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Thoughts on the U.S. Economy and the Year Ahead

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Thank you for having me today.[1] It's great to be with all of you and I am honored to join my fellow panelists.

January is a good time to take stock and to think about what lies ahead. I'd like to provide an overview of how I see economic developments in the U.S. and some of the themes that I think will be important for monetary policy this year. Before I get into my remarks, please note that I am speaking just for myself and these are my views and not necessarily those of my Federal Open Market Committee (FOMC) colleagues.

Let me start with inflation. If I had to pick a theme for inflation for 2026 it would be "cautious optimism." We recently received inflation data for November of last year, but the lack of data collection during the government shutdown complicates the interpretation of those data, so I am going to focus on data through September of 2025.

Twelve-month core Personal Consumption Expenditures (PCE) inflation came in at 2.8 percent in September. And it was also 2.8 percent for the 12 months ending in September of 2024. On the surface, it looks like we made little to no progress in getting inflation down last year. However, when we dig into the components, I see some progress and reasons for my cautious optimism. First, while goods inflation is clearly up, it seems likely to return to normal over the next 12 months. Goods inflation, which was declining in 2024, is up more than 1 percent over the last year or so.

We know why this is happening: Higher tariffs on imports are showing up in goods prices. Based on my reading of the evidence, I expect that we've already seen a lot of the price adjustments.[2] That being said, producers may still have some more price changes to make.

[1] The author gratefully acknowledges Brie Coellner, Ryan Michaels, and Keith Sill for their invaluable contributions to these remarks.

[2] Minton, Robbie and Mariano Somale. 2025. "Detecting Tariff Effects on Consumer Prices in Real Time." *FEDS Notes*, Board of Governors of the Federal Reserve System, May 9, 2025, https://www.federalreserve.gov/econres/notes/feds-notes/detecting-tariff-effects-on-consumer-prices-in-real-time-20250509.html.

The data for January will be especially useful for gauging this because the beginning of the year is a natural time for firms to change prices. All in all, though, I see an environment where tariff-induced price adjustments are largely confined to goods, as would be the case if tariffs lead to a shift in the price level but do not create sustained inflation. I expect the shift in the price level to run its course in the first half of this year and for goods inflation to return to levels consistent with overall inflation being near 2 percent sometime in the second half of the year.

It is also encouraging that core services inflation excluding housing eased a bit last year, coming in at 3.3 percent (year over year) in September of 2025 compared to 3.5 percent (year over year) in September of 2024. It's still elevated, but it is moving in the right direction.

The remaining component of inflation is housing, and here the news is unambiguously good. Housing inflation has gone from 5.1 percent (year over year) in September of 2024 to 3.7 percent in the 12 months ending in September of 2025. And data on new market rents that feed into housing inflation on a go-forward basis mean that it should continue its return to levels consistent with 2 percent core PCE inflation as we go through 2026.

So, I am feeling cautiously optimistic on inflation, and I see a decent chance that we will end the year with inflation that is close to 2 percent on a run-rate basis; that is, 12-month inflation may still be a little elevated, but three-month inflation will be 2 percent by the end of the year.

Monetary policy will help here. I view the current level of the funds rate as still a little restrictive. So, the combination of past and current monetary policy restrictiveness will help to bring inflation all the way to two.

We've seen progress on underlying inflation that is likely to continue and there is no evidence to date that tariff-induced price increases are leading to broader inflation. In addition, long-term inflation expectations are anchored at levels consistent with a gradual return to 2 percent inflation. These trends, especially given labor market developments, argue against tighter monetary policy.

Turning to output and employment, I think the theme for 2026 will be "waiting for clarity." Currently, we are receiving divergent signals on growth and the labor market. Gross domestic product (GDP) growth has been very strong, with third quarter real GDP growth coming in at an above-trend 4.3 percent, with continued strong consumption. But this growth is happening against the backdrop of a slowing labor market.

Payroll growth has fallen substantially and the base for job creation has narrowed. Nearly 90 percent of net private job creation through November of last year occurred in a single sector: healthcare and social assistance. In the ADP data, we see other evidence of uneven performance: Firms with 250 or more employees added workers between August and November, while smaller firms shrank.

I see the broad deceleration in the labor market as stemming from both supply and demand factors. On the supply side, the sharp drop in immigration has slowed the growth of labor supply. On the demand side, firms tell us that uncertainty is holding back hiring as they consider a range of factors, including trade policy and the potential for artificial intelligence (AI) to transform the need for workers. They also point to over-hiring during the pandemic recovery as a restraint on labor demand. I expect that monetary policy restrictiveness is also playing a role. On net, the slowdown in demand appears to have outpaced the slowdown in supply, with the unemployment rate up to 4.6 percent in November, about a half a percentage point above the range that prevailed through July of last year.

While the labor market is clearly bending, it is not breaking. We can see this in the unemployment insurance (UI) claims data. Initial claims have been essentially flat over the last year. Still, labor market risks have risen and that has been an important factor in my support for the 75 basis points of cuts that the FOMC did last year. I will be monitoring labor market developments closely.

What could reconcile strong growth, with apparent momentum from consumer spending, and the slowing labor market? It's possible that some combination of the growth data being revised down or the labor market data being revised up could move the two trends into better alignment. If the patterns of the last couple of years hold, though, I would expect job gains to be revised down and not up. And, typically, when GDP and labor market signals are in conflict, the labor market signal turns out to be more accurate.[3]

Even setting aside possible data revisions and taking the very strong topline growth data for Q3 at face value, what it means for future momentum is unclear. Income growth has not kept up with consumption growth, and the savings rate fell in Q3. And, certainly, not everyone is doing great. Contacts consistently report that low-income households are struggling, pressured by high prices, and they are increasingly concerned about job security. High-income households, bolstered by a strong stock market, appear to be driving elevated consumption growth.

We don't see a lot of momentum in other major spending categories like aggregate investment. While investment in high-tech equipment was strong through the third quarter, residential investment has been negative, as one might expect with restrictive monetary policy.

Another possibility that could help reconcile the conflicting GDP and labor market signals is that we are seeing the beginning stages of a step up in productivity growth, likely driven by AI and deregulation. Initial investments in AI are concentrated in things

[3] Barnes, Michelle L., Fabià Gumbau-Brisa, and Giovanni P. Olivei. "Do Real-Time Okun's Law Errors Predict GDP Data Revisions?" Federal Reserve Bank of Boston Research Department Working Paper (2013), https://www.bostonfed.org/publications/research-department-working-paper/2013/do-realtime-okuns-law-errors-predict-gdp-data-revisions.aspx.

like data centers that don't require a lot of workers. And, going forward, we could see a period of strong growth where relatively few jobs are created as AI becomes fully embedded.

This type of structural change is challenging for monetary policymakers. Monetary policy can offset a cyclical slowdown in demand, but it can't do anything about a structural change in the demand for labor. And it is difficult to tell in real time if growth is driven by structural or cyclical forces. For instance, we've seen slowing job gains, particularly for younger, entry-level workers.[4] This could be a sign of a coming cyclical slowdown, as it often has been in the past. But these are also the types of jobs that we might expect to be very exposed to AI.

More generally, if a productivity boom does materialize, we will see high growth long before we will know with certainty what is driving it. Policymakers will likely worry that apparently above-trend growth could lead to higher inflation. Of course, this doesn't have to be the case if growth is high due to elevated productivity. But there's no way to be sure in real time.

The FOMC successfully navigated a scenario like this in the second half of the 1990s under Chairman Greenspan's leadership. Firms were investing heavily in information technology (IT) and growth was higher than what was thought to be sustainable. At Committee meeting after Committee meeting, FOMC members anticipated raising rates at the next meeting, assuming they would see inflationary pressures emerge. But inflation never came and the patience of the Committee paid off. The economy experienced strong GDP growth, a decline in unemployment, low inflation, and, eventually, a lower federal funds rate.

In my view, a key factor behind this successful outcome was the FOMC's inflation fighting credibility. That credibility allowed the Committee to be patient, to hold rates steady, and eventually even lower them, without fueling inflation or inflationary expectations. The FOMC had earned the public's trust during earlier inflation-fighting episodes and could, therefore, afford to be patient. To be sure, some FOMC members in the 1990s worried that they might be sacrificing some of that credibility by not tightening policy. Former New York Fed President McDonough argued that the Committee's credibility ultimately depends, not on reflexively raising rates or keeping them arbitrarily high, but on pursuing whatever policy path is most likely to achieve stable prices and maximum employment. At the July 1997 FOMC meeting he told his colleagues: "Credibility is not the result of raising rates whether needed or not; credibility is doing the right thing."[5] Of course, we now have the benefit of hindsight in knowing that not raising rates during this period was in fact the right thing!

[4] Brynjolfsson, Erik, Bharat Chandar, and Ruyu Chen. "Canaries in the Coal Mine? Six Facts about the Recent Employment Effects of Artificial Intelligence," Stanford Digital Economy Lab Working Paper, November 13, 2025, https://digitaleconomy.stanford.edu/publications/canaries-in-the-coal-mine/.
[5] Transcript of the Meeting of the Federal Open Market Committee, Board of Governors of the Federal Reserve System (1997): 45,
https://www.federalreserve.gov/monetarypolicy/files/FOMC19970702meeting.pdf.

As we go through 2026, both of the themes I discussed will be important: cautious optimism on inflation and wanting greater clarity on what is pushing growth up and employment down and whether these trends will continue. Although I see labor market risks as somewhat elevated, my baseline outlook is pretty benign and does not take strong signal from Q3 growth or the recent uptick in the unemployment rate. I see inflation moderating, the labor market stabilizing and growth coming in around 2 percent this year. If all of that happens, then some modest further adjustments to the funds rate would likely be appropriate later in the year.

At the same time, I will be paying close attention to both cyclical and structural influences on the economy, including AI, and what they may mean for the health of the labor market, progress on inflation, and the restrictiveness of monetary policy.

I suspect that it will take some time to assess all of these factors and their implications for monetary policy. No matter where we land on those assessments, or the economic circumstances that arise, I'll be focused on actions that promote price stability and maximum employment and monetary policy credibility.

In other words, I'll be striving to follow President McDonough's advice to do the right thing.