Monetary Policy in Moments of Financial Uncertainty

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The views expressed today are my own and not necessarily those of the Federal Reserve System or the FOMC.

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Introduction

Thank you, David, for your kind introduction. I'm happy to be back with you.

Seems like some things never change. Chicago's ten days of spring have begun. The Economic Club of Chicago is meeting to discuss the issues of the day. The Cubs and Sox both had their home openers, and if the playoffs started today, they would both already be eliminated.

Some things are new, though. I became president of the Chicago Fed in January. It's been quite an experience. In this short time on the job, I've already voted to increase the federal funds rate two times. My predecessor, Charlie Evans, it took him more than eight years to do that!

Of course, the environment is much different now than it was back then. That's why the first thing I've been doing as Chicago Fed president is traveling around our District to hear directly from people and businesses and community organizations about the economy. Our District covers the heart of the Midwest—all of Iowa and most of Illinois, Indiana, Michigan, and Wisconsin[1]—and I've heard from a lot of people in these places. Turns out, folks have some pretty strong opinions about the Fed these days.

[1] Further details on the Seventh Federal Reserve District, which is served by the Chicago Fed, are available online, https://www.chicagofed.org/region/region.

Speaking of opinions, this is the point where I officially need to say that the views I am expressing are my own and not necessarily those of my colleagues on the Federal Open Market Committee (FOMC) or in the Federal Reserve System.

Summary

The law assigns the Fed two monetary policy goals: maximum employment and stable prices. When inflation gets too high, as it has been lately, the Fed fights it with the main tool it has—cooling the economy through tighter financial conditions. That's why the Fed has increased the federal funds rate so aggressively—almost 5 full percentage points over the past year.

It takes time for policy moves to work their way through the economy, and it's hard to know how long that might take and how much is enough. So that's why we say that central banks need to be "data dependent"—to watch how things go and adjust policy accordingly.

Well, the data in late 2022 and early 2023 were surprisingly strong. Spending held up; job growth was remarkable. Inflation did not come down enough. Based on these data alone, you would think the Fed would be pushing more aggressive policy moves than we were a few months ago.

But if you look at the Summary of Economic Projections (SEP) made by the Federal Reserve Governors and Reserve Bank presidents in mid-March,[2] the expectations of where rates are headed for the rest of this year moved only slightly from the previous projections made in December,[3] and many private sector estimates have them going down.

[2] Federal Open Market Committee (2023). The quarterly Summary of Economic Projections presents FOMC participants' forecasts of key economic variables over the next three to four years and for the longer run.

[3] Federal Open Market Committee (2022).

Of course, that's because these latest projections include an early assessment of the new big hairy elephant in the room—the fact that two significant banks failed in a high-tech version of an old-fashioned bank run and triggered broader financial market turmoil. To restore calm, the Federal Deposit Insurance Corporation (FDIC), Treasury, and the Fed stepped in to guarantee all deposits at these banks, not just those below the FDIC cap, and also created a new lending facility and enhanced the existing discount window—all to help prevent further runs on the system.[4]

Today, I want to explain why I think that at moments like this, of financial stress, the right monetary approach calls for prudence and patience—for assessing the potential impact of financial stress on the real economy.

I don't say that because I believe we should stop prioritizing the fight against inflation if markets get upset. That's a perspective I call "financial dominance"—that financial issues should dominate monetary policy concerns. Some people believe that should drive Fed actions. I absolutely do not. Congress gave us a job: maximize employment and stabilize prices. They didn't say to always keep financial markets happy or make sure investors don't lose any money.

The reason to include financial conditions in our monetary policy discussion is that history has taught us that moments of financial stress, even if they don't escalate into crises, can mean tighter credit conditions. These can have a material impact on the real economy in a way that the Fed absolutely needs to take into account when setting policy.

[4] Board of Governors of the Federal Reserve System (2023).

Now, in today's environment, there is no conflict between our current monetary policy and these tighter credit conditions, especially if they are part of strengthening the financial system; they can work in tandem to help cool inflation. But we also have to recognize that this combination could hit some sectors or regions in a way that looks different than if monetary policy was acting on its own.

Potential credit crunch has real implications

If you are old enough to remember 2008—a few of you in this room look like you may be—or if you are a student of financial history, you know that when stress turns into a full-blown financial crisis, the entire economy—workers, businesses, and consumers—all suffer immense harm. So, in crises, central bankers and other policymakers act quickly to provide substantial support to the economy. Sidenote: Moments of financial stress are a particularly bad time to take actions that could ignite a financial crisis on their own like, say, defaulting on U.S. Treasuries in a fight over the debt limit.

But even financial stress that doesn't spiral into a crisis can still lead to a pullback in credit and have a material impact on the real economy. The research is full of studies showing this across countries and across time. In U.S. history, think of the fallout from the savings and loan restructuring in the 1980s and 1990s. It didn't spiral into a systemic crisis, but it made the 1990–91 recession worse and significantly slowed gross domestic product (GDP) growth in the subsequent recovery.

Now, these historical episodes may not be perfectly analogous to what's happening today. First of all, the banking situation and related market turmoil have quieted over the past couple of weeks. Second, our financial system today is less reliant on bank credit than most other countries are or than the U.S. itself was 30 years ago.

Still, we need to be on watch for the real possibility of tighter credit conditions. Notably, banks could pull back on lending in order to protect their balance sheets. Indeed, the Fed's *Senior Loan Officer Opinion Survey* seemed to indicate tightening lending standards even before the Silicon Valley Bank and Signature Bank failures.[5]

Accounting for potential headwinds and today's data dependence

If they develop, the Fed would need to account for these potential headwinds when setting monetary policy. In some ways, it's almost mechanical; we've been tightening financial conditions to bring inflation down, so if the response to recent banking problems leads to financial tightening, monetary policy has to do less.

It's not clear by how much less, but private sector analysts have speculated that it might amount to raising the funds rate by something in the range of 25 to 75 basis points. We need to get a handle on the size of the financial headwinds, and that's why we need to monitor a wide variety of financial indicators. This is just today's funkier version of the old "data dependence" moniker.

Out here in the Reserve Banks, we'll also talk to a lot of people. Hearing what households, businesses, and community groups are experiencing can reveal things that haven't yet shown up in the formal data, which get released with some significant lags.

Given how uncertainty abounds about where these financial headwinds are going, I think we need to be cautious. We should gather further data and be careful about raising rates too aggressively until we see how much work the headwinds are doing for us in getting down inflation.

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[5] Further details about the Federal Reserve's *Senior Loan Officer Opinion Survey on Banking Lending Practices* are available online, https://www.federalreserve.gov/data/sloos.htm.

Supervisory tools as the first line of defense

There is a branch of the financial dominance school of thought that takes the argument even further. They argue that if there's a chance of significant financial stress, we should preemptively cut rates to reduce the odds of it.

I think we should be careful with that logic, though, given our trouble getting inflation down in recent years—not to mention the dangers of setting a precedent for giving in any time the market throws a tantrum. The principal defense for avoiding or mitigating financial stress should be supervisory and regulatory tools that are aimed at ensuring the safety and soundness of both individual institutions and the financial system more broadly. These tools include capital and liquidity requirements, stress testing, and our supervision process that examines institutions' portfolios and risk management practices. Pressing on these dimensions to strengthen the financial system can help it weather stress events like these recent bank failures.

And it's worth noting that our situation today is significantly better because of the reforms put in place after the Great Financial Crisis—particularly the higher capital and liquidity buffers required of our largest financial institutions.

Unusual circumstances

It is also worth noting a couple of ways that the impact of credit conditions and monetary policy today may look different from normal.

First, the economy is still coming back from the bizarre Covid times. Initially, people spent more time at home, and we saw a huge surge in demand for Pelotons and durable goods and a plunge in demand for services like travel or going to the dentist. More recently, consumption is shifting back toward such services, and that has been reflected in the inflation data, with goods inflation coming way down but services inflation—

especially for categories where spending is very discretionary like travel, hotels, restaurants, and recreation—proving particularly persistent. With the service sector generally being less interest rate sensitive, it might take longer to reduce inflation here, though it will moderate as tighter financial conditions take the heat off of the economy in general.

Second, today we do not face a common problem found in many earlier times of financial stress: Our financial stability goals and our monetary policy goals do not conflict.

Often, moments of financial stress happen when the macroeconomy is struggling. The kinds of actions that financial institutions need to take—or that the Fed or other regulators require them to take—like tightening lending standards or conserving and raising capital may strengthen the banking sector, but also reduce the availability of credit when the economy cannot afford to get slowed down.

At present, we do not face this dilemma. Actions that strengthen the banking sector's financial position and reduce the likelihood of additional financial problems currently make the job of monetary policy easier—they tighten credit and help bring inflation down.

This brings me to the last point I want to make today. The impact of credit conditions and monetary policy now may look a bit different than during historical tightening cycles.

Much of the recent financial turmoil has seemed to be concentrated in the regional bank sector. If a potential credit crunch were concentrated there, it would mean that sectors and areas that are particularly exposed to these institutions would feel the impact of tighter conditions more acutely. These institutions are a particularly important source of credit card and midsize business funding, as well as lenders for commercial real estate and autos. Different parts of the country are more reliant than others on these regional banks as well.

Conclusion

At the end of the day, the best central bankers are data dependent and the Fed's job is to be more paranoid than anyone else. In lucky times we might not need to follow too many data series to decide where inflation, unemployment, and GDP are headed. In unluckier, more *interesting* times like the one we are in right now, with wild shocks including a pandemic and wars and cryptocurrencies and financial stress, it means digging into loads of new information to glean where the economy is headed in order to set appropriate monetary policy.

The Fed must use everything in its toolkit to maximize employment and stabilize prices. Sure, it's harder in an unpredictable world full of pandemics and digital currencies and social-media-fueled bank runs. But we will do it. We're from Chicago. We get the job done no matter what the conditions. There is no bad weather, only bad clothing.
So remember: Financial stresses come and go. The Fed's mandate is forever.

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