOMC Decision	Federal Funds Rate	Bank of England MPC Decisions	Bank Rate
March 15, 2020	0 - 0.25	March 19, 2020	0.1
No change until…		No change until…	
		December 16, 2021	0.25
		February 3, 2022	0.50
March 16, 2022	0.25 - 0.50	March 17, 2022	0.75
May 4, 2022	0.75 - 1.00	May 5, 2022	1.00
June 15, 2022	1.50 - 1.75	June 16, 2022	1.25
July 27, 2022	2.25 - 2.50	August 4, 2022	1.75
September 21, 2022	3.00 - 3.25	September 22, 2022	2.25
November 2, 2022	3.75 - 4.00	November 3, 2022	3.00
December 14, 2022	4.25 - 4.50	December 15, 2022	3.50
February 1, 2023	4.50 - 4.75	February 2, 2023	4.00

Sources: US Federal Reserve and Bank of England.

The Likelihood of a Soft Landing

A "soft landing" in this context refers to a scenario in which monetary tightening results in moderating demand just enough to bring down inflation without the economy falling into recession.

Officials of the US Federal Reserve have consistently been upbeat on the chances of achieving a soft landing for the economy. For example, Jerome Powell, Chair of the US Federal Reserve, pointed to a good chance of achieving "a soft or softish landing" with monetary tightening moderating demand and bringing the extraordinarily high level of vacancies down "fairly significantly", reducing pressure on wages and helping reduce inflation, "without unemployment rising materially" Powell (2022:6). Governor Christopher Waller went further in suggesting it is plausible that "the vacancy rate can be reduced substantially, from the current level to the January 2019 level, while still leaving the level of vacancies consistent with a strong labor market and with a low level of unemployment, such as we had in 2019." Waller (2022:9).

This optimistic view is not shared by all. Olivier Blanchard, Alex Domash, and Lawrence Summers (hereafter BDS) are sceptical, warning "it is highly unlikely that the decrease in the vacancy rate can be achieved without a substantial increase in the unemployment rate" and conclude that the Federal Reserve officials' hope for a soft landing "flies in the face of theoretical and empirical evidence" BDS (2022a:2,13).

The Federal Reserve spelt out their view in more detail in Waller and Figura (2022), but in a robust reply titled "The Fed is wrong: lower inflation is unlikely without raising unemployment", BDS (2022b), suggested that Waller and Figura's analysis has "misleading conclusions, errors, and factual mistake". The public disagreement has grabbed some headlines in the New York Times and the Financial Times (Krugman 2022, 2023, Armstrong and Wu 2022a,b and Wu 2022). Successive data releases are being watched with heightened interest.

In the UK, the Bank of England has been less optimistic than the Federal Reserve, even before the challenges presented by the intense political instability last autumn. The May 2022 Monetary Policy Report included a forecast rise in the unemployment rate to 6.5% by 2025; this was seen as necessary to help moderate wage claims and bring down inflation.

They were markedly more pessimistic in November, but the February 2023 forecast suggests a relatively more favourable outcome, with unemployment reaching 5.3% in 2026. The Monetary Policy Committee's central projection now suggests "the weakness in labour demand is more likely than usual to be met by a reduction in job vacancies rather than by an increase in redundancies" Bank of England (2023:53).

The Beveridge Curve

Differing perceptions of the Beveridge curve are critical to the debate on whether monetary tightening will result in a soft landing or a painful recession.

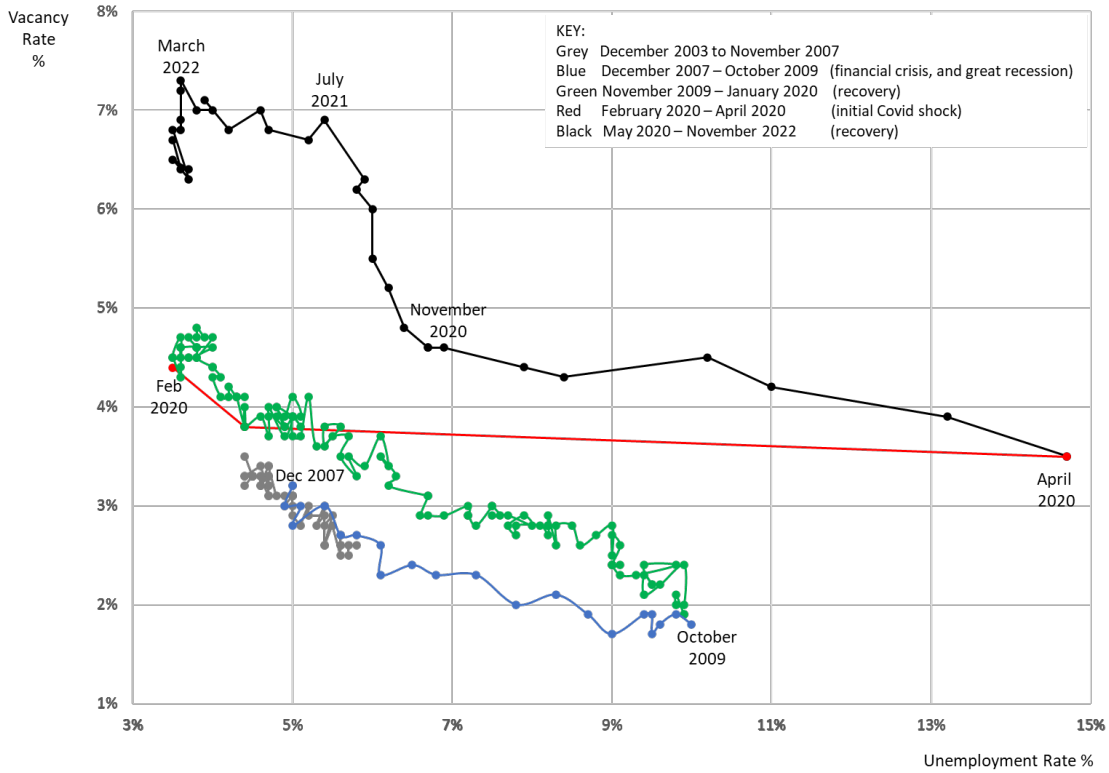
The Beveridge curve, named after the British economist, politician, and social reformer William Beveridge, is a graphical representation of the typical inverse relationship between job vacancy and unemployment rates. The inverse relationship reflects the general empirical regularity that as economic activity declines, fewer job vacancies are posted, and the unemployment rate rises, resulting in a move down to the right along the curve. Conversely, as economic activity recovers, more job vacancies are posted, and the unemployment rate declines, resulting in a move up along a Beveridge curve. It is, therefore, usual for points on the curve to follow a counter-clockwise loop over an economic cycle.

Past data fit this pattern well. For example, data for the period following the 2007/8 global financial crisis, the great recession and subsequent protracted recovery fall into this pattern for the US, the UK, and many other countries. The downturn is shown in the blue portion of Chart 1A and Chart 1B, while the upturn is coloured green.

Although a stable Beveridge curve can be observed over various periods, it has not always remained in the same position. For example, during the recovery from the great recession, the green sections of the US and UK Beveridge curves shifted out relative to the blue portions capturing the downturn and the grey points showing pre-financial crisis data.

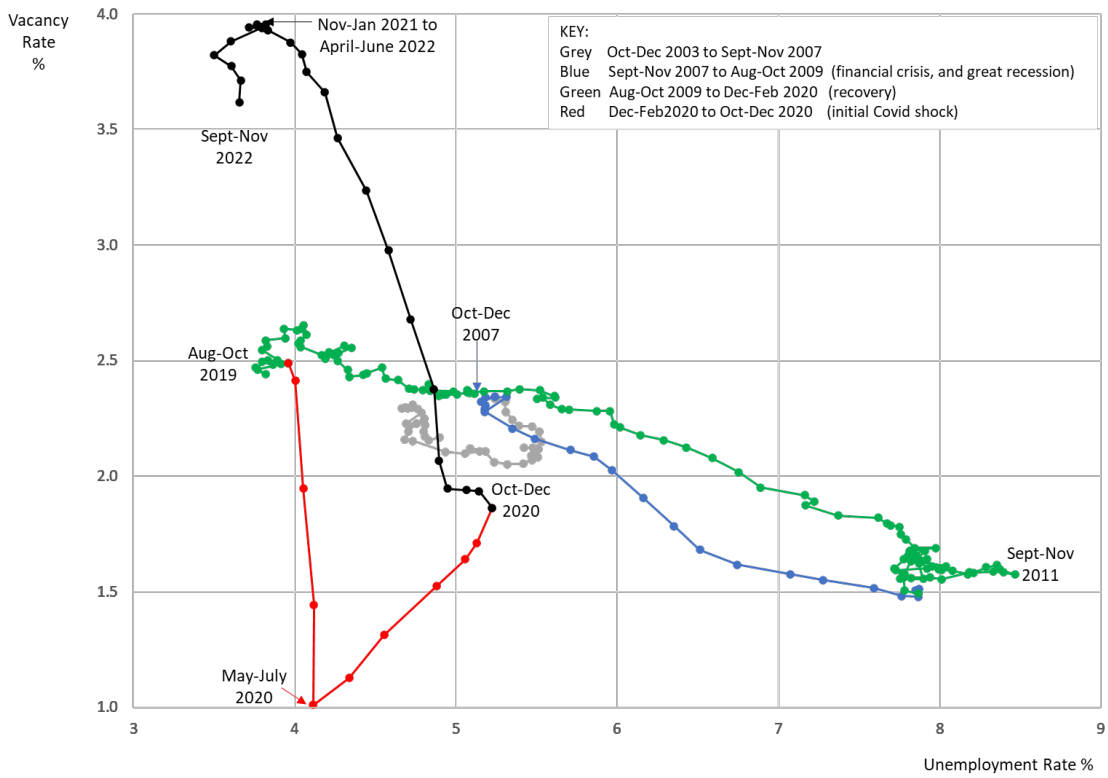
Explanations proposed for this outward shift include a rise in skill-based and regional mismatch and a cyclical reduction in hiring intensity. The skill-based mismatch reflected the substantial effect of the downturn on the housing construction industry. Construction workers who lost their jobs did not match well with the vacancies available in the early stages of the recovery. The increase in geographical mismatch reflected the limited

Chart 1A: The US Beveridge Curve



Source: Bureau of Labour Statistics and own calculations.

Chart 1B: The UK Beveridge Curve



Source: Own calculations and Office for National Statistics

mobility of some job seekers, a consequence of the collapse in house prices and high rates of home ownership. Many homeowners were trapped in a house that was worth less than they had paid for it, unable to sell and move to an area with more job vacancies, and consequently restricted their choice of jobs (Sterk 2015). Alongside these changes, the slack labour market made it easier for employers to hire in general, so less recruiting effort was required to achieve the same job filling rate.

Disruption to the pre-pandemic Beveridge curve

Early in the Covid pandemic, the US labour market saw a substantial fall in the vacancy rate and a rapid increase in the US unemployment rate to exceed 14% in April 2020. Initial job losses were particularly concentrated in contact-intensive sectors such as hospitality and travel. In the UK, the unprecedented support for the labour market during lockdowns through furlough and other schemes prevented a corresponding rise in the unemployment rate. This disruption is evident in the red portions of Charts 1A and 1B. In both countries, the pre-Covid Beveridge curve relationship had broken down.

BDS and others (e.g. Barrero et al. 2021) see the COVID-19 recession and recovery as having created a massive reallocation shock. The uneven impact of the pandemic led to a mismatch between those looking for work and the jobs available. Those entering the labour market for the first time during the pandemic and others who lost their jobs early on did not have the necessary skills and experience to move into the advertised jobs. Clearly, a school leaver or a former worker in the hospitality sector would not have been able to take up a job as a respiratory nurse on a Covid ward. Jobs openings that were perceived to involve a high risk to personal health attracted fewer applicants, and there was reluctance among workers with specific skills that were not needed during the pandemic to switch into lower-paid occupations with lesser skill requirements. An unemployed former airline pilot would be unlikely to switch directly to a job as a supermarket delivery driver. These factors, combined with temporarily increased unemployment benefits, were likely to result in longer periods spent searching for alternative forms of work.

As the unemployment rate rose, more people were looking for jobs, and the most attractive vacancies attracted many more applications. This effect was exacerbated by the fact that a higher proportion of the jobs on offer involved working from home were advertised online

and seen by a large number of potential applicants. Faced with a much larger pool of applicants, employers have a much harder job selecting the best candidates.

Such arguments can potentially explain a shift out in the pre-pandemic Beveridge curve; this also looks consistent with the data. The black portion of Chart 1A seems to trace a Beveridge curve that is positioned considerably further out than the pre-pandemic curve. It's worth pointing out that the Bank of England discusses the UK Beveridge curve in the February 2023 Monetary Policy Report. Their version of the curve differs from Chart 1B since they increased the recorded unemployment rate over the period March 2020 to September 2021 to reflect an MPC judgement that 10% of workers who had been furloughed were actively searching for work, Bank of England (2023:83). This adjustment results in a considerably less steep portion of the rising black section of the curve in Chart 1B.

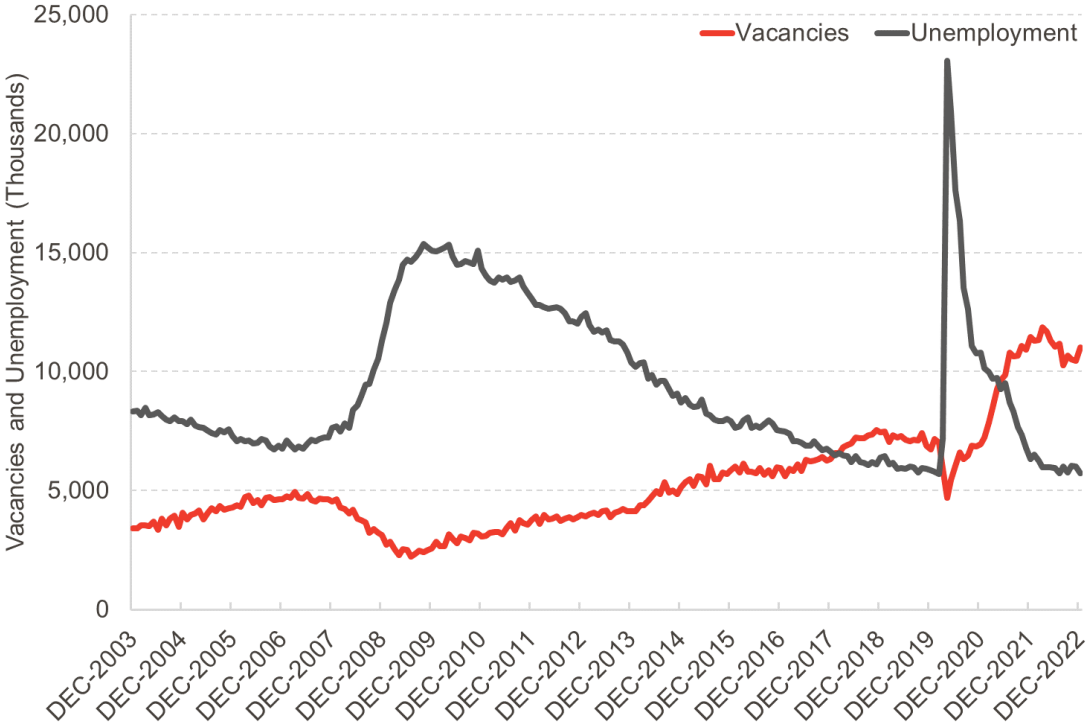
BDS believe that monetary tightening will see the US economy contracting along a Beveridge curve that has yet to shift back to its pre-pandemic position, raising the unemployment rate. They draw on historical evidence, focusing on what happened to the unemployment rate in the two years following each of nine local peaks in the vacancy rate between 1953q1 and 2007q1. In every case, the unemployment rate rose and "the average of the ratio of the change in unemployment to the change in the vacancy rate was −0.4 after 6 months, and increased to −0.7 after 12 months and −1.5 after 24 months." BDS (2022a: 13). Figura and Waller and others at the Federal Reserve do not share this view.

Reasons to be optimistic

The optimism of officials at the Federal Reserve reflects their belief that most of the pandemic-related disruptions to the US labour market look to have been short-lived. The unemployment rate had halved by November 2020.

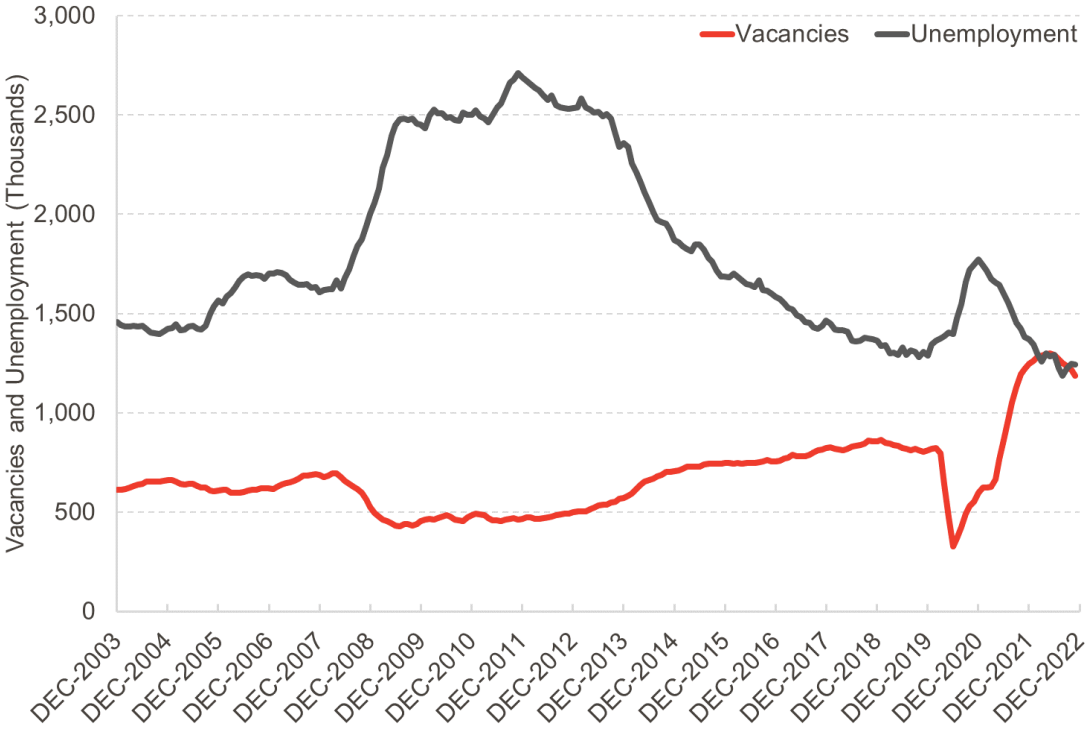
A wide range of indicators, in particular, record highs in vacancies relative to the number of people out of work and searching for jobs since the end of 2021, have pointed to the tightness of the US labour market (see Chart 2A and Chart 3). In the UK, vacancies have also reached unprecedented levels relative to the number of unemployed workers seeking jobs (Chart 2B and Chart 3).

Chart 2A: US Vacancies and Unemployment December 2003 – December 2022



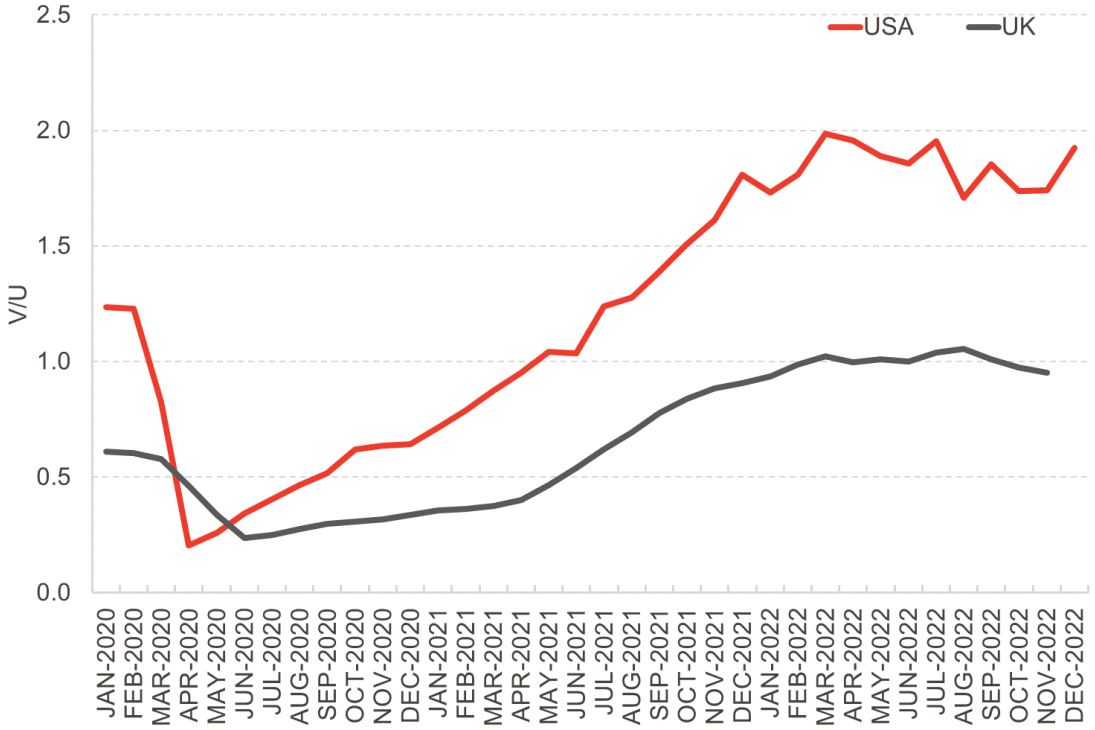
Source: Federal Reserve Economic Data and Bureau of Labour Statistics.

Chart 2B UK Vacancies and Unemployment December 2003 – November 2022



Source: ONS (figures are 3 month averages).

Chart 3: The Ratio of Vacancies to Unemployment, USA and UK since January 2020.



Sources: as indicated in Charts 1 and 2.(UK data are 3 month averages)

Figura and Waller believe the post-Covid recovery has resulted in the US economy settling on a “steep extension” of the pre-pandemic Beveridge curve, from where a given decline in labour demand can reasonably feed through to a decline in vacancies but see a much smaller increase in the unemployment rate. It follows that they believe monetary tightening can result in a decline in labour demand, with fewer vacancies and hopefully avoiding layoffs, such that the economy moves down the steep section of the Beveridge curve. The potential for a very small rise in the unemployment rate is consistent with a soft landing. This would be good news relative to moving down a flatter Beveridge curve.

They “recognize that it would be unprecedented for vacancies to decline by a large amount without the economy falling into recession... we are, in effect, saying that something unprecedented can occur because the labor market is in an unprecedented situation. Because the V-U ratio is so high currently, it is possible to reduce vacancies with a much smaller effect on hiring than is typical.” Figura and Waller (2022:8).

This outcome is, of course, more likely if monetary policy dampens demand for the goods and services provided by companies that have been facing particular difficulties in filling job

openings. For example, if inflation and monetary tightening cause households to cut back on eating out, unfilled vacancies in the hospitality sector are no longer required. But tightening monetary policy is a blunt tool in this regard. It is asking a lot for the areas of acute labour shortages to match the fall in demand. Nonetheless, a more nuanced understanding of the remaining areas of labour market tightness would be beneficial.

An alternative, but still relatively optimistic view, is that as hiring has picked up and the considerable reallocation of labour caused by the pandemic has worked through, the US economy is now experiencing a shift down in the Beveridge curve towards its pre-pandemic position. In these circumstances, there is scope for hiring intensity to cool off and matching efficiency to improve.

It is hard to believe that all the pandemic-related disruption has dissipated.

Alongside the changes outlined so far, the US and the UK have also seen reductions in the labour force and rises in inactivity rates; these will have exacerbated the tightness of the labour market. In the short term, the fear of contracting the virus and high numbers of quarantining workers reduced labour supply. While these initial drivers have lessened, there is evidence of individuals having brought forward their planned future retirements by a few years and others exiting from the labour force due to long-term illness or taking on caring responsibilities. Brexit and the consequent loss of EU migrants has also been a factor in the UK. The extent to which these effects are behind the recent tightness of the labour market, and are still unwinding, is unclear.

The current phase of monetary tightening has so far seen high vacancy rates fall somewhat, with very little change in the unemployment rate.

The most recent data points in both Charts 1A and 1B show local peaks in vacancy rates in March 2022. Subsequent declines have yet to be accompanied by any marked increase in the unemployment rate. Yet this is not sufficient to make a call on delivery of a soft landing. Nor is it clear that the current phase of monetary tightening is over.

BDS stress that we should learn from history. They specifically look at what happened to the unemployment rate in the two years following each of nine local peaks in the vacancy rate between 1953q1 and 2007q1. In every case the unemploymen rate increased and “the

average of the ratio of the change in unemployment to the change in the vacancy rate was −0.4 after 6 months, and increased to −0.7 after 12 months and −1.5 after 24 months." BDS (2022 a:13).

While BDS (2022b) accept that the initial vacancy rate when monetary tightening began was unusually high, they are unconvinced by Figura and Waller's analysis. They stress that the question of whether declines in vacancies will involve lesser increases in unemployment when the initial vacancy rate is high needs to be addressed empirically. Their historical analysis further suggests that the typical dynamics are such that rises in the unemployment rate tend to peak some two years after the peak in vacancies.

While the early data look promising, the jury on whether a soft landing will be achieved is still out.

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