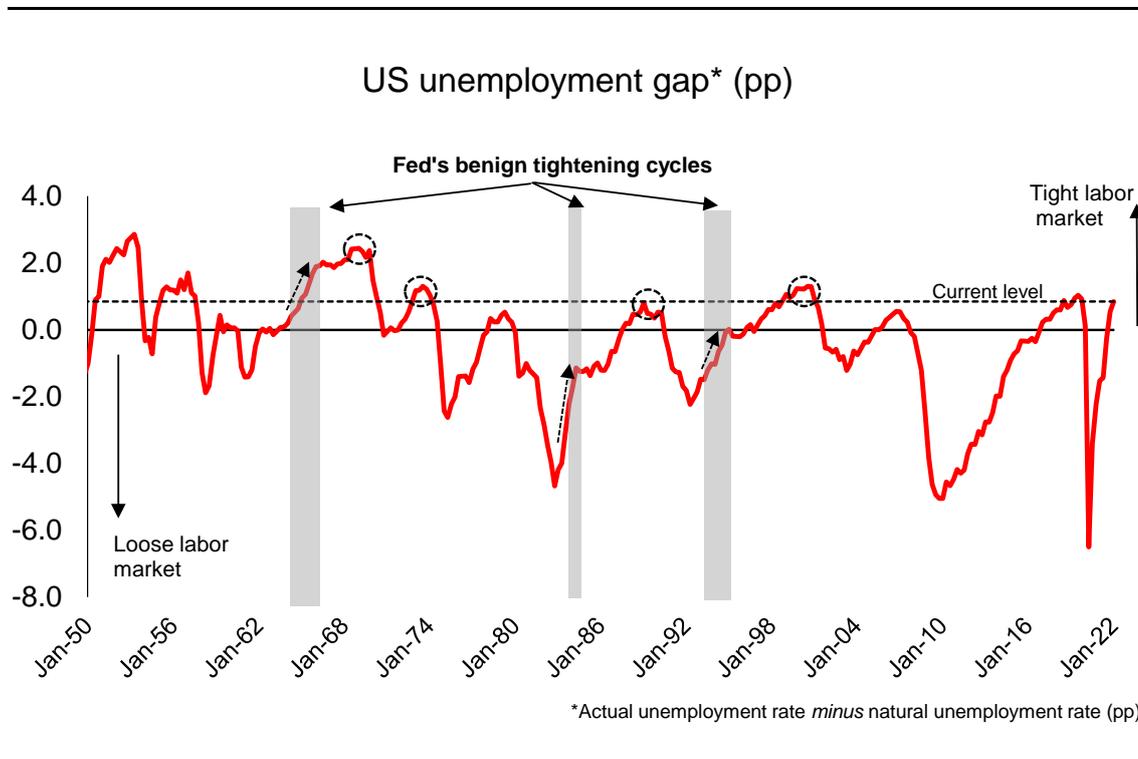


Fed: Why a soft landing will be harder to achieve this time



Source: CBO, BLS UniCredit Research

- The Fed has embarked on eleven tightening cycles since 1965. Eight were followed by a recession, three ended with a soft landing. The three benign cycles (1964, 1984 and 1993) coincided with a drop in inflation, a fall in the unemployment rate, and an easing in economic growth. In a recent speech, Fed Chair Jerome Powell referred to these three episodes to express the FOMC's optimism that it can remove monetary policy accommodation and restore price stability, while engineering a soft landing for the economy.
- Our *Chart of the Week* shows that, this time around, the task will be more difficult. It reports the so-called unemployment gap – the difference between the actual and the natural unemployment rates.* A positive difference means that the labor market is tight, whereas a negative difference indicates that there is still sizable slack. The chart indicates that today's starting point is very different from the three benign monetary tightening cycles mentioned by Mr. Powell. In both 1984 and 1993, the gap was negative; in 1964, it was close to zero. Thus, it was possible to hike rates without necessarily creating substantial economic slack to bring inflation down. In fact, during all three episodes the actual unemployment rate dropped, pushing the unemployment gap up.
- At the moment, however, the unemployment gap is at its highest level in about twenty years and at one of the highest levels in four decades. This means that the tightening cycle is starting late, with the unemployment rate already in inflationary territory. A positive unemployment gap of 1pp implies that the labor market is adding to inflationary pressures, via wages. Therefore, in order to rein in inflation, the unemployment rate would have to rise substantially to generate slack and bring the gap down – a very different situation from the three prior benign hiking cycles. Add to this that inflation is currently well above target, and much higher than at the start of the three previous benign episodes, and it's clear that the Fed has to perform a very complicated balancing act.
- Whether or not this also implies a hard landing is an open question given the high degree of uncertainty. For example, it could be that the natural rate of unemployment is currently lower than the Congressional Budget

Office estimates. The 1964 episode is reassuring in this respect. Even though the initial gap was below the current level, it crossed it at the end of the tightening cycle – meaning that a soft landing is possible. However, during all the other episodes where the gap was close or above current levels, interest rate hikes were followed by a recession.

- Therefore, there are two potential paths for the Fed, with direct implications for the labor market. In a benign scenario, price pressures will come down as demand weakens (due to fiscal and monetary tightening and higher inflation eroding real incomes) and supply bottlenecks ease. In this case, the Fed tightens only back to a neutral setting, unemployment rises back to neutral and there is a soft landing. In a less-benign scenario, if supply shortages persist (for example, as a result of the Russia-Ukraine conflict and the COVID-19 outbreak in China) or if inflation expectations were to become de-anchored, the unemployment rate will need to do most of the heavy lifting, moving well above the natural rate. This implies faster and larger monetary tightening, which would risk triggering a recession.
- The FOMC looks poised to bring interest rates towards the natural rate – and, thus, a neutral stance initially and then will decide whether the inflation outlook warrants a restrictive monetary policy (i.e. rates above their neutral level). Some, for example, former New York Fed president William Dudley or former Treasury Secretary Larry Summers, think that a restrictive stance (a target fed funds rate well above the natural rate) is warranted as a result of the labor market tightness and well-above-target inflation. In our view, but acknowledging the high degree of uncertainty, inflation is likely to return to around the 2% target in 2H23 as supply and demand adjust, even without restrictive monetary policy.

*The natural rate of unemployment is the unemployment rate that is consistent with stable inflation. It varies over time as a result of structural factors. The Congressional Budget Office estimates that in the seventies it was around 6.2% in the US, whereas now it is at 4.4%.

Edoardo Campanella, Economist (UniCredit Bank, Milan)
+39 02 8862-0522
edoardo.campanella@unicredit.eu

Legal Notices

Glossary

A comprehensive glossary for many of the terms used in the report is available on our website: <https://www.unicreditresearch.eu/index.php?id=glossary>

Disclaimer

Our recommendations are based on information obtained from or are based upon public information sources that we consider to be reliable, but for the completeness and accuracy of which we assume no liability. All information, estimates, opinions, projections and forecasts included in this report represent the independent judgment of the analysts as of the date of the issue unless stated otherwise. We reserve the right to modify the views expressed herein at any time without notice. Moreover, we reserve the right not to update this information or to discontinue it altogether without notice. This report may contain links to websites of third parties, the content of which is not controlled by UniCredit Bank. No liability is assumed for the content of these third-party websites.

This report is for information purposes only and (i) does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for any financial, money market or investment instrument or any security, (ii) is neither intended as such an offer for sale or subscription of or solicitation of an offer to buy or subscribe for any financial, money market or investment instrument or any security nor (iii) as marketing material within the meaning of applicable prospectus law. The investment possibilities discussed in this report may not be suitable for certain investors depending on their specific investment objectives and time horizon or in the context of their overall financial situation. The investments discussed may fluctuate in price or value. Investors may get back less than they invested. Fluctuations in exchange rates may have an adverse effect on the value of investments. Furthermore, past performance is not necessarily indicative of future results. In particular, the risks associated with an investment in the financial, money market or investment instrument or security under discussion are not explained in their entirety.

This information is given without any warranty on an "as is" basis and should not be regarded as a substitute for obtaining individual advice. Investors must make their own determination of the appropriateness of an investment in any instruments referred to herein based on the merits and risks involved, their own investment strategy and their legal, fiscal and financial position. As this document does not qualify as an investment recommendation or as a direct investment recommendation, neither this document nor any part of it shall form the basis of, or be relied on in connection with or act as an inducement to enter into, any contract or commitment whatsoever. Investors are urged to contact their bank's investment advisor for individual explanations and advice.

Neither UniCredit Bank AG, UniCredit Bank AG London Branch, UniCredit Bank AG Milan Branch, UniCredit Bank AG Vienna Branch, UniCredit Bank Austria AG, UniCredit Bulbank, Zagrebačka banka d.d., UniCredit Bank Czech Republic and Slovakia, ZAO UniCredit Bank Russia, UniCredit Bank Czech Republic and Slovakia Slovakia Branch, UniCredit Bank Romania, UniCredit Bank AG New York Branch nor any of their respective directors, officers or employees nor any other person accepts any liability whatsoever (in negligence or otherwise) for any loss howsoever arising from any use of this document or its contents or otherwise arising in connection therewith.

This report is being distributed by electronic and ordinary mail to professional investors, who are expected to make their own investment decisions without undue reliance on this publication, and may not be redistributed, reproduced or published in whole or in part for any purpose.

This report was completed and first published on 6 April 2022 at 11:45.

Responsibility for the content of this publication lies with:

UniCredit Group and its subsidiaries are subject to regulation by the European Central Bank

- a) UniCredit Bank AG (UniCredit Bank, Munich or Frankfurt), Arabellastraße 12, 81925 Munich, Germany, (also responsible for the distribution pursuant to §85 WpHG). Regulatory authority: "BaFin" – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany.
 - b) UniCredit Bank AG London Branch (UniCredit Bank, London), Moor House, 120 London Wall, London EC2Y 5ET, United Kingdom. Regulatory authority: "BaFin" – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany and subject to limited regulation by the Financial Conduct Authority, 12 Endeavour Square, London E20 1JN, United Kingdom and Prudential Regulation Authority 20 Moorgate, London, EC2R 6DA, United Kingdom. Further details regarding our regulatory status are available on request.
 - c) UniCredit Bank AG Milan Branch (UniCredit Bank, Milan), Piazza Gae Aulenti, 4 - Torre C, 20154 Milan, Italy, duly authorized by the Bank of Italy to provide investment services. Regulatory authority: "Bank of Italy", Via Nazionale 91, 00184 Roma, Italy and Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany.
 - d) UniCredit Bank AG Vienna Branch (UniCredit Bank, Vienna), Rothschildplatz 1, 1020 Vienna, Austria. Regulatory authority: Finanzmarktaufsichtsbehörde (FMA), Otto-Wagner-Platz 5, 1090 Vienna, Austria and subject to limited regulation by the "BaFin" – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany. Details about the extent of our regulation by the Bundesanstalt für Finanzdienstleistungsaufsicht are available from us on request.
 - e) UniCredit Bank Austria AG (Bank Austria), Rothschildplatz 1, 1020 Vienna, Austria. Regulatory authority: Finanzmarktaufsichtsbehörde (FMA), Otto-Wagner-Platz 5, 1090 Vienna, Austria
 - f) UniCredit Bulbank, Sveta Nedelya Sq. 7, BG-1000 Sofia, Bulgaria. Regulatory authority: Financial Supervision Commission (FSC), 16 Budapeshta str., 1000 Sofia, Bulgaria
 - g) Zagrebačka banka d.d., Trg bana Josipa Jelačića 10, HR-10000 Zagreb, Croatia. Regulatory authority: Croatian Agency for Supervision of Financial Services, Franje Račkoga 6, 10000 Zagreb, Croatia
 - h) UniCredit Bank Czech Republic and Slovakia, Želetavská 1525/1, 140 92 Praga 4, Czech Republic. Regulatory authority: CNB Czech National Bank, Na Příkopě 28, 115 03 Praga 1, Czech Republic
 - i) ZAO UniCredit Bank Russia (UniCredit Russia), Prechistsenskaya nab. 9, RF-119034 Moscow, Russia. Regulatory authority: Federal Service on Financial Markets, 9 Leninsky prospekt, Moscow 119991, Russia
 - j) UniCredit Bank Czech Republic and Slovakia, Slovakia Branch, Šancova 1/A, SK-813 33 Bratislava, Slovakia. Regulatory authority: CNB Czech National Bank, Na Příkopě 28, 115 03 Praha 1, Czech Republic and subject to limited regulation by the National Bank of Slovakia, Imricha Karvaša 1, 813 25 Bratislava, Slovakia. Regulatory authority: National Bank of Slovakia, Imricha Karvaša 1, 813 25 Bratislava, Slovakia
 - k) UniCredit Bank Romania, Bucharest 1F Expozitiei Boulevard, 012101 Bucharest 1, Romania. Regulatory authority: National Bank of Romania, 25 Lipskani Street, 030031, 3rd District, Bucharest, Romania
 - l) UniCredit Bank AG New York Branch (UniCredit Bank, New York), 150 East 42nd Street, New York, NY 10017. Regulatory authority: "BaFin" – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany and New York State Department of Financial Services, One State Street, New York, NY 10004-1511
- Further details regarding our regulatory status are available on request.

ANALYST DECLARATION

The analyst's remuneration has not been, and will not be, geared to the recommendations or views expressed in this report, neither directly nor indirectly. All of the views expressed accurately reflect the analyst's views, which have not been influenced by considerations of UniCredit Bank's business or client relationships.

POTENTIAL CONFLICTS OF INTERESTS

You will find a list of keys for company specific regulatory disclosures on our website <https://www.unicreditresearch.eu/index.php?id=disclaimer>.

RECOMMENDATIONS, RATINGS AND EVALUATION METHODOLOGY

You will find the history of rating regarding recommendation changes as well as an overview of the breakdown in absolute and relative terms of our investment ratings, and a note on the evaluation basis for interest-bearing securities on our website <https://www.unicreditresearch.eu/index.php?id=disclaimer> and <https://www.unicreditresearch.eu/index.php?id=legalnotices>.

ADDITIONAL REQUIRED DISCLOSURES UNDER THE LAWS AND REGULATIONS OF JURISDICTIONS INDICATED

You will find a list of further additional required disclosures under the laws and regulations of the jurisdictions indicated on our website <https://www.unicreditresearch.eu/index.php?id=disclaimer>.

E 20/1

UniCredit Research*

Macro Research



Marco Valli
Global Head of Research,
Chief European Economist
+39 02 8862-0537
marco.valli@unicredit.eu



Dr. Ingo Heimig
Head of Research Operations
& Regulatory Controls
+49 89 378-13952
ingo.heimig@unicredit.de

Head of Macro Research



Marco Valli
Global Head of Research,
Chief European Economist
+39 02 8862-0537
marco.valli@unicredit.eu

European Economics Research



Dr. Andreas Rees
Chief German Economist
+49 69 2717-2074
andreas.rees@unicredit.eu



Dr. Loredana Federico
Chief Italian Economist
+39 02 8862-0534
loredanamaría.federico@unicredit.eu



Stefan Bruckbauer
Chief Austrian Economist
+43 50505-41951
stefan.bruckbauer@unicreditgroup.at



Tullia Bucco
Economist
+39 02 8862-0532
tullia.bucco@unicredit.eu



Edoardo Campanella
Economist
+39 02 8862-0522
edoardo.campanella@unicredit.eu



Walter Pudschedl
Economist
+43 50505-41957
walter.pudschedl@unicreditgroup.at



Chiara Silvestre
Economist
chiara.silvestre@unicredit.eu

International Economics Research



Daniel Vernazza, Ph.D.
Chief International Economist
+44 207 826-7805
daniel.vernazza@unicredit.eu

EEMEA Economics Research



Dan Bucsa
Chief CEE Economist
+44 207 826-7954
dan.bucsa@unicredit.eu



Gökçe Çelik
Senior CEE Economist
+44 207 826-6077
gokce.celik@unicredit.eu



Mauro Giorgio Marrano
Senior CEE Economist
+43 50505-82712
mauro.giorgiomarrano@unicredit.de



Artem Arkhipov
Head, Macroeconomic Analysis
and Research, Russia
+7 495 258-7258
artem.arkhipov@unicredit.ru



Hrvoje Dolenc
Chief Economist, Croatia
+385 1 6006-678
hrvoje.dolenc@unicreditgroup.zaba.hr



Dr. Ágnes Halász
Chief Economist, Head, Economics and
Strategic Analysis, Hungary
+36 1 301-1907
agnes.halasz@unicreditgroup.hu



Ľubomír Koršňák
Chief Economist, Slovakia
+421 2 4950 2427
lubomir.korsnak@unicreditgroup.sk



Anca Maria Negrescu
Senior Economist, Romania
+40 21 200-1377
anca.negrescu@unicredit.ro



Kristofor Pavlov
Chief Economist, Bulgaria
+359 2 923-2192
kristofor.pavlov@unicreditgroup.bg



Pavel Sobíšek
Chief Economist, Czech Republic
+420 955 960-716
pavel.sobisek@unicreditgroup.cz

UniCredit Research, Corporate & Investment Banking, UniCredit Bank AG, Am Eisbach 4, D-80538 Munich, globalresearch@unicredit.de
Bloomberg: UCCR, Internet: www.unicreditresearch.eu

MR 22/1

*UniCredit Research is the joint research department of UniCredit Bank AG (UniCredit Bank, Munich or Frankfurt), UniCredit Bank AG London Branch (UniCredit Bank, London), UniCredit Bank AG Milan Branch (UniCredit Bank, Milan), UniCredit Bank AG Vienna Branch (UniCredit Bank, Vienna), UniCredit Bank Austria AG (Bank Austria), UniCredit Bulbank, Zagrebačka banka d.d., UniCredit Bank Czech Republic and Slovakia, ZAO UniCredit Bank Russia (UniCredit Russia), UniCredit Bank Romania.