The Importance of Prices and Price Stability Remarks

by: Jeffrey Schmid

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Thank you for the opportunity to speak today at the 2024 Agricultural Commodity Futures Conference hosted by the Commodity Futures Trading Commission and the Center for Risk Management Education Research at Kansas State University. A special thank you to our hosts, Joe Parcell and Emily Garwood from Kansas State, and Chuck Marvine and Russ Behnam from the CFTC. Russ was kind enough to provide the keynote for the Kansas City Fed's National Ag Credit Conference last month. These types of cross-institution events are crucial for helping us understand key economic issues in the agricultural sector.

Agriculture plays an important role in the economy, especially in this part of the country. While locally important, the factors that influence the ag economy are often global. Commodity markets are subject to shifting weather patterns, swings in global growth, and geopolitical developments. Commodity prices adjust quickly to these influences and provide a real-time signal on the balance between supply and demand. Commodity futures markets help communicate supply and demand conditions to a wider audience and allow users and producers to hedge price risk. The CFTC plays an important role in promoting the integrity and resilience of these markets through effective regulation.

Just as in commodity markets, prices and inflation in the broader economy also reflect the balance between supply and demand. And, as we have witnessed in recent years, a persistent imbalance between the two can lead to prolonged episodes of elevated price inflation.

In my remarks this afternoon, I will offer my thoughts on the evolution of imbalances in our economy and their implications for our progress towards low and stable inflation as well as for the appropriate path of monetary policy.

Inflation and Wages

Congress has provided the Federal Reserve with two monetary policy mandates: price stability and maximum employment. The Fed interprets price stability to be consistent with a 2 percent inflation objective as measured by the annual change in the personal consumption expenditures (PCE) price index. This measure aims to capture price movements across the vast array of goods and services purchased by consumers.

During the post-pandemic economic recovery, inflation surged above 7 percent, a 40-year high, as robust demand ran up against supply bottlenecks and constraints on production. Although inflation has stepped down significantly since the Fed began raising interest rates in 2022, it remains above the 2 percent definition of price stability. Inflation has surprised to the upside since the beginning of the year and has run at roughly a 4 percent annual rate during the first quarter. This recent data underscores what I believe is the need for the Federal Reserve to be patient as we wait for clear and convincing evidence that inflation is on track to sustainably return to 2 percent.

Looking ahead, I will be watching three factors to monitor progress towards our inflation goal:

- First, the tightness of the labor market and consequent upward pressure on labor-intensive service prices.
- Second, the potential for an increased supply of labor to relieve labor market tightness.
- And third, the risk that renewed supply chain challenges could provide an unwelcome boost to inflation.

Elaborating further on the first factor: Elevated services price inflation is now the primary driver of overall inflation in the economy.[1] For example, higher prices for healthcare services contributed significantly to the rebound in inflation since the beginning of the year. The production of many services tends to be labor intensive. As a result, strong services prices are being supported by the tightness of the labor market and the ongoing imbalance between the economy's demand for workers and the available supply of labor.

And the demand for labor continues to be strong. This is evidenced by robust hiring and elevated wage growth. So far this year, firms added an average of 270,000 jobs per month to their payrolls, far above the historical norm. Postings for new positions also remain elevated, while initial claims for unemployment insurance have remained low for some time now.

Indirectly, the ongoing tightness in the labor market has also pushed up the cost of housing, an important contributor to the current strength of overall inflation. New work arrangements and changing preferences increased the demand for living space during and after the pandemic, leading to a rapid increase in house prices and rents. After peaking near 9 percent in 2022, rent inflation moderated significantly last year. However, the contribution of rents to overall inflation remains well above its the pre-pandemic rate. Research by staff at the Kansas City Fed suggests that the ongoing tightness in the labor market could keep rent inflation elevated for some time.[2] Job gains and wage increases put upward pressure on rents and housing prices as income growth increases household demand for additional and higher-quality living spaces.

A second factor I will be watching is the outlook for the supply of labor. Last year, the economy experienced a large increase in the workforce, especially among women aged 25-55. In addition, the economy experienced a post-pandemic rebound in immigration over the last year. This improvement in the economy's ability to supply labor helped to ease tightness in the labor market.

Despite these improvements in the supply of labor, wage growth continues to signal an imbalance between labor demand and the number of available workers to meet that demand. While wage growth has moderated from its recent peak, it remains elevated compared to early periods and likely is continuing to put upward pressure on services prices.

Looking beyond wages, the Kansas City Fed's Labor Market Conditions Indicators (LMCI) provide another way to measure the ongoing tightness in the labor market. These indicators, which are published monthly on the Kansas City Fed's website, summarize many different labor market variables into measures of activity and momentum.[3] According to the most recent LMCI, activity in the labor market remains well above its longer-run average level, suggesting that the labor market remains tight relative to its historical norm.

A third thing I will be keeping an eye on is a potential reacceleration in goods inflation. As robust demand for goods ran up against supply bottlenecks during the post-pandemic recovery, prices for many goods rose rapidly and contributed significantly to the overall increase in inflation. While prices for goods have been roughly flat over the past year, recent disruptions to global shipping imply some upside risk to goods prices going forward. Relatedly, energy prices are also up significantly since the beginning of the year, which poses an additional headwind to sustainably low and stable inflation.

Ultimately, achieving better balance in the labor market will likely be necessary for Federal Reserve policymakers to deliver on our price stability mandate and achieve 2 percent inflation. However, uncertainty remains as to the role that improvements in labor supply will play versus slower labor demand in rebalancing labor markets. While I welcome the significant growth witnessed in the economy's workforce last year, it remains unclear whether this rapid pace of supply improvement will continue going forward.

The Outlook for Monetary Policy

With inflation still running above 2 percent and labor markets still tight, it is appropriate that monetary policy remain restrictive. Over the past two years, the FOMC has raised the federal funds rate by over 500 basis points and has started to unwind the large portfolio of security holdings it amassed on its balance sheet. All of this is an effort to help rebalance demand and supply in the economy and restore price stability.

Even with these actions, the demand for goods and services has displayed remarkable resilience to higher interest rates. The economy continues to grow at a pace well above its longer-run trend. Much of this increase in overall growth has been driven by strong consumer spending. With increasing house prices and equity markets near all-time highs, the strength of household balance sheets appears to be encouraging households to spend rather than save despite the high interest rates. Accordingly, the household savings rate remains near historic lows.

Similarly, in the agricultural sector, although farm incomes are expected to be down this year, they remain above their pre-pandemic levels. While higher interest expenses and reduced incomes may be weighing on some highly leveraged producers, the overall financial picture in agriculture remains strong. Most lenders report that the credit quality of their farm portfolio has been strong, loan delinquencies are still historically low, and profits of recent years continue to support strong balance sheets. In addition, despite the increase in interest rates over the past two years, farmland values remain firm alongside relatively strong global demand for agricultural products. The strength of global demand for agricultural products is a topic we will explore further in an event next month in Omaha, where we will look forward to connecting with a variety of businesses tied to agriculture to hear their thoughts on longer-term factors shaping commodity markets.

This ongoing resilience in the economy creates some uncertainty about the path of the federal funds rate that will be needed to restore price stability. With inflation running above target, economic growth continuing to show momentum, and elevated prices across a range of asset markets, the current stance of monetary policy is appropriate. Therefore, rather than preemptively adjust the policy rate, I would prefer to be patient and wait for clear and convincing evidence that inflation is on track to hit our 2 percent target before adjusting the stance of policy.

The Outlook for the Federal Reserve's Balance Sheet

Now, I'd like to turn to another one of the Fed's policy tools: its balance sheet. While the level of the federal funds rate has held steady since July of last year, the Fed has continued to shrink the size of its balance sheet. As I see it, reducing the Fed's balance sheet is important for two reasons. First, balance sheet reduction helps reduce the overall degree of policy accommodation at time when policy should remain restrictive. And second, moving towards a smaller balance sheet is important to lessen the Fed's footprint in financial markets.

For some context, the balance sheet grew significantly as the Fed responded forcefully to the COVID-19 pandemic. To help stabilize the economy, the Federal Reserve purchased large quantities of Treasuries and agency mortgage-backed securities. These purchases were carried out to reduce long-term interest rates and ensure financial markets continued to function amid lockdowns and historic uncertainty. Consequently, the Fed's balance sheet more than doubled from just under $4.5 trillion in 2019 to nearly $9 trillion in 2022. To fund these purchases, the Federal Reserve expanded the quantity of reserves in the banking system.

Since June of 2022, the FOMC has reduced its holdings by more than $1.5 trillion. However, the balance sheet remains large and continues to put downward pressure on long-term interest rates. With inflation running above target, a tight labor market, and historically high equity valuations, the economy and financial markets no longer require support from a large central bank balance sheet. Rather, given the state of the economy, my preference is for a much smaller balance sheet with a shorter average maturity.

The Fed's large balance sheet and footprint can also obscure price signals and distort financial markets. Our holdings put downward pressure on longer-term rates and flatten the yield curve. This stresses the traditional model of borrowing and lending central to the health of many community banks. In addition, the Federal Reserve continues to hold a large fraction of the total outstanding stock of agency mortgage-backed securities. These significant holdings could distort the allocation of credit and lead to future imbalances. As the Committee discussed in its Principles for Reducing the Size of the Balance sheet,[4] I believe our balance sheet should primarily be composed of Treasury securities to minimize the effect of the Fed's holdings on the price and allocation of credit in the economy.

The Fed's large balance sheet is also suppressing price signals in funding markets. Fluctuations in interbank lending rates provide timely signals to market participants about liquidity conditions in funding markets. For some time now, the federal funds rate has traded consistently 7 basis points below the interest rate on reserve balances and shown no sensitivity to fluctuations in reserves. This suggests that liquidity remains abundant. These price signals imply that our current pace of balance sheet reduction is not creating strains in funding markets.

However, unlike our previous balance sheet normalization in 2019, the Federal Reserve has established the Standing Repo Facility, and banks have shown a greater willingness to use the discount window. If runoff began to unexpectedly stress funding markets and the spreads in the interbank market rose significantly, these liquidity tools would be available to prevent a significant increase in short-term market interest rates. As we learn about broader liquidity demand in the system through these price signals, I believe it will be important to tolerate some more normal volatility in interest rates.

Tolerating some interest rate volatility during runoff could improve the longer-term health of funding markets, which may allow the financial system to operate with fewer reserves. With a constantly evolving financial system, the appropriate amount of reserves needed to efficiently conduct monetary policy will not be defined by a fixed quantity but rather the ability of the financial system to redistribute that liquidity as needed.

Consistent with the theme of my remarks today, price signals from markets will be necessary to help properly allocate this liquidity. Stopping balance sheet runoff too early poses a risk of further weakening the channels of liquidity redistribution. Along these lines, completely smothering rate volatility could make the interbank market less resilient and sow the seeds of future financial market instability.

Conducting Policy Under Uncertainty

With various unknowns surrounding the macroeconomic outlook, knowing the exact future course of monetary policy is always difficult. Jim Collins, the author, has been influential in my thinking as a leader throughout my career. In his book, *Great By Choice*, he says that, "None of us can predict with certainty the twists and turns our lives will take." In a rapidly evolving economic and financial landscape only four years after the outbreak of a global pandemic, this statement resonates with me.

As a policymaker though, I *am* certain that my colleagues and I on the FOMC will take necessary actions to restore price stability and achieve maximum employment. For now, I view the current stance of monetary policy as appropriate to achieve those objectives. Going forward, I'll be watching for further signs of progress in returning inflation sustainably back to our 2 percent target.

Endnotes

[1] See Supercore PCE Inflation Surged in January to Its Highest Monthly Level in More than Two Years, by Jordan Rappaport, A. Lee Smith, and Shu-Kuei X. Yang.

[2] See A Tight Labor Market Could Keep Rent Inflation Elevated, by Brent Bundick, A. Lee Smith, and Luca Van der Meer.

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

[4] See https://www.federalreserve.gov/newsevents/pressreleases/monetary20220126c.htm

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Jeff Schmid is president and chief executive officer of the Federal Reserve Bank of Kansas City. He represents the Tenth Federal Reserve District on the Federal Open Market Committee, which sets monetary policy for the United States.Schmid leads a workforce of nearly 2,000 professionals engaged in the work of the central bank, including monitoring economic conditions, supervising banking institutions, and providing financial services to banks and the United States government. Through offices in Kansas City, Denver, Oklahoma City and Omaha, the Bank serves a seven-state region that includes western Missouri, Kansas, Nebraska, Oklahoma, Colorado, Wyoming, and northern New Mexico. As Bank president, he hosts the annual Jackson Hole Economic Policy Symposium, bringing together international central bankers, academics, and policymakers to discuss economic and financial policy issues.Among the Bank's accomplishments under his leadership is the implementation of a five-year strategy aligning the Bank's efforts in serving the Tenth District. It is focused on deepening and expanding talent investments, leveraging expertise in technology and artificial intelligence, maximizing regional connections and communications, and advancing value-added analytics.Schmid has more than 40 years of experience in banking and bank supervision. Prior to joining the Kansas City Fed in August 2023, he served as the president and CEO of the Southwestern Graduate School of Banking Foundation at Southern Methodist University's Cox School of Business, which focuses on bank leadership and strategic planning for community banks.Among his banking experience, he led Mutual of Omaha's entry into banking sector, serving as chairman and CEO of Mutual of Omaha Bank which served depositors and borrowers nationwide.Jeff is a graduate of both the University of Nebraska-Lincoln and the Southwestern Graduate School of Banking at SMU. He is a native of Nebraska.Explore his latest speeches, outreach and more on the Office of the President page.See Jeff Schmid's 2024 financial disclosure form here.See Jeff Schmid's updated 2023 financial disclosure form here (updated Oct. 21, 2024).See Jeff Schmid's 2023 financial disclosure form here.See Jeff Schmid's previous financial disclosure form here.