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Fed Official Concedes Risk of Low Rates, but Signals No Shift

By SEWELL CHAN

WASHINGTON — Federal Reserve officials “have no choice” but to try to “contain future bubbles and credit binges” and limit their damage to the economy, the central bank’s vice chairwoman said on Monday, detailing the Fed’s newly broadened mandate to promote financial stability.

In her first speech since she was sworn in Oct. 4 as the Fed’s second-highest ranking official, Janet L. Yellen acknowledged that expansionary monetary policy — holding interest rates low to stimulate the economy, as the Fed has been doing for more than two years — “could provide tinder for a buildup of leverage and excessive risk-taking in the financial system.”

But Ms. Yellen did not say that such risks should deter the Fed from resuming purchases of government debt to prop up the flagging recovery, an action most Wall Street analysts expect the Fed to take as early as next month.

She is associated with the camp of so-called inflation doves at the Fed, who tend to emphasize the persistently high unemployment rate rather than the risks of setting off inflation. As a member of the Fed’s board of governors from 1994 to 1997, Ms. Yellen served under Alan Greenspan in an era when the Fed did not emphasize tough regulation. Later, she was an adviser to President Bill Clinton and the president of the Federal Reserve Bank of San Francisco.

In her speech, to the annual meeting of the National Association for Business Economics, in Denver, Ms. Yellen discussed the interplay between monetary policy and “macroprudential supervision,” which focuses on the safety of the financial system as a whole rather than the soundness of individual banks and institutions.

Supervision and regulation must be the “first and main line of defense” against risks to the financial system, Ms. Yellen said, because monetary policy has other objectives and is “too blunt an instrument” to contain such risks. That position is in line with a central belief of Ben S. Bernanke, the Fed’s chairman.

Effective supervision should focus on the accumulation of high levels of risk and leverage, Ms. Yellen said, sources of vulnerability that are shared by multiple institutions, and the interconnectedness of the system.

Banking supervision and regulation were a focus of the annual meeting last week of the International Monetary Fund. On Sunday, the Institute of International Finance, a global association of commercial and investment banks, said that many countries were piling on regulations too rapidly and giving too little time for new rules to take effect, and warned that bank lending and economic growth could be curtailed as a result.

But the same day, the Group of Thirty, a private association of finance leaders, called for “urgent action” on macroprudential supervision. “As we have seen, a focus on individual institutions and markets, absent a systemic view, cannot ensure financial stability and resilience,” said Roger W. Ferguson Jr., a former Fed vice chairman who led the working group that prepared the Group of Thirty’s report.

Ms. Yellen, who was a member of that working group, threw her support behind its findings on Monday.

She argued against the idea, fashionable before the 2008 crisis, that business cycles had been tamed and that markets were self-correcting. “That view lies in tatters today as we look at tens of millions of unemployed and the trillions of dollars of lost output and lost wealth around the world,” she said.

Regulators had been “lulled into complacency by a combination of a Panglossian worldview and benign experience,” she said. Turbulent events — like the Latin American debt crisis and the savings-and-loan disaster in the 1980s; the Asian financial crisis and the failure of the giant hedge fund Long-Term Capital Management in the 1990s; and stock market declines in 1987 and 2000-1 — appeared to be manageable at the time.

“We appeared to have entered a new period of stability,” Ms. Yellen said. “We even gave it a name: the Great Moderation. We were left with a mirage of a system that we thought was invulnerable to shock, a financial Maginot Line that we believed couldn’t be breached. We now know that this sense of invincibility was mere hubris.”

She also spoke favorably of the Dodd-Frank overhaul of Wall Street, which President Obama signed in July and which expanded the Fed’s mandate, and of proposed global bank regulations, known as Basel III, that will gradually force banks to hold more and higher-quality capital. And she said that regulators should compel financial institutions to have enough liquidity and not to rely too much on unstable, short-term financing.

Ms. Yellen said the new regulatory system should incorporate automatic safeguards and straightforward rules, and involve extensive international coordination. While recognizing that “overly strict supervision” posed dangers, she said that policy makers “had veered disastrously too far in the direction of laissez-faire, with consequences we know too well.”

She concluded by saying: “Next time I hope we can say, ‘We did see it coming, and we did something about it.’”

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