Remarks on the Economic Outlook and Monetary Policy

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Good afternoon. I would like to thank the organizers of the NABE Economic Policy Conference for their invitation to speak with you today. I look forward to an engaging dialogue with Greg Daco after first offering some comments on the U.S. economy and monetary policy. Let me stress that these are my personal views and not necessarily those of my FOMC colleagues.[1]

As economists, we have a firm belief in efficiency, so I will get straight to the point with four key messages.

First, the outlook for continued solid economic growth looks good, the labor market is healthy, and financial conditions are supportive. But recent data have been weaker than expected, especially consumer spending and housing market data, posing some downside risk to growth.

Second, inflation has continued to decline but remains above the FOMC's 2% target. More monetary policy work is needed to achieve price stability. While market and some survey measures of near-term inflation expectations have risen recently, and I am closely watching this, longer-term inflation expectations remain broadly anchored.

Third, after 100 basis points of interest rate cuts in the fall, monetary policy is well positioned to address risks to both sides of the Fed's dual mandate. Policy is now modestly restrictive and meaningfully less restrictive than it was seven months ago. I believe a patient approach now will help us as we seek maximum employment, price stability and a durable economic expansion. If the economy remains strong and inflation remains above target, then I believe modestly restrictive policy will continue to be appropriate until there is confidence inflation is converging to the FOMC's 2% target. If labor market conditions were to deteriorate, with

[1] I would like to thank David Wheelock for help in preparing these remarks, with contributions from Greg Cancelada, Riccardo DiCecio, Kristie Engemann and Kevin Kliesen.

inflation stable or declining toward target and inflation expectations anchored at a level consistent with 2% inflation, policy could be eased further.

Fourth, while I believe the economy will continue to expand at a solid pace, with a healthy labor market and inflation converging to 2%, as economists we must admit there are other plausible scenarios. In determining how monetary policy should respond under different scenarios, especially those that might involve difficult employment and inflation trade-offs, it will be important that medium- to longer-term inflation expectations remain well anchored. As I will discuss further, experience has shown that well-anchored inflation expectations provide the stable monetary policy foundation required for achieving maximum employment and price stability for the American people.

Current Conditions and Outlook

The U.S. economy entered 2025 on a solid footing with healthy forward momentum as consumers continued to power growth.[2] In the fourth quarter, real personal consumption expenditures grew at a robust 4.2% rate—the highest of any quarter in 2024—while real final sales to domestic purchasers grew at a healthy 3% annual rate.

Going forward, the prospects for continued growth look good. The balance sheets of firms and households are generally in good shape. Financial conditions are supportive of economic activity, especially for owners of financial assets and borrowers who directly access capital markets for funding. Real new orders for core capital goods rose strongly from November to January, and surveys indicate business confidence and planned capital expenditures also rose over those months.[3] Still, recent anecdotal reports from business contacts are more mixed, and some measures indicate that business activity has slowed, suggesting increased caution at least among some firms.[4]

Recent data indicate that consumers have been more cautious since the start of the year, which, if continued, would suggest growth in the first quarter may not be as strong. Inflation-adjusted consumption spending declined in January, and some reports suggest that consumers remained cautious in February. Rough winter weather likely was a contributing factor in

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[2] The St. Louis Fed's dashboard Economy at a Glance, which is powered by FRED, the St. Louis Fed's signature database, provides a high-level overview of current U.S. economic conditions.

[3] Surveys of business confidence include the National Federation of Independent Business (NFIB) January 2025 Small Business Optimism Index, with results reported in a Feb. 11, 2025, article, "Small Businesses Remain Optimistic, But Uncertainty Rising on Main Street," and the Jan. 24, 2025, S&P Global Flash US PMI. Surveys reporting capital expenditure intentions include the NFIB Small Business Economic Trends report, surveys by the Federal Reserve banks of Dallas, Kansas City, Philadelphia and Richmond, and the Federal Reserve Bank of New York's Business Leaders and Empire State Manufacturing surveys.

[4] The Feb. 21, 2025, S&P Flash PMI Output Index indicated a marked slowing in business activity since December.

reduced consumer spending, but a decline in consumer confidence may have played a role as well.[5] Measures of economic policy uncertainty have risen and are now higher than average.[6] This could also be weighing on consumer spending.

Low- and moderate-income consumers continue to be financially stretched. Their consumption growth is estimated to have moderated by more than that of higher-income consumers over the three months to January. For most of 2024, consumption growth is estimated to have been balanced and strong across income groups.[7]

While I continue to expect the economy to grow at a good pace in coming quarters, I would become concerned if we begin to see more evidence of a consumer pullback or a dampening of business confidence and investment plans.

Part of my optimism about economic activity stems from the labor market, where conditions remain solid. After softening through the first three quarters of 2024, the labor market has stabilized and has recently shown some signs of strengthening, though the recent uptick in initial claims for unemployment insurance bears watching. Payroll growth averaged 237,000 from November to January—exceeding estimates of the break-even pace—and the unemployment rate ticked down to 4%.[8] Job openings and quits rates have declined, but layoffs have remained low. A recent National Federation of Independent Business survey found a sizable net percentage of small businesses are expecting to add jobs in the coming three months.[9] Recent surveys conducted by several Federal Reserve banks also show increases in the percentage of firms planning to add jobs in the months ahead.[10] I will be watching closely for whether the sentiment conveyed in surveys shows up in hard data.

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[5] For recent measures of consumer confidence, see, for example, January and February surveys from The Conference Board and the University of Michigan.

[6] For a widely followed measure of economic policy uncertainty, see the US Monthly Economic Policy Uncertainty Index. Baker, Bloom and Davis (2016) and Jackson, Kliesen and Owyang (2020) show that increases in economic policy uncertainty foreshadow declines in investment, output and employment, and propagate through both household consumption spending and business fixed investment.

[7] Research colleagues at the St. Louis Fed estimate that LMI consumption growth moderated to a range of 0.9% to 1.4% at an annual rate, compared with a range of 1.9% to 3.0% for higher-income consumers, in the three months to January. The moderation could be related to weather effects. Consumption growth is estimated to have been balanced and strong across income groups from the fourth quarter of 2023 through the third quarter of 2024 at around 3%. Expenditure levels are used as a proxy for income levels in this analysis. See, for example, Sánchez and Mori (2024).

[8] The Bureau of Labor Statistics reported in the January 2025 Employment Situation report that adverse weather conditions and wildfires had no discernible impact on employment in January. However, researchers at the Federal Reserve Bank of San Francisco estimated that adverse weather conditions reduced January payroll growth by some 84,000 jobs, as shown on the Weather-Adjusted Employment Change data page.

[9] See the NFIB report cited in Footnote 3.

[10] Summary based on surveys conducted by the Federal Reserve Bank of Chicago and by the Federal Reserve banks of Dallas, Kansas City, New York, Philadelphia and Richmond linked in Footnote 3.

While growth in average hourly earnings and in other measures of employment costs has remained firm, the labor market does not currently appear to be a significant source of inflationary pressures because productivity has also risen. I will continue to monitor the balance between compensation growth, productivity growth and inflation going forward.

Inflation has retreated substantially from its peak in mid-2022 but remains above the FOMC's 2% target. Core PCE inflation, which I consider a good measure of underlying inflation, is 2.4% when averaged over the past three months, and is thus somewhat lower than the 12-month rate of 2.6%. Inflation convergence to the FOMC's 2% target remains my expectation, in part because many of our business contacts tell us they expect to have difficulty passing along higher input costs to their downstream customers, especially to price-sensitive final consumers. Still, more monetary policy work is required to achieve price stability.

Alternative Scenarios and Implications for Monetary Policy

Looking ahead, my baseline scenario has inflation continuing to converge to target and the labor market remaining near full employment. This baseline requires that monetary policy remains modestly restrictive until inflation convergence is assured. Critically, this scenario also requires that inflation expectations remain well anchored, as they broadly are today. The risk that recent increases in short-term inflation expectations feed into longer-term expectations may be elevated given current economic conditions: growth estimated to be near or possibly above long-run potential, a full-employment labor market, supportive financial conditions and inflation above target. Thus, I perceive the risks to inflation as skewed to the upside and am watching near- and longer-term inflation expectations carefully. My baseline scenario is likely if the *net* effects of any new trade, immigration, regulatory, fiscal or other policies and any other changes in the economic environment are small over the policy horizon.

Conceivably, a more favorable scenario is possible. For example, if the net effect of new government initiatives or other changes in the economic environment is a meaningfully positive and sustained impact on aggregate supply, then inflation might converge to 2% more quickly than in my baseline projection with the labor market likely at full employment. This would provide more confidence for reducing the policy rate toward neutral.

However, a less favorable but plausible scenario must also be considered. In this scenario, inflation stalls above 2% or rises while at the same time the labor market weakens. This scenario could occur for a variety of reasons. Recently, the possible effects of higher tariffs or changes in immigration policies have been widely discussed and thought likely to raise prices and soften aggregate demand and employment, at least in the near term. From the standpoint of monetary policy, it could be appropriate to ignore, or "look through," an increase in the price

level if the impact on inflation is expected to be brief and limited, or if there is meaningful trade retaliation from other countries.[11] However, a different monetary policy response could be appropriate if above-target inflation is sustained, or longer-term inflation expectations rise. In that scenario, a more restrictive monetary policy than the baseline path *might* be appropriate, and the implications for how to manage both sides of the dual mandate would have to be considered, as I will soon discuss.

Leaving tariffs and immigration aside, a similar pattern of higher prices and a weaker labor market could arise from an adverse supply shock—for example, a large, unexpected increase in energy prices or a sharp reversal in productivity growth. Neither seems likely today, but prudent policymaking requires us to consider a range of possibilities. Again, the distinction between a one-time increase in the price level and a sustained increase in inflation is important for determining the appropriate monetary policy response.

A deterioration of the labor market alongside higher inflation could present difficult choices. With inflation already above 2% and a full-employment labor market, the stakes are potentially higher than they would be if inflation were at or below target, and if consumers and businesses had not recently experienced high inflation, perhaps raising their sensitivity to it.

How should the FOMC, or any central bank, respond to a scenario in which the labor market weakens while inflation remains elevated or rises? History provides some lessons, and I will briefly discuss two disinflation episodes.

In the 1970s, the U.S. economy was buffeted by two major energy supply shocks when underlying core inflation was already high and rising. The shocks caused both inflation and unemployment to spike. Although inflation fell after each shock subsided, it declined to a level that was still higher than what had prevailed before the shock. Underlying inflation continued to climb higher. Inflation expectations followed a similar path, rising with each shock and then falling only partway before resuming an upward climb.[12]

Throughout much of the 1970s, the FOMC's attention shifted between inflation and unemployment. Some have described the resulting policy path as "stop-go-stop."[13] Policy oscillated—from tight to combat high inflation and then to easy to combat high unemployment. At that time, Fed officials viewed the economic and political costs of eliminating inflation as too

[11] Bergin and Corsetti (2024) argue that the optimal monetary policy response to an increase in tariffs depends on such factors as the extent of retaliation, importance of imported intermediate goods in domestic production, and importance of the home currency for invoicing international trade.

[12] See Benigno and Eggertsson (2023) for evidence on inflation expectations in the 1970s and in other disinflation episodes.

[13] See, for example, Goodfriend (2007).

high to stick with a policy that was sufficiently restrictive, and so underlying inflation continued to rise. The FOMC's approach at the time is widely viewed as a failure because neither inflation nor unemployment was satisfactorily contained.[14]

Under the leadership of Chairman Paul Volcker, the FOMC ultimately determined that restoring price stability was critical to achieving the Fed's maximum employment goal as well as its price stability goal. In October 1979, the FOMC implemented a highly restrictive monetary policy and committed to bringing inflation under control.[15] Despite two severe recessions from 1980 to 1982 and an unemployment rate that exceeded 10% for 10 straight months, the FOMC stuck with restrictive policy until inflation and inflation expectations were clearly headed lower.[16] The economics literature has concluded that the cost of reducing inflation was high because the public doubted the Fed's resolve. After years of aborted attempts to control inflation, the public's inflation expectations remained high despite the FOMC's stated commitment to restoring price stability.[17] The fact that people didn't believe the Fed could or would bring down inflation made inflation much harder to tame.

Fast forward to 2022, when the Fed again confronted high inflation and initiated a rapid tightening of monetary policy. After peaking at 7.2% in June 2022, headline PCE inflation had fallen to less than 3% by the fourth quarter of 2023. Disinflation has since continued, albeit at a slower pace. Unlike the disinflation of the early 1980s, the recent disinflation has had little negative impact on the overall economy. Real GDP growth has remained strong, and while the labor market has cooled from an overheated state, the unemployment rate has barely budged. Most of the labor market adjustment has occurred through a reduction in labor demand, as reflected in a sharp decline in the job openings rate rather than layoffs, while the unemployment rate has remained in the range of 3.4%-4.2% since March 2022, when the FOMC first increased its target range for the federal funds rate.[18] Notably, medium- to longer-

[14] CPI inflation averaged over 7% throughout the 1970s, exceeded 10% in 1974-75, and eventually peaked at 14.6% in early 1980. The unemployment rate ranged from 3.9% to 9% and averaged 6.2% during the 1970s. The literature on the Great Inflation of the 1970s and reasons for the failures of monetary policy in that era is voluminous and includes Bernanke (2022, pp. 3-30), Bordo and Orphanides (2013), Meltzer (2009, pp. 843-1007) and Hetzel (2022, pp. 381-401). Bernanke (p. 14) offers a succinct answer for why the Fed failed to control inflation: "The short answer is that a brew of raw politics and flawed views of the inflation process prompted Fed leaders to hold back at crucial moments, avoiding the painful steps that would have brought inflation under control."

[15] See Lindsey, Orphanides and Rasche (2005) for discussion.

[16] Kliesen and Wheelock (2021) review the policy debates within the FOMC on key issues during 1979-82, and Dupor (2025) examines the FOMC's decision to ease policy in 1982.

[17] See Bernanke (2022, pp. 32-43), Goodfriend and King (2005), Erceg and Levin (2003) and Benigno and Eggertsson (2023; 2024).

[18] See Figura and Waller (2022) and Benigno and Eggertsson (2024) for analysis suggesting that at high levels of job vacancies per unemployed worker, the labor market cooling underpinning disinflation can be achieved mostly through a decline in the vacancy rate.

term inflation expectations have also remained stable throughout the disinflation, which has likely contributed to inflation falling with little loss of output or employment.[19]

These two disinflation episodes clearly show the importance of well-anchored inflation expectations. In a scenario in which the employment and price stability goals may seem to be in conflict, I would look closely for assurance that inflation expectations are remaining well anchored over the medium to longer run when considering a balanced approach to monetary policy.

The FOMC's Statement on Longer-Run Goals and Monetary Policy Strategy addresses scenarios in which the Committee's employment and price stability goals are in conflict. In those circumstances, the statement indicates the Committee will take into account the size and timing of deviations of each goal from its target.[20] In implementing that strategy, one approach would be to adjust the policy rate in accord with the relative size of the deviation of inflation from 2% and of the shortfall of employment from some measure of maximum employment, but not necessarily change the relative weights the Committee has assigned to deviations of each goal from its target. In other words, a balanced approach need not entail a change in the Committee's reaction function. Policy might appear to lean more heavily toward the objective that deviates the most from its target while not ignoring the other goal.[21] But again, it is crucial that inflation expectations remain well anchored. The FOMC's statement makes that clear.[22]

Well-anchored inflation expectations reflect the credibility of the central bank's commitment to low and stable inflation. That credibility is a valuable asset that makes controlling inflation easier and provides scope for the central bank to respond effectively to declines in output and employment.[23] In other words, anchored inflation expectations make feasible a balanced approach to addressing conflicting goals. A balanced approach was not feasible in the 1970s because inflation expectations were not anchored. Elevated inflation expectations were a key reason why bringing inflation under control was so much more costly at that time than it has been since 2022. That is why I would be especially concerned if I saw evidence suggesting

[19] Benigno and Eggertsson (2024) and Bundick, Smith and Van der Meer (2024) argue that stable inflation expectations help explain why the recent disinflation has been accomplished with little impact on economic activity and employment.
[20] Specifically, the Statement on Longer-Run Goals and Monetary Policy Strategy describes the approach as taking "into account the employment shortalls and inflation deviations and the potentially different time horizons over which employment and inflation are projected to return to levels judged consistent with its mandate."
[21] The academic literature suggests that simple rules that balance trade-offs between potential conflicting inflation and employment objectives are robust across a broad range of aggregate demand dynamics (Levin, Wieland and Williams, 2003).
[22] The specific language is: "The Committee judges that longer-term inflation expectations that are well anchored at 2 percent foster price stability … and enhance the Committee's ability to promote maximum employment …"
[23] See Bernanke (2022, p. 42) for discussion.

inflation expectations were becoming unanchored today, and why I put a high priority on making sure inflation continues to converge to the FOMC's 2% target in a full-employment environment.

Conclusion

I will close by reiterating four main points:

First, the outlook for continued solid economic growth looks good, the labor market is healthy, and financial conditions are supportive. But recent data have been weaker than expected, posing some downside risk to growth.

Second, inflation has continued to decline but remains above the FOMC's 2% target. While there has been an uptick in near-term inflation expectations, which I am watching closely, longer-term inflation expectations have broadly remained stable. We have more work to do to achieve price stability.

Third, monetary policy is well positioned to address risks to both sides of the Fed's dual mandate. I believe a patient policy approach now will help us as we seek maximum employment, price stability and a durable economic expansion.

Fourth, in determining how monetary policy should respond to alternative scenarios, especially when they might involve difficult employment and inflation trade-offs, it will be important that medium- to longer-term inflation expectations remain well anchored. By continuing to pursue convergence of inflation to the 2% target, I believe we can maintain the solid monetary policy foundation that underpins maximum employment and price stability for the American people.

Thank you.

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