

Guideposts for a New Central Banker

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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.

I am now six months in as president and chief executive officer of the Kansas City Fed. And though that time has gone by remarkably fast, my relationship with the Fed goes back much further, shaping my view of the institution, its importance, and how I plan to approach the job.

As a former regulator and banker—and also as a native of the Tenth District—I’ve seen firsthand the quality and importance of the Kansas City Fed’s work.

As a young Federal Deposit Insurance Corp. examiner in Kansas City, I partnered and worked with Kansas City Fed supervisors and examiners to regulate district banks. As a former bank CEO, I came to appreciate the importance of the Fed’s payment services for our nation’s economy. And more generally, as a resident of the region, I’ve always found the Kansas City Fed to be a trusted resource on regional and national economic issues.

These interactions with the Kansas City Fed built my trust in the institution. And now, as Bank president, I am responsible for maintaining your trust, both in the Kansas City Fed and the Federal Reserve System as a whole.

My goal today is to start that process by sharing the three core principles I will bring to the policy table as our District’s representative on the Federal Open Market Committee.

- First, and perhaps foremost, I believe that the authority and effectiveness of a Federal Reserve Bank is rooted in its connections to the region it serves. And I see the strength of those ties, not just in Kansas City but for all 12 District banks, as instrumental to the success of the Federal Reserve System.
- Second, I believe in central banking that is accountable and transparent but independent of political influence. The independence of the Fed, and the ability to set monetary policy without political consideration, best serves our economy and nation.
- Third, and relatedly, I believe that an independent Fed is best served by a cautious approach to the Fed’s role in the financial system. We must carefully consider how our actions can affect the long-term structure of financial markets. I will bring a preference for minimizing the Fed’s footprint, particularly as it relates to the Fed’s balance sheet.

The Importance of a Regional System

One of the most important parts of the job for a Fed president is building relationships in the communities we serve. Events like this, carried out regularly across the Tenth District, give me an opportunity to establish a dialogue between the Federal Reserve and our stakeholders. Through these conversations, I can share with you my thinking on monetary policy. But more importantly, I can gather information, insight, and perspective from you that I can take back to Washington, D.C., and share with my colleagues on the Federal Open Market Committee (FOMC).

Over 100 years ago the Federal Reserve System was designed to build public trust by dispersing power and decision-making across the country. It was for this reason that the Fed System was established with governors in Washington, D.C., and 12 regional Reserve Banks located across the country. This decentralized system invites diverse views, an important ingredient in setting monetary policy by committee.¹

The regional Reserve Banks and Branch offices allow the public to engage directly with the central bank. This happens at all four of our District offices, including the one here in Oklahoma City as well as those in Kansas City, Denver and Omaha.

Local bankers, labor leaders, community development officials, non-profit directors and business executives serve on our boards and advisory groups. They provide an on-the-ground view of the economy that can't be found in aggregate economic data.

For example, in the Tenth District economy, agriculture and energy play an outsized role compared to rest of the nation, and therefore national economic statistics don't always align with the economic experiences of district contacts. Unique economic features like these from each of the 12 Federal Reserve districts feed into regional survey results and Beige Book reports that are shared ahead of each FOMC meeting.

In my brief stint on the job, I've quickly come to realize the value of these regional reports as a compliment to the national economic indicators that also inform FOMC deliberations.

¹ Michael D. Bordo and Edward S. Prescott (2023) argue that the Federal Reserve's decentralized structure is also important for generating new ideas and reducing groupthink. These authors attribute many important concepts that have shaped the intellectual framework for monetary policymaking to the work done by research departments at regional Reserve Banks.

A regional perspective is also important for regulating and supervising financial institutions. Simply put, the business model of a community bank in rural Nebraska, like the one I led early in my career, is fundamentally different than a global financial institution in New York.

For this reason, it is important that bank regulators take a tailored approach to manage the unique risks posed by different institutions. Effective regulation should ensure that the hundreds of regional and community banks in the Tenth District are safe and sound. But regulatory frameworks should also acknowledge that a one-size-fits-all approach to regulation can come with significant compliance costs and threaten the ability of community banks to supply credit and deposit services to rural households, agricultural producers, and small businesses.

While I've emphasized the importance of a regional perspective, it is also essential for certain aspects of the U.S. financial system to be integrated across geographies, including the clearing of payments. For this reason, the Federal Reserve has taken a more centralized approach to providing financial services.

The Federal Reserve's new 24/7/365 payments system, FedNow, is a great example of how the larger Federal Reserve System can be leveraged to deliver services that benefit our district and the nation. FedNow is the Fed's first major new payment rail in over 40 years and aims to bring instant payments technology to all financial institutions, no matter their size or location.

Central Bank Independence

The second principle that is core to my thinking as a new member of the FOMC is the importance of the independence of the central bank.

The policy choices made by the Fed impact the livelihoods and finances of everyone in the economy. Naturally, this invites scrutiny, especially in difficult economic times.

And historically it is not unusual to hear disapproval of the Fed's handling of the economy. There are times that the criticism is justified. Acknowledging mistakes and learning from them is important for maintaining our accountability. However, history has shown that a

central bank that acts without political interference delivers better economic outcomes.²

Therefore, preserving the independence of the central bank is essential for securing long-run economic prosperity.

The best way to maintain the Fed's independence is by remaining narrowly focused on the mandates that Congress has assigned the Federal Reserve. The Federal Reserve Act directs the FOMC to conduct monetary policy to promote the dual mandate of maximum employment and stable prices. By assigning the Fed these goals, but removing itself from the conduct of monetary policy, Congress created a system for the Fed to pursue policies that are in the economy's long-run interests without interference from short-term political considerations.

Nevertheless, history shows that the Federal Reserve Act does not prevent the Fed from being the subject of outside pressures. These pressures tend to intensify when the FOMC faces a tradeoff between promoting maximum employment and price stability. Paul Volcker, for example, received substantial criticism for pursuing lower inflation at the cost of high unemployment.³

This is an instance when the Fed's two mandates were not complementary, which places the Fed in an especially difficult position because it can appear that the FOMC is elevating one mandate above the other. But one lesson that can be learned from the economy's historical performance is that price stability is an important precondition for sustaining maximum employment.

The economy's pre-pandemic performance is a great example of the benefits that price stability can bring to the labor market. In 2019, the unemployment rate reached multi-decade lows without pushing up inflation. This was in large part because prior decades of experience had established the confidence that the Fed would deliver price stability.⁴

² Researchers have found that more independent central banks (i.e., those that conduct policy without political influence) deliver lower and less variable rates of inflation over time without any apparent sacrifice of higher unemployment. See: Cukierman, Alex, Steven B. Webb, and Bilin Neyapti. 1992. [“Measuring the Independence of Central Banks and Its Effect on Policy Outcomes”](#). *The World Bank Economic Review*. and Alesina, Alberto and Lawrence H. Summers. 1993. [“Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence”](#). *Journal of Money, Credit, and Banking*.

³ The pressures that Chairman Paul Volcker and the FOMC came under during this period are well documented in: Todd, Timothy. [The Balance of Power: The Political Fight for an Independent Central Bank, 1790-Present](#)

⁴ Kansas City Fed staff research has found that the FOMC's efforts to anchor longer-run inflation expectations likely weakened the inflationary effects from low rates of unemployment during this period. See Bundick, Brent and A. Lee Smith. 2023. [“Did the Federal Reserve Break the Phillips Curve? Theory and evidence of Anchoring Inflation Expectations”](#). Federal Reserve Bank of Kansas City Research Working Paper 20-11.

Of course, this favorable balance was upset by the aftermath of the pandemic. Inflation spiked to 40-year highs, and the FOMC took decisive actions to reduce inflation, reinforcing its commitment to restoring price stability. Returning to a low and stable inflation rate is important for the economy's long-run health and I believe will set the stage for sustainably achieving maximum employment.

Minimizing the Federal Reserve's Financial Footprint

The severity of the past two economic recessions strained the ability of the Fed to pursue its dual mandate with the use of conventional monetary policy. Rather than rely solely on reductions in the federal funds rate, the FOMC turned to unconventional forms of policy easing, including large balance sheet expansions. This brings me to the third principle that guides my thinking as a new policymaker, which is to minimize the Fed's footprint in the financial system, particularly as it relates to the Fed's balance sheet.

The Fed's actions during both the 2008 Global Financial Crisis and the COVID-19 pandemic included purchasing large quantities of Treasury and agency mortgage-backed securities. These purchases increased the size and scope of the Fed's balance sheet.

To put some numbers on it, the Fed's balance sheet increased from less than \$1 trillion dollars in 2007 to nearly \$9 trillion by 2022, making the Fed a dominant holder of Treasury and government-backed mortgage debt. To fund these purchases, the Fed pumped money—mostly in the form of bank reserves—into the economy. Managing interest rates with so much liquidity has required a larger role for the Fed in overnight debt markets. This includes a sizeable reverse repurchase facility with many non-bank counterparties. All of these developments have increased the Fed's footprint in financial markets in recent decades.

Decisive actions are appropriate and necessary when stresses threaten the health of the financial system and the economy. In this regard, the Fed's ability to stabilize markets and the economy with its balance sheet is an important policy tool. However, maintaining a persistently large presence in markets in normal times comes with costs and increases the possibility of unintended consequences. These concerns have been highlighted by the Kansas City Fed in the past and are concerns I also share. To be specific, I offer three examples:

1. First, maintaining a large portfolio of long-term Treasury and mortgage debt can create distortions in the price of assets and the allocation of credit. These distortions risk misallocations that can ultimately sow the seeds of future imbalances in the economy.
2. Second, a persistently large balance sheet can have unintended consequences on the structure of the financial system. In making asset purchases, the Fed is lowering longer-term interest rates and flattening the yield curve. Failure to unwind these purchases can challenge the ability of banks to borrow short and lend long. This is the business model that many community banks rely upon. And the Fed's sizeable overnight reverse repo facility may have unintended consequences on the allocation of liquidity and the role of depository institutions in the economy.
3. Third, maintaining a large balance sheet can give the uncomfortable impression that monetary and fiscal policy are intertwined. As we've seen of late, a large balance sheet exposes the Fed to operating losses. And maintaining an excessively large Treasury portfolio offers the impression that the Fed's balance sheet is supporting government debt markets. Over time, both have the potential to threaten the Fed's independence.

To be clear, my position is that the balance sheet is an important monetary policy tool, especially in times of crisis. However, once a crisis has passed, it should be a priority for the Fed to reduce its balance sheet and to lessen its footprint in financial markets.

Outlook for the Economy and Monetary Policy

Before concluding, I'd like to share some brief thoughts on the outlook for the economy and monetary policy.

Since the start of monetary policy tightening in 2022, inflation has stepped down significantly. While this progress has been encouraging, when it comes to too high inflation, I believe we are not out of the woods yet. The drop in inflation has largely been driven by reductions in energy and goods price inflation as oil markets rebalanced and supply chains healed.

But, as you well know in Oklahoma, energy prices are anything but stable. And turmoil in shipping routes through the Red Sea and the Panama Canal raise the prospect that supply chain conditions could worsen and put renewed pressure on goods prices.

Absent further help from goods and energy prices, further disinflation will need to come through services. The January CPI inflation data argues for caution on this front. The prices of services—which comprise two-thirds of consumer spending—continue to rise briskly amid still tight labor markets and elevated wage growth.

Given the importance of labor costs for many service providers, restoring balance in labor markets and moderating wage growth will likely be needed to secure inflation's return to the FOMC's 2 percent target.

Labor market tightness has eased over the past year but has yet to fully normalize by a variety of measures, including the Kansas City Fed's Labor Market Conditions Indicators. Much of the progress last year in rebalancing labor markets and tempering wage pressures appeared to be driven by increases in labor supply. More recently though, labor force participation has fallen off from its recent highs, suggesting that a further moderation in demand could be needed to tame price and wage pressures.

But demand has remained resilient to date. GDP growth has come in well above trend in recent quarters, supported by strong consumer spending. And after adding more than 3 million jobs in 2023, hiring in January remained robust with net job gains of more than 350,000. Looking ahead, many District contacts are upbeat about demand conditions in 2024, and I'm hearing few instances of layoffs. These reports are consistent with the low levels of initial jobless claims and other indicators that generally point to still strong labor demand.

With inflation running above target, labor markets tight, and demand showing considerable momentum, my own view is that there is no need to preemptively adjust the stance of policy. Instead, I believe that the best course of action is to be patient, continue to watch how the economy responds to the policy tightening that has occurred, and wait for convincing evidence that the inflation fight has been won.

Tying back to my earlier comments, I'm also in no hurry to halt the ongoing reduction in the size of the Fed's balance sheet. How much further the Fed can shrink its balance sheet is an open question. I would note that a return to any pre-crisis norm is not realistic. Some balance sheet growth was inevitable; as the economy grows, so too does demand for cash and bank

reserves that the Fed must meet. However, I don't favor an overly cautious approach to balance sheet runoff for the sake of avoiding any volatility in interest rates. Instead, some interest-rate volatility should be tolerated as we continue to shrink our balance sheet.

Conclusion

As just the tenth president in the 109-year history of the Federal Reserve Bank of Kansas City, I am humbled by the responsibility I have been given to lead this trusted institution.

My job is to be a steward of this Bank's reputation for service and integrity in carrying out our public mission and to preserve that reputation for future presidents. In sharing these principles with you and my thoughts on the outlook, I hope that I have begun that process of building your trust in how I will lead this Bank and represent the Tenth district at the FOMC.