

The Outlook for the Economy and Monetary Policy

Remarks by

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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.

Welcome to the Kansas City Fed's Agricultural Economic Summit. Omaha Branch Executive and Senior Vice President Nate Kauffman has organized an impressive gathering, and I thank each of you for being here. As leaders in your field, I recognize the value of your time, and I appreciate your commitment in attending this event. Likewise, my Fed colleagues and I are committed to listening and learning from the discussion today and tomorrow. Events like these play a critical role in the Fed's mission. By engaging with a wide cross section of industry and society, the Fed receives necessary information and input to guide the nation's monetary policy. The strength of this network has helped make the Federal Reserve one of the most successful central banks in the world.

The Federal Reserve's effectiveness is rooted in its 12-district regional structure. Having 12 geographically defined Federal Reserve regions, each represented by a different Bank, allows for the efficient and effective collection of diverse views on the economy while also strengthening relationships with the communities we serve and ensuring that all segments of the economy have a voice in monetary policy. The system continues to work very well and is a credit to the vision of its creators.

For the Kansas City Fed, agriculture is an important element of our distinct voice, as is energy, the theme of this year's summit. Agriculture touches all 12 Federal Reserve districts, but its imprint is particularly large in the seven-state region covered by the Kansas City Fed. We devote a fair amount of time, led by Nate Kauffman, to analyzing and reporting on the sector and events like this further strengthen our bond.

The agricultural economy in our region, and nationally, has gone through significant changes over the past 10 to 15 years, with many of those changes tied to evolving global demand for agricultural products. Growth in emerging economies, such as China, and the rise of biofuels are two examples of factors that have shaped long-term demand for key agricultural commodities in the U.S. and globally. As we look ahead to factors that may further shape agriculture over the next decade, we recognize that demand for energy, and renewables in particular, will continue to play a significant role.

As we look to understand how the structure of agriculture might evolve in the years ahead, I am here as an information consumer, to listen and learn from the experts in the room. However, since now is my time on the agenda to be a producer, I will turn to my views on the overall economy and the outlook for monetary policy.

Substantial Progress but Challenges Remain

At the end of 2022, with inflation running near a 40-year high and the Fed in the middle of a historic tightening cycle, almost everyone was asking how much of a slowdown was it going to take to bring inflation back down towards the Fed's 2 percent objective. The consensus answer at the time was quite a bit. The majority of professional forecasters predicted a recession in 2023. But we didn't have a recession. Instead, the pace of economic growth more than doubled even as inflation halved, all while the unemployment rate remained near all-time lows.

Despite this relative success, challenges remain. Primarily, inflation is still too high. The Fed is committed to bringing inflation back to its 2 percent objective. So far this year, prices have been increasing at about twice that pace, suggesting that the Fed has more work to do.

We have seen a substantial shift in the underlying drivers of inflation over the past two years. Goods price inflation has eased considerably, as pandemic-related production disruptions faded and supply chains healed. In contrast, services price inflation has remained firm, supported by a tight labor market.

Part of the strength of services inflation has been rents and the cost of housing. Rents have been supported by strong income growth and the healthy labor market. When a worker gets a job, they often want to upgrade their living space, and a tight labor market has historically driven higher rents and housing costs.¹

However, the strength of services price inflation has been broader than rents alone. Services tend to be very labor intensive, so a tight labor market can be an important driver of inflation in this area. And it is not just that the cost of labor tends to increase with labor market tightness. If businesses are not able to hire sufficient labor, increasing prices is one way to balance supply and demand for their products and services independent of what they are doing with wages.

To recap, inflation is too high on account of a continued imbalance between the strength of demand and the economy's ability to produce enough supply to meet that demand. Whereas with the start of the recent inflation, this imbalance was most apparent for goods. Now the imbalance has moved to services and housing.

¹ ["A Tight Labor Market Could Keep Rent Inflation Elevated."](#) Lee Smith, Brent Bundick, and Luca Van Der Meer. *Economic Bulletin*. Federal Reserve Bank of Kansas City. March 1, 2023.

Though elevated inflation is always painful, it is important to note that inflationary periods are not the same. The high inflation of the 1970s and early 1980s was rooted less in a strong economy than in the psychology of price setting. During that period, prices increased because firms and workers expected prices to go up, even though the economy was not particularly strong.

Today, inflation expectations remain relatively low and anchored. The inflation we are seeing is coming from strong demand and an imbalance in the economy. It is important that the Fed act to preempt inflation from becoming ingrained into the price-setting process, a development that would make lowering inflation all the more difficult.

The Path Forward

With the current imbalance-driven inflation, the Fed's approach is relatively straightforward. The Fed must hold back demand growth until supply can catch up and the imbalance that is driving inflation closes. This is what the Fed is doing. By increasing the policy rate by 5¼ percentage points over the past two years, the Fed has tightened financial conditions and slowed demand growth.

While the overall economy remains strong, there are signs that the imbalances driving inflation are easing. The labor market has come off a historic boil by many measures. At the peak, there were over two available job postings for every person reporting themselves as unemployed. More recently, this number has fallen below 1½ postings for every unemployed person, which is still high but is easing back. We have also seen a decline in the rate at which workers are quitting their jobs. When the labor market was very tight, workers were quitting at a historic rate, either as they found new jobs or expected to find them quickly.

The Fed works on inflation by easing demand, but our job is made easier by increases in supply. An increased supply of goods and services can also close imbalances and lower price pressure. Recently the supply outlook has improved, with solid growth and increased productivity. The decline in the quits rate has been one factor boosting labor productivity and the supply side of the economy. Worker churn during the peak of labor market tightness and the associated high hiring and training costs were a drag on the productive capacity of the economy. As the labor market cools, this drag on productivity has dissipated, boosting supply and easing inflation.

Over time, I expect inflation to ease back towards the Fed's 2 percent objective. I am prepared to be patient as this process plays out. This will require a data-dependent approach that looks at the data over time rather than loading too much weight on any one release. Although there is an eagerness to spot turning points, I prefer a steady approach to policy, and one that dampens the volatility in financial markets rather than contributes to it.

Interest Rates Could Stay Higher for Longer

That said, my own view is that interest rates could remain high for some time. The economy has undergone seismic shifts so far this decade. I have no certainty that we are headed back to the low interest rate environment that prevailed in the decade prior to the pandemic.

One factor that I view as particularly important here is the prospect of continued large fiscal deficits and the tremendous expansion of government debt, both in the United States and throughout the world. Prior to the pandemic, one often-cited explanation for the relatively low interest rates of the period was high demand for safe assets, including government debt, relative to the supply of those assets. Increased demand from financial institutions as well as strong growth in China and emerging markets had boosted demand for such assets, bidding up their price and holding down interest rates across the yield curve.

However, now this demand has cooled even as the supply of government debt has jumped and is expected to continue growing at a very rapid rate. As such, it is possible that the balance of demand and supply for government debt will shift from a factor holding down interest rates to a factor boosting interest rates.

Importantly, shifts in supply and demand for safe assets influence interest rates independent of the Fed's actions. Though the Fed is not a passive bystander and plays a role in setting short-term interest rates, it can't perpetually deviate rates from market forces without risking its mandates for maximum employment and price stability. In this way, the Fed takes fiscal decisions as given and steers monetary policy in the appropriate direction to achieve its dual mandate.

In the end, large fiscal deficits will not be inflationary because the Fed will do its job and achieve its inflation objective, through in doing so the outcome could be persistently higher interest rates. This relationship is also at the crux of the rationale for the political independence of the central bank. Political authorities could very well prefer that deficits not lead to higher

interest rates, but history has shown that following through on this impulse has often resulted in higher inflation. An independent central bank insulated from immediate political pressure and guided by a clear inflation objective has historically been an effective means for achieving and maintaining low and stable inflation.

The Fed's Balance Sheet

In part, central bank independence also motivates my position on another aspect of Fed policy, the size and composition of the Fed's balance sheet. As part of the policy response to the pandemic, the Fed embarked on a historic expansion of its balance sheet, purchasing trillions of dollars of Treasuries and mortgage-backed securities. With the short-term policy interest rate stuck at zero, the purpose of these purchases was to depress longer term interest rates and stimulate economic activity. With the economy recovering and price pressures growing, the Fed appropriately started to reverse these purchases in the middle of 2022, allowing maturing securities to roll off and shrinking its balance sheet by \$1.5 trillion relative to its peak.

At the FOMC meeting two weeks ago, the committee announced that it would slow the pace of this run off starting in June. The idea is that a slower pace will allow for a safer and less disruptive approach to the balance sheet's ultimate size as determined by bank demand for reserves, the Fed's primary liability.

While I understand this rationale does not imply that the balance sheet will end up being any larger in the end, I would still reconfirm my preference to shrink the balance sheet as much as possible 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 cost. I am focused on three costs in my preference for a relatively aggressive approach to balance sheet reduction:

1. First, a large balance sheet weighs on longer-term yields, distorting the price of duration in financial markets and potentially leading to distortions in the allocation of credit. A smaller balance sheet concentrated in shorter duration securities would lessen this distortion.

2. 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.
3. And third, as I alluded to earlier, 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.

In conclusion, I believe policy is in the correct place, and with patience we are on a path to achieve our policy objectives. However, nothing is certain and continued vigilance and flexibility are necessary.

Thank you again for joining us in Omaha, and I look forward to our discussion.