FEDERAL RESERVE BANK of ST. LOUIS

Economic Conditions, Risks and Monetary Policy

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The text is as prepared for delivery.

Good morning. I would like to thank the Peterson Institute for International Economics for the kind invitation to speak with you today. I am especially looking forward to an engaging discussion with Esther George. I have long admired her exemplary service to the nation as president and CEO of the Federal Reserve Bank of Kansas City. She set a high bar for every Fed official.

Before taking Esther's questions, I would like to begin by offering a few observations about economic conditions and monetary policy. These are my personal views and not necessarily those of other FOMC participants.

Economic Outlook and Balance of Risks

The pace of economic activity picked up in the second quarter, propelled by higher consumer spending and solid growth in business fixed investment. Real GDP grew at an annual rate of 1.4% in the first half of 2025, which is somewhat below estimates of long-run potential.[1] I expect output growth at a similar rate in the second half of 2025, before it returns to potential in 2026 or sooner. The policy uncertainty that has held back business and household spending continues to lift, and I expect some stimulus to growth from fiscal policy.

Financial conditions are also broadly supportive of economic activity and consistent with a modestly restrictive setting of monetary policy. The equity market is buoyant, credit spreads are low, and corporate profit margins are elevated by historical standards. Also, net capital market issuance and bank lending continue to grow at a healthy pace.

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[1] For the first half of 2025, the average of real GDP and real gross domestic income (GDI) growth—an alternative measure of growth—was 1.9%. That is more in line with the 1.8% median long-run potential growth projection of FOMC participants in the June 2025 Summary of Economic Projections.

However, mortgage origination and refinancing activity remain sluggish, despite a recent decline in mortgage rates. Rising inventories, slowing home price appreciation and low turnover suggest the weak housing market poses some downside risk to the pace of economic activity.

Labor Market

The August employment report on Friday will provide a fresh look at the labor market. As of today, available data indicate the market is close to full employment. In addition to the unemployment rate, the vacancies-to-unemployed ratio, initial claims for unemployment insurance, the pace of job-to-job transitions, and the employment cost index are among measures consistent with a labor market near full employment.

Payroll growth has slowed in 2025, reflecting both lower demand and lower supply of labor. Estimates of the breakeven pace of job growth have fallen with the recent decline in immigration and lower labor force participation. Breakeven estimates are currently in the range of 30,000 to 80,000 jobs per month, compared with estimates above 100,000 in prior years.[2]

Looking ahead, I expect the labor market to gradually cool and remain near full employment with risks tilted to the downside. Throughout the year, businesses have said that uncertainty about the impact of tariffs and other economic policies made planning difficult and left them hesitant to add to payrolls. With the pace of hiring low, any increase in layoffs could produce a more substantial labor market weakening than would occur in a more active market. While I am not hearing from businesses about an imminent increase in layoffs, real GDP growth that is somewhat below potential and profit margin pressures related to tariffs could contribute to such an outcome.

Recent data have further increased my perception of downside risks to the labor market. These include a higher proportion of longer-term unemployed workers, rising unemployment rates for demographic groups that are more sensitive to economic cycles, and substantial downward revisions to payroll growth estimates. The upcoming preliminary Quarterly Census of Employment and Wages, or QCEW, benchmark revisions may reveal an even lower pace of recent payroll growth.

Inflation

Through July, core inflation is running closer to 3% than to the Fed's 2% target, reflecting some tariff effects.

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[2] See Alexander Bick, "Lower Immigration Projections Mean Lower Breakeven Employment Growth Estimates," *St. Louis Fed On the Economy*, Aug. 28, 2025.

As a baseline, I expect the effects of tariffs will work through the economy over the next two to three quarters and the impact on inflation will fade after that. Through July, the pass-through of tariffs to consumer prices has been modest, at around 20%.[3] Below-trend real GDP growth and stable longer-term inflation expectations should limit the persistence of inflation. I expect inflation will resume convergence toward 2% in the second half of 2026.

However, there is considerable uncertainty, and I perceive a reasonable possibility that above-target inflation could be more persistent. Indirect effects on non-imported goods and services or second-round price increases stemming from tariffs could cause the adjustment process to take longer. The pass-through rate could rise as inventories of goods purchased before tariffs are drawn down, or as final tariff rates become more certain. Some firms tell me they have been absorbing cost increases while tariff rates have been in flux to avoid making multiple pricing adjustments, but they expect to eventually raise prices.

Also, the public is already sensitive to inflation. A prolonged period of inflation above the Fed's target could increase the risk that elevated near-term inflation expectations seep into longer-term expectations.

Monetary Policy

Now that I've summarized my views on the outlook and balance of risks, let me conclude with a few comments on monetary policy.

The current modestly restrictive setting of the policy rate is consistent with today's full employment labor market and core inflation nearly one percentage point above the Fed's 2% target. Multiple Taylor rule specifications currently prescribe a policy rate around today's level of the federal funds rate and above estimates of the long-run neutral rate.[4]

From this starting point, policy must be forward-looking and based on the evolving economic outlook and balance of risks. When the maximum employment and price stability goals are not complementary, it is important to take a balanced approach. This means appropriately weighing the probability of missing on each goal, the potential size of each miss, and the different time horizons needed to return employment and inflation to levels consistent with the Fed's dual mandate.[5]

[3] St. Louis Fed economists estimate a tariff pass-through to date on the order of 20% relative to a theoretical full pass-through scenario.
[4] The specifications I am referring to assume a neutral rate of 3%, which is the median long-run federal funds rate projection of FOMC participants as reported in the June 2025 Summary of Economic Projections.
[5] The FOMC's Statement on Longer-Run Goals and Monetary Policy Strategy, as amended effective Aug. 22, 2025, describes this balanced approach.

Pursuing a balanced approach requires care. For example, putting most of the weight on the labor market goal runs a risk of unwarranted or excessive policy easing, causing a further steepening of the yield curve, a rise in the term premium or an increase in inflation expectations. Any of those potential outcomes could do more harm than good to the labor market and contribute to more persistent above-target inflation. Although longer-term inflation expectations are anchored today, markets are sensitive to these risks, as evidenced by increases in the term premium and in some measures of long-term inflation expectations.[6]

At the same time, putting most of the weight on the inflation goal runs the risk of not providing enough support to maintain a full employment labor market at a time when downside risks have risen. Again, balance is the key.

As always, in the coming weeks and months, I will continue to update my outlook and my assessment of the balance of risks to seek a forward-looking path of interest rates that best positions monetary policy for achieving and maintaining maximum employment and price stability for all Americans.

Thank you.

[6] See Don Kim, Cait Walsh and Min Wei, "Tips from TIPS: Update and Discussions," FEDS Notes, Board of Governors of the Federal Reserve System, May 21, 2019. Current data are available.