A Central Bank on the Brink:
The Future of the Federal Reserve in the Trump Administration

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- Slow growth, heightened economic inequality, and a deaf ear to public discontent jeopardize the FRB's ability to craft independent monetary policy and stabilize the financial system under acute stress.
- "Duck-and-cover" policy during this time of political risk is likely, but still more risky for both the Fed and economic growth.
- The Fed should move quickly to normalize rates, shrink its balance sheet, and realign post-crisis rules so that robust financial intermediation from regulated institutions resumes.

A recent *New York Times* article[1] on the next financial crisis intriguingly highlighted how hard it is to spot trouble coming by telling the tale of watching the solar eclipse last month on a Cape Cod beach. Transfixed by the celestial spectacle, hundreds looked up at the sky and therefore missed a huge great white shark bearing down not only on all the kids in the water, but also on a hapless harbor seal.

Fortunately for eclipse watchers, the shark went first for the seal. But, the lesson is clear: don't take your eyes off the ground game.

In the wake of the financial crisis, the combined impact of Fed monetary and regulatory policy has made it the market's sun god. All eyes are fixed on it not only at risk of losing sight of critical macroeconomic and financial-stability fundamentals, but also at overlooking the looming political challenge threatening the ability of the U.S. central bank to proffer or pull the proverbial punch bowl.

As I'll lay out this evening, the Fed has made a basic mistake since 2008: deciding to be a party-maker instead of chaperone. Because its party hasn't been a happy affair, other guests – most importantly the voters – want to get their hands on the punch bowl. And, with President Trump now the party-maker-in-chief, they have a good chance of getting it too.

The Fed may well deserve some of the blame heaped on it, but we won't join that chorus. Tonight, I'll lay out why our interests are aligned with a strong, but humble and hands-off central bank and what must quickly be done to get one.

First, Ignore the Spectacle

For the Federal Reserve, the celestial spectacle preoccupying global financial markets as sharks circle is who President Trump will nominate as the Board's next chair. Each day brings story after story about whether Chair Yellen will or won't be nominated, if she would stay on the Board if she isn't, what the President thinks each day about Gary Cohn, and – given that the take now is that what he thinks isn't all that flattering – which other top contenders have entered the race.

All of this is as exciting as watching each episode of "House of Cards" (although in this Administration, "Game of Thrones" seems more the thing). But, however important the Fed chair is – and he or she is very important in current market conditions – to watch this political drama is to miss the real story not only about the Federal Reserve, but also the future of U.S. financial policy.

As William Miller learned, the Fed's institutional gravitas can and thankfully sometimes does grind up an unqualified chairman. Conversely, presidents with a demanding nature can make life very difficult for even the most independent-minded chairman – think for example of how hard it was for the man who crafted the punch-bowl image of a strong Fed, Marriner Eccles, as he confronted a furious LBJ.

The same is true with governors on the Reserve Board. Some years ago, I was flattered to be under consideration for a seat. Lunching with a very senior Fed staffer, I was asked if I would be taking the post. I replied that I wasn't planning to pursue it because Fed governors had to work for Fed staff, not the other way around. The staffer chuckled and said, "Yes, although sometimes it can take time for them to figure it out."

The strength of the Fed is its awesome, technically-proficient staff. The vulnerability of the Fed is its dependence on models, dissertation hypotheses, and deep learning at international conferences that miss the U.S. point into which chairs and Board members put too much credence. Combine this vulnerability with political insularity and one has a central bank in the voters' cross-hairs.

Second, Watch the Shark

Several of the names being circulated as possible Fed chair and new members of the Board of Governors are highly qualified and would be strong, stable leaders. A good thing too – the Fed must now deal with the legacy of a decade of post-crisis monetary and regulatory policy with an array of unintended consequences. This legacy is both daunting and politically costly. It ensures that the next few years will be the most challenging the U.S. central bank has faced in decades.

Although central banks in most countries are centuries-old and honored parts of trusted economic establishments, the U.S. Federal Reserve has been viewed with deep suspicion after progressives were able to buffalo it into existence in 1913. Sometimes, the most radical left takes the most issue with a Fed seen as too sympathetic to Wall Street; other times, the most conservative members of the right complain about too heavy a hand on the free market. Now, though, the forces of the far left and right are united in populist anger at a central bank seen as a prime cause of economic inequality, slow growth, and excessive regulation. Liberals such as Sens. Sanders and Warren are angriest about some Fed actions and Tea Party types such as Chairman Hensarling are incensed by others. Under Mr. Hensarling's leadership, the House has twice passed legislation to stifle Fed monetary-policy discretion, strangle its rulemakings, and eviscerate emergency-liquidity backstops. For the first time I can recall, the two sides of the American political spectrum combine with a President who hears merit in much of what each says based on how well it positions him with the populist tide that swept him into the Oval Office.

Now, Are the Sharks Right?

In many ways, yes. Fed independence is an awesome strength, but it becomes a structural weakness when independence turns into insularity. Independence was what gave the Fed the power and vision to take unprecedented actions in 2008 to stave off as much of the macroeconomic doom as it could. Insularity made it blind before 2008 to emerging weaknesses. Since then, insularity has also made it deaf to growing complaints about the collateral damage done by steadfast adherence to accommodative monetary policy and neutron-bomb rules for the nation's largest banks. These have left the banks standing but their business models so damaged that U.S. credit is now a "shadow" game.

Still, the Fed is completely confident that more of what it has done means a better macroeconomic response. As a result, it has doubled down on both monetary and regulatory policies since 2009 even as worrisome signs have emerged of dangerous unintended effects. My firm warned of these as early as 2011,[2] by 2016 evidence was everywhere that the combination of monetary policy and all the new rules was worsening economic equality and sowing seeds for renewed financial instability.[3] Early next week, we'll issue a new paper showing how quantitative easing exacerbates U.S. economic inequality, building on recent research showing also that the combination of accommodative policy and new rules exacerbates economic stagnation and stymies effective systemic regulation.

Nonetheless, the Fed has plowed on blind to emerging warnings, deaf to criticism, and mute in the face of questions from Congress. Knowing that the central bank had a firm friend in the White House and stalwart backers in the U.S. Treasury, the central bank during the Obama Administration often failed to answer letters from Members of Congress and stone-walled unpleasant inquires. This was tempting given what some of the letters said and the inquiries were about, but it's made the Fed still more

vulnerable given the results of the 2016 election. As I said, the Fed has never been this vulnerable to structural change in living memory.

So, Uncertainty and Opportunity

What has all this Washington fury to do with the decisions each of you makes in Chicago? Given the expertise here tonight, I do not need to tell you that Fed decisions about interest rates and its $4.5 trillion portfolio matter. Indeed, they matter too much – the Fed should not be the be-all and end-all of U.S. economic policy. But it is, so here's what I think will happen over the near term as macroeconomic events and political battles continue. I'll close with what the Fed should do to turn this ship around.

For the next six months or so, the Fed will be in never-never-land and we all had better hope it's a happy place in terms of macroeconomic and financial stability. With the sudden resignation a week ago of Vice Chair Fischer, the Board is down to three – Chair Yellen and Govs. Powell and Brainard. This could speed Senate confirmation of Randal Quarles as Vice Chair for Supervision – Democrats are nowhere as opposed to Mr. Quarles as to other Trump nominees. But, going will be slow and even with it, the Fed will be very, very short-handed well into next year.

This gives Chair Yellen a lot of room to complete the policies she wants not only as her legacy, but also as a body of decisions any successor that isn't her will have difficulty dismantling. As with a recent rule related to giant-bank resolution, these finishing-act rules will reflect more sensitivity to burden and better acknowledge the very different business models of banks as one goes farther and farther down the asset-size scale. But, accommodative policy will remain largely intact and post-crisis rules will be finished, not re-evaluated.

What should the Fed do instead? Fundamentally, let its guard down and hear outside voices. Some like mine are pointing to the Fed's unintended but nonetheless devastating impact on U.S. economic inequality. Others have identified ways regulated providers of financial intermediation could restart services that enhance economic growth without sparking new risk. The Fed could also play a vital role guiding Congress through growth-critical decisions such as the future of the housing government sponsored-enterprises and be far more specific about those fiscal policies that enhance growth and those that might just make the rich richer and its job all the harder.

Yes, I know, the "dual mandate" limits the Fed's mission to maximum employment and price stability. The Board thus regularly eschews comment on anything that might get it into trouble with one side of the aisle or the other. What has this gotten it? The biggest institutional challenge to effective monetary and regulatory policy in decades. Now it is time to speak truth to power.

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[1] *New York Times*, Knowing Where to Look 10 Years After Start of Financial Crisis, August 27, 2017, at https://www.nytimes.com/2017/08/24/business/dealbook/knowing-where-to-look-10-years-after-start-of-financial-crisis.html.

[2] Federal Financial Analytics, *A New Framework for Systemic Financial Regulation: Simple, Transparent, Enforceable and Accountable Rules to Reform Financial Markets*, November, 2011, at http://www.fedfin.com/images/stories/client_reports/complexityriskpaper.pdf.

[3] Federal Financial Analytics, *Square Pegs and Round Holes: The Effectiveness of Monetary Policy and Macroprudential Regulation in the Post-Crisis Regulatory Regime*, May 16, 2016, at http://www.fedfin.com/info-services/issues-in-focus?task=weblink.go&id=269.