FEDERAL RESERVE BANK of ST. LOUIS

Remarks on the Economic Outlook, the Balance of Risks and Monetary Policy

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The text is as prepared for delivery.

Good morning. I would like to thank the Brookings Institution for the kind invitation to speak with you today. I look forward to an engaging discussion with David Wessel. First, I will offer a few remarks on the U.S. economic outlook and monetary policy. These are my personal views and do not necessarily reflect those of my FOMC colleagues.

At last week's FOMC meeting, I supported the Committee's decision to reduce its target range for the federal funds rate by 25 basis points. Although the labor market is currently at or near full employment and inflation is meaningfully above the Committee's 2% target, I supported this action because recent data indicate that the downside risks to employment have increased relative to the risk of inflation remaining persistently above target.

To be clear, I expect the labor market will remain near full employment or soften only modestly, and inflation will return to a path toward 2% as the effects of tariffs wane.

However, there are two-sided risks, and I believe we should remain forward-looking and take account of these when making policy decisions. I see a risk that above-target inflation could be more persistent than is desirable. I supported the rate decision because I perceived the risk of labor market weakening had increased sufficiently to warrant a policy adjustment.

I will now expand on these points.

Economic Outlook and Balance of Risks

Activity

Real GDP grew at an annual rate of 1.4% in the first half of 2025, which is slightly below estimates of long-run potential.[1] Tracking forecasts indicate a strong third quarter, so it's

[1] For example, the median long-run real GDP growth projection of FOMC participants is 1.8% in the September 2025 Summary of Economic Projections.

possible that real GDP growth will exceed 1.4% in the second half of this year. I expect growth near long-run potential in 2026 and possibly higher.

Consumers remain resilient. Adjusted for inflation, consumer spending rose in July. Retail sales in August were also solid. Spending has remained especially strong among high-income households but has slowed among low- and moderate-income households and certain demographic groups. For example, contacts report slower consumption growth among Hispanic households.

Financial conditions and positive wealth effects are supportive of economic activity. A buoyant stock market, historically low credit spreads, healthy bank lending and capital market issuance are indicative of accommodative financial conditions. Profit margins are elevated—driven more by cost control and efficiencies than by revenue growth. Publicly traded companies reported solid earnings and revenues in the first half of the year, and earnings guidance for the third quarter was mostly positive.

The outlook is shaped by both structural and cyclical factors. Economic policy uncertainty is having mostly cyclical effects, while immigration, tariffs and AI are having mostly structural effects. AI continues to fuel a surge in non-residential construction spending, which is expected to continue. The AI boom is also dampening demand for entry-level technology and administrative jobs. Reduced immigration is contributing to slower growth in consumer spending and labor supply.

Economic policy uncertainty remains elevated but has declined over the past few months. My contacts are now telling me that businesses are adjusting to tariffs and fewer are in "wait and see" mode, suggesting that greater policy certainty could have a positive impact on economic growth later this year and into 2026. Fiscal policy, which looks slightly restrictive this year, is also likely to provide more support early next year.[2]

The weak housing market continues to pose some downside risk to the economic outlook. Residential fixed investment declined in the first half of 2025. New construction has slowed as inventories of unsold homes have risen, while the mortgage lock-in effect continues to weigh on the market for existing homes, keeping prices high. Mortgage origination and refinancing activity is sluggish, and mortgage rates and spreads remain elevated despite some recent declines. Price appreciation has slowed, and home prices have begun to fall in some markets. Industry contacts expect that the prices of single-family homes will be flat over the next 12 months nationwide.

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[2] My expectations for real GDP growth in 2025 and 2026 and underlying factors are similar to those of the Congressional Budget Office, as reported in September 2025: "CBO's Current View of the Economy From 2025 to 2028."

Labor Market

Turning to the labor market, the unemployment rate, job-to-job transition rate, wage growth and low level of layoffs are all indicative of a market around full employment.

Sluggish payroll growth reflects both structural and cyclical factors. Research by St. Louis Fed economists finds that negative supply shocks have contributed meaningfully to the downshift in private sector hiring and above-trend wage growth in the services sector. Lower immigration and labor force participation have reduced the growth of labor supply, while economic policy uncertainty and perhaps other cyclical factors have reduced labor demand. St. Louis Fed economists estimate payroll growth in the range of 30,000 to 85,000 jobs per month is currently required to prevent the unemployment rate from rising, with confidence weighted toward the low end of that range.

Looking ahead, labor market risks appear weighted to the downside. Recent data have reinforced my perception of those risks. The unemployment rates of cyclically sensitive demographic groups, such as younger workers and African Americans, have been rising, as has the broader U6 unemployment rate, which includes workers marginally attached to the labor force and those working part time who would prefer to be working full time. The percentage of unemployed workers who have been out of work for more than 27 weeks has also been rising, while job-finding expectations have been falling.[3]

My business contacts have not been reporting plans for layoffs, and actual layoffs have remained low. However, some measures of layoff announcements have been rising.[4] The modest pace of economic activity and low hiring rate suggest that the unemployment rate could increase sharply if layoffs were to rise significantly.

Inflation

Turning now to our price stability goal, inflation remains above the FOMC's 2% target. The PCE inflation rate for August will be reported on Friday. Economists expect a core PCE inflation rate of 2.9%, which I view as the best measure of underlying inflation. This is nearly a full percentage point above target.

August data on the consumer price index indicated that inflation is rising. Measures of goods, services and shelter inflation all moved higher on a three-month annualized basis, and "supercore" inflation exceeded 4% for the first time since February.[5]

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[3] A recent New York Fed survey finds that job-finding expectations are at their lowest point since the survey began in June 2013.

[4] See, for example, the Challenger, Gray & Christmas Inc. report, "Pharma and Finance Lead as August 2025 Job Cuts Rise 39% to 85,979."

[5] Supercore inflation is a measure of inflation for nonhousing services that excludes prices of shelter (primary residence rent and owners' equivalent rent) as well as food and energy prices.

Tariffs have been contributing to inflation, but the effects are uncertain in terms of measurement, magnitude and persistence. St. Louis Fed economists estimate a direct pass-through of realized tariffs to core PCE of 0.2% from January to July, and of 0.3% to core CPI from January to August. Estimates of direct plus indirect effects are about 0.1% higher. So far, the effects on inflation have been more muted than expected, suggesting that factors other than tariffs are contributing to above-target inflation.

Business contacts tell us it takes three to six months to adjust to an increase in tariffs, and only four months of data are available since tariffs rose meaningfully in April. Business contacts report that producers of intermediate goods are fully passing on tariffs to their customers in the form of price increases and surcharges, while firms closer to the final consumer are less able to do so. Some firms have also told us that rather than making frequent price changes, they are waiting until tariff rates and policies seem set before making price adjustments. This suggests the pass-through of tariffs to consumer prices could rise later as final tariff rates become more certain and inventories are re-stocked.

Monetary Policy

Let me conclude with a few comments on monetary policy. Given the economic outlook and balance of risks, I supported the 25-basis-point reduction in the FOMC's policy rate last week as a precautionary move intended to support the labor market at full employment and against further weakening. The stance of monetary policy now lies between modestly restrictive and neutral, which I view as appropriate.

However, I believe there is limited room for easing further without policy becoming overly accommodative, and we should tread cautiously for three reasons.

First, as I said earlier, financial conditions—which are how monetary policy transmits to the economy—are already supportive of economic activity.

Second, looking through direct one-time effects of tariffs on inflation is appropriate, but this posture could risk price stability if taken too far, or if maintained for too long. While providing insurance against labor market weakness, I believe that monetary policy should continue to lean against persistence in above-target inflation, whether it materializes from the impact of tariffs, lower labor supply growth, or for other reasons.

Finally, the ex ante real policy rate is already close to neutral. The nominal policy rate is now 4.1%.[6] Markets expect an inflation rate of 3.3% over the next 12 months.[7] So, the ex ante real policy rate is 0.8%. This is below the 1% median long-run real neutral rate of FOMC

[6] For illustration purposes, I am using 4.1% to represent the FOMC's current target range for the federal funds rate, which is 4.0%-4.25%.
[7] Markets expect 3.3% inflation as reflected in the 12-month inflation swap rate, and August survey data on consumer expectations are for 3.2% inflation over the same period.

participants.[8]

I do not view 1% as a floor below which the real policy rate must not go. But to go there, I believe the outlook or balance of risks must shift further from where they are today, especially if inflation looks likely to remain persistently above target. Should further signs of labor market weakness emerge, I would support additional reductions in the policy rate, provided the risk of above-target inflation persistence has not increased and longer-term inflation expectations remain anchored.

The risks of persistent above-target inflation would be especially problematic if longer-term inflation expectations begin to move higher. Both market measures and surveys indicate the public expects inflation to exceed 2% over the next year or so. Most measures of longer-term inflation expectations have remained stable and consistent with our 2% target.[9] But people are already sensitive to inflation, which could increase the possibility of elevated expectations becoming entrenched. If the public begins to doubt that inflation will converge to 2%, the job of restoring price stability would be more difficult and potentially costly for the economy.

Looking ahead, my focus is on a policy path that equally weighs both sides of our dual mandate. Pursuing a balanced approach to policy requires care. Putting too much weight on one goal at the expense of the other can lead to undesirable outcomes.

Overemphasizing the labor market objective runs a risk of excessive policy easing, which could cause a further steepening of the yield curve, a rise in the term premium or an increase in inflation expectations. Any of those effects could do more harm than good to the labor market and contribute to more persistent above-target inflation.

However, if inflation expectations are well anchored, overemphasizing the inflation objective 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.

I do not have a pre-set course for policy. In the weeks and months ahead, I will continue to refine my economic outlook and 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.

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[8] The median long-run federal funds rate projection of FOMC participants is 1.0%. Subtracting a 0.2% core CPI- core PCE premium from inflation would put the adjusted ex ante real policy rate at 1.0%. Typical Taylor rule specifications lead to the same conclusion. Given current values of inflation (around 3%), the output gap (about zero), neutral long-run real rate (say 1%) and standard parameters, multiple rules prescribe a nominal policy rate that is at or above the current federal funds rate.

[9] A notable exception is the University of Michigan Surveys of Consumers preliminary survey for September 2025.