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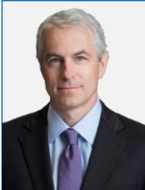
A Close VIEW

Hard Truths on Soft Landings

MARCH 31, 2022



Authored by Steven Friedman
Senior Macro Economist

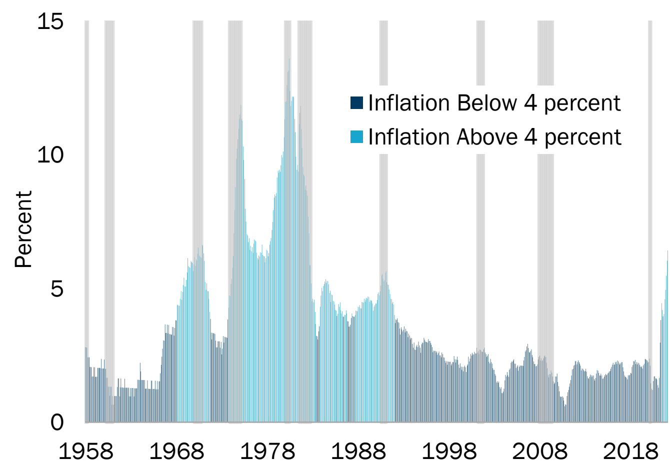
In his first speech following the March FOMC meeting, Chair Powell noted that the historical record provides "some grounds for optimism" regarding prospects for a soft landing. But focusing on periods of high inflation suggests this optimism may be ill-founded.

Give credit where credit is due. In his first speech after the March Federal Open Market Committee meeting, Chair Powell tackled head-on the topic on everyone's mind: the prospects that the Federal Reserve can achieve its price stability objective without tipping the economy into a recession. Such "soft landings" for the US economy have occurred, but not often. Powell noted three instances when the Federal Reserve raised rates to address a possible overheating of the economy without causing a subsequent recession: 1965, 1984, and 1994. He also highlighted the 2015–2019 tightening period, which likely would have ended in a soft landing if not for the pandemic. Based on this record, Powell noted "some grounds for optimism" that the FOMC can achieve a soft landing in the years ahead.[1] In fact, Powell highlighted that a soft landing is the Committee's current base case, as reflected in the most recent Summary of Economic Projections, with inflation projected to moderate and GDP growth slowing toward its potential rate of growth in the years ahead.

But Powell's historical framing of the issue is somewhat misleading and injects a bit too much optimism into the medium-term outlook. The real question is, how successful has the Fed been at achieving soft landings during periods of high inflation? Reframing the question this way suggests a less rosy outlook. Figure 1 shows the historical record: year-over-year core CPI inflation, with instances of high inflation (defined as over four percent) indicated in light blue. During the high-inflation period from 1969 to 1982, there were four recessions. In fact, the economy was in recession almost a third of the time. If we extend the window out to the 1990-91 recession, which also occurred amid high inflation, the economy was in recession over 20 percent of the time, compared to eight percent of the time in the three decades since then.

When inflation is high, soft landings are hard to achieve because the central bank has much less flexibility to respond to weaker growth. Thus it should come as no surprise that only one of the soft landings that Powell mentions, following the 1983-84 tightening period, occurred amid high inflation. In fact, narrowing in on high-inflation periods when the Fed was

FIGURE 1: CORE CPI INFLATION



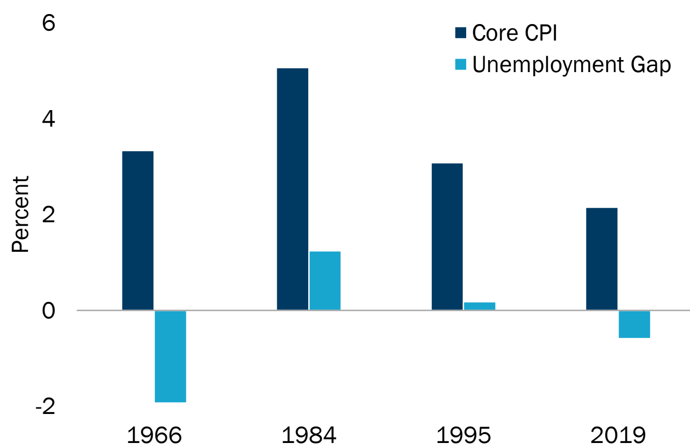
Source: Bureau of Labor Statistics, National Bureau of Economic Research. Grey shading represents recessions

1. Jerome Powell (2022), "Restoring Price Stability," speech delivered at "Policy Options for Sustainable and Inclusive Growth," 38th Annual Economic Policy Conference, National Association for Business Economics, March 21.

also raising rates, a recession occurred within one year 48 percent of the time. The historical probability jumps to 69 percent over a two-year horizon.[2]

Even the 1984 soft landing may give false comfort regarding the prospects of a soft landing over the next few years. The economic backdrop back then was entirely different from today. In 1984, the unemployment rate was 7.5 percent, well above the Congressional Budget Office's estimate of a "neutral" or full employment rate of unemployment, as the chart below shows. Hence, the Committee had more justification for focusing on risks to growth, which a read-through of meeting documents from that time period suggests were quite elevated.[3] The 1984 pivot also occurred before the era of central bank inflation targeting, giving the Fed more flexibility in balancing growth and inflation risks.

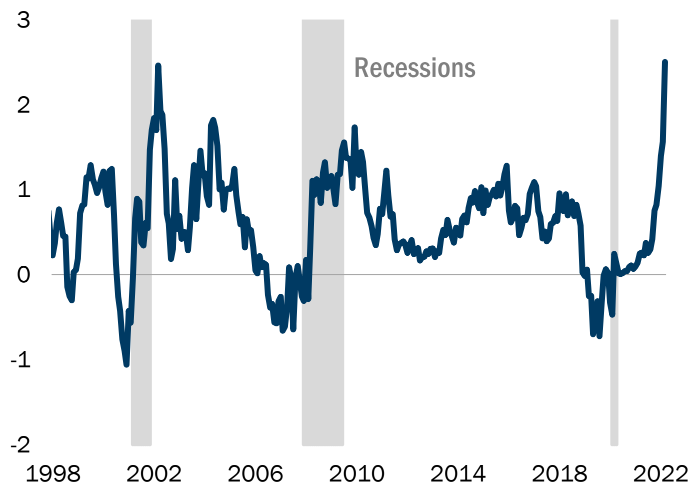
FIGURE 2: SOFT LANDINGS: ECONOMIC CONDITIONS WHEN THE FED STOPPED TIGHTENING



Source: Bureau of Labor Statistics, Congressional Budget Office, MacKay Shields

None of this is to say that a recession is imminent, or even "baked in the cake". In fact, while the slope of the 2- to 10-year Treasury yield curve is on the verge of inverting, the front of the Treasury curve remains quite steep, suggesting limited recession risks for the next 12 to 18 months. But unless inflation moderates significantly over this period, the path to a soft landing beyond then will become increasingly narrow.

FIGURE 3: NEAR-TERM FORWARD TREASURY SPREAD



Data as of March 29, 2022.

Source: Board of Governors of the Federal Reserve System, National Bureau of Economic Research, Bloomberg. The near-term forward spread is the differential between the implied forward rate on a 3-month Treasury bill six quarters shading represents recessions.

2. Based on 104 monthly observations from 1958 through 2019 where the economy was in an expansion, year-over-year core CPI inflation was at or above four percent, and the policy rate was higher than six months prior.

3. For example, the record of policy actions at the October 2, 1984 meeting, at the start of the pivot towards an easier policy stance, noted weaker consumer spending, a sharp fall in household employment, a cooling housing market, slower business fixed investment, and concerns over dollar appreciation. While inflation was high, it was well off the extreme levels seen earlier in the decade, and Committee members were encouraged by underlying trends, including lower inflation expectations.

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