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Fighting Inflation in Challenging Times

Remarks by

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Thanks to the Kansas Bankers Association for the invitation to share my perspective on the economy and bank regulation. It is always a pleasure to be here with you for this annual gathering. I am especially looking forward to hearing what is on your minds about supervision and regulation, how you are navigating current economic conditions, and your expectations going forward.

I'll start with a recap of the decision from July's Federal Open Market Committee meeting and then move on to my thoughts about the current economic uncertainty and challenges that lie ahead. The number one challenge, of course, is inflation, which continues to be much too high, and a heavy burden for households and businesses. As I'm sure you all already know, the Federal Open Market Committee decided last week to raise the federal funds rate by 75 basis points, to a range of 2¼ to 2½ percent. I will share my reasoning for supporting this increase and why I support continued increases until inflation is on a consistent path to significantly decline. I will then touch on the current federal regulatory climate and the Fed's agenda for supervision.

Inflation continued to climb in June, reaching 9.1 percent as measured by the consumer price index. This is yet another concerning high reading, and it set another 40-year record high despite the expectation of many forecasters that inflation had peaked earlier in the year. I have seen few, if any, concrete indications that support this expectation, and I will need to see unambiguous evidence of this decline before I incorporate an easing of inflation pressures into my outlook.

Many of the underlying causes of excessive inflation are the same as they have been over the past year or so—supply chain issues, including those related to China's

COVID containment policies, constrained housing supply, the ongoing conflict in Ukraine, fiscal stimulus, and limitations on domestic energy production.

Regardless of the source of the inflationary pressure, the Federal Reserve has a duty to bring inflation down to our 2 percent target. This duty is mandated by Congress to carry out monetary policy that results in price stability—meaning low and stable inflation. We all understand why this is a critically important responsibility, especially in times of extreme inflation. Rising prices for food, housing, and energy negatively impact affordability for all Americans, but especially those with low or moderate incomes. For those workers who drive long distances to get to work, high inflation is especially concerning, requiring some to make tradeoffs between feeding their families and buying fuel to fill gas tanks. Some workers have seen their wages grow significantly over the past two years, but most have seen any gains in wages far outpaced by higher prices. Therefore, in my mind, it is absolutely critical that we continue to use our monetary policy tools until we are successful in returning inflation to our 2 percent goal.

Businesses are also suffering from elevated inflation through rising and volatile prices for inputs and the need to price their own goods and services to cover costs without losing customers. This dynamic is evident in agriculture and what we are hearing directly from farmers and ranchers, who are dealing with added weather challenges and on-going drought. Prices for commodities have declined lately but are still at historically high levels. In contrast, prices for fertilizer and many crop inputs continue to rise. In some areas, high input costs and drought conditions are contributing to record early season cattle auction sales, as many ranchers choose to sell herds early to limit further outlays for input expenses.

I see a significant risk of high inflation into next year for necessities including food, housing, fuel, and vehicles. Rents have grown dramatically, and while home sales have slowed, the continued increasing price of single-family homes indicates to me that rents won't decline anytime in the near future. Recently, gasoline prices have moderated but are still roughly 80 percent higher than pre-pandemic levels due to constrained domestic supply and the disruption of world markets. And I see continued inflation risk from motor vehicle prices, as auto manufacturers struggle with supply chain problems that haven't improved significantly. Demand for cars continues to exceed supply, and retail used car prices are still very high, about 50 percent more than before the pandemic.

The supply problems pushing up inflation seem likely to persist. Indications are that the conflict in Ukraine will continue, and that the effects of shipping disruptions of agriculture products and limits on energy supplies from Russia will continue to be a significant problem. Even with the recent agreement intended to facilitate Ukrainian grain exports, it is unclear whether supply pressures on global markets will ease as a result. An announced reduction in Russian natural gas supplies to Western Europe has driven European prices even higher, causing ripple effects on world energy markets and raising concerns about shortages this winter. China has eased some of its most stringent COVID containment measures but recently revived travel restrictions in some areas, and its approach to the pandemic remains an upside risk for inflation. Despite a slowdown in sales of new and existing homes, inventories of homes for sale and rental vacancies remain low, supporting ongoing increases in housing costs.

On the other side of our dual mandate, maximum employment, we continue to see a tight labor market, though there are some emerging signs that would support

expectations of loosening. Yesterday's job report showed continued significant growth in hiring with the unemployment rate finally returning to the pre-pandemic level of 3.5 percent. As I am sure you all know, the job market in Kansas is even stronger, with an unemployment rate of 2.4 percent in June. In our state, finding workers is a bigger problem in most communities than finding a job.

One aspect of the job market that has not recovered is labor force participation. Based on the pre-pandemic trend, there are nearly four million people who are still sitting out of a strong labor market.

In contrast to this labor market strength in Kansas and nationwide, output growth has slowed this year. Real gross domestic product, GDP, edged lower in the second quarter, following a larger decline in the first quarter.

My base case is for a pickup in growth during the second half of this year and for moderate growth in 2023. As we learned during the summer and fall of 2021, both GDP and jobs numbers are subject to significant revision, both in subsequent months and then again the next year. From my perspective, had we known at the time about the eventual large upward revisions in last year's employment data, we likely would have significantly accelerated our monetary policy actions. Going forward, we have to consider the possibility of these kinds of revisions when making real-time judgments as policymakers, which includes looking at other kinds of indicators instead of relying too heavily on the data. Taking all of that on board, while the data on economic activity are indeed lower and the view is murky, the evidence on inflation is absolutely clear, which brings me to the implications for monetary policy.

Based on current economic conditions and the outlook I just described, I supported the FOMC's decision last week to raise the federal funds rate another 75 basis points. I also support the Committee's view that "ongoing increases" would be appropriate at coming meetings. My view is that similarly-sized increases should be on the table until we see inflation declining in a consistent, meaningful, and lasting way.

On the subject of forward guidance, I am pleased to see that following the July meeting, the FOMC ended the practice of providing specific forward guidance in our post-meeting communications. I believe that the overly specific forward guidance implemented at the December 2020 FOMC meeting requiring "substantial further progress" unnecessarily limited the Committee's actions in beginning the removal of accommodation later in 2021. In my view, that, combined with data revisions that were directly relevant to our decision making, led to a delay in taking action to address rising inflation.

It is helpful that the FOMC provided clear direction earlier this year that it was prepared to act quickly to tighten monetary policy. Since we have now taken actions to raise rates and finally reduce the Fed's balance sheet, we are following through on that commitment. Looking ahead, the FOMC will be getting two months of data on inflation and another month on employment before our next meeting in September, and while I expect that ongoing rate increases will be appropriate, given the uncertainty in how those data and conditions will evolve, I will allow that information to guide my judgment on how big the increases will need to be.

I do expect that the labor market will remain strong as we continue to increase interest rates and allow the balance sheet to run off, but there is a risk that our actions will

slow job gains, or even reduce employment. Growth has softened, and perhaps this is an indication that our actions to tighten monetary policy are having the desired effect, with the ultimate goal of bringing demand and supply into greater balance.

When considering the risks to the labor market, these risks must be viewed in the context of its current strength and with the understanding that our primary challenge is to get inflation under control. In fact, the larger threat to the strong labor market is excessive inflation, which if allowed to continue could lead to a further economic softening, risking a prolonged period of economic weakness coupled with high inflation, like we experienced in the 1970s.

In any case, we must fulfill our commitment to lowering inflation, and I will remain steadfastly focused on this task.

With my outlook out of the way, let me turn to another of my responsibilities at the Fed, which is bank regulation and supervision. I am sure that we will have the opportunity to discuss many issues of interest to you during our discussion, but I'd like to mention a pending rulemaking that would update the Community Reinvestment Act. I understand that the draft rule was intended to provide greater clarity to banks regarding community development activities and their consideration for CRA. While I am a strong supporter of the fundamentals behind CRA, and I support community development activities, I am concerned that the proposal does not adequately account for the costs and benefits of certain provisions, and that no attempt has even been made to either ensure that or to analyze whether the benefits exceed the costs, which is a fundamental element of effective regulation. The comment period for the proposal ended on August 5, and I will repeat what I have said in the past: if this proposal affects you or your business, I

hope that you made your voice heard by submitting a comment to the more than 600-page proposal within the short 90-day comment period. Public comments really do matter when considering the content of proposed rulemakings.

Of course, my comments about the benefits of public participation in rulemaking apply beyond the CRA proposal, and there are other regulatory topics on the horizon that would benefit from robust engagement. One that comes to mind is the regulatory framework for analyzing bank mergers. Earlier this year, the Justice Department requested comment on whether to revise their 1995 Bank Merger Competitive Review guidelines, seeking input on a wide range of issues. The FDIC also issued a request for information on the Bank Merger Act framework. I expect this review will be a focus across the banking agencies, and I will be very interested to see how the framework for small and regional banks is affected by any proposed change. I would be concerned about any changes that would result in making mergers among these institutions more difficult or would not address some of the longstanding issues with the existing framework. Among those are that the framework doesn't account for new technologies or overwhelming competition posed by credit unions, internet based financial services, and non-bank financial companies. Another concern is that overly strict criteria for mergers could have the unintended consequence of depriving consumers in some areas of access to any banking services. "Banking deserts" in rural and underserved areas are a real problem and regulators should guard against this outcome when proposing or evaluating rules.

I should also briefly mention three other regulatory topics of interest to all banks, including those here today.

First, the Fed's LIBOR proposal is currently out for comment on a short timeline. That proposal implements the recently passed LIBOR Act by providing default rules for certain contracts that use the soon to be discontinued reference rate. Second, comments are currently under review for the third-party risk management guidance jointly proposed by the Fed with the other banking agencies. Banks and third parties will benefit from clear guidance that helps banks navigate the challenging issues and risks raised by third party engagement.

Finally, another area that could benefit from more regulatory clarity is digital assets, including stablecoins and crypto assets. Some banks are considering expanding into a range of crypto activities, including custody, lending backed by crypto collateral, and facilitating the purchase and sale of these assets for their customers. In the absence of clear guidance, banks should consult with their primary regulator and exercise caution when engaging with customers in these types of activities.

I will conclude with a brief comment on supervision. While the trend of returning to on-site bank examination is continuing, progress has been somewhat slow. This may be driven in part by the varied pace of employees returning to the office. That said, the Fed intends to return to some form of on-site supervision. We find substantial value in those in-person interactions during bank examinations.

In closing, thank you again for the opportunity to speak to you today. I look forward to hearing how high inflation is affecting you and your communities and your thoughts on the regulatory agenda.