Balancing Act: The Dual Mandate on an Economic Tightrope

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Introduction

My thanks to the Economic Club of New York for inviting me to speak today and to Bill Dudley for moderating what I'm sure will be an engaging discussion. As many of you know, I lived and worked in New York for 30 years before moving to Cleveland to begin my new role at the Federal Reserve. I love Cleveland, and I love talking with friends and neighbors about all the great things to see and do in Northeast Ohio. But I have to chuckle when the topic turns to Cleveland traffic, which is nothing compared to the endless gridlock that I experienced in Manhattan—before congestion pricing kicked in, of course.

Some of you might be thinking, *just take the subway!* If only the decision were that simple. When I lived in New York, I faced the daily debate about the comfort of a cab or the certainty of subway timing. But even once in the subway, I faced the maddening choice: do I jump on the local 1 train pulling into the station or wait for the express 3 train that says it's four minutes away? Getting around New York is a balancing act to optimize every second of every day, and right now a balancing act feels like the perfect metaphor for monetary policy: If the economy is a tightrope, policymakers are tasked with walking a fine line to keep our dual mandate goals of maximum employment and price stability in balance.

Today I'm going to talk about why I believe policy should be at a mildly restrictive setting to strike the right balance between our goals. But let me stress the "I" part of that sentence and indicate, as always, that these are only my views and not necessarily those of the Federal Reserve System or of my colleagues on the Federal Open Market Committee (FOMC).[1]

Balancing Act

This is a challenging time for monetary policy. Often times, policymakers are faced with high inflation

[1] I'm grateful to Edward Knotek, Dani Carlson, and Doug Campbell for assistance with these remarks.

OR high unemployment. But at the moment, there is pressure on both sides of the mandate. Inflation continues to be above our 2 percent objective, and the labor market is showing signs of softening. High inflation usually calls for raising interest rates to bring inflation down. But a slowdown in job growth typically calls for reducing interest rates to support the labor market.

Under these conditions, balancing such misses to both the maximum employment and price stability sides of the Fed's dual mandate is like walking a tightrope. At times it's necessary to use your available tools—whether a balancing pole or interest rates—to counterbalance the greater threat. If you lean too far in either direction, you might lose your footing.

The concept of balance is at the heart of the FOMC's Statement on Longer Run Goals and Monetary Policy Strategy.[2] In the most recent update to the statement, the Committee said that it would follow a balanced approach to promoting its goals during times when the objectives are not complementary—which is a fair characterization of today's situation, with both inflation and employment under pressure. We need to assess how much and for how long we are missing on each side of the mandate and then determine which way policy should tilt to compensate for those misses.

Applying this framework to the current economic environment, I remain concerned about high inflation and believe policy should be leaning against it. After last week's meeting, I see monetary policy as barely restrictive, if at all, and it's not obvious to me that monetary policy should do more at this time. But the future is inherently uncertain, and I'm watching developments closely. So let me share in more depth

[2] The Statement on Longer Run Goals and Monetary Policy Strategy as amended effective August 22, 2025, is available via the website of the Board of Governors of the Federal Reserve System at federalreserve.gov/monetarypolicy/files/FOMC_LongerRunGoals.pdf. Materials from the framework review are available at federalreserve.gov/monetarypolicy/review-of-monetary-policy-strategy-tools-and-communications-2025.htm.

what I'm seeing in the economy that frames my view of appropriate policy.

Inflation Misses

I'll begin with inflation. The government shutdown has meant that we don't have access to as much official data as usual, but there are other sources we can look to. Compared with our 2 percent objective, inflation is too high, and it's still trending in the wrong direction.

In the most recently available reading as of August, PCE inflation was 2.7 percent, somewhat higher than its corresponding reading from 2024. Core PCE inflation, which excludes volatility coming from food and energy prices, was 2.9 percent. Meanwhile, the September report for CPI inflation showed both the headline and core measures at 3 percent. The Cleveland Fed's Center for Inflation Research calculates multiple measures of the trend in inflation, and those are also elevated.[3]

So how do we make decisions while the official statistics are limited? In addition to using other data releases and results from surveys conducted both inside and outside the Fed, one way I stay current on economic developments is by talking frequently with businesses and community contacts in the Fourth Federal Reserve District. I meet regularly with our three boards of directors and our 14 advisory councils. And I supplement these with individual meetings. I always find these engagements helpful. But they've recently taken on added importance given the more limited official data releases.

The data and real-life stories suggest that there are a variety of forces at play that are contributing to elevated inflation.

[3] Find the Cleveland Fed's alternate measures of inflation at our Center for Inflation Research website, clevelandfed.org/center-for-inflation-research.

Business and community leaders frequently mention to us that sharply rising health and property insurance premiums are a key cost pressure. Rising electricity costs are also top of mind for many businesses. I spoke with the leader of a grocery store chain in the Fourth District a couple weeks ago who shared that margins are low and costs are higher, including extremely high electricity costs. As a result, the company is trying to identify efficiencies to minimize how much of this cost to pass along to consumers. Advances in artificial intelligence hold promise for raising productivity, but I hear from businesses that the new technologies are lifting costs in the near term.

Tariffs also loom large for many firms, especially retailers, manufacturers, and construction companies that use parts that come from abroad. These businesses are making tough decisions about which costs to absorb and which ones they need to pass through to customers, a balancing act of their own. Cleveland Fed surveys find that the more a firm is reliant on imports, the greater the expected passthrough.[4] That helps explain why more than two-thirds of our construction contacts told us they expect to pass all or most of their tariff-related costs increases on to their customers.

Last month I heard from a range of businesses and community leaders—including insurance companies, construction contacts, auto manufacturers, and nonprofit representatives—during roundtable discussions in Cleveland and Columbus, Ohio. Among the businesses, virtually no one wanted to be the first to raise prices. But given the cost pressures they are facing, a number of those business leaders said the reality is that they will likely have to do so early next year. Reflecting the balancing act going on in the economy, other business leaders have said that they would like to raise their prices but, for now, don't think that they can because of softer demand.

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[4] See Gerring, Jayme V., Carol Moseley, and Stephan D. Whitaker. 2025. "SORCE Insights: Tariff-Related Uncertainty and Pass-Through to Pricing." Federal Reserve Bank of Cleveland, *Cleveland Fed District Data Brief*. doi.org/10.26509/frbc-ddb-20251001.

Some inflation measures that should be relatively unaffected by tariffs are also stuck above prepandemic levels. Inflation in core services excluding housing was 3.4 percent in August, little changed from the 3.6 percent reading in August 2024. This inflation rate has moved a little higher compared with where it had been earlier this year. I'm also watching for shifts in inflation expectations. Right now, short-term expectations are elevated, while longer-term inflation expectations have been more stable.

How all this plays out remains uncertain. Economic theory tells us that it's reasonable to believe that a small and one-time change in tariffs would eventually produce a one-time increase in the price level, without persistently affecting inflation. The situation today is that inflation is coming from several directions and has been running above our objective for the last four and a half years. Additionally, the tariff changes have been large, dynamic, and ongoing, far from a textbook implementation. Based on all of these considerations, I don't see elevated inflation as a purely transitory phenomenon that I should look through.

My base case has PCE inflation rising to around 3 percent by the end of this year. It then remains elevated through much of 2026 and only gradually comes down thereafter.

I am firmly committed to achieving our 2 percent inflation objective in a timely fashion. Policy cannot offset every short-lived miss of our goals, but it should limit the duration of persistent misses. Otherwise, consumers, businesses, and markets may come to doubt our commitment to the inflation objective.

High inflation has real costs for the economy.[5] We see and feel those costs on Main Street every time we go to the store, pay for a service, or shop online. Elevated inflation makes it hard for consumers and businesses to plan for the future. This is especially true for lower-income Americans, who spend proportionately more on food, housing, and energy and often experience higher inflation rates than others.[6] Recent survey work by the Cleveland Fed finds that the top concern affecting low- and moderate-income households was the ongoing impact of rising prices on budgets.[7]

Labor Market Misses

As monetary policy walks along the tightrope, we need to balance those inflation developments with the Fed's other mandate, maximum employment. Here, labor market conditions remain generally healthy, but they have softened, and there is a risk of further slowing.

Let me start with the good news: The unemployment rate, a useful statistic to summarize the overall state of the business cycle, remains low. The unemployment rate was 4.3 percent in August, up only one-tenth of 1 percentage point over the last 12 months. In fact, the unemployment rate is very close to my estimate of its longer-run level of 4-1/4 percent.

A number of other metrics have been consistent with stable, healthy labor market conditions. This includes initial claims for unemployment insurance, which look like they have remained low through late October. WARN notices of mass layoffs were relatively low through September, though recent

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[5] See L'Huillier, Jean-Paul, and Martin DeLuca. 2023. "The Long-Run Costs of Higher Inflation." Federal Reserve Bank of Cleveland, *Economic Commentary* 2023-17. doi.org/10.26509/frbc-ec-202317.

[6] See Luduvice, André Victor D., Anaya Truss-Williams, and Christopher J. Walker. 2025. "Did Inflation Affect Households Differently? A Look at the Postpandemic Inflation and Wage Growth Dynamics." Federal Reserve Bank of Cleveland, *Economic Commentary* 2025-11. doi.org/10.26509/frbc-ec-202511. See also Klick, Joshua, and Anya Stockburger. 2024. "Examining US Inflation across Households Grouped by Equivalized Income." *Monthly Labor Review*, July. US Bureau of Labor Statistics. doi.org/10.21916/mlr.2024.12.

[7] See the Cleveland Fed's most recent Community Issues Survey, clevelandfed.org/publications/community-issues-and-insights.

announcements bear watching.[8]

Recent changes in immigration policies have sharply reduced net migration to the United States. Fewer immigrants entering the US labor force implies slower growth in labor supply. This means the economy doesn't need to add as many jobs compared with what it needed a couple of years ago to keep the unemployment rate steady.

And, indeed, we have seen a softening in payroll growth, something which brings me to the not-so-good news. The most recent report from the Bureau of Labor Statistics estimated that employers added 29,000 jobs per month on average in June, July, and August. In early 2023, job gains averaged nearly 300,000 per month. Historically, marked slowdowns in job gains have usually, though not always, been associated with stress in the labor market.

Additionally, the unemployment rates for certain parts of the population who are often most affected during economic downturns, such as younger workers and Black workers, have risen considerably over the last year. Together, these signs suggest that the downside risks to the labor market have been rising.

Based on the slowing labor market, I expect the unemployment rate will tick up in coming months, ending this year just above its longer-run value. Looking further ahead, the US economy has proven very resilient. Financial conditions are quite accommodative, reflecting recent gains in equity prices and easy credit conditions. As uncertainty subsides and businesses take advantage of the strong capital markets landscape, I expect that economic growth next year will pick up from its fourth-quarter pace, eventually

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[8] Cleveland Fed researchers collect and analyze advance notices filed under the Worker Adjustment and Retraining Notification (WARN) Act. Updates on WARN notices are available at clevelandfed.org/research/additional-research-resources. See Krolikowski, Pawel M., and Kurt G. Lunsford. 2024. "Advance Layoff Notices and Aggregate job Loss." *Journal of Applied Econometrics*. 39(3): 462–480. doi.org/10.1002/jae.3032.

putting some downward pressure on the unemployment rate.

Balancing Misses

In practice, sound policy requires both considering the most likely outcomes and managing risks. There is an element of juggling while on the highwire.

I see inflation misses starting 2026 around 1 percentage point, which will take two to three years to resolve. If this happens, it would mean that inflation exceeded our 2 percent objective for the better part of a decade. Now, this is just a forecast, and I could be wrong. But without appropriately restrictive policy, this long stretch of elevated inflation could eventually cause high inflation to become embedded into the economy.

On the labor market side, I see the unemployment rate starting 2026 a couple of tenths of a percentage point above its longer-run value before coming down over two to three years. A range of other indicators, including consumer spending and GDP growth, point to ongoing health of the broader economy, so I do not currently put high odds on a labor market downturn. But subdued job growth may indicate more fragility in the labor market.

Policymakers may differ on the weights they place on the two misses, their baseline forecasts, and their risk assessments. But to me, comparing the size and persistence of our mandate misses and the risks, inflation is the more pressing concern.[9] This argues for a mildly restrictive stance for our policy rate to

[9] A variety of approaches provide guidance in this situation. Simple monetary policy rules, including some that are forward looking, usually provide prescriptions for the policy rate as a function of the inflation gap and the output or unemployment gap. Based on the differences in the gaps outlined above, most such rules would call for a restrictive stance of policy compared with its long-run neutral level. For example, see the Simple Monetary Policy Rules section of the Cleveland Fed's website, available at clevelandfed.org/indicators-and-data/simple-monetary-policy-rules. Optimal control policies often seek to set the interest rate to minimize the expected discounted future losses coming from the squared inflation gap and the squared output or unemployment gap. A common baseline approach in the context of the FRB/US model assumes that policymakers place equal weights on both inflation and

ensure that inflation returns to 2 percent in a timely fashion. In the tightrope metaphor, I'm using my balancing pole to help lean against inflation, because under these conditions, keeping the pole equally balanced seems like a good way to lose my footing. But the lean is only a slight one—hence "mildly"—to balance the labor market concerns.

Where is Neutral?

Determining the right lean is important, but we also need to find the center. A key technique used by tightrope walkers is known as "focusing." By fixing their gaze on a steady point, they can keep their body aligned and maintain stability while taking steps across the wire. The central bankers' equivalent to focusing might be r-star, an estimate of the medium-run real neutral funds rate that neither stimulates nor restricts economic activity. This can help tell us how restrictive policy is today, guiding our assessment of appropriate actions to achieve our dual mandate objectives.

Right now, my estimate of r-star leads me to see monetary policy as only barely restrictive, if at all. I base this view on three main reasons that I'll cover briefly in the interest of getting to your questions. There are many interesting developments influencing r-star, such as AI and immigration, and I'll have to leave a deeper discussion of those for another day.

First is the economy's recent performance. GDP growth has been right around my estimate of its longer-run trend, and the unemployment rate is close to my estimate of its long-run level. Inflation has been

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unemployment misses, a placement which again would cause the cumulative expected inflation misses to be a larger factor influencing interest rates given the projected gaps outlined above, but the literature on optimal policy suggests that other weights can be appropriate depending on the model. For example, see Brayton, Flint, Thomas Laubach, and David Reifschneider. 2014. "Optimal-Control Monetary Policy in the FRB/US Model," FEDS Notes. Washington: Board of Governors of the Federal Reserve System, November 21, 2014. doi.org/10.17016/2380-7172.0035. Risk management can also factor into these approaches; for example, see Garga, Vaishali, Edward Herbst, Alisdair McKay, Giovanni Nicolò, and Matthias Paustian. 2025. "Monetary Policy, Uncertainty, and Communications," Finance and Economics Discussion Series 2025-074. Washington: Board of Governors of the Federal Reserve System, doi.org/10.17016/FEDS.2025.074.

above our 2 percent objective and is now trending up again. A straightforward interpretation of these indicators is that policy hasn't been very restrictive. With the nominal federal funds rate now 50 basis points lower than it had been in August, policy is now less restrictive, and that will put less downward pressure on inflation.

A second factor informing my estimate of neutral comes from economic modeling. Recent estimates from Thomas Laubach and John Williams' seminal model put r-star around 1.4 percent, notably higher than it was shortly after the Global Financial Crisis (GFC).[10] Recent Cleveland Fed research has proposed a model that simultaneously captures many unobservable "star" variables, including r-star.[11] This model also estimates that r-star has been trending up and was 1.5 percent as of the second quarter of this year. There is considerable uncertainty around all estimates of r-star, but the upward trends in these and other estimates suggest to me that the neutral real rate is rising.

Finally, I'm taking some cues on the whereabouts of r-star from financial markets. Rather than being restrictive, broad financial conditions appear to me to be quite accommodative. Equity prices are high, credit spreads are narrow, and interest rates have come down from their post-pandemic highs. Recently, the 10-year Treasury yield has been in the low 4 percent range, similar to readings from the early 2000s before the GFC, and real forward rates from TIPS (Treasury Inflation Protected Securities) have returned to their pre-GFC levels. In my conversations with businesses, interest rates are not typically described as

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[10] See Laubach, Thomas, and John C. Williams, "Measuring the Natural Rate of Interest," *Review of Economics and Statistics*, 85, no. 4 (November): 1063–1070; working paper version available at federalreserve.gov/pubs/feds/2001/200156/200156pap.pdf. The New York Fed provides updated estimates from the model at newyorkfed.org/research/policy/rstar.

[11] In addition to r-star, this model includes a number of other long-run trend concepts related to the unemployment rate, productivity growth, and price inflation, among others. See Zaman, Saeed. Forthcoming. "A Unified Framework to Estimate Macroeconomic Stars." *Review of Economics and Statistics*. doi.org/10.1162/rest_a_01570. For updated estimates, see Horn, Taylor N., and Saeed Zaman. 2025. "Neutral Interest Rates and the Monetary Policy Stance." Federal Reserve Bank of Cleveland, *Economic Commentary* 2025-08. doi.org/10.26509/frbc-ec-202508.

being overly restrictive. I hear more about trade policy uncertainty and high construction costs as impediments to investment. In the 1990s, the 10-year Treasury yield averaged more than 6-1/2 percent. There was plenty of lending, borrowing, and M&A activity during those earlier periods, consistent with the view that the economy is able to adapt to higher interest rate environments. My growing sense is that the period of ultra-low rates and low r-star we experienced following the GFC—which was coupled with household deleveraging and regulatory tightening—was an anomaly rather than a new normal.

Conclusion: Achieving Balancing

So let's return one last time to the FOMC's balancing act. On one side, inflation is too high and trending in the wrong direction. On the other, labor market conditions have softened but remain generally healthy. As I navigate the economic high wire, I see an important role for the balancing pole to help counter the misses to the inflation side of our mandate. This means monetary policy should be mildly restrictive to return to our 2 percent inflation objective in a timely fashion while limiting the misses from maximum employment. And with my focus guided by r-star, I see policy as only barely restrictive, if that. At this point, I don't think there is more that monetary policy can do without risking a fall off the wire.

Like a careful tightrope walker, I'm mindful that the winds could start blowing from either direction and that there could be swings in the environment. I'm taking this one step at a time, alert to developments that could change my forecast and my view of appropriate monetary policy. In the meantime, I thank you for your attention and look forward to your questions.