Remarks

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Thank you for having me. It is an honor to participate in the Kansas Bankers Association annual meeting. You have quite a lineup of speakers, and I am pleased to be part of such an esteemed group.

Today, I will speak to some issues of importance to the industry before turning to a discussion of the outlook for the economy and monetary policy.

Banking and the 10th District

It is exciting to see you once again. We were fortunate to host many of you in April at the Kansas City Fed for a Workshop on the Future of Banking, which was also attended by Gov. Bowman. That event was a recognition of the importance of banking to the nation's economy, but even more so a recognition of the importance of banks to the Tenth District. I will say here that the banking industry as a whole in the Tenth District, and specifically in Kansas, is in sound condition as a result of your leadership.

Our District is home to a large number of banks, most of which are small community banks. An understanding of and connection with community banks has long been part of the Kansas City Fed's DNA. As a former community banker myself, I will continue this tradition.

Locally focused banks, with their unique understanding of the challenges and opportunities of their communities, play a key financial and civic role across the country, and particularly in the rural geographies that make up much of the Tenth District. In serving the public, the Fed has an interest in the health of community banks. This includes understanding the unique issues facing community banks and working to prevent such banks from being disadvantaged relative to other financial institutions.

For this reason, it is important that bank regulators and supervisors take a tailored approach to manage the unique risks posed by different institutions. Effective supervision and regulation should ensure that the hundreds of regional and community banks in the Tenth District are safe and sound. But supervisory and regulatory frameworks should also acknowledge that a one-size-fits-all approach can come with significant compliance costs and threaten the ability of community banks to supply credit and deposit services to rural households, agricultural producers, and small businesses.

It is also important that regulation not disadvantage smaller banks. Small banks already maintain, on average, higher capital ratios than larger, more systemic banks. However, large banks continue to enjoy implicit funding subsidies that convey an unfair competitive advantage. It is important that we continue efforts to level the playing field to enable effective competition between small banks and larger more systemic institutions. Overall, adequate capital is at the heart of the resilience of the banking system. Since the 2008 financial crisis, the system has become much better capitalized. However, given the importance of capital, we should always work to make sure that capital is commensurate to the risk, especially for larger systemic organizations.

The Fed should also be aware of the challenges that smaller institutions face, especially in the context of rapid technological change, which has implications for cost and accessibility. One important development here is the launch of FedNow, the Federal Reserve's new 24/7/365 payment rail. FedNow is the Fed's first major new payment rail in over 40 years and aims to bring instant payments technology to all financial institutions, no matter their size or location.

Our continued commitment to discount window lending modernization is also helpful in reducing risks related to bank funding. I applaud the progress we have made to improve banks' operational readiness regarding discount window access. But I also agree with Dallas Fed President Lorie Logan's recent remarks that technological advancements and policy changes can further assist us in achieving our goal of making the discount window an effective liquidity risk management tool. Bankers also have a role to play and should prioritize their discount window readiness. A diversified funding stack is essential, and the discount window has a role to play.

Economic Outlook and Monetary Policy

I would like to turn now to an update on the current state of the economy and the outlook for monetary policy. Next year will be my first rotation as a voting member on the Federal Open Market Committee (FOMC), which has responsibility for setting the Fed's policy interest rate target. With that responsibility comes a need for transparency. It is important that I explain how I view the economy and how that view informs my take on appropriate policy.

Of course, my view of the economy is importantly shaped by my connections and conversations with individuals in the 10th District. The structure of the Fed, with 12 independent regional banks, was designed to collect views and information from across the country. This design, which has worked well for over 100 years, makes sure that the whole country has a voice in monetary policy. The vote on the FOMC is my responsibility, but it is not a decision I take in isolation.

It is helpful to review where we are now before turning to a more uncertain view of where we might be going. Following recent sharp movements in financial markets, it is important to stress that all discussions of monetary policy must be rooted in Congress's instruction that the Fed pursue a dual mandate of price stability and full employment. Of course, financial conditions can both reveal important information on the trajectory of the economy and can also spillover to impact the real economy. However, the Fed has to remain focused on achieving its dual mandate, and in recent years we have had our work cut out for us.

Price stability is defined as an inflation rate of 2 percent. Inflation at this pace is thought to be modest enough not to affect people's day-to-day decision making. The target is not zero so that the economy has some flexibility for relative prices to adjust over time. Since 2021, the Fed has been missing on this part of its mandate, with inflation peaking at a 40-year high in the middle of 2022. Accordingly, the Fed reacted, and quite strongly, increasing the policy interest rate 525 basis points over a short period of time and holding it there for the past year.

The inflation that we have seen over the past few years was caused by an imbalance in the economy, with demand for goods and services outpacing the economy's ability to supply those goods and services. In a market economy, when demand exceeds supply, prices go up.

By tightening monetary policy, the Fed's goal has been to slow the pace of demand growth to allow supply to catch up, closing the imbalance in the economy and relieving price pressure. Demand has eased and supply has increased, in part as pandemic-related disruptions to production cleared up. And inflation has come down, falling from over 7 percent at its peak to 2½ percent by the middle of this year, much closer to our 2 percent objective. We are close, but we are still not quite there.

The most recent monthly price numbers have also been encouraging, with inflation easing across a wide cross section of goods and services. Given this data, I am more confident that inflation is on a path to return to our target. But the price data can be volatile, and it is standard practice to look at inflation over longer periods of time to smooth through the monthly ups and downs. Given the multi-decade shock to inflation that we have experienced, we should be looking for the worst in the data rather than the best. However, if inflation continues to come in low, my confidence will grow that we are on track to meet the price stability part of our mandate, and it will be appropriate to adjust the stance of policy.

The outlook only gets more uncertain from there. My view, as outlined earlier this year in remarks at the Kansas City Fed's Agricultural Symposium in Omaha,[1] is that while the current stance of policy is restrictive, it is not that restrictive.

This view is based in part on the resilience of the economy and growth over the past two years even as interest rates climbed sharply higher. Of course, last week's employment report for July led many to question this resilience. But it is important to note that many other indicators point to continued strength. Real GDP increased over 3 percent last year, faster than any year but one in the decade prior to the pandemic, notwithstanding the low interest rates of that era. More recently, real GDP increased a further 2¾ percent in the second quarter, supported by the continued strength of consumer demand and solid investment spending, and while it is admittedly early, indicators for the third quarter show these trends continuing. Even more important, as I talk to contacts in the region, I continue to hear a general tone of optimism and resilience.

Returning to last week's labor market data for July. The rise in the unemployment rate to 4.3 percent has certainly refocused attention on the employment side of the Fed's mandate. Across many indicators, there has been a noticeable cooling of the labor market from the historically tight conditions of 2023 and 2022. But overall, the labor market still appears healthy.

At the Kansas City Fed, we combine information from 26 labor market indicators into what we call the KC Labor Market Conditions Indicator (or LMCI).[2] Looking much broader than the unemployment rate alone, the labor market still appears to be quite strong by this measure. This aligns with my discussions with district contacts, which generally acknowledge a cooling of the market but not a sense of widespread disruptions or declines. At this point, the cooling of the labor market can be viewed as a necessary condition for the easing of inflation that we have experienced. Imbalances in the labor market were a key factor keeping inflation high, and a looser market was needed to bring inflation down. However, this story could change if conditions were to weaken considerably more.

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[1] See https://www.kansascityfed.org/Speeches/documents/10168/2024-Schmid-Omaha-05-14.pdf.

[2] See https://www.kansascityfed.org/data-and-trends/labor-market-conditions-indicators/.

The path of policy will be determined by the data and the strength of the economy. With the tremendous shocks that the economy has endured so far this decade, I would not want to assume any particular path or endpoint for the policy rate. This is to say the data and the performance of the economy should guide policy rather than a presumption that we must return to some pre-pandemic perception of normal. I will be carefully watching the data and gathering information on growth, jobs, and inflation as I judge the appropriate path for policy. Thank you.