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His Warnings On Inflation and QE Were Early and Right. What Worries Robert Kaplan Now?

The banking crisis is only starting, fighting inflation will take years, and fiscal policy is undermining the Fed: former Dallas Fed President Kaplan lays out the risks for investors

By Lisa Beilfuss
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While leading the Federal Reserve Bank of Dallas, Robert Kaplan warned that pandemic-era inflation wouldn't be transitory and urged his colleagues to begin tightening monetary policy well before the central bank began doing so. He was at the time considered one of the Fed's most hawkish members. More apt: Kaplan is an independent voice with a knack for connecting dots across monetary and fiscal policy, financial markets, and the business community.

Previously a professor at Harvard Business School and a 23-year veteran of Goldman Sachs, Kaplan now warns that the banking crisis is just getting started. He cautions that the U.S. economy is heading into a downturn with an undercapitalized banking system, and he thinks further interest-rate increases are futile and only risk premature rate cuts that will undermine the Fed's inflation fight. That inflation fight, he says, is already being undercut by expansive fiscal policy.

Praxis recently caught up with Kaplan. An edited version of the conversation follows.

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While at the Fed, you were a dissenting voice on inflation and overly-accomodative monetary policy. What are the Fed's blind spots now?

Robert Kaplan
Monetary policy is very important in terms of promoting full employment and price stability. However, it's worth recognizing that it doesn't work in isolation. While the Fed has raised the Federal Funds rate dramatically, in an effort to slam on the brakes to cool the economy and reduce the rate of inflation, you still have a number of other fiscal and structural factors that are limiting the Fed's ability to make progress toward achieving its

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2% inflation target.

On the fiscal side, my conversations with mayors and civic leaders suggest that there is still a substantial amount of unspent money from pandemic programs sitting in the bank accounts of cities and states around the country. For example, American Rescue Act (ARPA) money must be spent by states and municipalities between now and the end of 2024 or it's lost. This local spending is increasing demand for goods, services, and labor at the same time the Fed is trying to cool demand for goods, services, and labor. Also, certain portions of the infrastructure bill and Inflation Reduction Act funds are earmarked for projects that are increasing demand for labor.

As a result of the substantial amount of fiscal spending, as well as higher interest rates, the Congressional Budget Office expects the federal government to run a deficit of almost $2 trillion dollars in fiscal 2024. That is nearly 10% of GDP. You normally run big deficits *after* a recession; typically you want more budget discipline in good times, because you know that tax revenues will likely decline in a downturn and you may want capacity for fiscal stimulus. Moreover, running this sizable deficit now is stimulative to the economy at a time when the Fed is trying to cool the economy.

From a structural point of view, we should recognize that we are an aging society and, as a result, workforce growth continues to decelerate. The rate of workforce growth was 2.5-3% in the 1970s and 1980s--today it is closer to 0-0.5%–and the deceleration is expected to continue. The substantial fiscal and monetary stimulus of 2021 and most of 2022 has exacerbated shortages/imbalances in the U.S. workforce.

Additionally, while a sensitive topic, the important efforts to transition our economy away from fossil fuels have resulted in reduced levels of fossil-fuel production at a time when supply from alternative energy sources isn't yet sufficiently robust to fill the gap. This is resulting in higher energy prices which particularly impact more than 50 million families that earn approximately $50,000 a year or less. These workers now need higher wages to make ends meet. The point is that structural forces and highly stimulative fiscal policy may be offsetting, to some degree, the impact of recent monetary tightening.

Where are we in the banking crisis and how will it unfold?
Phase one was an asset/liability mismatch at several banks. Alarmingly, two of the top 20 U.S. banks, Silicon Valley and First Republic, had mismatches large enough to wipe out substantially all of their capital. For whatever reason, supervisory oversight was insufficient to forcefully address at least these two highly visible situations.

Phase two began with the stock market deciding to do its own supervisory scrubbing. It analyzed every public bank's hold-to-maturity, or HTM, account, and then marked-to-market each bank's stock dollar for dollar. While they were at it, investors also scrutinized each bank's loan book, focusing in particular on the loan-to-deposit ratio and

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the exposure to commercial real estate. Then investors screened for banks with a higher-than-average percentage of uninsured deposits. While all this was going on, depositors actively increased their scrutiny regarding the safety and wisdom of housing their savings or business accounts with their existing bank. Small businesses particularly questioned whether it was prudent to keep a $1 million plus payroll account at a small or midsized bank (when only $250,000 is insured by the FDIC).

We are now heading into the third phase. Bank leadership at small and midsize banks are considering how to shrink their loan books in order to address the mark-to-market loss of capital, as well as to guard against potential deposit instability in the future. Bank leadership is very aware that the economy is slowing, and that we are likely about to enter a challenging credit environment.

While asset/liability mismatches are relatively easy to spot, assessing the quality of loan portfolios is much more complicated. CEOs of many small and midsize banks are in a tough position. They can't easily raise equity because their stock prices are down. As a result, they are turning to shrinking their loan books, finding places to pull back on existing loans and future loan commitments. This is making it much harder for small and midsize businesses to get and keep their bank loans. It is a quiet phase that won't make headlines but is nevertheless relentlessly going on beneath the surface.

How undercapitalized is the banking system, and how did we get there?
First, we tolerated an accounting fiction. Banks were able to classify investment securities as hold-to-maturity, which allowed them to mark these securities at par even though, due to substantial increases in rates, their market values had declined to, say, 80 or 85 cents on the dollar. The idea was that underwater HTM bond portfolios didn't reduce bank capital because Fed supervisors said that, for accounting purposes, the losses wouldn't be marked against their capital. Once Silicon Valley Bank had sufficient deposit runoff to force sale of their HTM securities, the market realized that this practice was more widespread than they previously understood–and that the market value of bank capital was lower than previously understood.

In the aftermath of the last two months, bank depositors are now much more sensitive to deposit safety as well as deposit rates. On a market basis, bank capital is lower than two months ago. Most banks are now trading at a discount to book value. All of this is happening *before* we head into the tougher part of a credit cycle which is likely to occur as the economy weakens due to the Fed's efforts to cool inflation.

Will the Fed succeed in getting inflation back to 2%--and is that still the right target?
I think it's going to be a lengthy process to get inflation below 4% because inflation in the service sector is particularly sticky. However, I don't think the Fed should in any way signal it is backing off its 2% target.

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Why is service-sector inflation sticky? Consider the some 50 million workers in the country making $50,000 a year or less. That is ground zero in the inflation fight. Many of these workers are in the service sector or other jobs that have a physical component. Employers around the country tell me they are unable to find and hire enough of these workers to staff their businesses. If overall inflation is running at, say, 4.5%, the inflation rate for these workers and their families may feel more like 10% given the share of wallet they spend on food, rent, energy, transportation, and healthcare.

Employers are finding that these workers need higher wages to make ends meet and, in turn, employers are trying to pass these higher costs onto their customers. That fuels higher inflation which further leaves these workers still needing to catch up. This is why government programs that increase demand for these workers may help perpetuate this wage/price spiral.

What should the Fed be doing now?
All things considered, I would be inclined toward advocating a "hawkish pause" at this point, explaining that the Fed remains in a tightening stance but wants to digest the cumulative impact of the 10 or so rate hikes already executed over the past 12 months. I would also make clear that we may have to raise the Fed Funds rate in the future if we don't see more progress in achieving the Fed's 2% inflation target. I would particularly emphasize to market participants that they should *not* be expecting the Fed to be cutting rates later this year.

I would mention two related concerns. First, at this point in the tightening cycle, rate increases seem to be impacting the front end of the yield curve while the back end of the curve is now substantially inverted. Small and mid-sized companies borrow based on the Fed funds rate. Larger firms–those in the S&P 500–tend to borrow very little at the Fed funds rate other than for seasonal working capital needs and instead do most of their funding based on medium- and longer-term rates. As a result, Fed funds increases seem to be disproportionately impacting smaller businesses, creating an increased advantage to size and scale organizations. Is this distributional impact helpful to fighting inflation and strengthening job growth and price stability in the longer run? I'm not sure.

On a related point, the recent banking turmoil has highlighted the disparity between too-big-to-fail banks and smaller and midsize banks. I worry that increasing the Fed funds rate from here may create further strains on the deposit base for those smaller banks. I'm concerned that, as the Fed raises rates, it is tightening the vice on small and midsize banks and the small and midsize businesses that rely on those banks for funding.

Let's face it: We need a greater slowing in the economy in order to get inflation under control. My worry is that after the downturn, how do we climb out? We may not be able to use the big cannon of monetary and fiscal policy because we are far more leveraged today as a country due to substantial use of these tools during and in the aftermath of COVID. We

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will need small- and midsize banks to lend to small- and midsize businesses to climb out of the next downturn.

Is over tightening or under tightening the bigger risk for the Fed right now?
Right now, the market seems to be pricing in that the Fed will be cutting rates later this year. That means that the forward interest rate curve is downward-sloping. Fed funds rate increases impact those that primarily borrow from banks, namely small and midsize businesses. At this point, I don't think financial options for big companies are being materially negatively impacted. Pfizer just executed a $31 billion bond deal at rates *below* the Fed funds rate.

I don't think that inflation is like a fever that can be broken by higher and higher Fed Funds rates. I think that, due to structural elements of the economy, the war on inflation is not going to be a six-month war. It is more likely to go on for the next couple of years. In that context, it is more important to hold rates at a sustainable level for longer than the market is currently expecting. Trying to squeeze in a couple of more rate increases in the near term may precipitate other strains that cause the Fed to have to cut rates prematurely and limit the consistency of the inflation campaign. So, from here, I think officials should express a tightening bias and warn markets to prepare for a Fed funds rate that stays higher for longer than markets think.

What, if anything, can the Fed do about fiscal policy offsetting its efforts?
I believe that the Fed might be well served to identify some of the forces away from monetary policy that are impacting the battle on inflation. I would like to see a "whole-of-government" approach to fighting inflation versus the Fed going it alone and saying it can win this battle on its own.

If I were in my old seat, I would be saying that monetary policy will do its part, but it's not the only policy action needed to fight inflation. I'm concerned that, without more of a "whole of government" approach that incorporates fiscal and structural economic decisions, the Fed will need to keep rates higher for longer and, at a certain point, may find itself going too far or even pushing on a string in terms of fighting inflation.

What are your views on the current debt-ceiling debate?
I don't like the tactics and threats of this debt ceiling standoff–default should never be a subject we are debating. But it is also true that we need a national discussion about government spending discipline.

Government debt-to-GDP is running at approximately 120%. The present value of unfunded entitlements is about $75 trillion and growing. Monetary policy is not the cause of this debt buildup, but it has certainly enabled it. The Fed now owns more than $8 trillion of treasury bonds and mortgage-backed securities and is working to runoff its balance sheet at $95 billion per month.

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We are an aging society, so in order to grow GDP, we need to find ways to grow our workforce and improve its productivity. Our substantial government debt and spending choices might ultimately squeeze out investments in early childhood literacy, the digital divide, skills training, improving secondary education and so forth–investments that will improve productivity and GDP growth in the years and decades ahead. The current national debt situation will require additional focus on fiscal restraint and more discipline around spending decisions and tradeoffs so that we can fund our nation's critical priorities.

The U.S. dollar is one place where growing concerns over fiscal and monetary policy coalesce. What do you make of the de-dollarization narrative?
Running at this size fiscal deficit gives some further credence to conversations between China and Brazil about denominating trade transactions in currencies other than the U.S. dollar, and/or OPEC discussing denominating oil purchases away from the dollar. I wouldn't overreact to these discussions, but I do think it should remind us that fiscal discipline sooner rather than later would be appropriate and desirable in order to protect the dollar's role as the world's reserve currency.

I don't believe there will be an issue with the dollar's reserve status in the very near term, but I do believe it is a material risk over the horizon. Accordingly, I think we would be well-served to more explicitly consider this material risk as we debate fiscal and monetary policy over the horizon. You can debate probabilities, but if the U.S. dollar is no longer the reserve currency and we owe an additional 200 basis points more on some $30 trillion in debt, that is a problem.

We have to recognize that we spent and printed substantially, in great part to fight COVID, but also in the aftermath of COVID. Fiscal and monetary authorities drove the car at 120 miles per hour to get out of the COVID ditch but, instead of beginning to gently take the foot off the accelerator, they continued to drive at a high rate of speed into 2021 and most of 2022. As a result, the Fed ultimately has had to slam on the brakes.

In order to help the Fed in the inflation fight, I would suggest that the fiscal side of the house needs to play a key leadership role in order to create more of a "whole of government' approach in order to make more progress in getting inflation back to the Fed's longer-term target and restoring price stability to the U.S. economy.

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