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Remarks at the 23rd Annual Regional & Community Banker's Conference

at the Federal Reserve Bank of Boston

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The views expressed today are my own, not necessarily those of my colleagues on the Federal Reserve Board of Governors or the Federal Open Market Committee.

Good afternoon. And thank you, Steve, for the kind introduction. I'm delighted to join you today for the Bank's 23rd Annual Regional & Community Bankers Conference.

I'll extend my thanks to the Supervision, Regulation & Credit team here at the Boston Fed for their work, and for hosting these important annual gatherings. I also want to thank our New England Public Policy Center's Jeff Thompson for his presentation today on the regional economy. And I'd like to recognize the Bank's First Vice President and Chief Operating Officer Karen Pennell, who joined the Boston Fed this spring after serving for decades in roles at the Kansas City Fed and our National IT function. We're glad Karen is part of the Boston Fed, and I know that bankers around New England will appreciate her expertise and commitment to excellence.

And thanks to all of you for attending, and for your constructive engagement with us at the Boston Reserve Bank. It takes all of us to support a safe and sound financial system, which is so essential to a vibrant economy that works for everyone. It was great to hear some of the discussions today, including the insightful panel on instant payments and the FedNow® Service.

Today, I'll focus most of my brief remarks on the national economy, and then touch on banking trends, and financial inclusion. Before I begin, let me note, as always, that my remarks today are my own views. I'm not speaking for any of my colleagues at other Federal Reserve Banks or at the Board of Governors.

The Economy and Monetary Policy

I like to share my "bottom line" up front and will begin by saying that, overall, the U.S. economy is in a good place. Recent developments have increased my confidence that inflation will return to the Federal Open Market Committee's (FOMC's) 2 percent target in a timely way – and, crucially, amid a healthy labor market.

Looking ahead, preserving the current favorable economic conditions will require adjusting the stance of monetary policy, so as not to place unnecessary restraint on demand. A careful, data-based approach to policy normalization will be appropriate as we balance two-sided risks and remain highly attentive to both parts of our Congressional mandate – price stability and maximum employment. I'll say a bit more about each of these points.

In other recent talks, I've discussed in more detail how we evolved to the current juncture in economic conditions.[1] Very briefly, as we grappled with the COVID-19 crisis, a variety of factors led to demand outstripping supply, including in the labor market. The resulting unsustainably tight conditions contributed to price and wage pressures that fueled a surge in inflation. High inflation affects all of us and is particularly challenging for those with lower incomes. Indeed, I continue to hear about the challenges from inflation and high price levels as I speak with people in communities across New England. Restrictive monetary policy was intended to help realign our economy to meet our mandated goals – and this has been working.

Inflation

Where is inflation now? I'll focus, as I often do, on core inflation, using the Fed's preferred PCE measure. While it excludes the obviously important but very volatile categories of food and energy, it tends to more reliably capture underlying inflation trends. This indicator has declined significantly but remains elevated. And importantly, the disinflationary progress has resumed after an unexpectedly large inflation jump at the beginning of this year. I see this resumed progress as driven by economic developments that are broader and more solidly in place than at the end of last year, increasing my confidence that inflation is firmly on a trajectory to 2 percent.

I'll explain by considering the three components of core inflation – goods, shelter, and non-shelter services. Separating them reveals important insights. In the second half of 2023, disinflation was largely due to a rapid deceleration in *core goods* prices, as many of the supply chain disruptions receded. Since then, the contribution of core goods prices to the overall disinflation process has moderated, though inflation developments in this area continue to be favorable and in line with pre-pandemic trends.

The contribution of *services* inflation to the overall disinflation process has resumed, although services inflation is still elevated. Indeed, after a big jump in early 2024, *core services prices excluding housing* has been rising at a rate that is consistent with 2 percent overall inflation.

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[1] For example, see my May 8, 2024 remarks at M.I.T.: "Reflections on Uncertainty and Patience in Monetary Policymaking" available at Reflections on Uncertainty and Patience in Monetary Policymaking - Federal Reserve Bank of Boston (bostonfed.org).

While *housing* inflation has also moderated some more recently, this is the stickiest component and remains above its pre-pandemic average. But there are good reasons to think that this stickiness in current shelter inflation reflects existing rents still catching up to new market rents. In fact, rent growth for newly signed leases has been at or below its pre-pandemic range for many months. While these data do not suggest emergence of new inflationary pressures, it is difficult to predict how long this rent catchup process may take.

The moderation in new rent growth also reflects a labor market that is normalizing and reducing price pressures in the services sector more generally. Labor costs are a main driver of services inflation, and a labor market with supply and demand in better balance is a key reason for disinflation becoming more broad-based, and for my increased confidence that inflation is on a sustained path back to 2 percent.

The Labor Market

Turning to the labor market, the constellation of data points to notable softening from the unsustainably tight conditions a year ago. As Chair Powell noted in his August remarks at Jackson Hole, we do not seek or welcome further cooling in labor market conditions.[2] And the recent data, including September's unexpectedly robust jobs report, bolster my assessment that the labor market remains in a good place overall – neither too hot nor too cold.

I will mention just a few of the many indicators that my team and I review when assessing labor market health. First, the unemployment rate rose from very low levels over the past year – but has recently ticked back down and remains low by historical standards. Second, although job growth slowed notably in recent months, it remains relatively solid. Here, I'll note that recent job growth has been somewhat concentrated in a few sectors, which is one factor I continue to monitor. Furthermore, data adjustments combined with uncertainties about labor supply growth add to the difficulty of estimating the breakeven level of job creation. Finally, initial claims for unemployment insurance remain low, indicating a quite healthy labor market.

[2] See https://www.federalreserve.gov/newsevents/speech/powell20240823a.htm. Also see September 30 remarks where Chair Powell noted that "We do not believe that we need to see further cooling in labor market conditions to achieve 2 percent inflation" (https://www.federalreserve.gov/newsevents/speech/powell20240930a.htm).

Continuing UI claims are also muted, suggesting that unemployed workers can find jobs relatively quickly.

With the cooling of the labor market, wage growth is also moderating but remains above its pre-pandemic pace. However, I want to emphasize that the current, still-elevated wage growth also reflects robust gains in worker productivity and therefore, should not necessarily lead to additional price pressures.[3]

Demand

Going forward, it will be important to preserve the currently healthy labor market conditions. In my view, this will require economic activity continuing to grow close to trend, which is my baseline outlook. Recent revisions to measures of economic growth paint a picture of an economy that is solid and resilient overall. Importantly, the fundamentals underpinning consumer spending remain favorable, including job opportunities and the gradual recovery of real wages. However, my continued "realistic optimism" includes recognizing that there are risks on both sides of this outlook.

On the one hand, household net worth remains quite elevated by historical standards, which could contribute to a faster-than-expected pace of growth in consumer spending. At the same time, some strains have emerged, especially at the lower end of the income distribution. For example, credit card delinquencies have risen to above pre-pandemic levels, although they are still low by recent historical standards.

Monetary Policy

The next phase of monetary policy must focus on preserving current favorable economic conditions. A sustainable return of inflation to target and a strong labor market are both critically important to the public we serve.

A restrictive monetary policy stance has played a key role in the disinflation progress so far, and recent data on spending and production indicate that the effects of monetary policy are being felt, especially in interest-sensitive sectors of the economy. Indeed, with the labor market

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[3] For an analysis of wages, prices and productivity, see Is Post-pandemic Wage Growth Fueling Inflation? - Federal Reserve Bank of Boston (bostonfed.org). For additional analysis on this topic, see Productivity Improvements and Markup Normalization Can Support Further Wage Gains without Inflationary Pressures - Federal Reserve Bank of Boston (bostonfed.org).

cooling, and economic growth reverting to a more normal pace, the economy is somewhat more vulnerable to adverse shocks. My confidence in the disinflation trajectory has increased – but so have the risks of the economy slowing beyond what is needed to restore price stability.

For these reasons, the FOMC began the process of normalizing the policy stance at its meeting last month.[4] Further adjustments of policy will likely be needed. Indeed, the median projection from the FOMC participants' *Summary of Economic Projections*, released at the end of last month's meeting, includes an additional 50 basis points of cuts in the federal funds rate this year. But I will stress that policy is not on a pre-set path and will remain carefully data-dependent, adjusting as the economy evolves.

Banking Trends

I'll turn now to a brief discussion of community banking trends in New England. Despite a challenging environment, the region's community banking industry remains strong. A recent regional brief published by our New England Public Policy Center highlights the importance of banks classified as community banks here in the Fed's First District.[5]

Indeed, the regional and community banking industry is critical to the economic health of our communities – both households and businesses – across our six states. Just about two weeks ago, I was in Fitchburg, Massachusetts, where I met with community leaders and learned about their ongoing collaborative efforts to revitalize their city. I also heard from small businesses and bankers about local economic conditions and what it takes to start and operate a business. Not surprisingly, a key theme of the day was the importance of partnerships between community members and the local financial institutions to ensuring strong, resilient local economies. I have had similar conversations in my recent visits to other states in our district.

I'll say a bit about what we're seeing as far as the industry in this part of the country. Banks across New England have reported tighter liquidity positions and continued pressure on earnings, particularly a narrower net interest margin that has been largely driven by increased funding costs. A higher interest rate environment and the increasing ease with which consumers

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[4] See September 18, 2024 FOMC statement:
https://www.federalreserve.gov/newsevents/pressreleases/monetary20240918a.htm

[5] See A Portrait of First District Banks - Federal Reserve Bank of Boston (bostonfed.org) by J. Christina Wang.

can move their money have resulted in banks experiencing increased competition for deposits, leading to changes in balance sheet funding dynamics. Noncore funding sources, such as Federal Home Loan Bank borrowings and brokered deposits, have become a larger proportion of the overall funding mix. It's perhaps not a surprise, then, that prudent liquidity risk management practices have become increasingly important in this environment.

While loan growth has slowed more recently, the loan portfolio, and thus the commercial real estate category, remains a higher proportion of First District balance sheets relative to the rest of the country.[6] To date, asset quality has remained resilient; nonperforming loans, while inching up, have remained at levels that are relatively low historically. The allowance for credit losses remains adequate relative to nonperforming loans, although we have witnessed some reserve releases that requires heightened monitoring, given increasing loan balances. Capital remains satisfactory with an overall increasing trend but still below pre-pandemic levels, underscoring the importance of continuing robust credit risk management.

In summary, while New England community banks are well-positioned across the region, strong risk practices for capital, liquidity, asset selection, and underwriting, as well as earnings, are needed to remain resilient in an evolving environment.

Before I conclude this portion of my remarks, I want to highlight an important way the Fed works to support banks of all sizes. The discount window, one of the Fed's effective tools to support the liquidity and stability of the banking system and the effective implementation of monetary policy, provides ready access to funding for banks to manage their liquidity in the normal course of events, as well as under periods of stress.

All of us will recall the market turmoil from March 2023, when multiple banks experienced significant challenges that ultimately led to their failure. While interest rate risk and liquidity risk management issues were the root cause of those failures, operational challenges related to those banks' use of the discount window amplified their shortcomings.

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[6] Residential and, to a lesser degree, commercial real estate represents a higher proportion of total assets in the First District relative to the national community bank profile average. (CRE loans are actually a *slightly* lower share of the overall *loan* portfolio for First District banks relative to other banks. However, First District banks tend to have higher share of loans in their overall asset portfolios.)

Just last week, we hosted a seminar here at the Boston Fed in which we brought together leaders from banks and credit unions in the First District, as well as representatives from state and federal financial regulatory agencies, to provide a foundation on the discount window. Thank you to those of you in this room who were able to attend that session, and I encourage all of you to learn more about discount window readiness.

The Importance of Financial Inclusion

I'll end with a brief discussion of financial inclusion. Last month, as part of a workshop for Fed staff, I was please to sit down with the Federal Reserve Board of Governor's Adriana Kugler for a "fireside chat" to discuss financial inclusion and bank supervision.[7] Our conversation emphasized the importance of providing consumers and businesses access to the financial products and services they need to effectively and safely engage with the economy. I'll make two points here.

First, I relate financial inclusion to the Boston Fed's overarching mission of "a vibrant economy that works for all." Our central bank has a public mission, to serve the entire public. The ability to participate in the economy, job market, and financial system is an important component of vibrancy and consistent with the American ideal of widespread opportunity for those who want to participate and contribute.

Second, my perspective connects financial inclusion with an accessible and safe financial *infrastructure*. I'm referring to things like opportunities for credit and financing, secure and reliable payments systems, timely access to funds, and savings tools to address emergency needs as well as building wealth. Careful experimentation, with quantitative and qualitative research, can deepen our understanding of what works, and what doesn't - helping to advance this work.

Regional and community bankers like yourselves understand the opportunities that can emerge from including more of the public in your financial services. You also understand some of the challenges, for example, around things like small-dollar loans to emerging businesses. I do not want to minimize those challenges but do want to underline the importance of working

[7] See Collins, Kashkari host fireside chats on bank supervision and financial inclusion - Federal Reserve Bank of Boston (bostonfed.org)

together – and with other policymakers – to explore ways to make our financial infrastructure more inclusive.

As you know so well, this matters for your neighbors, your local economy, and overall economic vibrancy. I greatly appreciate our community banks' deep commitment to smaller communities across New England, and I look forward to engaging with you more on this important work.

Concluding Observations

I consider it essential to engage across all six New England states, to hear about the economic experiences of a wide range of stakeholders – workers, entrepreneurs, small and large businesses, local employers, bankers, community development experts, civic leaders, and so many others. These engagements make clear that regional and community banks are a crucial, valued dimension of our region's financial and economic infrastructure, and vital to economic vibrancy.

Thank you. I look forward to continuing the conversation with Steve, and to your questions.