WSJ Transcript

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Transcript: Chicago Fed President Austan Goolsbee Discusses the Economic Outlook

Federal Reserve Bank of Chicago President Austan Goolsbee, pictured in New York last year.
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Federal Reserve Bank of Chicago President Austan Goolsbee discussed the outlook for the banking system, inflation and interest rates during an interview with Wall Street Journal reporter Nick Timiraos on May 19. Here is a partial transcript of the interview, lightly edited for clarity and length.

WSJ: As it pertains to the banking system and the ability of the banking system to manage through a higher rate environment—how has your outlook around those challenges changed since the first incident in the middle of March?

GOOLSBEE: OK. I would say we have the middle of March, a couple of things on my timeline happen. We had the middle of March, I gave a speech about how should that affect our monetary policy that this is happening. And then we had another meeting and we gathered a bunch more data in the interim. I think the first, at first glance, the events of March happened right before the meeting. And so that was on our mind—what impact banking stress will have on the economy was on our mind when we put together the [Summary of Economic Projections]. Then we fast forwarded to the second meeting, I outlined in between in the speech that I thought, even if you aren't a subscriber to the financial dominance school, which mostly the subscribers to that school seem to be talking their own book. They're kind of hedge-fund managers who argue anytime there's a financial, a whiff of what might be a financial crisis, basically should subordinate the monetary policy goals to that.

I said, even if you don't subscribe to that view, which I basically don't, the presumption should be is this going to have a tightening effect on the economy. And we definitely should take that into account for setting the monetary policy. It argues that we need to be more expansive in what indicators we're looking at than we normally are. To oversimplify, it says if you had in your mind some Taylor Rule reaction function that was all we need to look at is—what's the fed-funds raise and what's the inflation rate and what's unemployment? And just kind of go from that. The impact of credit events and stresses is basically to change the relationship of inflation. The fed-funds [rate], inflation and unemployment together is not sufficient to tell what you should do because the credit impact is kind of like monetary policy. It's financial tightening. It's going to take a slightly different form. That was our presumption, I think. But certainly that's what I was thinking in March when this happened…

And I would say that coming into this last meeting in business contacts as well as in most public measures, you didn't see a lot. And in a way that's how I ended up voting for the—I gave a speech and people were like, "Oh, well that must mean that he's going to dissent; vote for pause." But it wasn't. The speech was about here's what we should look at. We should look at credit conditions and what is it having on the economy. And you did not see a lot yet in terms of credit squeeze. That said, that's not that big of a surprise. We've looked at historically credit crunches and they tend to take six months or so to become acute. And the impact on GDP with monetary policy, it happens with the lag. So it's over a year, 1½ years following these credit squeeze events when you start to see them. So that's the long-winded answer of thus far up to the last [Federal Open Market Committee] meeting. It hadn't changed my thought by much because the facts on the ground had yet to show that it was having that big of an impact. That said, now since the last FOMC meeting, it does feel like we're getting a little more evidence, both anecdotally and in the numbers about rising lending standards and sub spreads rising and stuff like that.
WSJ: And is that from the Senior Loan Officer Survey or is it from other sources?

GOOLSBEE: Senior Loan Officer Survey is one, though it was tightening before the Silicon Valley Bank. Then it's also the anecdotal, and if you just look at the amount of credit, this can't be hard to separate what might be happening because of rising fears about the debt ceiling. But in a way that kind of feeds into my thing of the debt ceiling could not be happening at a worse time. We were already on edge because of financial stresses. Adding a thing which is a clear financial stress and has a long history of undermining consumer confidence and driving up a bunch of risky loan spreads, is kind of the last thing you want to do with that in a moment like that. But that's the type of data that I think we should be, really we should definitely be mindful of.

WSJ: So I guess to step back from the next meeting, broadly some people have argued to me that the SVB shock marks a shift in the U.S. financial system because it illustrates how intolerable this highly inverted yield curve is to the banking sector. Raising rates rapidly worked when customers were inattentive to their earnings on savings potential. So the argument is that SVB makes it harder now to take actions that continue to steepen the yield curve. You could end up in a situation where you're actually forced to cut later if you keep giving poison to the banking system.

GOOLSBEE: Maybe, I'll just say maybe. I see the argument. In a way it's hypothetical. And the two things that I will emphasize are, one, historically interest rates going up helped the banking sector. That you increased interest rates was not bad for banking. And in a way, if you go look at the Barr report, it's pretty notable that Silicon Valley Bank itself had interest rate hedges in place and then explicitly took them off, and took a bet because they thought the Fed was going to start cutting rates. So they took a bet and ultimately one major part of their failure was just bad business decision making, making a bet. So I guess I'm objecting a little to the argument that is this is the Fed's fault. The Fed raised the rates and inverted the yield curve, and there's nothing anyone could do. Once that happens, they're going to blow up. That I think is not true. They could have hedged and they were hedged. Now, the second part though is, in a world with a steep yield curve like that and maybe it's with the inverted yield curve at that point where you're borrowing short and lending long, that seems like a tough environment. But the one caveat to that is, whatever the interest rate is makes a big difference. And higher rates in the short run are historically good for the deposit franchise of the banks, and that offsets the steepness of the yield curve. So the fact that we have short rates that are high is inverting the yield curve, which is a problem, but is also raising the value of the deposit franchise, which is helping them…

So I just think we should be a little careful with the argument that just because there's a inverted yield curve, the banks are automatically going to be in trouble. I don't think that's true, especially because the deposit franchise side.

WSJ: If you think an inverted yield curve is poison and you're administering poison to the banks—you're less concerned about that kind of argument.

GOOLSBEE: Yes. Because in that you've given a more sophisticated, a more subtle argument of why there are people who believe in the financial dominance viewpoint. That is the financial dominance viewpoint, that it's like this is poison and if you keep doing this, you're going to blow up everything. So therefore you need to take a step back from your monetary policy goals to not do this.

And my concerns about over-tightening in an environment like this are dual mandate concerns. They are that this tightening is doing the work of monetary policy. There's some people saying at the minimum they think it was the equivalent of 25 basis points. And there's some people saying 150 basis point equivalent of the fed-funds rate from this and that's going to affect the unemployment rate, that's going to affect GDP. And so we just need to take that into account.

WSJ: So, sticking with this idea. Banks that lost deposits but were able to borrow from the Bank Term Funding Program, they're replacing a low cost source of funding deposits where they weren't having to pay with a higher cost. [Former Dallas Fed President] Rob Kaplan compared it to a ventilator. It's stabilizing the patient, but you don't want to be on a ventilator for the rest of your life. And so there's an earnings erosion that could occur if a bank ends up having to fund itself from a more expensive Fed lending program. Is that a concern at some point that you have these…?

GOOLSBEE: Let's distinguish between micro-prudential and macroprudential concerns. For sure that's a micro-prudential concern for banks who lost deposits, and are going to this new facility; their cost of funding went up. Now in my world, those banks are going to raise their lending standards. They're going to be conserving capital and that's going to have a real economy impact. And that's why I think credit crunch or credit stress is a real thing…

That's different than you're in the hospital on life support on a ventilator. And I guess that's the thing. What he's saying is not wrong, it's just how much do you buy into financial dominance? That this thing is more important than the monetary policy goals. I don't think it is, but the way I'm mostly thinking about this so far has been we should adjust our monetary policy goals because this thing is affecting both sides of the dual mandate.

And I don't know if you've seen bank deposits leaving these regional banks. Kaplan's argument is it's definitely going to be a squeeze on certain business bank business models. If you were heavy on uninsured deposits and just transaction accounts, a lot of the businesses it feels like are moving the transaction accounts out of there…. If the deposit franchises are all going to be squeezed and the net interest margin is going to be tiny, there's going to definitely be more stress on the banking system than there is now. And in a way that would be something different than in the past where for any given loan rate, raising the short rate either inverts or flattens the curve, which is worse for banks but raising the short rate simultaneously raises the deposit franchise. And so that's why it's always been raising short rates we've thought has been better for banks, not worse.

Maybe that changed. If it did change, that's where you would see it. You would expect to start seeing major squeezes on the net interest margin paid by banks. But I don't know. There might be some banks for which that's true, but overall, there are other banks that are attracting deposits and if anything they're going the opposite way like the G-SIB and the perceived too big to fail banks.

They're getting all these deposits. It's not even clear they want this many deposits. And so they're not reducing the net interest margins at all. They're basically like, "Well, if you're going to come here, we're going to pay you 20 basis points…. That's super low and we're earning 5½% or something and we're only, we only have to pay 20 basis points."

WSJ: Is there a point at which it becomes harder to separate out using financial stability tools to address bank funding stresses? And at some point monetary policy has to take on board the credit stress to the extent that you're seeing it.

GOOLSBEE: In a way, it sounds like you're asking in the extreme, does somebody have to—do you have to admit financial dominance at some point along the way? Is that point somewhere before 2008? In 2008, that is what happened…. But I would pass it to you to think about this issue of the—don't take without a grain of salt the argument that the inverted yield curve is the whole problem and raising the short rate so rapidly is what's destroying the banking system because raising the short rate is historically good for the banking system. And if you were one of the banks like Silicon Valley Bank who doesn't have a big deposit franchise, you would've thought that a bank like that should be hedging the interest rate risk. And they were, until they decided that they could make even more money by taking the hedges off because they thought the Fed would back down. And then when it didn't, they lost all their money. I guess I'm just like introducing a slight note of skepticism in the argument.

WSJ: Now to come at this from the other side, the economists at JPMorgan had an interesting note a couple of weeks ago looking at how gradualism and monetary policy can promote supply side healing, but when you see more persistence in wages, inflation expectations—at least at the one year horizon it's still high—that the battle against salience could call for more forceful action that depresses pricing power, that normalizes near-term expectations. So the question there is, how concerned are you that a more gradual approach to fighting inflation could lead expectations to stay elevated, could allow inflation to become more entrenched?

GOOLSBEE: Somewhat concerned. I mean this is the balance for sure that we're trying to weigh off and the gold standard, which has been very difficult to achieve in previous business cycles, but we're hopeful in this one because this was such a weird business cycle, is to bring down inflation without having a recession. Now, one, I would observe long run inflation expectations have barely moved. And that was even true—there was a time when the CPI inflation was 9%, the fed-funds rate was at 25 basis points or something. The Fed had not even started to act, and inflation expectations did not become unhinged even at that moment. So in a way I find it a little odd to think through the argument that a difference of 25 basis points now versus six weeks from now that we threatened to unhinge the expectations. I guess it's possible, but it's just like we've been through this environment where that doesn't feel like that could be. And that said, there has proved to be some persistence, but we are definitely making progress. And I think the thing that we should—it kind of takes me back to a relatively wonky point, but it is important. So I'm just going to state it again.

Chicago Fed Letter research and some research done in Atlanta basically verify an older literature about inflation that shows wages are stickier than prices. They change less frequently than prices do. Prices change two to three times a year. Wages tend to change about once a year. In a world like that where wages are stickier, when shocks hit, prices go up and then wages go up. So wages are not a leading indicator of price inflation. And there is an argument made by some that like we should just keep looking at wages in the service sector. Wage growth in the service sector is—they treat it like price inflation can't come down in services because wages are growing too fast. But that's fundamentally wrong. I think that's the wrong way to read the data. Wage growth is basically what happened in price growth six months ago.

It's like you see the lightning, later you hear the thunder, but that was the same shock. That was both. It's just when you detect it and if you buy into that, it emphasizes watch the month to month, the new monthly price readings are the critical thing. That's what contains the most timely information. And those have come down. I wish they had come down more. Because of the housing thing, I think that they're going to keep coming down and goods are already down pretty…. Services has proved more persistent than I thought. But collectively, if those monthly readings are coming down, I feel very differently about it. And in a way I'm not ignoring wages, but I'm putting a lot less weight on wages because I think they're lagging. If you know that there's credit stress coming and inflation long run expectations haven't moved and the monthly readings of prices are coming down, then I think it behooves you to think a little bit more about keeping your eyes open of patience and prudence, as I say, try to figure out how much is the credit stress going to do to GDP before you do that.

If what you observe over the next six months, let's say, is unhinging of the medium- and long-run inflation expectations and you start to see the monthly inflation numbers rising and becoming unhinged—that's a type of data dependence. You start seeing that then it's fundamentally the job wasn't done and so that's when they have got to move. But the arguments about expectations, a lot of it feels it's in the hypothetical of, "Well, they may be about to explode" And I think we should just keep an eye on it.

WSJ: So you had said May was a close call. I think you had said that somewhere.

GOOLSBEE: Yes.

WSJ: Why? Why was May a close call?

GOOLSBEE: Because we know that the history of financial stresses suggests that they can have a pretty sizable impact, negative impact on GDP and on the economy. So that would be an argument for, whoa, let's wait and see. Yet at the same time, the business contacts in our district and in the national measures had yet to show that it did anything. So we still fundamentally have to figure out the question of, is this as big of a credit stress event as say the [Savings and Loan] problems in the late ’80s and early ‘90s? Is this—not a blip, but is this—a temporary thing that is just a rebalancing from deposits in threatened institutions, but the deposits are just going to different institutions and they’re going to replace the lending? That whole space remains undecided. And that’s why for me it was a close call….

What we care about in setting the monetary policy are the dual mandate objectives. And even if that thing is not a financial crisis, it’s going to affect one side of the dual mandate objectives, not both…. Sometimes what’s necessary for the Fed to assist financial stability ends up being counter to the monetary policy goals. And so in 2009, for example, you’ll remember there was a whole, we knew with Dodd-Frank that basically banks need to raise capital and we need to have tighter standards and we need to do all of these things. But the unemployment rate is super high and the banks are saying, “Oh, we’d love to lend to you, but our regulator won’t let us.” And so there is often a tension there.

And now is a moment where there isn’t. To the extent that financial stability goals that banks are going to be conserving capital and raising lending standards and whatever to stabilize their financial positions, that’s perfectly dovetailing with the monetary policy goals. And so that’s why I think it’s worth—it’s not, I will hesitate. The word “pause” is super loaded…so I’m not going to use the word pause. But that’s why being more open to observing and going slower than normal I think is justified just on the uncertainty grounds.