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One Transitory Shock After Another

Remarks by

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Thank you, Joe, and thank you for the opportunity to speak to you today.¹ My subject, as it often is, is the outlook for the U.S. economy and the implications for monetary policy. My last outlook speech was at the end of February, which, I have to say, now feels like it was a year ago.² Before I get to everything that has happened since, let me remind you of how things looked back then. The economic data indicated that, in the absence of the temporary effects of tariffs, inflation was running a bit above the Federal Open Market Committee's (FOMC) 2 percent goal. The larger question was whether the labor market was substantially weakening, with the unemployment rate fairly steady but little job creation and other signs of a softening labor demand relative to supply. At that point, I was looking for a clearer picture of whether the risks to the FOMC's maximum employment goal called for a cut in our policy rate or if we should hold that rate steady to support continued progress toward 2 percent inflation.

After that speech and before the FOMC's March meeting, two critical things occurred. The first was the start of the conflict with Iran, which quickly disrupted energy production and transportation in the Middle East and sent global energy prices soaring. While central bankers rightly tend to discount the effects of temporary oil supply shocks, it was apparent that a prolonged disruption in that region could have a lasting effect on inflation and U.S. economic growth, and that was a consideration going into the FOMC's March 17 and 18 meeting.

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 See Christopher J. Waller (2026), "Labor Market Data: Signal or Noise?" speech delivered at "The Great Realignment: Navigating AI, Demographic and Geoeconomic Change," 42nd Annual NABE Economic Policy Conference, National Association for Business Economics, Washington, February 23, <https://www.federalreserve.gov/newsevents/speech/waller20260223a.htm>.

The second development is what we have come to more fully recognize about the supply side of the labor market. Over the course of last year, we got the details of how net immigration, which was 2.3 million in 2024, fell to a minimal level in 2025 and is continuing at a very low level in 2026. This pattern has lowered population growth and, hence, the growth of the labor force. This change in immigration, combined with the continued aging of the population, means that very little or no net job creation is necessary to absorb new workers into employment.³ This development is unprecedented in recent history, and I believe it is a significant factor in understanding the economic outlook and what that means for monetary policy.

Before I say more about these two important considerations for the outlook, I will start with how the economy looked ahead of the outbreak of the conflict in the Middle East and then discuss how I think things will evolve if the cease-fire in place today holds and if there is progress toward reopening the Strait of Hormuz. But since that outcome is not assured, I will also discuss another scenario, where supply disruptions continue for an extended time. Beyond the length of these disruptions, with this economic shock coming on the heels of the boost to prices from import tariffs, I believe there is the possibility that this series of price shocks may lead to a more lasting increase in inflation, as we saw with the series of shocks during the pandemic.

So far, there is limited data for March, which is when the conflict began, but what we do have indicates that real gross domestic product (GDP) was growing modestly in the first quarter of 2026, in the absence of a temporary boost from the rebound in activity

³ For a full discussion of this issue, see Seth Murray and Ivan Vidangos (2026), “Labor Force Growth, Breakeven Employment, and Potential GDP Growth,” FEDS Notes (Washington: Board of Governors of the Federal Reserve System, April 2), <https://doi.org/10.17016/2380-7172.4045>.

after the end of the government shutdown in late 2025. A continued surge of business investment in the first two months of the year seems to have mostly offset the apparent softness in consumer spending to keep the economy growing. Data center construction and related spending on high-tech equipment are very strong, and these both have spillovers to investment in other capital goods. Meanwhile, surveys of purchasing managers for both manufacturing and nonmanufacturing businesses indicate that their companies expanded sales in March. And the consensus of respondents to the Blue Chip survey implies that real GDP grew at a 2.4 percent annual rate in the first quarter.

Let's turn to the labor market. Any assessment has to take on board the supply-side considerations I mentioned earlier. One that has been a factor for some time is the aging of the population. Members of the "baby boom" generation associated with the surge in births in the 20 years after World War II began to reach retirement age around the year 2008. Since then, retirements have outpaced new entrants to the labor force, pushing down the labor force participation rate. The other big factor has been the decline in net immigration I mentioned, which was around 400,000 in 2025, much lower than in previous years, and is expected by some to be around zero in 2026. Together, these two forces are holding labor force growth at about zero.

An important implication is a reduction in the number of new jobs needed to reflect a healthy labor market and keep the unemployment rate steady. In previous years, this number ranged between 50,000 and 150,000 per month, but with no growth in the labor force, it is now likely close to zero. In fact, over the second half of last year employers shed 50,000 jobs, an average of 10,000 per month, and the unemployment rate moved largely sideways.

Low payroll growth means that there is a much greater likelihood of employment shrinking in any month, something that was a fairly unusual occurrence in the past during an economic expansion. And, in fact, payroll gains have alternated between positive and negative numbers for the past 10 months. Most recently, after closing the year with a loss of 17,000 jobs, payrolls grew 160,000 in January—the largest increase in more than a year—promptly fell 133,000 in February and bounced back to grow 178,000 last month.

This head-snapping volatility has only made it harder to assess the state of the labor market and where things stand relative to the FOMC's maximum-employment goal. I am going to have to get used to payroll numbers that are lower than I am accustomed to seeing in a growing economy as well as the possibility that even several months of negative payrolls may not be the warning sign of a recession that it often has been in the past.

Nevertheless, I want to explain why I continue to see weakness in the labor market that leaves it vulnerable, starting with data showing low numbers of both hires and people losing their jobs. This phenomenon is documented in the Job Openings and Labor Turnover Survey data and is consistent with what business contacts have been telling me, as well as stories collected in the Federal Reserve's Beige Book survey of business conditions. On the one hand, employers are hesitant to shed workers, even in the face of softening demand, perhaps because of the difficulties they faced in finding workers in the tight labor market after the pandemic. On the other hand, employers are very hesitant to hire workers because of the considerable uncertainty over the outlook. My sense is that employers are walking a tightrope between their earlier challenges in finding qualified workers and where they think the economy is going, leaving them

vulnerable to some economic shock that could tip them over and lead to significant job reductions. While the unemployment rate is fairly steady and close to FOMC participants' views of its longer-term, or natural, rate, data on job finding, availability, and openings are continuing to edge lower. The low job-finding rate means that workers are unemployed for longer, and behind the fairly stable count of unemployed people, a growing share are out of work for an extended time.

Before I turn to how the conflict with Iran is affecting inflation, let's consider where it was through February. According to the FOMC's preferred inflation measure, personal consumption expenditures (PCE) prices were up 2.8 percent in February from a year before. Core prices, excluding volatile food and energy, are a better guide to ongoing inflation, and they were up 3 percent. Neither measure is close to the FOMC's 2 percent goal, both are just about where they were a year before, and it might seem we hadn't made progress. But this view doesn't consider the role of import tariffs that were first introduced a year ago, which have boosted prices for those goods.

Being here at Auburn University and as a former professor, I don't want to miss an opportunity to impart a lesson on price levels versus inflation. When tariffs are passed along in consumer prices, they raise prices and push up inflation, which is the rate at which prices are rising. Once that tariff effect is in place, prices are at a new, higher level; it no longer raises inflation; and, over time, we see the effect on inflation fade. While tariffs boosted inflation considerably in 2025 and into this year, using research by the Federal Reserve staff on their estimated effect and taking that out of the published

inflation numbers, we find that underlying inflation—by which I mean excluding tariff effects—is running close to 2 percent.⁴

So, through the end of February, I found that underlying inflation was making progress toward our goal and that it wasn't a significant concern for monetary policy. I was more concerned about the labor market, which showed signs of weakness and I felt was more vulnerable than it might otherwise be due to the low rates of hiring and layoffs.

That was the picture on February 28, when the conflict with Iran began. Then we saw higher energy prices quickly feed through to headline inflation. Prices for gasoline have risen by more than one-third since the conflict started, with a national average of \$4.10 per gallon as of Thursday. Using crude oil futures as a proxy for other energy prices, we find that Brent—the global benchmark—was \$61 per barrel at the start of the year and has bounced around \$95 per barrel in recent days.

We have seen the effects of the increase in energy prices in March inflation data. The energy component of the consumer price index jumped 10.8 percent last month. This is a one-month change! Twelve-month headline inflation was boosted to 3.3 percent and core inflation to 2.6 percent. When we combine this information with producer price data, estimates suggest March PCE inflation will come in even higher, standing around 3.5 percent for headline and 3.2 percent for core.

So what happens next? Let me stipulate that I believe economic forecasting is hard even in normal circumstances. I am tempted to say it is a bit like batting averages in baseball, where an excellent result is failing two-thirds of the time, but that wouldn't be

⁴ For a detailed discussion of the methodology to detect tariff effects on inflation, see Robert Minton, Madeleine Ray, and Mariano Somale (2026), “Detecting Tariff Effects on Consumer Prices in Real Time – Part II,” FEDS Notes (Washington: Board of Governors of the Federal Reserve System, April 8), <https://doi.org/10.17016/2380-7172.4040>.

fair to baseball—we forecasters have an even lower rate of success. Anyway, add a military conflict in the Middle East to the task of predicting the course of the economy, and things get very complicated. The first thing to do is establish a good baseline, which I hope I have done in the foregoing discussion of the outlook on the eve of the conflict’s outbreak. Beyond that, when presented with a new development that could produce a range of economic outcomes, I have found it helpful to use stylized scenarios.⁵

Progress Is Made to Reopen the Strait of Hormuz

The first scenario assumes progress to reopen the Strait of Hormuz and the return of energy markets and broader trade flows relatively quickly toward conditions that existed before the conflict started. I hope, and do still believe, that this scenario is a reasonable probability.

Even after the failure of peace talks last week, futures prices have Brent falling to \$82 per barrel by the end of 2026 and \$75 per barrel by the end of 2028, consistent with the view that markets will return to something close to normal in a reasonable length of time. If this comes to pass, I expect that the boost to energy prices in headline inflation will fade over the medium term and that expectations of future inflation will remain anchored. The pass-through of higher energy prices to other goods and services should be limited. And despite the pain caused by higher energy prices, consumers and businesses will understand that the worst is past, energy prices should begin to recede, and this view will tend to support ongoing growth in spending, production, and hiring. This prospect probably represents a best-case scenario for the economy.

⁵ For two scenarios on the effects of import tariffs, see Christopher J. Waller (2025), “A Tale of Two Outlooks,” speech delivered at the Certified Financial Analysts Society of St. Louis, St. Louis, Missouri, April 14, <https://www.federalreserve.gov/newsevents/speech/files/waller20250414a.pdf>.

The Strait of Hormuz Remains Closed

Unfortunately, to me, the oil futures prices I cited and securities markets in general seem to be undervaluing the risk that the conflict continues, the Strait remains closed, and disruptions to production and shipping keep energy prices high, which I consider a very possible scenario. Supporting this view is the fact that economic policy uncertainty indexes have risen to quite elevated levels in recent days.⁶ While futures prices in general seem too optimistic, I note that the tail of the distribution of oil prices at the end of this year is skewed toward the higher prices that I see as more likely than what markets are pricing in. For inflation, the risk is that the longer the conflict drags on and energy prices remain high, the more likely it is that these elevated prices will bleed into other prices, as businesses incorporate costly energy input costs in setting their prices.

With continued constraints on shipping in the Strait, I would also expect supply chain constraints. Commodity inputs, including fertilizer and helium, are produced in the region, and these prices in turn could drive up farm prices globally. Meanwhile, if some regions of the world experience a slowdown in production due to energy shortages, this will introduce additional supply constraints.

Then there is the issue of how the oil shock, piled onto the lingering effect from import tariffs, affects expectations of future inflation. The standard practice for policymakers is to look through shocks like this that temporarily elevate inflation.⁷ But what happens when there is a sequence of these shocks? In 2021 and 2022, the

⁶ This increase is true if one looks at indexes for just the U.S. or across the globe. See the Economic Policy Uncertainty Index from Scott R. Baker, Nicholas Bloom, and Steven J. Davis, available at <https://www.policyuncertainty.com/index.html>.

⁷ For a review of the look-through approach, see the discussion by Edward Nelson (2025), "A Look Back at 'Look Through,'" Finance and Economics Discussion Series 2025-037 (Washington: Board of Governors of the Federal Reserve System, May), <https://doi.org/10.17016/FEDS.2025.037>.

pandemic-induced demand and supply chain constraints were each considered one-off shocks that initially led me to look through their upward pressure on prices. But, ultimately, this series of shocks pushed up inflation to near 9 percent by one measure, longer-range inflation expectations started to move up, and the Federal Reserve took action.⁸ Learning from that experience, I will be cautious when faced with a sequence of transitory shocks. While intellectually it makes sense to look through each shock, with a sequence of shocks, policymakers need to be more vigilant. This is because if the shocks hit one after another, they will keep inflation elevated for quite some time. The standard “look through” can become problematic if businesses and households start to believe inflation is persistently high and it affects their price- and wage-setting behavior.

One way I watch for this possibility is to look at readings on inflation expectations. While near-term inflation expectations have, naturally, risen, so far longer-term expectations have not. Inflation-adjusted Treasury securities in the range of 5 to 10 years are around 2.3 percent, a bit below their level at the end of 2025. While it is early, there is a risk that prolonged high energy prices and secondary effects that raise the price for other goods and services eventually do change the expectations of firms and consumers, who I note have seen inflation above 2 percent now for five years.

Beyond inflation, there are other implications for the economy from a continuing conflict and high energy prices. Consumers may reduce spending because of higher prices, lower stock market wealth, and a drop in confidence. You may have heard that

⁸ See Christopher J. Waller (2022), “Responding to High Inflation, with Some Thoughts on a Soft Landing,” speech delivered at the Institute for Monetary and Financial Stability (IMFS) Distinguished Lecture, Goethe University Frankfurt, Germany, May 30, <https://www.federalreserve.gov/newsevents/speech/waller20220530a.htm>.

the University of Michigan Surveys of Consumers last week reported its lowest-ever reading for consumer confidence. While that survey hasn't tracked closely with actual spending in recent years, I still find the signal from the data meaningful. Consumers seem to have mostly shrugged off the effect of import tariffs in their spending, and they may shrug off the latest shock, but then again, there may be a threshold crossed at which point they start to economize. If households respond with less spending, this shift will mean firms need to produce less, and that affects labor decisions. It might be the force that pushes employers off the tightrope that I invoked earlier in talking about their caution in hiring and layoffs. As we have seen often in past recessions, when the labor market weakens and unemployment starts rising, it can drive a cycle of reductions—herding behavior by firms that mimic each other's response to the shock—resulting in a significant decline in employment. The longer this conflict continues, the more closely I will be watching payroll numbers and the unemployment rate for signs of such a downward cycle in employment.

Policy Response

So, what are the implications of recent events for monetary policy? It depends on how the conflict evolves and its effect on the economy, both highly uncertain. These will have a major influence on the path of policy.

If the Strait of Hormuz opens and trade flows return somewhat to normal, then I can look through the effect of recent higher energy prices on inflation because I know it will unwind, and my focus will be on how the labor market evolves in the current no-hire, no-fire environment. Here, abstracting from the effects of tariffs and energy, I see a forecast in which underlying inflation would continue to move toward 2 percent, leaving

me cautious about rate cuts now and more inclined toward cuts to support the labor market later this year when the outlook is more steady.

But the longer energy prices remain elevated and the Strait is constrained, the greater the chances that higher inflation gets embedded across a wide variety of goods and services, various supply chain effects start to emerge, and real activity and employment start to slow. I will be particularly attentive to indications that this latest price shock, on top of the effects from tariffs, has moved up inflation expectations. A slower economy would restrain demand for goods and services, and perhaps soften the increase in prices, but I expect higher inflation than in the first scenario and that it would be elevated for some time. In this case, I also believe we would have a weaker labor market. High inflation and a weak labor market would be very complicated for a policymaker. If I face this situation, I'll have to balance the risks to the two sides of the Fed's dual mandate to determine the appropriate path of policy, and that may mean maintaining the policy rate at the current target range if the risks to inflation outweigh those to the labor market.