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Review

Economic Cycles And Trends

What Happens After the U.S. Economy's Soft Landing?

by Philipp Carlsson-Szlezak, Paul Swartz, and Martin Reeves

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Summary. A year ago, a recession was seen as a foregone conclusion — and yet the Fed appears to have successfully lowered inflation without triggering a recession. Many of the negative forecasts followed a pattern of underestimating the U.S. economy's resilience,... **more**

The U.S. economy has defied the doomsayers once again. More than a year has passed since a recession was seen as a foregone conclusion and a "soft landing" pronounced near impossible. But today, the soft landing is well advanced, even if not complete: The

Fed has found success in lowering inflation without triggering a recession. The labor market, the only reliable evidence that the economy is in recession, has cooled without pushing up the unemployment rate.

Though this is welcome news, the protracted uncertainty surrounding the economy has confounded many leaders — and came at a cost for those who hunkered down prematurely in anticipation of recession. This uncertainty will persist. What comes after the soft landing (if in fact it can be completed)? To answer this question, we look at why the recession calls were wrong and what lies ahead.

Recession Prophecies, Unfulfilled

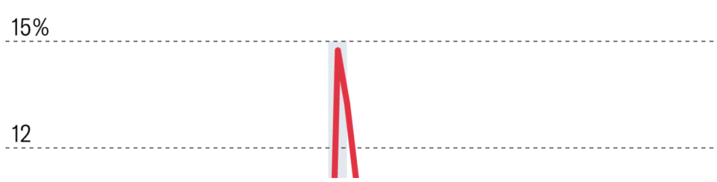
As in the pandemic, when doomsayers predicted a "Greater Depression," much negativity dominated public discourse of the last year and a half. Some leaders predicted a "hurricane" would hit the economy shortly; others dismissed even the possibility of a soft landing.

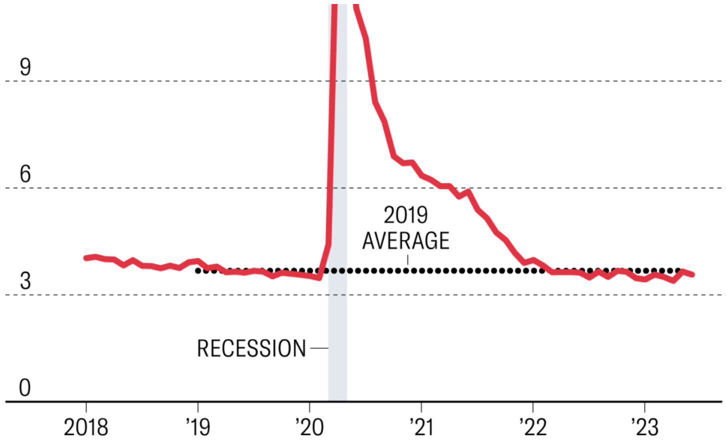
But as the below graphic illustrates, that is exactly what has played out over the last 16 months. Job openings have come off their highs as firms feel under less strain, and quit rates have fallen as workers feel less enticed to jump ship — all while hiring ("payrolls") continues at a robust pace. As the unemployment rate remains near its 60-year low there is no sign of recession.

U.S. Labor Market's Progress Toward a Soft Landing

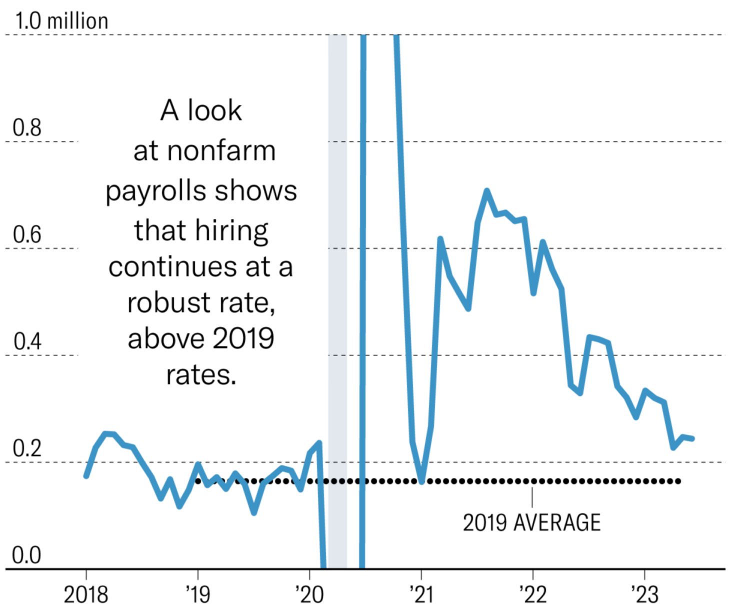
Easing the post-lockdown hot labor market without raising unemployment was widely viewed as impossible. But as the below charts show, this is exactly what has played out over the past 16 months.

Unemployment rate *(monthly)*

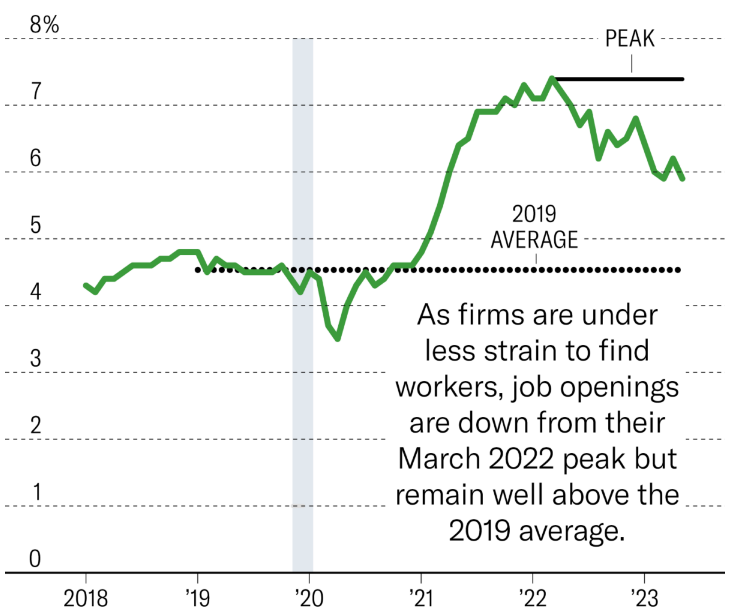




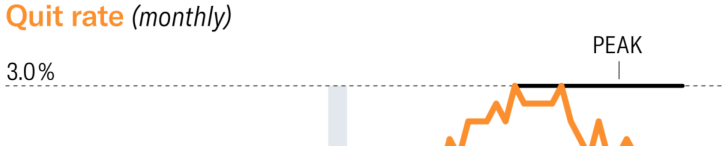
Change in nonfarm payrolls *(monthly, 3-month moving avg.)*

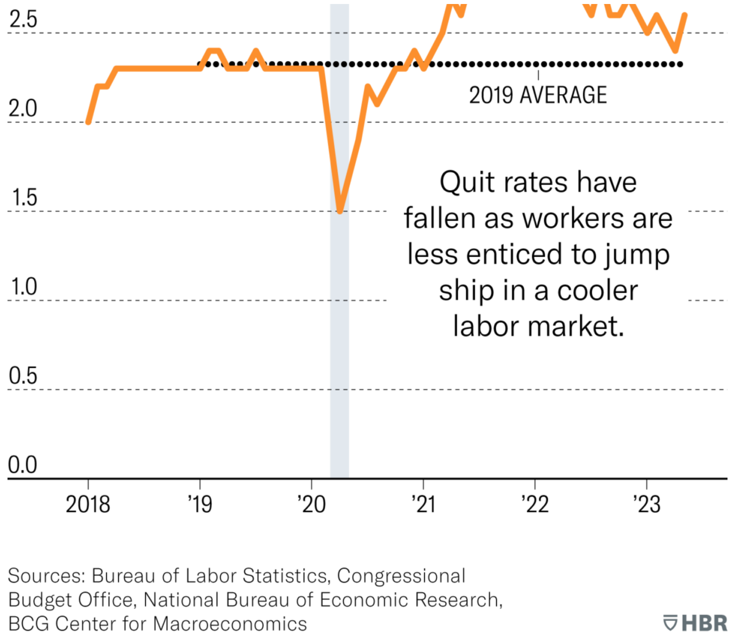


Job-openings rate *(monthly)*



Quit rate *(monthly)*





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What went wrong, or, more appropriately, what went right?

Many of the negative forecasts followed a pattern of underestimating the U.S. economy's resilience, typically because they were based on historical models and precedent – not situational and idiosyncratic context. Consider the following four displays of resilience:

- **Labor market resilience.** The widespread assumption was that monetary policy would push labor demand collectively under water. Instead we have seen pockets of weakness, covered by aggregate strength. Significant layoffs happened where hiring had overshot (e.g., tech) but in other sectors (e.g., services) hiring was still catching up and remained strong. Laid-off workers found new jobs. Resilience was found in the unusual economic diversification of recessionary sectors with booming ones.
- **Consumer resilience.** Growing layoffs, inflation eating away at household budgets, and falling portfolios weakening balance sheets led to predictions of a collapse in spending. But the context mattered. Balance sheets had buffers, including cash.

And while individual budgets were squeezed, the total number of incomes continued to grow rapidly as hiring persisted, providing consumer strength. The aggregate downdraft has not happened.
- **Housing resilience.** A common fear has been that rising interest rates would kneecap the housing market — delaying construction activity, pushing down prices, or even, as some doomsayers predicted, causing another housing-centered recession. But these narratives overlooked the fact that activity remains precisely because housing inventory is low. As a result, higher rates have tamped down — rather than choked — housing activity. Housing starts and prices dipped, and transactions fell, but they have stabilized and are rising again.
- **Financial system resilience.** Another common fear was that the Fed will hike until something breaks. The idea that the financial system would be the collateral damage of higher rates is not unreasonable as the collapse of SVB demonstrated. But the risk of contagion was overestimated, while the ability of policy-makers to avert it was underestimated.

The better-than-expected outcomes share a pattern. Each concern had merit but was considered too narrowly. The idiosyncratic, contextual, and situational drivers mattered more than what historical relationships — and the models that are based on them — said about these sectors.

A lesson that cannot be learned often enough, it seems, is that trust in macroeconomic models remains too strong. The idiosyncrasies of the cycle call for judgment rather than precise forecasts. Meanwhile, the doomsaying is routinely amplified as the microphone is reliably passed to the gloomiest voices.

The Path Ahead

Economics often unhelpfully frames the economic cycle as "moving to equilibrium." (The aviation analogy of a "soft landing" is similarly guilty.) In reality, we are always moving from one idiosyncratic disequilibrium to another, meaning executives cannot rely on forecasts. New idiosyncratic drivers will always deliver new situations that models won't readily pick up on.

So, what could the new disequilibrium be?

Though the first stages of the soft landing are a success, ruling out a recession would be a mistake. It remains a possible, even plausible, outcome (and over time an inevitability). Monetary policy still has a foot on the brake. Real shocks can always end a cycle, particularly when growth is already slow and the economy thus more vulnerable, and financial stressors, such as bank failures, can pop up unexpectedly. Considering the three types of recession risk remains indispensable, but we still view recession risk in the near term as much lower than consensus.

A re-acceleration is more likely, as a resilient economy successfully weathers this period of weak (but non-recessionary) growth. Yet, such a re-acceleration could play out in different ways – some are welcome, others are not.

Scenario 1: A Re-run of the Overshooting Economy

If demand picks up strongly and outstrips the economy's capacity (think available labor, capital, and known processes), another bout of inflation is likely. This would necessitate a fresh round of monetary tightening with all the risks we discussed above.

Even so, it would *not* immediately point to an "inflation regime break" — the mistaken narrative of the last two years that the U.S. economy was seeing a structural return of inflation. It would mean another bout of cyclical inflation that comes (and goes) with a mismatch of demand and supply.

Scenario 2: A Just-Right Economy

If demand grows in line with the economy's capacity, the expansion can plod along at acceptable growth rates without renewed inflation pressures. Monetary policy could ease from its very tight stance toward a more neutral stance — until a shift toward a new disequilibrium arises.

Scenario 3: A Better-Than-Good Economy

We know this has arrived when the economy's capacity grows considerably faster than demand, facilitating rapid growth without concomitant cyclical inflation. While strong capital formation and strong labor participation can help facilitate this scenario to a degree, it's crux would be an acceleration of productivity growth.

Can this happen and is it likely?

Many are eager to pencil in much higher growth courtesy of ChatGPT and other applications of AI — but not so fast. The mere availability of labor does not guarantee faster productivity growth; think of tech as just the fuel. The *spark* typically comes in the form of tight labor markets. When firms are forced to substitute capital for labor, they tend to do more of it. When they can't hire the next worker, they transform their processes.

Such sustained labor market tightness and its benefits are a realistic prospect. Still, leaders should remain prudent about size and speed of such gains. Big productivity gains at the macroeconomic level come gradually, not abruptly, and their size is often overestimated — as we saw in the pandemic, when analysts rushed to pencil in an extra 1 percentage point of growth that did not materialize.

The benefits of such a scenario would be broader than just somewhat higher growth. Tight labor markets create real wage growth across the income distribution, and the biggest winners tend to be at the bottom of the distribution. This creates opportunities for career advancement and job creation for those who have had fewer opportunities or struggled to get on the job ladder, and it pulls into the labor market those who may have otherwise exited.

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While the soft landing may be progressing with promise, it won't be an end state — a new disequilibrium will emerge. Leaders can't wait for macroeconomic certainty or stability. Instead, they must recognize that the macroeconomy will remain untamed by models — and that what matters is judgment. Gloomy headlines will persist, and economic models will offer a flat view of the world that misses out on critical context. Leaders must apply the same skills they employ each day to lead their firms through uncertainty to navigating the macroeconomy. They must avoid both overreacting to the latest piece of data and preparing for only one unchanging view the future.

For firms, the challenges of a tight economy, including margin pressure, as well as higher, but healthy interest rates, are likely here to stay — but they are preferable to the alternative of recession. Meeting these challenges head on means more capital for labor substitution, more reinvention, and more technological absorption. Each of these form the foundation of the better-than-good economic scenario.

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Philipp Carlsson-Szlezak is a partner and managing director in BCG's New York office and global chief economist of BCG. He can be reached at: Carlsson-Szlezak.Philipp@bcg.com.

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Paul Swartz is a director and senior economist in the BCG Henderson Institute, based in BCG's New York office.

Martin Reeves is the chairman of Boston Consulting Group's BCG Henderson Institute in San Francisco and a coauthor of *The Imagination Machine* (Harvard Business Review Press, 2021).

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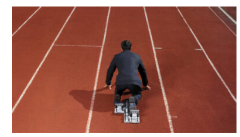

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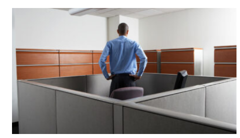

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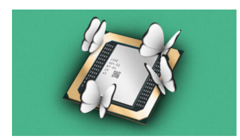

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