Peterson Institute for International Economics

Policy Brief

NUMBER PB13-30 DECEMBER 2013

Five Challenges for Janet Yellen at the Federal Reserve

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Janet Yellen, who will serve as the 15th chair of the Board of Governors of the Federal Reserve System after her likely confirmation in December 2013, has the experience, intelligence, and judgment to be an excellent successor to Ben S. Bernanke. But she will need to employ all those strengths, and then some, to deal with the challenges facing the nation's central bank. Her success in confronting these challenges will profoundly affect the United States and world economies. Five key challenges await her.

1. GETTING THE EXIT FROM QE3 RIGHT

The Fed announced at the conclusion of its December 2013 Federal Open Market Committee (FOMC) meeting that it would begin to wind down in January 2014 its third and most recent round of asset purchases—a practice known as quantitative easing (QE)—from a pace of $85 billion per month to $75 billion per month. This tapering of asset purchases was prompted by increasing signs that economic activity is accelerating as the sizable fiscal drag on the economy in 2013 begins to wane. Moreover, the Fed's efforts to push down longer-term interest rates through its QE program have boosted interest-sensitive outlays, most notably housing and motor vehicles. And the continued improvement of household balance sheets is providing consumers the wherewithal to increase their spending. The recent readings from the labor market have, moreover, been favorable, with gains in private payrolls averaging nearly 200,000 over the past three months and the unemployment rate falling to 7 percent.

But the Fed will need to exercise caution as it scales back further on its pace of asset purchases. We have experienced several episodes in the past few years when a burst of favorable data led to increased optimism that soon proved unwarranted. To be sure, the Fed could taper purchases now and then ramp them back up should economic results fall short. But reversing course like that would be a difficult maneuver to execute and communicate. It would also not be an auspicious way for Yellen to start her chairmanship. By contrast, the costs of proceeding slowly seem limited and could be countered by a more rapid tapering should economic or financial developments turn out to be more positive than expected. Fundamentally, despite some recent improvement, US labor markets remain weak. Payroll employment has yet to regain its pre-recession peak and remains far below the level required to keep up with the growth of the working-age population.

The Fed's premature talk of tapering in the spring of 2013 illustrates the potential costs of getting too far out in front of the data. Chairman Bernanke' suggestion in May that tapering could start at one of the next few meetings resulted in a steep run up in long-term interest rates. Those higher rates, in turn, have weighed on activity in the housing sector—not by enough to derail its recovery but enough to put a dent in one of the bright spots in an otherwise subdued economy. For that reason, the FOMC should taper further only as the data clearly indicate that the pace of activity is sufficiently strong to withstand some further potential tightening of financial conditions. Although Yellen will not likely chair an FOMC meeting until March 2014, the consequences of the decisions taken between now and then will largely be hers to manage.

2. ATTENDING TO THE DUAL MANDATE

Yellen has long supported the so-called dual mandate given to the Federal Reserve—the twin objectives of achieving maximum sustainable employment and stable prices. Much of the Fed's policy focus since the onset of the Great Recession has been on promoting better performance in US labor markets. That emphasis has been appropriate given the damage that occurred in the downturn and during the slow recovery. But the Federal Reserve's inflation objective deserves full attention as well.

If the FOMC is serious about the dual mandate, it cannot acquiesce to current low rates of inflation.

Many observers associate Yellen with the wing of the FOMC most concerned about the employment situation, but it should be remembered that she led the subcommittee that developed and proposed the 2 percent inflation target adopted by the FOMC in early 2012. The committee now faces a policy challenge on this front. Over the past year and a half, price inflation has fallen well short of the established 2 percent objective and below levels that had generally been anticipated by economic forecasters and financial market participants. The headline personal consumption expenditure (PCE) price index has risen just 0.7 percent over the past year, and the PCE index excluding food and energy prices—so-called core PCE—is up only 1.1 percent. This shortfall relative to both target and expectations poses risks to economic performance. Unexpectedly low inflation raises the real burden of households and businesses to service debts. And should low inflation become embedded in the inflation expectations of financial market participants, the structure of nominal interest rates will shift down. Because of the zero lower bound on nominal interest rates, this would leave the Fed less room to lower interest rates and thereby make the US economy more vulnerable to negative shocks to aggregate demand. If the FOMC is serious about the dual mandate, it cannot acquiesce to current low rates of inflation.

3. IMPROVING INTEGRATION OF FINANCIAL STABILITY CONSIDERATIONS INTO THE MONETARY POLICY FRAMEWORK

The FOMC has made clear that decisions about its large-scale asset purchases will take into consideration the efficacy and costs of these purchases. Most studies have found that asset purchases have eased financial conditions, though estimates of those effects range widely from minimal to sizable. By contrast, there are few quantitative assessments of the costs of large-scale asset purchases. Fed Governor Jeremy Stein, in a speech in February 2013,[1] laid out in a constructive and specific manner his concerns about how asset purchases and low interest rates could be prompting some troubling behaviors in financial markets. Other FOMC members have expressed more general concerns about the potential for continued asset purchases to impair market functioning. But the FOMC has largely been silent or vague about how either its specific or general concerns are factoring into monetary policy decisions.

All central banks are struggling with the integration of their macro and financial stability objectives, and it would be unrealistic to expect the Fed to have a fully formed framework in place any time soon. But to the extent that these concerns become key to policy decisions in the near term, the Fed owes the public a better window into its thinking about the possible costs of quantitative easing. To that end, the Fed could begin by publicly specifying the market metrics that it is monitoring to assess potential negative effects of quantitative easing. The FOMC is already reviewing a wide array of market indicators on an ongoing basis. By putting those indicators into the public domain, it would provide additional transparency to its decision making.

In addition, by providing markets with greater insight into its financial stability concerns, the FOMC might induce greater introspection on the part of market participants about the positions they are taking in financial markets. If market participants found these concerns warranted and responded appropriately, the Fed's greater transparency could support its financial stability objectives. Policymakers also stand to benefit from increased communication about its financial stability concerns. When large differences of judgment about financial conditions remain between the FOMC and market participants, the FOMC will be forced to adjust or defend its positions internally and externally; in either case, the process of exposing its thinking to external scrutiny is likely to help sharpen the quality of the FOMC's analysis.

Identifying the perceived costs of quantitative easing and low interest rates will be especially important if the FOMC determines that these costs have become large enough to affect the course of monetary policy. In these circumstances, the FOMC owes the public some explicit analysis comparing the potential costs of continued monetary accommodation with

1. Governor Jeremy C. Stein, Overheating in Credit Markets: Origins, Measurement, and Policy Responses, speech at the "Restoring Household Financial Stability after the Great Recession: Why Household Balance Sheets Matter" research symposium sponsored by the Federal Reserve Bank of St. Louis, St. Louis, Missouri, February 7, 2013, www.federalreserve.gov/newsevents/speech/stein20130207a.htm.

the consequences of output remaining short of its potential and inflation running below the FOMC's objective.

Yellen may wish to consider recommending other structural innovations to integrate financial stability concerns into the monetary policy process. Many approaches could be taken to facilitate this integration. The Bank of England (BoE) offers one possible model. Monetary policy at the Bank of England is the responsibility of the Monetary Policy Committee (MPC), which is composed of five internal bank executives and four external members. In addition to the MPC, the BoE also has a Financial Policy Committee (FPC) charged with monitoring and taking action to remove or reduce systemic risks in the financial system; like the MPC, the FPC is a mix of internal and external members. The governor and deputy governor serve on both the MPC and FPC, creating a natural channel of communication between the two committees. The FPC has only been in full operation since April 2013. Thus it is far too early to assess how well this arrangement will work in practice. But the setup is a direct effort to achieve closer integration of the macro and financial stability missions that have been assigned to the BoE.

Yellen and her colleagues at the Fed may wish to consider developing formal or informal structures to promote external analysis of financial stability issues related to monetary policy.

In principle, the Financial Stability Oversight Council (FSOC) offers some of the same opportunities for cross-communication among US policymakers as the BoE's FPC. The FSOC includes the Treasury secretary and nine other members from federal regulatory agencies and financial organizations; in addition, there are some nonvoting members of the FSOC. Yellen, as chair of the Fed, will be a prominent member of FSOC. But the broad remit and large membership of the FSOC does not make it well-tailored to developing the type of financial stability analysis that can serve as an important input into the monetary policy process. For that reason, Yellen and her colleagues at the Fed may wish to consider developing formal or informal structures to promote external analysis of financial stability issues related to monetary policy. Opening the Fed to greater external challenge in this area reduces the possibility of groupthink or complacency preventing the identification of emerging risks. Such an opening would also increase the odds of achieving the complementary objectives of macroeconomic and financial stability.

4. FURTHER IMPROVING COMMUNICATIONS AND TRANSPARENCY

The Federal Reserve has come a long way in improving its communications and transparency over the past 20 years. Its efforts at disclosure have reinforced the effectiveness of monetary policy actions and increased accountability of the institution. In the Bernanke years, further significant enhancements were made to the FOMC's forecasts for economic activity, inflation, and policy rates. In addition, various forms of forward guidance about policy were implemented and refined, adding to the monetary policy toolbox. But this remains a work in progress, and the confusion that has accompanied the copious pronouncements by FOMC members in 2013 about the timing and possible schedule of Fed tapering suggests that some rethinking of the communications strategy is warranted.

The clarity of Fed communications would improve if Yellen were to exert greater control on the FOMC's central message. This will be especially important as the Fed begins to wind down its purchases of treasuries and mortgage-backed securities. Several avenues for greater disclosure could be followed. During the wind-down of QE3, the FOMC may wish to present updated forecasts at every meeting, and Chair Yellen could explain those forecasts and their implications for policy at press conferences following each meeting. This would allow her to articulate the committee's views with enough nuance and texture to illuminate the factors influencing the Fed's decisions.

At the same time, other FOMC members should probably talk less than in the recent past. To be clear, less communication by other FOMC members does not mean no communication by them. The diversity of views on the FOMC is a strength of the Federal Reserve System, and committee members do a service by communicating those views to the general public, shedding light on the difficult and contentious issues under discussion by policymakers. But there are limits to the value of this communication.

One of Ben Bernanke's objectives when he became chairman in 2006 was to depersonalize the role of Fed chair. That was never going to be fully achievable. Nations and institutions need leaders, and leaders have personalities (even when they are economists). But he did put the institution more front and center than himself. Ironically, some other members of the FOMC marched into the space he created to "personalize" their own participation in the policy process. In some cases, FOMC participants have moved beyond expressing and explaining their views in public speeches and ventured into active promotion of their views in the media. Because these promotional efforts have not been evenly pursued by FOMC participants, communications end up being dominated by those with the most aggressive efforts to court media attention, distorting the perception of the balance of committee thinking. At the very least, the participants in the FOMC should ask themselves and each other whether the communications of individual members serve the objectives of the Federal Reserve in a constructive manner.

5. EFFECTIVELY LEADING THE REGULATORY MISSION OF THE FEDERAL RESERVE

The one indisputable lesson learned from the financial crisis is that regulatory lapses and inattention carry heavy costs. The banking regulatory agencies, including importantly the Federal Reserve, failed to detect and prevent cumulative behaviors that ultimately inflicted enormous harm on the US economy. That experience should not be repeated. Many decisions remain to be taken to complete implementation of the Dodd-Frank legislation, and many adjustments in the legislation and in supporting regulations are likely to follow in coming years. Yellen does not need to micro-manage that process, but like any good chief executive, she needs to be certain that her team understands and is willing to execute the strategic vision she and the other members of the Board have for financial regulation and its relationship with the Federal Reserve's other key responsibilities.

Beyond implementing existing regulations, Yellen can play an important and constructive role in shaping the direction of financial services regulation.

The adoption of the Volcker Rule earlier in December 2013 by the financial regulatory agencies offers one example of her potential influence. The adoption of the complex rule after much wrangling among the interested parties is just the first step process. The ultimate effectiveness of the rule will be influenced importantly by the rigor, energy, and focus that the regulatory agencies apply to its implementation and monitoring. Yellen and the Federal Reserve will be key in overseeing the application of the rule by examiners in a manner that best ensures the safety, soundness, and efficiency of the banking system. Much the same will be true for many other aspects of the Dodd-Frank legislation; Yellen's real test will come after the rule-writing is finished and the actual day-to-day oversight begins.

Beyond implementing existing regulations, Yellen can play an important and constructive role in shaping the direction of financial services regulation. The regulatory environment is not likely to be static over the next few years. There may be areas where Dodd-Frank did not go far enough to contain behaviors that threaten the safety of the financial system or limit the exposure of taxpayers to the consequences of those behaviors. In other areas, the legislation may be seen as having gone too far and imposed inefficient and unnecessary costs on financial institutions and the economy. As Fed chair, Yellen will have both the opportunity and responsibility to weigh in on these matters to advocate the right balance between prudence and innovation. On that score, the administration can help the Yellen-led Fed by finally nominating a vice chairman for supervision; with the prospect of a filibuster of nominees now more remote, there are no excuses for not moving forward on filling this important position.

Transitions between Fed chairs typically create a measure of uncertainty and, perhaps, even some anxiety. The job is so large and so daunting that it can be difficult to envision anyone other than the incumbent being up to the task. To be sure, Yellen faces some formidable challenges as the economy and financial system continue to recover from the long-lasting effects of the crisis and the accompanying Great Recession. But a changeover in leadership offers opportunities as well as challenges. All organizations need periodic changes of leadership to bring new visions, new approaches, new questions, and new styles. The opportunity to contribute to the nation's welfare and to the welfare of many of those around the world through the leadership of the Federal Reserve System is now given to Janet Yellen. Her greatest challenge will be to make the most of that opportunity.