ECONOMY

Fed Faces a Fresh Test: Engineering a Soft Economic Landing

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Federal Reserve Chair Jerome Powell, left, and former chairs of the Federal Reserve Janet Yellen and Ben Bernanke participate in a discussion at the American Economic Association conference in Atlanta on Friday. PHOTO: JESSICA MCGOWAN/GETTY IMAGES

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ATLANTA—Federal Reserve officials, after navigating the U.S. economy through the financial crisis and its rebound, face a fresh test in 2019: engineering an economic soft landing.

The central bank's challenge is to manage a moderation in growth that keeps inflation contained but avoids a recession. It was a main topic at an annual economic conference in Atlanta this weekend that featured top current and former Fed officials.

Investors will look this week to talks by Fed Chairman Jerome Powell and Vice Chairman Richard Clarida for new clues on the officials' thinking, as well as Wednesday's release of minutes from the Fed's December meeting.

The Fed's job has become more difficult as the partial federal government shutdown continues. Many economic data releases it uses to get a read on the economy, including a scheduled report this week on durable goods orders, are being delayed because of the closure.

The economy has seldom looked stronger, exemplified by gangbuster job growth in December reported by the Labor Department on Friday. But stock prices and bond yields, which have fallen sharply since October, are signaling a rising risk of recession as growth in foreign economies, especially China's, has slowed sharply.

The disconnect presents the Federal Reserve with a tricky choice: focus more on the domestic economy and keep nudging interest rates higher to combat inflationary concerns, or pay greater attention to stresses abroad and in the markets, and hold rates steady or even nudge them lower.

The central bank has been at such crossroads before in the past quarter-century, averting recession while raising rates in 1994 and 2015, but stumbling into downturns at other moments, such as 2001 and 2008. At another point of uncertainty, in 1998, the Fed cut rates to keep the global economy going.

The current period is complicated by matters out of the Fed's control—most notably a trade dispute between the world's two largest economies, the U.S. and China, and the government shutdown.

For now, the Fed has signaled it is listening to the markets—though not ready to act on investors' worries. Mr. Powell said Friday the Fed would be patient and see how the economy

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evolves, laying the groundwork to take a break from raising rates.

"I can see a possibility where the Fed steers through a slight global slowdown that causes U.S. growth to slow, but not to stop," said Betsey Stevenson, a University of Michigan economist who served as an adviser to President Obama. "There's also a possibility that the global slowdown is worse than expected and that moves the U.S. into a recession."

At its December meeting the Fed signaled plans to raise rates twice this year, to between 2.75% and 3%.

The stock market posted its worst year in 2018 since 2008, with almost all of the declines coming in the fourth quarter. The volatility spared few asset classes. Oil prices hit multiyear highs in October, only to fall in the fourth quarter as investors grew increasingly worried about a potential supply glut.

Stock and bond markets routinely convulse when the Fed is tightening monetary policy by raising rates. The central bank usually does so in pursuit of a soft landing.

That is still what the Fed expects to happen this time. Though the unemployment rate rose in December, it remains at levels the Fed believes will eventually push inflation higher. In mid-December, officials were counting on growth slowing to around 2.3% this year from 3% last year to prevent that overheating.

Soft landings are rare and often aren't painless.

Rate increases in 1994 didn't cause a recession, but spurred large losses for bond investors and precipitated the bankruptcy of Orange County, Calif. They also rippled abroad. A currency crisis in Mexico required a bailout from the U.S. and the International Monetary Fund.

In late 2015 and early 2016, markets convulsed amid fears of a Chinese slowdown and that nation's bungled currency devaluation. In the U.S., an index of factory activity fell into contraction territory, the three-month average job growth slowed to a four-year low, and annual domestic growth dropped to 1.6%.

As a result, the Fed shelved its plans to raise its benchmark rate several times. The global repercussions, where higher U.S. rates led to slower growth abroad that in turn slowed growth in the U.S., "were sufficiently strong that we ended up raising rates only once, and I don't have regrets about that," said former Fed Chairwoman Janet Yellen, who joined Mr. Powell on stage in Atlanta on Friday.

Mr. Powell cited the 2016 example to emphasize the Fed's flexibility going forward.

Former Fed Chairman Ben Bernanke said the current market volatility didn't seem unusual. What was more surprising, he said, was "how benign markets were for such a long time despite the risks of trade wars and other things that were going on," he said Saturday during a panel about the 2008 crisis.

Looking back on that episode, Mr. Bernanke reflected, "what we've seen in the last year, I hate to tell any investors here, this is not all that huge."

The Fed must be careful about responding too quickly to market gyrations, Mr. Bernanke added. Such action could lead to the idea of a Fed "put"—an assumption by investors they can take more risk because the Fed will bail them out.

Some analysts cite 1998 as analogous to today, when financial crises in Asia and Russia and the near-failure of a giant hedge fund prompted the Fed to cut rates. The following year the U.S. economy took off and the Nasdaq bubble inflated.

As in 1998, investors have been stunned by the exposure of the U.S. to events abroad. Last week's warning by Apple that revenue would fall short because of a sudden drop-off in China sales was a sign of how central that economy is to global growth.

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Twenty years ago, China accounted for 2.5% of the world's imports; in 2017, it was 10%. It is now the largest trading partner for many countries that are also key customers of U.S. exporters, linkages that make it hard for the U.S. to remain unaffected by a slowdown in China.

"All those that wish for China to do poorly…should be careful what they wish for," Hank Paulson, who was Treasury secretary during the global financial crisis, told the conference. That was a veiled criticism of President Trump's efforts to weaken China in an attempt to strengthen the U.S. negotiating position on trade.

Given the risks of slower global growth and "dysfunction in government, there's nothing surprising about this volatility," Mr. Paulson said.

A bond-market development that traditionally has been a harbinger of recession is also flashing warning signs: the narrowing gap between short- and longer-term Treasury yields.

The gap typically shrinks when the Fed raises short-term rates. When short-term Treasury yields rise higher than longer-term yields, a so-called inverted yield curve, it often is a sign that investors believe the economy is slowing and in need of lower rates. A recession has almost always followed within a year or two.

The spread on three-month and 10-year Treasurys has fallen to 0.15 percentage point, down from 0.86 percentage point at the end of September. It is near levels seen in December 1994 and June 1998, two other periods in which the spread tightened but didn't turn negative.

"Maybe that's telling you something about either market expectations about policy or…the economy," said Cleveland Fed President Loretta Mester in an interview Friday.

While Ms. Mester said she still expects steady growth that will warrant higher rates this year, "I'm in a position now where I don't feel there's urgency."

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