Resolutions for a New Year

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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.

Introduction

Thank you for joining me and my colleagues at the Bank today and appreciating this winter view of Kansas City's iconic World War I memorial. We are honored to bring everyone together here today and want to thank the Economic Club and its president, Amy Hawley Rose, for the opportunity to host you.

There is a lot going on in the country today. Our thoughts are very much with those on the West Coast where horrible wildfires are devastating homes and businesses in one of the most beautiful areas of the United States. Meanwhile, on the other side of the country, President Jimmy Carter is being memorialized in Washington, D.C. Notably, from the perspective of this institution, it was President Carter who, faced with an inflation problem that he largely inherited, had the boldness to appoint a hawkish Paul Volcker as Fed Chair. Even more impressive, he then had the courage to stand clear and allowed the Fed to exercise its independence when Volcker started on the difficult and painful path of bringing inflation under control through extremely high interest rates. It was a decision with considerable economic and political cost for Carter, and it put extreme pressure and criticism on Fed policymakers. But the eventual payoff benefited the nation greatly in the subsequent decades.

With the new year just over a week old, this a good time to step back and take stock of where we are and where we might be going. It is also a time for the longstanding practice of setting goals and resolutions for the upcoming year.

I will not bore you with my personal resolutions, but rather I will focus on my resolutions as president of the Kansas City Fed. There are three I would like to share.

First, I resolve that the Kansas City Fed will play its part in ensuring that the Federal Reserve continues to be the most efficient, consequential, and, when appropriate, innovative central bank in the world. Second, I resolve to represent the Tenth Federal Reserve District at the Fed's policy table, giving voice to the opportunities and challenges of our region as I do my part in setting monetary policy in a manner consistent with the Fed's congressionally determined dual mandate of price stability and full employment. And third, I resolve to continue to advocate for policies that will reduce the Fed's footprint in financial markets, including the continued shrinking of the Fed's large balance sheet.

A High-Performing Central Bank with a Wide Range of Responsibilities

Starting with my first resolution: continuing the high performance of the Kansas City Fed and contributing to the Federal Reserve System as a whole. It is important at this point to acknowledge the breadth of the Fed's responsibilities. Monetary policy attracts a disproportionate amount of media attention relative to the day-to-day jobs of most of the individuals working for the Kansas City Fed and filling up this building.

In addition to our responsibility for monetary policy, the Fed also supervises financial institutions, is the Bank for the United States Treasury, and works to maintain the payment system. To explore only one of these areas, it would be hard to overstate the importance of a well-functioning, secure, and efficient payment system for the health of the overall economy. Payments are often compared to the circulatory system of the economy. They are the ledger that determines how decisions are made and how resources are allocated in a market economy. Payments can take many different forms, including cash, check and wire transfer; and the Fed plays a role in ensuring the security and efficiency of all of these.

Fedwire, for example, transfers and processes more than $4 trillion on average each business day. The dominant role of the dollar, supported by our payment system, as well as the strength and stability of our financial system and sound monetary policy, provide tremendous advantages to the United States, advantages we should not take for granted nor tamper with lightly.

Payments are also an area of tremendous innovation, both for the private sector and for the Federal Reserve. The Fed has introduced FedNow, a new 24/7/365 instant payments system and the Fed's first major new payment rail in over 40 years. This innovation owes a debt of gratitude to my predecessor Esther George, whose leadership was invaluable to its creation and who we are fortunate to have in the room with us today. FedNow aims to bring instant payments technology to all financial institutions, no matter their size or location, and has a multitude of uses that are just now being explored, including allowing employees to be paid daily, speeding the availability of funds to small businesses, and quickening the delivery of disaster-assistance payments.

Another aspect of payments where the Fed plays an essential role is in its interaction with the U.S. Treasury. As the Treasury's fiscal agent, the Fed is responsible for distributing payments to individuals throughout the economy, including Social Security and disaster relief payments.

In addition to maintaining the nation's payments infrastructure, a contingent of employees in this building as well as in our branch offices in Denver, Oklahoma City and Omaha are responsible for supervising financial institutions in the Tenth District and contributing to the health, strength and resilience of the country's financial system. A well-supervised banking system is in everyone's interest as it promotes the public trust that allows financial institutions of all sizes to flourish rather than just the largest and most well-known.

Effective supervision also requires an innovative mindset as the risks and stress points in the financial system are constantly evolving.

Price Stability and Full Employment: The Fed's Dual Mandate

Turning to my second resolution: that monetary policy be set to meet the Fed's dual mandate of price stability and full employment. In two weeks, I will have my first opportunity to cast a vote on interest rates as a member of the Federal Open Market Committee. Representing the communities, individuals and businesses of our region is a responsibility I take very seriously.

So where are we now? Starting with inflation, the Fed has defined price stability as an inflation rate of 2 percent. We are not quite there. Prices increased 2½ percent over the past year. But we are a lot closer than we were two-and-a-half years ago when inflation was at a 40-year high, and I am fairly optimistic that inflation will continue to move in the right direction. Some of the continued stickiness of inflation has been in slow-moving components, like rents, where more forward-looking measures, such as new tenant leases, point to a further easing of inflation.[1]

My confidence that inflation will return to target is premised on three factors. First, pandemic-related disruptions to production, probably the largest factor behind the spike in inflation, have faded as supply chains have healed. Second, a historically tight labor market, also a big contributor to the rise in inflation, has eased. At the peak of the recent inflation, there were two job postings for every potential worker. As the labor market has loosened, inflation has

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[1] Nida Çakır Melek, Emily Pollard, and A. Lee Smith, "Rent Trends for New Tenants Suggest Rent Inflation Will Continue to Decline." *Charting the Economy* via KansasCityFed.org. November 15, 2024.

fallen. And third, inflation expectations from surveys and markets have remained anchored at a level consistent with 2 percent inflation. This is important.

Circling back to the beginning of my talk, unanchored inflation expectations are what made the inflation Paul Volcker had to deal with so pernicious. The inflation we experienced over the last few years was driven by an imbalance between supply and demand in the economy. The economy was tight, and that is what drove our recent experience with inflation. Inflation in the 1970s and 1980s was not driven by economic tightness, rather the unemployment rate was high and growth was mediocre.

That historic experience with inflation was driven by expectations of price increases that had become embedded into the psychology of price setting. It took more than just easing economic tightness to bring down inflation in the 1980s. It took the Fed building credibility as an inflation fighter, credibility that came at the cost of a steep increase in unemployment and a recession. Now, even as inflation has come down following a rapid tightening of monetary policy, it is essential that the Fed remain vigilant and maintain this hard-fought credibility.

Turning to the second leg of our mandate, I am optimistic about employment and the strength of the economy. Though the job market has loosened, it remains healthy. The number of available job vacancies has declined but remains high relative to history. The unemployment rate has inched up but remains low. The Kansas City Labor Market Conditions Indicators (LMCI), a model developed by my staff that combines 24 different labor market series into an aggregate measure, is signaling a healthy labor market that remains stronger than its historical average.

More broadly, growth has been running in the 3 percent range over the past year, a solid pace and a bit faster than what we saw prior to the pandemic. Strong consumption has been driving growth, and the trend looks to continue following robust holiday sales. One factor supporting consumption has been the strength of the labor market.

More people working means more disposable income, and higher income leads to more spending, which, in a beneficial cycle, supports further hiring. Another factor pushing up consumption has been generally healthy household balance sheets. Although not universally true, many households are in good financial shape with low debt-to-income ratios and the benefit of

strong asset price appreciation. While again not true for every household, across the entire economy, credit card data are showing few signs of financial stress.[2]

Overall, my read of the data is that we are currently pretty close to meeting our dual mandate of price stability and full employment, so where does that leave us as far as the path of policy? One can think of monetary policy as a two-part question. First, should the setting of policy be restrictive or accommodative? Second, is the current stance of policy restrictive or not?

With inflation close to target and growth showing continued momentum, I believe we are near the point where the economy needs neither restriction nor support and that policy should be neutral. This partly reflects the easing the Fed has already done, having lowered the policy rate by a full percentage point since September.

The second question is harder to answer than the first. Is the current target range for the policy rate at 4¼ to 4½ percent restrictive? Or is it close to neutral? I argued in a speech last November that there are many good reasons to expect that interest rates might settle at a higher neutral rate than we saw before the pandemic, including strong growth and investment demand, perhaps related to recent robust productivity growth and the prospect of exciting new technologies like artificial intelligence.[3]

More concerning, interest rates could also settle higher on account of the continued deterioration of the U.S. fiscal position and an abundance of Treasury borrowing that needs to be financed. My read is that interest rates might be very close to their longer-run level now. Regardless, I am in favor of adjusting policy gradually going forward and only in response to a sustained change in the tone of the data. The strength of the economy allows us to be patient.

Minimizing the Fed's Footprint

This brings me to my third resolution: to shrink the Fed's footprint in financial markets. As part of the policy response to the pandemic, the Fed doubled the size of its balance sheet, purchasing some $4.5 trillion in treasuries and mortgage-backed securities. At the time, these purchases helped keep financial markets functioning through a very stressful period while also

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[2] Jordan Pandolfo. "Consumer Credit Cards Show Few Signs of Financial Stress." Kansas City Fed Economic Bulletin. December 6, 2024.

[3] Jeff Schmid. "Longer-term Considerations for Growth and Monetary Policy." Remarks before the Omaha Chamber of Commerce. November 19, 2024.

providing economic stimulus by lowering longer-term interest rates. When the economy improved and inflation picked up, the Fed reversed course, and for over two years the Fed has been shrinking its balance sheet. Substantial progress has been made, with the size of the Fed's asset holdings declining by about $2 trillion from its peak. However, I would like to see even further declines this year.

Shrinking our footprint will lessen our distortion of asset prices. Our holdings are disproportionately weighted towards longer duration assets and continue to push down long-term interest rates. I would prefer to shift the composition of our balance sheet into shorter duration assets to minimize our impact. Also, I would prefer that we move towards holding only treasuries in our portfolio in line with previous communications from the FOMC.

We should minimize our impact on relative asset prices. Currently, this means moving out of mortgage-backed securities. Even more emphatically, I would strongly oppose using our balance sheet to intervene in any other asset classes. When it comes to relative prices, the Fed should remain neutral and allow markets to price assets without our influence.

Conclusion

They say most resolutions do not make it out of January. However, I feel good about our prospects in 2025. I am optimistic about the outlook and look forward to an interesting year of FOMC discussions and decisions. Thank you.