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The Economic Outlook and Some Comments on My Policy Communication

Remarks by

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at

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Thank you, Howard. To set the stage before we talk, let me give you a sense of my thinking, as of today, about the economic outlook and the implications for monetary policy.[1] The short version is that, while inflation remains meaningfully above the Federal Open Market Committee's (FOMC) 2 percent goal, recent data suggest we are finally seeing some signs of disinflation. If this continues in the data due over the next two weeks, I would be inclined to support holding the target for the federal funds rate at its current setting. But there continues to be considerable uncertainty about how military conflicts, trade policy, and artificial intelligence (AI) will affect prices and economic activity. If the incoming data for August show this improvement has been fleeting, then it may be appropriate to raise the policy rate when the FOMC meets on September 15 and 16. After a description of my outlook for the economy and monetary policy, I will offer some thoughts on how I communicate those views to the public.

Let me start with the real side of the economy. Despite the uncertainties I mentioned, most of which weigh on economic activity, growth in real gross domestic product (GDP) is continuing at a solid pace. Real GDP grew at a 1.8 percent annual rate in the first half of this year. Consumer spending growth was solid in the second quarter after a slow start to the year, while business investment has been strong throughout. Overall, real private domestic final purchases, the measure of spending that best reflects the underlying strength of consumer demand, rose a strong 3 percent in the first half of 2026.

We have only limited data for the third quarter, including July retail sales, which were weak. But this decrease reflected the fact that Amazon's Prime Day promotion was

[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.

held in June, dragging down seasonally adjusted sales in July. Outside of "non-store" sales, retail spending grew. Given the rise in wealth from the increase in equity prices this year, I believe this should sustain consumption growth.

On the business side, data center plans point to continued rapid growth in business investment associated with the ongoing buildout of AI and related technological upgrades. High-tech investment continues to rise at a rapid pace, and software investment, which some feared could be depressed by AI's coding ability, has grown near its long-term historical average rate.

Some would argue that this investment in a narrow sector that tends to be capital intensive, rather than labor intensive, is misleadingly propping up GDP and should in some sense be discounted. I don't agree.[2] AI investment is a legitimate part of GDP today, and I expect this technology will continue to be an important part of the economy after the buildout peaks and AI becomes as integrated into our lives as the internet has been.

More broadly, one signal of continuing business spending growth was another increase in July in sentiment among purchasing managers for nonmanufacturing firms—to a level that I would also describe as "solid." New orders for these firms, which represent the majority of businesses in the economy, continued to grow in July, and the index of supply problems continued to improve. Today we will get the August nonmanufacturing survey, so we will see if this trend continues.

[2] I see this as a technological change that will reliably raise productivity and living standards while improving the quality of our lives. For a discussion on how AI is likely to affect our lives along these lines and how it differs from past technological changes, 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.)

Combining the various pieces of the economy, I expect real GDP to grow a bit more than 2 percent this year, a respectable outcome considering the uncertainties I mentioned.

Turning to the labor market, it is also in satisfactory shape. While there were indications in the second half of 2025 of easing labor demand, relative to supply, those signs evaporated. Job creation, though a bit volatile, has increased this year by an average of 60,000 a month through July. That is close to and probably a bit above estimates of what it takes to keep pace with the slow growth in the labor force—mostly because of much lower net immigration. Payroll gains have broadened to most sectors of the economy in recent months, and the unemployment rate has fallen a bit to 4.1 percent in July, a historically low rate and slightly below the median of FOMC participants' long-run or equilibrium rate. Layoffs and initial claims for unemployment insurance are likewise low. I expect more of the same tomorrow when we get the August employment report.

With economic activity and the labor market in good shape, they are not a large factor in my determination of the appropriate setting of monetary policy. But they are an important backdrop for the part of the outlook that is my focus right now, inflation, and my judgment about how much the current stance of policy is working to return inflation to 2 percent. More about that in a moment.

Inflation is elevated significantly above the FOMC's 2 percent goal and has exceeded that target for five and a half years. In July, prices based on personal consumption expenditures (PCE) rose 0.2 percent, and core prices excluding food and energy increased 0.2 percent. While I was happy to see this monthly number for core inflation because it continued the pattern of lower monthly readings that we saw earlier in the year, what caught my eye in the last PCE report is that nonmarket services prices accounted for approximately half of the increase in core prices. As you are probably aware, I don't like throwing out specific categories going into the estimate of PCE inflation, but nonmarket services prices have always been an issue for me, since they are imputed and not actual price changes.[3] So, ignoring this one factor, my take is that underlying inflation is doing better than the core numbers suggest.

PCE prices are up 3.7 percent in the past 12 months, and core PCE inflation is 3.3 percent. While it is important to acknowledge these 12-month increases for the real-world effect they have had on businesses and consumers, they are not the best guide for where inflation is today. I say this because, notwithstanding uncertainty over the geopolitical factors that have raised prices, I don't see elevated energy prices and tariffs now as a significant source of ongoing inflation pressure. The evidence is that the price effects of tariffs have largely passed through inflation, and my earlier worry that higher energy prices would bleed into many goods and services prices hasn't come to pass, at least so far.

In the wake of these price shocks, to get a fix on the current trend for inflation, it is helpful to focus on more recent price increases, such as how inflation measured over the past three months has evolved over the year. To deal with the ongoing volatility in

[3] For a discussion on how imputed prices were holding up inflation in 2024 and how, because they are estimated rather than directly observed, I consider them to be a less reliable guide to the balance of supply and demand across all goods and services in the economy, see Christopher J. Waller (2025), "Challenges Facing Central Bankers," speech delivered at Lectures of the Governor, Organisation for Economic Co-operation and Development, Paris, France, January 8, https://www.bis.org/speeches/20250114-challenges-facing-central-bankers.)

energy prices, I will focus on core inflation, excluding food and energy prices, which is a good guide for inflation going forward.

Three-month core inflation is 3.05 percent for the three months through July, a level that is still not consistent with the FOMC's 2 percent goal. Nevertheless, it is important to note the trend. Three-month inflation has fallen steadily from 4.76 percent in February. That is a considerable improvement, and the speed of this downward trajectory is encouraging.

One factor that I expect will lower reported inflation a bit is a pending change in the way the Commerce Department estimates the fees paid to stock market traders and related professionals. That change in this "nonmarket" price estimate, which I expect to be made shortly, could lower 12-month PCE inflation by a few tenths of a percentage point. Given my issues with nonmarket services prices, this is a welcome measurement correction.

I do see some upside risks to inflation. Energy prices have moved up again and remain significantly higher than they were at the beginning of 2026, and the economy faces both pressure on technology goods prices related to the AI buildout and the possibility of more tariff increases. But, in contrast to the period of high inflation after the pandemic, wage growth, once one accounts for productivity growth, is broadly consistent with an expectation that inflation is continuing to come down to 2 percent.

I am also attentive to the fact that public views about future inflation could rise after the long period of inflation above the FOMC's goal. Fortunately, the Fed has a very good record of making good on its commitments, and we haven't seen a significant increase in longer-term inflation expectations, but it must be acknowledged as a risk—

one that the FOMC should be prepared to act on if longer-term expectations rise and progress on inflation reverses.

This leads me to my outlook for monetary policy, which I previewed at the beginning of these remarks. As of today, the labor market is stable, with employment near its maximum sustainable level, and inflation is making slow but continued progress on reaching 2 percent. We will get another employment report and inflation reading before the next FOMC meeting. I don't expect that the employment data will deviate much from what we have been seeing. So my decision on the appropriate stance of policy will be heavily influenced by what we learn about August inflation. If there is continued progress toward our 2 percent goal, then I am willing to support holding the policy rate at its current level.

But if inflation comes in hot, I would consider a rate hike. I judge that policy is currently only slightly restricting aggregate demand, and it may not take much acceleration in inflation to nudge me into supporting tighter policy. If there is evidence that progress toward 2 percent inflation reversed in August, a small adjustment in our stance would help ensure that it resumes.

By way of wrapping up, I want to speak about central bank communication, which I consider an essential part of the monetary policy process. I distinguish between three types of communication that matter for monetary policy and how I try to communicate my views to the public.

First, I try to communicate why I have taken my *current* policy position. If I vote to hold rates steady, I explain how *current* economic conditions affected my policy decision. I was comfortable supporting the FOMC's decision in late July to hold rates steady because the data at that time led me to view the real side of the economy as solid and we finally saw hints that disinflation may be starting. So I was willing to be patient and see if the disinflation would continue.

The second way in which I communicate is to explain how *future* economic data will shape my *future* monetary policy decisions—in short, I try to describe my "reaction function." When thinking about future data, I communicate that IF the data comes in a particular way, THEN I will advocate for policy to be set a particular way. The key point here is that this it is not a commitment to a policy action—it is a conditional policy statement. A different economic outcome would lead me to advocate for a different policy action. In my remarks today, I have outlined what it would take for me to support a continued pause as well as what would cause me to support tighter policy. By communicating my reaction function, consumers, businesses, and investors can better understand how I will vote on policy given the range of outcomes and then factor that into their planning for the future.

Now, is that reaction function perfect? No. But my years as a professional economist and policymaker have given me substantial knowledge on how policy should respond to shocks. In this sense, I view myself as a home plate umpire in baseball. The pitcher is trying to strike out the batter, and the batter is trying to hit the ball or walk to get on base. Both want to play the ball, but they cannot do that until they know the umpire's strike zone. The strike zone is the umpire's reaction function. If the ball goes here, it's a strike; if it goes there, it's a ball. The players don't expect the umpire to have a perfect strike zone—they just need a rough idea of its parameters and some guarantee that it won't change much on every pitch. Perfection is not needed for them to play well.

So, when it comes to my reaction function, I do not let perfection become the enemy of the good.

The third and final type of communication is forward guidance, which specifies a path for the policy rate that is essentially *independent* of incoming data. This type of communication is most warranted when the policy rate is at the effective lower bound and additional communication is needed to guide market expectations.[4] For example, by September 2021 it was clear to me that we needed to raise the policy rate to deal with accelerating inflation. But as this would only happen after asset purchases had stopped, I supported forward guidance that strongly signaled the end of those purchases, setting the stage for rate increases in 2022. By communicating to markets that rate hikes were coming and coming soon, market interest rates began to climb. By March 2022, the two-year Treasury note had increased 200 basis points, and we hadn't moved the policy rate off the effective lower bound yet. In this example, forward guidance helped tighten economic conditions long before we actually raised the policy rate. But it is important to remember that those actions were taken when the policy rate was near zero. I agree with Chairman Warsh that forward guidance isn't appropriate now or in many other situations. But when it is truly needed, I believe it should be used.

[4] See my July 6, 2026 remarks on where I discuss how forward guidance can be a valuable tool that has, at times, significantly strengthened policymaking and will continue to be useful and yet is more art than science and there have been times when it has hindered, rather than helped, policymaking. Christopher J. Waller (2026), "Two Thoughts on the Transmission of Monetary Policy," speech delivered at "Challenges for Monetary Policy Transmission in a Changing World," a conference sponsored by the Bank of Italy for the research network initiated by the European System of Central Banks, Rome, Italy, July 6, https://www.federalreserve.gov/newsevents/speech/waller20260706a.htm.)

And with that, I think I have said enough. So, Howard, let's get to your questions, which I am sure will be well informed and probably better informed than my answers.