

The Economic Outlook 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

Thank you for the opportunity to speak with you today. Welcome to the Kansas City Fed. I know many of you have been here before, and it is nice to have you back. But to those who have not visited before, it's great to have you in the building. One of the benefits of the Fed's structure, with 12 regional banks spread across the country, is that it allows a level of interaction that would not be possible if all our operations were centralized in Washington. We are your Fed. You should have a connection with this institution, and I hope that being here today will make that connection more immediate and real.

We are two weeks into 2026, and while I would like to keep my eyes on road ahead, I keep glancing back, a bit concerned that the developments of 2025 might not be done with us quite yet. Last year introduced a fair amount of uncertainty into the economic outlook—uncertainty that I don't think has been resolved, including the effect of higher tariffs on prices and output as well as the potential outcomes of the tremendous surge in artificial intelligence investment on financial markets, productivity and employment.

But before diving into the outlook, I would like to take a minute to look even further back. This year marks the 250th anniversary of the independence of our great nation, and we have a lot to celebrate. The United States has been a tremendous experiment in political representation, economic organization and freedom. We have a lot to be proud of. We represent about a fifth of the global economy. Our innovation sector is the envy of the world, as is the productivity growth that underpins increases in living standards. Closer to the Fed and its responsibilities, the creation of the Federal Reserve over 100 years ago established a system that could elastically supply liquidity when needed, reducing financial stress and panic and providing confidence. The resulting stability of our financial system helped to establish the U.S. dollar as the predominant global currency, lowering our trade and financing costs relative to other countries.

Part of what has made America so successful has been its decentralized federal system. Distributing authority encourages decision-making to take account of local conditions. The Federal Reserve, with 12 distinct regional banks working alongside the Board of Governors, embodies this national belief in decentralization. This model for managing monetary policy is uniquely American. I spend a lot of time here in Kansas City; in our branches in Denver, Oklahoma City, and Omaha; and throughout the district talking to business and community leaders about the economic conditions they face and the problems that they are solving. These

conversations inform my views on the economy and provide the input I need as I travel to Washington to participate in the Federal Open Market Committee (FOMC) meetings that set monetary policy.

The decentralized Federal Reserve System is also important for what I call monetary operations. The reality is that the vast majority of the work done at the Kansas City Fed and carried out by the public servants that fill this building is not related to monetary policy but rather monetary operations. This includes maintaining the payments infrastructure that is the circulatory system of our \$30 trillion economy. The payment system is essential to our economic health and must work consistently, safely and securely.

The staff in this building are also essential to the flow of money into and out of the U.S. Treasury. The Fed acts as the Treasury's banker, and staff here are integral to the daily transfer of billions of dollars, from social security to disaster recovery payments.

We also help ensure the safety and soundness of banking institutions throughout our seven-state region, bringing local knowledge and understanding to our interaction with district bankers. By enhancing confidence in the security of institutions of all sizes, our examiners help level the playing field and support the many smaller banks operating in the rural communities that help define our region.

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The decentralized Fed also allows for differing views on the correct course of monetary policy. This is a strength of the system. Policy discussions are stronger when they incorporate a diversity of views. In October and December, the Federal Open Market Committee voted to lower the policy interest rate and ease the stance of monetary policy. The Fed sets policy to achieve its Congressionally mandated goals of full employment and price stability. One way to interpret the recent rate cuts is that the Committee had become a little more worried about the employment side of its mandate and a little less worried about the inflation side.

My preference at both meetings, as reflected in my vote, was to leave the policy rate unchanged. My reasoning was based on three factors. First, inflation remains too high. Second, I believe that cutting rates could disproportionately harm the inflation side of our mandate without providing much benefit to the employment side. And third, I don't think that monetary policy is currently very restrictive. I will elaborate on these points in turn.

Inflation

Inflation is too high. Inflation is running around 3 percent, which is above the Fed's 2 percent objective. Last year's government shutdown disrupted the collection of official data, and, although the flow of data has resumed, the effect of the shutdown on the quality of the data will likely persist through the first part of this year. That said, what data we do have, including this week's CPI release for December, is consistent with an inflation rate that remains close to 3 percent.

Over and above the official data, prices and inflation remain a top concern in my discussions with District contacts. These concerns show up in our regular survey of Tenth District manufacturing firms. In December, these firms reported rising input prices and an expectation for further increases in the months ahead. While firms report moderating wage pressure, I have heard quite a bit about rising healthcare premiums. Inflationary pressures could build further if firms raise selling prices to offset these higher costs. To this point, a national survey of small businesses showed a sharp increase in the percentage of firms reporting higher average selling prices at the end of the year, with the index increasing to a post-pandemic high.

There are some encouraging signs on inflation. Housing costs and rents are moderating. While I am hopeful that price pressures will ease, I am reluctant to step back until I see more convincing signs that overall inflation is headed in the right direction. Both non-energy goods and non-housing services inflation—categories that together account for roughly 80 percent of consumer spending—remain above levels that have historically been consistent with the Fed's 2 percent inflation target. Price increases across goods are widespread, including food prices, which are especially salient for households. Along with food, rising electricity prices are receiving a good deal of attention in many communities, and these costs are likely to continue to climb. This was noted during the energy conference we hosted towards the end of last year with the Dallas Fed, where it was highlighted that the power sector is struggling to keep up as higher demand stresses an aging infrastructure. Meanwhile, significant new capacity is likely years away.

The Fed's job, as I see it, is to set interest rates to maintain the balance between economy-wide supply and demand, and the best indicator of that economy-wide balance is the

overall inflation rate. With inflation too high, prices are sending us a signal that demand growth is outpacing supply growth.

Inflation has been above the Fed's 2 percent objective for over four years. I don't think we have room to be complacent. History has shown us that persistent inflation can shift the psychology around price-setting, and inflation can become ingrained. Were that to occur, re-anchoring inflation at 2 percent would be more difficult and costly. It is unlikely in that situation that we will still be talking about soft landings. As I have said before, I take small comfort in most measures of inflation expectations having not moved up. I view inflation expectations not as an input into the Fed's decisions, but as the outcome of the policy decisions that the Fed makes.

Looking back over the past few decades, one of the greatest economic policy successes, for the Fed, for the country, and perhaps for the world, has been the decline in worries about inflation. It is not just that the level of inflation had decreased, but also households' and businesses' perceived risk that higher inflation could happen again. The declining risk of inflation for most of the past three decades has had real benefits, allowing greater certainty and better planning.

My concern is that we risk moving away from a world where, to quote former Chair Greenspan, "inflation is so low and stable over time that it does not materially enter into the decisions of households and firms." In 2019 only 1 percent of small businesses reported inflation as their most important problem. In December, 12 percent of small businesses reported inflation as their number one problem. We should never underestimate how much people hate inflation—and for good reason. Inflation is an economic thief. Holding all else equal, a 1 percentage point increase in inflation lowers the purchasing power of U.S. household income by close to \$300 billion. Though I believe our credibility on inflation remains intact, I don't think we can be complacent, and the costs of losing that credibility are high.

The Labor Market

Which leads me to the second factor informing my views on monetary policy and my preference for keeping interest rates unchanged. I believe that there is a risk that lowering rates could do more harm to the inflation side of our mandate than benefit on the employment side.

The labor market has clearly cooled in recent months. The pace of job creation has fallen off sharply and the unemployment rate has climbed. Other indicators are more mixed. The number of new claims for unemployment insurance, a sign of layoffs, remains near record lows. And a large part of the step down in job growth reflects the departure of federal workers from government service. A useful summary of the sometimes conflicting data is the Kansas City Fed’s Labor Market Conditions Indicator, released monthly and accessible on the Bank’s website.¹ I encourage you to check this out. This measure, which combines 24 different data series into a single indicator of labor market health, has been cooling but remains a touch above its historical average.

Overall, the data suggest a low-fire/low-hire labor market. A possible explanation is that this is just the flipside of the labor market we saw coming out of the pandemic. An extremely tight labor market in 2022 and 2023 led to an outbreak of labor hoarding as firms held on to as many workers as they could, worried that they would not be able to hire to replace turnover. Now that the labor market has cooled, firms are finding that they are well stocked with workers and able to accommodate attrition without having to hire. This certainly aligns with what we have been hearing from regional contacts—that headcount reductions are occurring primarily through attrition rather than layoffs.

In addition to this dynamic, there are large-scale structural changes that are also affecting the labor market. First, the United States is at a demographic inflection point, which, in combination with a dramatic decrease in immigration, has led to a deceleration in the growth of the workforce. A smaller workforce leads to both fewer new jobs and fewer unemployed people looking for jobs. Estimates by my staff suggest that an aging population and declining immigration could lower the breakeven level of employment growth—that is, the pace of job creation needed to keep the unemployment rate flat, to somewhere in the vicinity of 50,000 jobs per month.²

On top of the demographic changes, we are all hearing quite a bit about AI and the potential impact on hiring. Almost every firm I have talked to has expressed interest in utilizing AI and is weighing any increase in head count against an AI alternative. The structural

¹ See <https://www.kansascityfed.org/data-and-trends/labor-market-conditions-indicators/>.

² “[Declining Immigration, Aging Population Reducing Breakeven Employment Growth](#)” by Yusuf Mercan. Kansas City Fed *Economic Bulletin*. Oct. 15, 2025

undercurrents affecting the labor market suggest that monetary policy might not be the right tool to address the cooling labor market. Monetary policy is best suited to address cyclical downturns in the labor market coming from a shortfall in demand. As such, I do not think further cuts in interest rates will do much to patch over any cracks in the labor market—stresses that more likely than not arise from structural changes in technology and immigration policy. However, I worry that cuts could have longer-lasting effects on inflation as our commitment to our 2 percent objective increasingly comes into question.

The Restrictiveness of Policy

Which brings me to the third factor shaping my view on interest rates—that the current stance of policy does not seem very restrictive to growth or economic activity. The economy grew by 4.3 percent in the third quarter of 2025, the fastest pace in two years and far above recent historical trends. Consumption growth has been strong, as has investment spending, especially for IT-related capital goods. Looking ahead, changes in tax policy and deregulation are likely to spur additional business investment and support consumer spending, further boosting demand in the new year.

Discussion of the restrictiveness of policy is often wrapped up in the academic conversation around the neutral interest rate or r^* . Simply put, the neutral interest rate is the theoretical rate at which monetary policy would neither restrict nor boost growth. Before the pandemic there was a widespread understanding that the neutral rate had declined. One way to see this is that when the interest rate was set to zero for an extended period of time, economic growth remained lackluster and inflation did not pick up. Even at zero, interest rates were not stimulating much activity. The low neutral rate during this time was attributed by many to a high desire of savers to save and a low desire by investors to invest. Some called this a saving glut, while others preferred to call it an investment drought. Regardless, the imbalance between desired saving and desired investment put downward pressure on equilibrium interest rates and hindered the ability of monetary policy to stimulate growth.

Where are we now in regard to the neutral interest rate? Long-term interest rates are quite a bit higher now than they were in the decade before the pandemic. The yield on the 10-year Treasury is about 4.2 percent compared to an average of 2.4 percent throughout the 2010s. All

else equal, higher interest rates might be expected to push down investment and push up saving. But that is not what we are seeing.

Last year, investment ran at about 21½ percent of GDP, about 1 percentage point higher than in the 2010s. In contrast, the economy-wide saving rate has fallen by almost 2 percentage points over the same period. Even though interest rates are higher than in the 2010s, the economy is saving less and investing more. This suggests the saving glut or the investment drought—whichever you prefer—that was weighing on interest rates prior to the pandemic has diminished. As such, the data suggest to me that the neutral interest rate in the economy has moved up and that the current stance of policy, which well could have been restrictive before the pandemic, is no longer very restrictive now.

With inflation pressures still evident, my preference would be to keep monetary policy modestly restrictive. And I will judge the restrictiveness of monetary policy by how the economy evolves, both in the data and based on what I'm hearing from contacts. Right now, I see an economy that is showing momentum and inflation that is too hot. And while the labor market has cooled, some cooling is likely necessary to keep the inflation outlook from worsening. I see little reason at this point to further lower the policy rate, though of course, I will be watching the data closely for signs that growth is losing momentum or that the labor market is weakening more substantially.