

Maintaining the Balance in 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 Denver Branch of the Kansas City Fed, and thanks to Nick Sly, our Denver Branch executive, for hosting us. Whether you are here in the room or joining us online, thank you for participating in this year's energy conference jointly organized by the Kansas City and Dallas Federal Reserve Banks. This year marks the 10th annual iteration of the conference, and the staff—both in Kansas City and Dallas—have once again pulled together a collection of the most influential and impactful voices in the energy industry.

In today's discussions around the energy economy, I will largely be a consumer. I look forward to learning and benefiting from the collective expertise gathered in this room. I will use my time with you to discuss the current balance between inflation and employment in the economy and how that balance shapes my view on the appropriate path of monetary policy.

Two weeks ago, the Federal Open Market Committee voted to lower the policy rate by 25 basis points. I dissented on this decision. My preference, based on my assessment of the balance of risks, was to keep the interest rate unchanged. By my view inflation remains too high, the economy shows continued momentum, and the labor market—though cooling—remains largely in balance. Also, I view the current stance of monetary policy as being only modestly restrictive, which is about where I think it should be.

The Importance of the Regional Fed System

Before elaborating on inflation, employment, and the stance of policy, I would like to address another issue facing the Committee: The lack of official data from the federal government. Policymakers often talk about their decisions being data dependent. But how can you be data dependent when so of the most important data is missing?

The answer, importantly, is that the Fed has a robust system for collecting information even without official data releases. And although my dissent at the recent meeting was my responsibility alone, my decision was importantly informed by what I have been hearing in my district.

Though we are missing some of the key benchmarks that guide policy, it would not be accurate to say that we are flying blind. When the Fed was established over 100 years ago, Congress recognized it was important to have a central bank that was not isolated in Washington or New York. Instead, they designed a regional structure, with 12 district banks leading local engagement across the United States. For much of the Fed's history, this structure has provided valuable economic insight for policymakers. Today, Reserve Bank presidents bring local information and perspective to the discussion at the FOMC.

This system for collecting information is well developed. The district banks and their branches, including this one in Denver, engage widely and deeply with the businesses, industries, and communities that make up their regions. Before each FOMC meeting, my staff and I are in contact with hundreds of local leaders and businesses. In addition to collecting information in person, we also regularly survey hundreds of local contacts on conditions in the manufacturing, services, banking, and energy sectors as well as community development organizations. This is all in addition to the information we gather from the directors who sit on our boards in Kansas City, Denver, Oklahoma City, and Omaha as well as the members of our numerous advisory councils.

The Outlook for the Dual Mandate: Inflation and Employment

Turning to my outlook for the economy. When I talk to contacts in my district, I hear continued concern over the pace of price increases. Some of this has to do with the effect of tariffs on input prices, but it is not just tariffs—or even primarily tariffs—that has people worried. I hear concerns about rising health care costs and insurance premiums, and I hear a lot about electricity. Overall, the message is that inflation is too high. And I agree: Inflation **is** too high. The most recent data suggest that inflation is running in the 3 percent range, above the Fed's 2 percent objective, and spreading, with a growing proportion of goods and services experiencing higher prices.

I would like to offer two additional points on inflation. First, though tariffs are likely contributing to higher prices, my concerns are much broader than tariffs alone. Overall, my expectation is, as I have said for some time, that tariffs will have only a limited, though drawn out, effect on inflation. This effect will be hard to identify in real time, and I am not confident that we will ever be able to measure the exact (or even general) contribution of tariffs to inflation.

The problem is complex. The pricing of each tariffed product is determined by the action and interaction of many different actors, from the foreign producer to the domestic importer, to the domestic supply chain and the retailers that ultimately deliver that product to the consumer. Which of these actors bears the cost of the tariff will be determined by an intricate chain of negotiations that importantly will be affected by the availability and costs of substitutes along the entire path to the final consumer. This chain of interactions will vary for each product. Hence, it is almost impossible to anticipate exactly what the effect of tariffs will be on final consumption prices. Considering the additional complication that these decisions are likely to be dynamic and

change over time, it is apparent that it is not only hard to know **how** prices will change but also **when** prices might change. Given all this uncertainty, my preference is to keep my eye on the overall inflation rate when setting policy.

My second point is in regard to inflation expectations and the psychology of price setting. 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 that we will still be talking about soft landings in that situation.

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.

Now looking at the other side of the dual mandate: employment. The labor market has cooled this year. This is most apparent in the pace of job growth, which took a sharp step down in the spring. Before May, the economy was producing about 150,000 new jobs a month. Through August, the pace had fallen to an average of 25,000 jobs a month. However, other indicators of the labor market have held up better, and the latest reading on the unemployment rate—4.3 percent—is close to most estimates of full employment.

Slow job growth and low unemployment are consistent with a sharp fall in workforce growth, reflecting both the continued retirement of baby boomers and a sudden slowdown in immigration. 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.¹

To summarize, the job market has cooled, but some of this cooling likely reflects important structural changes in labor markets rather than a cyclical downturn in the economy.² That said, I will be monitoring the labor market closely for signs of a more significant deterioration.³

The Outlook for Policy: Is Monetary Policy Restrictive?

What does this all imply for the proper course of policy? My view is that with inflation still too high, monetary policy should lean against demand growth to allow the space for supply to expand and relieve price pressures in the economy. I view the current stance of monetary policy as being only modestly restrictive.

Financial market conditions are not indicating tight monetary policy. Equity prices are near all-time highs with many standard valuation measures near the top of their historical ranges. Corporate bond spreads are narrow, and high-yield bond issuance is near record levels. Outside of financial markets, the real economy is also not showing signs of being overly restricted. Consumption remains solid, and data for July and August suggest an acceleration through the summer. Fixed capital investment, an interest-sensitive component of growth, has shown some of the strongest increases. The contribution of software spending to GDP growth in the second quarter was the largest on record. And the contribution of investment in information technology

¹ [Declining Immigration, Aging Population Reducing Breakeven Employment Growth - Federal Reserve Bank of Kansas City](#)

² [Jackson Hole Economic Symposium Explored How Demographics and Technology Are Influencing Productivity and Labor Markets - Federal Reserve Bank of Kansas City](#)

³ [An Alternative Version of the KC Fed LMCI Suggests the Level of Activity Was Little Changed but Momentum Decelerated Sharply in October - Federal Reserve Bank of Kansas City](#)

to GDP growth in the first quarter was the highest on record, with the exception of the first quarter of 2000.

Discussion of the restrictiveness of policy is often wrapped up in the academic conversation around the neutral interest rate or r^* . I say academic, because the neutral rate is a theoretical concept, it is not observed and has no real-world equivalent. That said, theory and models can highlight important influences that might shift the neutral rate over time. But theories are best when they are simple, and the world is complex. In the end, 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, suggesting that policy is not overly restrictive.

With interest rates so much higher than before the pandemic, why wouldn't rates at this level be restrictive? One factor pushing up the neutral interest rate could be strong underlying growth and increased productivity. This could reflect technological developments—perhaps around artificial intelligence—or changes in government policy that favor investment, including tax policy and deregulation. These factors could increase the demand for capital spending, and activity more broadly, at any given level of interest rates.

The Outlook for Policy: Balancing Economic Constraints

With our dual mandate, Congress has directed us to manage the tradeoffs that arise from the economy-wide constraint that ties inflation to unemployment. Constraints lead to difficult decisions over how to balance competing objectives. The Fed is provided the independence to manage the tradeoff between employment and inflation not because these decisions are easy, but because they are hard. I might argue that it is better to be confronting a hard decision than an

easy one. A hard decision suggests that we are actively balancing our two objectives. An easy decision generally means that we have waited too long on one side of our mandate.

In certain circumstances our actions might have disproportionate effects on the two sides of our mandate. Now, for example, 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, cuts could have longer-lasting effects on inflation as our commitment to our 2 percent objective increasingly comes into question. This was my rationale for dissenting against the rate cut at the last meeting and one that continues to guide my thoughts as I head into the meeting in December. Importantly though, my decision in that meeting will be informed by my discussions and information gathering in the coming weeks.

The Fed's Balance Sheet

In addition to lowering the policy rate at its October meeting, the FOMC also announced that the ongoing run-off of the Fed's balance sheet would end on December 1. I supported this decision. As background, in response to the economic and financial market turmoil of the pandemic, the Fed had roughly doubled the size of its balance sheet over a short period of time, adding almost \$4.5 trillion to its holdings of Treasuries and mortgage-backed securities. In the first quarter of 2022, with inflation rising, the Fed stopped purchasing assets and then started to allow those it had purchased to roll off its balance sheet when they matured. Up until now the Fed has decreased its asset holdings by more than \$2 trillion.

However, the ultimate size of the balance sheet will not be determined by our demand for assets, but rather by the banking sector's demand for Fed liabilities. In its operating framework,

the Fed must provide a sufficient supply of reserves to meet bank demand at a fed funds rate within the announced target range. Up until now, it appeared as though the supply of reserves was more than sufficient to meet this demand and we could shrink our balance sheet with little impact on short-term interest rates. However, more recently, we have seen signs that suggest we may be moving away from reserve abundance.

That said, in the longer-term I would like to operate with the smallest and least distortive balance sheet that we can. A large balance sheet increases the Fed's footprint in financial markets, distorts the price of duration and the slope of the yield curve, and potentially blurs the line between monetary and fiscal policy. Ultimately, shrinking the balance sheet further will require a careful analysis of bank reserve demand and what the Fed might do to offset some of this demand.

One possibility is to ease access to Fed facilities that might serve as substitutes for reserve holdings, such as the Standing Repo Facility. Another possible action could be to lower the interest rate that the Fed pays on reserves within the target band. Currently this rate is 15 basis points above the bottom of the band. Lowering the rate within the band would allow more space for other interest rates to move before bumping up against the top of the band. This would allow for a greater range of private intermediation of reserve demand before the Fed would feel the need to take action. Finding ways to foster a more vibrant interbank market for reserves would not only support a smaller Fed balance sheet but could also promote a more efficient allocation of liquidity, an allocation influenced by price signals and market forces.

Even without changing the overall size of the balance sheet, the Fed can take action to lessen its footprint in financial markets. Currently, our asset holdings are disproportionately weighted towards long-duration assets, which distorts the price of duration, lowering long-term

rates and artificially flattening the yield curve. By shifting our holdings toward shorter-duration securities we can decrease this distortion.

A shorter maturity balance sheet could also better adapt to the rapidly changing payments environment. While the ample reserves framework eliminates the need for day-to-day reserves management, once run-off ends there will still be a need to regularly assess the level of ample reserves. And I see little reason to think that reserve demand will grow steadily with nominal GDP, particularly given innovation in payments. For example, the move towards instant payments could have unforeseen effects on the level of ample reserves. A portfolio with a greater proportion of bills and short-term coupons could more quickly adjust should we see a shift in the demand for our liabilities.

This is to say that even though we will soon stop the run-off of the balance sheet, we will still have a number of decisions to make. Just as the Committee has to balance the constraint that connects inflation to employment, we will have to balance a number of competing objectives when it comes to the balance sheet and managing the Fed's ample reserves regime.