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Transcript: Cleveland Fed President Loretta Mester Discusses the Economic Outlook

'There are longer-term issues that have to be resolved in the financial system. In the short term what we're doing is making sure that we're really monitoring what's happening in the banking industry' said Loretta Mester, president of the Federal Reserve Bank of Cleveland.
PHOTO: JIM URQUHART/REUTERS

Cleveland Fed President Loretta Mester discussed the outlook for inflation, financial stability, and interest rates during an interview with Wall Street Journal reporter Nick Timiraos on Friday, May 26. Here is a partial transcript of the interview, lightly edited for clarity and length.

WSJ: There have been some concerns—more after the May meeting than in the last couple of days here—that a deeply inverted yield curve would at some point have ramifications for banking industry profitability that would become potentially harder for monetary policy to ignore. How successful do you think the Fed and other regulators have been since March in maintaining financial stability so that monetary policy can focus on inflation control?

MESTER: It's a good question and I think we have examples of that, even in the March meeting, right? We'd seen those stresses in the banking system with the two failures before that meeting, and actions were taken by the Fed, the Treasury and the FDIC, and including the Fed's [Bank Term Funding Program] facility. And then of course discount window lending, so those were liquidity providing actions tools, if you will…And that allowed us to keep all the FOMC meeting focused on our price-stability goals. That was a clear example of using tools to address financial instabilities that might be emerging, in that case, it was a liquidity problem, right? And then using monetary policy tools to address high inflation. And again, the stresses had calmed down a bit for the May meeting and then we were able to do that again. So there are examples of that, I guess it really depends on what you mean by the separation principle because different people have different views on what that is.

I think it's important to note that monetary policy effects really are interconnected in a number of ways. Of course the monetary policy transmission mechanism is a key one—by affecting financial conditions with our monetary policy. So if you have disruption in financial markets, the transmission of monetary policy to the economy is disrupted, and so that clear interconnection there. And if you think back to the beginning of the pandemic, we were buying assets not because of monetary policy reasons, but because of the dysfunction in the Treasury market. And then later on, once interest rates were at zero, we were continuing to buy assets, but there it was being used as a monetary policy action. So I know some people think of the separation principle as being, you use conventional tools, interest rate tools for monetary policy and nonconventional tools for finance solely. And that doesn't really hold when you're in an environment where the tool can be used for both purposes…

The other one, of course, is kind of the goals are interconnected—to have financial stability in order to get to price stability and full employment. And so if you communicate your monetary policy in a transparent way, that also supports financial stability because it allows institutions to know kind of where monetary policy is going and households and firms can make better financial decisions. So there's an inner linkage between the goals.

And then a third course is just—and I think this is what people have in mind is [that] changes in monetary policy can either expose risk and vulnerabilities in the financial system, and one could argue that that would happen at SVB, right? Interest rate increases revealed some of that or exposed some of those risks and vulnerability. And then other people argue that, well, monetary policy itself can create vulnerabilities if it [gives rise to a] search for yield. Remember, and then when interest rates were very low, there was a lot of discussion about search for yield behavior or encouraging a buildup in leverage which could then lead to financial instability. So there are all these interlinkages between them.

The first steps in my mind would be if we could use our micro-prudential tools of regulations and supervision and macroprudential tools like stress tests to make sure that the financial system is resilient. And then have our macro tools, our interest-rate tool, and to some extent [quantitative easing] or [quantitative tightening], depending on where we are in the cycle, focused on our price stability, maximum employment goals. And then obviously that can't happen, nothing is perfect, so you can't maintain a complete separation between them because of the interlinkages.

It's depending on your time frame that you're looking, think about what's going on now in the banking industry, right? We had, even before the tensions in the industry, we had banks reacting to the tightening in monetary policy, right? They were tightening their own credit standards in reaction to higher interest rates, and that's the typical monetary policy transmission mechanism. But when you're thinking about, well, what's the next step for monetary policy, you have to take into account the reaction of the banks in

terms of extending credit, because that does affect the macroeconomic environment, right? That's going to affect demand; less credit availability is going to mean some pullback in demand. So that it kind of works in the same direction as another increase in interest rates. So you can't ignore that transmission mechanism and that's an interlinkage between financial stability and monetary policy.
Your comment about, will eventually the monetary-policy makers have to take into account the fact that the yield curve—short rates are going up faster than long rates and that impacts the banking system. That's already incorporating that because we are already doing a lot of monitoring so that we can understand what the credit conditions are and the extension of credit going on in the banking system. So I don't think it's like ignore it until you have to take an action, I think we're actively monitoring.

WSJ: In the current context, how do you balance worries about a credit crunch? Particularly if there has been poor risk management on the part of institutions that never anticipated policy rates could rise above, say 5%. How do you balance those worries against the risks that inflation doesn't come down as quickly as anticipated? That it's more persistent, which maybe is what we've been seeing from some of the recent data. Does that create a trade off in your mind to how you set monetary policy?

MESTER: I don't see it as a trade-off, right? I fundamentally believe that you need to have a sound financial system in order to actually get price stability. And you need to have price stability for employment and a healthy economy in order to ensure that you have a resilient financial system. There's no real trade-off there. But you're right, part of what we do is we want to make sure that our policy tools, and I'm talking now on the financial stability side, are making sure that the financial system is resilient. So it's important that we have effective supervision of the institutions that we supervise. It's important that we ensure that the buffers, in terms of liquidity buffers and capital buffers in the industry, are at a level to encourage resilience. And as a longer-term proposition, it's important that we address some of the—and it wouldn't be necessarily the Fed addressing this—but some of the structural issues that were revealed early on in the pandemic about the Treasury market not being as resilient as one would desire.

So there are longer-term issues that have to be resolved in the financial system. In the short term what we're doing is making sure that we're really monitoring what's happening in the banking industry. And as you know Vice Chair [Michael] Barr's report indicated that that's a focus area, to make sure that we're doing all we can to make our decision very effective and he is also going to review on the regulatory side as well. So again, I don't really see it as a trade-off at this point, in fact, when we talk to bankers, what we found is—the way I like to think about it is, is bankers were tightening their credit standards, right, because of changes in monetary policy, and we saw that before March. And then I ask myself, "OK, are we seeing more than we'd expect of that credit standards given the stresses in the banking industry?"…And so far when we talk to the banks and also to their customers, we don't see that in any widespread way. Basically the industry has told us, "We're tightening credit standards. Because we're looking at our customers and we have some projections about where credit conditions are going, in terms of not solvency issues for the firms."

But right now the credit quality is extremely good and they have some projections that maybe if the economy slows, that some of that will change. So that's just the normal kind of banking what banks do. They do risk management and so we see that and our bankers are telling us that that's what they're doing. And, for a short time, of course, during this high stress period in March, they were looking at a lot of their balance sheets…Those intense stresses have gone down and now it's very attentive to the risks that are out there. So again that's something that I think we're going to have to continue to monitor, because that does work in the same direction as a tightening in monetary policy, right? If the stresses had caused a strong contraction in credit availability, then that would be something that could certainly slow the

economy more than expected. So far, we're not seeing that, we're just seeing the typical way that monetary policy trading transmits to the broader economy through the banking system.

WSJ: Since the stress events of mid-March, and now that we've had maybe more time to kind of sift through what's happened, has your outlook changed for either inflation/economic activity this year? Or has your outlook changed on credit supply and demand, again, relative to where we were in the middle of March?

MESTER: There's still some data that's going to come out including the employer report and the [Job Openings and Labor Turnover Survey] report next week. So I haven't really finalized my forecast, but my overall view is kind of what I've been saying is look, inflation has been incredibly stubborn…We certainly have made progress compared to last summer. But inflation's been stubborn, if you look at the core inflation measure or if you look at services, core services excluding housing, those things that moved in the wrong direction in this [May 26] report and that they actually went up…So that's more of reinforcing the view that inflation is stubborn, and on the other hand we got some of the information that basically says the consumer is actually hanging in there, right? It's been a little more resilient…So both of those kind of push you in the same direction as I think we're going to have more work to do in order to get inflation back down sustainably…I haven't finalized my forecast yet, but I haven't seen that much that would suggest that that's changed.

In the banking industry…we have to continue to monitor that, because stress can happen and that can change relatively quickly. So we need to continue to express that, but so far I haven't seen that, I would call that excess tightening from stress in the banking industry. Most of the tightening I'm seeing in credit standards is just because of the interest-rate environment.

WSJ: And so when you said that you think you have more work to do to get inflation back down sustainably, we're talking, just to be clear, we're talking about interest-rate increases and not holding rates?

MESTER: Yes, yes, yes. I think we need to bring the interest—and of course I haven't decided anything about the June meeting, but if you think about what the path of rates are going to be. What I'd like to do is get…to a level of the funds rate where I could say, OK, in my mind, there's a [equal probability the next move is] up or down, whenever that move would be. And I don't think we're there yet because I think inflation has just…remained stubborn.

If you go back to the last [median projection from the Summary of Economic Projections], it's not till 2025 that inflation gets back to down 2%. And I think that our inflation risk will be on the upside. So again, that's a long time for having inflation well above our goal, and I am concerned that we're not making progress…

But I really want to reserve judgment until we see all the data that's going to come in and to sort of formulate a firm view on what to do in June and July and for the rest of the year. I think we do have to be understanding that as we get closer…we need to be very attuned to the data and having it really look carefully…

A lot of people say, "Oh you guys are so backward looking. You always quote the data dependency." When I say data I really mean the information we're getting from our board of directors, contacts in the district, survey evidence that we collect ourselves and other surveys. So there are a lot of forward-looking indicators that we look at as well and information. So that goes into formulating my outlook as well.

WSJ: And in terms of the tactics, do you see a stronger case for getting this higher sooner? June versus July, do you have a view about the tactics?
MESTER: That's a chair decision, I guess, but I don't—it depends on what happens also with the debt ceiling and what's going on in the financial market, right? Because that influences things as well, you don't want to be doing things in the midst of a lot of volatility in the market or a lot of dysfunction in the market. So that is an issue for June that we have to be cognizant of, but I guess I would push back on this waiting until we get more information 'cause there's never—There's always more information…. Once I formulate a view of…that rate that I want to get to where I think that I'm balancing the risk…of over-tightening, under-tightening then hold there for a while…If my judgment tells me and my analysis tells me that we have to do more, then I would rather do that and then hold there for a while. And then I want to avoid the risk of "stop-going" and that's why I'd like to frame this into, "OK, have I gotten to the point where I think I'm really balancing the risk between over-tightening and under-tightening?"

We know of course that there's uncertainty out there and there's going to be more information that comes in and your views may change as you get more information. But I need to feel comfortable that I'm at that level, and once I'm at that level, then I feel like [we should] hold there for a while, assess conditions and then be in a better position to then make a judgment about what the next step is. And I guess, given the information we got this morning [in the Commerce Department report on spending and inflation] and given where inflation is…I don't think we're at that level yet.