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A soft landing comes with risks

At the Jackson Hole Economic Symposium, major central bankers appeared to be comfortable that a soft-landing scenario is unfolding. What made the gathering notable was that it represented a pivot away from the pessimism of the last few years. No longer was fear expressed about imminent recession. Nor was there any discussion this time about troubling tradeoffs between inflation and employment. Rather, the gathering exhibited general confidence that the major economies can experience a soft landing[i].

Since then, the economic data have mostly corroborated their outlook. The global composite purchasing managers index ticked higher in August, with gains seen in the United States (US), Eurozone, and Japan[ii]. Consumer spending and income growth in the US have been strong, while employment growth remained positive in August even if it was little lower than anticipated[iii]. Headline inflation in the Eurozone has continued its descent, largely due to a drop in energy prices, which should support domestic demand[iv]. It should also give the European Central Bank (ECB) additional confidence to cut rates further. Meanwhile, wage growth continues to accelerate in Japan, setting the stage for stronger consumer spending and a tightening of monetary policy[v].

Despite the relatively good economic news of late, there are still plenty of risks. One risk is that services inflation may not come down, preventing central bankers from achieving their inflation targets. This is especially worrisome in the eurozone where services inflation was 4.2% on a year ago basis in August[vi]. That is the highest rate of services inflation since October 2023. A tight labor market and still-strong wage growth could prevent services inflation from coming down further. Labor productivity has been of little help since it has declined over the last year and remains below prepandemic levels[vii]. Still, services inflation is unlikely to dissuade the ECB from cutting rates in the near term, but without further progress on services inflation, additional rate cuts may need to be put on hold.

The persistence of services inflation is a challenge in the US as well. Services inflation remains elevated compared to the period prior to the pandemic[viii]. In addition, wage growth accelerated in August. However, the outlook for services inflation is more benign in the US. Services inflation has come down steadily since the beginning of 2022. Plus, the labor market is showing clear signs of loosening, which suggests wage growth should come back down. Labor productivity has also been relatively strong in the US, which should help the service sector to absorb some of the rise in labor costs[ix].

Interest rates may need to come down more quickly in the US when compared to the eurozone. For one, interest rates are higher in the US than they are in the eurozone. Plus, the president of the Chicago Federal Reserve bank recently noted that the 30-year fixed rate mortgage, which predominates in the US, may lengthen the lagged effect of monetary policy[x]. That could put more downward pressure on interest rates in the US as the Federal Reserve attempts to avoid a recession at a time when the unemployment rate is rising.

While the US and Europe attempt to tame inflation, China is struggling with deflation as domestic demand remains weak after the collapse of the property market[xi]. Real gross domestic product growth has slowed and may undershoot the government's target of about 5% growth this year. Rising debt burdens and limited fiscal stimulus risk worsening economic outcomes in the world's second largest economy.

China's ability to use exports to support growth is also in doubt. Canada recently imposed a 100% tariff on electric vehicles coming from China[xii]. This follows similar moves by the US and European Union. China has also placed export restrictions on critical minerals used in the production of semiconductors. The threat of even higher trade barriers following the US election has caused companies to frontload orders from China. The Secretary General of the International Chamber of Shipping said that "the world order has never been under such threat since before the second world war."[xiii]

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Endnotes

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[i] Colby Smith, "Jackson Hole bankers pivot to rate cuts as soft landing comes into view," *Financial Times,* August 25, 2024. https://www.ft.com/content/78b4e899-1562-451c-81f6-fc6dabc28038
[ii] S&P Global via Haver Analytics
[iii] US Bureau of Labor Statistics via Haver Analytics
[iv] Eurostat via Haver Analytics
[v] Japan Ministry of Health, Labor, and Welfare via Haver Analytics
[vi] Eurostat via Haver Analytics
[vii] Ibid
[viii] US Bureau of Labor Statistics via Haver Analytics
[ix] Ibid
[x] Rocio Fabbro, "Chicago Fed President Austan Goolsbee on interest rates, economic challenges — and vibes," *Quartz*, September 5, 2024. https://qz.com/chicago-fed-president-austan-goolsbee-interest-rates-1851636725
[xi] "China's Deflationary Spiral Is Now Entering Dangerous New Stage," *Bloomberg News,* September 9, 2024. https://www.bloomberg.com/news/articles/2024-09-09/china-s-deflationary-spiral-is-now-entering-dangerous-new-stage?sref=TtzswLLC
[xii] Ian Austen, "Canada Will Impose 100% Tariffs on Chinese Electric Vehicles," *New York Times,* August 26, 2024. https://www.nytimes.com/2024/08/26/business/canada-ev-tariffs-china.html
[xiii] Oliver Telling, "Shipping chief warns of dangers of Trump presidency to trade," *Financial Times,* August 11, 2024. https://www.ft.com/content/fc684104-375e-4d43-8428-1960d44a95b7