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The Economic Outlook and Appropriate Monetary Policy

Remarks by

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at

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Thank you, Barbara, and thank you for the invitation to speak to you today. It is an honor to join other members of the Federal Open Market Committee (FOMC) who have addressed the Economic Club of New York over the years.[1]

My subject is the current state of the U.S. economy, the economic outlook, and the implications for monetary policy. The short version is that the labor market appears resilient and stable and economic activity is continuing to grow, although at a more moderate pace than in the second half of last year.

While the labor market is currently at or near the FOMC's goal of maximum employment, there is the prospect that trade and other policy changes could raise the unemployment rate and push employment away from our objective. These policies, especially higher import tariffs, could also raise inflation over the rest of this year. In fact, while progress toward the FOMC's goal of 2 percent inflation has continued, we have seen an escalation in goods inflation and data from surveys, and non-traditional sources point to some inflationary pressures as well.

In addition to increases in U.S. import tariffs and retaliatory increases in the tariffs foreign countries apply to U.S. exports, other policy changes, either proposed or already underway relate to immigration, fiscal policy and regulation. Those policies could affect economic conditions, and since it is the FOMC's job to set monetary policy that is best able to achieve our mandated goals of maximum employment and stable prices, we must consider the effects of these policies. So far, we are beginning to see the impact only of higher tariffs on inflation. Still, thinking about the outlook requires

[1] The views expressed here are my own and not necessarily those of my colleagues on the Federal Reserve Board or the Federal Open Market Committee.

consideration of how the economy could be affected by all these policy changes moving forward.

It remains difficult to judge the current strength of economic activity, based on data through the first four months of 2025, primarily because of the front-loading of imports ahead of the implementation of tariffs. While real gross domestic product (GDP) declined slightly in the first quarter, that was largely because of a surge in imports ahead of anticipated tariff increases, a surge that will likely reverse. Putting aside fluctuations in trade and in inventories and focusing on the April data, personal income and consumption point to a slight moderation in economic activity. While personal disposable income increased at a healthy pace so far this year, consumption grew more slowly in April, which may indicate consumers are becoming more cautious. That said, there is considerable uncertainty about imports in the second quarter and uncertainty about the impact that higher prices will have on spending, so I will be looking for more evidence about economic activity in May ahead of the FOMC's next meeting, June 17 and 18.

One encouraging sign about economic activity is the resilience of the labor market. We will get the May employment report tomorrow, but the data in hand indicate that employment has continued to grow and that labor supply and demand remain in relative balance. In April, employers added 177,000 jobs, slightly higher than the average for the previous six months. The unemployment rate was steady in April at 4.2 percent, in the historically low range of 4 percent to 4.2 percent that it has remained in since May 2024. Data on job openings and quits for April likewise point to a resilient but somewhat looser labor market with a balance of supply and demand. The vacancy rate, a measure of demand for workers, was 4.4 percent, down from a peak of 7.4 percent three years ago and roughly the same level as just before the pandemic.[2] The quits rate, an indicator of the confidence workers feel in finding a job, has been in the narrow range of 1.9 to 2.2 percent since December 2023, and just a bit below the average level in 2019.[3]

Ahead of tomorrow's employment report, other data that we have for May are generally consistent with this picture of the labor market but may suggest some cooling. The average of private-sector forecasters' predictions for total job creation is 130,000.[4] Also, while the pace of job layoffs remained at historically low levels through the final week of May, based on the number of new claims for unemployment benefits, other measures suggest modest increases in layoffs. For instance, Worker Adjustment and Retraining Notifications (WARN notices) of layoffs have ticked up since the beginning of the year, as have the mentions of layoffs in the Fed's Beige Book survey and job cuts data reported by Challenger, Gray and Christmas.

The other side of the FOMC's dual mandate is price stability. Progress in lowering inflation toward the Committee's 2 percent target has slowed some since last summer, even if headline and core inflation have continued to decline. The FOMC's preferred inflation gauge, based on personal consumption expenditures (PCE), grew at a 2.1 percent annual rate in April. While that is quite close to the FOMC's target, it was dragged down by a decline in energy prices. Core inflation—which excludes volatile prices for food and energy and is a good guide to future inflation—came in at 2.5 percent,

[2] The vacancy rate is defined as the number of vacant jobs as a percentage of total employment.
[3] The quits rate is defined as the percentage of employees who voluntarily quit their jobs relative to total employment.
[4] I report here the median of economists' expectations for total nonfarm payrolls polled by Bloomberg.

so I do believe that our monetary policy stance, which I view as modestly restrictive, is currently appropriate to achieve and sustain 2 percent inflation over the longer term.

Sticking with core inflation, to help me judge ongoing progress toward price stability, I like to look at the 12-month change in each of the three main categories of core inflation: housing services, services excluding housing, and goods. The PCE price index for housing services has declined markedly in the past year, from 5.7 percent in April 2024 to 4.2 percent in April this year, but it is still considerably above the level that persisted before the pandemic. Meanwhile, the PCE price index for core services excluding housing, which makes up more than half of core PCE inflation, has declined from 3.6 percent in April last year to 3 percent in April 2025, still somewhat above the level that prevailed before the pandemic. And the third category is core goods inflation, which rose at a 0.2 percent annual rate in the 12 months through April, compared with April 2024 when it had actually fallen 0.5 percent over the previous 12 months. In recent decades, core goods prices have typically fallen over time, helping to keep a lid on overall inflation, so this is a meaningful reversal of the disinflationary process. To sum up, while core services inflation has fallen, it is still running above the rate before the pandemic, and the progress on core goods inflation has reversed. I have been paying attention to this reversal for some time and how this could be exacerbated by the announced and implemented tariffs.

Research published recently by Federal Reserve Board staff calculates the pass-through of tariffs enacted before April 2 to individual product categories tracked in personal consumption expenditures.[5] Using PCE data from February through April, the authors estimate that the 20 percentage point increase in tariffs on Chinese imports earlier in the year raised overall core PCE prices by two tenths of 1 percent. Since tariffs on China are currently higher than 20 percent, and tariffs have increased for other countries, these results tell me, first, that the pass-through of tariffs into prices is relatively quick, and, second, should elevated tariffs persist, even just in the short run, larger effects may be coming soon. The import surge I mentioned earlier, ahead of sharp tariff increases, has delayed the price effects associated with those tariffs, and the reversal in that surge that I expect in the next few months will likely signal larger price increases.

An important feature of most of the data I have mentioned so far is that it is released with significant lags. For example, the initial estimate of GDP is released about 30 days after the end of the quarter, and two later revisions mean that we may not get a clear idea of how output increased until nearly three months afterward. Monthly data on job openings are typically released with a one-month delay. The reasons for these lags are well known. For instance, statistical agencies can only survey households and businesses every so often, and it takes time to compile and publish high-quality statistics. Still, if policymakers solely rely on these traditional data to forecast what the economy will do in the future, they end up focusing on the past, which is a little like driving down the road by looking in a rearview mirror.

As I mentioned in my speech last year to the National Association for Business Economics, there has been an explosion of nontraditional or soft data produced by the

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[5] See Robert Minton and Mariano Somale (2025), "Detecting Tariff Effects on Consumer Prices in Real Time," FEDS Notes (Washington: Board of Governors of the Federal Reserve System, May 9), https://doi.org/10.17016/2380-7172.3786

private sector, giving us an opportunity to measure economic developments with greater timeliness (sometimes even in real time), at a higher frequency, and with more granularity.[6] These data are released closer to the time of collection, such as several surveys from the Federal Reserve Banks. Given today's fast-changing and uncertain environment, soft and non-traditional data becomes all the more important.

That said, nontraditional data often face their own challenges, including issues with representativeness, the lack of methodological consistency, and a short time-series history. And, to be clear, while some non-traditional data are indeed "soft data" in that they capture sentiment or expectations, other data in this category are decidedly "hard," since they are based on actual decisions and actions by businesses and households. In evaluating both traditional and nontraditional data on the economy, I face a tradeoff between timeliness and precision, but both sources are essential for me in formulating an outlook.

So, in the context of hard data that has lately been providing a less-than-clear view of the economy, what are the nontraditional data telling me about meeting the FOMC's two economic objectives? On the price-stability side, survey data from businesses suggest that price increases are coming. These surveys report diffusion indexes, which are calculated as the percentage of total respondents reporting increases in prices minus the percentage reporting declines. Surveys for May point to indexes for inputs and selling prices being elevated relative to the beginning of the year, probably reflecting effects from higher tariffs. Manufacturing and non-manufacturing surveys

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[6] See Adriana D. Kugler (2024), "The Challenges Facing Economic Measurement and Creative Solutions," speech delivered at the 21st Annual Economic Measurement Seminar, National Association for Business Economics Foundation, Washington, June 16, https://www.federalreserve.gov/newsevents/speech/kugler20240716a.htm.

from the Institute for Supply Management (ISM), as well as several surveys from the Federal Reserve Banks report increases in material prices and prices charged to customers, with many respondents volunteering that this is related to tariff increases.

I believe expectations of future inflation are an important determinant of current inflation, and data for May continue to point to increases in measures of near-term inflation expectations. An average of private-sector economists published by the Survey of Professional Forecasters finds that expectations for core PCE inflation over the next year moved up from 2.4 percent in April to 2.9 percent in May. Among data on inflation expectations, the most dramatic increases have been seen in the University of Michigan Surveys of Consumers. While I take seriously the concern that recent methodological changes in the survey may have made this measure less reliable, this survey is a longstanding and important barometer of consumer sentiment, and I still monitor the signals it is giving us closely. According to the Michigan survey, consumers expect inflation in the next year to average 6.6 percent and over the next 5 to 10 years to average 4.2 percent. Tariffs continued to be an important issue in the Michigan survey, with nearly three-quarters of consumers mentioning them, up from almost 60 percent in April. Firms have also raised their inflation expectations, with a survey by the Cleveland Fed reporting an increase in one-year-ahead expectations from 3.2 percent in the first quarter to 3.9 percent in the second.

However, I still see stability in most measures of longer-run inflation expectations. Notably, expectations among professional forecasters for inflation 6 to 10 years ahead decreased from 2.1 percent in April to 2 percent in May. That provides me some comfort, as it points to confidence from the public in the Fed to bring inflation to our goal of 2 percent over the medium term.

Recent developments and the data I have been monitoring have led me to consider at least three channels through which tariffs could have a persistent influence on inflation. First, as I have mentioned in some previous speeches, while it is true that short-run inflation expectations are influenced by short-term economic shocks, I value them because they often represent the horizon of decisionmaking for businesses and consumers.[7] The increase in short-run inflation expectations that I previously mentioned may give businesses more leeway to raise prices, thus increasing the persistence of inflation. A second channel for tariffs influencing inflation could be opportunistic pricing by firms, if they take advantage to increase prices of items not directly affected by tariffs. This, along with tariffs on intermediate goods, could generate second-round effects on inflation. And a third channel is that lower productivity may lead to upward pressure on prices. As firms adjust to the higher input costs and lower demand, they may cut back on capital investment and shift to a less-efficient combination of inputs. While, so far, I have only seen anecdotal evidence for the opportunistic pricing among these three channels, I am closely monitoring any signs of increased persistence on inflation.

Nontraditional data indicators of real activity suggest that the economy might be starting to slow. Measures of household sentiment about economic conditions remain downbeat, such as those from the University of Michigan or the Conference Board. As for businesses, manufacturing surveys, such as the ISM, report a slowing in new orders.

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[7] See Adriana D. Kugler (2025), "Inflation Expectations and Monetary Policymaking," speech delivered at the Griswold Center for Economic Policy Studies and the Julis-Rabinowitz Center for Public Policy and Finance, Princeton University, Princeton, N.J., April 2, https://www.federalreserve.gov/newsevents/speech/kugler20250402a.htm.

Additionally, the May Beige Book reports that economic activity has declined slightly relative to April. On the services side, representing the majority of businesses, the ISM PMI has trended down in the past few months and reached a level in May consistent with stagnation. Focusing on the ISM services new order component, it declined significantly in May to one of its lowest levels in recent years.

In summary, the nontraditional data on economic activity are consistent with my overall assessment that we might be seeing some moderation in the growth of economic activity but not yet a significant slowdown. As policies on fiscal matters and immigration take shape, I find it important to also account for their implications for the U.S. economic outlook. On the fiscal side, the omnibus bill passed by the House would add stimulus to the economy.[8] On the immigration side, we have seen inflows substantially down since last year, which decreases the labor supply and could add meaningful upward pressure to inflation by the end of the year in sectors reliant on immigrant labor such as agriculture, construction, food processing, and leisure and hospitality. That said, I have not yet seen much of an imprint on wages from these developments.

Let me conclude with the implications of all this for monetary policy. As inflation has declined over the past two years, due in part to tighter monetary policy, the U.S. economy has remained resilient, with stable labor markets and employment near its maximum sustainable level. Disinflation has slowed, and we are already seeing the effects of higher tariffs, which I expect will continue to raise inflation over 2025. I see greater upside risks to inflation at this juncture and potential downside risks to

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[8] See Congressional Budget Office (2025), *Preliminary Analysis of the Distributional Effects of the One Big Beautiful Bill Act* (Washington: CBO, May), https://www.cbo.gov/publication/61422.

employment and output growth down the road, and this leads me to continue to support maintaining the FOMC's policy rate at its current setting if upside risks to inflation remain. I view our current stance of monetary policy as well-positioned for any changes in the macroeconomic environment.

Thank you for the opportunity to speak to you today, and I look forward to what I expect will be interesting questions.