Loretta Mester:

So, thank you for your attention, and I really am looking forward to our discussion.

Speaker 2:

Well, thank you very much for those remarks. For those of you who are new to NYU events, we have a somewhat drawn-out Q and A process where we go from table to table, asking questions. While you think of your questions, I'll take the prerogative of asking the first one. So, President Mester, talk to us a little bit about what you think the lagged impact of policy interest rate hikes have been on financial stability. To what degree has the turbulence that we've seen in the banking system in recent weeks been a function of interest rate changes earlier on in the year and last year?

Loretta Mester:

Yeah, I mean, I think the way I interpret what happened in March in terms of the banks is there were a few banks, a handful, small number of banks where stresses were emerged, and the Fed took some quick action with the Treasury and FDIC to make sure that those stresses didn't contagion out to other banks, other healthy banks. So far, that has seemed to stabilize things at the moment, but we're still going to be very much focused in on that to ensure that we make sure that firms still have access or financial institutions still have access to liquidity.

Again, I don't want to extrapolate from a handful of banks to a broader issue. I think we've been very much, I think, communicating what our path of policy has been since we started raising rates, where we thought policy needed to go. We've made a lot of progress on that, in terms of bringing in basically from a very accommodative policy last year, in the spring of last year to where we are now in terms of restrictive policy. I think our job is to make sure that we continue to communicate that and our reaction function to the markets, to the public in general, to firms, to businesses.

Speaker 2:

All right. Thank you very much. Over here. Yep.

Speaker 3:

All right. Thanks for joining us. So, this Silicon Valley thing has unveiled a fault line in our financial system, and I don't think a lot of people appreciate it. On the one hand, we have 30 systemically important banks or 29 now. Credit Suisse was one of them, and they have trillions of dollars that they get to their primary desks, get to work with the Fed, and they make money off of that. Then, they take those excess reserves and they park them at the Fed, and they make money off of that, 4.9%, and then to the extent that they have extra cash beyond that, they can reverse repo that to the Fed and get 4.9% on that, trillions of dollars, maybe all told, four to $5 trillion earning almost 5% a year to do nothing.

Now, on the flip side, we have over 4,000 banks in this country that, no disrespect to the folks from Citibank and other banks here, but they have to work a little harder for a living. They have to go to the Rotary Club. They've got to speak at charity events. They have to go to Small Business Association. They have to know the CEOs of all their local firms, and they have to take risk. They have to put risk on their balance sheet. Some of that may go wrong. Silicon Valley Bank may be the most egregious of that, but in the end, they had mortgages. They didn't have crazy CDOs or any kind of leverage and weird crypto loans. These were high quality liquid assets.

Now, if you're a Silicon Valley Bank or a bank like that, not only do you not take advantage of all those funds that the Fed is giving to the systemically important bank, but the actual opposite happens. You're now posting them back to the Fed and paying 4.9%. So, your profitability relative to the systemic banks is seriously eroded. So, my question to you is, if I'm a CFO of a local firm and I've got $5 million and I'm concerned about the profitability of my local bank, why wouldn't I then just put my money with a big systemically important bank, and are you concerned about the systemic problem that that may create where some banks just no longer can compete anymore?

Loretta Mester:

Well, I think that it's important to have a viable banking system with banks of all sizes. I certainly believe that ... I talk to bankers all the time in my district. We have some larger banks in our district and small community banks, and they are all trying to do the best they can in terms of risk management, right, and also to lend in their communities and to actually support businesses and households so that they have credit, can offer credit. So, this is a challenging environment, no doubt.

We're undertaking, the Fed is with Vice Chair Barr, is undertaking a study of what actually happened in Silicon Valley Bank so that we have a better insight into actually what happened there, but you're right in terms of you don't want to find yourself in a situation where the Fed has to take action that we had to take in middle, mid-March, right? So, my bottom line is we have to make sure that we're being very effective in how we do supervision regulations so that we can avoid being in the situation we found ourselves in last month.

Whether that means that we have to learn from this incident and change how we're doing some of the things that we're doing in terms of supervision regulation, that remains to be seen. That's part of what the study is going to be, but no doubt, banks, bankers, at least the ones I talk to all the time, right, it is a challenging environment for them. They are doing the best they can in terms of risk management and certain banks are better at risk management than others. So, I think interest rate risk is bread and butter banking, and you should be ... knowing that interest rates were going up and you should have been taking precautions and handling your interest rate risk.

Speaker 2:

Over here. Please everyone, raise your hands. We need some more hands up.

Barry Cohen:

Thank you for speaking to us, President Mester. Barry Cohen from Caventor Capital. My question has to do with inflation and the fact that in this period, inflation seems to be vexing both market participants, the Fed, and economists as the fact that it's gone up quite a lot, but it seems to be very sticky coming down. There's been a lot of discussion that some of that stickiness may be related to economic concentration within the markets itself. Monopolization, mergers and acquisitions that have gotten to be inflationary in themselves in the way they pass through cost increases to consumers, and they have more pricing power than they used to have. If this is the case, and I don't know if you believe it is or not, but if it's the case, are interest rate hikes effective against this sort of inflation?

Loretta Mester:

I mean, I know there's discussion about whether the economy has become more ... is there more market power now in the economy? Frankly, I think that's not the main driver of the inflation that we've seen. I mean, you can go back to when inflation started picking up, and bottom line is we had an

economy that was a new economy, right, in terms of we had the pandemic, right? The economy shut down. The economy picked back up. We had constrained supply because of that effect, and then we had very much high demand. We had an underlying policy, both fiscal and monetary policy, that turned out to be too accommodative given where the economy was and where it was going.

So, bottom line is this is a typical what causes inflation, right? Accommodative policy. So, what we've been doing in the Fed is trying to change that, right? We move from a very accommodative policy to a restrictive policy, and you are seeing that effect affect the economy in the right way. As you say, inflation has come down from its peak of last summer. It's just needs to come down further.

Speaker 5:

Thank you. Yilian [inaudible 00:09:07] from BNP Paribas. Just a quick one. I totally understand that it's about the totality of data and in terms of the data dependence, but sometimes, some data mean more than others. Given the current circumstances with the banking sector, so how big of a deal is it usually the Senior Loan Officer Survey update from the staff at your FOMC meetings, so in normal times and how much will it be of a deal coming into the main meeting?

Loretta Mester:

Right,

Speaker 5:

Thank you.

Loretta Mester:

Okay, so we look at this ... The Senior Loan Officer Opinion Survey, SLOOS as we like to call it in the Fed, right, I look at that all the time. So, that's one of the pieces of data that I look at, and it's certainly part of the committee's discussion, but you're right. In this particular point, right, given what happened in March, right, it's going to be particularly useful to talk to bankers. The survey data is going to be very important because it's going to give us a sense of whether firms, financial institutions are pulling back even more on their credit standards, right?

We already saw that happening, which you'd expect to see as interest rates moved up, right? So, that was kind of the normal thing. Now, we're going to be really assessing, okay, is this even a stronger impact because that's going to matter, right, because we're trying to calibrate our monetary policy, and tightening credit conditions is the mechanism through which that's going to impact the broader economy. So, I would say certainly, I'm going to be paying even more attention to it. Of course, we engage with a number of businesses, community, contacts, bankers as we go through the periods in between FOMC meetings. That's going to be particularly important now to sort of get a better sense of how much are credit standards tightening. That's going to be an important factor.

Speaker 2:

We'll do a quick lightning round over here. We have three people, so you each have to ask three super short questions, one after the other.

Speaker 6:

Okay. Real short, switching to unemployment rate, what level of unemployment rate do you feel triggers enough of the labor market being on side with you in terms of disinflationary forces that gives the Fed the room to begin to cut rates?

Ebrahim Rahbari:

Thank you very much, President Master. Ebrahim Rahbari from Citigroup. You've been very clear about the role of inflation expectations, and I hope I'm not misquoting you. You used to say that the dangers of doing too little were greater than doing too much. Now, in light of, let's call it the banking instability that we've seen and the gentleman argues could be enduring, how might that have changed that balance of risks and not just specifically about the banking sector but also potential economic non-linearities that we're not yet aware of?

Igor:

Thank you very much for your remarks. Igor [inaudible 00:12:19], Millennium Management. I'm actually going to piggyback a little bit on Ebrahim's question there about that balance between financial stability and fighting inflation. You mentioned in your speech that you find those two topics quite separate, and yet thinking about the March meeting, there was talks about 50 basis points hikes, then ended up being 25. Chair Powell said there was talk about not hiking at all. So, going forward, would you personally be willing to turn a blind eye for a little bit on the fight on inflation if an episode like in March were to happen again or if something worse were to happen in the banking sector? Thank you.

Loretta Mester:

Well, okay. All right.

Speaker 2:

We're experimenting with this. I'm not sure it's a good idea but-

Loretta Mester:

No, no, no, no, no. I just have to remember what the questions were. So, look as much as possible, and that's as much as possible, that's an important phrase there, I want to keep monetary policy and financial stability apart and use the appropriate tools for each. So, I'm not ignoring financial stability, but I want to be able to use our micro and macro credential tools to focus on that so that we do have the scope to really use our monetary policy tools to focus on our macro stability goals, price stability, maximum employment.

So, obviously, right, as if an incident were to happen and something came up as it did before the FOMC meeting, it's reasonable for us to have sat down at the table and said, "Okay, what should we be we be doing in this environment?" but we had taken ... The Board of Governors had established the bank term funding program, right, the actions were taken with Treasury, right? So, there were actions in FDIC, so those stresses, right, had calmed enough that we can move ahead.

The idea of whether it would be 50 or 25, right, that's really a judgment call now of given what's happened, where do we think monetary policy needs to go? So, early in the year, data had come in stronger than many people that had expected, which brought 50 basis point back into the discussion, right, but you have to recognize now with banks perhaps tightening credit standards even more than

they were going to internally, so, it's this mechanism through the ... That's what I was trying to say it's the mechanism through the outlook, right? So, something happened, something changed, right? It has an effect on the economy perhaps, right? How do you take that into account, and then what is policy? What's the appropriate policy?

So, that's basically the way you do monetary policy all the time, right? Conditions come in, right? You think about what does that mean for the outlook and risk, and therefore, what's the appropriate policy path going forward? So, I was very comfortable with moving ahead with the 25 basis point increase at the last meeting. We're going to do the same kind of evaluation as we go into the next meeting and so on.

In terms of the unemployment rate, I think my policy path has the unemployment rate ... It is, I assume, going to go up this year, but I do think we're going to have to keep the funds rate restrictive for some time in order to make sure that inflation is on that down the path to 2%. So, I still think that we have more work to do on inflation, and that's where my focus is, but obviously, we've come a long way in terms of bringing the funds rate to a restrictive stance, right? We're not going to be doing the same amount again, right, so we're going to have to keep looking, and now we're getting into the part where we're evaluating going forward. That's, I think, the right thing to be doing in terms of making sure that we are getting inflation down back on this path to 2%, but also being very attuned to the risk that are out there, right?

There's a lot of uncertainty in the economy still even regardless of the banking, right? There was heightened uncertainty around the economy regardless. Then, the banking stresses happen, and that's another uncertainty. So, you have to be attuned to this uncertainty as you go forward, but my own view is that we still have an inflation issue, right? Inflation is too high, and we know it's stubborn, and we're just going to have to keep at it in order to make sure that inflation is on that path down to 2%. I do think it's crucially important for the long run health of the economy to get back to 2% inflation.

Speaker 2:

Over here.

Abby Smith:

Hi. Abby Smith here, Southern Ridges Capital. Thank you for being here. You talked a little bit about extrapolation, right, from the Silicone Valley Bank. To add on to their questions, I guess, the market has definitely extrapolated from that event. I think that they're pushing back a lot on whether or not it's accurate. I think a lot of your rhetoric, a lot of your colleagues' rhetoric, which I'm absolutely on board with, but I guess the question is, how do you think that we're going to remedy the difference between what the market is pricing in, and again, this extrapolation which the market is priced in after the events from March and everything that you have said, everything that your colleagues have said in terms of we're not looking for cuts, we're not looking for the extreme scenarios to continue in terms of the banking crisis going forward. I guess the question is, what do you think will change that and get in between that differential between what you're saying and what the market is now extrapolating?

Loretta Mester:

So, you're extrapolating about the funds rate path in the market is what you're talking about, right, and interest rate?Well, we'll see, right? We've seen cases where we've had a view at the Fed about where the economy is going, and we've seen the market have a view, and then that's kind of what happens,

right? They have a view, we have a view, we get more data in, and we decide which direction we're going. You guys decide as market participants where you want to place your bets.

I can tell you what drives us is that we need to get back to 2% inflation and maximum employment. That's kind of what our guide is, right? We're going to do what we have to do with monetary policy to get there and to make sure that inflation is moving down on a sustainable downward path to 2%. So, we take signals from the market obviously, like we look at what the market's saying and we're saying, "Okay, they have a different forecast than we do. Why? What are they seeing in the data? What are we seeing in the data?" That's very important.

Then, moreover, right, financial conditions are part of our assessment of how policy is affecting the economy. So, that's another avenue through which what's happening in the financial markets do affect our decisions about policy, but we've seen these juxtapositions before where the markets have one view of the world, and things come together. So, we'll see. I'm going to be very attuned going forward to what the economy is doing, right? So, we're going to be very, I'm going to be very interested in what's happening in the financial markets and particularly what's going on in terms of credit conditions and tightening credit conditions because we have seen episodes like this where credit conditions did tighten, and we want to make sure that we're incorporating that into our monetary policy decisions.

Speaker 10:

Thank you for your time, President Mester. My question revolves around SMBs. Small and medium term businesses are the backbone of the U.S. economy, and given the recent stress in the banking system, which will likely lead to tighter lending conditions, how resilient do you think these SMBs will be, and how do you think that affects the labor market going forward?

Loretta Mester:

Okay, that's a really good question. That's one of the things that when we go out and talk in our districts, we talk to a lot of small businesses, and we talk to a lot of small bankers. That is something that both sides agree. Bankers know that they're an important factor for small businesses. Small businesses know that having access to credit is important for their health, and that's why this focus on what's happening in the banking industry going forward is going to be important given what happened in March.

So far, the small businesses are telling us that they are doing okay. Many of them still have desire for workers, but they are also seeing what's going on in the economy, so they've become a little more cautious than they were before. Similarly, with banks, banks have also ... they recognize that they're adjusting to what's going on in the economy and the fact that interest rates are going up. They also are starting to tighten their credit standards, but so far, this is the normal activity that you'd expect given interest rates are moving up. So, there hasn't been this extra bit yet, but we'll see. That's one of the things that we're going to be evaluating, but you're right, that's going to be an important factor about how fast the economy and demand slows.

Speaker 2:

Do you mind taking a couple more questions or-

Loretta Mester:

Sure.

Speaker 2:

All right. Fantastic.

Mike Chambers:

Hi. Mike Chambers, Landesbank Hessen New York. President Mester, thank you very much. I think you and your colleagues should be put up on a pedestal, so thank you for coming. Simple question. We've heard lots of stuff about inflation, incredibly rapid rise of rates. One thing we haven't talked about is something that when I started in my career decades ago, much longer than I'd like to admit, was money supply and the EM numbers were always the most important numbers that came out. We haven't talked about the Fed balance sheet. We haven't talked about money supply. Perhaps that might be the key to bringing inflation into control at a more rapid rate. We've seen an absolutely historic rise in rates, and yes, we're seeing inflation come down but not at a rate that us or the Fed are happy with. So, perhaps money supply and the EMs is more important. I'd love to hear your thoughts on that.

Loretta Mester:

Yeah. I mean, I don't really think so. However, your point about looking at the balance sheet and making sure that you're incorporating that into how you're thinking about your policy, I think, is important. So, I mean, just the way we implement monetary policy now is very different than it was in the past when the money supply was sort of the key variable that we looked at. So, that's why I think that, but you're right. We are letting the balance sheet shrink and letting assets run off the balance sheet. That does have an effect on the stance of monetary policy.

Now, what we've been doing, which I think is the right thing to do, is allowing that to just be in the background passively doing it, right? That doesn't mean we're ignoring it because it will have an effect on the economy, and then we're using our interest rate as the main sort of act a total policy. If the way to think about it is if we weren't doing anything of the balance sheet, perhaps the funds rate would be at a different level, but because we're doing something to the funds rate, the funds rate is the level that we think is the right level to get inflation back down to 2%.

So, I think that mechanism is still the right mechanism, but your broader point is there's more things going on than just the Fed funds rate. That's why a lot of ... when we're out talking, we talk about overall financial conditions because we understand that the Fed fund rate is just one interest rate, and then what does it imply about the rest of the interest rates? Your point is a good one. It's not just even the interest rates. It's going on with the balance sheet. What does that imply for the rest of the interest rates that then affect the economy?

Speaker 12:

Thank you, President Mester, for your speech. Elizabeth [inaudible 00:25:13] from [inaudible 00:25:14]. I would like to reconnect to one of the questions asked before about the current market pricing. So, the market is effectively pricing the start of a cutting cycle from the second half of 2023.

Loretta Mester:

Can you just talk slow for me?

Speaker 12:

Sorry. So, I would like to reconnect to one of the questions asked earlier about the current market pricing. So, the market is effectively pricing the start of a cutting cycle from the second half of 2023. So, my question is, does any of the scenarios that you might have considered when building your forecast agree with the current markets market pricing? If so, what would that out outlook look like in terms of what would need to happen in the economy for the start of a current cycle to effectively happen from the second half of 2023?

Loretta Mester:

Okay, so you want me basically to work backward from what the market path is. Okay, so can I come up with scenarios that would have the Fed cutting interest rates? Yes. Is it my modal forecast? No, but we understand we're in an uncertain environment, and so things can happen and shocks that we can't ... I mean, the nature of shock is you can't predict it, right? So, something could happen, right, but if you look at where I think the economy is and where it's going, right, I think we're going to have to keep ... We're not going to keep ... Let me say it this way, we're not going to keep raising interest rates until inflation gets back to 2%. That would be wrong, right? We've got to be forward-looking. We know that our policy affects the economy for a while, right?

If things play out the way I anticipate, right, I do think we're going to have to move interest rates up from here a little bit more and then hold it there for some time, real rates restricted for some time so that we're assured that inflation is back down to 2%, but if the economy involves in a different way, then we're going to be using that to inform our outlook, and we will set a different policy path if it's appropriate, but again, we're still always guided by the two goals that we have from Congress, which is maximum employment and inflation at 2%, which is the way we've interpreted price stability. That's the real driving force here.

So, if the economy evolves differently and we can get to inflation faster, our policy path might be different, but my own forecast is that it's been stubborn, and I expect a little bit more persistence, which means that we're going to have to keep the funds right up for some time.

Speaker 2:

All right, we'll just try to get a couple quickly in here in the corner. Maybe we'll do a two-person lightning round here so ...

Speaker 13:

Thank you for your remarks, President Mester. For 10 years in this group, we've been discussing how stubbornly low inflation was, right? I mean, we seem to have forgotten all that. It just took two administrations with some aggressive fiscal policy to totally end that problem at least for now. Don't you think it also works in reverse more effectively and in a more directed way?

I'll tell you why I'm asking this question. Unlike oh '08, '07, '08, we don't have a speculative real estate bubble over construction. We have the opposite. I mean, this young gentleman lives in Williamsburg here and asking what's happening to the housing market out there? I mean, millennials don't have homes. At age 35, they're living with roommates. Your raising rates is curtailing the supply of housing, correct, which is going to keep rent stubbornly higher. Your OER is not going to come down, and it is one-third of your inflation measure.

Speaker 2:

We'll let him ask a question in the next lightning round.

Speaker 14:

Yeah, you mentioned the forward-looking component, but in the past, you've kind of cited a backward-looking component as well, saying that you need to see a series of several good inflation prints before thinking about a pause. After the events of this last month, is that still the case? Do you still think we need to get that backward-looking evidence that inflation has slowed, or is the expectations piece alone enough to actually pause rates at this point? I guess a quick follow up too would be, do you consider the last few inflation prints we've seen good?

Loretta Mester:

Well, inflation is moving down, which is good. Do we need to see backward-looking information? Yes, to the extent that actually helps predict future, right? So, again, we want to be forward-looking, but we have models, and I think some pretty good models. We have an inflation research center at the Cleveland Fed, which does a lot of inflation modeling. So, the reason the backward information is important is because it actually tells you something about where inflation is going. So, yeah, we're going to still need to see inflation moving back down, and it's been pretty stubborn. So, I would like to see more progress than I've seen.

In terms of, yeah, there are long-term structural problems in the housing market. I kind of alluded to that in the speech, and you're right, affordable housing in particular is a problem. I don't think of that as being a monetary policy issue, right? So, we're raising interest rates and yes, it's going to affect the interest rate sensitive sectors including housing, of course, but we need to do that in order to get inflation back down. There are other policies that perhaps other groups who are responsible for them could think about and implement that would help some of these longer term structural issues in the housing market.

Speaker 2:

Okay. Well anything left in this corner? One last question, and then we'll wrap this up. So ...

Speaker 15`:

Thank you, and thank you President Mester for a clear presentation. I want to ask you about the long-term anchoring of interest rates. Now, last year, my issue was a lot of Fed officials were signaling two and a half percent. We need to get back to neutral, which is two and a half percent. You correctly said it was an error of a emission because that was really the long-term inflation rate, and we were above that. What about the other side of the equation? The 50 basis points in real rates because we now have a market where a 10-year real yields in PC price terms for the last six or seven months have been between 1.3% and 2%.

John Williams has not been publishing any R-star estimates. You suspended those in the third quarter of 2020, and that was a big intellectual basis for the lower rates. So, what about the signaling that the long term rates, 50 basis points when the market's perhaps suggesting it, we're moving back to a more normal world and it should be somewhat higher.

Loretta Mester:

So, I mean, as you know, all the estimates on the stars are with arrow bands around them. They are guides to how policy is, but I'm going to go back to what I said, apparently said before, which is there's long run R-star, and there's short run R-star. In an environment we're in, we need to have real rates higher than they are in order to get inflation back down. Whether you interpret that as a rule of thumb, say take year ahead inflation forecast and use that to derive what your real rate is or whether you want to look at a long run R-star and say it's temporarily higher either way, but nonetheless, right, the models and our forecasts and what actually has been happening in the economy suggests that we probably need a little more tightening in terms of the real Fed funds rate, and then allowing that real Fed funds rate to stay up for some time in order to get inflation down.

Where once we get back to price stability, the long R-star is, I don't think we know that yet. There's a lot of smart people who think that it will fall back down to be lower than it was. There's other people who say no, it'll end up being higher than it was. I don't think we need to know that right now. It's not like job one, but it's an interesting question about where the economy's going after this so let's-

Speaker 2:

All right. So, we're past time. I would like everyone to thank President Mester. We had a lot of questions about inflation. We did inflation questions, and our next event will be pretty soon, actually, in two weeks, we'll be back at our old huts at the Downtown Association Downtown with President Williams of the New York Fed. So, please look out for an email tomorrow or the day after. Please consider coming. Please sign up. We look forward to it. Again, one more hand for President Mester. Thank you for fantastic event.