INSIGHT

Where Is the U.S. Economy Headed: Soft Landing, Hard Landing, or Stagflation?

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The Economic Recovery So Far

The recovery from the 2020 recession was rapid through the first half of 2021, but the transition to moderate, sustainable economic growth has been choppy, with negative growth in the first quarter of 2022. Moreover, high inflation has complicated the path forward. Since March 2022, the annual change in the Consumer Price Index has been above 8%.

To reduce inflation, the Federal Reserve (Fed) is raising the federal funds rate (a short-term interest rate) to reduce aggregate demand (total spending). Since March, the Fed has raised rates from a range of 0-0.25% to a range of 1.5-1.75%. This raises the question of how much demand needs to slow to restore low inflation. This Insight discusses three scenarios for what might come next—a soft landing, a hard landing, and stagflation.

Soft Landing?

Fed leadership aspires to restore price stability through a "soft landing," where growth is moderate but positive, and unemployment rises modestly, if at all. This is reflected in Fed leadership's median projection that inflation will fall to 2.6% in 2023, while unemployment will remain below 4%. Fed Governor Christopher Waller envisions a soft landing where firms reduce job openings instead of laying off workers. Skeptics refer to this scenario as the "immaculate disinflation" because, under standard theory, a sizeable and rapid reduction in inflationary pressures requires an increase in unemployment.

Soft landings are infrequent. Fed Chair Jerome Powell recently argued that soft landings occurred after monetary tightening in 1965, 1984, and 1994, as shown in **Figure 1**, and that some other recessions, such as in 2020, should not be attributed to tightening. However, inflation was low in 1965 and 1994, and below 5% in 1984.

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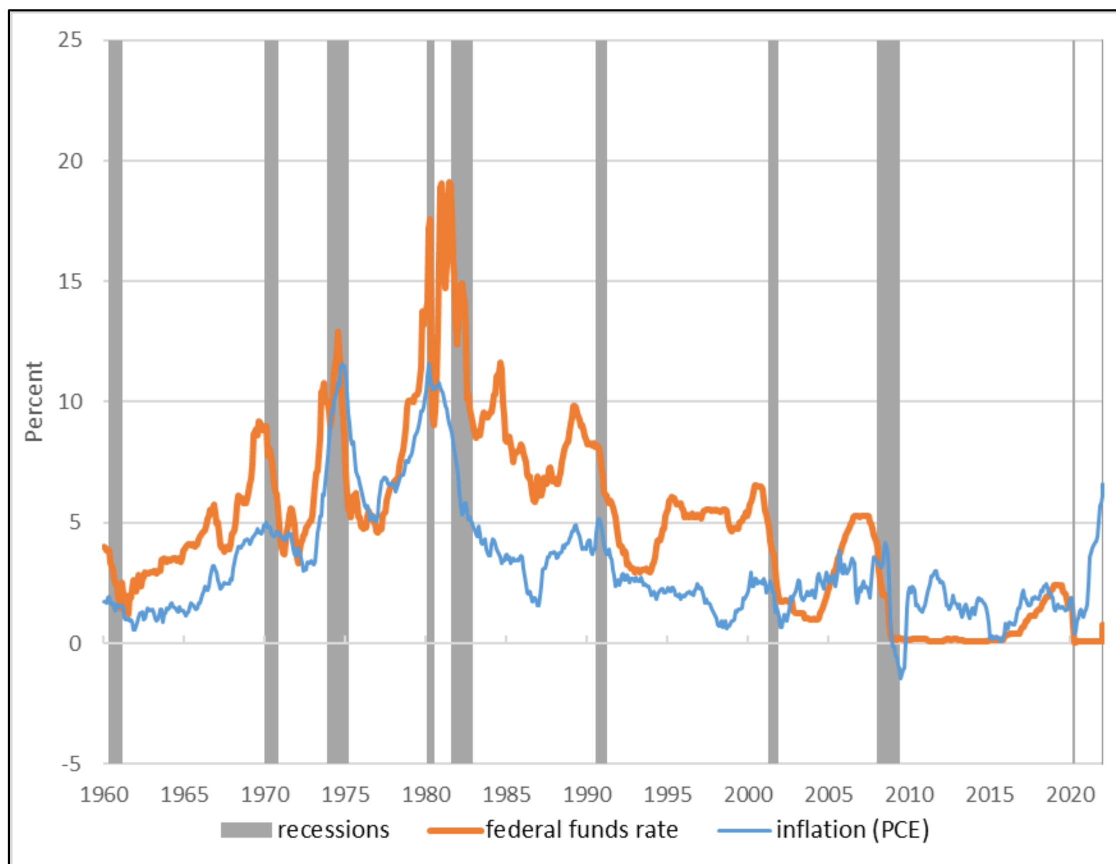
Figure 1. Federal Funds Rate and Inflation

1960-2022



Source: Federal Reserve, Bureau of Economic Analysis.

Hard Landing? Stagflation?

After negative first quarter economic growth, some economists are forecasting a "hard landing," where rising rates causes the economy to reenter a recession. In fact, although not necessarily causal, every recession since the 1950s has been preceded by an extended period of rising rates, sometimes with a lag. Hard landings are more common than soft landings when, as now, inflation is high and the Fed is raising interest rates. High inflation and low unemployment are evidence that demand is too high, and it has been difficult to reduce demand in those circumstances without triggering a hard landing.

A hard landing could occur in two ways. If high inflation expectations become entrenched and a wage-price spiral occurs, the Fed may have to overcorrect with tightening to restore price stability. Alternatively, it could overdo it by tightening too quickly when inflation would have eventually subsided with less tightening.

Since the last recession ended in 2020, this scenario is also called a "double dip recession." Double dip recessions are rare, but there are parallels between the last one in the early 1980s and today. The early 1980s was the last time inflation exceeded 7%. The second recession in that episode is widely attributed to the Fed rapidly increasing interest rates, peaking at over 19%, to reduce inflation. Inflation had far to fall to restore price stability, and therefore interest rates remained high until 1982, causing an unusually long and deep recession.

To date, the Fed has not discussed raising rates close to 1980s levels, and it is debatable whether the Fed would again be willing to keep tightening in a recession. The final scenario is that, for fear of triggering a hard landing, the Fed does not raise rates quickly enough to restore low inflation. Thus, there is the risk that successfully avoiding a recession now could lead to worse outcomes down the road. Once high inflation expectations become entrenched, the relationship between inflation and unemployment weakens. From then on, high inflation could be accompanied by low or high unemployment, regardless of whether the economy enters a recession. High inflation and unemployment, last experienced in the 1970s, is popularly called "stagflation."

Future Policy and Outcomes

Policymakers still forecast that inflation will be reduced relatively quickly on the grounds that, after 40 years of persistently low inflation, households will view the last year as an anomaly and will keep expectations of future inflation low. This was not the case in the 1970s, however, and some data show an increase in inflationary expectations since 2021. Once households expect higher inflation to persist, a deeper recession might be needed to wring high inflation out of expectations, as was the case in the early 1980s.

The extent to which inflation expectations remain anchored depends largely on whether the Fed is willing to raise interest rates as much as is necessary to rein in inflation. Although rates have been rising, they are not high. As shown in **Figure 1**, the Fed has to date maintained negative real interest rates (i.e., nominal interest rates that are lower than the inflation rate) in the face of rising inflation, as it did in the 1970s. The Fed has been successful in reducing high inflation since 1960 only when real rates have been positive. The Fed has raised rates rapidly since March but belatedly from a low starting point. As a result, the amount of stimulus still in place is large by historical standards, complicating a soft landing.

Future Surprises?

The broad direction of the economy since 2020 has been driven by factors outside the Fed's (or federal government's) control—namely, supply disruptions caused first by the pandemic and, more recently, by war in Ukraine. Until the pandemic ends, the path of the economy will remain unpredictable. A soft or hard landing could occur because of outside events instead of any action by the Fed. For example, a rapid resolution of supply disruptions would ease inflationary pressures and boost growth, making a soft landing more likely. Alternatively, if supply constraints take longer to resolve, at that point a soft landing may not be possible because expectations of high inflation have already become endemic.

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