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Economic Outlook

National Association for Business Economics 67th Annual Meeting
Philadelphia

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The views expressed today are my own and not necessarily those of the Federal Reserve System or the Federal Open Market Committee (FOMC).

Remarks as prepared for delivery.

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Good afternoon, everyone, and thank you, Greg,[1] for that very kind introduction.

It is a pleasure to welcome you all to Philadelphia for this year's NABE Annual Meeting. I'm especially glad to be here with all of you — people who think deeply about the economy and how economic developments impact families, businesses, and communities across the country.

As an economist, I've learned as much from direct conversations with some of those families, businesses, and communities as I have from studying data and models. That's why I feel such a strong connection to NABE and the work that you all do.

As you know, the Federal Reserve System is committed to serving the public by fostering conditions that lead to stable prices and maximum employment. As president of the Philadelphia Fed, I look deeply and widely at the economic data and complement that with perspectives I've gained from talking directly with people in the communities we serve.

Those conversations allow me to bring regional insights to our broader analysis of the economy and monetary policy. And they help me to keep front of mind the ways in which Federal Open Market Committee (FOMC) decisions impact all of us.

I'm looking forward to talking with Greg and taking your questions. But first, I'd like to take some time up front to describe how I see the economy and what I believe this means for monetary policy.

And, before I do that, let me emphasize that the views that I express today are mine and not necessarily those of my colleagues in the Federal Reserve System or on the FOMC.

Let's jump right in. The latest available data suggest an economy that is doing pretty well, although inflation remains elevated.

Economic activity generally came in above expectations over the summer, with a strong showing from the U.S. consumer as well as strength in business investment. After declining in the first quarter, real Gross Domestic Product (GDP) grew at a 3.8 percent

[1] Gregory Daco, vice president, NABE Board of Directors, and chief economist, EY.

annual rate in the second quarter and early indications are that above trend growth will continue in the third quarter as well.

The unemployment rate was 4.3 percent in August, near what I would characterize as full employment. But unemployment is up from 4.1 percent in June, and the August employment report suggests that momentum in the labor market is to the downside.

Job gains have slowed markedly but labor supply and demand appear to be slowing more or less in tandem, leaving overall conditions in a rough balance. I am hearing similar sentiments from employers who can find workers when they need them but generally describe being in a low-hire, low-fire stance.

Total Personal Consumption Expenditures (PCE) inflation came in at 2.7 percent year over year in August and core PCE was a little higher at 2.9 percent. While inflation continues to be above 2 percent, it is down significantly from pandemic highs.

And this process has come with an assist from restrictive monetary policy. With the federal funds rate currently at 4 to 4-and-a-quarter percent, I see policy as modestly restrictive now.

Let me spend a minute describing how I think about tariffs and inflation. My base case is that tariffs will increase the price level, but they won't leave a lasting imprint on inflation. And, given this base case, monetary policy should look through tariff effects on prices.

Why? Let me start with the economics. Here the lessons from economic theory are clear: So long as inflation expectations are anchored, increases in prices due to supply effects do not turn into an inflation problem.

Going beyond the theory, the data so far have largely been consistent with this view. We are definitely seeing the effects of tariffs in the inflation data — the increase in goods price inflation is clear.

But relative to what our analysis predicted, tariff-induced price increases have been somewhat smaller than anticipated. Now, we have seen some strength in service prices as well, and this bears watching — it would be a problem if tariff induced price increases spill over to inflation more generally. That said, I don't see conditions as supporting problematic spillovers.

First, labor market conditions are very different than they were during the pandemic when turnover was elevated and workers were job hopping to get higher wages. Some of my contacts have described lowering starting wages, for example. This is not what I would expect to hear if the labor market was going to be a force that accelerated inflation.

Second, many firms report being focused on preserving market share and this makes them motivated to find creative ways to avoid passing on increased costs. Finally, monetary policy is modestly restrictive and has been restrictive for some time.

The flip side of the famous “long and variable lags” axiom is that the effects of past policy persist over time. For me, the bottom line is that I simply don’t see the type of conditions, especially in the labor market, which seem likely to turn tariff-induced price increases into sustained inflation.

But I reach this conclusion with an awareness that we need to be careful. We have heard a lot about how uncertainty is delaying some investment projects — when there is greater clarity, we might see a burst of growth.

And after four plus years of above-target inflation, it’s important to consider the ramifications. Firms have had a lot of practice raising prices and consumers have had to get used to a lot of price increases as well.

My own research has focused on how living through things like financial crises can impact future behavior, so I am sympathetic to the idea that the experiences of the last four years may have left an enduring legacy and that is another reason to proceed cautiously.

I do still expect some additional goods inflation over the next few quarters, due in part to current tariffs working their way through and also to new tariffs that have been announced. This combination of new and old does complicate the exercise, so let me share an analogy that has helped me.

Some of you may be familiar with the children’s book *Lowly Worm Meets the Early Bird* by Richard Scarry. If you aren’t, I highly recommend it, along with everything else by Richard Scarry!

Lowly is a dapper worm who wears a hat, a bow tie and, naturally, a single shoe. At one point in the story, Lowly and Early Bird are having a meal. Lowly is eating peas, and you can clearly see the imprint of each pea on his long body. But when you turn the page, Lowly is back to his usual slim self. The peas have been digested and left no lasting imprint. That’s my base case on tariffs and inflation. But Lowly worm is eating a lot of peas, so we need to keep a close eye on him to make sure he doesn’t get indigestion.

Given my views on tariffs and inflation, monetary policy should be focused on balancing risks to maximum employment and price stability which means moving policy towards a more neutral stance.

Why? First, because of the progress on underlying inflation, excluding the effects of tariffs. Ignoring this could add unnecessary stress to the labor market. Second, labor market risks do appear to be increasing — not outrageously, but noticeably. And momentum seems to be going in the wrong direction.

Against this backdrop, the FOMC's decision to cut rates by 25 basis points in September made sense. Over the rest of this year, I view easing along the lines of the median Summary of Economic Projections (SEP) policy path as appropriate. Of course, that is if economic and financial conditions evolve as I expect. And I'll return to that "if" in a moment.

But first, what about next year? I see two important questions for monetary policy to grapple with in 2026. The first question is: What is the neutral policy rate? And the second question is: How quickly should policy move to neutral? My short answer to these questions is: I don't know, and because I don't know, we should proceed cautiously.

To expand on this just a little bit, there are a wide range of plausible estimates of the neutral policy rate, and I think we will need to feel our way there, paying close attention to what economic developments tell us about the stance of policy.

The ability to go slowly and assess is particularly valuable as we get closer to neutral. We will be better positioned to go slowly in the future if we adjust policy in the near term in a way that better aligns labor market and inflation risks.

I anticipate that 2026 will see growth near potential, and inflation rising and then subsiding as tariffs, together with current and past monetary policy restrictiveness, work their way through.

If the economy evolves as I expect, the monetary policy adjustments we make this year and next will be sufficient to keep labor market conditions close to full employment.

"If the economy evolves as I expect" is doing a lot of work here. I am particularly focused on the breadth of support for growth, and I see some reasons to think that it might be somewhat narrow, and this could make the economy vulnerable to shocks.

To start with, virtually all of the net job growth we've seen this year has been confined to health care and social assistance. Employment in most other sectors has been flat to down on the year.[2]

Consumption, the largest component of GDP, has proven "resilient" again and again. However, there are reasons to examine the breadth of support for consumer demand as well.

I have been hearing from many contacts that households, particularly at the lower end of the income distribution, are feeling the weight of higher prices and slower wage

[2] U.S. Bureau of Labor Statistics. n.d. "Employment by Industry: Monthly Changes." Accessed October 12, 2025. https://www.bls.gov/charts/employment-situation/employment-by-industry-monthly-changes.htm. The net job creation since December 2024 is 590K, with private education and health care sectors contributing 521K jobs. Calculations based on the provided data.

growth. In response, they have been adjusting discretionary spending, and often "trading down" to lower cost alternatives to preserve cash flow.

With lower-income consumers more constrained, spending by high-income households may be even more important than usual. Indeed, recent analysis suggests that consumption is growing considerably faster among high-income households compared to medium- to low-income households. That means aggregate consumption growth is more dependent than usual on higher-income households.[3]

So, what is driving spending growth among higher income consumers? The top 20 percent of households by income own over 85 percent of corporate equity, so it is not surprising that spending by high-income households is linked to the fortunes of the stock market.[4] And the stock market has mostly been on a tear.

However, this performance has been largely driven by just a handful of firms, and the market has been quite sensitive to the narrative around artificial intelligence (AI). It seems likely that AI will eventually have profound impacts on all aspects of the economy, but where we are currently seeing a lot of the action is in the stock market.

This might all turn out great. And I see tremendous promise in how AI may eventually boost productivity. But in the more immediate term, the relatively narrow base of support for the labor market, the importance of high-income consumers together with the prominence of the narrative around AI for equities, adds up to a relatively narrow base of support for growth over the next year or so. Indeed, some business contacts are wondering where future demand will come from. This is something to watch closely.

Let me make a final point about inflation. Over the past four years, long-run inflation expectations from market measures have remained remarkably stable. Over this period, we've seen headline PCE inflation of over 7 percent and big increases in shorter run inflation expectations.

The stability of longer run inflation expectations is an important testament to the credibility of monetary policy and to the value of that credibility. Even during the largest run-up in inflation in over 40 years, markets overwhelmingly had faith that the Fed would return inflation to 2 percent over a reasonable timeframe.

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[3] Wallace, Alicia. "The Impact of the K-Shaped Economy on US Spending Habits." *CNN*, September 18, 2025. https://www.cnn.com/2025/09/18/business/us-k-shaped-economy-spending; Bhattarai, Abha. "The wealthiest are boosting the economy, as consumer spending rises again." *The Washington Post*, September 26, 2025. https://www.washingtonpost.com/business/2025/09/26/wealthy-spending-economy-consumers/.

[4] Board of Governors of the Federal Reserve System. 2025. "Financial Accounts of the United States - Z.1 - Current Release." Accessed October 8, 2025. https://www.federalreserve.gov/releases/z1/default.htm; Board of Governors of the Federal Reserve System. 2022. "Survey of Consumer Finances." Accessed October 8, 2025. https://www.federalreserve.gov/econres/scfindex.htm.

That credibility, in turn, has been key to enabling the FOMC to bring inflation down a lot, while keeping the labor market at levels close to full employment. But it’s critical to finish the job and return inflation all the way to 2 percent.

Credibility is a hard-won asset that allows us to fight inflation, while preserving the labor market strength that benefits all Americans.

Thank you so much and I look forward to continuing the conversation with Greg and to your questions.