John Williams takes the helm of the New York Fed.

The Insider

By Michelle Celarier

When San Francisco Federal Reserve President John Williams crosses the country to become the New York Fed's president in June, the Wall Street he will be tasked with overseeing is a much different animal than the one that crashed the entire world economy almost ten years ago. Financial power has become even more consolidated, technological disruption has created new dangers, nonbank players are gaining ground, and the world economy, while more stable, remains in a fragile state.

Yet it is the successes of the past decade that underscore what a pivotal time it is now for the Federal Reserve System. After markets went into a tailspin in 2008—threatening to take the major banks along—the Fed used every tool at its disposal, from temporary bailouts to quantitative easing, to fulfill its role as the lender of last resort. With Congress unwilling to take significant action to stimulate the economy, most of the burden fell on the Fed's shoulders following the crash. It managed to keep the United States from falling into a deflationary spiral that could have sunk the economy into a 1930s-era type Great Depression, and despite naysayers in Congress, academia, and Wall Street questioning its every move for years, the Fed succeeded. Getting the economy back on track took perhaps more time than expected, but in 2018, here we are: The economy is finally near full employment, with inflation around 2 percent.

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It is perhaps because the waters seem so calm now that the risks may now be even greater. With interest rates still at very low levels but slowly climbing, and the yield curve flattening, any new shock to the system will test the Fed's ability to maneuver. The financial markets have been buoyed by Fed-engineered liquidity, and fears of an asset bubble bursting can't be ignored, especially as new ways of adding risk to the system are always inevitable—and inevitably unknown until too late. Such concerns must weigh heavily on the Federal Reserve. "Everyone at the Fed is very well aware that this is the top of the business cycle and very unlikely to stay this benign for much longer," says Karen Shaw Petrou, managing partner of Federal Financial Analytics.

The Fed has never been good at pinpointing what will trigger the next crisis or predicting the next recession, admit former insiders. But as the president of the New York Fed and working alongside Fed Chairman Jerome Powell, Williams will have a big role in whatever comes next. Powell, who is a lawyer, not an economist, reportedly supported Williams for the job, given that he needs to rely on his economic expertise.

Anticipating, or avoiding, potential crises may be a tall order for someone like Williams, who has no bank supervisory experience. Supporters like to say that he's a quick learner. But perhaps just as important, given his background as a Fed economist, Williams may help bring important changes to monetary policy that can help the United States survive the next downturn.

Targeting Price Levels, Not Inflation

Incoming New York Fed chief John Williams, considered a pragmatist in monetary issues, is a leader in the current discussion among economists arguing for targeting price levels instead of inflation. (A variation has also been put forth by former Fed Chairman Ben Bernanke.)

"Although an inflation targeting framework has served central banks across the globe well in the past, the world has changed in ways that call into question its efficacy going forward." Williams said in a May 5, 2017, speech to the Shadow Open Market Committee in New York. "In particular there is mounting evidence that the natural rate of interest … in the United States and elsewhere has fallen to historic lows, which hampers the ability of conventional monetary policy to respond to the next downturn."

—M. Celarier

John C. Williams

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"He's clearly a super star," says Stephen Oliner, resident scholar at the American Enterprise Institute who worked at the Federal Reserve for twenty-seven years and interviewed Williams when he applied for his first job at the Fed in Washington in 1994, before moving to the San Francisco Fed. There, Williams was the research director under Janet Yellen and succeeded her as the president when she left for Washington in 2011 to be Fed vice chair. "He has rocketed through the ranks and is a great choice for the New York Fed," says Oliner.

But, Oliner cautions, "Williams is an insider and is not going to take the institution in a different direction."

Williams will be joining the regional bank with the most power in the system. The New York Fed is the only one of the regional banks that is a permanent member of the Federal Open Market Committee, which directs open market operations and is often called the "eyes and ears" of the Fed on the financial markets. Its fortress of a building sits smack in the middle of Manhattan's Wall Street, a symbolic nod to its connection to the world financial center in New York City.

Williams was not located in the heart of the financial markets during the last crisis and has no ties to Wall Street, unlike the New York Fed's current president, William Dudley, who had been a managing director at Goldman Sachs. But former New York Fed President

Timothy Geithner had always worked in government and still was still seen as too close to the industry he regulated, and was criticized for ignoring the risks of derivatives that were building up in the system before the crash.

Williams's status as a longtime insider has led some to argue he doesn't have the proper distance to see risks building up. "It's always a problem that the Fed regional banks are creatures of the banks they regulate," says James Galbraith, an economist and professor in government at the University of Texas at Austin. "They represent a projection of banker interest and power into the federal government where it should not be."

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That said, the new New York Fed chief has had his finger on the pulse of every change the crisis wrought, say those who have worked closely with him. The biggest criticism leveled at him—by Senator Elizabeth Warren (D-MA)—is that he did not avert the problems at Well Fargo, which was in his district and recently paid a $1 billion fine over its mortgage and auto lending practices. Such failures were a system-wide problem pre-2008.

"In hindsight, the Fed realized that its supervision of the banks wasn't sufficiently tough leading up to the crisis," says Donald Kohn, who was vice chairman of the Fed under Ben Bernanke until 2010 and is now a senior fellow in the economic studies program at the Brookings Institution. Since 2008, Kohn says, "the FOMC has taken a greater interest in how the financial system is working and how its policies are being transmitted to the real economy and whether there are any financial threats to the economy."

As president of the San Francisco Fed during the past decade, Williams has spoken at length on these issues in interviews and speeches. He has criticized the banks for their past behavior, and told the *American Banker* in a 2016 interview that he feared the banks would continue prioritizing short-term profits, knowing they will only have to pay small fines for any problems that arise down the road. "Hopefully the lesson learned is to recognize that the long-run health and reputation actually matters a lot more than short-term gains. That's still a question mark, though, how much that has stuck."

However, Williams sounded more sanguine as he continued in the interview. "For the vast majority of banks—and especially the biggest banks—the resilience, the level of capital, liquidity, everything about the institutions, both quantitatively in terms of capital, but also the risk management—all those things are in much better shape than they were. So I think we've learned lessons from the crisis, I think the banking system is much better prepared for whatever the next thing is," he said.

Not everyone is so sure. Williams takes on this crucial role at a time when regulations are starting to loosen up during the Trump era. President Trump just signed a rollback to the Dodd-Frank financial reform legislation enacted post-crisis. Although designed to help small community banks, the changes would lower capital requirements and do away with stress tests and the Volcker Rule for a wide swath of institutions. House Republicans want to gut Dodd-Frank even more.

That's not all. The Treasury Department last fall, for example, recommended changes to the process for labeling nonbank financial institutions as "systemically important" that many big nonbank institutions like New York-based MetLife have fought to avoid. The "systemically important" designation subjects firms to stricter regulatory oversight from the Financial Stability Oversight Council in hopes of averting another financial crash in which big intertwined institutions require a bailout to keep contagion from spreading.

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Any changes could ease pressure for such a designation on New York-based heavyweights, such as BlackRock, which owns trillions of dollars in mortgage-backed securities, or the Blackstone Group, which has become the largest owner of residential real estate (and landlord) in the country since the housing crisis. Neither is overseen by the Fed, nor have they been labeled systemically important, which would force them to have more capital. To be sure, the real estate market is nowhere near the levels it attained during the housing bubble of the early aughts, but the leverage that

accompanies real estate always makes it a potential weak spot. "Crises are almost always sovereign debt or real estate," notes Oliner.

Galbraith worries about what we don't know. "I would be generally worried ten years after the crisis that some new forms of exposure are out there," he says. "I worry about new off-balance-sheet exposures. This is characteristically what happens. The notion that capitalization will save the banks was belied by the last crisis." He argues that right after a crisis, people are generally cautious, and the situation tends to stabilize. "But to keep the expansion going, people look for ways around the rules."

Whatever risks are out there, few think regulators will anticipate them. The next financial crisis is "probably not something we're prepared for," says Oliner. "The Fed never forecasts the next recession." During the twenty-seven years he worked there, he says, "We were always taken by surprise."

Ultimately, we may have to rely on the Fed's resiliency in the face of the next crisis. That's where Williams' expertise in monetary policy may offer the biggest potential benefit.

In recent years, fulfilling the Fed's dual mandate of trying to get the economy up to full employment as well as keeping inflation in check has become a fraught exercise using traditional methods of analysis. That's because of the breakdown of the Phillips Curve, which historically showed a tradeoff between the two mandates. But the lack of wage pressure during the recovery has kept inflation in check despite the economy nearing near full employment. If using the Phillips Curve to predict inflation is no longer useful to central bankers, what else can be done?

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The concern is that when the next recession hits, the Fed won't have much room to cut interest rates to spur growth. Right now, the Fed has an inflation target of 2 percent. But over the past five years, inflation has only hit 1.2 percent annually, giving almost a percentage point of slack in the system each year. Under price level targeting, which would try to keep the price levels on a steady growth path of, say, 2 percent a year, "you'd need to run inflation at 3 percent to make up for the shortfall," explains Oliner.

The higher inflation would last only until the shortfall had been made up, at which point the Fed would again be shooting for prices to rise 2 percent annually, he says. Price level targeting would not be expected to result in higher nominal interest rates over the long run. Rather, the effect of price level targeting is that the Fed would be slower to tighten policy after a period in which inflation has been below 2 percent, explains Oliner.

In today's context, that would mean that the Fed would be planning to raise the funds rate more gradually than it currently projects. In a downturn, the Fed might also be able to keep the funds rate at zero longer than under the current regime, would have the effect of lowering long-term interest rates (such as mortgage rates) and stimulating the economy.

So far, price-level targeting is just an idea. In terms of monetary policy, it appears the Fed is willing to ignore past years of low inflation and hope the future takes care of itself. The next crisis could test that view, not to mention New York Fed President John Williams. ◆