

## National Overview

# Soft or Hard Landing?

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For the past few years, the United States has enjoyed above-trend real gross domestic product (GDP) growth. This type of growth is not unusual following a recession (the last one having occurred from March to November 2001), but such growth is not sustainable in the long run. Once labor becomes fully employed and capital fully utilized, growth is limited to the rate at which productive capacity is increasing.

After a lengthy period of accommodative policy, the challenge faced by monetary authorities in recent years has been to remove monetary policy accommodation in a timely manner so that the economy slows to its potential growth rate. Excessive restraint increases the risk of an extended period of growth slower than potential, while insufficient restraint can produce high and accelerating inflation. The job of the monetary authorities is complicated by the fact that monetary policy actions operate with long and variable lags. Consequently, decision-makers operate under much uncertainty.

Prior to the Aug. 8 meeting of the Federal Open Market Committee (FOMC), policymakers had increased the federal funds rate target in 25 basis-point increments at each of 17 prior meetings. These adjustments left policymakers with three possibilities to ponder at the August meeting:

1) whether the culmination of their recent actions was helping to orchestrate a soft landing as the housing market tumbled and energy prices continued at high levels;

2) whether their actions, coupled with developing economic conditions, might slow growth more significantly and for a greater period of time than desired (i.e., a hard landing); or

3) whether inflationary pressures were persistent enough to warrant further tightening.

With one member dissenting because of inflation concerns, the FOMC decided to pause.

### Recent Data

Since the meeting, incoming economic data can be characterized

as a mix of good news and not-so-good news. July marked the fourth consecutive month of decreasing sales of existing single-family homes. Single-family housing starts and sales of new single-family homes continued to decline as well, and construction spending for July fell by a surprising 1.2 percent. Energy costs remained elevated, although oil prices as of early September moderated from August's peak. High energy costs likely factored into a 2.4 percent decline in factory orders for manufactured durable goods in July as demand for transportation equipment, such as aircraft and automobiles, decreased. Second-quarter real GDP growth, while revised upward to 2.9 percent from 2.5, remained well below the first-quarter rate of 5.6 percent—leaving no question that growth is slowing.

The slower pace of growth is reflected in the payroll employment numbers. During the first quarter, an average of 175,000 jobs were added each month. Since then, the biggest monthly increase has been 134,000, which occurred in June. In August, the increase was 128,000.

Meanwhile, personal income increased by 0.5 percent in July, personal spending increased by 0.8 percent and retail sales exceeded expectations with an increase of 1.4 percent. The increase in retail sales was the largest increase since January 2006. While consumers express concern over falling home prices and high gasoline costs, consumer spending—spending which accounts for two-thirds of gross domestic product—is not a cause for alarm.

### Inflation Vigilance

According to minutes from the August FOMC meeting, “all members agreed that ... inflation risks remained dominant and that, consequently, keeping policy unchanged at this meeting did not necessarily mark the end of the tightening cycle.”



Both the consumer price index (CPI) and the Fed's preferred measure of inflation, the core personal consumption expenditures (PCE) index, increased in July. The overall PCE showed a 3.4 percent increase from a year earlier, while the core PCE, which excludes food and direct energy costs, was up 2.4 percent from a year earlier. In the three months ended in July, the core PCE increased at an annual rate of 2.2 percent, which was less than the rate of 2.7 percent for the three months that ended in June. Without question, the increase in the core PCE was outside the Fed's comfort zone of 1 to 2 percent. Forecasts, which are subject to much uncertainty, call for the core PCE to moderate along with the deceleration of growth.

### A Wait-and-See Approach

Data to be released over the upcoming months will help to shed light on whether the FOMC's current pause will continue or whether changes in the federal funds rate target are warranted. According to the minutes of the August meeting, most FOMC members anticipate that “the current stance of policy could well prove to be consistent with satisfactory economic performance.”

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