How Far and How Fast?

Jeff Schmid
President and Chief Executive Officer
Federal Reserve Bank of Kansas City

October 21, 2024
Delivered to the Chartered Financial Analysts Society of Kansas City
Kansas City, Mo.

The views expressed by the author are his own and do not necessarily reflect those of the Federal Reserve System, its governors, officers or representatives.

Thank you for inviting me to speak today. I will offer some remarks on the outlook for the economy and monetary policy, and then I look forward to any questions you may have.

At its meeting in September, the Federal Open Market Committee (FOMC) lowered its policy interest rate by ½ percentage point to a range between 4¾ percent and 5 percent. This was the first change in the policy rate in over a year and came about five years after the Fed last started a rate cutting cycle. But a lot has happened in those five years. After gradually lowering rates in the second half of 2019, the Fed quickly dropped rates to zero with the outbreak of the pandemic. Only two years later, with inflation on its way to a multi-decade high, the Fed embarked on the fastest tightening cycle of the modern era, pushing up rates 525 basis points over the course of a year-and-a-half. In the context of these outsized moves, one may wonder what the future holds now that monetary policy has reached a new inflection point.

My hope is for what I might call a more normalized cycle. A cycle where the Fed engages in modest adjustments to policy to keep the economy on an even keel of steady growth, stable prices, and full employment. Absent any major shocks, I am optimistic that we can achieve such a cycle, but I believe it will take a cautious and gradual approach to policy. While I support dialing back the restrictiveness of policy, my preference would be to avoid outsized moves, especially given uncertainty over the eventual destination of policy and my desire to avoid contributing to financial market volatility. In the remainder of my remarks, I will first discuss why now is the right time to start lowering rates. Then I will turn to how low rates might go and how quickly they should get there.

How We Got Here

In my view, it only became appropriate to lower the policy rate after inflation convincingly appeared to be on a persistent path towards the Fed's 2 percent objective. Since 2022, inflation has been the main plotline in the monetary policy narrative, and understandably so as prices surged at a pace not seen since the 1980s. More recently, we have seen considerable progress in returning inflation to the Fed's objective, with prices increasing 2.2 percent in the year ending in August. I would not be comfortable lowering the policy rate if I were not reasonably confident that inflation was heading in the right direction.

There are a couple of factors that have considerably improved the outlook for inflation in recent months.

First, the pandemic-related disruptions that led to the initial burst of inflation now appear to be largely behind us. This is especially true for the price of goods. It was a jump in goods prices that provided much of the initial impetus for the surge in inflation, but that impulse has been absent for over a year now. In fact, over the past 12 months, goods prices have declined almost 1 percent.

The fading of goods inflation reflects developments in both supply and demand. During the pandemic, the supply of goods was lowered by production disruptions and logistical snarls. At the same time, demand for goods surged as homebound consumers shifted spending away from services. This imbalance between low supply and high demand led to rapid price increases. However more recently, supply chains have recovered, the mix between goods and services consumption has returned to pre-pandemic patterns, and goods prices are no longer a source of inflation.

A second factor increasing my confidence that the easing of inflation will persist is the loosening of the labor market. The pandemic led to severe disruptions in the labor market, contributing to historic tightness, and increasing pressure on labor-intensive services prices. More recently, the labor market has cooled. The vacancy ratio has fallen to about 1 posting per available worker from a historic high of 2 postings per available worker at the height of labor market tightness in 2022. We have also seen the unemployment rate creep up to 4.1 percent from 3.4 percent at the start of last year.

While the loosening of the labor market has led to some concern that the economy is on shaky ground, my read is that we are seeing a normalization rather than a significant deterioration of conditions. It might not be surprising that a historically tight labor market would be followed by a period of relatively slack hiring. When markets were tight and workers were quitting positions at a record pace, employers made every effort to retain existing workers and hire new workers, fearful that they would be caught short-handed. Now that employers are confident in their ability to fill open positions, they are no longer hoarding labor, easing retention efforts, and likely turning back the dial a bit on the aggressiveness of their hiring. All of this will at least temporarily slacken the labor market as employers make these adjustments.

With a variety of data sources and many different ways to view the labor market, I find it helpful to reference the Kansas City Fed's Labor Market Conditions Indicators (LMCI) for an overall view of the health of the labor market. The LMCI combines 24 separate labor market data

series into two easy-to-interpret indexes. Recently the LMCI has been trending down, suggesting a loosening, but it remains above its historical average, suggesting the overall labor market remains quite healthy.[1]

Adjusting Rates: How Low and How Fast?

With the data suggesting inflation is heading in the right direction, there is a compelling argument that the policy interest rate should come down. Less certain is how low rates should go and how quickly adjustments need to occur.

Starting with the first question of how low interest rates will go, there is ample evidence that the current stance of monetary policy, and the level of interest rates, is restrictive, but less evidence that it is *very* restrictive. Growth remains strong and the economy has shown continued momentum. Real GDP increased 3 percent in the second quarter and appears to be poised to increase a similar amount in the third quarter. Not bad, considering growth averaged a little over 2 percent in the decade before the pandemic when interest rates were far lower.

The economy has been supported by strong consumer spending, which in turn has been supported by growing labor income and relatively healthy household balance sheets in the aggregate. Of course, not all household balance sheets are healthy, and the aggregate numbers mask all the differences across actual households. But to summarize, if the economy does not appear to be very restricted, then it seems unlikely that monetary policy is all that restrictive.

It is my belief that interest rates could settle well above the levels we saw in the decade before the pandemic. There are several reasons why this may be true. One favorable, and some may say optimistic, scenario is that continued strong productivity gains boost economic growth, strengthen investment and support consumption. Such a combination would increase the demand for investable savings and hence push up interest rates.

A less favorable scenario, and one I discussed at length in a speech in May, is that the tremendous increase in government debt coming out of the pandemic, not just in the United States but around the world, maintains upward pressure on interest rates across the economy.[2]

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[1] More information about the Kansas City Fed's LMCI is available at https://www.kansascityfed.org/data-and-trends/labor-market-conditions-indicators/.

[2] See "The Outlook for the Economy and Monetary Policy" at https://www.kansascityfed.org/Speeches/documents/10168/2024-Schmid-Omaha-05-14.pdf.

However, there are some long-run structural factors that likely contributed to the low level of interest rates before the pandemic, and these factors have not gone away. In particular, demographic trends point to aging populations in the United States and around the world. As older populations age into retirement, they tend to work less, which reduces demand for physical capital and investment, depressing interest rates. Older populations also save more, particularly in fixed-income assets, which can further push down interest rates. Though it is hard to know which of these factors will dominate — productivity, debt, or demographics — we must be open to the possibility that interest rates will settle higher than we observed before the pandemic.

Now let's turn to the question of timing. If the Fed is to further lower interest rates, at what pace should it be done? Given the uncertainties I just outlined about our eventual destination, a cautious and deliberate course of action seems appropriate. Lowering rates in a gradual fashion would provide time to observe the economy's reaction to our interest rate adjustments and give us the space to assess at what level interest rates are neither restricting nor boosting the economy.

A cautious approach will also work to minimize the Fed's contribution to financial market volatility. Outsized policy moves can provoke outsized financial market reactions to data surprises. The data are messy and subject to large revisions as we have seen in recent months. Our policy must be linked to the flow of data, but we should avoid putting too much weight on any single data point. As policymakers we should be flexible, but being nimble can come with a price. Reacting quickly builds expectations of further quick reactions. This widens the scope for financial market expectations to diverge from the intent of the Committee, potentially contributing to heightened financial market volatility. Already, we have seen large swings in Treasury yields over the past few months as markets assess and reassess the potential course of policy interest rates.

The Impact on the Balance Sheet

Volatile interest rates could potentially complicate another aspect of Fed policy, which is our work to decrease the size of our balance sheet. Following a tremendous expansion during the pandemic, the Fed has been shrinking its balance sheet since the middle of 2022. My preference is to shrink the balance sheet as much as possible while remaining consistent with the Fed's current operating framework. While a larger balance sheet lowers the risk of sharp movements in

money market interest rates, maintaining a large balance sheet is not without costs. I am focused on three costs in my preference for a relatively aggressive approach to balance sheet reduction.

First, a large balance sheet weighs on longer-term yields, depressing the price of duration in financial markets and potentially leading to distortions in the allocation of credit. It is my view that one factor contributing to the flatness of the yield curve is the large size and elevated duration of our balance sheet. The long-term health of the traditional banking industry, which is well represented in my Federal Reserve district, requires a positive slope to the yield curve. A smaller balance sheet concentrated in shorter duration securities would lessen our impact on the slope of the yield curve. Recent research from the Kansas City Fed reviews some of the considerations around the eventual composition of the Fed's balance sheet.[3]

Second, a large balance sheet increases the Fed's footprint in financial markets, potentially diminishing and weakening other mechanisms and markets for distributing liquidity across financial institutions and leading to a more brittle financial system.

And third, maintaining a large balance sheet can give the uncomfortable impression that monetary and fiscal policy are intertwined. Maintaining an excessively large Treasury portfolio can give the impression that the Fed's balance sheet is supporting government debt markets.

As we move past the post-pandemic surge in inflation, we have the prospect of transitioning to a more normalized cycle where the Fed regularly recalibrates monetary policy to meet its dual mandate of price stability and full employment. I am optimistic the Fed can achieve such an outcome, but it will take a careful approach that is attentive to the data and signals from the economy. My belief is that a cautious and gradual approach to policy adjustments would be best suited for this uncertain environment.

[3] See Sengupta and Smith (2024). "Considerations for the Longer-Run Maturity Composition of the Federal Reserve's Treasury Portfolio".