Atlanta Fed, Raphael Bostic, Interview

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Inflation. Bank failures. Rate hikes

The 2023 economy is dealing with a series of intertwined issues that shape the lives and futures of business owners, employees and investors both now and into the future.

So what will that future look like?

During the Atlanta Federal Reserve Bank's annual Financial Markets Conference held on Amelia Island last week, the Business Journal sat down with Atlanta Fed President Raphael Bostic for a wide-ranging conversation about what actions he sees the Fed taking over the rest of the year, what worries he has other than inflation and what lessons should be learned from bank failures. Lightly edited for clarity and length, here's what he had to say:

Starting out with the question that you have been asked ad nauseum this week: You've made it very clear that you don't see inflation being wrung out of the economy in the short term, but let me get that in your words. Where do you see interest rates going?

I think the place to start is inflation got really high and far above what our target was, which was 2%. As we've been trying to work to get inflation back down to that target, the progression happened in kind of unexpected way.

There are some products where their prices are pretty volatile, and so they're going to go up fast, and then they're going to go down fast. We think about goods and you see this in terms of gas prices, we all have seen that, right? And then there are other types of products where the prices adjust much more slowly — think about services, so like wages, restaurant prices, servers, all that kind of stuff.

And the goods stuff has really resolved itself, and now we've got the slower-to-adjust products that are going to have to move. And because they move more slowly, my expectation is that it's just going to take us a while for them to adjust so that we get back to that 2% target. And that's why in my outlook, with the economy sort of getting back to balance on a steady level, inflation will still not move rapidly. And so that's kind of where I start in terms of thinking about how the economy is playing out.

Now the other thing that is really important, though, is that we are seeing signs of progress. So slow doesn't mean no, and we do see that the inflation situation is easing in some pretty significant ways. We were at 9% or 10%; now we're at four to five; that's the first big movement, four to five. I want to say again, our target is two, so four is still a lot more than two, and so we have a ways to go. If you unpack how inflation is playing out, there's a lot of inflation.

When you measure inflation, the way we do it is, you take a basket of goods and you just say for each good, how much did you pay for it a month ago? How much a year ago? And last summer, of all the

goods we did that to calculate a consumer price index, more than 75% of them were showing 5% year-over-year growth. And so you can't get two, it's hard to get to two, if 75% [of goods] is more than five.

What we see now in the most recent inflation report, it is less than 50% of goods are showing increases of 5% or more. And that is real progress. So inflation, high inflation is narrowing, which means that the math is really going to start to work in your favor and we have a better likelihood of getting to that 2%.

Are you open to another hike in June?

Well, I try to tell everyone, we go meeting to meeting, and we let the data guide us. My outlook right now is that, if the economy proceeds as I expect, we're in a good place in terms of policy.

But there's a lot of data that's going to come out between now and that next meeting. We have two new inflation reports, we have a job report, we have consumer confidence. There's a lot that's going to come out. And if those data were to signal a significant turn that was concerning, I'd be very open to doing some more. But again, that's not my base case.

When we talk about the economy and we talk about inflation coming down, we talk about the economy shrinking, we talk about a recession.

You talk about a recession. I have not said that word yet.

True. And in the past you have said that recession is not your baseline. In general, when there has been the rate hikes like this, it leads to fairly severe unemployment. Why do you think this time might be different though? Why do you think that there might not be severe unemployment despite the rate increases?

I think because we are coming to this moment after being through a pandemic, and the pandemic has created a bunch of economic circumstances that we've never seen before, the combination of things we've never seen before.

This economy is actually quite strong. Usually when the Fed has to move is because there's excessive risk taking in the marketplace, people are really stretching for yield, and so they're trying things that would under ordinary circumstances make people nervous. We don't see any of that today.

So when I talk to bankers, and you could talk to bankers, I'm sure you do as in your role, they all say, loan performance delinquencies are at historic lows. Customers are looking for loans, they want to keep producing. They feel like demand is there for the taking, they're not having to stretch to meet their performance goals. And consumers are also actually in a very solid position.

So unlike what you typically see in a rate hiking environment, this economy is rock solid at its foundations. And so that tells me that the slowdown is not going to likely produce the same amount of damage.

Businesses aren't that far out over their skis, so there's not that much at risk. And so I often say there's a lot of momentum that you usually get, we see in the economy, and a lot of our restriction is taking that

momentum away first. And we're still producing like 200,000 jobs a month. That is the momentum that you don't often see at this stage of an economic cycle.

Do you have any fear that there will be a credit crisis with small businesses that have just come out of a pandemic, that barely survived, that this might be the one-two punch that has more dire economic impacts?

So I always worry about that. And so I ask people about what their experience is. I ask bankers how they're thinking about lending, and I ask businesses also how are they thinking about what their needs are likely to be in the next 6 to 12 months.

On the banking side, I think what you're describing is partially right, and you use the word credit crisis. I don't think we have a crisis right now. I think where we are is, we're seeing some pull back by banks, but again, they were lending a lot, there was a lot of demand. There were good loans out there to be made.

And so when they're pulling back, it's really from a very strong position. They're not really trying to say, 'we're not lending to anyone.' It's that 'we got to be a little more careful.' And some of that has emerged from all the turbulence in banking, Silicon Valley Bank, First Republic, the liquidity risks and the cash flow risks that really put those banks in trouble. The way you prevent against that is you hold more capital, so you don't do as much lending.

So a lot of what we're seeing in the finance financial market side is precautionary, because they want to be sure that they're not subject to that same thing.

On the business side, it's actually quite interesting. Many businesses are actually in a stronger position than they have been before. And so their need for lending is actually lower than it has been historically.

And that's another interesting dynamic here that even without the loans for most of the businesses, we do a lot of surveys and the businesses are telling us we can rock and roll on our basic business. And the loans we would do now was really maybe to expand a site or a location, buy some new technology, that kind of stuff. That's a different kind of lending. It's not at the existential level.

Now of course, we're going to keep asking these questions, and as we get into the summertime and the economy is starting to slow, I'm expecting we may start to hear some businesses say, this is really trying to bind us or starting to bind us, but we are not seeing that today.

And that's pretty gratifying at this point.

You mentioned the bank failures. In your role as a regulator, I know you spend a lot of time paying attention to banks and their soundness. What lessons have you taken away from the regional bank collapses, from Silicon Valley and First Republic and the others?

So for me, I'd say they're probably two lessons. The first is that old is new again. The Silicon Valley Bank problem came about because of interest rate risk, and liquidity risk. These are things that are well known, and if you look in any kind of finance textbook, there's a whole chapter on both of those things.

And because of that, I think people just assumed that the risk managers would take care of those things, and focused on other things more like credit risk and loan performance, and how you're exposed that way. And so for me it is just a reminder that every kind of risk can matter. And just because it hasn't reared its head in 40 years, doesn't mean that it won't tomorrow. So we've got to be on it.

And so I've talked to my bank examiners to say, okay, let's go through the checklist. Let's make sure we are checking with every one of our banks that we're covering all the risks, and they are thinking about that. And my reports so far have been very positive on that, and that's a good thing.

The second takeaway for me is the number 36.

That's a very specific takeaway.

It is a very specific takeaway, and it's almost like it's branded into my brain.

Silicon Valley Bank died in 36 hours. And that has never been seen before. That kind of speed and the dynamic associated with that is actually quite jarring. When I woke up Thursday morning, it wasn't an issue. Friday afternoon, the bank was dead.

And that to me says, we have to approach supervision totally differently. Our processes aren't calibrated to responding in that kind of timetable. And so we have to change and think hard about what does the nature of our relationship with the banks that we supervise have to be, so that we are positioned to prevent things from spiraling out of control so rapidly?

It's a really hard question because we all have these cell phones, we all have the apps that you're moving money around from the banks that you're in, you're withdrawing, and there's no coordination on this, there's no hours out of operation. But it just really does change fundamentally how banking has happened.

Now that's happened gradually over many years now, I remember the first time I took a picture of a check to deposit it, and now it's just a thing. But those have implications and I had not really thought or realized that it could trigger a bank run like that, in such an extreme way. So I don't have the answers right now.

We are working on this. Vice Chair Michael Barr up in Washington just issued a report about his findings on that. And what really emerged out of that is that we've got a lot of work to do — to adjust our processes and our relationships and our approaches to these things — so that we're better ready for what comes.

What are you worried about other than inflation?

So let me just start by saying inflation is too high and we got to get that under control. And that is job one. That's our primary focus.

But we are always thinking about what are the barriers to businesses doing the work that they want to do, and meeting the needs of our communities.

The thing that we hear outside of inflation — and actually I think now our surveys are telling us in this is right there with inflation — is finding workers. The labor market is incredibly tight, we have an unemployment rated 3.4% — which is in my lifetime, I don't know that we've had that for many, many years. And it means that if you have a vacancy, it's hard to fill it. And if you don't have workers, it's hard to produce goods that then meet the demand and you keep that imbalance in place, and the price pressures remain.

So we are asking everyone, how's the labor market? Are you having problems filling positions? Are you seeing elevated turnover?

And the answer that they're telling us today is, it's hard. Now there's an asterisk on that in the sense that it's not as hard as it was a year ago, but if you look over the arc of the last 15 years, it still raises a very difficult labor market. And that is a tension that businesses really are facing.

When I sometimes go and talk to the local chambers of commerce, and invariably someone brings up the R word, which I do not use, and I ask them, okay, so I understand you're worried that there might be a downturn — and so I ask, how many of you in this room are thinking about laying off workers?

And for the last year and a half, no hands have gone up. And so I'm like, OK, everyone look around the room. I've never heard of a downturn where you didn't lay anybody off. So when that comes into play, that's the sign that something seems to be imminent. So that's another question we're asking all the time: In terms of labor market, are you letting people go? 'Oh, no, no, we want to keep everyone we can, because it's hard and we are already behind and demand. We want to continue to meet that.'

So that is one that we're definitely keeping an eye on.

A second one, which is very closely related, is around wages, and how much are businesses planning to pay their workers moving forward. So last year what we saw was, they increase their wages early in the year, becasue inflation's high. Inflation came in higher than they expected. They increased it again. And then some even increased it a third time in the course of a year, because their employees were falling behind.

So we asked them today and they say, well, we're not thinking we're going to have to do any mid-cycle increases in wages. That kind of pressure is off. We know inflation's coming down. We've seen it reduce pretty significantly.

And that's another thing that is — a point of comfort, is probably too strong, but it's a sign that things are moving in the right direction that we're not going to see a business's input costs in terms of labor really drive them to need to increase their product costs on the shelf as much. And that's a very positive thing.

You've written and spoken a lot about the challenges that entrepreneurs of color face systematically. Now as interest rates are rising, as access to capital has become a bit tighter, what do you see on the horizon in terms of that situation?

So that's actually a very interesting question. It turns out that during the pandemic, the number of small businesses that were started skyrocketed, and it turned out a larger fraction than you would've

expected are minorities, people of color. A lot of them are small enterprises — someone always wanted to have a bake shop or something, or run a side business. And they're trying it. For many businesses that are startup, they're usually funded by friends and family. They don't have formal banking relationships. It's only after time that kind of financing becomes material.

So they've been up for a year or two years now, and I think we're almost at a fulcrum, where they may be now positioned to turn to try to get that capital, and we'll have to see what happens. But I don't know if that's going to happen. One of the interesting things in Atlanta, for example, the vast majority of minority owned businesses have fewer than five employees. And if you're at that kind of business structure, you may not need a robust banking relationship.

One of the questions will be for these new businesses, do they have ambition to get above 5 employees? Because if so, then capital becomes an issue. If not, if they're going to stay in the smaller space, small enterprise, I'm doing my stuff and just happy with that, it may be less of an issue.

But because this is all new, this new pattern, there's a lot of learning that's about to happen. And I'm be very interesting to see how this plays out because a lot of these new firms are in communities that have historically seen less entrepreneurship, have seen fewer businesses. And this may be a way to broaden the space of business activity in these communities, and get them to be more resilient and more creative. It could be very interesting, but still, I think at this point it is a little early to draw a conclusion.

Last question, looking out broadly at the economy. The hope is inflation will come down, economy might shrink a bit, not necessarily recession. What happens if the economy shrinks, but inflation doesn’t come down as quickly as you’d like? Do you have any fears that we might be stuck in a stagflation sort of space? And if so, what do you do about that?

So I don’t have that fear. Look, we always have to worry about inflation not getting to where it needs to go, but we have tools that can allow us to make sure that it does.

What we’re trying to do right now is acknowledge that there’s a lot of uncertainty in the world.

There’s turbulence in banking. We talked about all the labor market changes that are happening. You’ve got war in Europe. There’ve been a lot of geopolitical developments.

And what I really think we need to do is avoid feeling like there’s more certainty about the path of the economy and then acting, assuming that a certainty has already happened, but rather acknowledge that we’re on a journey.

And with all the uncertainty that’s around, take our time, pay attention, and try to get true signals from things.

And so the conversations we’re having with businesses, the surveys they give us on the ground intelligence, it tells us, either we’re on the right trajectory, or an expected trajectory, or there’s some surprise that has to make us recalibrate what policy is.

And so for me, I think right now, the trajectory is pretty much where I expected it to be. And that makes me comfortable. But comfortable doesn’t mean complacent. And we’re going to continue to pound the

pavement, get in front of as many people as possible, and notice when the changes happened, so that we are ready to act appropriately.