Yellen's Long Journey

A transition fraught with risks.

BY JOHN M. BERRY

In terms of intellect, training, personality, and experience, Janet L. Yellen was as qualified as anyone in history to be chair of the Federal Reserve when she was sworn in on February 1. She was already the central bank's vice chair and earlier had been a member of the Fed Board and president of the San Francisco Federal Reserve Bank. But none of that means she's going to have an easy first year on the job.

Fed policy has entered a period of transition with the Federal Open Market Committee taking the first step to slow the increasing flow of massive liquidity to the economy. That's also the beginning of the long journey to "normalize" policy—that is, return eventually to focusing on moving overnight interest rates up and down to stabilize the economy. The transition is fraught with risks for Yellen and the Fed.

Fortunately, she likely will soon have the help of Stanley Fischer, one of the most respected economists and central bankers in the world. Fischer, who ably led the Central Bank of Israel through the crisis, has been nominated by President Obama to replace Yellen as Fed vice chairman. Lael Brainard, another mainstream economist with public policy experience, most recently as undersecretary of Treasury for international affairs, has also been nominated to join the Fed Board. Both are expected to be solid Yellen allies.

There is strong opposition among conservatives to many of the things the central bank has done to deal with the financial

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THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
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crisis and its aftermath, and there is a nascent effort to curb its powers in the future. How successful that attempt will be is hard to predict, but some actions the Fed will have to take as part of the policy transition, such as increasing the interest rate paid on bank reserves, won't be politically popular.

Many of the underlying problems Yellen faces have their roots in misguided fiscal policy. Following the financial crisis, small-government conservatives in Congress, occasionally with the help of the Obama administration, cut government spending enough to partially throttle the economic recovery. Given the drag from fiscal policy, reducing the Fed's target for overnight interest rates from 5.25 percent almost to zero in 2008 was not enough to spur growth and quickly bring down the high unemployment created by the recession. Most Fed officials, including Chairman Ben S. Bernanke, were not willing to shrug and say there's nothing more we can do.

Unable to lower short-term rates any further, the Fed sought to bring down longer-term rates as well. Since long rates are affected by expectations of changes in short rates, officials promised not to begin to raise them until well into the future. In addition, officials began to swap some of the tens of billions of dollars worth of short-term Treasury securities in their portfolio for longer-dated ones. Then they began to buy large quantities of both longer-term Treasuries and mortgage-backed securities. Finally, their "forward guidance" about when and under what circumstances they might begin to raise short-term rates became ever more explicit.

By the fall of 2012, each month the Fed was purchasing $40 billion worth of mortgage-backed securities and $45 billion worth of long-term Treasuries as part of its so-called quantitative easing policy. Some FOMC members opposed quantitative easing from the beginning and questioned its efficacy. Others were disturbed by its open-ended nature.

At the moment, the most significant point of agreement is that quantitative easing should end this year.

Embarrassing Losses?

Janet Yellen

Chair Janet Yellen and the Fed may have to deal with the possibility that the central bank could incur losses if it has to sell some of the securities in its portfolio before they mature. Generally, they have been acquired during a period of exceptionally low interest rates, and if they were sold after rates rise to a more normal level, there would be a capital loss.

The unemployment rate has come down much faster than Fed officials expected even though economic growth has remained subdued.

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In December, the FOMC began pulling back. It reduced the quantitative easing purchases in January to $75 billion a month from $85 billion and lowered that again to $65 billion in February. In Yellen's first congressional testimony ten days after becoming chair, she said this tapering of purchases would continue unless the economic outlook becomes much weaker than Fed officials now expect.

The purchases over several years have expanded the Fed's balance sheet to more than $4 trillion, and if they end later this year the total will be close to $4.5 trillion. That is a serious complication as far as normalizing policy is concerned. In the past, the Fed kept overnight rates approximately where officials wanted them by adding or subtracting bank reserves—cash really—available in the banking system. However, currently about $2.5 trillion worth of the liquidity the Fed has pushed into the economy has ended up on bank balance sheets in the form excess reserves. That means when the Fed wants to raise short-term rates, it probably will have to use an entirely new method that won't be tied to bank reserves. The Fed is already testing ways that might be done.

Yellen, as did Bernanke, regards the tapering of asset purchases not as a tightening of policy but reducing the amount of additional stimulus being supplied. Many market participants see it the other way around. When Bernanke first mentioned tapering last May, investors took it to be a signal that the Fed would begin raising short-term rates sooner than had been expected, and

Stanley Fischer

Lael Brainard

New Yellen Allies

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long-term rates jumped. It then took several months and repeated reassurances in Fed communications that it would still likely be sometime in 2015 before short-term rate targets rise.

A new complication arose just as Yellen was taking office. In both December and January, job growth was much weaker than expected, probably partly due to severe winter weather, which continued into February. On the other hand, perhaps it wasn't just weather but a sign of slower growth. Such uncertainties could well persist, though it seems plain that now that the tapering of quantitative easing has begun, Yellen and most of the other FOMC participants will be loathe to stop it.

During Yellen's testimony before the House Financial Services Committee, its chairman, Rep. Jeb Hensarling, a conservative Texas Republican, attacked the Fed on all fronts.

"Perhaps the most critical issue we must examine is the limit of monetary policy to actually promote a healthy economy," Hensarling said. "We have now witnessed both the greatest fiscal and monetary stimulus programs in our nation's history, and the results could not be more disappointing. Despite being almost five years into the so-called Obama recovery, we still see millions of our fellow citizens unemployed or underemployed, shrinking middle-income paychecks, and trillions of dollars of new unsustainable debt."

Earlier, Hensarling began a year-long set of hearings pointing toward legislation focused on limiting the Fed's powers and perhaps threatening its independence in making monetary policy decisions. With Yellen at the witness table, Hensarling and other Republicans complained that, while not fixing what ails the U.S. economy, the Fed's super-low interest rate policy is facilitating deficit spending, stripping seniors of needed interest income from their savings, hurting Americans investing in emerging market countries, and picking winners and losers by allocating credit to particular industries. Finally, Hensarling declared, instead of following a "policy rule" in making monetary policy decisions, the Fed "seems to favor a more amorphous forward guidance, shifting from calendar-based, to tight thresholds, to loose thresholds which arguably leaves investors and consumers lost in a hazy mist as they attempt to plan their economic futures and create a healthier economy."

Amidst that hyperbole—and total mischaracterization of fiscal policy—there is more than a grain of truth in the complaint that Fed officials have had trouble communicating its policy intentions to the public. That's one reason Yellen might have a difficult time this year—just as Bernanke did last year.

After Yellen was done, Hensarling had a panel of economists and former Fed Vice Chairman Donald L. Kohn testify. One of the panelists was John B. Taylor of Stanford University, an acknowledged authority on the Fed and author of the Taylor Rule, a rule for guiding central bank policy when either inflation or economic growth has deviated from where the bank wants it to be. He has been a sharp critic of the Fed since it failed to follow his version of the rule and lowered its target for overnight rates to only 1 percent in 2003. That helped fuel the housing boom, the collapse of which played a key role in the financial crisis, Taylor said.

Taylor criticized the Fed's unconventional policies and its forward guidance, particularly the latter.

"Rather than simply saying that the interest rate would remain low for a 'considerable period' or increase at a 'measured pace,' the Fed began saying that it would keep the federal funds rate near zero until a certain date, such as 2015. It then changed the policy, saying it would keep the rate at zero at least until the unemployment rate hit 6.5 percent. With the unemployment rate already at 6.6 percent today, many are speculating that the Fed will have to change its forward guidance again," Taylor said.

Indeed, in her testimony Yellen said the FOMC is looking at "a broad range of measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments." She added that "it likely will be appropriate to maintain the current target range for the federal funds rates well past the time that the unemployment rate declines below 6.5 percent, especially if projected inflation continues to run below the 2 percent goal."

The unemployment rate has come down much faster than Fed officials expected even though economic growth has remained subdued. The share of the civilian population in the labor force has fallen as workers have dropped out of the labor force. That has brought down the unemployment rate even without employment rising very much. Part of the decline is demographic as baby boomers have begun retiring in large numbers. However, participation by younger age groups has declined too, and analysts don't know how much is cyclical—that is, due to a lack of demand for workers—and how much is structural—due to demographics or some other reason beyond the reach of economic policies. Either way, it was an unexpected development that has had made the Fed's explicit forward guidance less convincing.

Following the financial crisis, small-government conservatives in Congress, occasionally with the help of the Obama administration, cut government spending enough to partially throttle the economic recovery.

Witness Mark A. Calabria of the Cato Institute raised another issue that Yellen and the Fed may have to deal with that could cause political problems: the possibility that the central bank could incur losses if it has to sell some of the securities in its portfolio before they mature. Generally, they have been acquired during a period of exceptionally low interest rates, and if they were sold after rates rise to a more normal level, there would be a capital loss.

Continued on page 84

Representative **Jeb Hensarling** *(R-TX), chairman of the Financial Services Committee.*

Full Court Attack

During Fed Chairman Janet Yellen's testimony before the House Financial Services Committee, its chairman, Representative Jeb Hensarling, a conservative Texas Republican, attacked the Fed on all fronts. With Yellen at the witness table, Hensarling and other Republicans complained that, while not fixing what ails the U.S. economy, the Fed's super-low interest rate policy is facilitating deficit spending, stripping seniors of needed interest income from their savings, hurting Americans investing in emerging market countries, and picking winners and losers by allocating credit to particular industries.

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Continued from page 45

Fed officials are quite aware of this issue, and if possible they would avoid it by shrinking their balance sheet gradually as the securities mature and are paid at par. But if the Fed needed to raise rates relatively quickly, losses might become a political problem.

As a result of quantitative easing and the big balance sheet, the Fed has been making money like mad on the spread between the yield on its assets and the near-zero cost of the money it creates. After financing its operations, the Fed returns what's left from its portfolio earnings to the Treasury. In 2012, that was more than $90 billion, and last year it was nearly $80 billion. Ray Stone of Stone & McCarthy Research Associates estimates that since 1947, the Fed has paid Treasury more than $1 trillion, about one-third of which was paid over the past five years. Some Fed officials and analysts, including Joseph Gagnon of the Peterson Institute for International Economics, think the Fed should tackle this issue up front so the public and politicians will not be surprised if losses were incurred several years from now, emphasizing these profits. Others, including Kohn, caution that the both the profits and potential losses are the result of policy decisions that have nothing to do with making a profit, and that that may be a better way to explain this.

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In his testimony, Kohn strongly defended the use of the unconventional policies Taylor attacked. "We are in uncharted waters with respect to economic circumstances and policy responses," Kohn said. "When the economy behaves in unprecedented ways, policy must respond in unprecedented ways—and the financial crisis, the resulting great recession, and sluggish recovery were unprecedented in post-war U.S. economic history."

Both quantitative easing and guidance "have been successful in easing financial conditions—lowering long-term rates, raising asset prices, and probably helping to keep the dollar from rising further in a troubled global economy," Kohn said. "Logic, experience over very long periods, and observation of recent data would suggest that these steps have helped the U.S. economy. Housing, auto sales, exports, consumption generally are stronger than they would have been if the Fed had sat on its hands in recent years."

Nevertheless, the former Fed vice chair cautioned that the Fed "faces considerable challenges in the execution of monetary policy. The most important such challenge will be deciding when to begin raising interest rates and at what pace they should rise. Raise them too soon or too steeply and growth will soften and inflation remain too low. Raise them too late or too slowly and the economy would overshoot its long-run potential and it if overshoots too much for too long, inflation will settle

Fuzzy Guidance

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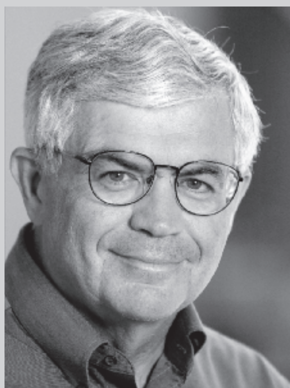

John B. Taylor

above its 2 percent target and inflation expectations would begin to rise."

In December, the seventeen FOMC participants—five Fed Board members and twelve reserve bank presidents—provided their individual economic forecasts for the next three years, 2014–2016, and indicated when they expect the first increase in short-term rates to occur. Two thought it should come this year. Three thought it should not come next year either. Nine others through that by the end of 2015 the overnight rate target should reach between a half- and a full percentage point, compared to the current quarter-point. The remaining five said it should be higher than that, with one saying it should be all the way to 3.25 percent.

That enormous spread in what officials think would be appropriate policy is indicative of the different attitudes among the policymakers whom Yellen has to lead. At the moment, the most significant point of agreement—and even that is not necessarily unanimous—is that quantitative easing should end this year. Furthermore, exactly how the Fed will go about raising short-term rates hasn't been agreed upon either.

It used to be that there was a market among banks for reserves. The Fed kept the system as a whole slightly short of all the reserves required, with those who had more than they needed lending them overnight to those who were short, with a few borrowing directly from the Fed. That market no longer exists when there are $2.5 trillion in excess reserves.

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The first step in raising rates likely would be to increase the current quarter-percentage point the Fed is paying the banks. But there are some major financial market entities with money to invest or lend overnight that cannot earn that quarter-point. They include money market mutual funds, government-sponsored enterprises such as Fannie Mae and Freddie Mac, Federal Home Loan banks, and the primary dealers, with whom the New York Federal Reserve Bank regularly deals when it intervenes in financial markets. Collectively, these institutions could make a significant amount of reserves available at interest rates below whatever floor the Fed might like to establish.

Pondering an Unprecedented Step

A recent paper published by the Peterson Institute said that the Fed should use the interest rate at which it will offer overnight repurchase agreements as its "policy instrument" and that that rate should be the same as that paid banks on reserves.

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So at the direction of the FOMC, the New York Fed has created what is known as a pool of overnight reverse repurchase agreements to approved institutions not eligible for interest on reserves. The Fed can accept up to $5 billion overnight and while paying for now a tiny 3 basis points in interest. That compares with the 25 basis points being paid on reserves. Still, that 3 basis points is better than nothing, and recently the amount in the pool was around $90 billion.

In a recent paper published by the Peterson Institute, Gagnon and Brian Sack, a former head of the New York Fed open market desk now at the D.E. Shaw Group, said that the Fed should use the interest rate at which it will offer overnight repurchase agreements as its "policy instrument" and that that rate should be the same as that paid banks on reserves.

"Under our proposal, all banks and many other financial institutions would have an unlimited ability to invest at the Fed at the specified interest rate," they said. "All other interest rates, including the federal funds rate, would be determined in the market, presumably with the risk-free interest rate set by the Fed exerting a powerful influence on them."

In a sense, this would be one more unprecedented step by the Fed that could upset the economists and the politicians, like Hensarling, who believe the Fed is wildly off track. As Kohn noted, however, the world has changed. The failure by the Fed and many others to understand fully how much financial markets had changed was one reason the financial crisis occurred in the first place. Sure, it would be great if the world were simple enough again that the central bank could help stabilize the economy by nudging the federal funds rate up and down. Maybe down the road that could be true again. Meanwhile, Yellen has her work cut out for her. ◆