Following from Fed – December 2022

Vipin Malik, Chairman and Mentor, Infomerics Ratings

Sankhanath Bandyopadhyay, Economist, Infomerics Ratings

- U.S. real gross domestic product (GDP) was increasing at a modest pace in the fourth quarter of 2022 after expanding strongly in the third quarter. The forecast for U.S. real GDP growth through 2025 remained subdued (a median forecast of 1.8% in 2025).[1] Output was expected to remain below potential in 2025.
- Consumer price inflation remained elevated but had eased in recent months. Total PCE price inflation was 6.0 percent over the 12 months ending in October, 0.3 percentage point below the September figure.
- Core PCE price inflation, which excludes changes in consumer energy prices and many consumer food prices, was 5.0 percent over the 12 months ending in Oct22, down 0.2 percentage point from its Sept22 reading. Total PCE price inflation was expected to be 5.5 percent in 2022, while core inflation was expected to be 4.7 percent, both lower than in the Nov'22 projection. In the latest inflation data, the *pace of increase for prices of core services* (excluding shelter),[2] which represents the largest component of core PCE price inflation was high. **This component of inflation has tended to be closely linked to nominal wage growth** and therefore would likely remain persistently elevated if the labor market remained very tight.
- **Hope**: inflation is expected to decline over the next two years. Core goods inflation was anticipated to slow further, housing services inflation was expected to peak in 2023 and then move down, while core non-housing services. inflation was forecast to move down as wage growth eased. In 2025, both total and core PCE price inflation were expected to be near 2 percent.
- **Fear**: With inflation still elevated, the risks to the inflation projection as skewed to the upside. Moreover, the sluggish growth in real private domestic spending expected over the next year, a subdued global economic outlook, and persistently tight financial conditions were seen as uncertainty associated with

[1] https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20221214.pdf (p-2).

[2] Services Inflation in the United States averaged 4.42 Percent from 1950 until 2022, reaching an all time high of 18.09 Percent in June of 1980 and a record low of 0.57 Percent in February of 2010. For inflation break-up for Oct22, see this- (https://www.cnbc.com/2022/11/10/heres-the-inflation-breakdown-for-october-2022-in-one-chart.html)

their economic outlooks was high and that the risks to the inflation outlook remained tilted to the upside, and the possibility of a recession sometime over the next year as a plausible alternative to the baseline, cannot be ruled out. (erratic supply side factors also cannot be ruled out, and tight labour market can pose challenge further).

- Labor market conditions eased somewhat over October and November'22 but remained quite tight. Total nonfarm payroll employment posted solid gains in October and November that were slower than the average monthly pace seen over the earlier part of the year. The unemployment rate was expected to move above the staff's estimate of its natural rate near the end of 2024 and remain above it in 2025. Overall, job gains had been robust in recent months, and the unemployment rate had remained low.
- **Nominal wage growth continued to be elevated** and remained above the pace judged to be consistent with the Federal Open Market Committee's (FOMC's) 2 percent inflation objective. In fact, Euro zone wages are growing quicker than earlier thought and the European Central Bank (ECB) must prevent this from adding to already high inflation, ECB President Christine Lagarde has highlighted. "We know wages are increasing, probably at a faster pace than expected," Croatian newspaper Jutarnji list quoted Lagarde.
- High inflation continued to contribute to a decline in real disposable incomes, which, together with disruptions to energy supplies, depressed economic activity, especially in Europe.
- Higher mortgage interest rates have notably restrained housing activity and housing activity is expected to remain weak. Households' budgets were stretched for low-to-moderate-income households and many consumers were shifting their spending to less expensive alternatives. Many households were increasingly using credit to finance spending.
- High costs for inputs like diesel, feed, and fertilizer were creating challenges for the agricultural sector.
- A major potential challenge is that the lagged cumulative effect of policy tightening could end up being more restrictive than is necessary to bring down inflation to 2 percent and lead to an unnecessary reduction in economic activity, potentially placing the largest burdens on the most vulnerable groups of the population.

- The Federal Open Market Committee (FOMC) seeks to achieve maximum employment and inflation at the rate of 2 percent over the long run. In support of these goals, members agreed to raise the target range for the federal funds rate to 4.25% to 4.5% percent. Fed officials in December projected that rate, currently in the 4.25%-4.50% range, would rise to just over 5% by the end of 2023 and likely remain there for some time.
- A potential challenge is to anchor long-term inflation expectations. A lack of confidence among economic agents that the Fed will be able to make a return to 2%, would be costly for the society. Therefore, the commitment of 2% is reiterated, but too much of such rate hike would jeopardize growth. Hence, a balance is required. [As reported by Howard Schneider for Thomson Reuters, "for some policymakers the risks to growth had become more pressing, with Fed staff suggesting that a recession over the next year was a "plausible alternative."].