Global Economic Research

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Soft Landings: Skill Meets Luck

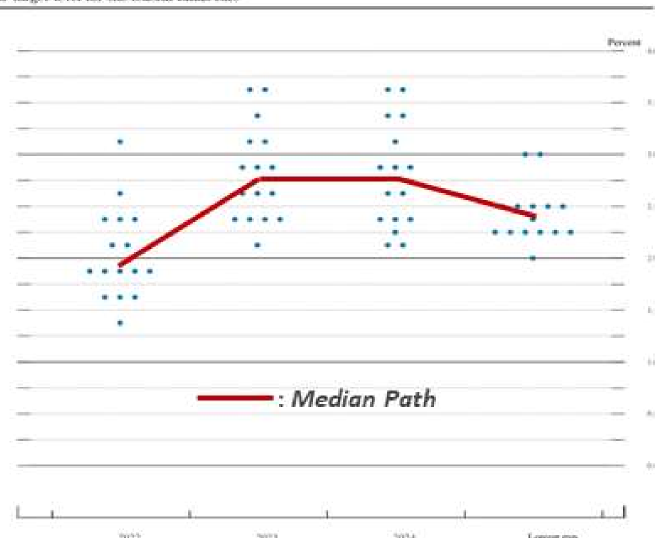
Rate hiking cycles can end with continued growth.

By Ryan James Boyle

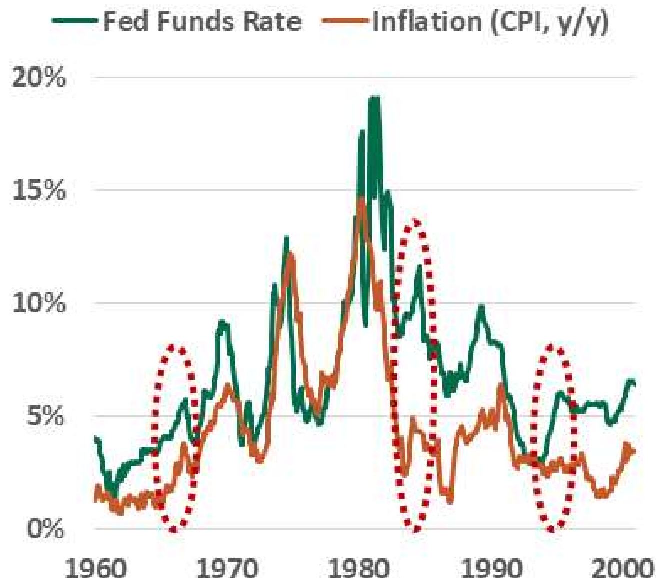
In the past week, the Federal Reserve has made it clear that managing inflation is their top priority. The "dot plot" outlook in the quarterly Summary of Economic Projections set an aggressive interest rate path that aims to bring inflation under control. The Fed Funds Rate is

expected to rise quickly to a point above its neutral level before settling at a lower long-run rate.

Dot Plot, March 2022



Uneventful Rate Hikes



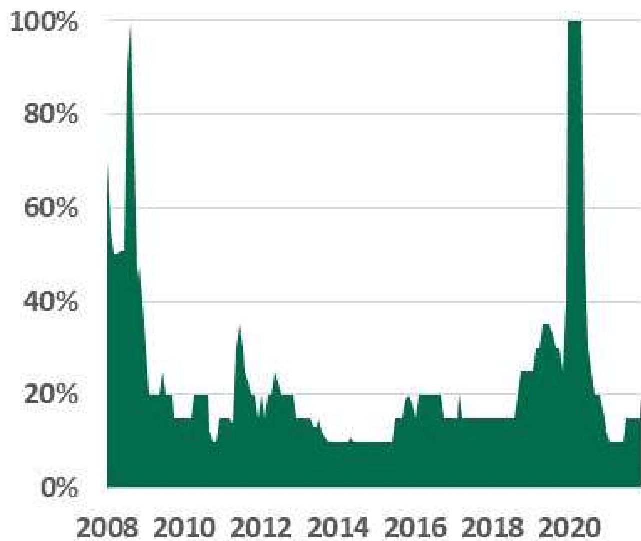
Sources: Federal Reserve, Bureau of Labor Statistics, Haver Analytics

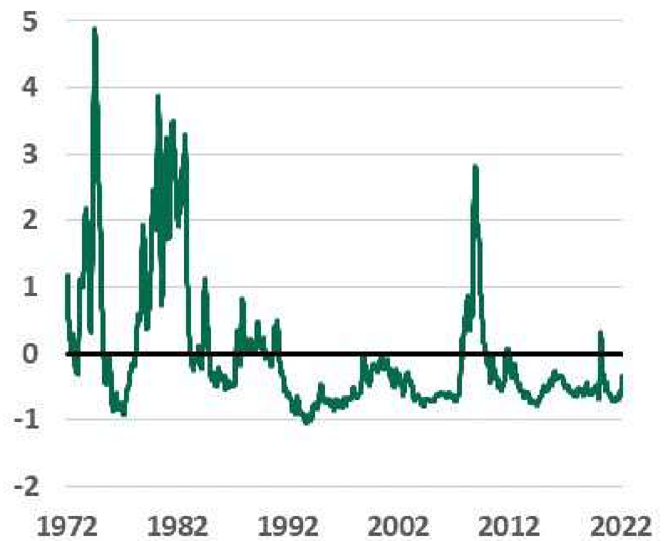
The Fed is seeking to deliver a *soft landing*: tightening policy enough to slow the economy into a steady state, without initiating an excessive correction. The soft landing is a mixed metaphor: "Landing" an economy is not like landing an airplane or a gymnastic flip. Cycles play out over the course of years, and the economy never stops moving.

The process is more akin to a marathon or 24-hour auto race. After starting with an initial sprint, contestants settle into the right pace for the long haul. Runners train to manage their fatigue; drivers monitor their fuel and temperature gauges; both take rest stops accordingly. Whether we call it a landing or pace-setting, this will be a complicated maneuver, but history gives a few examples of where it was executed successfully:

- **Mid-1960's:** The effective Federal Funds Rate rose from 3.4% in October 1964 to 5.8% in November 1966. Inflation reached a peak of 3.8% in October 1966 and fell thereafter, while the economy carried on for three more years of growth.
- **1984:** The target rate increased by two percentage points from March to August of 1984. Inflation leveled off, with no recession until 1990.
- **1994:** The Fed Funds target doubled from 3.0% to 6.0% in the span of a year; inflation stayed in check while the economy grew fervently for the rest of the decade.

Of course, this is a selective recollection. Rate hiking cycles can culminate in recessions, as was the case when rates rose starting in 1988 and 1999. The Fed recognized the overheating economy in the 2000s, raising the target rate from 1.0% in 2004 to 5.25% in 2006, but that could not prevent a housing-driven correction. And the most recent set of hikes ended inconclusively. The Fed lifted rates without impairing growth, but COVID-19 brought the cycle to an abrupt and unavoidable halt.





Sources: Bloomberg, Chicago Fed, Haver Analytics

Achieving an economic soft landing is not easy, but not impossible.

These past soft landings contained some elements of luck. No idiosyncratic events like pandemics or wars disrupted the economy. Circumstances were often favorable, like growth-supporting fiscal policy in the 1980s and the disinflationary combination of globalization and technology investment in the 1990s.

Circumstances today are very challenging. For starters, the Fed has an explicit inflation target: the optimal rate of 2% only became formal policy in 2012. Past successful policy pushes helped to arrest inflation from rising higher; bringing inflation down from an elevated starting point is a different challenge for central banks.

And it may be harder for interest rates to slow inflation this time around. Many of today's price pressures have arisen from supply constraints, which are not directly affected by monetary policy. The last time we had persistently high inflation, supply constraints were also involved: the energy-driven challenges of the 1970s. Monetary policy can help to manage demand, but today's **elevated savings**, **low leverage**, **rapid hiring** and **inventory rebuilding** are all economic tailwinds that can continue growth even amid higher interest rates.

The Fed is working to find a steady pace, but policy may have to sprint before settling. At the moment, the finish line seems a long way off.

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