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U.S. Economy: Soft Landing or Delayed Recession?

Although most current data indicates that inflation is cooling with a modest economic slowdown, it takes time for interest rate changes to work their way through the economy.

Economists have been predicting a recession for the U.S. economy ever since the Federal Reserve began aggressively raising interest rates in 2022. This is Econ 101. High interest rates, which make it more expensive to borrow, are intended to tame inflation by slowing business and consumer spending. A rapid and extreme increase in rates, as the Fed has carried out over the last year and a half, can be expected to slam the economy into reverse. The classic example is the early 1980s, when the Fed pushed the economy into a deep recession in order to stop runaway double-digit inflation.[1]

So far, the economy is proving resilient in the face of interest-rate pressure. Inflation, as measured by the 12-month change in the consumer price index (CPI), dropped from a high of 9.1% in June 2022 to 3.2% in July 2023. Growth in real gross domestic product (GDP) was a solid 2.1% in Q2 2023, and the August unemployment rate was 3.8%, up from 3.5% in July but still near a 50-year low.[2–3] These "headline" numbers suggest an economy coming in for a "soft landing" — a term for controlling inflation without serious economic damage. As with most headlines, however, the full story is more complex.

Long-term inflation prospects

Although consumers may notice the ups and downs of prices, the Fed is primarily concerned with controlling the longer-term inflationary trend. Its preferred measure is the price index for personal consumption expenditures (PCE), which captures a wider range of spending than the CPI, and the target for a healthy economy is PCE inflation of 2.0%. The 12-month change in the PCE price index was 3.3% in July 2023, down from a high of 7.0% in June 2022. The Fed also looks closely at "core" PCE, which excludes volatile food and energy prices and ran at a 4.2% 12-month rate in July. These numbers have trended downward over the last year, but they ticked upward in July and are still above the Fed's target. It remains to be seen whether further increases in interest rates will be necessary.[4]

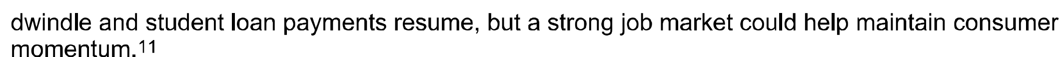
A slower but sound labor market

Despite rising rates and predictions of a recession, businesses have continued to hire workers at a solid pace. The 187,000 jobs added in August was slower than post-pandemic job growth (over 200,000 jobs for 29 months) but a solid bounceback from lows of 105,000 in June and 157,000 in July.[5] Unlike typical recessions, when lower-paid workers are often the first to go, recent layoffs have tended to be in industries like finance and tech, where higher-paid workers typically have other job prospects and savings to maintain financial stability. Some analysts have called this a "richcession" (though the workers are hardly rich), and it may be dampening the effects of a jobs slowdown on the broader economy.[6]

Strong spending by businesses and consumers

Steady hiring is one indication that businesses are continuing to spend and expand. The Q2 GDP report also showed increased investments in equipment, nonresidential structures, and intellectual property.[7] All of these point to expectations of business growth. Many companies restructured their debt when interest rates were low, which has delayed the impact of higher borrowing costs, and may put off widespread effects for some time.[8]

Consumer spending accounts for two-thirds of GDP, and increased spending was a key contributor to Q2 GDP growth. Spending accelerated even further in July, increasing 0.8% over June — the largest month-over-month increase since January.[9] Like businesses, many consumers still carry debt with low interest rates, providing more discretionary income.[10] Spending may slow as pandemic-era savings



dwindle and student loan payments resume, but a strong job market could help maintain consumer momentum.[11]

Expectations and the wage-price spiral

Two factors that can drive inflation are consumer expectations and the so-called wage-price spiral — when rapidly rising wages push demand and a willingness to pay higher prices, which leads to higher wages and more demand. Both of these seem to be settling. In a July 2023 survey, consumer expectations for inflation in one year dropped to 3.5% — the lowest since April 2021 — while expectations for three and five years dropped to 2.9%.[12] Average hourly earnings increased 4.3% for the 12-month period ending August 2023, higher than the rate of inflation but down from 5.4% a year earlier.[13]

Signs of trouble remain

Although most current data indicates that inflation is cooling with a modest economic slowdown, it takes time for interest rate changes to work their way through the economy. Pessimists point to measures that suggest a recession may still be on the way. The Conference Board Leading Economic Index, a suite of 10 statistics that tend to rise and fall ahead of the broader economy, fell for the 16th straight month in July 2023.[14] The yield curve (yields of U.S. Treasury securities by maturity date) has been inverted since mid-2022, and the disparity between the 2-year and 10-year Treasuries, traditionally a sign of a coming recession, reached its most extreme inversion since 1981 in early July.[15]

More optimistic analysts suggest that these indicators may not apply to the current situation: a strong economy briefly derailed by the pandemic, with a big, fast bounceback and inflation due to supply-chain disruptions and pent-up demand. In this view, the economy is finding its footing after these extremes and may be poised for extended growth. Time will tell, but for now the predicted recession seems hard to find.

U.S. Treasury securities are guaranteed by the federal government as to the timely payment of principal and interest, but their principal value fluctuates with market conditions. If not held to maturity, they could be worth more or less than the original amount paid. Forecasts are based on current conditions, are subject to change, and may not come to pass.

1, 10) *The Wall Street Journal,* July 27, 2023

2, 5, 13) U.S. Bureau of Labor Statistics, 2023

3–4, 7, 9) U.S. Bureau of Economic Analysis, 2023

6) Associated Press, July 29, 2023

8) Insider, July 21, 2023

11) Reuters, August 15, 2023

12) Federal Reserve Bank of New York, August 14, 2023

14) The Conference Board, August 17, 2023

15) CNBC, July 7, 2023

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