Fed Unfiltered, Transcript
9/27/22 – Neel Kashkari, Interview: WSJ Live

Nick Timiraos:

Hello and welcome back to Ask WSJ. I'm Nick Timiraos, chief economics correspondent for The Wall Street Journal, and I'm pleased to be joined today by former Treasury Secretary Larry Summers and president of the Federal Reserve Bank of Minneapolis, Neel Kashkari. Thank you both for being here. This is a special opportunity for our readers to ask questions and viewers can submit them right now.

Neel, I'll start with you. After the last meeting in July of the Federal Open Market Committee, markets rallied because they liked that Chair Jay Powell acknowledged the prospect of an eventual downshift in the pace of rate increases and you came out right after that meeting and said you and your colleagues were nowhere near done. Again, at Jackson Hole, Chair Powell tried to lay out more of a one-note message to the Fed was really in it until inflation was defeated and after that you came out and said you were pleased with the reception to Chair Powell's speech. As we sit here today, as markets have digested what the Federal Open Market Committee presented at its meeting last week, are market participants doing a better job of understanding what exactly it is that you and your colleagues are trying to accomplish here?

Neel Kashkari:

Thank you, Nick. Thank you for having me. I think they are. I've been on the Federal Market Committee now for almost seven years. The only other time I have seen us this united was at the beginning of the pandemic when we knew we had to act boldly to support the economy through the pandemic and through the downturn. We are all united in our job to get inflation back down to 2% and we are committed to doing what we need to do in order to make that happen and that leads to more tightening of monetary policy in the near term. Now, ultimately how much we need to do is not just up to us, it's going to be determined also by the supply side of the economy and whether we get some help on the supply side. But whatever happens on the supply side, my colleagues and I are committed to doing our part to restoring price stability. That's what I think markets are now understanding.

Nick Timiraos:

Neel, at the last meeting, the Fed raised interest rates by three-quarters of a percentage point or 75 basis points for the third straight meeting. You and your colleagues put together these projections of where you see appropriate policy under a baseline economic assumption and almost all of you had interest rates later this year above 4%, a narrow majority just below 4.5%. If that's the destination for policy here, and there's only a couple of meetings left, there's only a little bit of economic data you're going to get over those next couple of months, would you have supported actually doing more at last week's meeting, as in doing a hundred basis point increase last week?

Neel Kashkari:

We are moving very aggressively. If you look at real interest rates, medium and long-term real interest rates, we have tightened policy by driving up medium and long-term real interest rates much faster this year than we even loosened policy during the pandemic, and so we are moving very, very aggressively. Now, one of the challenges is, as we all know, that monetary policy operates with a lag, and so there's a lot of tightening in the pipeline. We are committed to restoring price stability, but we also recognize given these lags, there is the risk of overdoing it on the front end, and so I think we are moving at an appropriately aggressive pace, but we're also not just simply saying, "We're going to shoot up as high as possible as quickly as possible." I do think the pace that we're undertaking right now is appropriate.

Nick Timiraos:

I want to bring in Larry to the conversation. Larry, you've been quite critical of the Fed for the last year and a half. You've argued that they've moved too slowly and so I would ask you because people are asking me all the time right now, "Jeez, is the Fed overdoing it?" Do you think the Fed right now is overdoing it?

Larry Summers:

No, I think the Fed allowed itself to get way behind the curve for a long time in 2021 and early '22 and in the process sacrificed a reasonable amount of credibility and in that context it is necessary to move very strongly and to be very clear and straightforward. That's why I think Neel's intervention after the July press conference that was interpreted by the markets as being very supportive of asset prices rather than disinflation, I think Neel was very constructive afterwards, and I very much welcomed the adjustments that Chairman Powell made.

I think we do absolutely need to do what's necessary to bring inflation substantially down and the more determination with which that's done, the less painful the process is likely to be. Of course, there's a risk that it will be overdone, but certainly, at the current level of interest rates of a 3% Fed funds rate when the most recent core inflation figure was seven and the month was more than the quarter, the quarter was more than the half-year, the half-year was more than the year, I certainly don't think it's been overdone yet. As Neel said, it's a difficult set of judgments that the Fed's going to need to make going forward.

Nick Timiraos:

Larry, if you were on the Open Market Committee right now, or on the board at the Fed, what would you be looking at to determine this is enough that the risk management here calls for maybe airing on the side of over-tightening because inflation's so high but you don't want to create unnecessary harm to the extent you can avoid it? What would you be looking at right now to decide this is enough or this destination for the federal funds rate feels like the right level to be at for now?

Larry Summers:

I would be watching very carefully what was happening in the labor market and I'd be looking for evidence that signs of an overwhelmingly tight labor market were giving way to signs of a labor market with more slack. I would be looking at a broad range of price increases to see whether in the median price for example, we were starting to see evidence of a substantial decline in inflation. I would be looking at the kind of reports that the Fed gets on everything from future hotel reservations to business orders for a sense that a precipitous recession was starting to break out. Those would be the kinds of things that I would be looking at, but I would be very much with the understanding that just as a patient to do the right thing has to take their whole regimen of medicine, even when they're starting to feel better and even if there's a bit of side effect, that the fact that there was some dislocation and economic distress was not a reason to abandon the objective of restrictive policy.

I think the encouraging thing in Chairman Powell's rhetoric at Jackson Hole and more recently in his press conference and the encouraging thing about what Neel just said about the unanimity of the Fed is that what's being privileged is bringing down inflation rather than assuring that there's no bumps in the road for the real economy. As you know, Nick, I have felt for quite some time now that having allowed inflation to rise so much, a soft landing was possible but certainly not the likely thing, and that you needed to make some choices and you needed to signal how those choices were going to be made. I think the Fed has moved now with clarity in the direction that I've been advocating for the last year when I was sharply critical of Chairman Powell's 2021 speech. I'm glad to see that now the Fed's views and my views are in much closer accord.

Nick Timiraos:

Neel, a lot of people including, well, maybe not Larry today, but a lot of people are accusing the Fed of overreacting now to one type of policy, or last year with a similar type of response now. For example, two years ago the Fed said it was going to set policy based on actual inflation and not a forecast, but then last year when inflation picked up, you and your colleagues stuck to your low-rate policy based on a forecast that inflation would come back down quickly, and now, the Fed is again saying that it will set policy based on actual inflation and not a forecast. Some people are worried that this will lead to unnecessary weakness in the economy. Are you and your colleagues raising rates in these 75 basis point intervals maybe again in November per your projections last week because you are getting impatient? Is the Fed right now impatient with the lack of progress in this process of getting inflation out of the economy?

Neel Kashkari:

Well, we need to see some progress, and we're not seeing it yet. I mean, we know the gasoline prices have fallen, we know The Wall Street Journal reported today that lumber prices have fallen back down to pre-pandemic levels. Those are all good signs, but we're also seeing wages continue to climb. We're seeing that rents have been climbing. There's a lot of increased inflation still in the pipeline and this is stickier inflation, not just a volatile inflation that we've been seeing with commodity prices and energy prices as an example, and so that makes me concerned that we have more work to do.

There's a lot of uncertainty, right? The economy, whether it's the GDP numbers versus GDI numbers, what's happening with real wages, the economy is sending us a lot of mixed signals right now, and for me, I believe we need to keep tightening policy until we see some compelling evidence that underlying core inflation is actually having peaked and heading on its way down. Then I think we need to sit there and we need to pause and wait and let the tightening work its way through the economy to see at that point, have we done enough? The one mistake that I am acutely aware of that I want to avoid repeating from the 1970s is when policymakers saw the economy weakening, saw inflation start to tick down, and then they cut rates thinking they had done the job, and then inflation flared back up again. That is a mistake I believe we cannot make and we will not make and that means we need to get policy to a stance where we're clearly tightening the economy and then we need to be patient and allow inflation to come back down towards our 2% target.

Nick Timiraos:

I'm looking at a real 10-year rate right now around 1.3%, a five-year real rate around 1.5%. Neel, is policy tight right now? Is policy easy? How would you assess the stance of policy right now?

Neel Kashkari:

I think the overall stance of policy right now is tight in the sense that we are putting some downward pressure on inflation. If you compare those numbers that you looked at, which I pay a lot of attention to those numbers five and 10-year real rates, they are substantially above where they were prior to the pandemic. As a rough estimate, I would say prior to the pandemic, we were close to a neutral stance of policy, and now, policy is tighter than it was pre-pandemic. Is it tight enough? I don't know, but certainly, we are beginning to tap the brakes. We've got more work to do, but we need to start to see inflation heading down before we can be convinced that we're headed in the right direction.

Nick Timiraos:

Larry, same question for you. Is policy tight right now? Is policy easy? In July, when Chair Powell came out and said the Fed was had raised rates close to their estimates of their long-run neutral rate, you said that was analytically indefensible. How would you judge the stance of policy right now?

Larry Summers:

I think the policy path that's being signaled is broadly reasonable. That is, I do not think there is any argument that a 3% interest rate is appropriately restrictive in the current context, none. But the Fed has basically created an environment where there is a expectation in the marketplace that rates will peak somewhere above 4.5%. That is, I think, a broadly reasonable and appropriate place. My guess is that the ultimate adjustment is likely to need to be more than that rather than less than that, but that's a guess, and 4.5% is reasonable.

The entirely fallacious argument made by many of the Fed's critics is to say, "Well, look at break-evens, they're relatively low. Therefore, the Fed is credible. Therefore, the Fed doesn't have to raise rates," without understanding that the only reason that break-evens are so low is that the Fed is signaling a path of substantial rate increases and that if the Fed were not to be signaling that then break-evens would be higher, so I think it's important to distinguish between the current level of interest rates and the signaled policy approach. I think the signaled policy approach is now broadly the right one, but to interpret the fact that the signaled policy approach is the right one as licensed to shift away from that policy towards maintaining the level of current interest rates would, I think, be a blatant error.

Nick Timiraos:

Larry, you were at the Treasury Department in the 1990s, Under Secretary for International Affairs, Deputy Treasury Secretary, and then Treasury Secretary. There was obviously a lot of crises internationally during that period and we're seeing right now the effects of a stronger dollar and financial tightening around the world after many years of very low-interest rates. My question to you is what, if anything, can the Fed do here to minimize global ripples?

Larry Summers:

I would put that question in a rather different way, Nick. I think the worst thing the Fed could do from the point of view of the global economy is to fall further behind the curve and not to have made the adjustments it has made in the last six months because that would be setting up the global economy for an episode like the late 1970s, early 1980s with a catastrophic increase in US rates, an egregious recession, double-digit interest rates, a dollar skyrocketing much more than it is now, and that would be the ultimate mistake from the point of view of the global economy. I think the best thing the United States can do for the global economy is to properly manage our own global economy. As I've said, I think the Fed is moving in that direction.

What I have to say has troubled me is the near absence of global economic diplomacy apart from sanctions issues in these years. You don't see the IMF expressing strong views on the growing inflation in many parts of the world. The IMF said almost nothing about the excessively expansionary policies that were being pursued in the United States. To my knowledge, the IMF has been silent on the hugely misguided policies pursued in Britain. You don't see major discussion of fortifying the global financial institutions so that they can much more support emerging markets in what is likely to be a challenging period going forward. The Fed at other points has been a stronger voice for tariff reduction, for... Obviously, it's not their sphere, but the Fed has been much more vocal on questions of climate policy that are largely unconnected from concerns about inflation than it has been about concerns about supply-side policies, like the removal of tariffs, like the removal of restrictions on energy supply that relate much more directly to an inflation mandate.

Nick Timiraos:

There are a number of questions coming from readers about the Fed's 2% inflation target. Neel, I want to ask you, the Fed almost exactly two years ago, changed its framework to support periods of modestly higher growth and higher inflation because there had been concerns that inflation was running below the 2% target. You actually dissented against how the Fed operationalized that new framework at the Federal Open Market Committee meeting two years ago in September. You later explained your dissent like this: "If this new guidance helped to generate higher inflation that the FOMC then had to respond to by raising rates, I think we would consider that a high-class problem." Neel, a high-class problem. Did the Fed misjudge the degree of difficulty that it would have in mopping up all the excess liquidity that was pumped into the system during the pandemic?

Neel Kashkari:

Well, the high inflation that we're seeing right now is partly driven by, obviously, huge surge of demand from fiscal stimulus, also from monetary stimulus, overlaid with that, supply chain issues related to the pandemic, overlaid with that, the Russian invasion of Ukraine, and commodity price shocks, and whatnot, so there's a lot going on right now. The thing that I like about our framework is it's asymmetric, it's designed to provide more stimulus during times of very low inflation when we are constrained by the Zero Lower Bound on the federal funds rate. But once we get out of that regime and we're back into a higher inflation regime, the new framework reverts to being the old framework.

If you'll go back in time back in May 2021 when core inflation first ticked across 2% for the first time in a long time, the headline unemployment rate was still 5.9%. That signal to me at the time, it seems like there's still a lot of slack in the economy given that we had been at 3.5% unemployment rate prior to the pandemic with no inflation, and so it took us a few months to realize that hey, there are big structural changes, and some of this high inflation is not transitory the way that I thought it was. Then we've moved aggressively, and so I think the new framework, it's far too soon to judge whether that new framework is ultimately going to be the long-term right framework. But the important point is it's asymmetric. In this environment that we're in now, it reverts to being the old framework. It's not changing how we're doing anything right now.

Nick Timiraos:

Larry, I want to bring you in on this because you were an evangelist late in the last decade for the Fed to change its framework. You wrote in 2017, "Responsible new leadership at the Fed will have to give serious thought to shifting the monetary policy framework." In 2018 at Brookings, you elaborated, "I will argue that any appropriate framework will have the property that in normal times the federal funds rate will exceed 4%." You were concerned about the Fed not having enough policy space. Even in November of 2020, you said, "There may be a role for inflation targeting, but it is largely beside the point in a world where the real problem is insufficient price inflation." The Fed changed their framework in August of 2020. What went wrong?

Larry Summers:

What went wrong was that we had an entirely different fiscal regime. We were spending 15% of GDP a year. My comments didn't contemplate an environment where the government was injecting 15% of GDP into the economy and that created an entirely different world.

But I think more broadly, Nick, we probably need to step back a bit from the somewhat academic approaches that have guided the Fed over the last decade. I always felt that the Alan Greenspan definition of price stability as we've got price stability when people aren't thinking about rising prices all the time is probably sufficient. I'm not sure it was well-advised to set a numerical target for the level of inflation, but I think I would agree with Chair Powell, and I think with Neel, that having set such a target, and then having fallen as far behind the curve, and Neel, respectfully, I don't think it's a few months. I will always wonder how in March of 2022, after house prices had risen by 20-some%, the Fed was still buying mortgage-backed securities. I think it was quite a long time behind the curve for the Fed. I think in that context, this is not the moment to do anything other than carry through on a determination to reach the target that has been very widely proclaimed whether or not it was advisable to set such specific targets.

Nick Timiraos:

I'll get to reader questions here. William asks, "After the 2001 dotcom meltdown, it took a decade for the NASDAQ to recover its losses. Japan's market is still not back to the levels of the 1980s. What are the odds that American financial asset prices might remain lower for longer?" I'll ask both of you that question, but Neel, I'll start with you.

Neel Kashkari:

I have no idea. People say, "Oh, you guys are trying to boost asset prices or stock prices," or whatnot. We are trying to achieve our dual-mandate goals, and there's a mechanism by which it flows through financial conditions to ultimately affect economic activity, but I don't have any interest in trying to forecast the stock market.

Nick Timiraos:

Larry, the odds that American financial asset prices might remain lower for longer?

Larry Summers:

I don't think we're here to give investment advice. Nick, I do think that if one looks at asset prices, they seem to factor fully in what's happened to real interest rates. I'm not sure the kind of earnings that would be likely to accompany a recession if we have one is something that's fully factored into asset prices at this point.

Nick Timiraos:

Neel, we have a question from Elmo who asks, "In your opinion, do you believe that a soft landing is still possible, or is it your opinion that a hard longer recession is coming?"

Neel Kashkari:

Well, I think a soft landing is still possible, and certainly, we will work very hard to try to achieve it, but a lot of it is out of our control. It's do we get more help on the supply side of the economy, or is bringing the economy into balance entirely up to reducing demand? That's through the Federal Reserve. If that's the case, then it's much more likely to be a hard landing. We are going to try to achieve a soft landing, but we are going to get inflation back down to 2%.

Nick Timiraos:

Miroslav asks, "According to Thanos Vamvakidis, global head of currency research of B of A, when inflation and developed economies rose beyond 5% between 1980 and 2020, it took on average 10 years to bring it down to 2%. Today, however, the consensus seems to be that inflation in the US will decelerate to the Fed's target at some point in 2025 at the latest. What is different this time that makes people think inflation will be brought down to 2% in the span of three years?" Neel, I'll go to you first on that question.

Neel Kashkari:

Well, I think it's a couple of things. I think that the Fed does have credibility earned over many decades that we are committed to restoring price stability and you have somebody like me who is historically one of the most dovish members of the Federal Open Market Committee arguing strongly that we need to do whatever we need to do to get inflation back down to 2%, and so I think people are seeing the unity on the Federal Open Market Committee to restore price stability, and that is helping give people confidence so that inflation expectations do not start to increase and potentially unanchored.

Larry Summers:

If I could just come in on that, Nick?

Neel Kashkari:

Please, please.

Larry Summers:

I think a hard landing is substantially more likely than a soft landing. I think if inflation is going to come down in two or three years rather than the 10 that you're questioner mentioned, that's likely to be in the context of a recession, not in the context of a smooth path. Neel said that unless we get a miracle on the supply side, or unless we get a lot of happy news on the supply side, it's likely to be a hard landing. I think that's right, and I don't know what reason there is for thinking that we are going to get some kind of sudden major increase in productivity.

I supported the Inflation Reduction Act and a number of other steps that are directed at strengthening the economy's potential, but none of those policies have serious arguments associated with them that they're going to produce huge supply-side benefits quickly, so I think the likelihood is that the current Fed forecast, which is that both unemployment will peak at four and a half and that we will get back to 2% inflation within two and a half years. I think the odds that both those things are going to happen together are probably less than one in four.

Nick Timiraos:

We don't have much time, so I'll make this the last question. Larry, I'll pose it to you. Andre asks, "What do you believe is the probability of China's overextended real estate market affecting other global markets, particularly the United States' credit and real estate markets?"

Larry Summers:

Look, I think China's slowdown is already a very important factor affecting oil and other commodity markets. I think it's a retardant to global growth. I would be surprised if it proved to be a financially systemic event outside of China. I don't think it's likely to have major effects on Western banking systems.

Nick Timiraos:

Larry, Neel, thank you both so much for joining us this afternoon. I wish we had more time. I think our audience probably would, too, but I really enjoyed our conversation, so thank you so much.

Neel Kashkari:

Thank you for having me.

Larry Summers:

Thank you.

Nick Timiraos:

To all the viewers out there, thank you so much for joining us today. You can email us at voices@wsj.com with any further questions or stories and keep up on our live coverage at wsj.com. If you missed part of this event, the full Q&A will be available to rewatch on this page. Thanks again for joining us.