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The Prospects for Disinflation in 2023

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St. Louis

CENTRAL TO
AMERICA'S ECONOMY®

Any opinions expressed here are my own and do not necessarily reflect those of the Federal Open Market Committee.

Introduction

This talk

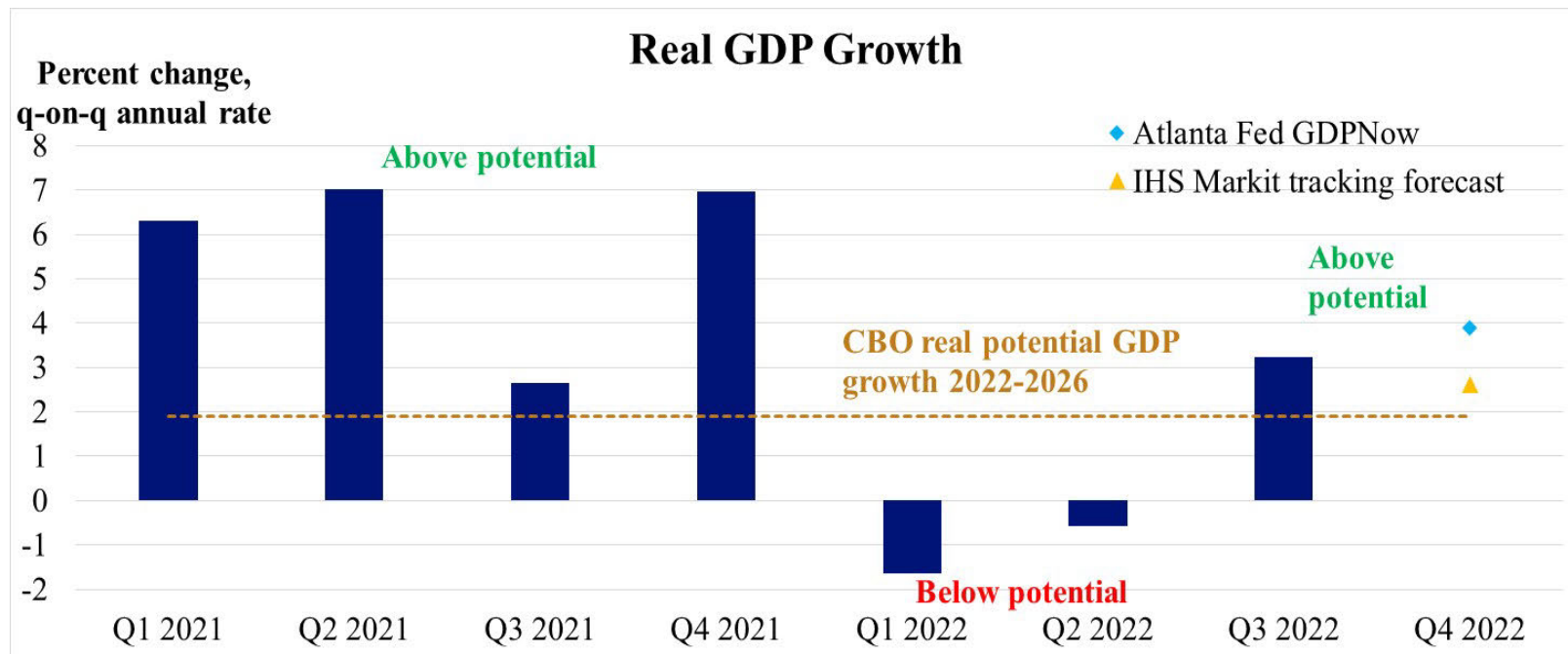
- GDP growth appears to have improved in the second half of 2022.
- Labor market performance remains strong.
- Inflation remains too high but has declined recently.
- The policy rate is not yet in a zone that may be considered sufficiently restrictive, but it is getting closer.
- Front-loaded Fed policy has helped keep market-based measures of inflation expectations relatively low.
- These factors may combine to make 2023 a disinflationary year.

GDP Growth Improves

Improved real GDP growth

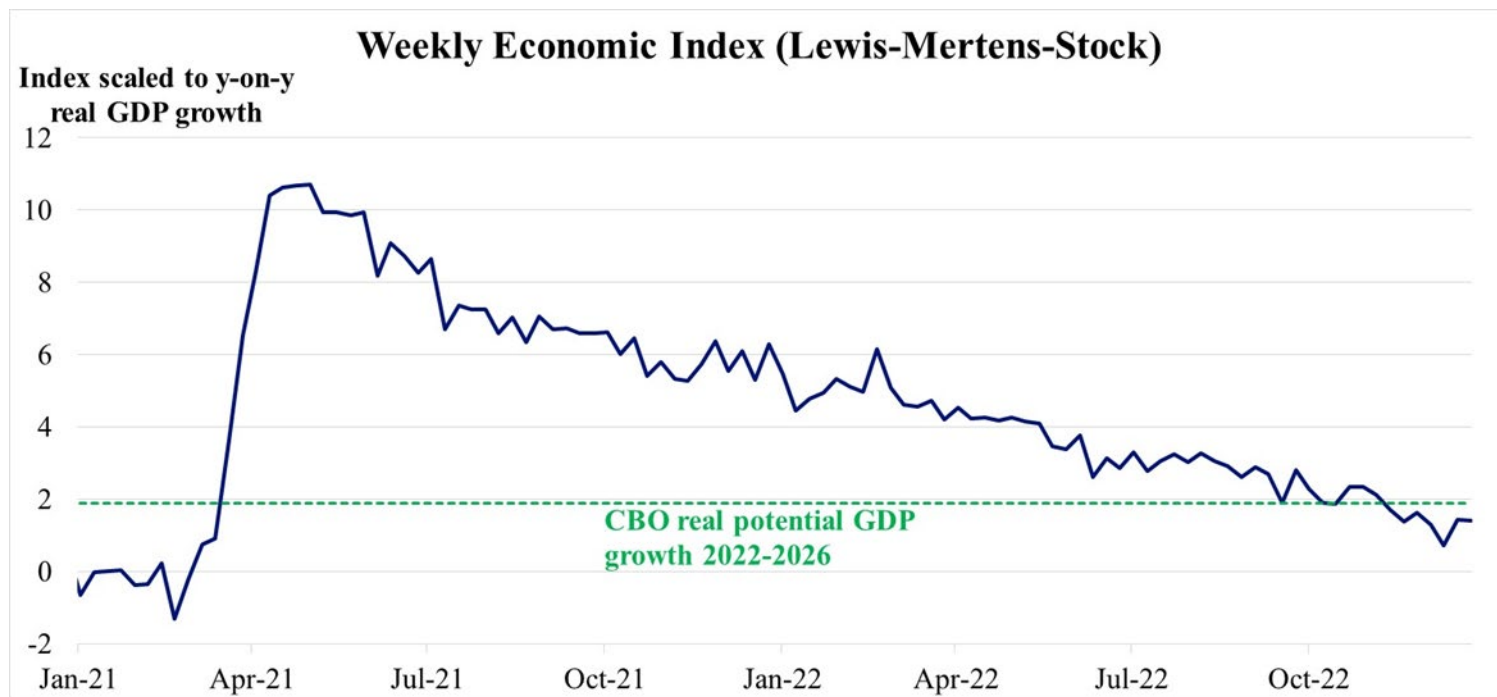
- After negative real GDP growth in the first half of 2022, GDP growth appears to have improved in the second half of 2022.
- Third-quarter 2022 real GDP growth is now estimated to have been 3.2% at an annual rate, and fourth-quarter 2022 tracking estimates now suggest the economy grew at an above-trend rate in the fourth quarter as well.
- Year-on-year growth is slowing, according to incoming weekly data, and the output gap remains positive.

Improved growth in the second half of 2022



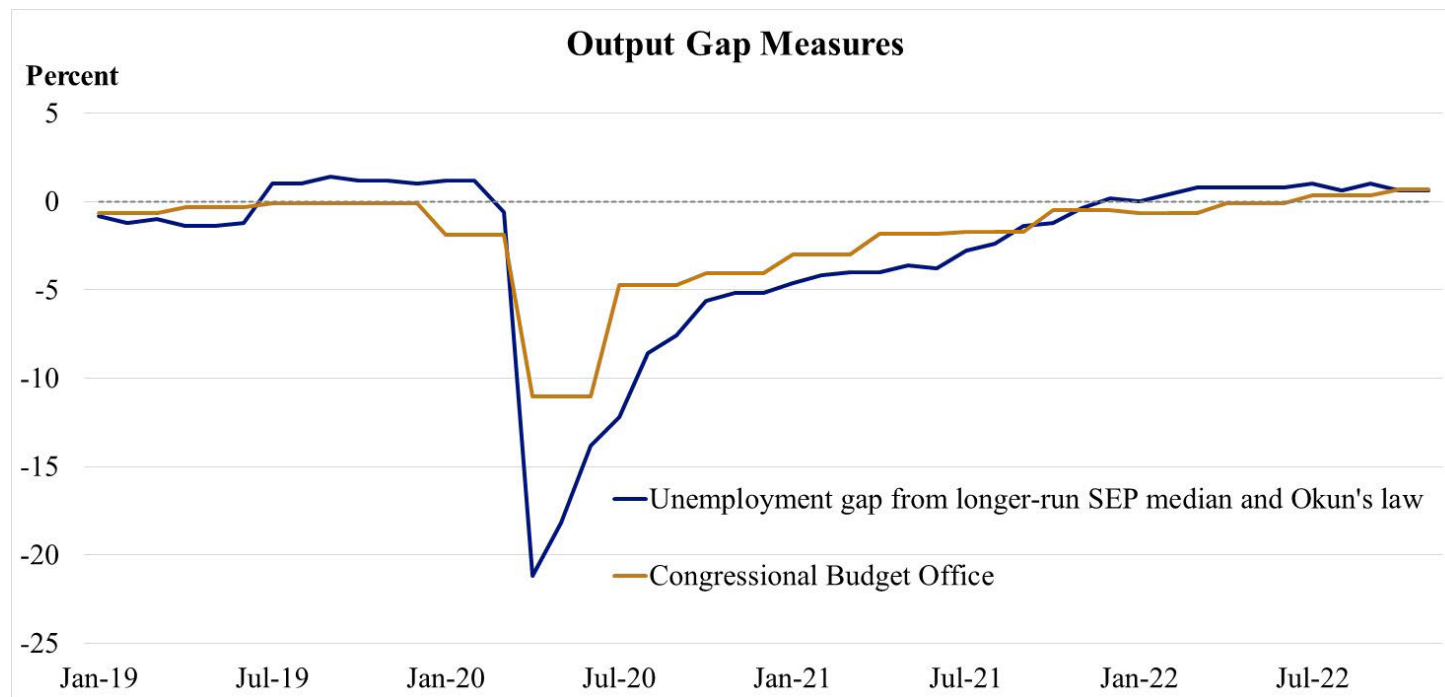
Sources: Bureau of Economic Analysis, Congressional Budget Office, Federal Reserve Bank of Atlanta and IHS Markit.
Last observation: 2022:Q3. Projections for Q4 are as of Jan. 3, 2023.

Year-on-year growth is slowing to potential



Sources: Federal Reserve Bank of New York and Congressional Budget Office. Last observation: Week ending Dec. 24, 2022.

Level of real output is slightly above potential



Sources: Bureau of Labor Statistics, FOMC's Summary of Economic Projections (SEP), Congressional Budget Office and author's calculations. Last observation: November 2022.

Assessing real GDP growth

- Real GDP growth now appears to have been stronger in the second half of 2022 than previously thought after puzzling readings in the first half of 2022.
- Perhaps the best interpretation is that real GDP growth is slowing to be in a neighborhood just below the potential growth rate of about 2% on a year-on-year basis after stellar growth in 2021.

Labor Market Performance Remains Strong

Labor market performance

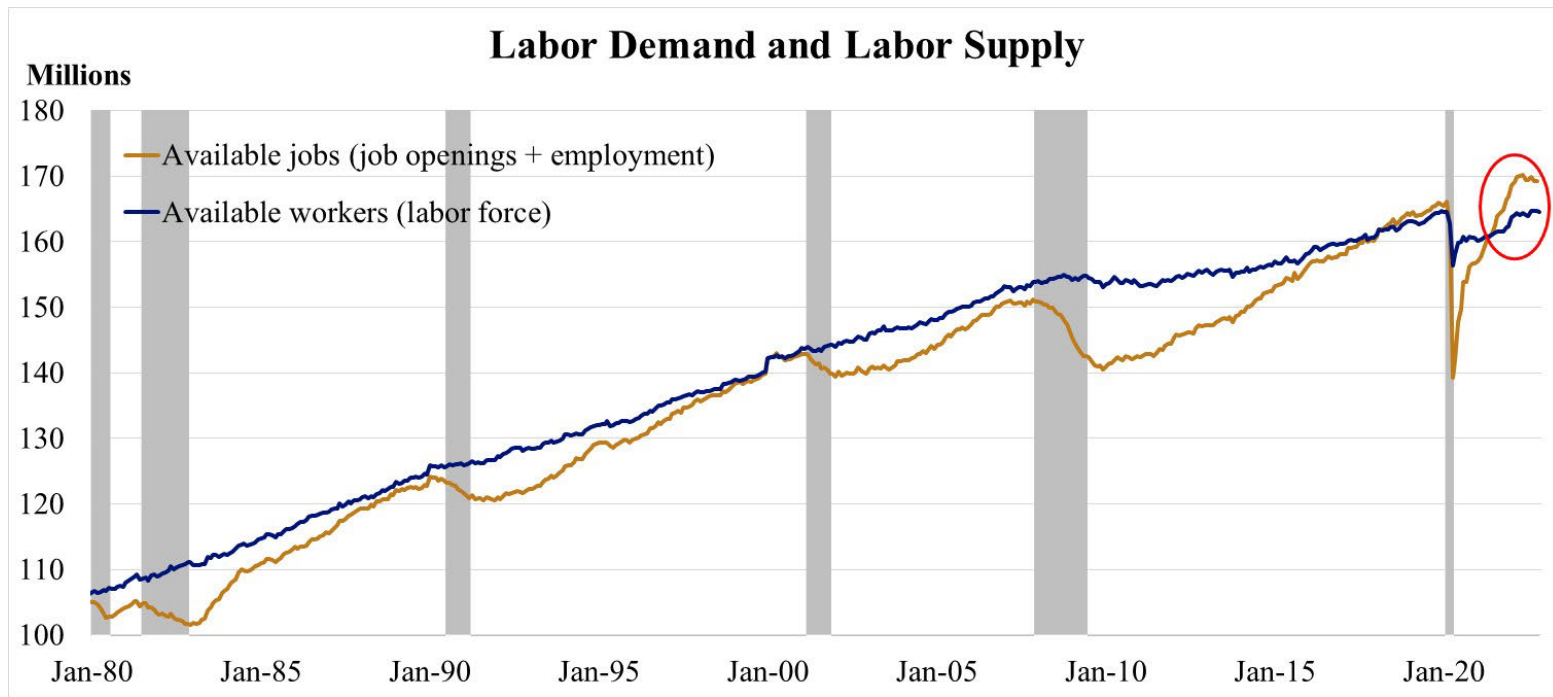
- Labor market performance remains strong.
- The number of job openings per unemployed worker remains at a high level.
- Viewed in historical perspective since the 1980s, the current labor market situation is unprecedented, with measures of labor demand significantly exceeding measures of labor supply.
- Unemployment insurance claims in 2022 generally remained at levels below those experienced during pre-pandemic years.

Vacancies per unemployed person remain high



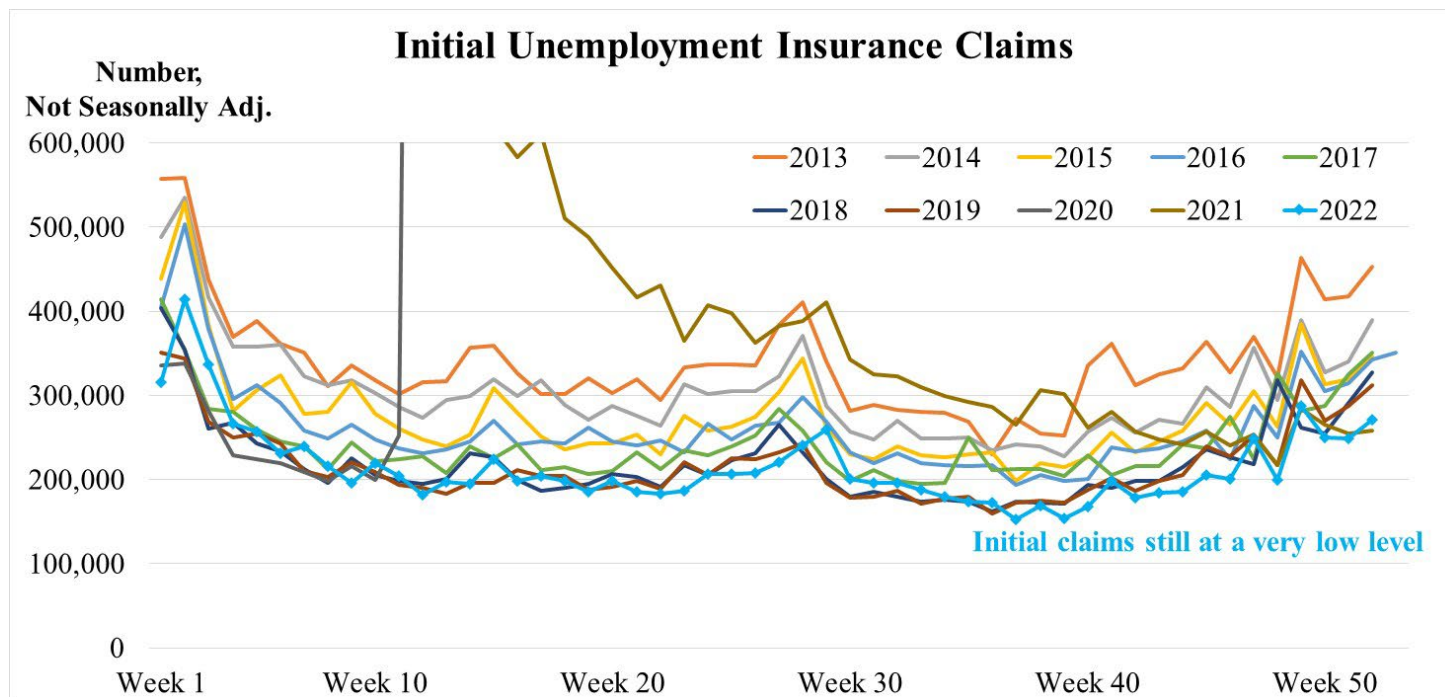
Sources: Bureau of Labor Statistics and author's calculations. Shaded areas denote U.S. recessions. Last observation: November 2022.

The labor market situation is unprecedented



Sources: Bureau of Labor Statistics; R. Barnichon, “Building a composite Help-Wanted Index,” *Economics Letters*, December 2010, 109, pp. 175-178; and author’s calculations. Last observation: November 2022.

Unemployment insurance claims remain low



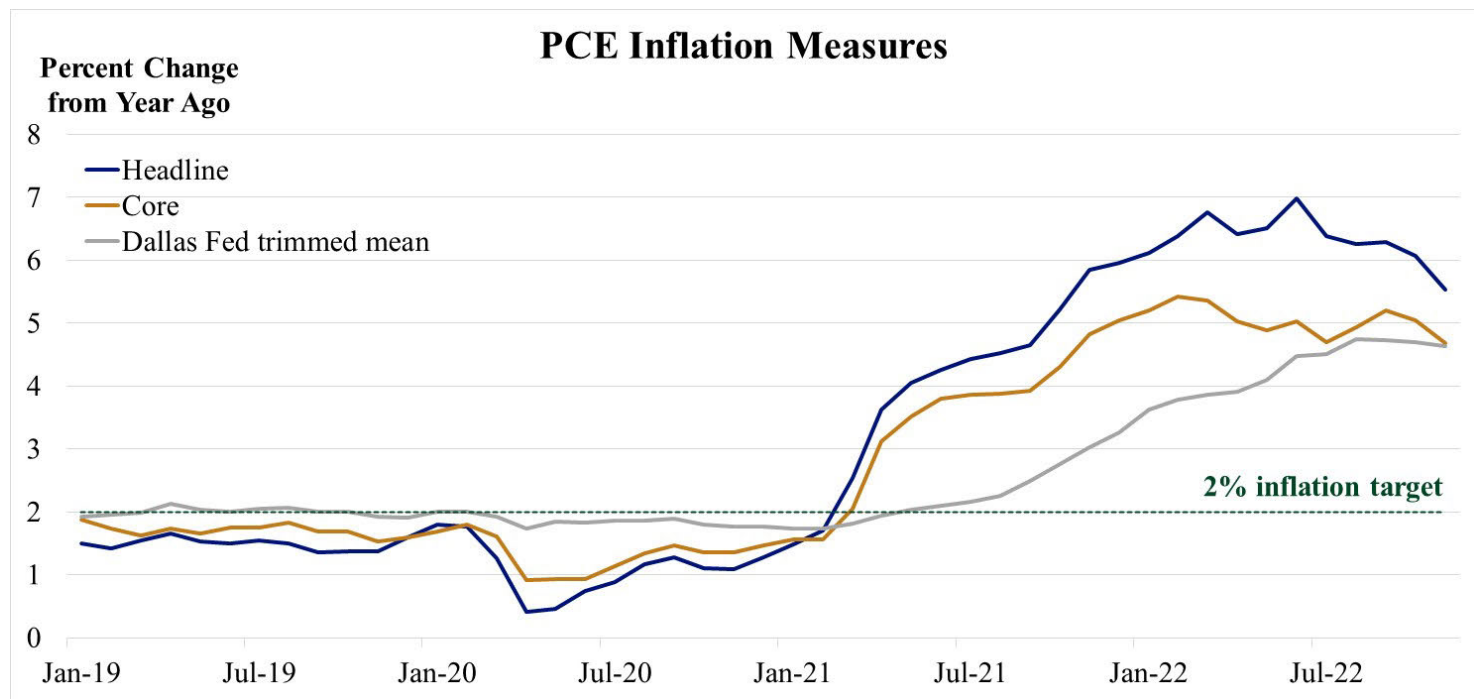
Source: U.S. Employment and Training Administration. Last observation: Week of Dec. 24, 2022.

Inflation Is Too High, but Declining

Inflation

- Inflation remains too high, but it has declined recently.
- The FOMC has a 2% inflation target specified in terms of headline personal consumption expenditures (PCE) inflation.
- Headline inflation has declined, but it can be inordinately influenced by fluctuations in energy and food prices.
- Measures of inflation that strip out volatile price movements, such as core PCE inflation and the Dallas Fed's trimmed mean inflation measure, have also declined but by less than the headline measure.

Inflation remains well above target



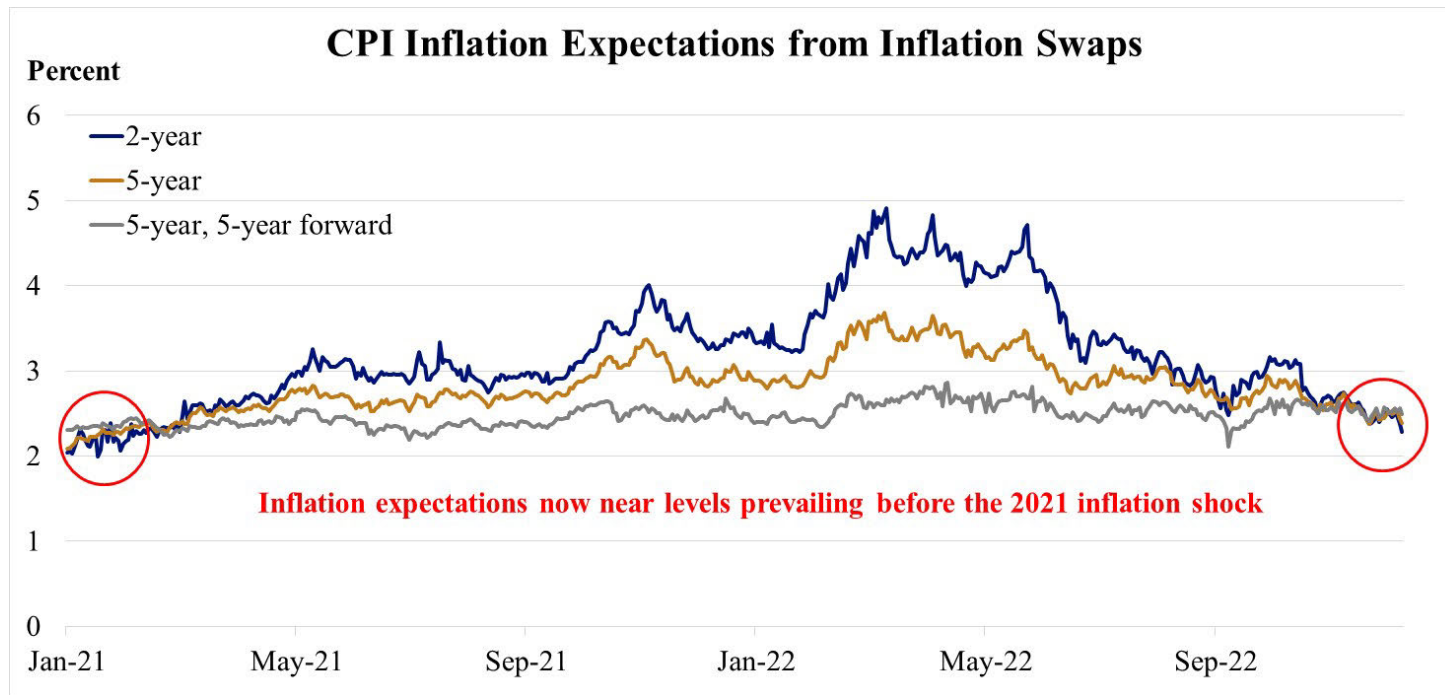
Sources: Bureau of Economic Analysis and Federal Reserve Bank of Dallas. Last observation: November 2022.

Inflation Expectations Are Relatively Low

Inflation expectations

- In part due to front-loaded Fed policy during 2022, market-based measures of inflation expectations are now relatively low.
- According to standard macroeconomic theories, inflation expectations are a key determinant of actual inflation.

Inflation expectations are back to low levels



Sources: Bloomberg and author's calculations. Last observation: Jan. 4, 2023.

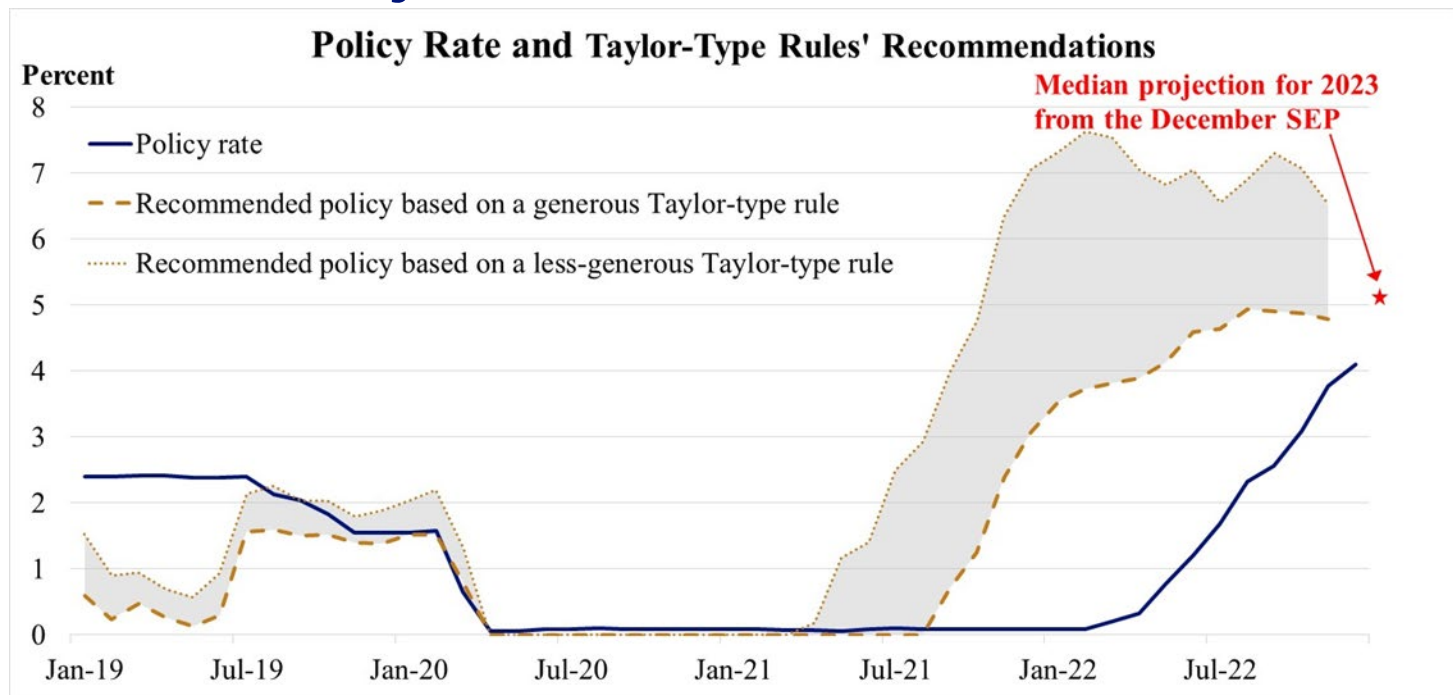
Policy Rate Is Closer to Sufficiently Restrictive

Sufficiently restrictive

- The policy rate is not yet in a zone that may be considered sufficiently restrictive, but it is getting closer.
- The following chart was developed for a talk I gave in November.*
- The chart shows a zone for one conception of a “sufficiently restrictive” policy rate, along with the actual level of the policy rate.
- It now appears that the policy rate will move into the sufficiently restrictive zone during 2023.

** See J. Bullard, “[Getting into the Zone](#),” remarks delivered at Greater Louisville Inc., Louisville, Ky., on Nov. 17, 2022.*

The sufficiently restrictive zone



Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve Bank of Dallas, Federal Reserve Bank of New York, FOMC's Summary of Economic Projections (SEP) and author's calculations. Last observations: November 2022 and December 2022.

2023: A Year of Disinflation?

Disinflation prospects

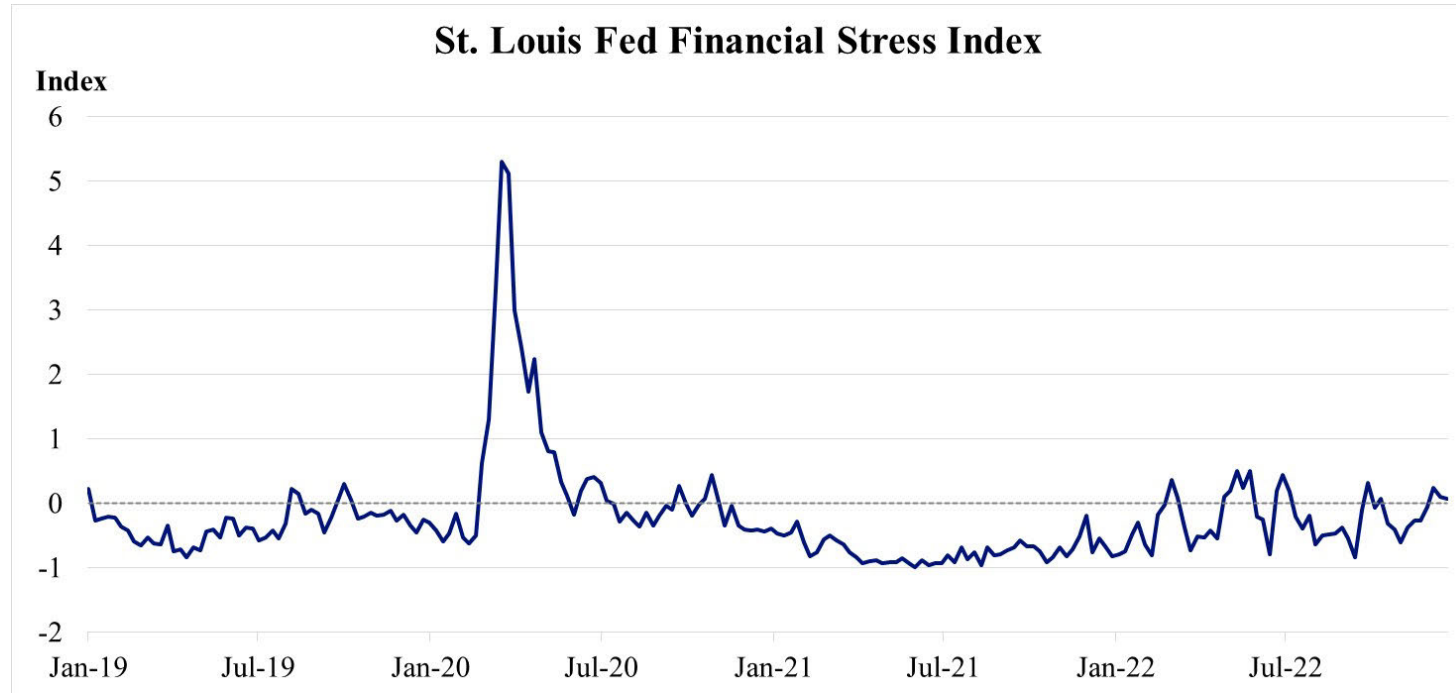
- The real side of the economy seems to indicate GDP growing faster than previously thought during the second half of 2022 plus a labor market with unemployment below its longer-run level.
- A natural forecast is that the pace of quarterly growth will now moderate and unemployment will rise to return to its longer-run level.
- Meanwhile, the FOMC has taken aggressive action during 2022, with ongoing increases in the policy rate planned for 2023, and this has returned inflation expectations to a level consistent with the Fed's 2% inflation target.
- During 2023, actual inflation will likely follow inflation expectations to a lower level as the real economy normalizes.

Related Issue

Financial stability risks

- The policy rate was increased by 50 basis points at the most recent FOMC meeting and by 75 basis points at each of the previous four meetings. These moves have been part of a front-loading strategy to move to an appropriately restrictive stance given very high inflation.
- It is possible that increased financial stress could develop in such an environment.
- However, the transparency with which these increases have been delivered, along with forward guidance, seems to have allowed for a relatively orderly transition to a higher level of interest rates so far.
- The St. Louis Fed's financial stress index is so far indicating a relatively low level of financial stress despite the higher policy rate.

Financial stress readings remain low



Source: Federal Reserve Bank of St. Louis. Last observation: Week of Dec. 23, 2022.

Conclusion

Conclusion

- GDP growth appears to have improved in the second half of 2022.
- Labor market performance remains strong.
- Inflation remains too high, but some measures have declined recently.
- FOMC policy has kept market-based measures of inflation expectations relatively low.
- The policy rate is not yet in a zone that may be considered sufficiently restrictive, but it is getting closer.
- These factors may combine to make 2023 a disinflationary year.

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