

January 12, 2023

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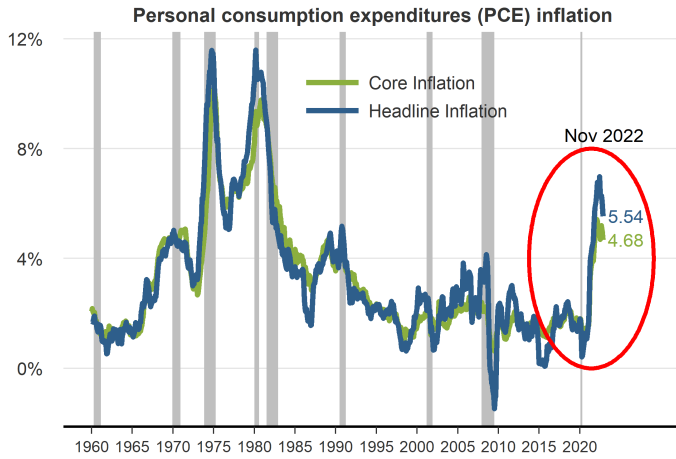
Adam Shapiro, vice president at the Federal Reserve Bank of San Francisco, stated his views on the current economy and the outlook as of January 12, 2023.

- While continuing to cool over the last several months, 12-month inflation remains at historically high levels. The headline personal consumption expenditures (PCE) price index rose 5.5% in November 2022 from a year earlier. This marks a decline in inflation to a level last observed in October 2021, but still well above the Fed's longer-run goal of 2%. A portion of the inflation moderation is attributable to recent declines in energy prices. Core PCE inflation, which removes food and energy prices, has shown less easing.
- Owing to fiscal relief efforts and lower household spending over the course of the pandemic, consumers accumulated over \$2 trillion dollars in excess savings, based on pre-pandemic trends. Since then, consumers have drawn down over half of this excess savings which has helped support recent growth in personal consumption expenditures. A considerable amount of accumulated savings remains for some consumers to support spending in 2023.
- In the wake of the pandemic, consumer spending patterns shifted away from services towards goods. While there appears to be some normalization of spending behavior, this shift has generally persisted. Real goods spending remains significantly above its pre-pandemic trend, driven by strong demand for durables such as furniture, electronics, and recreational goods. Spending on services has shown a resurgence but remains below its pre-pandemic trend.
- Supply chain bottlenecks for materials and labor remain a constraint on production, although there are some recent signs of easing. The fraction of manufacturers who reported operating below capacity due to insufficient materials peaked in late 2021 and has moderately declined over the past year. However, the fraction of manufacturers reporting insufficient labor has persisted at high levels.
- The labor market remains tight, despite some signs of cooling. The number of available jobs remains well above the number of available workers, although vacancy postings have been trending down in recent months. The tight labor market has put continued upward pressure on wages and labor market turnover.
- A decomposition of headline PCE inflation into supply- and demand-driven components shows that both supply and demand factors are responsible for the recent rise in inflation. The surge in inflation in early 2021 was mainly due to an increase in demand-driven factors. Subsequently, supply factors

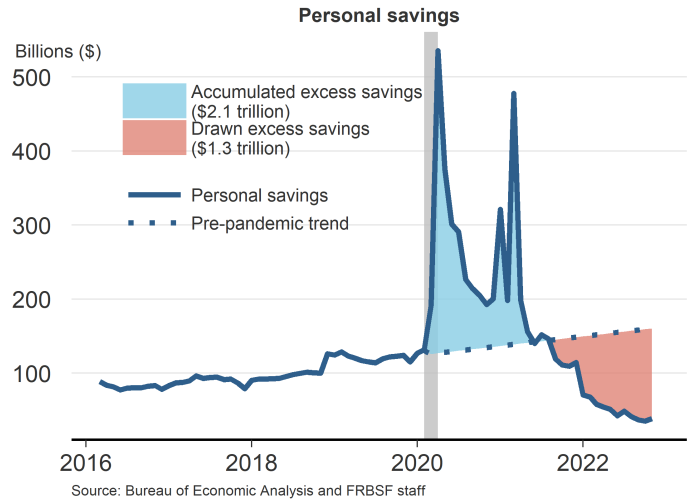
became more prevalent for the remainder of 2021. Supply-driven inflation has moderated significantly over recent months, while demand-driven inflation remains elevated.

- The Federal Open Market Committee (FOMC) raised the federal funds rate by 50 basis points at the December meeting to a range of 4.25 to 4.5%. This cycle of continued rate increases since March of last year represents the fastest pace of monetary policy tightening in 40 years. The increase in the federal funds rate has been accompanied by a gradual reduction in the size of the Federal Reserve's balance sheet.
- Economic activity in sectors such as housing, which is sensitive to rising interest rates, has slowed considerably in recent months. Housing starts have fallen steadily over the past year, as have other housing market indicators, such as existing home sales and house prices.
- Although the labor market is currently very strong, financial markets are pointing to some downside risks. Namely, the difference between longer- and shorter-term interest rates has turned negative, which historically tends to occur immediately preceding recessions. It remains unclear whether lower longer-term yields are indicative of anticipated slower growth or lower inflation.
- Short-term inflation expectations remain elevated relative to their pre-pandemic levels in December 2019. Consumers are expecting prices to rise 5% this year, while professional forecasters are expecting prices to rise 3.5%. Longer-term inflation expectations remain more subdued, indicating that both consumers and professionals believe inflation pressures will eventually dissipate.
- Rent inflation is expected to remain high over the next year. The prices for asking rents have grown quite substantially over the last two years. As new leases begin and existing leases are renewed, these higher asking rents will flow into the stock of rental units, putting upward pressure on rent inflation.
- We are expecting inflation to moderate over the next few years as monetary policy continues to restrain demand and supply bottlenecks continue to ease. We anticipate that it will take some time for inflation to reach the Fed's longer-run goal of 2%.

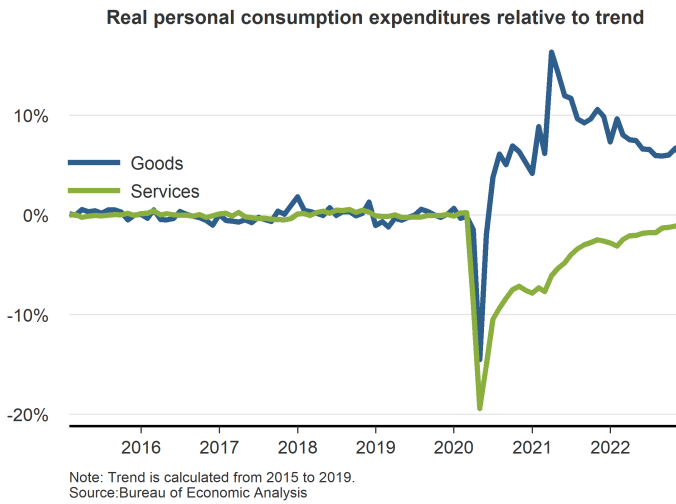
Inflation is cooling, but remains very high



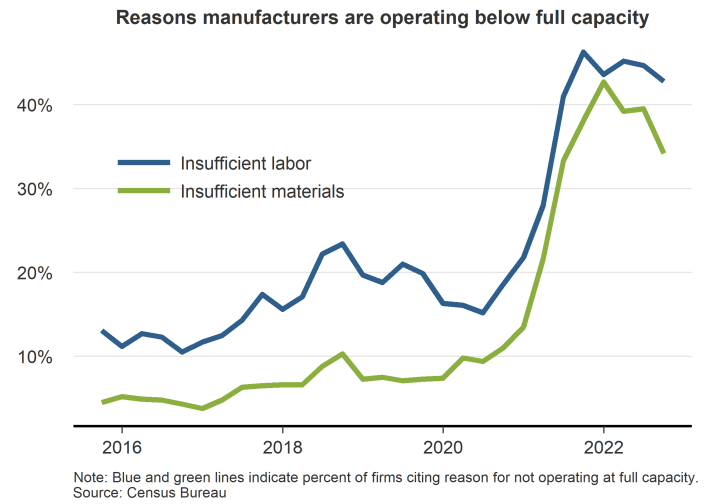
Savings are boosting consumer demand



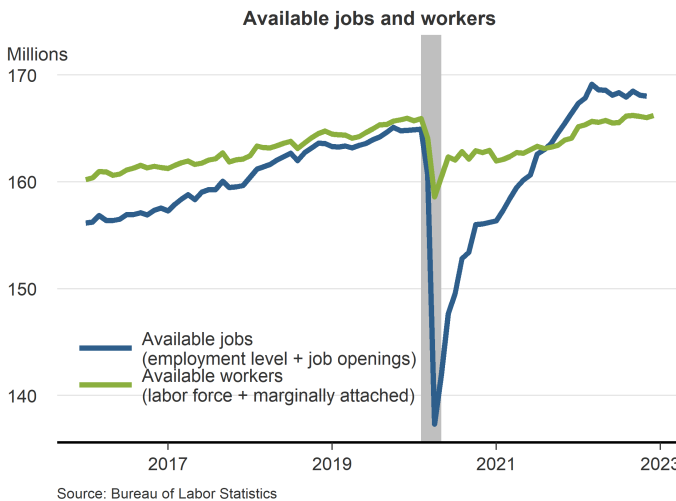
Goods consumption remains elevated



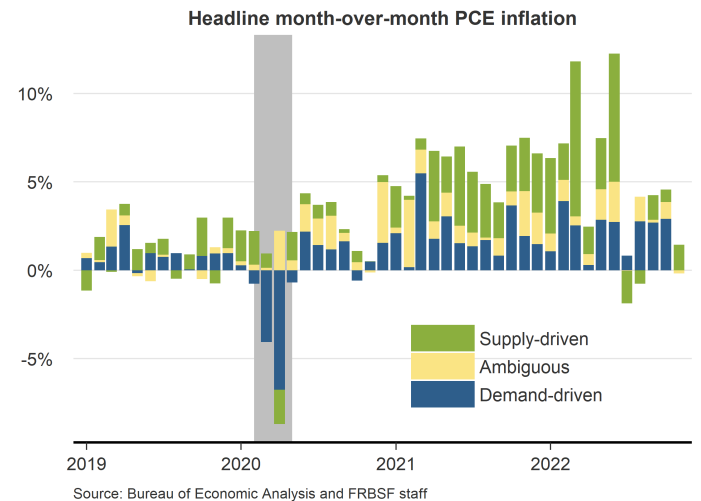
Supply shortages are prevalent, but easing



Labor market remains tight, but is cooling

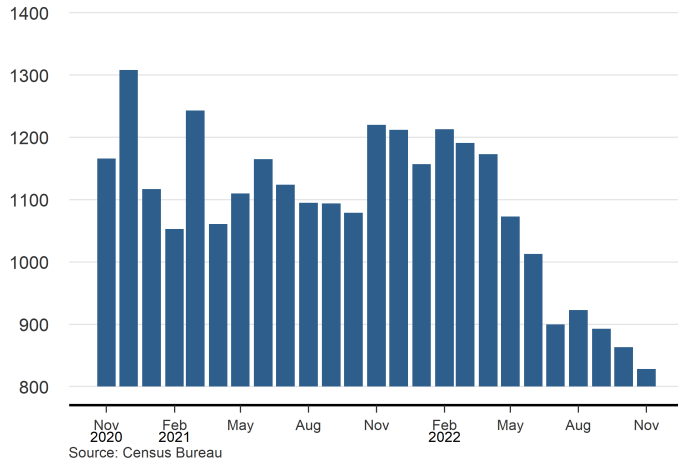


Both supply and demand drive inflation



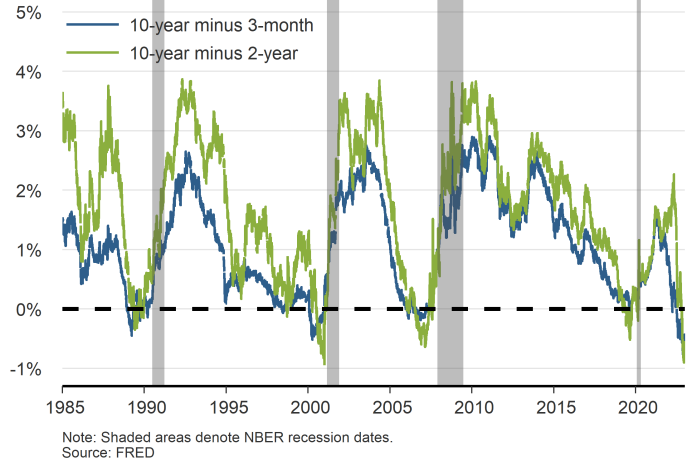
Monetary policy tightening is having real effects

Single family housing starts



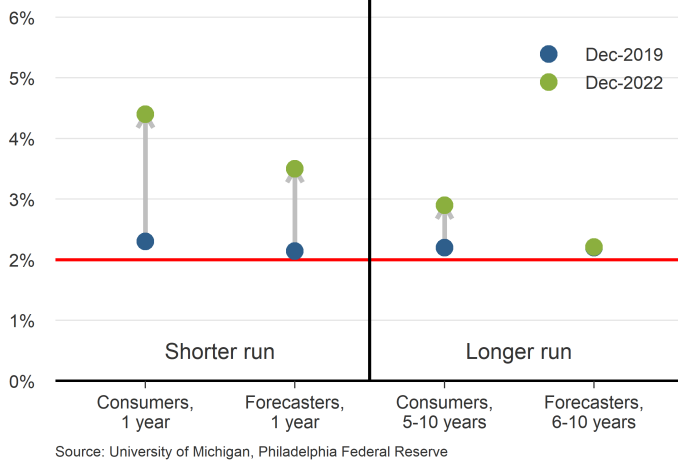
Yield curve is inverted, signaling recession risk

Treasury term spreads



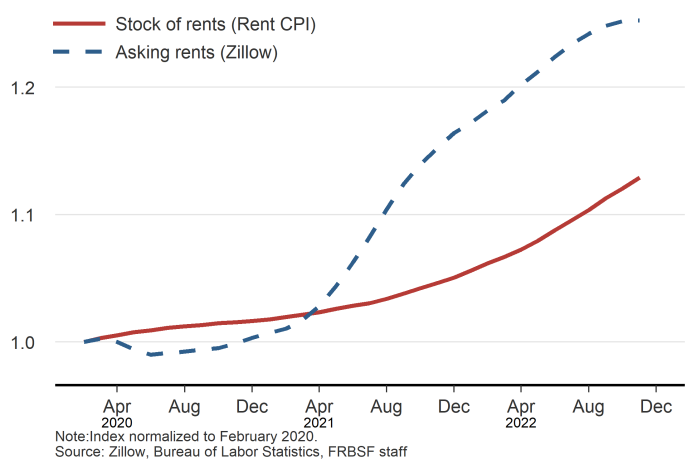
Short-term inflation expectations remain elevated

Consumer and forecaster expectations



High rent inflation is in the pipeline

Rental prices for housing



Inflation likely to remain above 2% for some time

Personal consumption expenditures (PCE) price inflation

