Twelfth Federal Reserve District

FedViews

December 5, 2024

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Federal Reserve Bank of San Francisco
101 Market Street
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Also available upon release at
https://www.frbsf.org/economic-research/publications/fedviews/

Robert G. Valletta, associate director and senior vice president at the Federal Reserve Bank of San Francisco, stated his views on the current economy and the outlook as of December 5, 2024.

- The U.S. economic expansion has slowed this year but remains solid. Cooling of the overall economy has helped bring supply and demand conditions in the labor market into better balance and supported the progress of inflation toward the Federal Reserve's 2% longer-run goal.

- The unemployment rate in early 2023 had fallen to 3.4%, its lowest level since 1969. Since then, it has risen above 4% and moved unevenly in recent months, registering at 4.1% in October. This is slightly below the Federal Open Market Committee's (FOMC's) median estimate of the long-term natural rate, suggesting that the labor market is at or near the Fed's maximum employment goal and hence largely in balance.

- The balance between supply and demand in the labor market also is reflected in measures of available workers relative to available jobs. In the aftermath of the pandemic, the excess of available jobs over available workers reached unprecedented levels. This gap closed steadily as solid labor force growth over the past few years pushed up worker availability, which now slightly exceeds available jobs.

- While the cooling economy and labor market have helped reduce inflation, progress toward the Fed's 2% longer-run goal has been slow and uneven this year. Following its surge to a 40-year high in 2022, the 12-month core personal consumption expenditures (PCE) inflation rate fell rapidly, from 5.6% in September 2022 to 3.0% in December 2023. Since then, core PCE inflation has fallen only two-tenths percentage point to 2.8% in October 2024.

- Our projected inflation path has changed little since the start of the year. Inflation was slightly higher than our initial projection in early 2024, but subsequent data confirmed its downward path. We expect progress on the 2% inflation goal to remain quite slow and uneven. This specific forecast does not incorporate any changes to federal policies, given prevailing uncertainty about their form and extent.

- Despite the progress in reducing inflation, a sustained period of high inflation has raised many prices well above their pre-pandemic levels. The initial price surge was especially severe for the volatile food and energy components of the overall PCE price index. Prices for these components have since flattened out, while prices for the housing services component have risen steadily. Overall prices in the economy are up about 20% on average since just before the pandemic. The average masks wide variation, however, with prices of some products and services up much more.

The views expressed are those of the author, with input from the forecasting staff of the Federal Reserve Bank of San Francisco. They are not intended to represent the views of others within the Bank or within the Federal Reserve System. This publication is edited by Kevin J. Lansing and Karen Barnes. Charts were produced by Deepika Baskar Prabhakar. The next FedViews is scheduled to be released around the middle of January 2025.

- Real household incomes, incomes adjusted for inflation, have risen substantially since the late 1960s. The largest cumulative growth has been for households near the top of the income distribution. Real incomes for households at the 90th percentile of the distribution, meaning that only one in ten households have more income, have risen about twice as much as real incomes for households at the median, the 50th percentile, or households near the bottom, the 10th percentile.

- Data show that during the long expansion following the end of the Great Recession in June 2009, the gains in household real incomes were more evenly distributed, with across-the-board growth of about 20 to 25% from 2012 to 2019.

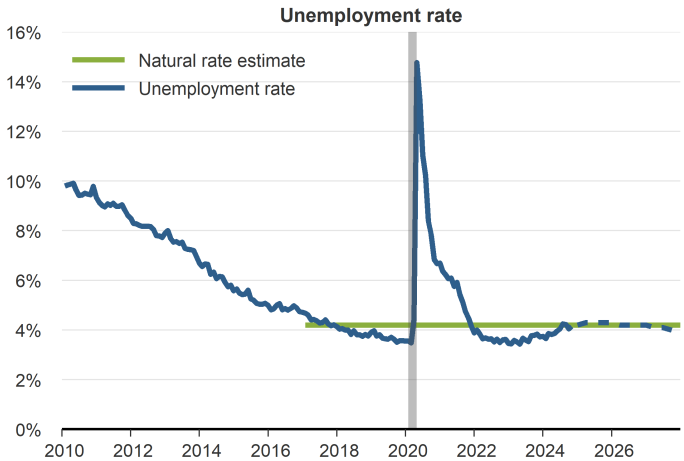
- The same data show that real household incomes fell during the COVID-19 pandemic and its aftermath, pulled down initially by the pandemic recession and then by surging inflation that exceeded the pace of nominal wage gains. The story changes, however, when we correct the underreporting of household income from pandemic-related unemployment benefits during 2020-21. After making this data correction, households in the 10th percentile of the distribution are found to have experienced a real income surge in 2020 that was partly sustained in 2021. Subsequently, however, real incomes for all income groups declined in 2022, as temporary unemployment benefits and other pandemic stimulus payments waned, and inflation eroded household purchasing power across the board.

- Real household incomes resumed growth for all income groups in 2023 as the pace of wage growth once again exceeded inflation. Continued growth in real household incomes is likely as the economic expansion proceeds and inflation declines further toward the 2% goal.

- In this context and given recent data, financial market expectations for the path of the federal funds rate have shifted upward in recent weeks. Market expectations in late October were aligned with the FOMC's median policy path in the September 2024 Summary of Economic Projections (SEP). The September SEP showed a reduction of a full percentage point in the federal funds rate for both 2024 and 2025, bringing it down to 3.25 to 3.50% at the end of 2025.

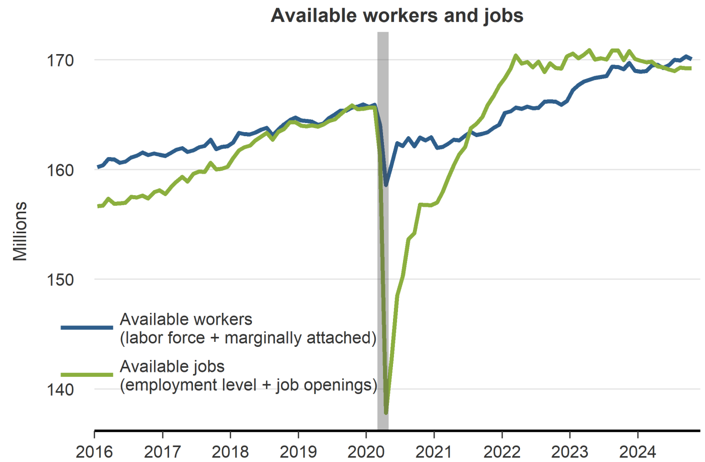
- In contrast, more recent market expectations imply fewer rate cuts, with the funds rate falling to a level slightly below 4%. This shift in expectations is reflected in higher yields on 2-year and 10-year Treasury securities, which reversed a decline from earlier this year.

Unemployment expected to remain low



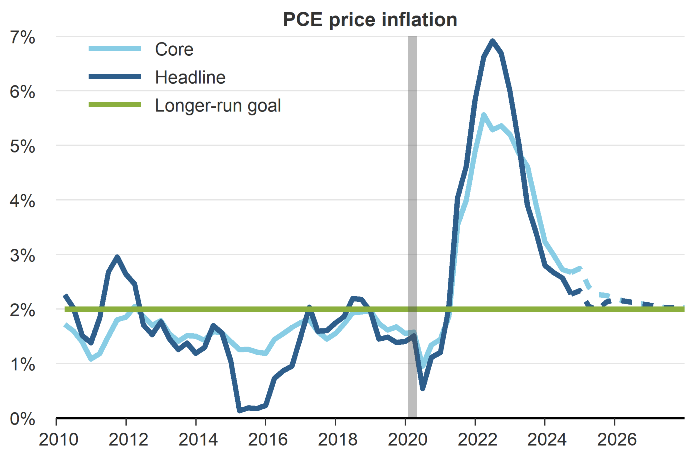
Note: Dashed line represents the FRBSF forecast. Shaded area denotes NBER recession dates.
Source: Bureau of Labor Statistics, Federal Reserve Board of Governors, and FRBSF staff

Labor supply has surpassed demand



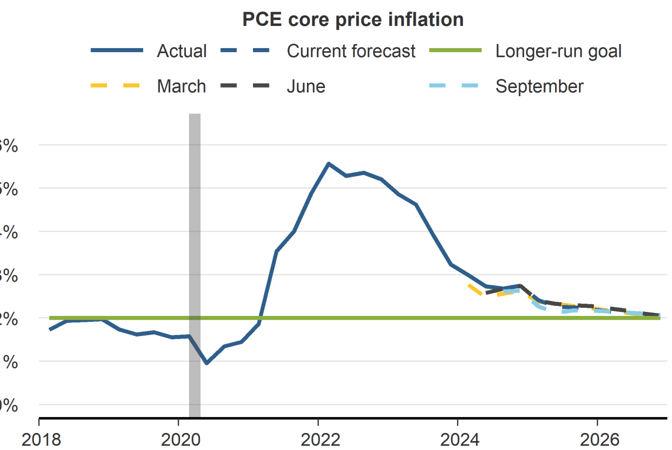
Note: Shaded area denotes NBER recession dates.
Source: Bureau of Labor Statistics and FRBSF staff

Inflation on uneven path toward 2%



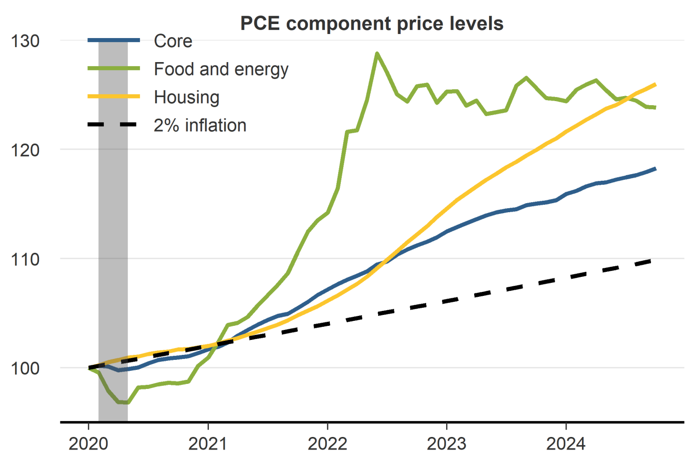
Note: 4-quarter change in personal consumption expenditures price index. Dashed line represents the FRBSF forecast. Shaded area denotes NBER reccession dates.
Source: Bureau of Economic Analysis and FRBSF staff

FRBSF inflation forecasts: largely stable this year



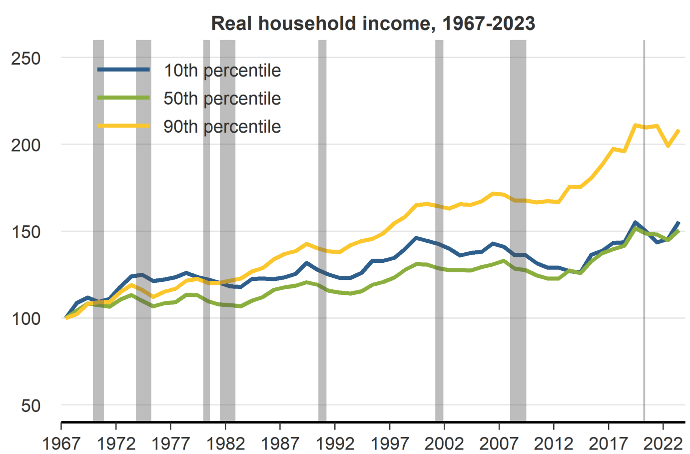
Note: 4-quarter change in core personal consumption expenditures price index. Dashed lines represent FRBSF forecasts. Shaded area denotes NBER recession dates.
Source: Bureau of Economic Analysis and FRBSF staff

Sustained inflation raised prices substantially



Note: Levels indexed to January 2020. Dashed line calculated using a constant 2% annualized rate of inflation. Shaded area denotes NBER recession dates.
Source: Bureau of Economic Analysis and FRBSF staff

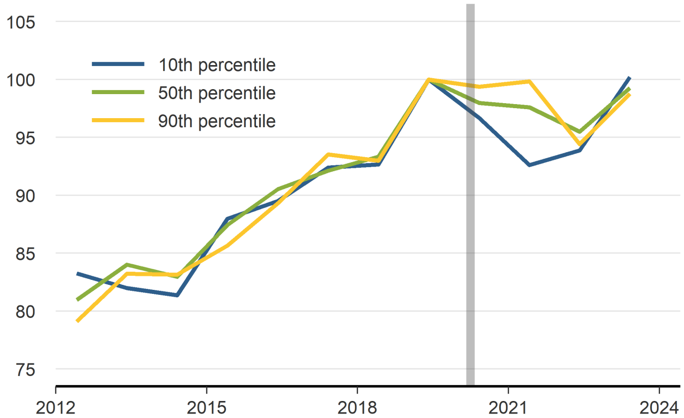
Real incomes up, especially households near top



Note: Inflation adjusted using the overall CPI index and normalized to equal 100 in 1967.
Shaded areas denote NBER recession dates.
Source: U.S. Census Bureau and FRBSF staff

Balanced gains during the pre-pandemic expansion

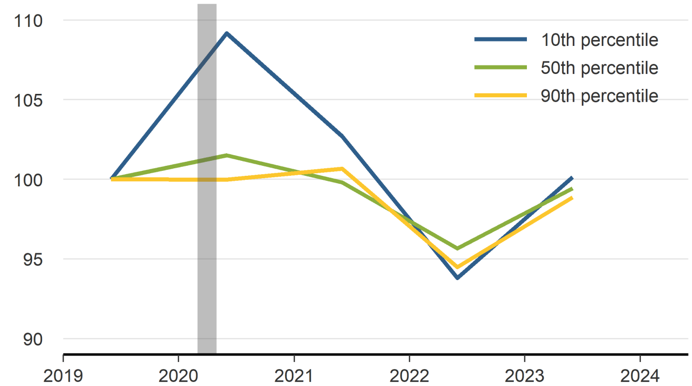
Real household income, 2012-2023



Note: Inflation adjusted using the overall CPI index and normalized to equal 100 in 2019.
Shaded area denotes NBER recession dates.
Source: U.S. Census Bureau and FRBSF staff

Income up in pandemic if corrected for UI payments

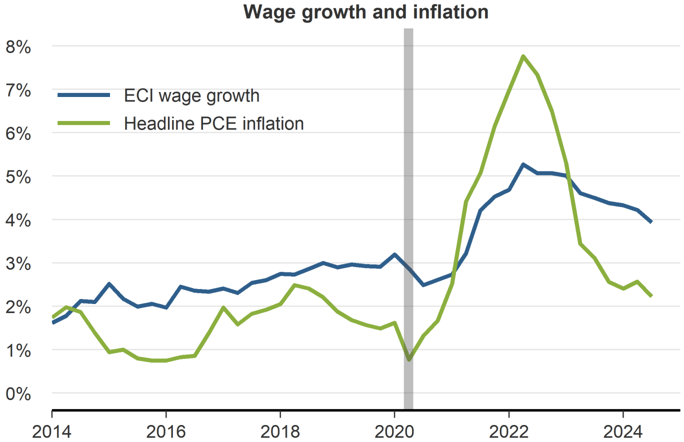
Adjusted real household income, 2019-2023



Note: Inflation adjusted using the overall CPI index and normalized to equal 100 in 2019.
Shaded area denotes NBER recession dates.
Source: FRBSF calculations using microdata from the Census Bureau, CPI from BLS, and corrected unemployment insurance benefit payments from Larrimore, Mortenson, and Splinter (2022)

Wages growing faster than prices since early 2023

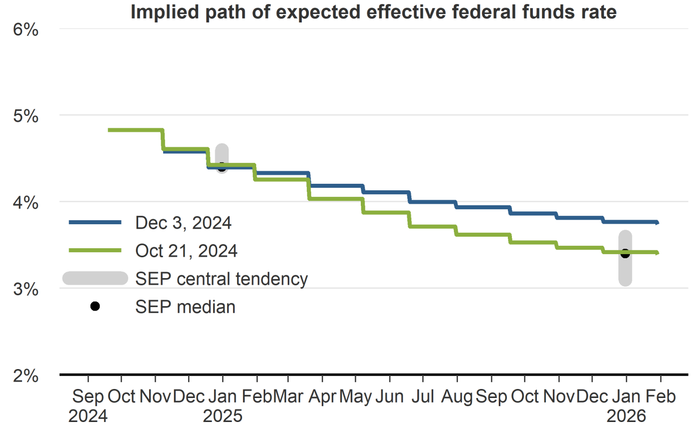
Wage growth and inflation



Note: 4-quarter percentage change for both series. ECI is Employment Cost Index.
Shaded area denotes NBER recession dates.
Source: Bureau of Economic Analysis and Bureau of Labor Statistics

Market expectations for funds rate shifted up

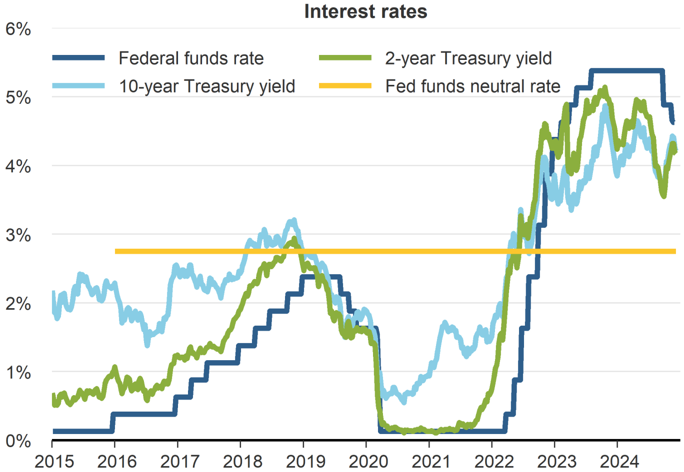
Implied path of expected effective federal funds rate



Note: Effective FFR path as implied from futures contracts covering announced FOMC meeting dates through Jan 2026. Black dots represent SEP median estimate. Central tendency shading shown in gray.
Source: Bloomberg and FRBSF staff

Recent interest rate movements show shifting views

Interest rates



Source: Federal Reserve H.15 Statistical Release