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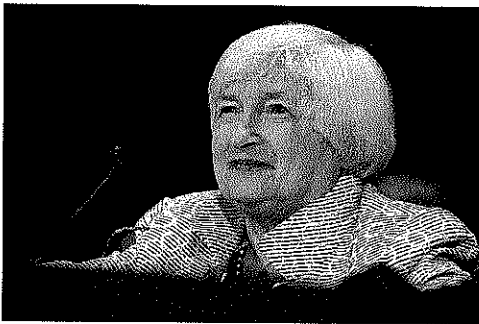
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OPINION | REVIEW & OUTLOOK

Our Political Central Bankers

Fed officials join the resistance against financial reform.



Federal Reserve Board Chairwoman Janet Yellen testifies before the Senate Banking, Housing and Urban Affairs Committee on Capitol Hill, July 13 PHOTO: CHIP SOMODEVILLA/GETTY IMAGES

By The Editorial Board

Aug. 28, 2017 7:06 p.m. ET

Janet Yellen didn't run for President, but you wouldn't know it from her policy démarche Friday at the Federal Reserve's annual Jackson Hole retreat. The Fed Chair unleashed a defense of post-crisis financial regulation that shows how political the world's central bankers have become.

"Already, for some, memories of this experience may be fading—memories of just how costly the financial crisis was and of why certain steps were taken in response," Ms. Yellen said. She added that regulatory changes "should be modest" and retain the superstructure built under Dodd-Frank.

Ms. Yellen's comments followed a blunter recent warning from Fed Vice Chair Stanley Fischer, who told the Financial Times that "one can understand the political dynamics of this thing, but one cannot understand why grown, intelligent people" would "reach the conclusion that" you should "get rid of all the things you have put in place in the last 10 years." Thank you, Senator Warren, er, Fischer.

This is extraordinary. Fed officials are launching a political campaign to retain their vast discretionary control over the American financial system. The brazenness of the effort shows how far afield central bankers have roamed from their traditional remit of monetary policy, which Ms. Yellen barely mentioned. You'd think she'd focus on that duty given that the Fed faces a watershed as soon as next month as it decides whether to begin rolling back the \$4.5 trillion balance sheet it has amassed since the 2008 financial panic.

The size and scope of that balance sheet is itself a political intrusion because the Fed's bond purchases are a form of credit allocation. The purchase of mortgage securities favors housing, while the Fed's focus on long-duration bonds has been a deliberate attempt to push investors into riskier assets.

These decisions haven't done much for the real economy, which has grown at a historically slow pace since the recession ended in June 2009. But the Fed has succeeded in lifting some asset prices, and no one knows what will happen to those prices once the Fed begins unwinding its portfolio. Perhaps it will all unfold without a hitch, but some very smart people aren't as sanguine.

As for the stability of the financial system, Ms. Yellen and Mr. Fischer are at pains to assure us that, due to their efforts, all is well. "Banks are safer," she says, thanks to capital and liquidity mandates and the wisdom of financial regulators. Oh, and "credit is available on good terms."

But Ms. Yellen wasn't nearly as optimistic about lending in the later Obama years. She often fretted that tight credit conditions were limiting growth, and the facts bear out that concern. Bank lending in the current expansion has trailed that of seven previous recoveries, and lending for small business has been especially slow. None of this is cause for Fed triumphalism.

Banks are safer, but they should be after eight years of modest expansion. The real test of financial stability comes in times of economic stress, when interest rates rise or investors get nervous and rush to safer assets. The system has already had one liquidity panic, in October 2014, when the yield on U.S. Treasuries moved some 40-basis points in a day.

You have to ignore history to believe that regulators are suddenly so wise that they know the current regulatory regime will prevent the next crisis. The Fed misjudged the economy in the mid-2000s and kept feeding easy credit that produced the housing bubble. Fed officials Ben Bernanke and Tim Geithner then underestimated the financial risks in early 2008 when the stresses were already apparent.

That's one reason to support a financial regime with high levels of capital to defend against potential losses but with less regulatory micro-managing. This is the trade-off that House Financial Services Chairman Jeb Hensarling has proposed, which contrasts with the lower capital and lower regulatory barriers that the Trump Administration seems to prefer.

This is the debate we should be having, but the Fed wants Americans to believe that Dodd-Frank is gospel and the only alternative is to return to pre-crisis policies. The irony is that Ms. Yellen is thus associating the Fed with the post-crisis status quo that has been splendid for Goldman Sachs and giant banks that have gained market share and can afford higher regulatory costs.

Ms. Yellen did concede that "there may be benefits to simplifying aspects of the Volcker rule" that limits propriety trading, which is the least she can do since the rule as written is more than 950 pages of text and explanation. But until she runs for public office, she and the Fed ought to stick to executing regulatory policy rather than trying to dictate it.

Ms. Yellen's term as Fed chair expires early next year, and her Jackson Hole foray is a signal to President Trump about what he can expect if he reappoints her. The Fed needs a leader who won't bend to political pressure. But it also needs a leader who understands the limits of the Fed's political role.

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