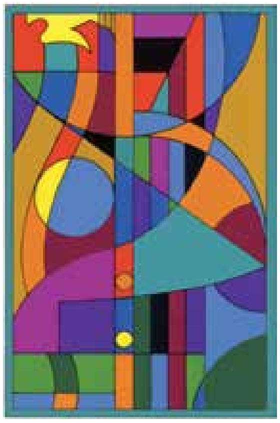
THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com



View from the Beltway

That Elusive Soft Landing

By Owen Ullmann

And the Fed's difficult circumstances.

As the Federal Reserve guides an economic expansion already in record territory for durability, it is striving to pull off a rare "soft landing"—moderate growth that keeps unemployment low, inflation in check, and avoids the hard landing of a recession.

The term was coined by former Fed Chairman Alan Greenspan, who pulled off the last soft landing in 1994–1995, when he and his colleagues on the Federal Open Market Committee deftly lifted interest rates just enough to dampen inflationary pressures without sending the economy crashing into a downturn.

Greenspan gets special credit for persuading the FOMC to avoid overtightening because he correctly realized that a sizeable jump in productivity was keeping inflation below 3 percent, even though unemployment fell below 6 percent and the economy continued to grow at a healthy rate of 3-plus percent. The economic consensus at the time was that the productivity boost was transitory, but Greenspan believed it had legs because of the internet-driven technology revolution. He was right. Productivity rose from a rate of 1.5 percent in the 1980s to 2.2 percent in the 1990s and 2.7 percent from 2000 until the end of 2007, when both the economy and the productivity rate collapsed.

We'll soon find out how good a pilot Powell is.

Former Fed Chair **Alan Greenspan** *gets special credit for persuading the FOMC to avoid overtightening because he correctly realized that a sizeable jump in productivity was keeping inflation below 3 percent, even though unemployment fell below 6 percent and the economy continued to grow at a healthy rate of 3-plus percent.*

The Fed's challenge now in piloting the economy is very different from the mid-1990s. The threat is not rising inflation, which continues to run well below the central bank's 2 percent target. Rather, the worry now is a series of dangers largely out of the Fed's control. They include an on-again, off-again trade war with China orchestrated by an increasingly impulsive and erratic President Donald Trump, a global economic slowdown caused by that trade friction, and the prospect of financial instability as a result of the mountain of new debt taken on by businesses and governments around the world because interest rates are so low.

Jeremy C. Stein, chair of Harvard University's economics department and a Fed governor from 2012 to 2014, says that a hard landing may be less likely given the low-inflation environment. "Hard landings after earlier periods of very low unemployment tended to be associated with rising inflation, and the Fed needing to react to that inflationary pressure. That particular worry is, thus far, absent this time around."

"Now the worry is the fallout from trade," says Stein. Economists "don't have great models to assess this impact. The United States is not that open an economy, but one worries that the standard models may leave out various mechanisms—such as disruptions of supply chains—that could exacerbate the impact."

Stein expresses some skepticism that the Fed should continue to cut rates preemptively to ward off a recession without any clear evidence of a coming downturn. "If there is a real and serious risk, of course one needs

Owen Ullmann is executive editor of TIE.

Former Fed Governor **Jeremy C. Stein:** *“Hard landings after earlier periods of very low unemployment tended to be associated with rising inflation, and the Fed needing to react to that inflationary pressure. That particular worry is, thus far, absent this time around.”*

to act,” he counsels. “At the same time, when things are less clear-cut, there may be some under-appreciated merit to the ‘dry powder’ view: Don’t use up ammunition you may need in the future.”

Indeed, Greenspan’s Fed had more running room to raise and lower the federal funds rates during the 1990s, from a high of 8 percent to a low of 3.25 percent. Today’s FOMC is making decisions within a narrow band, from a low of 0 percent in 2008 at the start of the Great Recession to a peak of 2.25–2.5 percent in December 2018. The rate following the FOMC’s rate cut on October 30 was 1.5 to 1.75 percent.

Donald Kohn, who spent four decades at the Fed until 2010, his last four as Vice Chair of the Board of Governors, argues that the central bank has had an exemplary record of managing the economy from 1982 until the crash of 2007. “Once (Fed Chair) Paul Volcker broke inflation’s back from 1979 to 1982 (with a deep and prolonged double-dip recession), the Fed did a pretty good job to keep the economy growing with low inflation and unemployment,” says Kohn, now a senior fellow in economics at the Brookings Institution in Washington and an advisor to the Bank of England. “I can’t think of a recession since the Volcker shock that the Fed wanted.”

Kohn considers a slowdown in 1984–1985 during the Reagan presidency a “soft landing,” and he contends the mild 1990–1991 recession that followed the U.S. invasion of Kuwait might have been a soft landing as well had Iraq not seized its neighbor’s oil fields, prompting the Persian Gulf War under President George H.W. Bush.

“The recession of 2001 was caused mainly by the dot.com bubble bursting,” Kohn adds. “Could the Fed have prevented that by raising rates more rapidly in the 1990s? Possibly. At every point, you try to you use your best judgment to keep a non-inflationary expansion going. In 2007, we didn’t see the fragilities in the financial sector that would cause a crash in the subprime market. A few analysts predicted problems but even they didn’t see coming what actually happened. We missed that for sure.”

The tricky part for the Fed is factoring in the lag in monetary policy, which gradually feeds into the economy over a year or more. At the same time, the absence of inflation and a looming trade war truce with China make it harder to determine appropriate rate levels.

Now, with the current expansion well into its eleventh year, Kohn argues that elements of a soft landing already have been achieved: Economic growth has slowed, unemployment is at a fifty-year low, and inflation is dormant.

Yet outside forces are making the path forward more uncertain. “You have this trade war and global weakness that’s affecting capital spending and confidence,” he says. “We faced this before in the late 1990s—the Asian and Russian debt crises. Economies are more intertwined and trade war effects are unknown. There aren’t clear examples of impact. So the Fed is dealing with exceptionally difficult circumstances to engineer a soft landing.”

Add to the central bank’s dilemma Trump’s increasingly belligerent demands that the Fed slash rates to zero—or even negative territory—to spur economic growth for his re-election in 2020.

And there also was pressure on the Fed from financial markets to lower rates. Fed Chair Jerome H. “Jay” Powell reversed course swiftly from a rate hike in December 2018 to three rate cuts this year, prompting criticism that he is too beholden to the markets and doesn’t want to risk further fallout from disappointing them.

Kohn notes that the same complaints about doing the markets’ bidding were leveled against Greenspan, yet the Fed managed to keep the economy going with only two minor recessions over a twenty-year span. “You can’t let the markets dictate policy but you can’t ignore market sentiment,” he notes. “Financial conditions and market confidence have an impact on the economy. You can’t just shrug it off. It’s tricky. You can’t be held hostage, but you can’t ignore it. You need a sophisticated, nuanced view on how to proceed.”

Former Fed Governor **Donald L. Kohn:** *“You can’t let the markets dictate policy but you can’t ignore market sentiment.”*

So far, the data suggest that Powell and Co. have the economy flying just at the speed and altitude they want.

Powell’s predecessor, Janet Yellen, agrees. “A soft landing is arguably in sight,” says the former Fed chair. “We’re down to a much more sustainable rate of job growth. But there’s a risk of a recession due to the trade war, which is creating uncertainty, a global slowdown, and a pullback in investment. The challenge for the Fed is to stay ahead of the curve with a somewhat more accommodative policy to avert a recession without causing inflationary pressures over time. It’s a difficult phase of policy.”

Indeed, the past three decades are littered with the wreckage of unintended consequences and crises—both at home and abroad—that weren’t spotted on the Fed’s radar until it was too late to avert a crash landing. We’ll soon find out how good a pilot Powell is. ◆