Dallas Fed

Speech by President Lorie K. Logan

Remarks on liquidity provision and on the economic outlook and monetary policy

May 18, 2023

Dallas Fed President Lorie Logan delivered these remarks to the Texas Bankers Association in San Antonio, Texas.

Thank you for the kind introduction, Chris [Furlow], and for inviting me to join you for this year's conference.

I understand the Texas Bankers Association is the oldest and largest association of bankers in the United States. This is very fitting for a state that has more community banks than any other, as well as regional and large banks that combine to form a diverse, vibrant banking ecosystem.

I grew up in Versailles, Kentucky, a small town that really revolved around our community bank. Its loans were an engine for economic and community growth. But more than that, it's where our soccer carpool gathered before going to games—and the bank's name was on the soccer jerseys. The bank also invested in the town in so many other ways, like supporting our personal finance classes in school. The bank served the community and was part of the community. That early experience gave me a strong appreciation for how important banks are in our economy and how important it is to have a strong and diverse banking system.

Today, I would like to speak with you about two topics. As a Federal Reserve Bank president and member of the Federal Open Market Committee (FOMC), I'm often asked for my views on the economy and monetary policy. I promise you I'll get to that subject in a few minutes. But first I want to discuss the Federal Reserve's role in providing liquidity to the financial system, particularly during periods of market stress, and what this means for your banks. Let me note that the views I share today are mine and not necessarily those of my Federal Reserve colleagues.

Liquidity provision

Liquidity provision is one of the oldest roles of central banks around the world and an original purpose of the Federal Reserve System. One of the first lessons we are taught as central bankers is that to prevent stress and address crises should they arise, a central bank should stand ready to lend freely against good collateral.

When a central bank offers a liquidity backstop, it supports financial stability in two ways: by reassuring the public and by actually adding liquidity to the system.

In many cases, the mere availability of ample liquidity can reassure depositors, calm stresses and help private funding markets continue to function smoothly. The central bank may not even need to make any loans.

And when reassurance is not enough, the central bank can relieve pressures by delivering more funding. Over the years, across many episodes of financial stress, loans from central banks have helped bankers meet the needs of their customers—Main Street businesses and households—when other funding sources were unavailable. For this mechanism to work, the funds have to get out the door of the central bank and in the doors of commercial banks. Practical operational details become critically important, and all the more so in an era when liquidity needs can arise faster than ever.

A banker I know told me how his great-grandfather managed a run on their family's bank in 1932. He got in the car, drove to Dallas, borrowed $40,000, brought it back to the bank, showed customers the cash, and the run stopped. The world moves a lot faster these days. And I am pretty sure you couldn't fit enough money in the car, either.

The events this year at Silicon Valley Bank (SVB) are only the latest example of how liquidity needs are speeding up. We also saw an astonishingly rapid dash for cash in financial markets at the onset of the pandemic. Liquidity needs surged so rapidly that the Fed's trading desk, which I led at the time, had to respond by buying more than $100 billion of securities on some days. And the rise of electronic trading has contributed to fast-moving shocks in securities markets.

Many people have spoken about lessons learned from the recent banking stresses for banks' risk management, supervision and regulation. If you haven't yet read [Federal Reserve] Vice Chair [for Supervision] Michael Barr's report on SVB, I encourage you to do so. It's a careful examination of the bank's failings and a transparent, candid and self-critical look at the Federal Reserve's own role in the matter.[1]

Today, I will look at lessons learned through a different lens: operational readiness. Operational readiness was a focus of my work leading the Fed's trading desk for many years, and I believe it should be a priority for banks of all sizes in this era of fast-moving stress. I'll share some thoughts on implications for banks, for bank supervision and regulation, and—in the spirit of a candid look in the mirror—for our own operations at the Federal Reserve.

When phones can move money, and bank names can trend on apps on those same phones, bankers must look at contingent liquidity sources in a new light. The traditional ways to mitigate deposit flight, such as face-to-face conversations and phone calls to answer questions from depositors, may not be available in all instances. If you can't borrow from a funding source with almost as much speed as your depositors can push buttons on their phones, it might not help you meet withdrawals.

One important funding source for many banks is the Federal Reserve's discount window. The ability to borrow at the window can be particularly critical for smaller banks that lack access to broader capital markets, as well as for larger banks that could need funding late in the day when other borrowing relationships may not be available.

When banks establish access to the discount window, they can also gain access to the Bank Term Funding Program (BTFP), which we set up in March to respond to the recent stresses. With backing from the

Treasury Department, the program allows banks to borrow for up to one year against Treasury and agency securities.[2] We lend through the BTFP based on the collateral's par value, even if rising interest rates have reduced its market value. This additional funding, beyond what's available at the discount window, helps ensure banks can meet their customers' needs.

Discount window loans are priced a bit above prevailing market rates—we call this a backstop rate—because we don't want to crowd out private funding. For that reason, banks generally do most of their borrowing elsewhere. But nevertheless, I strongly believe that every bank in Texas and every bank in our country should be fully set up at the discount window as part of its liquidity toolkit.

Legal documents and collateral arrangements for the discount window should be in place well before any funding need arises. A bank facing today's potential liquidity challenges may not have the luxury of waiting for setup.

And banks should test the plumbing. Take out and repay a small-dollar loan. Practice moving collateral between the Fed and other funding sources that you use, such as the Federal Home Loan Banks. Evaluate how the lendable value of collateral varies across funding sources. These steps sound simple, and they usually are. But you want to have the muscle memory, so they'll be easy even on a challenging day.

The same need for readiness applies to other contingent funding. Well-managed banks maintain access to a diverse set of funding sources. Maintaining access means more than a general idea that you could access funding from some source. The paperwork needs to be in place, and the operations need to be tested.

As the authorities continue to learn from the recent episode, it will be valuable to examine how supervision and regulation can best take operational readiness into consideration. For example, an expectation that depository institutions establish and periodically test access to the discount window could help make individual firms and the financial system more resilient. Unlike requirements for banks to hold more liquid assets, an expectation for discount window readiness would allow banks to engage as much as always in the traditional business of banking—taking deposits and making loans—that is so critical to our economy. Also, if all depository institutions regularly tested their discount window access, the traditional stigmas associated with borrowing from the Fed would be further reduced. To be clear, healthy banks borrow from our programs all the time. In the first quarter of 2021, the most recent period for which data have been released, 388 depository institutions took a total of 818 loans from the discount window.[3] Periodic borrowing by every bank would make it even more clear that borrowing is not in any way a negative signal.

If we are going to expect more of banks, we must also expect more of ourselves as the central bank. Liquidity tools that are not ready to get money out the door right away might not help us fulfill our responsibility to provide a liquidity backstop for the financial system. To be sure, the Federal Reserve has taken important steps to increase our operational readiness.[4] For example, the Standing Repo Facility (SRF) and Foreign and International Monetary Authorities (FIMA) Repo Facility, which we established in 2021, automatically add liquidity to the financial system when needed.[5] That eliminates the need to decide whether to provide liquidity and, if so, how much, a step that slowed us down in the past. Banks are eligible to access the SRF, and I'd encourage you to consider whether this would be another helpful funding source for your bank.

But there is more the Fed can do. Some bankers have expressed concerns that our setup process for discount window access can move slowly. We hear you. Senior executives at the Dallas Fed are collaborating with our counterparts at other Reserve Banks to accelerate the setup process.

Looking forward, the Federal Reserve should also consider expanding the hours of operation for critical services like the discount window. Our liquidity backstop should be available whenever banks might need it. As liquidity increasingly becomes a 24/7/365 business, that could come to include nights, weekends and holidays.

And while I've focused mainly on banks today, we should examine our readiness to provide liquidity broadly in the financial system. Besides the recent banking stresses, we should consider experiences from the pandemic, the repo market pressures in September 2019 and other episodes since the Global Financial Crisis. And we should think about potential risks not yet experienced. We should consider how we can employ the full range of the Federal Reserve's tools, including emergency lending authority, support for financial market infrastructures and open market operations. For example, the FOMC could further consider the potential benefits of centrally clearing SRF operations.[6] Maximizing the effectiveness of our liquidity tools is essential so we can maintain financial stability while also taking the appropriate monetary policy actions in today's macroeconomic environment.

Economic outlook

In the rest of my remarks, I'll assess the economic outlook and describe how I think monetary policy needs to respond.

Inflation remains much too high. The FOMC aims for 2 percent annual inflation as measured by the price index for personal consumption expenditures, or PCE, but prices rose over the past year by 4.2 percent—more than twice our goal.

This high rate of inflation challenges families and businesses in the short run, and it weakens our economy in the long run. So, restoring price stability remains a critical priority.

Now, inflation in recent months has been lower than the worst peaks last year. The labor market has cooled somewhat. And activity in some sectors, such as housing, has slowed dramatically. The economy is not nearly as far out of balance as when the FOMC began raising rates 14 months ago.

But the question for monetary policy is not whether there has been some progress. It's whether inflation is on track to return all the way to our 2 percent target and to do so in a sustainable and timely way.

The closer we get to a turning point in the economy, the more difficult it becomes to answer that question. The economy doesn't cool uniformly. Some sectors can continue to boom even as others slow. And inflation may not fall in lockstep with hiring or output. So, we have to parse the statistics and qualitative information with even more care and humility than usual.

I'm keeping an open mind and a close watch on economic developments as we head toward the next FOMC meeting in mid-June.

As of today, though, I remain concerned about whether inflation is falling fast enough.

Part of the slowdown in inflation in recent months has been due to lower prices of oil and other commodities. But while it’s a relief to see lower prices at the gas pump, energy prices can’t keep falling forever.

Core inflation, which excludes volatile food and energy prices, has historically been a better guide to where overall inflation will go in the future. And core PCE inflation was 4.9 percent annualized for the first quarter of 2023.

That is higher than overall inflation over the past year, higher than core inflation in the previous quarter and much higher than the inflation rate the public is counting on us to deliver.

The picture is the same with other statistics that filter out especially volatile prices to get a better signal of where overall inflation is headed. For example, the Dallas Fed Trimmed Mean PCE inflation rate is higher than headline inflation, and the 12-month rate has leveled off above 4.5 percent in recent months.

We haven’t yet made the progress we need to make. And it’s a long way from here to 2 percent inflation.

The labor market’s continued strength appears to be contributing to high inflation. To be sure, some labor indicators are no longer boiling over the way they were last year. But the job market is still very strong. If it isn’t boiling over, it hasn’t cooled to a gentle simmer, either.

Last month, the U.S. economy added 253,000 jobs. That’s down significantly from the rate late last year. But it’s still more than twice what’s needed to keep pace with the growth of the labor force over time. And the unemployment rate last month ticked down to 3.4 percent, tied for the lowest unemployment rate since 1969.

Last year and early this year, job openings were another red-hot indicator. At one point, there were two openings for every unemployed person in the United States—a historic high. Today, the ratio has fallen to 1.6 openings per unemployed person. That shows some progress toward better balance, but it’s still well above the 1.2 openings per unemployed person in the very strong labor market of 2019.

And while wage growth has moderated, there are hints that it might be leveling off at a relatively high pace. The Employment Cost Index and average hourly earnings accelerated a bit in the latest readings. And the Dallas Fed’s regional surveys show no clear signs of deceleration in wages.

If labor productivity tracks historical trends, wage growth of 4.5–5 percent just isn’t sustainable, because it isn’t consistent with keeping inflation at 2 percent over time. And without price stability, high wage growth may not even make workers better off. Taking home more dollars doesn’t do much good if your budget is stretched thinner and thinner.

This complex environment calls for watching the data closely, interpreting the data carefully and remaining flexible.

I recognize the arguments that if we tighten monetary policy too much or too fast, we risk seeing the labor market weaken more than is necessary to control inflation. Those job losses would be very costly, particularly for lower-income households.

I am also attentive to the potential for nonlinear and unexpected deterioration in financial conditions. We are still learning how much the stresses at some banks will affect lending and economic growth in the aggregate. The Dallas Fed's latest Banking Conditions Survey, which was released on Monday, found that 48 percent of responding bankers tightened credit standards and terms over the preceding six weeks. That's the most since we started the survey in 2017. But it is not a huge surprise. Bankers have been telling us since last fall that higher interest rates are causing credit conditions to tighten. And, even now, they say the main reason for the latest tightening is restrictive monetary policy, not stress in the banking system.

Analytical models that try to calculate the incremental effect of banking stresses predict only a modest further drag on the economy. Most calculations so far suggest an effect comparable to raising the federal funds rate by 25 or 50 basis points. And it's worth noting that other aspects of financial conditions have eased since March. Still, the estimates from these models are highly uncertain. We have to be prepared to respond to a range of outcomes.

Fiscal negotiations and geopolitics could slow the economy, too.

But all of these downside possibilities are risks, not likelihoods or certainties. And there are upside risks as well: The data could come in hotter than expected, or other lenders could substitute more for bank credit.

Moreover, if the FOMC doesn't stay committed to restoring price stability, the public could come to expect persistently high inflation. A self-fulfilling spiral of unanchored inflation expectations would require much larger rate increases to stop. Ultimately, that scenario would be worse for workers, households, businesses and banks than the costs of tighter monetary policy today.

So, even as we consider how best to manage the risks, they must not stop us from doing what's necessary to achieve 2 percent inflation.

Concluding remarks

The FOMC is committed to delivering a healthier economy, with maximum employment and stable prices. To me, because of the potential costs of unanchored expectations, the path to that goal runs through bringing inflation back to 2 percent in a sustainable and timely way. After raising the target range for the federal funds rate at each of the last 10 FOMC meetings, we have made some progress. The data in coming weeks could yet show that it is appropriate to skip a meeting. As of today, though, we aren't there yet.

Thank you.

Notes

1. "Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank," by Michael S. Barr, Board of Governors of the Federal Reserve System, April 28, 2023.
2. Program details are available at https://www.federalreserve.gov/financial-stability/bank-term-funding-program.htm.
3. "Discount Window Lending," Board of Governors of the Federal Reserve System.

4. For additional background on operational readiness in the Federal Reserve's open market operations, see "Open Market Operations During 2022," by the Markets Group of the Federal Reserve Bank of New York, report prepared for the Federal Open Market Committee, 2023, pages 43–44.
5. See "Liquidity Shocks: Lessons Learned from the Global Financial Crisis and the Pandemic," by Lorie K. Logan, remarks at the 2021 Financial Crisis Forum, Panel on Lessons for Emergency Lending, Federal Reserve Bank of New York, Aug. 11, 2021.
6. See "Preventing and responding to dysfunction in core markets," by Lorie K. Logan, remarks at the Workshop on Market Dysfunction at the University of Chicago Booth School of Business, Federal Reserve Bank of Dallas, March 3, 2023.