FROM THE
FOUNDER

Yellen's Plea

Those who worry whether Janet Yellen, President Obama's nominee as Federal Reserve chair, has the personal heft for the job are singing an old tune. That's what they said when Alan Greenspan replaced Paul Volcker, and Ben Bernanke replaced Greenspan.

Yellen's tenure will nevertheless be challenging. Given her reputation as leader of the Fed's dovish wing, both debt and equity markets will almost certainly test her resolve.

Yellen needs to be particularly careful early on. When Alan Greenspan assumed the chairmanship in 1987, critics complained that the acolyte of former Chairman Arthur Burns was too political. Burns was charged with engineering an excessively easy monetary policy to help facilitate the 1972 reelection of Richard Nixon.

In his first FOMC meeting, Greenspan surprised financial markets with a discount rate hike. Bond traders suspected, perhaps unfairly, that the move was to demonstrate the new chairman's independence.

A number of other developments helped lead to the stock market crash six weeks later. But the unexpected rate hike didn't help matters. Yellen should avoid the temptation to try to immediately prove her credibility.

The new chair already faces Mission Impossible over the $90 billion in bonds the Fed purchases each month to keep interest rates from rising. The Fed is now central banker to the world. It is a world increasingly investment-dependent for growth, financed to a surprising degree by the Fed's quantitative easing.

Keep buying bonds for too long, and the world risks an ever-expanding financial bubble that could someday burst. Taper, or taper too much, and the result could be the same, perhaps sooner.

Let's avoid the politics of personal destruction.

Yellen's dilemma is that it is impossible to predict when financial bubbles burst. Policymakers also have a poor track record of successfully pricking bubbles.

Yellen must also confront the Bernanke legacy. During the financial crisis, Bernanke deserved enormous credit for injecting liquidity quickly into the financial system, avoiding a depression. Yet in the five years since, there have been difficulties:

Independence. The Fed could be at risk of losing its independence. The undefined goal of "financial sta-

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bility" appears to have replaced the Fed's traditional dual role of maintaining price stability and full employment.

To achieve this stability, bank credit has migrated away from the private economy and into government debt. As analyst Criton Zoakos points out, pursuing financial stability the last five years has "seen credit and production move sharply in opposite directions." And as Tadashi Nakamae notes (page 16), quantitative easing's greatest flaw is the "lack of a mechanism to improve productivity," which is essential to raising economic growth rates. Since quantitative easing went into effect, labor productivity has plummeted.

Now the Fed worships regularly at the shrine of the financial sector. By not allowing financial asset prices to clear, the central bank has been cornered into becoming the safety net for only one economic sector. But now, who owns whom?

Rescuer-in-Chief. In a similar fashion, the Fed has allowed itself to be positioned as rescuer-in-chief without demanding the rest of Washington produce a growth strategy. The Fed can't do it all, particularly when monetary policy is pushing on a string. The longer the U.S. central bank gives the appearance of moving toward a World War II-style system of credit allocation, the more the rest of Washington will be tempted to avoid responsibility for fixing the economy.

Transparency. Chairman Bernanke became fixated on transparency—tell everything all the time, in a series of press conferences that sometimes produced more confusion than clarity. Given the tiny size of the Fed's reserves relative to the size of global financial markets, central banks have become an elaborate theater. In this theatrical effort to persuade markets, sometimes a bit of mystery is useful, particularly when the central bankers are as confused as the private markets. Yellen needs to rebuild the theater, recognizing of course that ultimately the essential element in managing the theater in today's "witch hunt" climate is to establish policy credibility.

Tower of Babel. The FOMC has increasingly become a Tower of Babel. Like a university economics department, everybody has their public say. Financial markets are left confused. When he was chairman, Paul Volcker had a board member who loved giving speeches. All well and good, but this official often contradicted the chairman about the FOMC's intentions. In a quick, tough, private word to his colleague, Volcker is said to have uttered after one such speech, "Do that again, and you're [not going to like the rest of your time here]." The public comments stopped. Yellen needs to collapse the Tower of Babel.

Vice Chair. Yellen needs a Vice Chair with financial market experience. This globe-trotting Vice Chair must have shrewd market instincts to complement Yellen's own superb analytical skills as a macroeconomist. Perhaps the Fed needs two Vice Chairs—one for global financial markets and the other for regulatory issues.

Capitol Hill. Finally, Yellen should quickly make the rounds on Capitol Hill, meeting even junior GOP members. The purpose: to show that the Fed's common-sense new leader is a problem solver, not an ideologue of the left. The new chair faces extraordinary challenges and needs broad-based support. That requires reaching out and explaining how the Fed will likely be forced to pick the least bad from a lot of ugly options.

Let's separate monetary policy from the muck of Washington's trench war partisanship.

Yellen's plea: Let's separate monetary policy from the muck and stench of Washington's trench war partisanship. In this one area, let's avoid the politics of personal destruction. The challenges ahead will be eye-poppingly difficult for all of us. We're in uncharted waters. The stability of the dollar can't be taken for granted, nor can anything else.

—DAVID M. SMICK
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