Can the FOMC Achieve a Soft Landing in 2020?

James Bullard
President and CEO

CFA Society St. Louis

Feb. 11, 2020
St. Louis, Mo.

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Introduction

Key themes

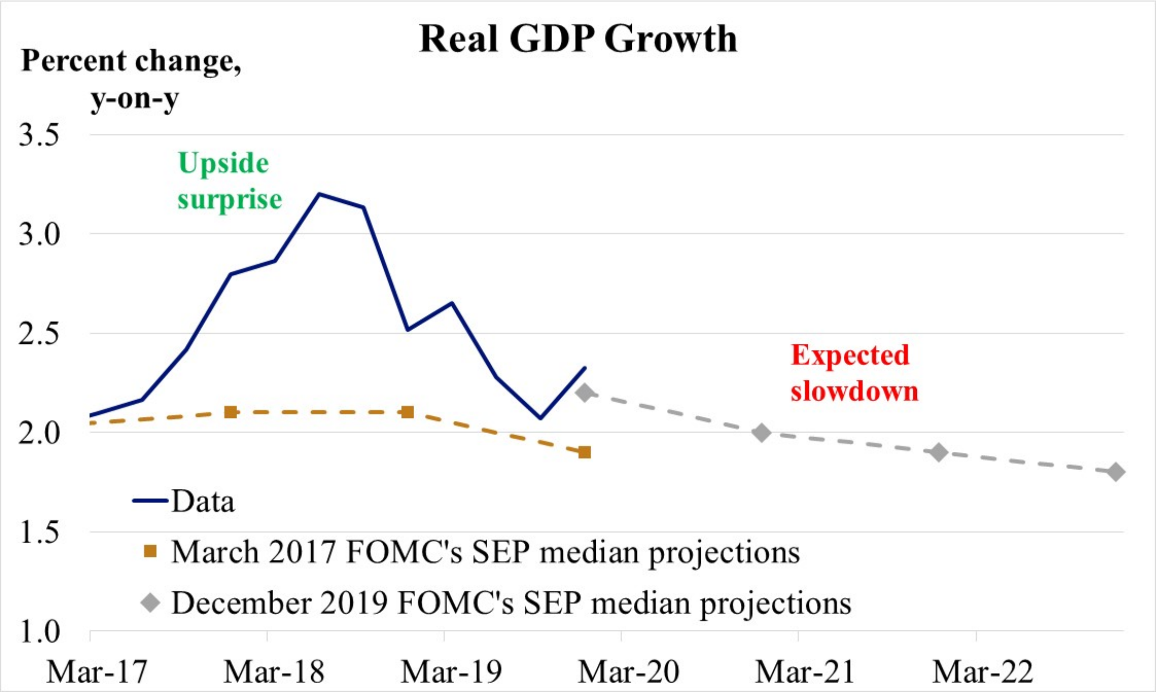
- U.S. economic growth slowed on a year-over-year basis during 2019.
- The Federal Open Market Committee (FOMC) took action to help ensure a soft landing by dramatically altering the path of monetary policy during 2019.
- The current baseline outlook for 2020 suggests a reasonable chance that a soft landing will be achieved.

A Soft Landing?

Slower growth

- The U.S. economy grew at a pace exceeding 3% on a year-over-year basis during the second and third quarters of 2018.
- Since then, growth has generally slowed on a year-over-year basis.
- The slowdown was widely expected because the economy tends to return to its potential growth rate, which is sometimes referred to as a soft landing.
- The key risk in 2019 was that this slowing would be sharper than anticipated—that is, a hard landing.

U.S. real economic growth



Sources: Bureau of Economic Analysis and Federal Reserve Board. Last observation: 2019-Q4.

U.S. Monetary Policy Changes in 2019

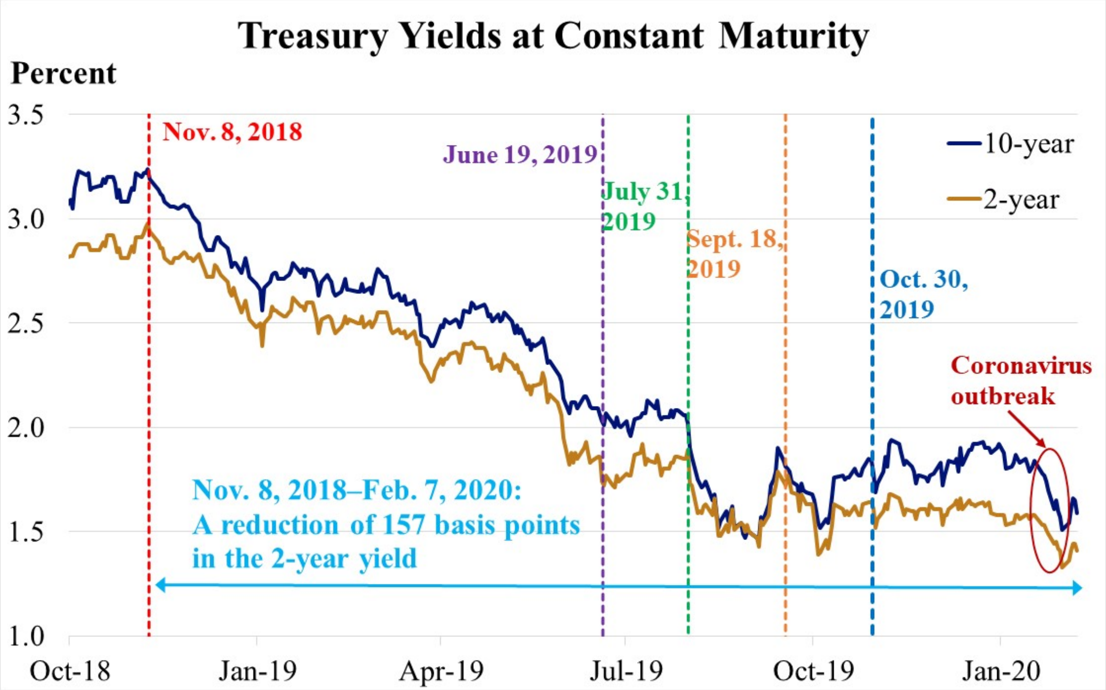
U.S. monetary policy in 2019

- The FOMC was cognizant of the slowing economy during 2019.
- During the first half of the year, the FOMC began to project fewer increases in the policy rate.
- In June, the FOMC indicated that a lower policy rate might be warranted.
- The FOMC then made reductions in the policy rate at three successive meetings, ending the year with a net reduction of 75 basis points in the policy rate.

Interest rates are dramatically lower

- What was the size of this turnaround in U.S. monetary policy?
- The size has been much larger than the three latest rate reductions alone would suggest because the expectation as of late 2018 was that the FOMC would actually *raise rates further*, not lower rates, in 2019.
- The following chart captures more of the true magnitude of the change in policy during 2019.

Size of the change in monetary policy



Source: Federal Reserve Board. Last observation: Feb. 7, 2020.

Interpretation

- One straightforward reading of these events is that the outlook for shorter-term interest rates influenced by the FOMC, as embodied in the two-year Treasury yield, dropped by 144 basis points from early November 2018 to early January 2020 because of FOMC actions.
- Additional reductions in the two-year yield since early January are likely attributable to risk to the global economy from the coronavirus outbreak in China.
- The bottom line is that U.S. monetary policy is considerably more accommodative today than it was as of late 2018.

Three Questions about the Soft Landing

Factors that could affect a soft landing

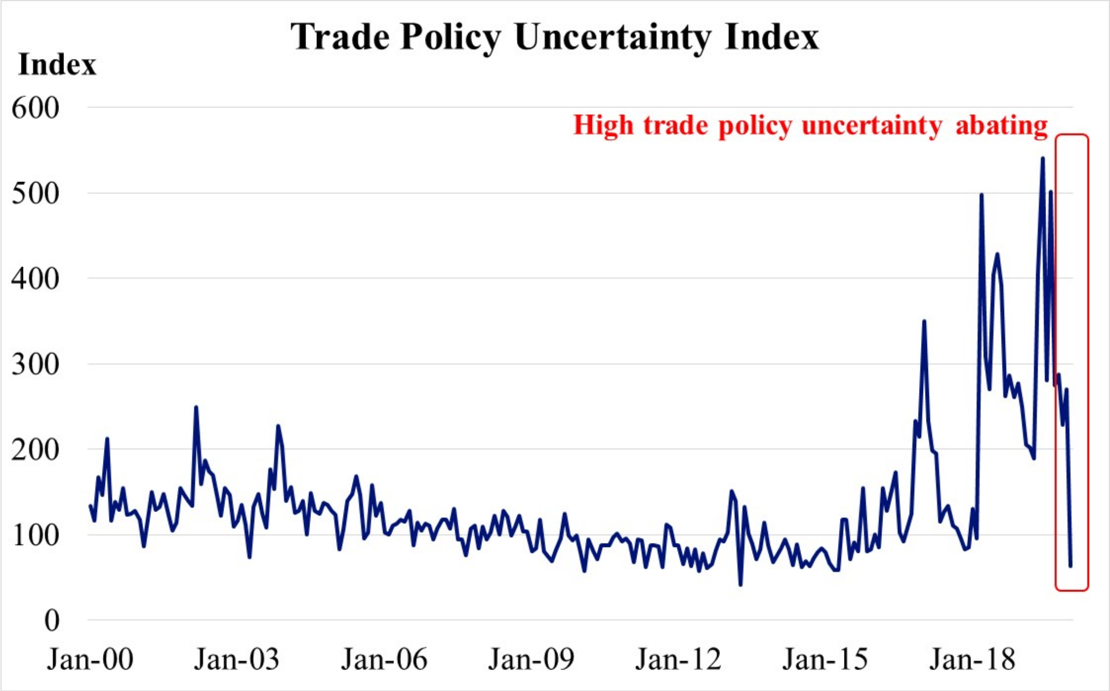
- One question for 2020 is whether global trade policy uncertainty has sufficiently been dampened to now encourage global manufacturing.
- Another question is whether interest-sensitive sectors in the U.S. will respond to the 2019 change in U.S. monetary policy.
- The third question is whether the coronavirus outbreak in China is likely to be contained as other important viral outbreaks have been.
- The answer to all three questions is, “Let’s wait and see.”

Dampened Trade Policy Uncertainty

Recent trade policy developments

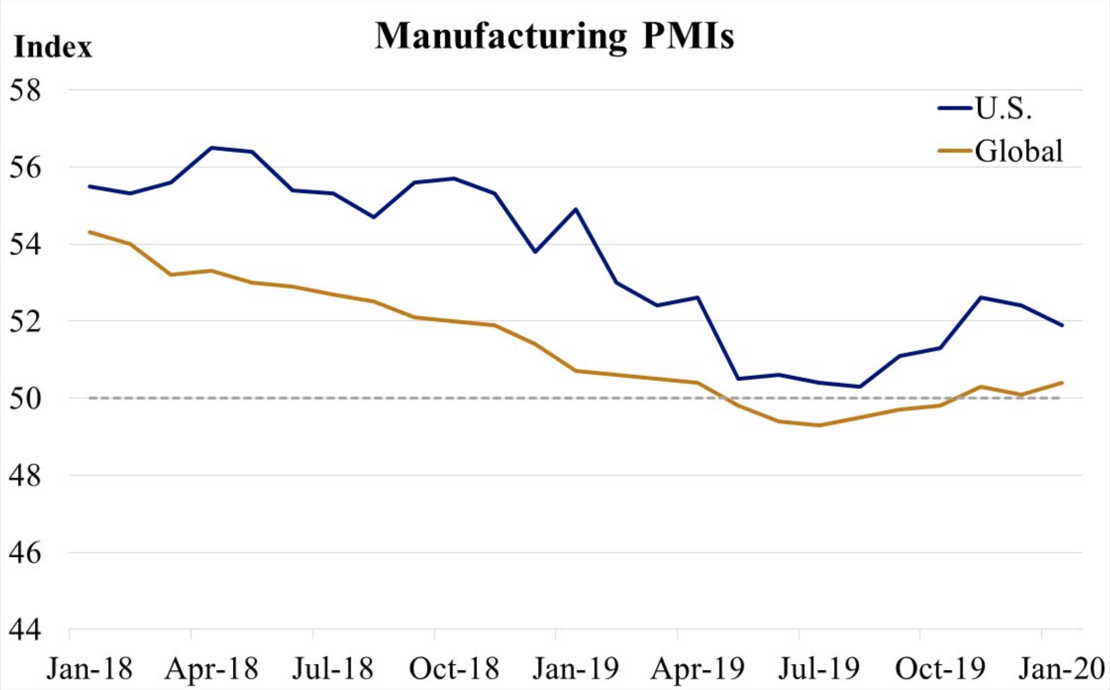
- Global trade policy uncertainty has abated in recent weeks as the U.S. and China signed a trade accord, the U.S. Congress approved the United States-Mexico-Canada Agreement (USMCA) and the U.K. approved a plan to depart the European Union.
- Trade regime uncertainty has been chilling global investment and feeding into slower global growth.
- Lower trade regime uncertainty, combined with business strategy adjustments that have taken place over the last two years, may provide a better environment for global manufacturing.

Global trade policy uncertainty has declined



Source: www2.bc.edu/matteo-iacoviello/tpu.htm. For details, see D. Caldara, M. Iacoviello, P. Molligo, A. Prestipino and A. Raffo, "The Economic Effects of Trade Policy Uncertainty," revised November 2019, Journal of Monetary Economics, *forthcoming. Last observation: January 2020.*

Global manufacturing PMIs improving?



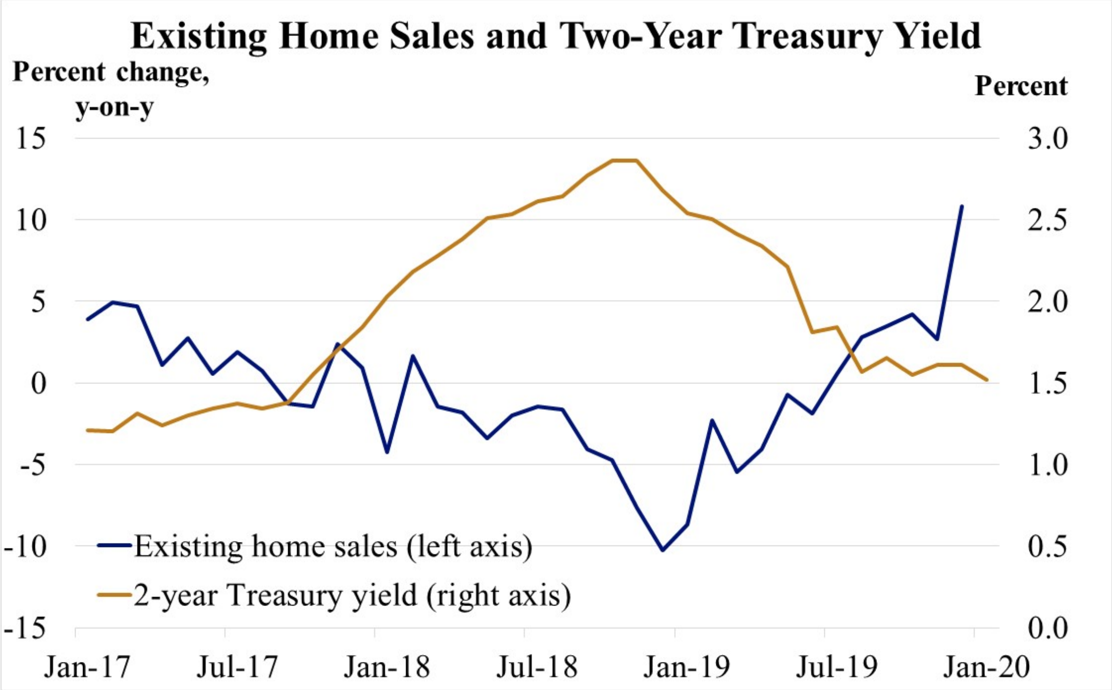
Source: IHS Markit/JPMorgan Chase. Last observation: January 2020.

Monetary Policy Effects

Monetary policy effects

- Monetary policy changes are thought to have effects on the real economy with some lags.
- Some of the most visible effects occur in interest-sensitive sectors, such as housing.
- To illustrate the effects of the turnaround in U.S. monetary policy, the next chart plots the two-year Treasury yield, which has declined since late 2018, and the change in existing home sales, which turned positive on a year-over-year basis in the second half of 2019.

Rebounding home sales



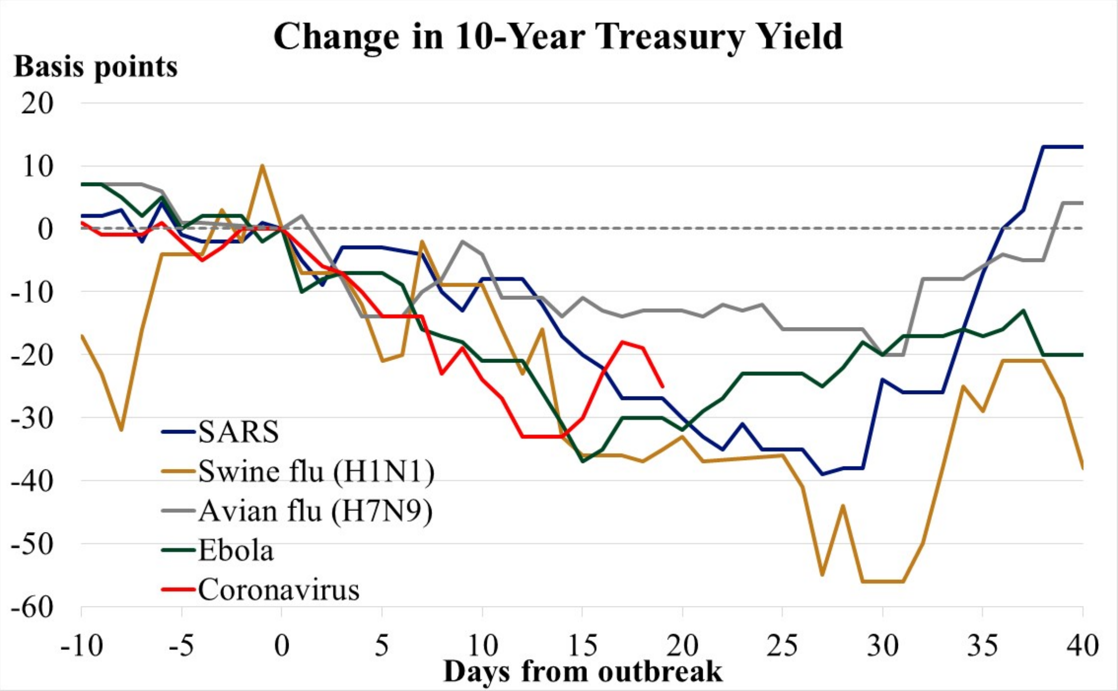
Sources: National Association of Realtors, Federal Reserve Board and author's calculations. Last observations: December 2019 and January 2020.

Coronavirus: A New Risk

The economic impact of the outbreak

- In recent weeks, the coronavirus outbreak in China, in addition to being a human tragedy, has been a major topic in global financial markets.
- The efforts to bring the virus under control are substantial enough that the Chinese economy is expected to grow noticeably slower in the first quarter of 2020 than it otherwise would have.
- Experience with previous viral outbreaks suggests that the effects on U.S. interest rates can be tangible and last until the outbreak is clearly contained.

Effect of viral outbreaks on long-term rate



Sources: Federal Reserve Board, Goldman Sachs and author's calculations. Last observation: Feb. 7, 2020.

Conclusion

A soft landing for the U.S. economy?

- The FOMC has taken actions that have changed the outlook for shorter-term U.S. interest rates considerably since November 2018, ultimately providing more accommodation to the economy.
- This has helped to create a reasonable prospect that the U.S. economy will achieve a soft landing in 2020.

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