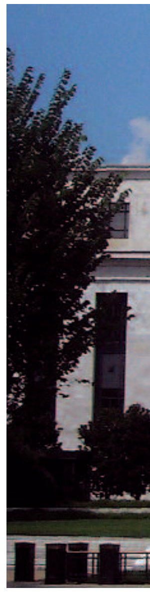
The *Challenge* of a Lifetime

The new Fed Chair will surely have her hands full.



"Any idiot can face a crisis—it's day-to-day living that wears you out."
—Anton Chekhov

By John H. Makin

In addition to her impending, and no doubt ultimately successful, quest for Senate confirmation, Janet Yellen will have a lot on her plate in the coming months. Now that House Republicans and Senate Democrats have come to yet another temporary agreement on the budget and debt ceiling, there still exists another threat to the economy: The Federal Reserve's temptation to pursue an overly ambitious monetary policy aimed at offsetting the damage to the economy arising from poorly conducted fiscal policy. Now that President Obama's Fed Chairman nominee has been announced, the Fed needs to shift its focus from wondering who will lead it to what its realistic goals can be. Substantially different views are held by Fed hawks and doves.

The economy is still on uncertain footing, and public frustration with the Fed is increasing, especially since the May-taper into September-no-taper serious misstep. The Fed seems to be making up policy as it goes along. It has become distracted with trying to fix problems it is not well-equipped to handle, including sustained lower unemployment and a faster pace of growth than is obtainable during a period of fiscal consolidation and weak global growth.

The Fed's post-financial crisis mission creep, since 2008, has fueled an unhealthy codependence between it and the market, akin to the infamous pre-crisis "Greenspan put," whereby the Greenspan Fed was expected to—and did—step in to support financial markets whenever there arose a threat to rising asset markets. Markets assume the Fed

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can and will fix any problems, such as the latest episode of Washington's fiscal policy bungling, that might harm the economy or depress stock prices. Once necessary, but now dangerous, improvisations of monetary policy—quantitative easing and forward guidance in particular—have become alternately ineffective and counterproductive, as the recent tapering trauma has shown. Yellen, as the primary author of the Fed's new communication strategy, needs to identify ways to improve the Fed's communication with markets and the public.

The Fed has come a long way since its founding one hundred years ago. Its original role was to be the lender of last resort in a financial crisis. That role, as a temporary emergency supplier of liquidity in a panic, has continued and should continue going forward. But in the post-financial crisis period, the Fed has been forced to accommodate the extra cash demands of households and firms confronting a world of elevated uncertainty about the direction and conduct of monetary and fiscal policy. That is because higher uncertainty has forced firms and wealthy households to self-insure against possible bad outcomes and to preserve optionality in the face of unforeseen shocks and opportunities.

Failure by the Fed to satisfy higher cash demands worsened the Great Depression in the United States and the deflationary lost decade in Japan. These elevated, post-crisis cash needs explain why the Fed's rapid additions to the monetary base through quantitative easing have been followed by disinflation, not inflation, as many, including some FOMC members, have predicted. Chairman Yellen will have to be vigilant to avoid tightening too soon, while uncertainty remains high.

The Full Employment Act of 1978 further complicates the Fed's task by increasing the risk that it will be forced to stay with easy money for too long, that is, until inflation rises above its target level of about 2 percent. This act requires the Fed to add full employment to its policy goals, without adding any new tools to its policy toolbox. The instability in interest rates and continued rising inflation that prevailed after 1967 and until 1981 was due in part to the Fed's focus on maintaining growth and lowering unemployment, long before Congress passed the formal full employment mandate in 1978. Pressing even harder for growth after 1978 caused inflation to spike above 10 percent. Paul Volcker, who had been appointed Fed Chairman in August 1979, in his effort to send to markets a clear message that the Fed's primary goal was to reduce and stabilize inflation, was forced to tolerate the sharply higher unemployment and interest rates that resulted from the battle to reduce inflation. Economic conditions improved markedly while inflation fell sharply by 1983. Still, there was one more brief inflationary episode during 1984, when the Volcker Fed had to reinforce its commitment to low inflation. Since then inflation has remained low and stable.

The tapering missteps generated considerable uncertainty.

The "Great Moderation" period of price stability and steady growth, lasting from 1985 to 2007, emerged once inflation and fears of inflation had been quelled by the Volcker Fed. Attainment of sustained growth was aided by a 1985 jump in technological productivity unrelated to monetary policy. The persistence of faster growth without inflation kept pushing stock prices higher until Alan

Continued on page 72

Continued from page 11

Greenspan, who had been appointed Fed Chairman in 1987, presciently warned of "irrational exuberance" in a widely reported December 1996 speech. Markets largely ignored the warning until the "tech bubble" burst in 2000.

In spite of Greenspan's caution, markets became convinced that stock prices could only rise, especially with the Fed around to sustain growth indefinitely, choosing to focus on the aforementioned "Greenspan put." Chairman Greenspan may have unwittingly encouraged "irrational exuberance" by asserting in a 1999 testimony to Congress that market bubbles were impossible to identify before they burst. The bursting of the 2000 tech bubble was forgotten by 2002 when U.S. residential real estate prices began to rise exponentially, chased up by buyers who were convinced that they would never fall.

That view and its leveraging into financial markets proved disastrous after the housing bubble burst in 2008, sending the Fed scrambling to contain the damage. It introduced unprecedented monetary stimulus, and, ultimately by 2012, had injected multiple rounds of quantitative easing aimed at sustaining tepid growth and reducing unemployment by boosting wealth as it encouraged yield-hungry investors to bid up prices of riskier-than-cash assets like stocks and, since 2011, real estate.

By May of this year, concerned that financial bubbles might be re-forming in asset markets, even though inflation in markets for goods and services was falling, Chairman Bernanke hinted that the Fed might begin "tapering," reducing its QE liquidity injections. When markets extrapolated a shortened period of Fed commitment to low interest rates, the cost of mortgage financing increased by 125 basis points. By September, growth had begun to slip as fiscal policy uncertainty resurfaced alongside elevated monetary policy uncertainty. On September 18, after having suggested in May that "tapering" should begin soon, the Fed declined to taper, citing a weaker economy and fiscal uncertainty as reasons.

The tapering missteps generated considerable uncertainty about the future path of monetary policy. Chairman Yellen will need to lead the Fed to a clearer messaging stance while deflecting calls for the Fed to achieve multiple targets with its limited arsenal of tools. The current Fed pledge—to keep interest rates near zero until unemployment falls to at least 6.5 percent—that she reinforced during brief remarks at her nomination ceremony is problematic. This pledge, aimed at conveying the Fed's intention not to raise its target interest rate for a considerable period, locks the Fed into an employment goal that it may not be able to achieve. It might be better to signal the Fed's determination to maintain a low and stable inflation target by setting a floor, in addition to the ceiling, on its inflation target.

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Once installed as chairman, Yellen could accelerate the transition to a reconfigured Fed by delivering a major address on the Fed's goals, methods, and ways of communicating with markets and the public. The goals should be modest: primarily, maintaining low and stable inflation and a continued readiness to serve as lender of last resort. It is especially important that Chairman Yellen clearly articulates the Fed's view on how asset markets will be used as a guide to policy. Will an effort be made to identify, and react to, bubbles before they burst?

Communication with markets and the public could be much improved by adopting press conferences after every meeting while reining in extended public comments on policy coming from FOMC members and regional Fed presidents outside of formal FOMC meetings. She could further reinforce the Fed's commitment to low and stable inflation by lowering the inflation target to a range of 0.5 percent to 1.5 percent from the current level of 1.5 percent to 2.5 percent.

Janet Yellen understands well the extraordinary challenges facing the Fed as it navigates back toward a more predictable, more sustainable path for monetary policy. She has the support of an FOMC and a Fed staff that are well aware of her considerable talents. We all wish her well. A great deal is riding on her ability to succeed in the face of formidable challenges. ◆