WSJ Transcript

Transcript: Minneapolis Fed President Neel Kashkari Discusses the Inverted Yield Curve

Federal Reserve Bank of Minneapolis President Neel Kashkari 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: Now that two months have gone by since the bank run, to what extent or how has your outlook toward the banking-system stresses changed, now that you've had a little bit of time to see what's unfolded?

NEEL KASHKARI: We're not seeing a lot of evidence of a big credit contraction yet resulting from the banking stresses. And certainly there are regional variations. When I travel around my region—I've been doing outreach trips to South Dakota; I was in Upper Peninsula of Michigan recently—when I talk to businesses, we're seeing little—very little—evidence of imprints of the Silicon Valley Bank stresses and related stresses actually affecting the lending environment in my part of the country, recognizing that there are regional variations, so that doesn't mean that that's true everywhere, but at least it's not showing up that much here.

So in terms of what's already happened, it isn't obvious to me that that's going to materially slow the economy down on its own, though we'll see. But I also am experienced enough from 2008 to know, all of these banking stresses are not necessarily completely behind us, and there may be more stresses yet to emerge, and it could be that when those stresses emerge those become serious enough that they actually put a meaningful damper on economic activity and a meaningful—help bring down inflation. That is possible, but we're not seeing strong evidence of that, at least I'm not seeing strong evidence of that yet, and then it comes back to something you touched on in your framing of this, which is how serious are these worries in the banking sector.

And to me, it really comes down to more than anything underlying inflation, their dynamics; if inflation is going to fall quickly as markets seem to expect, then I could argue we're probably close to being done on what we need to do in terms of monetary policy, and we might be in a position to be able to cut rates, if not this year, soon in the new year. And then that would release some of the pressure on the banks. But if on the other hand, inflation is much more persistent and much more entrenched, and we're either going to at least need to keep rates at this level, if not go higher, to bring inflation back down, then I think that the stresses in the banking system, probably become more serious. And some of these—you start to switch over from mark to market losses becoming more real economic losses, at least the potential for that.

WSJ: Because if I think back to pre SVB or when SVB happened you already had a situation where the Fed had raised rates at the fastest pace in 40 years, and that was only going to work to some extent in the banking sector if funding costs could rise slowly as the asset side of the balance sheet gradually repriced. And so to the extent that SVB provided maybe the catalyst for people to pay attention to where their money was, there's a catalyst now and so I guess the question is does there come a point at which there is a trade-off? Because an inverted yield curve can be difficult for a banking system, and monetary policy is inverting the yield curve because you need to fight inflation.

KASHKARI: Yes, and I think that that relates to the point I was making about how entrenched is inflation and how long do we have to keep the keep this yield curve inverted. There's no question an inverted yield curve is—it doesn't work for banks. It violates the fundamentals of their business models, and the longer it's inverted, the more challenging the environment becomes for banks. Right now, banks are basically saying, and the markets, think this is going to be a short-lived period when the yield curve is inverted. Most banks, the vast majority of banks have the financial wherewithal to endure this, but if this becomes an extended period of time, that becomes more challenging, of course. So actually the first part of that question again?

WSJ: To the extent that you now have this fragile equilibrium that's been destabilized because people are now attentive to where their money is, and maybe they're demanding higher deposit rates or they're moving money out of the bank—I don't want to presume that it does, but at what point does that begin to make it harder to separate, well, we can use emergency lending authorities to provide funding to banks, so that we can continue to raise interest rates. Does there come a point at which financial stability actually bleeds into monetary policy and you can no longer keep them separate?

KASHKARI: I think most likely, the inverted yield curve, to the extent that it continues to create stresses in the banking sector, it should manifest in tightening credit and in slowing economic growth and in tamping down demand and therefore helping to bring down inflation. So even that, I don't see that as in conflict. It's just harder to forecast, and suddenly, we talk about nonlinearities, could there be—if you triggered, if this inverted yield curve for an extended period of time were to trigger a serious crisis then maybe we don't glide down to 2%. Maybe inflation falls very quickly and even well below 2% because there's an actual meaningful credit contraction. I think it's the nonlinearities of that banking tightening that are hardest engaged and that we all have to keep our eyes open for, but I still think that credit crunch, so to speak, from an inverted yield curve should do work on inflation, which then means we would have to do less with our traditional monitoring policy tools, but that doesn't mean those things are in conflict, that just means the mechanisms are different.

WSJ: Once you start something in the banking system, as you learned from 15 years ago, it can become harder to rein in. Does that change your approach to monetary policy now that you see this sort of thing that's maybe being unleashed that could be harder to control?

KASHKARI: Yeah, I think it does. I think the fact that we've already raised by 5 full percentage points in a year, we know that there are lags, inflation is objectively lower than it was several months ago, it does seem to be coming down coming down quite slowly, but it is at least not getting worse. And then you add the uncertainties about the stresses in the banking sector and are the stresses really behind us, are there more stresses yet to emerge? I think that does give us some reason to say, "Hey, let's go a little bit slower." We have the ability now to go a little bit slower to both see what happens in the banking sector, to see the full bite of the tightening that we've already done and to see what the underlying inflationary dynamics really are, I do think that we will gain from being able to make some more observations.

WSJ: Why would a central bank in this situation that the Fed is in right now, not want to have to turn around and cut? What is the hazard of doing that?

KASHKARI: The hazard of doing that is that people lose confidence that we're serious about getting inflation back down to our 2% target. This was a mistake that the Federal Reserve made in the 1970s. They raised rates. They saw either some evidence inflation might be coming down or some weakness in the labor market, and then they turn around and cut. And that repeated cycle really led to an un-anchoring of inflation expectations, and that's something the committee is completely united and determined to avoid doing.

I would only be comfortable cutting if we were absolutely confident that we had conquered inflation and it was well on its way back down to 2%.

WSJ: If there's a financial stability episode in high inflation environment, does that—a number of people I talk to think that they see that as an argument for pausing here, not because the inflation trajectory is a lot better. It isn't. But because of the risk that you kick the hornet's nest, and now you're in a really difficult spot.

KASHKARI: I don't think the kicking the hornet's nest—I don't find that a persuasive argument because if we pause in June and then the inflation data is not positive, meaning it's not coming down fast enough and we raise again, we might kick the hornet's nest then. That metaphor for me is not very helpful, I think a more helpful metaphor is we're getting more information over time about the underlying health of the banking sector, about the persistence of inflation, about the health of the labor market, about wages. All of that gives us more insight into what's actually happening with the underlying inflationary dynamics; that to me is a much stronger reason to say, "Hey, if we were to pause in June, that would be the benefit of pausing in June," not that…

WSJ: Does that mean you're open to skipping June?

KASHKARI: I'm open at this point. The arguments, the things we've just been talking about, I can make the argument either way. And I want see whatever data we're going to get in, whether it's the formal economic data, which there's not a lot of, or it's the banking assessment, health of the banking sector. All of those are things that I'm going be paying close attention to going into June.

WSJ: It feels like the data you get from here is kind of asymmetric. You could get data saying things are getting worse because banking data can come out at any time. But in terms of the formal economic data, you're getting a personal-consumption expenditures report and the payroll report, and I'm not even going mention the consumer-price index report because that comes out on day one of the meeting, and it feels to me like usually things are pretty well ironed out by the time you get around the table.

KASHKARI: Yeah, usually things are—they are pretty well ironed out. Would have to be a pretty important inflation reading.

WSJ: Thinking back to March of this year, or May of this year, can you walk me through how you were evaluating the pros and cons of the rate increases at those two meetings?

KASHKARI: Unfortunately, all my weeks blur together, so it's hard for me to separate out. I mean, of course, I remember them as distinct events. But it's all the issues we've been talking about, which is how widespread do we think the, how idiosyncratic was Silicon Valley Bank and Signature? How many more banks were likely in similar related environments or related conditions? And then how likely are those, if the stress spreads within the regional banking sector, how likely is that going to have an imprint on economic activity and an imprint on inflation, and in a sense, do some of the work for us? Then what are the costs of raising rates another 25 basis points and the stresses turn out to be more serious, or not raising and the stresses turn out to be less serious? Basically, I'm in the position of inflation has been much higher than we expected for much longer than we expected. We have to get inflation down to 2% and the cost of not getting inflation down to 2% is much higher to Main Street than the cost of getting it down to 2%. That's my judgment.

And so I would rather err on being a little bit more hawkish rather than regretting it and having been too dovish. And I think that's the basic framework that I've had, both going into March and going into May. I continue to think that basic risk framework is right, but we continue to get more information. We've now raised more times. Inflation has come down somewhat, but it also seems pretty darn persistent. We just continue to get more data. So I'm more open to the idea that we can move a little bit more slowly from here.

WSJ: So just to make sure I understand that. So the argument for erring on the side of doing more because inflation is such a problem could still apply here in June, but you're also recognizing that you're somewhat tighter, somewhat higher than you were then. And I don't want to put words in your mouth, but maybe seeing more progress or glimmers of progress in terms of slowing inflation in the economy.

KASHKARI: Yes, I think that's right. And again, businesses I talked to in our region, they on average continue to do well. Labor market is not quite as tight as it was six to nine months ago. There is some evidence of some softening in the labor market. I mean, the unemployment rate is obviously very low, but it's not as frothy as it was. And so I guess what I would object to is I would object to any kind of declaration that we're done. If the committee chooses to skip a meeting because we want to get more information, I could make the argument why that makes sense and I could probably support that if that's where the committee ends up. What I don't think I would support is an announcement that says we're done or we think we're done because I don't know if we're done just based on the underlying inflationary dynamics. And so a skip to get more information is very different in my mind than, hey, we think we're done.

WSJ: I know a lot of my questions have been about financial stability and they maybe have a dovish slant to them because of that. And so I just want to ask about inflation because I hear other concerns. To the extent that you are seeing a slower move down in wages and prices, how concerned are you that a more gradual approach to fighting inflation could lead expectations to stay elevated or inflation to become more entrenched?

KASHKARI: I think it's something that we all think about. I mean, survey measures are important. I also look at financial market indicators. Financial markets seem to be convinced that inflation is going to fall quite quickly in the near future. I certainly hope that they're right. If I started seeing evidence that even financial markets were thinking that long-run inflation expectations, their expectations embedded in financial markets were starting to un-anchor and go up, that would give me a lot of concern. I'm not seeing evidence of that. So I guess keep our eyes open, be open to that possibility. I think the committee is still totally united in getting inflation back down to 2%. And if we need to go meaningfully higher, I'm confident we will go meaningfully higher. But I think anybody who declares that they definitively know these are the underlying inflation dynamics, I just don't see how they can be so certain of that.

WSJ: Have you thought about whether there could come a time that it makes sense to either lower the rate on the Bank Term Funding Program or extend the loan term, which could achieve the same thing, a lower rate, assuming that longer term rates are lower. Because it seems to me that otherwise you could get into this situation where the backstop facility, it's great in that banks can access funds, but it's more expensive than the deposits they have lost. And so you have sort of an automatic earnings erosion once a bank takes a big slug of funding from the Bank Term Funding Program. This gets into this issue of there's a structural short against certain banks as long as rates are this high. And that can become self-fulfilling if you don't have a [Troubled Asset Relief Program] or a way to recapitalize the banking system through kind of other policy needs.

KASHKARI: I just don't think our liquidity tools are intended to be, to inoculate banks from the fact that they're going to have to pay higher deposit rates. One of the mechanisms by which monetary policy works is we push the federal-funds rate through to short-term interest rates and short-term interest rates adjust. And I don't think our goal is to try to inoculate banks from having to experience that, recognizing it creates challenges for banks. You know, the ECB had this program, the TLTRO, which is basically from what I can tell a subsidy program for banks. They allow banks to borrow, and then they turn around and subsidize them. The thing you described I think is really fiscal policy, and if fiscal policy makers want to do something to support regional banks directly, then they can do that. But I don't think that's for the Federal Reserve to do.

WSJ: Is there anything we haven't covered that you think is worth getting out there?

KASHKARI: I'm just going to go back to where we started, which is to me, the health of the regional banking sector really does come down to how entrenched inflation is. And if inflation is going to come down quickly, as markets expect, then I think that there's a much better chance that the stresses in the regional banking sector are behind us. If inflation, in fact, is much more entrenched at higher levels, and we're going to have to continue using our policy tools to bring inflation down, being aggressive with our policy tools, then I think that these banking stresses become more serious. But that doesn't change the fact that we have to bring inflation back down, and we're going to do what we need to do to accomplish that.

WSJ: But just to follow on that, this kind of gets back to my last question. If the stresses become more serious because you have to stay higher for longer, I guess what you're saying is, to the extent that, additional support may be needed to help banks through this period, that would have to come from non-Fed actors. Is what you're saying?

KASHKARI: Yes, correct.