Richmond Fed

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# The Need to Be Nimble

**March 30, 2023**

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**Highlights:**

- The challenge in assessing today's economy is reconciling the strength of the recent data with the potential for weakness coming from the banking system.
- It is possible that tightening credit conditions, along with the lagged effect of our rate moves, will bring inflation down relatively quickly. But I still think it could take time for inflation to return to target.
- Policy will need to be nimble. If inflation persists, we can react by raising rates further. If I am wrong about the pricing dynamics at play, or about credit conditions, then we can respond appropriately.

Thank you for that kind introduction and for having me here today.

You follow the news. One of the 20 largest banks, one with heavy sectoral and regional exposure, was caught wrongfooted.[1] There was a run on the bank. The Federal Deposit Insurance Corporation (FDIC) took over in the second largest bank failure in U.S. history. Depositors were protected, but it was a shock, nonetheless. In order to control higher-than-desired inflation, the Fed chose not to back off its plan to continue tightening. You know this story. But I'm not talking about Silicon Valley Bank. I'm describing the 1988 failure of First Republic Bank in Texas. There's no connection to the bank with the same name in the news today.

Why do I start with that story? It's not a perfect historical parallel, but it's worth remembering that not every bank failure becomes Lehman Brothers. We are all understandably scarred by that memory, but banks have failed throughout our history, many without creating a broader crisis. Thirty-five years later, few of us remember First Republic Bank in Texas (which by the way was also sold to a North Carolina bank — one now called Bank of America).

How does that story relate to today? F. Scott Fitzgerald wrote: "The test of a first-rate intelligence is the ability to hold two opposed ideas in the mind at the same time ..." My dad put it simpler, saying I "needed to learn to walk and chew gum." The challenge in assessing today's economy is reconciling the strength of the recent data with the potential for weakness coming from the banking system. Let me take you through how I am thinking about each, and the potential implications for Fed policy. These are my thoughts alone and not necessarily those of anyone else in the Federal Reserve System.

Let's start with the banking system. The past few weeks brought the failure of two banks overexposed to crypto, and one with a severe asset/liability duration mismatch. Depositors got nervous and moved with unprecedented speed. The resulting systemic risk brought strong interventions. To mitigate the risk of comparable runs at other banks, the FDIC guaranteed all uninsured deposits at Silicon Valley Bank and Signature. To reduce liquidity risk, the Fed Board, with Treasury approval and backstop, created an emergency lending facility particularly attractive to banks holding Treasury and mortgage-backed securities with unrealized losses.

The broader implications of these events aren't yet clear. There are still, to be sure, a few individual banks working through their own issues. But overall deposit flows appear relatively stable. Banks have worked with intensity to ensure they have adequate liquidity. And, as I've talked to banks in my district, I've been encouraged by the resilience I've seen. But even resilient banks can impact the broader economy if, to minimize their liquidity risk and protect capital, they choose to tighten access to credit. Research shows that such a pullback would limit consumer spending and curtail business investment. But it is too early to know whether that will happen now, or not.

These failures hit at a time when economic data was coming in strong. 351,000 jobs were added on average over the past three months — about four times the pace needed to keep up with labor force growth. Unemployment remains historically low, at 3.6 percent. Inflation, though down from peak, continues to come in hot. Headline CPI was at 6 percent in February, and core was at 5.5 percent. Monetary policy is famously said to work with long and variable lags, but our 475 basis points of rate hikes over the past year have not yet compellingly moved inflation back toward our 2 percent target.

It is possible that tightening credit conditions, along with the lagged effect of our rate moves, will bring inflation down relatively quickly. But I still see three reasons why it could take time for inflation to return to target.

First, the pandemic is still with us. Not the public health crisis, thankfully, but the economic dislocation it caused. Over a trillion dollars in excess savings and trillions more in equity and housing wealth are funding consumption. Fiscal outlays are continuing, like the infrastructure bill and state tax cuts. Order backlogs are still being worked down. Inventories remain short in autos and homes, supporting prices in those sectors. The labor market remains historically tight, as I said earlier, in part because employers who have struggled to find workers are reluctant to let them go.

Second, firms and workers are intent on recapturing lost ground. I hear from a number of sectors (like health care, utilities and food) that margins have compressed and that they now feel the need to restore them through further price increases. Similarly, workers whose real wages fell are pressing to catch up. Both of these imply further inflationary pressure.

And third, and perhaps most fundamentally, two years of high inflation and ubiquitous conversation about inflation have surely had an impact on firm behavior. I think about it like this: For a generation, business leaders learned not to count on pricing to drive profits. Large retailers resisted every price increase and had options to redirect their business to lower-cost suppliers overseas. Consumers found that they had power as well through price-shopping enabled by e-commerce. The Fed had earned real credibility for its ability to deliver stable prices; you could say we played a role in every wage and every price negotiation.

But now pricing is back in play. Its impact is considerable as successful increases flow straight to the bottom line. Businesses have found inelasticity they hadn't had the courage to test for previously and are looking to find more. Supply chain challenges have worn down purchasing departments; they seem now more willing to accept increases, at a time when volatility has made supplier cost structures more opaque and availability more important. In most companies, there is a continual tug of war between a finance team that sees price as a path to profits and a sales team that fears loss of business and market share. Sales won for years, but finance is winning now and will continue to keep pressure on prices until customers and competitors reassert themselves.

Let me now turn to our most recent meeting. I saw substantial inflationary pressure and a resilient banking system. So, I supported raising rates 25 basis points. I am heavily influenced by the experience of the 70s. If you back off on inflation too soon, inflation comes back stronger, requiring the Fed to do even more, with even more damage. With inflation high, broad-based and persistent, I didn't want to take that risk.

But policy will need to be nimble. Most forecasts of our policy path seem to average the risk of higher inflation with the risk of further contagion in banking. I still see the range of potential outcomes as pretty wide. If inflation persists, we can react by raising rates further. It was only a few weeks ago that some were calling for a 50-basis-point increase. And if I am wrong about the pricing dynamics at play, or about credit conditions, then we can respond appropriately.

I started by quoting two great Americans: F. Scott Fitzgerald, and my dad. So let me close by quoting a third one: Ted Lasso, who said, "There's two buttons I never like to hit … And that's 'panic' and 'snooze.'" So, I am keeping calm in these uncertain times, and watching carefully.

Thanks, and I look forward to your questions and comments.

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*In 1988, 40 bank subsidiaries and one credit card subsidiary of the First RepublicBank Corporation in Dallas — the 14th largest bank holding company at the time — failed. (Source: FDIC in Managing the Crisis: The FDIC and RTC Experience).*