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The Recession Question

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Highlights:

- Inflation is too high. But the Fed has the tools to contain inflation over the medium-term, and we are committed to returning inflation to our target.
- The elevated concern about a recession is understandable. But the challenge in predicting a recession tomorrow is the strength of the aggregate data today.
- A slowdown from our current situation must be kept in perspective. We are out of balance today. Returning to normal doesn't have to require a calamitous decline in activity.
- The Fed has the credibility with households, businesses and markets required to return inflation back to normal levels. There is of course recession risk along the way, but there's also the prospect of the economy returning closer to normal.

I like giving speeches. The economy matters to everyone. When I speak, I get to share what the Fed is learning and doing, in what I hope is plain English. But my favorite part of every speech is when it ends. Of course, I hope that won't be your favorite part today.

I like ending a speech because that's when I get to hear from you. Through your comments and questions, I learn how you're experiencing the economy and what's top of mind. Before the pandemic, the most popular question was when our lengthy expansion would end. Then, of course it was the impact of COVID-19. Once stimulus passed, it became the deficit. Last year, audiences moved on to the definition of "transitory" and the value of cryptocurrencies. And so far this year, it's been all about rate increases.

So, what am I hearing today? Two questions. The first would have been hard to imagine just two years ago: "Will inflation go back down to normal levels?" Remember it had lagged our two percent target ever since the Great Recession. The second goes full circle, asking again, "Are we headed into a recession?"

Today, I want to try to tackle those questions. I caution that these are my thoughts and not those of anyone else in the Federal Reserve System. I also feel obliged to repeat the joke that economic forecasters were created to make weather forecasters look good. After all, when I answered recession questions three years ago, I certainly didn't talk about a pandemic shock.

So, first: “Will inflation return to normal?” That answer is simple: yes. Inflation is too high. But the Fed has the tools to contain inflation over the medium-term, and we are committed to returning inflation to our target. You’ve likely seen that over our last three meetings we have raised rates 150 basis points, started shrinking our balance sheet and signaled there are more rate increases to come. We are meeting the test we face and have made clear we will do what it takes.

But that commitment, which hopefully you welcome, directly leads to the second question: “Are we headed into a recession?” I would caution that no one canceled the business cycle, so one can never fully rule out a recession — it’s just a question of timing. But I get why the concern might be elevated today.

First, consumer and business sentiment are quite negative. In the most recent Michigan Survey, consumer sentiment fell to its lowest level on record. In addition, the percentage of small business owners who expect better conditions over the next six months dropped to the lowest level in that survey’s history in May. Both surveys show inflation driving this pessimism. Typically, sentiment this low is associated with a weakening in consumer spending and business investment.

At the same time, fiscal support from the pandemic is waning, and — as I mentioned — inflation is moving the Fed to increase rates. Higher rates tend to slow the economy by increasing borrowing costs and disincentivizing spending and investment. Historically, eight of the last 11 Fed tightening cycles have been followed by some sort of a recession.[1]

That change in policy may well be making markets skittish. That’s understandable: The Fed hasn’t moved this quickly in over 20 years. And forecasters are predicting that our current rate increase cycle will go higher than its predecessor’s relatively low 2.4 percent 2019 peak. Now, the stock market is not the economy. But if markets were to crater, that could slow the economy by leading individuals and firms to pull back their spending and investment.

Those who look more closely for signals may be pointing to flashing lights coming from the 2-10 yield curve, a closely watched recession predictor that inverted briefly in March and again in mid-June. When short-term interest rates are higher than long-term ones, markets see risk on the horizon. The 2-10 yield curve has predicted eight of the last seven recessions. I should note that Fed research suggests it’s the short end of the yield curve that is a cleaner signal — and that end remains steep.

Another frequently cited signal has been the dramatic recent increase in oil prices, which has occurred in advance of most of our past recessions.

There’s also a fear about what else may come our way. We’ve already seen multiple supply side challenges, including pandemic-era shortages, the war in Ukraine and the lockdowns in China. Each has fanned the flames of inflation and raised questions about future demand. Who knows what is to come next?

So, I understand why some are forecasting a recession. And risk managers like you need to consider this risk in your scenario planning. But the challenge in predicting a recession for tomorrow is the strength of the aggregate data today.

Consumer spending is about two-thirds of the economy, and it remains quite healthy, supported by strong personal balance sheets, excess savings accrued during the pandemic and freedom from COVID-19 restrictions. Just try to book a trip this summer. We are seeing spending pivot from goods to services (affecting some retailers), and early signs of stress for those with lower incomes — but not enough to affect the overall numbers. The negative first quarter GDP was driven by one-time reversals in inventories and net exports and should rebound this quarter. The unemployment rate is historically low at 3.6 percent, and there are still 1.9 job openings for every unemployed person. While rates are rising expeditiously, they have not yet reached the level which constrains the economy. I have noted pullbacks in auto and home sales, but — with prices still rising — attribute both mostly to continuing supply shortages.

And household and bank balance sheets look healthy. Households and financial institutions deleveraged after the Great Recession. By the start of the pandemic, households had returned to debt levels last seen in 2001,[2] and many used stimulus funds to pay debt down even further. You can see the different dynamics in play by looking at the housing market. If the phrase of the day before the Great Recession was "subprime mortgages," today it's "cash offer." We are in a very different place.

So, data on today's economy still looks relatively healthy. Tomorrow is of course unclear. Our path forward depends on three significant uncertainties. First, how long will it take the pandemic's impact on spending, labor supply and supply chains to normalize? Second, how high does the Fed need to raise rates to calm demand, bring inflation down and keep inflation expectations anchored? And third, what other outside forces will push demand and/or inflation up or down?

Barring an unanticipated event, I see rising rates stabilizing any drift in inflation expectations and in so doing, increasing real interest rates and quieting demand. Companies will slow down their hiring. Revenge spending will settle. Savings will be held a little tighter. At the same time, supply chains will ease; you have to believe chips will get back into cars at some point. That means inflation should come down over time — but it will take time.

This moderation of demand could happen without crossing the line into the technical definition of a recession. But my dad was a depression child, and he taught me not to expect the best case and run the risk of being disappointed. Instead, I always have my mind around the downside, and welcome it if I'm positively surprised. Perhaps many of you in risk management think the same way. A recession downside would of course be unwanted, but not all recessions are equal. We've been scarred by our memories of the Great Recession and the Volcker recession, but it's worth remembering that most other recessions aren't that long or that deep.

And a slowdown from our current situation must be kept in perspective: We are out of balance today because stimulus-supported excess demand overwhelmed supply constrained by the pandemic and global commodity shocks. Returning to normal means products on shelves, restaurants fully staffed and cars at auto dealers. It doesn't have to require a calamitous decline in activity. As for financial markets, they are hardly the whole economy, but even they could benefit from reaffirmation that trees don't grow to the sky and a reminder that valuations are always worth a fresh look.

Most importantly, moderating demand has a higher purpose squarely in our mandate: containing inflation. If there is any lesson that's been relearned in the last year, it is that everyone hates inflation. Workers who feel they have earned wage gains feel arbitrarily pinched at the gas pump. Homeowners like their sale price but can't believe their purchase price. Businesses work to capture value through pricing but feel they're being taken advantage of by suppliers.

Why do they hate inflation? Inflation creates uncertainty. As prices rise unevenly, it becomes unclear when to spend, when to save or where to invest. Inflation is exhausting. It takes work to shop around for better prices and for firms to handle complaints from unhappy customers and negotiate with insistent suppliers. And inflation seems unfair. In the '70s, those who owned a house with a cheap mortgage benefited; those on fixed incomes did not.

The Fed is on a path to return inflation back to normal levels. We have the credibility with households, businesses and markets required to deliver that outcome. We may or may not get help from global events and supply chains. There is of course recession risk along the way, but there's also the prospect of the economy returning closer to normal.

And now for the part I like the best. I'd like to hear your sentiment on the economy. I'm interested in how businesses might be changing their hiring, investment and pricing plans. I'm curious how supply chains, labor markets and spending patterns are evolving. We at the Fed have a commitment to open communication, but it's not a one-way street. What I learn from you is as important as what I get to share. And I welcome your questions (and perhaps advice for my next speech).

1

"Alan Blinder on Landings Hard and Soft: The Fed, 1965-2020." Princeton University Bendheim Center for Finance. February 11, 2022.

2

Household debt level is here measured as credit to households and nonprofit institutions serving households from all sectors at market value as a percentage of GDP via the Bank for International Settlements (Source: BIS total credit statistics).