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Cutting Rates in the Face of Conflicting Data

Remarks by

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Thank you, Tom, and thank you to the Council on Foreign Relations for the opportunity to speak to you today.¹

Since the Federal Open Market Committee's (FOMC) last meeting on September 16 and 17, economic data have tended to support my view of a labor market that is softening and inflation—absent temporary tariff effects—that is running fairly close to the FOMC's 2 percent target. Based on what I know today, I support continued easing of monetary policy from its current setting, which I judge is moderately restricting aggregate demand and economic activity. But I also see a conflict right now between data showing solid growth in economic activity and data showing a softening labor market.² So, something's gotta give—either economic growth softens to match a soft labor market, or the labor market rebounds to match stronger economic growth. Since we don't know which way the data will break on this conflict, we need to move with care when adjusting the policy rate to ensure we don't make a mistake that will be costly to correct. I believe that how that process plays out in the coming months will have a significant impact on the path of monetary policy.

Resolving this conflict has been complicated by the government shutdown, which has delayed important economic data that policymakers and the public rely on to judge economic conditions. Although private-sector data alternatives are available and a helpful complement to official statistics, they are less informative when they stand alone.

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

² Some have suggested that this could be the result of higher productivity growth. However, technology that improves labor productivity leads firms to demand more labor not less. Later in these remarks, I consider whether AI may be contributing to the decline in recent net job creation, an effect on the margin of the huge U.S. labor market, but it seems too soon in AI's adoption for it to have significantly raised productivity across the entire economy.

The delay in the September employment report in particular makes it harder to know whether the labor market is continuing to soften or is stabilizing. The shutdown also delayed today's retail sales report for September, which would help show if household spending is continuing to support solid growth in real gross domestic product (GDP) or if there are signs of slower spending that forecasters have been expecting for some time. Yesterday's and today's releases on consumer and producer prices were also delayed, data that is important in judging the impact of higher import tariffs and progress toward the FOMC's price-stability goal. The Administration has recalled some Labor Department employees to complete and release the consumer price inflation report on October 24—in time to inform the FOMC's policy decision five days later.

To deal with this lack of public data, I spend a lot of my time talking to business contacts, whose views help me form my outlook for the economy. So far that input tends to support—rather than resolve—the contrast we have seen between strong economic activity and a softening labor market. Employers indicate to me that there was some further softening of the labor market last month, while retailers report continued solid spending, with a bit of caution from lower-income households.

In the balance of these remarks, I will examine other information we have on economic activity, inflation, and the labor market, and what this implies for monetary policy. While I feel confident, based on what I know today, that monetary policy should take another step toward a more neutral setting at the FOMC's next meeting, the path of appropriate policy beyond that point will be influenced by how the conflict between data on economic activity and the labor market is resolved and the expected path of inflation.

While there are times when the data are consistent and paint a clear picture, the economy is vast and complex, and it is quite often the case that some of the data we look at will point in a different direction from other data and make that picture of the economy fuzzy. Almost every month, I need to use some judgment in sifting signal from noise in the economic data—it is just part of the job of economic forecasting and policymaking. Less often, but often enough, the conflicts in the data are consequential for the outlook. For example, recall that in the first half of 2022, the data were creating a puzzle: GDP was contracting while the economy created 2.7 million jobs.³ These conflicting data on the performance of the economy complicated the decision on how to set the policy rate. We are facing a similar problem today.

I have been referring to the surprisingly strong data on economic activity, so let's start there. After real GDP expanded 2.8 percent last year, it slowed in the first half of this year. GDP—after smoothing through the modest contraction in the first quarter and robust growth of 3.8 percent in the second quarter—grew around 1.6 percent in the first half. This pattern of GDP growth is partially a result of consumption growth that showed a similar pattern. Slower growth in spending and GDP made sense based on the restrictive setting of monetary policy, but it was stronger than many expected with the imposition of sizable tariffs. And after not observing the effects of tariffs on household spending in the first half of the year, many thought it would show up in the third quarter. Yet, the data we have for the third quarter indicate that growth has accelerated. Looking across all the available data, the Atlanta Fed's GDPNow model is projecting another

³ For a full discussion of how I was viewing this puzzle at the time, see Christopher J. Waller (2022), "Monetary Policy in a World of Conflicting Data," speech delivered at the Rocky Mountain Economic Summit, Victor, Idaho, July 14, <https://www.federalreserve.gov/newsevents/speech/waller20220714a.htm>.

quarter of GDP growth close to 4 percent, while the Blue Chip consensus of private-sector forecasts has a prediction of 2.5 percent. Even if the published estimate is closer to 2.5 percent, that is still not consistent with a labor market that has barely created any jobs since May.

One sign that GDP may be expanding closer to the lower end of these estimates is that business conditions seemed a bit softer in September, based on surveys of purchasing managers. The manufacturing sector continued to contract slightly—as it has since March. Purchasing managers for the large majority of businesses that are outside manufacturing reported a slowdown from August to a level that is at the breakeven point between expansion and contraction.

Something that will affect the growth rate of GDP in the fourth quarter is the federal government shutdown. If it is resolved in the next couple of weeks without major changes in government staffing or funding, the shutdown will lower GDP growth several tenths of a percentage point in the fourth quarter and raise it the same amount in the first quarter of next year. But if the shutdown lasts considerably longer and does result in permanent staffing and spending cuts, then the drag in the fourth quarter could be larger and the bounceback smaller.

Let me now turn to inflation. Twelve-month personal consumption expenditures (PCE) inflation rose in August to 2.7 percent, and core PCE inflation was up 2.9 percent—both above the FOMC's 2 percent target. Compared with an earlier era, when inflation ran close to 2 percent—from 2002 through 2007—core goods inflation is now running a half a percentage point higher, and research by Federal Reserve Board staff and others indicates that most of this is due to the effects of tariffs. Though a partial pass-

through of tariffs will permanently raise the price level, tariffs will only temporarily affect the rate of inflation. The FOMC does not target the price level, but it does target 2 percent inflation over the longer run. Since I expect tariff effects on inflation to fade in the coming months, what matters for monetary policy is the rate of inflation outside of tariffs, and estimates by Federal Reserve staff indicate that this underlying rate of inflation is running fairly close to our target.⁴ With market-based measures of longer-term inflation expectations apparently well anchored and a soft labor market keeping down wage demands, I judge that inflation is on a path to a sustained level of 2 percent and should not itself be a barrier to moving monetary policy toward a more neutral setting.

Given this benign view of inflation, I believe the ultimate disposition of the labor market will be the more salient factor affecting monetary policy. As I said, the broad message of all the labor market data is one of weakening in demand, relative to supply, even with substantially lower net immigration and a decline in labor force participation this year. Monthly job creation went from an average of 111,000 in the first quarter to 55,000 in the second, and the latest official report for August was 22,000. The numbers are nearly the same for the private sector, which I consider a better guide to the overall labor market. Furthermore, based on an estimate of the benchmark revision to the level of employment in March 2025 and extrapolating forward for the rest of this year, when the revisions are released next year it is likely that payroll employment has actually fallen, on net, since May. If the economy is growing as healthily as spending and GDP

⁴ For a detailed discussion of the methodology to detect tariff effects on inflation, see Robbie 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>.

data indicate, I would expect that employment would recover in the coming months to a positive but not high level, reflecting the reduced labor supply that I just mentioned. However, if spending and GDP growth slow, and better reflect an economy that doesn't seem to be creating jobs, then the labor market may continue to soften.

With the absence of the September employment report, we must rely on other data for a sense of what happened last month. Alternative labor market data for September present a mixed picture of how things are evolving. Private-sector employment tracked by the payroll services firm ADP points to continued slowing in job creation. ADP estimates that private employment fell 32,000 in September after falling 3,000 in August. The company said that "job creation continued to lose momentum across most sectors."⁵ Data on job postings on the online job search firm Indeed also point to a continued gradual reduction in employment but don't signal of a significant downturn in hiring.

Indeed's openings data are useful in the absence of the September jobs report because, over time, they line up closely with another report for September that may be delayed: the Job Openings and Labor Turnover Survey (JOLTS). The JOLTS data, available through August, have been echoing what I have been hearing consistently from my business contacts, which is that firms are holding on to workers but are not backfilling positions or planning to expand hiring. Total separations are quite low by historical standards, and both layoffs and the number of people voluntarily quitting their jobs are low. At the same time, the hiring rate has continued to fall and, outside of the pandemic recession, is at its lowest level since 2012.

⁵ ADP's National Employment Report is available on its website at <https://adpemploymentreport.com/>.

This situation may appear fairly stable, but I find this “no hire, no fire” stance by employers a bit ominous. It is possible that many employers who found it hard to find qualified workers during the pandemic are especially reluctant to let them go, even in the face of considerable uncertainty about demand and staffing levels in the future. But when workers do leave, they are not being replaced. Businesses have reported that hiring and expansion are “on pause,” but some of my business contacts say that they can’t wait forever and will soon have to decide whether more or fewer employees are needed. Both business and consumer surveys conducted by the New York Fed signal an upturn in expectations about future levels of unemployment.⁶

Looking further ahead, I can see two possible paths for the labor market.

On the one hand, we could see a stabilization of the labor market—in essence, it could move toward the story that consumption and GDP seem to be telling. Despite more than three years of restrictive monetary policy, spending has proved very resilient. Most forecasts called for a significant step-down in the pace of PCE growth this year, but that sizable slowdown hasn’t happened. One factor that may help explain this is that the savings rate has been revised notably upward, resulting in higher disposable personal income and more support for spending. It is possible that resilient spending will help convince businesses to maintain staffing and even expand in the coming months, bringing about a recovery in job creation. Another possibility is that r^* —the interest rate below which monetary policy stimulates demand—is higher than most forecasters believe. If

⁶ The September 2025 Business Leaders Survey is available on the New York Fed’s website at https://www.newyorkfed.org/medialibrary/media/Survey/business_leaders/2025/2025_09blsreport.pdf?sc_lang=en&hash=872CB84D638D0F3D1A3F833365E25EF4; information from the most recent Survey of Consumer Expectations is also available at https://www.newyorkfed.org/microeconomics/sce#.

this were true, then the current setting of monetary policy may not be holding back demand and economic activity very much, which would have implications for how quickly the FOMC should lower the policy rate.

Those are some reasons why the labor market may strengthen and validate the story being told, based on what we know so far, about economic activity in the third quarter. On the other hand, there are some reasons why the labor market could continue to soften while GDP growth steps down to a more moderate pace. For me, one of them is how dependent consumption is on a relatively small number of higher-income consumers. The highest-earning 10 percent of households are responsible for 22 percent of personal consumption. The top 20 percent of households spend 35 percent of the total. Their share of stock market wealth is even more skewed, and lots of research shows that these consumers are fairly unaffected by higher prices, higher unemployment, or a slower economy. The bottom 60 percent of earners represent 45 percent of consumption and hold only 15 percent of wealth. Their spending decisions are much more likely to be affected by prices, financing conditions, and job availability. I have heard from business contacts that this group has been affected by higher prices this year and is already changing its spending plans to find better value.

That view was echoed in the Federal Reserve's recently released Beige Book, which is a survey of business contacts.⁷ The consensus view across the country is that while consumer spending inched down in recent weeks, spending by higher-income households on luxury travel and accommodation was strong; lower- and middle-income households continued to seek discounts and promotions in the face of rising prices and

⁷ The October 2025 Beige Book is available on the Federal Reserve Board's website at <https://www.federalreserve.gov/monetarypolicy/publications/beige-book-default.htm>.

elevated economic uncertainty. At what point do higher prices prompt a larger cutback in spending by middle- and lower-income people?

Another reason for a greater weakening of the labor market is that artificial intelligence (AI) may reduce demand for workers. Over the past few months, retailers have told me that they will reduce employment next year because of the efficiency gains from AI. Firms are saying that they can and will replace workers in call centers and IT support with AI robots. This echoes what I read recently about the largest private employer in the United States: Walmart. Walmart says that despite expectations of solid sales growth, it plans to hold net employment steady for the next three years as AI replaces or transforms different roles at the company.

That said, while AI adoption is widespread among large firms, it is not nearly as common among smaller firms, which account for a large share of the U.S. economy, so the impact of AI on labor demand is uncertain. The implication of this for monetary policy is not so clear. Monetary policy addresses cyclical fluctuations in the economy, but if AI constitutes a structural shift in the demand for labor, monetary policy will not be an effective tool. Overall, I see AI as a short-term risk for the labor market, but, in the long run, AI should bring productivity gains that will be welfare improving.⁸

So where does all this leave monetary policy? Tariffs have modest effects on inflation, but with underlying inflation close to our goal and expectations of future inflation well anchored, I believe we are on track toward the FOMC's 2 percent goal. As a result, my focus is on the labor market, where payroll gains have weakened this year

⁸ For more discussion of how I see AI affecting the economy, see Christopher J. Waller (2025), "Innovation at the Speed of AI," speech delivered at DC Fintech Week, Arlington, Va., October 15, <https://www.federalreserve.gov/newsevents/speech/waller20251015a.htm>.

and employment may well be shrinking already. Lower labor supply has surely reduced what would be a good monthly rate of job creation, but I am very skeptical that it could be zero, or a negative number. Based on all of the data we have on the labor market, I believe that the FOMC should reduce the policy rate another 25 basis points at our meeting that concludes October 29. But beyond that point, I will be looking for how the solid GDP data reconcile with the softening labor market.

If GDP growth holds up or accelerates and the labor market accordingly recovers, it might be an indication that policy is less restrictive than I thought and that the pace toward a neutral setting for the policy rate should be slower than I expected at the last FOMC meeting. What I would want to avoid is rekindling inflationary pressure by moving too quickly and squandering the significant progress we have made taming inflation.

On the other hand, if the labor market continues to soften or even weaken and inflation remains in check, then I believe the FOMC should proceed to reduce the policy rate toward a neutral level, which I judge is about 100 to 125 basis points lower than it is today. The labor market has been sending some clear warnings lately, and we should be ready to act if those warnings are validated by what we learn in the coming weeks and months.

Thank you.