THE WALL STREET JOURNAL.
WSJ.com

OPINION | Updated August 26, 2013, 7:47 p.m. ET

John H. Cochrane: The Danger of an All-Powerful Federal Reserve

'Macroprudential' policy thinkers want central banks to micromanage the entire financial system.

By JOHN H. COCHRANE

Interest rates make the headlines, but the Federal Reserve's most important role is going to be the gargantuan systemic financial regulator. The really big question is whether and how the Fed will pursue a "macroprudential" policy. This is the emerging notion that central banks should intensively monitor the whole financial system and actively intervene in a broad range of markets toward a wide range of goals including financial and economic stability.

For example, the Fed is urged to spot developing "bubbles," "speculative excesses" and "overheated" markets, and then stop them—as Fed Governor Sarah Bloom Raskin explained in a speech last month, by "restraining financial institutions from excessively extending credit." How? "Some of the significant regulatory tools for addressing asset bubbles—both those in widespread use and those on the frontier of regulatory thought—are capital regulation, liquidity regulation, regulation of margins and haircuts in securities funding transactions, and restrictions on credit underwriting."

This is not traditional regulation—stable, predictable rules that financial institutions live by to reduce the chance and severity of financial crises. It is active, discretionary micromanagement of the whole financial system. A firm's managers may follow all the rules but still be told how to conduct their business, whenever the Fed thinks the firm's customers are contributing to booms or busts the Fed disapproves of.


Corbis

Macroprudential policy explicitly mixes the Fed's macroeconomic and financial stability roles. Interest-rate policy will be used to manipulate a broad array of asset prices, and financial regulation will be used to stimulate or cool the economy.

Foreign central banks are at it already, and a growing consensus among international policy types has left the Fed's relatively muted discussions behind. The sweeping agenda laid out in "Macroprudential Policy: An Organizing Framework," a March 2011 International Monetary Fund paper, is a case in point.

"The monitoring of systemic risks by macroprudential policy should be comprehensive," the IMF paper explains. "It should cover all potential sources of such risk no matter where they reside." Chillingly, policy "should be able to encompass all important providers of credit, liquidity, and maturity transformation regardless of their legal form, as well as individual systemically important institutions and financial market infrastructures."

What could possibly go wrong?

It's easy enough to point out that central banks don't have a great track record of diagnosing what they later considered "bubbles" and "systemic" risks. The Fed didn't act on the tech bubble of the 1990s or the real-estate bubble of the last decade. European bank regulators didn't notice that sovereign debts might pose a problem. Also during the housing boom, regulators pressured banks to lend in depressed areas and to less creditworthy customers. That didn't pan out so well.

More deeply, the hard-won lessons of monetary policy apply with even greater force to the "macroprudential" project.

First lesson: Humility. Fine-tuning a poorly understood system goes quickly awry. The science of "bubble" management is, so far, imaginary.

Consider the idea that low interest rates spark asset-price "bubbles." Standard economics denies this connection; the level of interest rates and risk premiums are separate phenomena. Historically, risk premiums have been high in recessions, when interest rates have been low.

One needs to imagine a litany of "frictions," induced by institutional imperfections or current regulations, to connect the two. Fed Governor Jeremy Stein gave a thoughtful speech in February about how such frictions might work, but admitting our lack of real knowledge deeper than academic cocktail-party speculation.

Based on this much understanding, is the Fed ready to manage bubbles by varying interest rates? Mr. Stein thinks so, arguing that "in an environment of significant uncertainty . . . standards of evidence should be calibrated accordingly," i.e., down. The Fed, he says, "should not wait for "decisive proof of market overheating." He wants "greater overlap in the goals of monetary policy and regulation." The history of fine-tuning disagrees. And once the Fed understands market imperfections, perhaps it should work to remove them, not exploit them for price manipulation.

Second lesson: Follow rules. Monetary policy works a lot better when it is transparent, predictable and keeps to well-established traditions and limitations, than if the Fed shoots from the hip following the passions of the day. The economy does not react mechanically to policy but feeds on expectations and moral hazards. The Fed sneezed that bond buying might not last forever and markets swooned. As it comes to examine every market and targets every single asset price, the Fed can induce wild instability as markets guess the next anti-bubble decree.

Third lesson: Limited power is the price of political independence. Once the Fed manipulates prices and credit flows throughout the financial system, it will be whipsawed by interest groups and their representatives.

How will home builders react if the Fed decides their investments are bubbly and restricts their credit? How will bankers who followed all the rules feel when the Fed decrees their actions a "systemic" threat? How will financial entrepreneurs in the shadow banking system, peer-to-peer lending innovators, etc., feel when the Fed quashes their efforts to compete with banks?

Will not all of these people call their lobbyists, congressmen and administration contacts, and demand change? Will not people who profit from Fed interventions do the same? Willy-nilly financial dirigisme will inevitably lead to politicization, cronyism, a sclerotic, uncompetitive financial system and political oversight. Meanwhile, increasing moral hazard and a greater conflagration are sure to follow when the Fed misdiagnoses the next crisis.

The U.S. experienced a financial crisis just a few years ago. Doesn't the country need the Fed to stop another one? Yes, but not this way. Instead, we need a robust financial system that can tolerate "bubbles" without causing "systemic" crises. Sharply limiting run-prone, short-term debt is a much easier project than defining, diagnosing and stopping "bubbles." That project is a hopeless quest, dripping with the unanticipated consequences of all grandiose planning schemes.

In the current debate over who will be the next Fed chair, we should not look for a soothsayer who will clairvoyantly spot trouble brewing, and then direct the tiniest details of financial flows. Rather, we need a human who can foresee the future no better than you and I, who will build a robust financial system as a regulator with predictable and limited powers.

Mr. Cochrane is a professor of finance at the University of Chicago Booth School of Business, a senior fellow at the Hoover Institution, and an adjunct scholar at the Cato Institute.