FEDERAL RESERVE BANK *of* ST. LOUIS

Disinflation: Progress and Prospects

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CENTRAL TO AMERICA'S ECONOMY®

Introduction

This talk

- U.S. GDP growth improved in the second half of 2022.
- Labor market performance remains strong.
- Inflation remains too high but has declined.
- Front-loaded Fed policy has helped keep market-based measures of inflation expectations relatively low.
- Continued policy rate increases can help lock in a disinflationary trend during 2023, even with ongoing growth and strong labor markets.
- These factors may combine to make 2023 a disinflationary year.

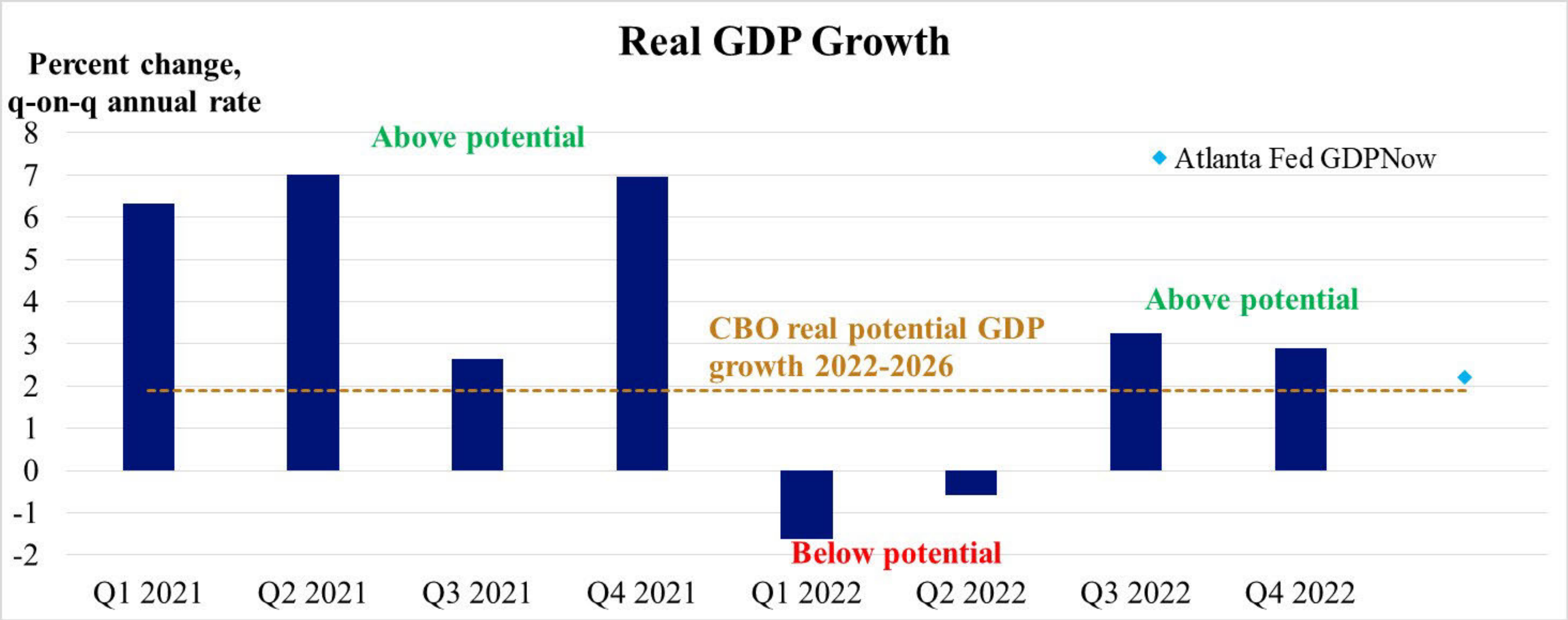
GDP Growth Improves

Improved real GDP growth

- After negative real GDP growth in the first half of 2022, GDP growth improved in the second half of 2022.
- Third-quarter 2022 real GDP growth was 3.2% and fourth-quarter 2022 growth is currently estimated at 2.9%.*
- Year-on-year growth is slowing, according to incoming weekly data, and the output gap remains positive.

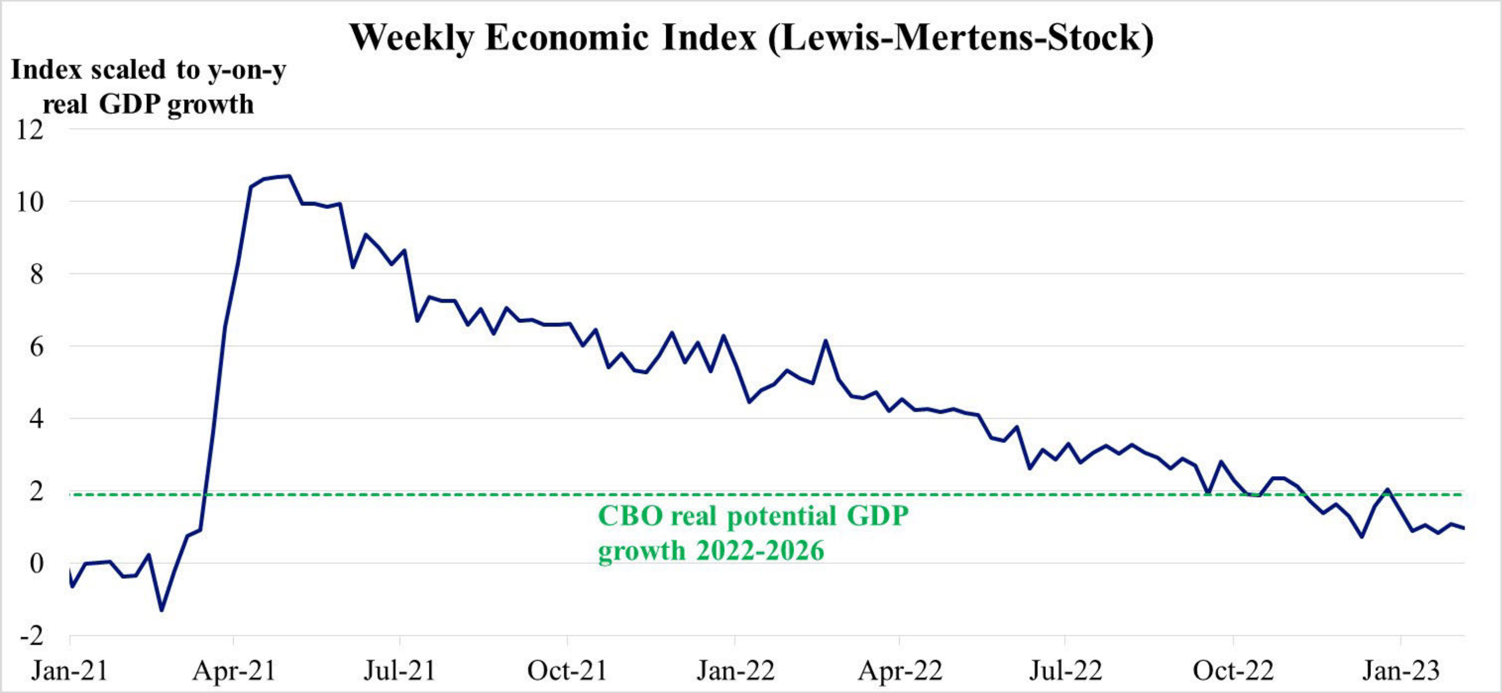
**These growth rates are from the previous quarter at an annual rate.*

Improved growth in the second half of 2022



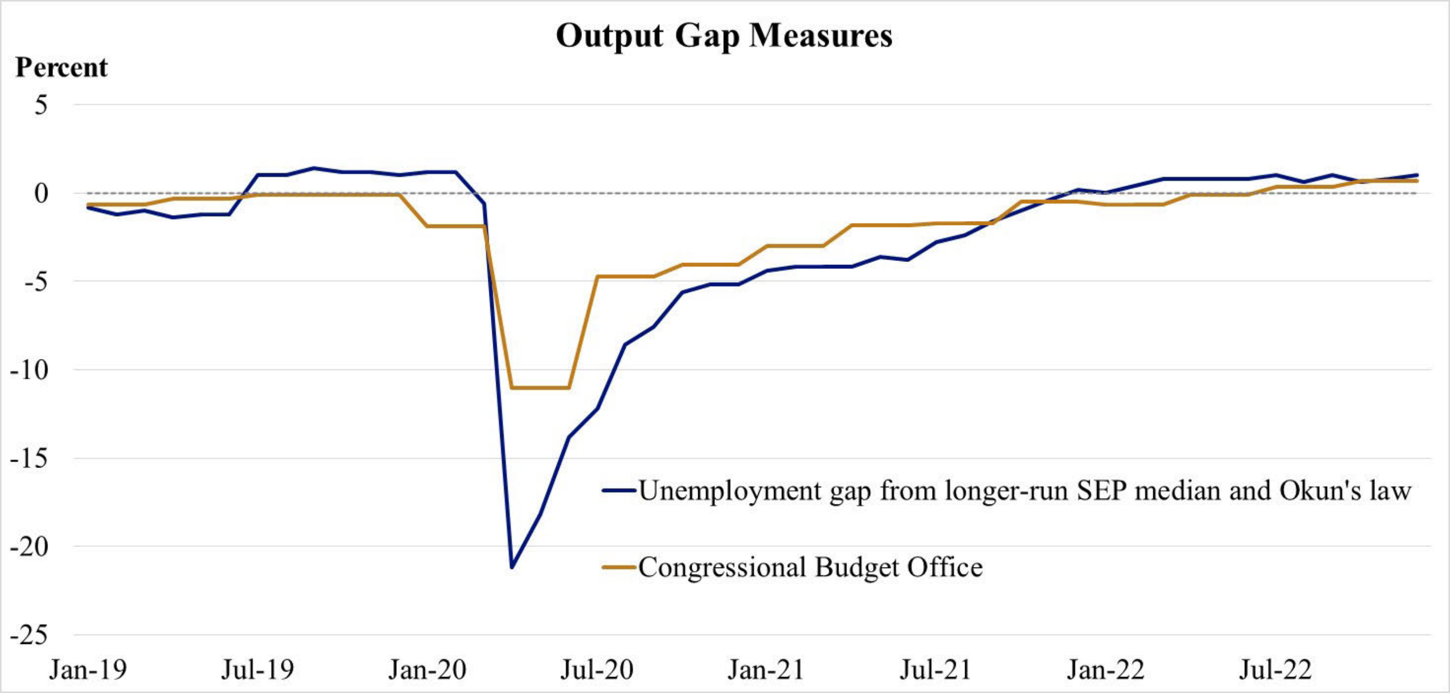
Sources: Bureau of Economic Analysis, Congressional Budget Office and Federal Reserve Bank of Atlanta. Last observation: 2022:Q4. Projection for Q1 is as of Feb. 8, 2023.

Year-on-year growth is slowing



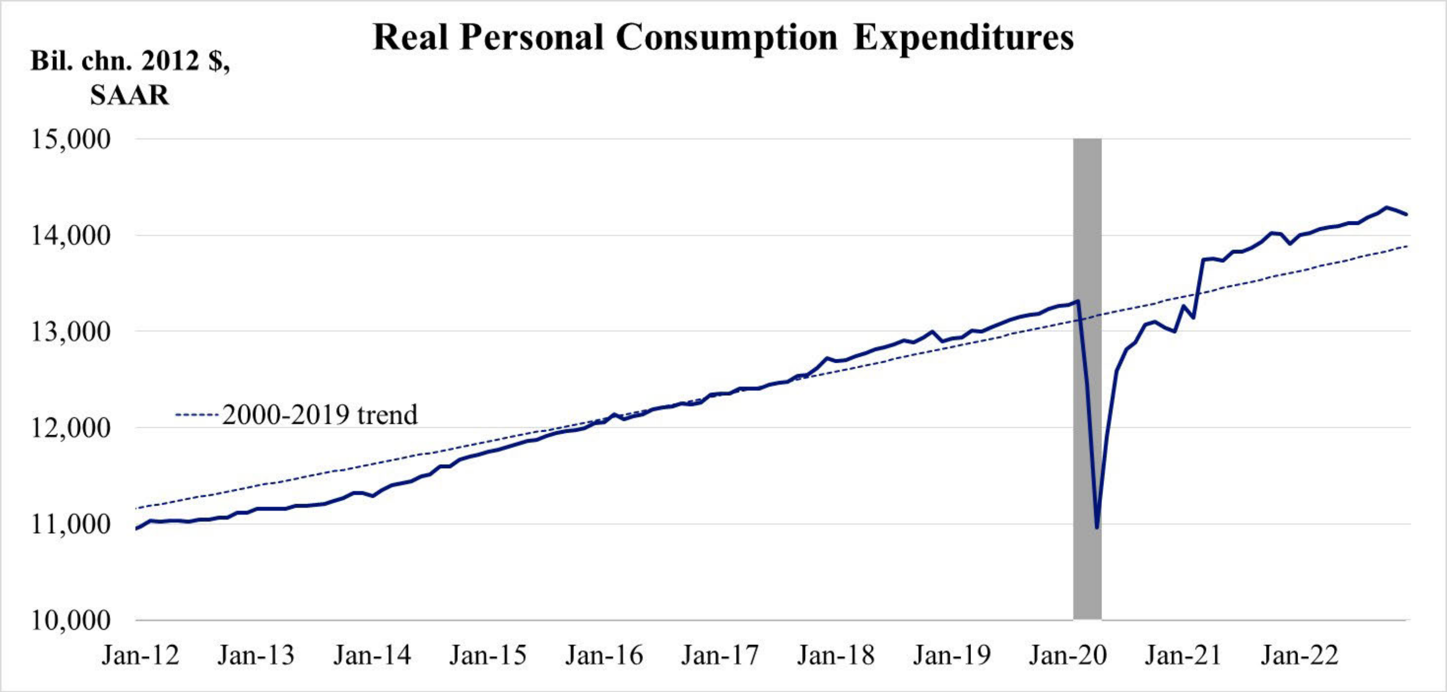
Sources: Federal Reserve Bank of New York and Congressional Budget Office. Last observation: Week ending Feb. 4, 2023.

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: December 2022.

Real consumption is above trend



Sources: Bureau of Economic Analysis and author's calculations. The shaded area denotes U.S. recession. Figures are billions of chained 2012 dollars at a seasonally adjusted annual rate. Last observation: December 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 of the potential growth rate of about 2% on a year-on-year basis after stellar growth in 2021.

Labor Market Performance Remains Strong

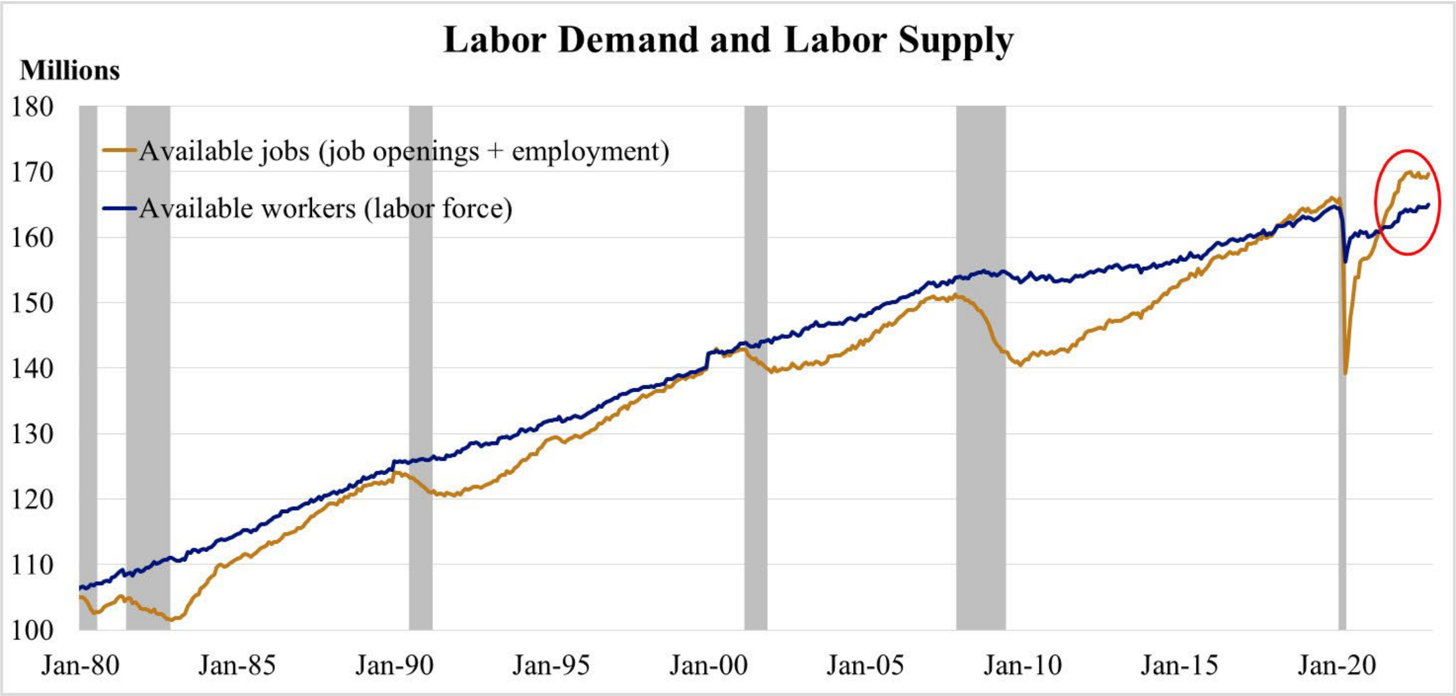
Labor market performance

- 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.
- The Kansas City Fed’s labor market conditions index remains at a high level.

Vacancies per unemployed person remain high

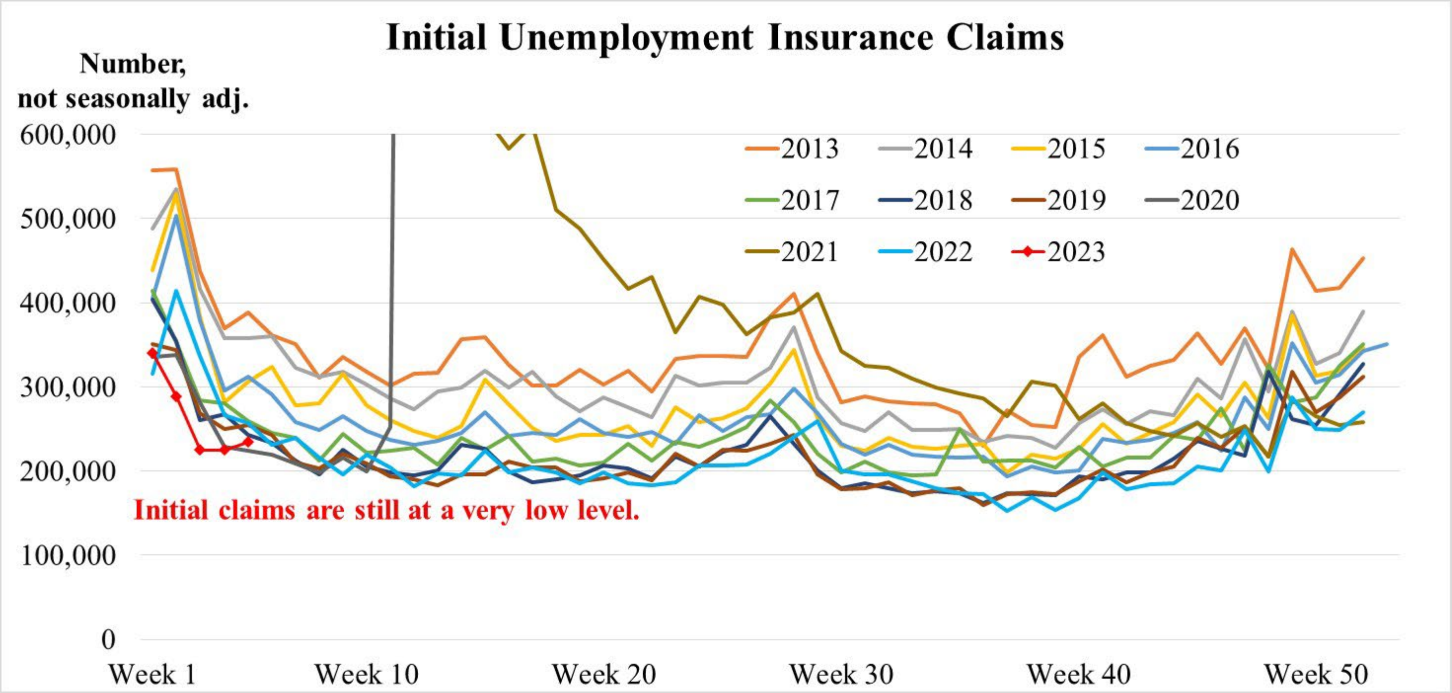
Sources: Bureau of Labor Statistics and author's calculations. Shaded areas denote U.S. recessions. Last observation: December 2022.

The labor market situation is unprecedented



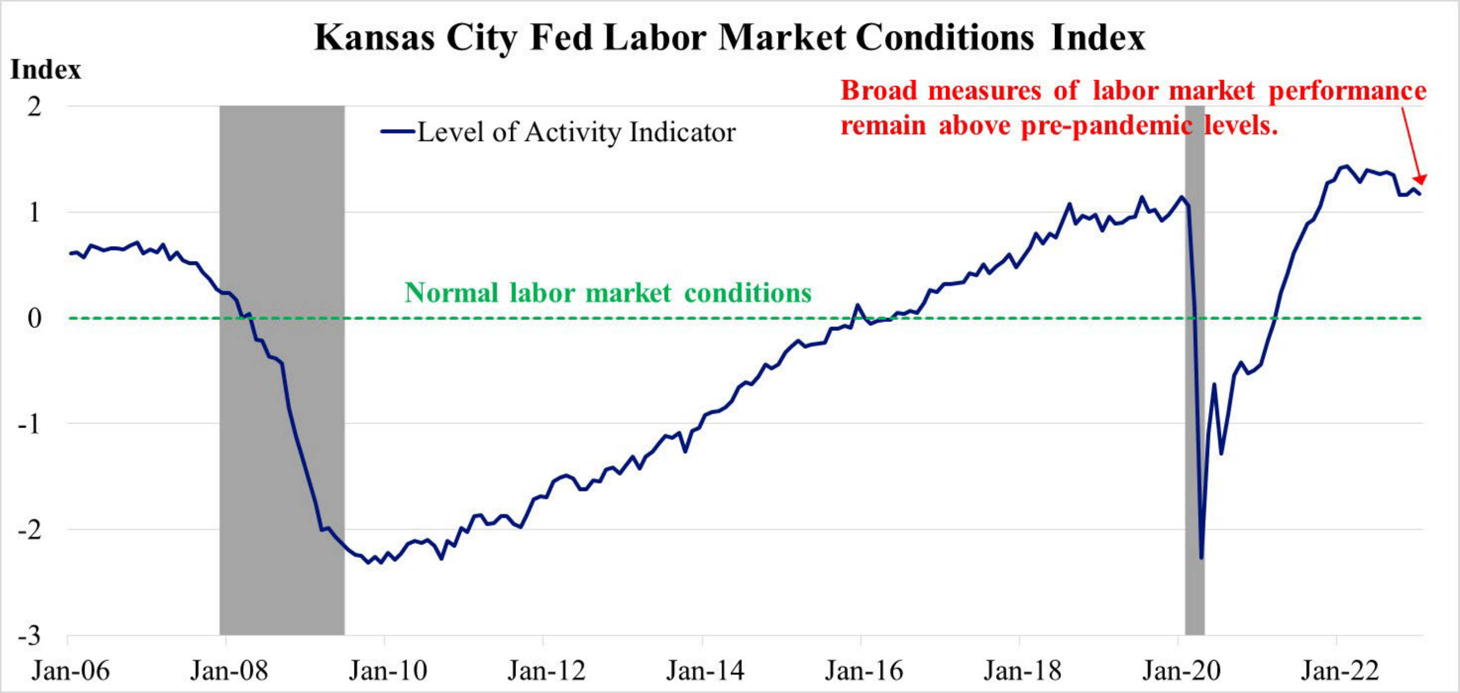
Sources: Bureau of Labor Statistics; R. Barnichon, "Building a composite Help-Wanted Index," Economics Letters, *December 2010, 109, pp. 175-178; and author's calculations. Shaded areas denote U.S. recessions. Last observation: December 2022.*

Unemployment insurance claims remain low



Source: U.S. Employment and Training Administration. Last observation: Week of Feb. 4, 2023.

Overall labor market conditions are strong



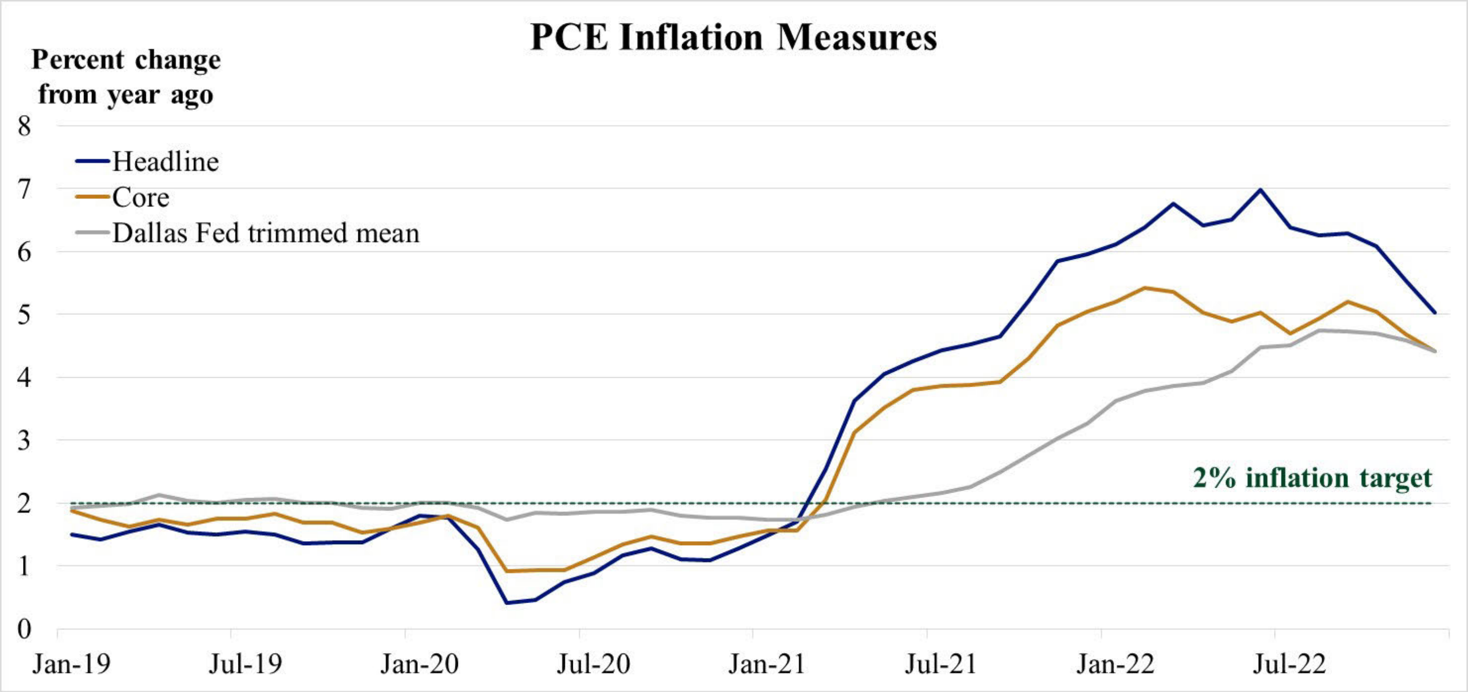
Source: Federal Reserve Bank of Kansas City. Shaded areas denote U.S. recessions. Last observation: January 2023.

The Disinflationary Process Has Started

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



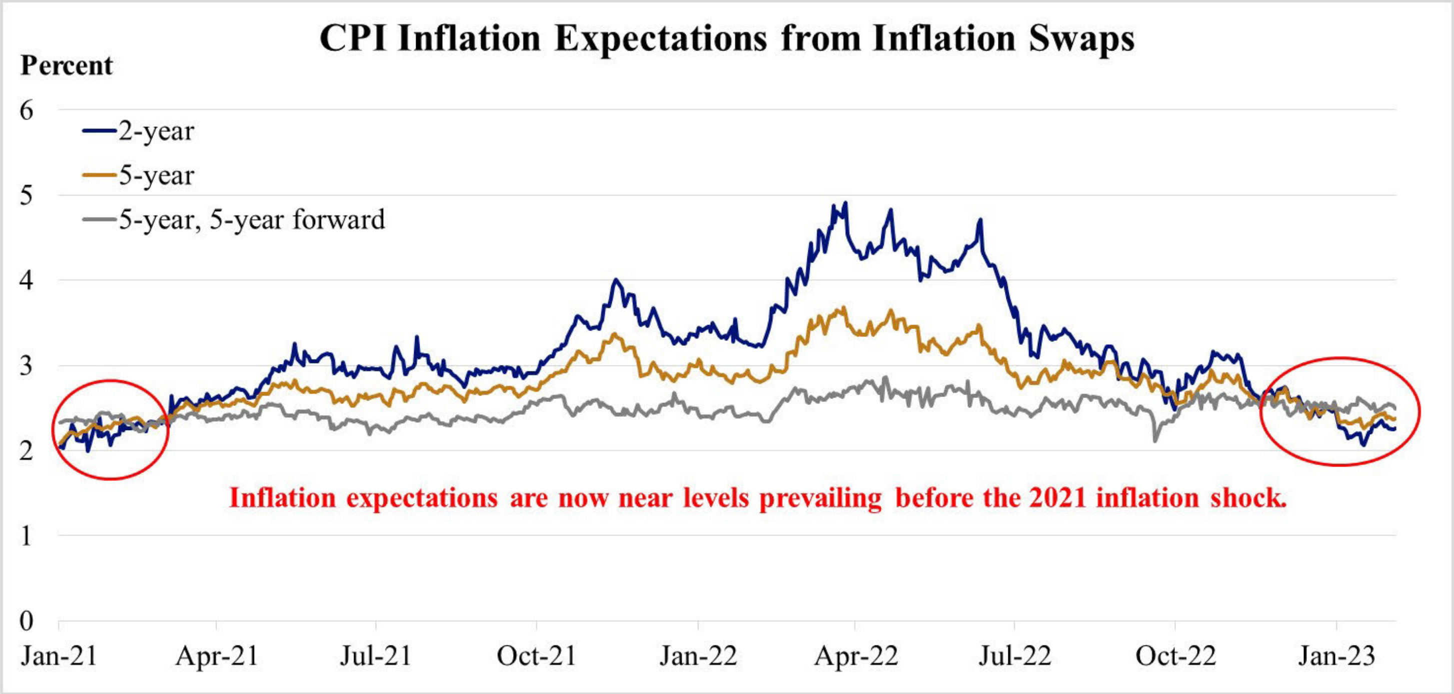
Sources: Bureau of Economic Analysis and Federal Reserve Bank of Dallas. Last observation: December 2022.

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: Feb. 14, 2023.

2023: A Year of Disinflation?

Disinflation prospects

- The U.S. economy is growing faster than previously thought, and labor market performance remains robust with unemployment below its longer-run natural level.
- A natural forecast is that the pace of quarterly real GDP growth will now moderate and unemployment will rise to return to its longer-run natural level.
- Continued policy rate increases can help lock in a disinflationary trend during 2023, even with ongoing growth and strong labor markets, by keeping inflation expectations low.

Conclusion

Conclusion

- Economic growth 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.
- Continued policy rate increases can help lock in a disinflationary trend during 2023, even with faster-than-expected economic growth and tight labor markets.

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