Disinflation: Progress and Prospects

James Bullard
President and CEO

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

Year-on-year growth is slowing

Level of real output is slightly above potential

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

The labor market situation is unprecedented

Unemployment insurance claims remain low

Initial claims are still at a very low level.

Overall labor market conditions are strong

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

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

Inflation expectations are now near levels prevailing before the 2021 inflation shock.

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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