Transcript – WSJ Interview with Cleveland Fed President Loretta Mester

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Federal Reserve Bank of Cleveland President Loretta Mester spoke with Wall Street Journal reporter Nick Timiraos in New York on Feb. 24 on the sidelines of a monetary policy conference. She discussed the path of potential interest rate increases and the outlook for employment and inflation. Here is a partial transcript of the interview, lightly edited for clarity and length.

MR. TIMIRAOS:
If we went back a year ago at this conference and you told people the Fed is going to raise rates 450 basis points over the next 12 months, people would've lost their minds. They would've thought that there would've been a much bigger slowdown in the economy than what we've seen. Are you surprised that the economy has been so resilient so far to the policy tightening that you've put in place?

MS. MESTER:
You're right, the economy has been resilient. But we saw that over the last expansion too. It's like there's much more resilience in the U.S. economy than sometimes we give it credit for. But you're right. Typically when you start raising interest rates and if someone had said—but remember how low it started from? So that's part of it. We had to take very strong action in the beginning of the pandemic. Remember, I think some people forget how scary and uncertain the times were. Then when inflation started moving up, there was good reason to think that some of that was the supply side really exerting its influence and once we got beyond that, we could then get back to more normal inflation rates. Well, that didn't happen. Those kept going.

So we had to take this decisive action. And the economy has been resilient, but remember there's a lot of other things going on that aren't necessarily cyclical things. You look at the labor market, there's been a lot of change in the labor market because of these structural things going on. At the same time, we have cyclical factors influencing it in the housing market. There's structural things going on in the housing market. Everyone moved, wanted to move farther away from cities and have bigger places because of remote work. And so that's what's made this a hard period to forecast and perhaps even part more uncertain than normal. Part of what's happening is that there's cyclical things going on at the same time, structural things going on. And that's what's created this environment which is very different from the past.

Nonetheless, inflation's too high. We have to do what we can do with the interest rate tool to get inflation down. It's our responsibility to get back to price stability, and we'll happen to let the economy tell us. And when I say the economy, I don't just mean looking backward. I think looking forward is very important in an environment like this, which is why we spend a lot of time with contacts asking them, "What are you seeing on the ground? What are community development organizations having to deal with? What are labor markets having to, people having to deal with, and what are businesses having to deal with in the labor market?" And that's going to be helpful as we go forward to sort of understand where should we really stop and really pause for a while and see how the economy's going out and then having to do more or not, right? We're going to have to judge that as we go.

MR. TIMIRAOS:
Are there things that are different in the postpandemic environment that may have lengthened the lag of policy? For example a lot of people refinanced their mortgages, they locked in low rates. Corporates termed out their debt. They may be less sensitive to higher short term rates than perhaps was the case before the pandemic. Are there reasons to think that the lags have lengthened?

MS. MESTER:
I've heard some people say that. I've heard some people say the lags have shortened. I don't think there's anything definitive that we can point to because, remember, there wasn't anything definitive about exactly what the lag was. That's why we have to be, I'll use the word data dependent, because that's what the Fed uses. But that's a shorthand for we really have to be gauging what's going on in the economy using all the sources we have, including anecdotal evidence, data models, past history, these structural things that may be different at this time, and then judge to actually see where the economy's going. We've got to be attuned to the fact that the economy can evolve differently than we expect. I mean we certainly learned that over the past couple of years, right? And so we just have to be attuned to that. It's definitely true that we are much more transparent about our views about policy, where it's going than we were in the last high inflation period, for example. And that meant that even before we made that first rate increase, the markets had already sort of built that in, right?

MR. TIMIRAOS:
The transmission from policy action to financial conditions.

MS. MESTER:
That was shorter, right? Now, does that mean that the impact on the economy was shorter? No, I don't think so. I think that still had to play out the way we've seen it play out. And so some of that's still going on. So some of the things that we've done with the policy rate are still feeding through in the economy. Could it be longer? Yes, sure. But it was always long and variable lags, and I think it's very important to recognize that in any kind of tightening or loosening cycle, it's not one monolithic economy. Parts of the economy react differently than other parts. We know that certain sectors are interest rate sensitive—housing for one, right? So we saw that contracting much faster, right? But we have seen demand come down, output tempering in manufacturing. Autos is one that you point to as being interest rate sensitive and so that's how it's going to play out and transmit through.

But we've got to be always engaging that, and that's how we're going to decide, "OK, is this a good time to stop?" It's always a risk management exercise. There's not going to be like, "Oh, we know that stopping now is the right answer." It's going to be, "Let's look at the risks." I'm waiting for that balance of risk to be there right now. I still think the risks on the inflation side are on the upside. And I also think the cost of having inflation remain too high is costly in the short run because households have to deal with that. Some of the people you talk to, they're like, well the usual safety net—you talk to like the Cleveland Food Bank. They've had to deal with very high prices, and difficulties in getting volunteers and labor and all that. So they're not as able to help as many people.

Then you have sort of the usual, like if I'm out of a job I can help, my sister can help me and vice versa. Those family, social informal safety nets—inflation is one of these things that everyone's dealing with at the same time. So that's a really costly thing, right? And then if you think about all the distortions that happen in terms of maybe I can't afford now to go to college or I can't afford to take training classes because I'm spending more money on these things. Those are long run implications for the economy. So

I think the cost of running a high inflation economy is pretty high, and I think that's something that also influences my views about how we have to get this inflation on a path down to 2%.

It certainly would not be appropriate to keep raising interest rates until inflation gets back down to 2%. But we have to have more assurance that we're on that downward path. and that's going to mean at, as we saw in the last [Federal Open Market Committee] meeting, we do have to continue to move the rate up some more. And then pause for a time to assess things. And hopefully we'll get that confirming evidence that inflation's moving back down. Because that's what would be great. Everyone is looking for that. Everyone wants that.

MR. TIMIRAOS:
So at the last FOMC meeting you had said there was a strong economic argument for raising by 50 basis points, though it hadn't been socialized or wasn't priced in. And you've said you don't like to surprise markets. You have a chance now to socialize for March. The economic data have come in stronger—retail sales, hiring, inflation readings. Isn't the argument you had for doing 50 in January just as strong or even stronger going into the March meeting?

MS. MESTER:
Well, I don't want to prejudge the committee discussion and we're going to have that conversation around the table. But you're right, and my view of the economy hasn't changed that much in terms of we do have inflation pressures that I think are um pretty "in there." We haven't seen the kind of sustained downward pressure. I'm very gratified that inflation rates have come down since last summer. But I think we have more work to do and certainly that's something that I'm very focused on. And I still think that the risks are to the upside on inflation, not to the downside. So again, it's very important for the Fed to articulate its strong commitment to getting back to 2%. And by taking actions to do it, that's actually going to make it less painful to get there. Because if people understand where we're going and understand we're committed to doing it and that we will not rest until we get there, being judicious about balancing the risks—because we do have a dual mandate goal and we're not going to forget about the other part of our mandate. It's going to be risk management as we go. I think that'll help get us back to 2% in a timely way and actually be helpful for the economy over the long run. A lot of times people phrase this as a trade-off between labor and prices. I don't see it that way because if we're going to have healthy labor markets, we've got to get back to price stability.

MR. TIMIRAOS:
In the run up to the last Fed meeting, there had been maybe more evidence of a deceleration and price pressures if you looked at three month annualized rates. Now, some of the seasonal factor revisions on the CPI, the PCE that we just had a couple minutes to look at this morning—it looks like some of that progress was revised away. Does a 0.6% monthly increase in the PCE change your view about the relative progress or the persistence of the inflation problem that we're facing right now?

MS. MESTER:
I haven't looked at the details of the report, so I don't want to comment too broadly on that specific report. But I do think that we have to be very cognizant of the fact that we have to see convincing evidence. I've said all along that you don't want to—what's the more costly mistake? The more costly mistake is assuming inflation is coming back down and pausing or loosening prematurely or not going as far. That's a more costly mistake.

Everything that we know from our past episodes is that you don't want to be doing that, which means you have to have a healthy bit of skepticism about it. Now I do think we have seen progress since last summer, so that's a good thing, but I think we've got to see more. And that's why coming out of the last meeting, it was very much the consensus view—and if you looked at the minutes that were released this week—that we've got to do some more with the policy rate in order to make sure that inflation is on that sustained downward path to 2%.

And it is an exercise in knowing, kind of like that—the fact that data can get revised, as you said. Even the seasonal factors can get revised in the CPI report. Because a lot of people think the CPI never gets revised. Well, indeed it does sometimes because of the seasonal factors. And just being able to use good judgment about "OK, where do you feel comfortable?" But that's the beauty of having a committee because everyone's going to bring their own views from either what they've gathered in their districts or how they're viewing the economy, so that we can do that kind of judicious balancing so that we no one's trying to go too far and no one's trying to do too little. What is that spot that we need to be in? And that's kind of the process that we go through at the meetings.

MR. TIMIRAOS:
It seems like one of the tactics or strategies that's emerging now would be to just extend the string of 25 basis point increases for longer if the data materialize in a way that suggests more resilience or inflation persistence. Is that a reasonable strategy to you?

MS. MESTER:
It's a strategy. I guess my feeling at the last meeting was that I came into that meeting thinking—I had the view that we have got to get at least to a 5% [federal-funds rate], and I said above 5%. We weren't there yet, right? And a 50 [basis point increase] last meeting would've gotten the top of the target range to 5%. Why would you not do that? Especially when we had done a 50 [in December.] It wasn't like now. This is a different situation now. We've already reduced it to 25 [basis points]. That's going to be part of the consideration.

MR. TIMIRAOS: The bar is a little bit higher?

MS. MESTER:
Well, I mean, I think you have to take where you are and what you did at the last meeting. I'm not saying that we shouldn't have a healthy debate about that, but that's part now of the discussion, right? Frankly, we'll have to see what happens at the meeting. I think it is a good idea to think about—instead of "do you do 25 now and 50?" That's not the discussion, really. The discussion is how much further do you think you need to get to. In order to get that convincing evidence, do what you have to do with the policy rate to get inflation back down to 2%

MR. TIMIRAOS:
I'm splitting hairs here, I'm sorry. But in December, were you above or below 5.5% in your terminal rate projection?

MS. MESTER:
I was above 5%,

MR. TIMIRAOS:
But 5.5%?

MS. MESTER:
I was above 5%.

MR. TIMIRAOS:
OK. To the extent that financial conditions have eased a little bit since October—not withstanding what's happened in the past two weeks, but between October and maybe the end of January, mortgage rates came down a little bit, credit spreads came in a little bit. Every time the market thinks the Fed is winning or succeeding in this battle, and the odds of the soft landing are going up, financial conditions ease in a way that I wonder, does that make the job that you have harder? Was the easing in financial conditions between October and January creating any kind of challenge for monetary policy?

MS. MESTER:
So there are a lot of reasons that financial conditions can move, right? So part of it is—when I think about it, are market participants understanding the Fed's policy and are we communicating well where we're going? But they might have a different view of the economy. So there is always a give and take. You want to be able to use the signals from markets to help inform your own outlook about where the economy's going, but you also want to make sure that they understand how you are viewing the economy and what your policy is likely to be going forward. So yes, you're correct in that when we're moving up the policy rate, we want to see broader financial conditions tighten. When we're moving down the policy rate, we want to see broader financial conditions loosened.

So to that extent, right, we have to be attuned to what's happening in the financial markets. In that particular period, it wasn't top of my mind as being a factor in driving the decision. The decision really was, we haven't done enough to get inflation on that sustainable downward path to 2%. Part of it is we're going to have to do more with the policy story and financial conditions then will tighten further and get us there. I think as the market participants do the same thing we do when the data comes in, you have that inform your outlook.

What's important for a policy maker, though, is to make sure that we're communicating as well as we can: where we're seeing the economy, what our outlook is, where we see the risk, and what we think the appropriate policy path is without prejudging in terms of being so dogmatic about something. Those are the difficulties. We're not prescient, but we have to be able to explain what our reaction function is so that people know "OK, if the economy evolves this way, we have a pretty good idea of how the Fed's going to react." If it evolves another way, maybe it's not the way they thought, but at least they know, "OK, if the economy does surprise us, we have a good idea of how the Fed's going to react."

MR. TIMIRAOS:
And have the moves over the past two or three weeks, as the market has come closer to where you were in December—has that been validating?

MS. MESTER:
It tells you that now they're seeing sort of the same developments in the economy that we are. So in that sense it's confirming, kind of, how we're seeing things. But again, we have to continue to do that. You cannot rest on your laurels. You have to continue to assess, "OK, what are different forecasters thinking about the economy? What are our models saying? What are our business contacts and labor market conducts telling us about what they're seeing in those labor markets? And what are businesses planning to do?"

So in this period, as we're transitioning monetary policy, that becomes very important because that's forward looking information. You know, businesses tell us I am seeing moderation in my costs. I am seeing supply chains [improve]…. That's a good thing in the sense that it's confirming that we are being able to moderate demand, right? To alleviate price pressures. It's just that we haven't gotten enough of that to bring price pressures on that path back to 2%.

MR. TIMIRAOS:
When I listen to earnings calls and I'm thinking here of some of the consumer packaged goods and food. But even in industrial and manufacturing, it appears that companies have rediscovered this pricing power because of the reallocation shock of the pandemic, and they don't want to let it go. Companies are reporting price growth in the still-high single digits, even if not the double digit increases of last year.

By what mechanism is monetary policy going to deter price setters from continuing to test the limits of how much price they can push on?

MS. MESTER:
Well, I can tell you what business contacts are telling us in our district. Yeah, they had a lot of pricing pressure, a lot of pricing power last year. But now they're telling us that now we're hearing from customers that they're saying no to they're customers. So we're already starting to see some of that come into play, and that'll be one of the mechanisms that's going to get inflation back down. You're going to see more of that saying "We've taken enough." And the businesses are telling us, "We've adjusted. We're not putting in [more increases] or we're stable now. We're not going to do anything." Those are kind of the mechanisms that you see in an economy that is transitioning and that's going to help get inflation back on that path back to 2%.