ECONOMIC REVIEW (A Monthly Issue)

Issue 6, 2024

中國銀行 香港金融研究院
BANK OF CHINA Hong Kong Financial Research Institute

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What Are the Prospects for the U.S. Economic "Soft Landing"?

Zhiteng Zeng, Economist

During the FOMC meeting in September 2024, the Federal Reserve (the "Fed" hereafter) lowered its federal funds rate target by 50bps, slightly exceeding market expectations. This decision marks a shift in the Fed's monetary policy making, as it moves its focus from inflation risks to concerns about the potential downturns in the labor market and the overall economy. Besides, the Fed Chairman Jerome Powell and other officials have indicated that achieving a "soft landing", defined as guiding inflation back to the target level while avoiding significant damage to the labor market and the macroeconomy, is a primary objective. These statements from the Fed, coupled with recent fluctuations in labor market data, have sparked market-wide discussions regarding the feasibility of a "soft landing" for the U.S. economy. This article will explore the current state and outlook of the U.S. economy, focusing on both labor market dynamics and macroeconomic conditions. In addition, it will provide a brief outlook of the Fed's future interest rate path.

I. Labor Market: Cooling Trends with Resilience and Manageable Downside Risks

In recent months, U.S. non-farm payroll growth has shown a drastic downward trend, accompanied by a rising unemployment rate that has triggered the Sahm Rule. This rule signals a recession warning when the 3-month moving average of the unemployment rate increases by 0.5% or more from its lowest point over the past 12 months. Consequently, there are growing concerns regarding a potential sharp downturn in the U.S. labor market. Our analysis indicates that while labor demand has noticeably cooled down, it remains resilient overall. Recent adverse signals in the labor market have been closely related to supply-side disruptions. Looking ahead, there's an increased risk that further cooling demand could lead to a significant rise in unemployment. However, with the Fed having shifted its policy stance, the risk associated with a deteriorating labor market remains manageable. These points of view will be elaborated in detail as follows.

Despite a cooling in labor demand, there have not been signs of a sharp deterioration. On one hand, due to the lagged effects of monetary tightening and slowing expansion in the services sector, U.S. labor demand has cooled significantly compared to the previous two years. According to The Job Openings and Labor Turnover Survey (JOLTS), the job openings rate fell to 4.8% in August 2024, a notable decline from the post-pandemic peak of 7.4%. Other indicators, such as hiring and quits rates, have reflected similar trends. On the other hand, this moderation in labor demand has merely brought it closer to the balance between labor supply and demand observed before the pandemic, without demonstrating a

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drastic decline, and remains well above recessionary levels. As shown in Figure 1, indicators related to labor shortages and labor market tightness have significantly dropped from their post-pandemic highs, returning to normalized levels without falling into the recessionary territory. In addition, indicators of layoffs and discharges remain low (Figure 2), which is inconsistent with features typically observed during economic recessions and further suggests that labor demand has not yet shown signs of deterioration.

Figure 1: U.S. Labor Shortages and Labor Market Tightness

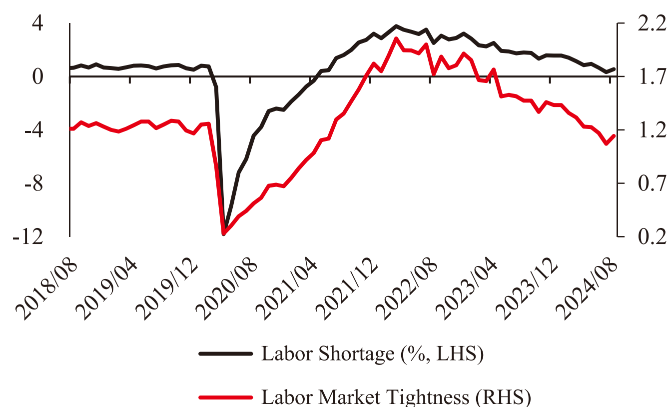
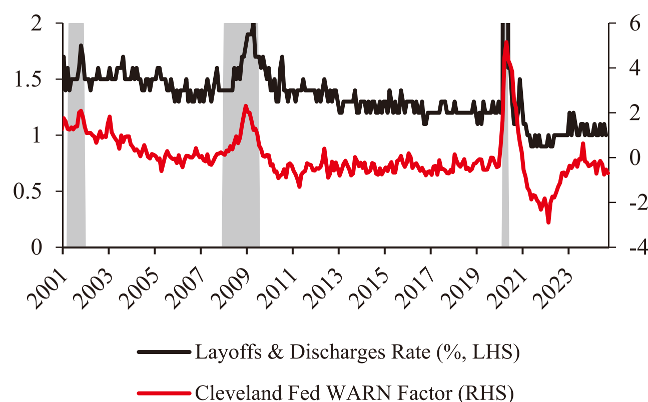


Figure 2: U.S. Layoffs and Discharges



Notes: 1. In Figure 1, labor shortages = (labor demand - labor supply) / labor supply × 100%, in which labor demand is the sum of job openings and employment, while labor supply refers to the number of people in the labor force. Labor market tightness = job openings rate/unemployment rate.

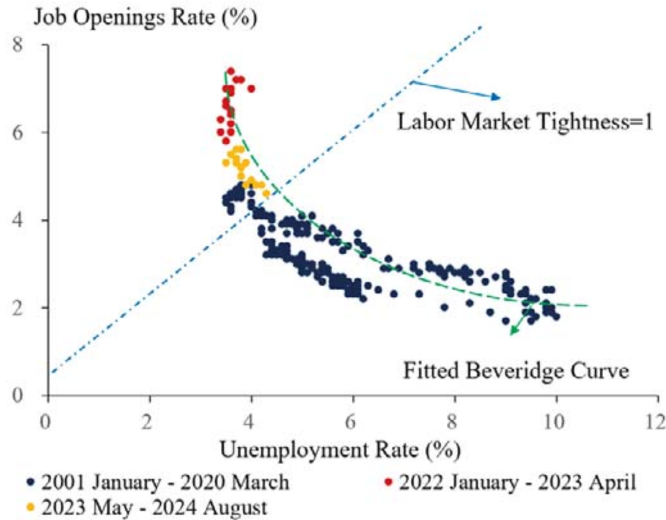
2. The shaded area in Figure 2 represents the economic recession periods as identified by the National Bureau of Economic Research (NBER).

Source: Macrobond, Hong Kong Financial Research Institute of Bank of China

Supply-side disruptions may have amplified the recent pessimistic signals in the labor market. Specifically, the labor participation rate has rebounded from a pandemic low of 60.8% to 62.7% as of September 2024 (with the participation rate for those ages 25 to 54 rising from 80.6% to 83.8% during the same period). Additionally, lenient border policies have led to an influx of immigrants, particularly unauthorized ones, significantly boosting the labor supply. Against the backdrop of normalizing labor demand, this unusual growth in supply has pushed up the unemployment rate. Research by Petrosky-Nadeau and Stewart (2024) from the San Francisco Fed suggests that maintaining stable unemployment required 70,000 to 90,000 new jobs per month prior to the pandemic. Even during the relatively sluggish period from June to August this year, the 3-month moving average of new non-farm jobs remained at 140,000. This suggests that the current pace of job creation should be adequate to absorb new labor supply and keep unemployment relatively stable under normal conditions. While the unemployment rate may rise in the short term, the Congressional Budget Office (CBO) projects that upward pressures from labor supply will gradually diminish. Coupled with the fact that layoffs and discharges have not shown marked escalation, we believe that the recent pessimistic signals from the labor market may be overstated due to supply-side disruptions.

The further cooling of labor demand has heightened the risk of a notable rise in unemployment, while the Fed's policy shift mitigates the possibility of a sharp downturn in the labor market. The U.S. Beveridge Curve, which illustrates the empirical relationship between job openings rates and unemployment rates (as depicted in Figure 3), indicates that as labor demand further declines, this curve will begin to flatten. This flattening implies that a contraction in job openings could lead to a more pronounced increase in unemployment. Nevertheless, the Fed's 50bps rate cut in September conveys the signal that it "does not seek or welcome further cooling in labor market conditions" (as stated by Powell). In light of diminishing inflationary pressures, the Fed has shifted its monetary policy focus from price levels to the labor market in order to fulfill its "dual mandate" of price stability and maximum sustainable employment. Moreover, the Fed has ample space for monetary easing. Therefore, although the likelihood of a vicious cycle—characterized by "rising layoffs and unemployment→ decreased consumption→reduced aggregate demand→further increases in layoffs and unemployment"—has increased compared to the last year, it remains well-managed.

Figure 3: U.S. Beveridge Curve

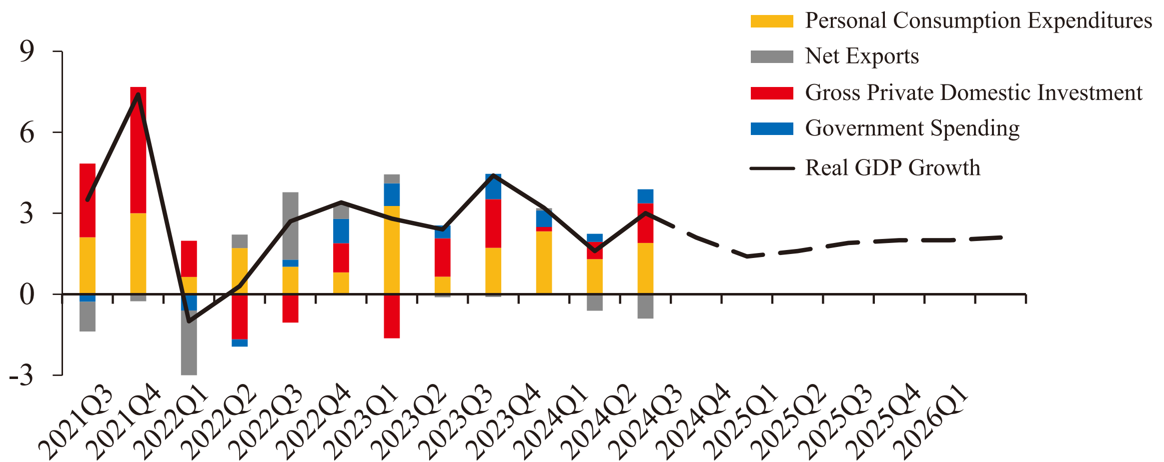


Notes: Due to factors such as a significant rise in the temporary unemployment rate, the U.S. Beveridge curve shifted outward after the pandemic. To simplify analysis, data from April 2020 to December 2021 is omitted from Figure 3.
Source: WIND, Hong Kong Financial Research Institute of Bank of China

II. Macroeconomic Conditions: Robust Private Sector Balance Sheets Bolstering Economic Resilience and Mitigating Recession Risks

Since the Fed's rate hike cycle starting in early 2022, the U.S. economy has demonstrated unanticipated resilience. Data shows that U.S. real GDP growth experienced apparent slowdowns only in the first two quarters of 2022, followed by solid growth momentum over the two years (Figure 4). In contrast to the Great Recession from December 2007 to June 2009, the private sector-including households, non-financial businesses, and financial institutions-has maintained relatively healthy balance sheets in the post-pandemic period. This has weakened the the amplification effect of the monetary tightening associated with the "financial accelerator" mechanism, where falling asset prices lead to deteriorating private sector balance sheets and can potentially trigger economic downturns. Our assessment suggests that robust private sector balance sheets have prevented the previous monetary tightening from significantly raising financing costs for the real economy. This has dampened the adverse impact of high interest rates on consumption and investment activities, thereby increasing the probability of a "soft landing" for the U.S. economy.

Figure 4: U.S. GDP Growth and Breakdown (Annualized Q-o-Q %)



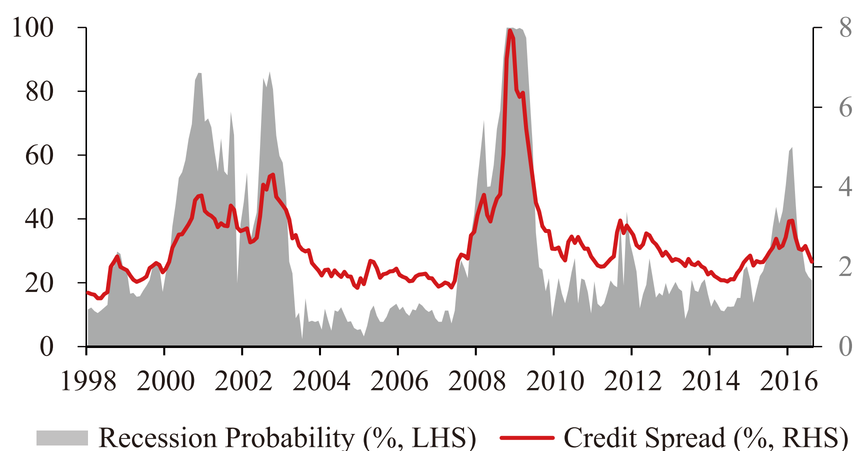
Notes: The blue dashed line represents the consensus forecast from Bloomberg.
Source: Macrobond, Hong Kong Financial Research Institute of Bank of China

U.S. households maintain relatively healthy balance sheets, which have limited the adverse effects of high interest rates on debt burdens and may continue to support consumption activities. Following the financial crisis, households adopted a more cautious approach to leveraging, and asset prices have been driven up by monetary easing measures following the financial crisis and the pandemic. These factors have collectively reduced household debt-to-asset ratios. In addition, amid the low-interest-rate environment during the pandemic, many households switched their loans from variable to fixed interest rates. Therefore, the Fed's aggressive rate hikes have not considerably raised household debt burdens. For instance, while the 30-year mortgage rates, reported by Freddie Mac, peaked at 7.8% in October 2023 (an increase of over 400bps compared to late February 2022), the effective rate on existing mortgages rose by only 49bps during the same period. This data indicates that the Fed's rate hikes have exerted a relatively modest impact on household interest expenditures, demonstrating that the negative impact of monetary tightening on household balance sheets are manageable. Consumption has remained solid, bolstered by well-managed household debt, a solid labor market, and robust growth in services spending. Looking ahead, while high interest rates may suppress demand for interest-sensitive goods like durable items, the probability of a substantial decline in consumption growth momentum in the near-term appears low, thanks to healthy balance sheets and stable income growth.

Similar to households, U.S. businesses maintain relatively robust balance sheets, lowering the risk of a drastic decline in corporate investment. Particularly, during the low-interest-rate period from 2020 to 2021, many non-financial firms extended their debt maturities when issuing bonds, making recent repayment pressures more manageable. Although overall debt service pressures are expected to build up over the next two years due to apparently higher financing costs compared to the pandemic period, the Fed's entry into the rate cut cycle and the ample liquidity assets held by businesses keep their repayment and refinancing challenges within controllable limits. Therefore, while corporate investment growth may be more volatile than household consumption, the likelihood of a sharp decline in corporate investment that could trigger a deep recession remains low.

The stability of the financial system has helped prevent a sharp spike in borrowing costs following monetary tightening, thereby shielding the economy from recession risks. The possibility regarding the outbreak of systemic financial risks has significantly diminished, thanks to robust household and corporate balance sheets, along with an enhanced financial regulatory system established after the financial crisis. In this context, the Fed's previous monetary tightening has not substantially magnified financial stress. Meanwhile, credit spreads have not widened remarkably in the high-interest-rate environment (Figure 5), which has somewhat alleviated the transmission of rate hikes to financing costs for the real economy. Calculations based on credit spreads indicate that the probability of an economic recession remains below 20% (Figure 5), suggesting that recession risks are relatively manageable.

Figure 5: U.S. Credit Spread and Recession Probability



Notes: The credit spread and the associated recession probability are based on Gilchrist and Zakrajšek (2012).
Source: Macrobond, Hong Kong Financial Research Institute of Bank of China

III. Risks Persist in the "Soft Landing" Baseline Scenario Amid Uncertainty About Future Interest Rates

Based on the analysis above, the U.S. labor market has returned to pre-pandemic levels after initially experiencing tight conditions in the post-pandemic period. However, labor demand remains strong. Recent negative signals in the labor market are primarily driven by supply-side factors, which differ markedly from the rapid decline in labor demand typically observed during economic recessions. While the chances of a further labor market slowdown leading to significant rise in unemployment have increased, the Fed's policy shift helps mitigate the risk of a severe deterioration. Moreover, healthy balance sheets across households, non-financial businesses, and financial institutions, combined with the Fed's entry into an easing cycle, should continue to bolster household consumption and corporate investment. Therefore, although economic growth may moderate in the future, these solid balance sheets will enhance the economy's resilience to adverse shocks. As a result, we expect a "soft landing" to be the baseline scenario for the U.S. economy.

Noteworthy, while a "soft landing" remains a relatively likely scenario, adverse factors in the U.S. economy have gradually been accumulating. These include the drag on consumption from depleted excess savings, the potential impact of debt refinancing on corporate credit conditions, and fiscal expansion that may fall short of expectations. Therefore, although the possibility of the U.S. economy experiencing a deep recession akin to 2007-2009 remains low, it still faces certain downside risks. Consequently, the possibility of a mild recession cannot be completely ruled out.

In the "soft landing" baseline scenario, the Fed is expected to address potential adverse economic impacts from risks related to an employment downturn through gradual rate cuts. Although the Fed's focus has shifted from inflation to the labor market, current conditions in the labor market and the overall economy do not show clear signs of recession. Additionally, the Fed may need to retain policy space to respond to potential large-scale economic shocks, suggesting that it will likely pursue its "dual mandate" through cautious fine-tuning. Therefore, the likelihood of the Fed maintaining a 50bps rate cut is low in the near term. However, with the Fed de-emphasizing forward guidance in favor of a more "data-dependent" approach, future policy adjustments have become less predictable. Given uncertainties surrounding upcoming employment and macroeconomic data, it remains possible that the Fed could implement more aggressive rate cuts to stimulate the economy if recession signals emerge. In this context, uncertainty regarding the pace of rate cuts may heighten volatility in U.S. and global financial markets. This underscores the need for ongoing vigilance to facilitate timely strategic adjustments.

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主要經濟指標 (Key Economic Indicators)

一、本地生產總值 GDP	2022	2023	2024/Q1	2024/Q2
總量 (億港元) GDP(HKD 100million)	28,090	29,010	7,299	7,165
同比增長率 (%) YoY change(%)	-3.7	3.3	2.8	3.3
二、對外商品貿易 External merchandize trade			**2024/8**	**2024/1-8**
外貿總值 (億港元) Total trade(HKD 100million)				
總出口 Total exports	45,317	41,774	3,813	29,530
總進口 Total imports	49,275	46,450	4,144	31,690
貿易差額 Trade balance	-3,958	-4,676	-331	-2,160
年增長率 (%) YoY Growth(%)				
總出口 Total exports	-8.6	-7.8	6.4	11.5
總進口 Imports	-7.2	-5.7	7.9	8.0
三、消費物價 Consumer Price				
綜合消費物價升幅 (%) Change in Composite CPI(%)	1.9	2.1	2.5	1.8
四、零售市場 Retail market				
零售額同比升幅 (%) Change in value of total sales YoY(%)	-0.9	16.2	-10.1	-7.7
五、訪港遊客 Visitors				
總人數 (萬人次) Total arrivals(10 thousands)	60.5	3,400.0	445.4	2,952.7
年升幅 (%) YoY change(%)	561.5	5,523.8	9.2	43.7
六、勞動就業 Employment			**2024/6-2024/8**	**2024/7-2024/9**
失業人數 (萬人) No. of unemployed(10 thousands)	16.3	11.3	12.2	12.0
失業率 (%) Unemployment rate(%)	4.3	2.9	3.0	3.0
就業不足率 (%) Underemployment rate(%)	2.3	1.1	1.2	1.2
七、住宅買賣 Domestic property sales and price index			**2024/7**	**2024/8**
合約宗數 (宗) No. of agreements	45,050	43,002	3,723	3,654
住宅售價指數 (1999=100) Domestic price index	369.7	337.4	297.2	292.1
八、金融市場 Financial market			**2024/8**	**2024/9**
港幣匯價 (US$100=HK$) 期末值 HKD exchange rate (US$100 = HK$), end of period	780.8	781.1	779.9	777.0
銀行體系收市總結餘 (億港元) 期末值 Closing aggregate balance(HKD 100million), end of period	962.5	449.5	448.9	478.0
銀行總存款升幅 (%) Change in total deposits(%)	1.7	5.1	5.0	-
銀行總貸款升幅 (%) Change in total loans & advances(%)	-3.0	-3.6	-2.7	-
最優惠貸款利率 (%) 期末值 Best lending rate (%), end of period	5.6250	5.8750	5.8750	5.6250
恒生指數 Hang Seng Index	19,781	17,047	17,989	21,134