

Christopher J Waller: Monetary policy at a crossroads

Speech by Mr Christopher J Waller, Member of the Board of Governors of the Federal Reserve System, at the New York Association for Business Economics, New York City, 13 July 2026.

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Thank you, Yelena, and thank you for the opportunity to speak to you today.^{[1](#)}

My subject is the outlook for the U.S. economy and the implications for monetary policy. Spending by households and businesses has been resilient, despite higher goods costs generated by tariffs and the surge in energy prices from the Middle East conflict. The labor market has also been stable, with employment close to the Federal Open Market Committee's (FOMC) maximum-employment goal. So I feel the real side of the economy is in good shape. But I believe inflation and monetary policy are at a crossroads.

Despite higher tariffs in 2025, core inflation held steady for most of the year. But it then began to rise in January. After the Middle East conflict disrupted production and transportation of petroleum and other commodities, this increase accelerated. Conventional wisdom among central bankers is to look through one-time price increases, such as those associated with higher tariffs and a jump in oil prices. But, at this point, I am concerned about the elevated pace of core inflation this year, which has steadily moved up—as measured by the 12-month personal consumption expenditures (PCE) rate—from 3 percent in December 2025 to 3.4 percent in May. Core inflation excludes the direct effects of consumer energy prices, and we are past the point where we can attribute large price increases to earlier tariff hikes. So, the question is, will core inflation continue on its upward trajectory, or has it reached a turning point where it will begin to decline back toward our 2 percent target? The direction it takes has very different implications for the path of monetary policy.

Because core inflation is a good guide to future inflation, I am concerned that, if this upward trend continues, it will be hard to push inflation back toward the Committee's 2 percent goal with monetary policy at its current setting. As I said in a May 22 speech, I am cognizant of the mistake we made in 2021 by not responding sooner to the high inflation we observed, and I am determined to avoid repeating it.^{[2](#)}

But the desire to avoid past mistakes is often the author of new ones. I argued in remarks on July 6 that one of the most important jobs of a policymaker is to clearly assess current economic conditions and not just rely on past experience to guide judgments of where policy should be headed.^{[3](#)} As I will explain, there are some crucial differences now compared with 2021, and there is still a credible case for inflation to begin to fall back to our 2 percent goal with policy at its current setting. But I am concerned about the equally plausible case that data in the coming weeks will show that inflation will remain at its elevated level or even trend higher, requiring tighter monetary policy in the near term.

I am committed to returning inflation to the FOMC's 2 percent goal but also determined to avoid overtightening policy and risking a recession. Tomorrow's inflation data will be one of several data releases I'll be looking at to determine the appropriate path of policy.

Let me now turn to the economic outlook. Economic activity continues to be solid. While high energy prices were likely a drag on consumer spending in the second quarter, spending appears to have held up reasonably well. At the same time, businesses continued to make investments related to artificial intelligence (AI). Together, private domestic final purchases, a good indicator of the underlying momentum of real GDP, likely rose strongly.

A consistent feature of the U.S. economy over the past several years has been the resilience of consumers. Starting with high inflation in 2021, followed by high interest rates from 2022 through 2024, the shock of import tariffs in 2025, and higher energy prices from the Middle East conflict, consumers have powered through and have continued spending at a solid pace. With a nod to that resilience, I expect solid consumer spending growth to continue, helped by energy prices that have recently fallen from their April highs. And, despite some concerns on Wall Street about whether AI demand will continue its fast growth, I expect that AI-related investment will continue at a strong pace in the near term and most likely next year as well.

Meanwhile, although there has been some noise in the labor market data recently, I believe the story there is one of stability and a balance between supply and demand. After three months of job creation averaging a reported 188,000 a month, most people were surprised by the initial estimate of only 57,000 jobs added in June and revisions that cut April and May by an average of 37,000 jobs a month. Despite this revision, the labor market has still created an average of 111,000 jobs a month for the past three months-compared with an average of 9,600 jobs a month in 2025, a year when real GDP expanded by 2.1 percent. This is a significant improvement, especially considering how much slower labor supply growth has lowered the threshold for how many new jobs constitute a healthy, balanced labor market. By these standards, a pace of 111,000 jobs a month reflects a strong level of labor demand relative to supply.

One curiosity of the June employment report was an unusually large drop in the prime-age labor force participation rate. While lower participation can be a sign of a weakening labor market, I don't want to read too much into this one data point. First, the drop in the prime-age labor force was concentrated among 25- to 34-year-olds, and a very large monthly drop in that cohort could be noise. Second, broader measures of labor underutilization, including people marginally attached to the labor force, declined in June, suggesting that the fall in participation was not because discouraged workers stopped looking for jobs. Both of these factors tell me this decline in participation could be reversed.

Other data in recent months support the idea that the labor market is stable and balanced. Job openings and hires were roughly unchanged in May, and total separations, reflecting both voluntary quits and layoffs, changed little. The ratio of job vacancies to those looking for work has moved up a touch in recent months, indicating a looser labor market, but is still close to one, just a bit lower than during the tight labor market for the couple of years before the pandemic.

In sum, I believe employment is close to its maximum sustainable level, neither a source of concern for the strength of the six-year economic expansion nor a source of inflationary pressure. Unless I see evidence of a significantly weakening labor market, my focus will be on inflation.

And no matter how you cut it, or what measure you want to use, inflation is up this year: Even accounting for the likely temporary direct effects of the oil price shock, it is running at levels inconsistent with the FOMC's 2 percent objective. Headline PCE inflation—the rate targeted by the FOMC—was 4.1 percent over the 12 months through May, after running in a range of 2.8 percent to 2.9 percent from September 2025 through February. The direct effect of high petroleum prices until recently has been a big reason for this surge, and the good news is that, if the lower oil prices of the past few weeks are sustained, they will lower headline inflation in the coming months.

But as I said, more concerning is the escalation in core inflation, which, at a 12-month rate of 3.4 percent in May, was more than 0.5 percentage point higher than last October.

⁴ The FOMC does not target core inflation but, when energy or food is having an outsized effect on overall prices, core is among the alternative measures that help us understand the underlying forces driving inflation. In this case, we can see that this trend began rising well before the oil price shock.

Sometimes a big change in only one component of core prices can move the total significantly without reflecting broader pressures from escalating inflation, but that doesn't appear to be the case this time. Both core goods prices and core services inflation are up relative to last year. And, they stand well above their averages at times when inflation was running persistently close to 2 percent, such as the six years from 2002 through 2007. The increases recently are quite broad. For core services, which accounts for 75 percent of core prices, nearly 70 percent of its categories have 3-month and 12-month inflation over 3 percent. Alternative measures of inflation may show different trajectories, but the results are sensitive to how they are calculated.⁵

Looking ahead, I do expect a deceleration of headline inflation due to declining oil prices, starting with the inflation data we get this week. Market prices for the delivery of crude oil between now and the end of December have given back much of their earlier increases, and that will put downward pressure on headline inflation in the coming months. But I will be focused on core inflation, and on that count, there are recent signs of continued pressure on goods prices. Core intermediate goods prices tracked in the producer price index, which may feed through to PCE prices, have increased noticeably in recent months. Also, purchasing managers for manufacturing businesses reported in June that their input prices have continued to increase, the 21st straight month they said so.

So, what is driving this upward pressure on inflation? There are three factors that every survey notes and every conversation I have with business contacts echoes—tariffs, energy prices, and spillovers from demand for the AI buildout.

Federal Reserve research finds that the effects of import tariffs on goods prices were relatively modest and that the vast majority of the effect on inflation of that one-time adjustment in the price level is mostly over.⁶ One unknown is the extent to which tariffs

may rise again in connection with new trade investigations and whether importers try to belatedly recover some of the substantial share of tariff costs that they reportedly absorbed last year and into 2026.

On energy, earlier concerns that higher oil prices could be passed through to inflation for other goods and services have greatly diminished, based on inflation data so far and the recent fall in oil prices. That said, crude oil prices are still volatile, farther-dated futures prices remain higher than before the Middle East conflict, and even the earlier surge in spot prices could show up in core inflation.

Another possible source of inflationary pressure is from AI-related demand. This is being reflected in some large price increases on selected goods such as semiconductors, computer chips, servers, computers, and peripherals. While these increases have had a limited effect on overall inflation so far, it is possible they could be a larger factor if the investment surge for AI continues. There are reports that shortages of memory and storage chips and central processing units for servers—all used in ramping up AI capabilities—are driving up prices for retail goods that also use those components.⁷ These are goods that, because of ever-improving capabilities, historically saw prices fall and, therefore, subtracted from inflation.

Overall, I am monitoring price movements and am alert to the risk that the increase in core inflation is a sign that inflationary pressures are spreading through the economy. The FOMC has to be ready to tighten monetary policy to prevent a repeat of the 2021-to-2022 inflation episode. But there are two differences between now and then that make me cautious about leaning too heavily on that experience to make this decision.

The first is that today's labor market isn't nearly as tight. When the FOMC started raising rates in 2022, there were two job vacancies for every unemployed person, and now the ratio is nearly one to one. While the main effect of higher rates then was to reduce vacancies—rather than employment—there is a much greater risk now that tighter monetary policy could drive up unemployment and even risk a recession.⁸ Another sign that the labor market isn't as tight is provided by data on nominal wage growth. Average hourly earnings grew at an annual rate of between 5 percent and 6 percent in 2022 but are only growing around 3.5 percent this year, a pace that is consistent with 2 percent inflation, given solid trend labor productivity growth.

Another difference with 2022 is that inflation expectations today seem well anchored. Measures of inflation expectations escalated sharply in 2022, and the FOMC considered it a risk that they could become unanchored. This was a big factor in the FOMC's decision to quickly raise rates and make clear that we intended to keep them high for some time. By contrast, today, the market-based measures of inflation compensation that I look at over the two- to five-year horizon are actually down a bit in recent weeks.⁹ Two- and five-year Treasury Inflation-Protected Securities indicate expectations of 2.1 percent and 2.3 percent inflation, respectively, over those time frames. From this, it seems to clear to me that inflation expectations are anchored near our 2 percent target.

I often hear people say that because inflation expectations are anchored, central bankers do not have to respond to above-target inflation. This view is wrong. When inflation is well above its target and the labor market is near full employment and stable,

any serious policy rule calls for raising the policy rate to bring down inflation. Sternly staring at inflation until it melts before our withering gaze is not an option. Anchored expectations assist policymakers trying to bring down inflation by allowing us to move more deliberately, and it allows rate hikes to be less persistent. In this situation, the central bank only faces one problem-getting inflation back to target.

But if inflation is above target and inflation expectations are unanchored, the central bank faces two problems-getting inflation back down and re-anchoring inflation expectations. This will typically require significantly larger and faster rate hikes for the same degree of above-target inflation. Furthermore, the hikes would need to be more persistent to keep inflation down and to re-anchor inflation expectations. In short, high inflation and unanchored inflation expectations require very aggressive policy actions and an acceptance of greater recession risk. This is the reason central bankers worry so much about inflation expectations becoming unanchored. Thankfully, we are not in this position today. But it does not mean we can be lackadaisical in responding to inflation that is well above target and headed in the wrong direction.

Tomorrow we will receive consumer price index inflation for June-and producer prices the day after-which together will give us a good estimate of PCE inflation, the measure the FOMC targets. I would be very pleased to see a lower reading on core inflation, but after its escalation over the first half of this year, I will need to see several months of lower readings to feel that inflation is moving in the right direction. For the reasons I have laid out today, I think that is still a reasonable outcome, and I would then continue to hold the policy rate at its current target range.

But I don't take the inflationary signals I have discussed today lightly. If we get another hot reading on core inflation this week, then the FOMC will need to consider tightening monetary policy in the near term. As always, we need to avoid making the mistake of fighting the last war and reacting too soon to tighten inflation, merely because we waited too long last time. But we also must avoid repeating the same mistake we made in 2021 and 2022 by waiting too long to respond.

In conclusion, we are at a crossroads for policy, and the appropriate action will depend on incoming data.

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), "[Policy Risks Have Changed](#)," speech delivered at the Frankfurt School of Finance and Management, Frankfurt, Germany, May 22.

³ See 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, Rome, Italy, July 6.

⁴ The Bureau of Economic Analysis recently announced an upcoming methodological change that is expected to lower 12-month core PCE inflation up to a few tenths. Knowing this revision does not change the big picture that core inflation is too high.

⁵ For example, the Dallas trimmed mean cuts more of the fastest-growing prices than the slowest-growing prices. As a result, skewness in the data can distort the signal from this measure. For a full discussion of this issue, see Tyler Atkinson, Jim Dolmas, and Rebecca Zarutskie (2026), "[Skewness Warrants Caution as Trimmed Mean PCE Inflation Eases](#)," Federal Reserve Bank of Dallas, *Dallas Fed Economics*, April 16.

⁶ 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).

⁷ See Laya Neelakandan (2026), "Rise in Memory Chip Costs Puts Pressure on Retailers of Laptops and Smartphones," CNBC, June 26, <https://www.cnbc.com/2026/06/26/ai-memory-chip-shortage-consumer-electronics-prices.html>.

⁸ For a detailed discussion of why the Fed could raise rates and achieve a soft landing in the labor market, see Andrew Figura and Christopher J. Waller (2024), "[What Does the Beveridge Curve Tell Us about the Likelihood of Soft Landings?](#)" Finance and Economics Discussion Series 2024-073 (Washington: Board of Governors of the Federal Reserve System, September).

⁹ It is common to hear measures of inflation expectations 5 to 10 years ahead cited as the most relevant for monetary policy, but I don't agree. I suspect neither investors nor consumers plan for inflation up to a decade ahead, and I don't consider it helpful for monetary policymaking, where the horizon is much shorter.