Transcript: FRB Cleveland President Mester at Central Bank of Ireland, May 16, 2023

Following is a transcript from Loretta J. Mester's audience Q&A at the Global Interdependence Center's Central Banking Series conference at the Central Bank of Ireland, moderated by Kathleen Stephansen, Vice Chair of the GIC College of Central Bankers and Chair Emerita.

Stephansen:

So what's interesting is that we started this morning with the governor's remarks about, essentially the global economy and political system in general being in transition and you Loretta have been telling us almost like a case study of the US and the longer run challenges that it is creating. And one thing that surprises me in a way is the challenge monetary policy and fiscal policy policymakers in general is to the necessity to adopt specific measures, policy measures such as long term, you know, the education, statistics that you gave us are quite alarming. The problem though, and I'd like to hear your thoughts about that, the problem is that these policy measures might very well be suppressed by the short-term election cycles.

Mester:

Well, we talked about this a little bit before the conference started. So I do think there's been a shift of much more short termism which concerns me is that we don't think long term. We don't think about investment in the way we should. And I think this is something that's distorting, you know, what we can do about these things. So I didn't mean to depress people. I did want to say that there are ways that we can appropriately address some of the issues, but it does take a long run focus, like it's not immediate gratification, right? We're, we're going to need to invest in productivity, we're going to be need to invest in human capital, and you're not going to see the impact of that immediately, but you will see if it's done correctly, some long-run game, and how do you get, you know, people to think about that in a world where we talked about this morning, like, everything is quicker, right, everything is quicker, and everyone's short-term focus, and that's a problem. Right? Because I believe in sort of the economic

animal, right, we're all interested in our self-interest, right? I get that. Right. But your self-interest can, you should be thinking long term, even if it is your own self-interest, because it may benefit you in the long run. And how do you get that thinking? So I'm concerned about the short termism. I don't have a solution for it, of course, but I do think it's worth having a conversation about: how do you kind of get people to think longer term than just a short news cycle? How do you get politicians to think more about, 'I got elected today and then tomorrow, I have to start my campaign for the next four years.' Right. And I don't know how to do that. But I do think it's a worthwhile conversation to have.

Stephansen:

And that ties into your comments this morning about the narrative that you know, it has to be clear it has to there is you know, this leadership that needs to take place in terms of you know, what is the vision...but it's a challenge indeed. And in that respect, I mean, if we may just come back to just said you know, instead of a longer, longer run to the shorter run if you if you don't mind because you you mentioned that monetary policy needs to achieve price stability. And we are in that boat at the moment whereby the Federal Reserve and other central banks are striving to get to that. So in your mind do you think that there are some longer term trends that will make it that will challenge in fact your effort of achieving.

Mester:

Well, we're committed to getting back to 2% in the US, and I know the ECB has made these statements about being committed. I don't doubt it. It does take resolve. It will take staying the course. The debate in the US now is whether the fed funds rate has gotten up to that rate that's necessary and is sufficiently restrictive to ensure that policy is on a sustainable path down to 2%. And I guess the approach I'm taking with that is, I would like the policy rate to get to a point where when I'm thinking about what would the next policy change be I want it to be equally a potential increase versus decrease when we get to policy at that rate, then I think we're going to be holding for a while and we’re going to make sure that the interest rate is coming back down. So I don't I don't put it in terms of a pause. I put it in terms of a hold. And so

the question, you know, in my mind is have we gotten to that rate yet? And at this point, given the data we've gotten so far, I would say no, I don't think we're at that rate yet. Because I don't see it equally likely that we'll be increasing the next time versus decrease. However, there's four weeks to go before the June meeting. And so I want to take into account all the data that's going to come in including the banking data. We know that things happen, you know, pulling back and raising their credit standards and pulling back on credit. They were doing that as interest rates had gone up and that's a typical monetary policy transmission. Whether the current turmoil that we saw in March with the three bank failures is adding to that we don't have good insight into yet but that's something that we're monitoring very closely. In my district, the banks that I talked to and the bankers I talked to in the businesses I talk to suggest that it's not an extra pullback, this is just the pullback that we've seen because interest rates have moved up, but that's something we'll monitor and then when we get to the June meeting, we'll make a decision at the June meeting. But at this point, you know, based on the data I have so far, given how stubborn inflation has been. I can't say that I'm at a level of with the fed funds rate where it's equally probable that the next move would be an increase versus a decrease.

Stephansen:

In that respect, do you think that the Fed will be comfortable in declaring victory only if the data shows that you're very close to 2%. And because I'm struggling with this concept of leads and lags, and whether with the pandemic, those leads and legs have been really changed dramatically. And in terms of you know how the economy is reacting to the various shocks.

Mester:

So the lead-lag thing is a very important component of sort of evaluating whether we're at that sufficiently restrictive level and as you say, we raise the funds rate, five percentage points. Okay. We know that part of that has not affected the economy yet, but we are seeing that effect. Right. We are already seeing growth slow down. We're seeing some, some slight slowdown in labor market conditions. I still think the

labor market is quite tight when you talk to businesses, but it is easier to hire now than it was a year ago. And we're starting to see sort of the effects of those monetary policy, but some of it is still to play out. We know that. I'm not convinced necessarily that the pandemic has necessarily changed the lead-lag, because I think some of the thing that happened is we communicated well before the first increase that we were pivoting policy. So where do you start, you know that, you know, the change in policy happened really before the actual first increase in the funds rate? So again, I don't think we have a definitive answer that things are moving faster or slower. So that's part of the catalyst, is policy sufficiently restrictive or not, and I think different policymakers will have different views about that. But again, the sort of the lens I'm having is, I need to sort of see more evidence that inflation is beginning, is still moving down. We won't be raising interest rates until inflation gets back to 2%. Because that would be obviously not taking into account the effect that monetary policy affects the economy with a lag. But I also don't think we should be premature in declaring victory because we know this is you know, this has been a hard problem. This has been a hard to get sort of overall inflation coming down. We've seen inflation move down from a year ago from last summer. Right, but it's still very high in the US and I think that we just have to stick with what we're doing. Because the long run implications for high inflation on the US economy are not good.

Stephansen:

And of course, there is some shifts from sector to sector, goods sector to the service sector depending...but what about the you mentioned the labor market, remaining quite resilient? Is that part of the leads and lags? That it's about to fall off the cliff? Or is there another explanation of why it has been so...

Mester:

Yeah, so I don't think the labor market is about to fall off the cliff. If you talk to businesses, they say, you know, some businesses say we're still hiring because we still want workers, other businesses say, Well, given the outlook and you know, now demand is falling off a little bit. We're happy with where we are, but there's nobody who's really telling us that we're cutting and running. There's nobody saying like, and I

think part of it is because it has been so hard to hire that businesses have told us we're going to do all we can to hold on to these workers that it took us so much effort to hire. So I think that is the labor market dynamics in this expansion, and because of the pandemic and the effects, the effect it had on the labor market, I think they could be quite different from pre prior. So the reason that people are worried about you know, and saying, Oh, my is the unemployment rate gonna just shoot up is because back in prior you know, recessions when they started, that's what you saw. This could be quite different. And we've seen that so far. Right? It's that we've seen that openings come down, but nobody, not mass layoffs. We haven't seen that yet. And so that dynamic is very different. So I think there's a very good chance. We could see inflation moving down without a as big an increase in the unemployment rate as we would have thought based on prior behavior.

Stephansen:

Of course, though, you know, some, many economic agents are now getting worried about the banking system, you alluded to that. And to what extent is that going to have an impact on financial stability? And in that respect, how do you manage the potential tension between financial stability and monetary policy?

Mester:

Well, so let's take a step back. So we did see the failure of Silicon Valley Bank and Signature Bank. I think the way, what the Fed did in those circumstances with Treasury and FDIC was the right thing to do. It was a classic bank run on SVB. Money moved out much more quickly than we talked about that this morning, how fast that money and how much moved in such a short period of time. And so the lending program that the Fed set up was the proper thing to do. To make sure that those things that spill over to healthy banks, right, that there was actual liquidity out there for the banks. That said that those stresses on the banking system have caused banks to sort of think about their portfolios what they're holding on their portfolio. We know that a lot of banks are holding on to Treasury securities and agency securities that if they had to mark them to market, right, they'd be worth less than what they paid for them. And we know

that commercial real estate on their balance sheets is another potential risk factor for the bank. So banks are being, starting to take actions and they are, if you look at the Fed surveys of senior loan officers, we've seen increasing credit standards and a pullback in credit availability. Okay, some of that is just what you'd expect to see as interest rates rise. That's the typical transmission mechanism. The question though on the table is how much additional pullback will we see because that additional pullback is again, you can consider as working in the same direction as a tightening of monetary policy, and that's sort of what we're assessing now. In terms of financial stability, to as much extent as possible, you want to sort of separate out the financial stability issues from the monetary policy issues. I think we were able to do that in March. Which is why we were able to sort of move ahead with another rate increase then. And I think we've, we've sort of handled that but we've got to be prepared to always have the lens that financial stability is a sort of cornerstone of a healthy economy. And so you're right at some point, perhaps there'll be a tension between the two. But so far, we've been able to, to navigate that. And my hope is that we'll continue to be able to navigate that going forward using our macro prudential tools. And micro prudential tools for financial stability issues, and focusing on our macro tools or monetary policy tools on the macro.

Stephansen:

And would would you say that the intervention in March was stronger than one might have anticipated given the size of the bank SVB? Just in order to precisely keep the financial stability intact?

Mester:

I think the intervention was precisely to avoid contagion, right? It wasn't to prop up one bank versus another. It really was, right, a run like that of liquidity, basically it was a typical bank run only sped up. And it was, you know, potentially could affect healthy banks. Right. And that's what you want to prevent. You want to prevent contagion like that get through the banking system. That was the purpose of that setting up that 13-3 facility and making sure that it was resolved in a way. And it did seem to work in terms of lowering the tension at that point.

Stephansen:

And do you think that this recent bank failure tells us that the data that we have available to us is, in fact ill suited to measure risk management of balance sheets?

Mester:

I think if you read, Governor Barr, Vice Chair of supervision, put out a report recently that's a worthwhile read if anyone hasn't read it that really walks through their evaluation of what happened with Silicon Valley Bank. And so there were a number of issues. One was, as you say, risk management was poor at the at the institution, but the Fed also said, right that we take some responsibility because our supervisory apparatus didn't work as well as it should have. So again, I think there's a, you know, there are several pieces to the puzzle there. I mean, the focus of SVB bank was not typical. In terms of like a regular bank of their size, they had grown very quickly. Risk management was not as good. The regulatory side, supervisory side, left something to be desired in terms of they identified things but didn't necessarily follow through as quickly. So again, that's why the Fed is looking at its supervision and its regulation. And Governor Barr is going to be evaluating that so I can't say it was a lack of data per se. But there was something that I think there are some parts that need to be improved.

Stephansen:

And talking about improvement or something like that. I don't want to be totally selfish. So I would like to now open the questions to the audience because I'm sure that everybody would like to have - There you go.

Unidentified Speaker 1

The question has been that in this cycle, the rates went up very quickly, very fast. And as a result, the cost of funding is very, very expensive for corporates and many others households et cetera, which means this

is at risk, put puts at risk, the growth of the economy. So how would you respond to that? That is on one hand, you try to handle the inflation, but on the other hand, you have the cost of capital and so expensive that it is a drag to the economy?

Mester:

Alright, so my own forecast is that growth will be well below trend. So okay, so you know, the policy is going to slow growth, we're seeing that already. We're seeing growth slow. We did raise interest rates quicker than typical, but you know, inflation was much higher than typical. So I don't think that the speed which we which we raised the rate was really the issue. I think what you're seeing is the level of the interest rate is now having this effect on dampening growth, but nonetheless, inflation has been stubborn, and persistent and too high. And so, you know, our job is to make sure that inflation is sustainably coming down to 2%. And, you know, the labor market has proven to be very resilient. And so that's why I think we can get inflation down and I expect inflation to come back down with appropriate monetary policy, and we'll see material improvement this year in inflation.

Unidentified Speaker 2:

You mentioned the report on Silicon Valley Bank (inaudible)...

Mester:

So, you know, Governor Barr is actually looking at sort of the supervisory, regulatory structure at least as far as the Fed is concerned, and I'm convinced that they'll take appropriate action to really analyze what what the causes were and to address them. I think the report is pretty clear. In sort of the interpretation was that, you know, there were things that were missed. I mean, when you think about, I think there there's some argument that says you know, interest rate risks seem to take a lower level than credit risk, right, because the regulators sort of were focusing on credit risks and the interest rate risk part of it. And maybe that's another outcome of the fact that interest rate risk wasn't an issue in banking, because we

were maintaining that very low interest rate for so long, right? So you can imagine that there's gonna be some thinking about, okay, how do we make sure that we're focusing not only on credit risks, but also interest rate risks when we're managing banks? You can imagine things like that you can imagine that there's going to be work on making sure that when risks are identified, right, they're elevated and so that more action is taken to make sure that the banks then address those risks. I mean, we can't force necessarily the banks to do things but we can escalate in a way that illuminates the dangers if they continue down not taking into account some of those risks. And so I think there's work going on, that will address some of the things that came out of those reports.

Unidentified Speaker 3:

My question goes a little bit between the short run and the long run. About three years ago, the Federal Reserve published its strategic review of monetary policy. And it was interpreted at the time as a little bit of a softening in as much as it said after a long period of low, lower than targeted inflation the Fed might aim for a higher than target inflation for a while. And my question really is, Do you think that that new orientation may have influenced the FOMC and delayed their response to the post COVID inflation?

Mester:

Well, it's a great question. And one that I certainly have thought a lot about. I guess I did not, I don't think so. But I but I do think it's the it's the forward guidance that we put out earlier in that year, like in 2021, that I think did influence how we were thinking about policy. That coupled with the fact that, you know, the traditional model of supply shocks is that you look through the supply shocks if you're monetary policy and I think what we didn't recognize at least how I'm doing this, these are my views is that the supply shocks happen, you look through them. But the only way that inflation can be perpetually ongoing, with a supply shock your price level goes up, but that doesn't create inflation, the inflation is created because you have too much liquidity. And I think the failure was not noticing that this is continuing on. It's not just a cascading of new plus the supply shock on the new supply shock. It was really was like

there was this mismatch now. The supply side was affected and we didn't do sufficiently withdrawal of accommodation to get demand in better sync with that constrained supply. And I think that was where perhaps the forward guidance that we based on the new framework affected kind of some of the decision making but I think there's going to be a lot of PhD students are going to study this for a long time and come up with something more definitive than mine.

Stephansen:
You know, would you have been feeling comfortable raising rates starting in the fall of 2021? When Omicron is just in full speed?

Mester :
I have to say yes, because I think in some of my speeches, I was saying that I didn't think that the interpretation that this was going to be short lived was the right interpretation. So I mean, at some point, you have to acknowledge that what we can control is, you know, inflation and we need to take action regarding the environment and some other things.

Stephansen:
Unfortunately, time is against us. As per usual, it's too bad because I would love to continue. And, you know, I don't know if there's any maybe one last question. If not, we have to applaud and thank you.

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