



# The Federal Reserve, Economic Outlook and Monetary Policy

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## Introduction

Welcome to the Kansas City Fed. Thank you for the invitation to speak with you today. I look forward to our discussion.

## The Fed's Responsibilities

Before turning to the outlook for the economy and monetary policy, I would like to take a moment to call your attention to the wide range of activities taking place in this building. Our role in monetary policy gets a lot of attention, and I will get to that, but the Federal Reserve System, and the Kansas City Fed within that system, has a much broader set of responsibilities than monetary policy alone. The staff that fill this building play varied and essential roles in maintaining the safety and efficiency of the nation's financial system.

I will briefly review three of these functions:

- First, the Fed provides payment services to the U.S. Treasury, in effect maintaining the government's bank account. The Fed's technology and teams connect the U.S. government with the financial system and the economy. For example, as the Treasury's fiscal agent, the Fed distributes payments to individuals throughout the economy, including Social Security and disaster relief payments.
- Second, the Fed plays an essential role in maintaining the financial plumbing that underpins the nation's payment system. 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. A safe, secure, and reliable payments system is one of the most important ingredients for the success of a modern market economy.
- Third, the Federal Reserve Board in Washington, and the 12 regional Fed banks across the country, play an important role in supervising the nation's banks, contributing to the health, strength and resilience of the country's financial system. A well-supervised banking system is in everyone's interest. Effective supervision promotes the public trust and allows

financial institutions of all sizes to flourish, rather than just the largest and most well-known. And the Fed's responsibility for bank supervision contributes to the effectiveness of our other mission areas, including monetary policy.

## **The Regional Structure of the Fed**

The Kansas City Fed is also an institution defined by and connected to its region and the seven states that make up the 10th District: Colorado, Kansas, Nebraska, New Mexico, Missouri, Oklahoma, and Wyoming. A major strength of the Fed is its regional structure and the local representation that provides. My view, as I've expressed before, is that the Fed's regional structure is essential for the effective supervision of the nation's banks. The Fed's regional and branch structure encourages the development of strong relationships between supervisors and the communities in which they work. These connections, in turn, help examiners build localized expertise. This produces better informed supervisory decisions that reflect each market's unique economic strengths and vulnerabilities. I believe that in many ways, the long-term supply of credit to small businesses and other industries served by mid-sized and smaller banking organizations depends on supervision being well-equipped with such a regional perspective.

The regional structure of the Fed is also important for the conduct of the nation's monetary policy. The Federal Reserve is America's central bank, and the nation is best served by a central bank that is directly engaged with the many distinct communities and economies that make up the country. It is important to remember that much early support for the creation of Fed came from farmers in our region. Farmers wanted an elastic supply of liquidity that would help smooth through their seasonal demand for credit. Before the Fed, bank reserves and liquidity tended to concentrate in big money center banks in Chicago and New York. The Federal Reserve was meant to be just that, a federal system for maintaining and allocating bank reserves and liquidity across the entire nation, allowing smaller banks and rural geographies greater access to credit when they needed it most.

## **The Outlook for the Economy and Monetary Policy**

Now I will turn to the outlook for the economy and monetary policy. In setting policy, the FOMC is guided by its congressionally determined dual mandate of price stability and full employment. By my assessment we are currently relatively close to meeting this mandate, though still not there yet. However, the FOMC must be forward looking. We are guided not just to meet the mandate now but also to meet the mandate in the future. Policy needs to be set with a view to where the economy is headed. My thinking on the appropriate path for policy is rooted in my outlook for inflation, my outlook for the labor market, and my assessment of just how restrictive the current stance of policy is.

I will address each of these in turn, starting with inflation.

## The Outlook for Inflation

Inflation is too high. The Fed has defined price stability as an inflation rate of 2 percent. Over the 12 months ending in August, prices increased 2.7 percent. Looking through the effects of a recent decline in gas prices, the rate of inflation was closer to 3 percent. The elevated pace of inflation reflects a few factors. First, prices for durable goods are rising. This is true for motor vehicles and for most other categories of long-lasting goods, including furniture and appliances. Though the inflation rate for a composite of these goods is only a little over 1 percent, the fact that durable goods prices are increasing at all is notable. Outside of the disruption of the pandemic, the composite price of durable goods has declined consistently for the past three decades. Given this historical pattern, durable goods inflation is currently about 3 percentage points higher than the pace that has been consistent with the Fed meeting its 2 percent inflation objective. Given that durable goods tend to be imported or compete with imports, higher tariffs are likely contributing to the increase.

Second, services price inflation seems to have settled in at around 3½ percent in recent months, higher than its average pace in recent decades and higher than has been consistent with the Fed meeting its 2 percent target. Some of this elevated pace reflects housing inflation, which spiked up during the pandemic and has since been trending down as rent increases have eased. However, even as rents have slowed, other housing-related costs have continued to climb, most notably the cost of utilities and electricity. But it is not just housing. Even excluding energy and housing, services prices have been increasing at a 3½ percent rate, considerably faster than the pre-pandemic average.

One worrying sign is that price increases are also becoming more widespread. At the start of the year, 70 percent of consumption categories reported price increases. By August, almost 80 percent of categories had increasing prices.

## The Outlook for the Labor Market

Turning to the labor market, the other side of the Fed's mandate. While many indicators suggest that the labor market has cooled this year, I view this cooling as consistent with relieving price pressure and returning inflation to 2 percent. However, some recent data suggests a growing risk that the labor market may weaken more substantially or abruptly than I have been anticipating.

Specifically, job growth has slowed dramatically since April. On average, employers have added about 25,000 jobs a month compared to an average of above 200,000 per month in the three years going into April. Also somewhat concerning is the concentration of job growth over the past year. Of the 1.5 million jobs created over the last year, almost two-thirds were in health care and social assistance, while many other industries have seen job declines. While the health care sector is large and important, it typically accounts for only around one-fifth of new jobs.

On the other hand, there are a number of indicators that continue to signal a labor market in balance. The unemployment rate is 4.3 percent, which is low relative to most of its history. Another common indicator, the vacancy ratio, or the number of posted job openings per person reporting themselves as unemployed, remains near one, right in line with the level consistent with a healthy balanced labor market. Looking across the range of labor data included in the Kansas City Fed's aggregate Labor Market Condition Indicators suggests a labor market that has cooled but remains healthy.

## **How Restrictive is Policy?**

The cooling labor market in turn suggests that the stance of monetary policy is restrictive, but I would argue that it is only modestly so. Financial market conditions appear to be fairly easy. Equity markets remain near record highs, corporate bond spreads are very narrow, and junk bond issuance is high. None of this suggests that financial conditions are particularly tight or that the stance of policy is restrictive. Likewise, the economy is showing continued momentum. Looking through the quarterly swings, real GDP increased 1.6 percent in the first half of the year, a little below trend, but with indicators of strength below the surface. Consumption remains solid, and data for July and August suggest an acceleration through the summer.

Interestingly, fixed capital investment, what is typically thought of as the most interest sensitive component of growth, has shown some of the strongest increases. At least partly helped by the AI boom, software spending grew at the fastest pace on record in the second quarter. And the contribution of investment in information technology to GDP growth in the first quarter was higher than every other quarter on record with the exception of the first quarter of 2000.

## **How Restrictive Should Policy Be?**

Overall, given the state of the economy and financial markets, I view the current stance of policy as only slightly restrictive, which I think is the right place to be. With inflation still too high, monetary policy should lean against demand growth to allow the space for supply to grow and relieve price pressures in the economy. For example, the cooling labor market is working against the passthrough of tariffs to inflation. The current environment is one where aggressively boosting demand could raise the risk of an outsized increase in prices, as firms gain pricing power and increase the passthrough of tariffs to consumers. Overall, I am anticipating a relatively muted effect of tariffs on inflation, but I view that as a sign that policy is appropriately calibrated rather than a sign that the policy rate should be aggressively lowered.

At the FOMC meeting in September I voted in favor of lowering the policy rate by 25 basis points. Given signs that the labor market has cooled, I viewed this cut as being an appropriate risk-management strategy as the Fed balanced the risks to inflation and employment.

One way to view the Fed's mandate is a responsibility to manage the trade-offs that arise from the economy-wide constraint that ties inflation to employment. Policies that boost the labor market often come at the expense of higher inflation, while policies that lower inflation often come at the cost of higher unemployment. Constraints lead to difficult decisions over how to balance competing objectives, and the Fed has been tasked with these difficult decisions when it comes to inflation and employment. In balancing this constraint, my view is that the Fed must maintain its credibility on inflation. History has shown that while all inflations are universally disliked, not all inflations are equally costly to fight. Inflation driven by imbalances between supply and demand, such as during the pandemic, can be brought down without a large increase in unemployment or a recession. On the other hand, inflations that result from higher inflation expectations and shifts in the psychology of price-setting, such as in the 1970s, are much more difficult to counteract and have historically taken a recession to bring under control.

So far, most measures of inflation expectations have not moved up, but I don't take much comfort in that. I view inflation expectations not as an input, or signal, for the Fed to respond to, but as the output of the policy decisions that the Fed makes.

Going forward, I plan to continue taking a data-dependent approach to any further policy adjustments. Of course, data dependency requires data. While I am hopeful that the government data that underpins Fed decision-making will soon become available again, in the meantime I will be monitoring alternative labor market and price data closely, including data we gather from District surveys and reports from our network of contacts as we approach our next FOMC meeting at the end of the month.

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## Author



### Jeffrey Schmid

#### President and Chief Executive Officer

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](#).