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Questions for Federal Reserve Nominee Janet Yellen

Prospective Fed Chair's Policy Views Matter to America and the World

By John Berlau, Iain Murray, and Ryan Young*

Janet Yellen is President Obama's choice to succeed Ben Bernanke as the Federal Reserve Chair. Yellen is well qualified for the position. Since 2010 she has been the Fed's Vice Chair, the number two job beneath Bernanke. She previously chaired the San Francisco Federal Reserve, and is Professor Emerita at the University of California, Berkeley. She also chaired the Council of Economic Advisers under President Clinton.[1] Yellen's credentials are not in question, but the wisdom of the policies she might pursue as Fed Chair is. Her upcoming confirmation hearing before the Senate Banking Committee is an important opportunity to learn in which direction Yellen would take the country's monetary policy if confirmed.

The following questions focus on several facets of the Federal Reserve's mission. Yellen's answers to them would say much about what her policy priorities in office would be. Those policies will have wide-ranging economic effects—an especially important consideration during a time of continued economic recovery.

Controlling Inflation. A stable price system is fundamental to a healthy economy. Prices convey information that businesses and consumers use in decision making—in both the short and long term.[2] Inaccurate prices yield misleading information, which can lead to bad economic decisions. Yellen needs to demonstrate a strong commitment to keeping inflation in check.

> Many observers expect you to pursue an inflationary stimulus, and believe this is likely a reason for your nomination.[3] If your actions are already expected, will markets not take these expected price level changes into account in advance? If so, do you believe this would blunt the employment impact of any monetary expansion? Would you respond to these pre-existing expectations with an unexpectedly high inflationary policy?

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Prices changes influence investment decisions. When unexpected inflation distorts prices, do you believe the net effect of the altered investment decisions will be positive or negative?

Everyone, from Keynesians to monetarists, believes that an unexpected inflation hike can cause a temporary boom. The inevitable tradeoff is a bust in the future. Do you believe this tradeoff is worth it or not?

Quantitative Easing. In an effort to stimulate the economy, the Fed has engaged in multiple rounds of rapid money supply expansion under the artful term "quantitative easing." It is important to know if Yellen intends to engage in further quantitative easing, as it could make inflation more likely.

Quantitative easing has involved large-scale purchase of assets such as Treasury bonds and mortgage-backed securities to increase the money supply—in other words, printing more money. Do you believe there is a sensible limit to this? What risks are associated with implementing this policy on so large a scale?

Quantitative easing immediately benefits large banks, which receive large cash inflows from selling securities to the Fed, at the expense of other economic actors—who through no fault of their own, suddenly see the value of their cash assets fall. Do you believe this short-term tradeoff is worth it?

The Dual Mandate. The Fed's original mission was to keep inflation low. In 1977, Congress added unemployment to the Fed's policy portfolio by amending the Federal Reserve Act "to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates."[4] Trying to fulfill both of these dual mandates has proven a difficult task.

The dual mandate's two objectives can contradict each other, as when the Fed raises inflation to attempt to induce a boom. If forced to choose between keeping either inflation or unemployment in check, which would you choose?

The dual mandate is based on the Phillips curve, which posits an inverse correlation between inflation and unemployment.[5] In other words, an economy can have high unemployment *or* high inflation, but not both. This theory was upended by the simultaneous high inflation and high unemployment of the 1970s. This means that either the theory or the data must be wrong.[6] Which do you think it is?

Basel III. The new Basel III standards for how much capital banks should keep in reserve are needlessly complicated and are unlikely to prevent further bank failures.

If quantitative easing increases the amount of money in circulation, higher capital reserve requirements, as under Basel III, would reduce it.[7] How would you reconcile these contradictory effects?

There is evidence that the Basel II capital requirements helped fuel the European sovereign debt crisis by weighting sovereign debt as less risky than private debt. The increased complexity of the Basel III requirements may lead to further misallocations as banks seek to comply with regulations rather than judge the riskiness of the capital assets they hold. How would you address this?

Lawmakers from both parties have said that the proposed Basel III international capital rules are too rigid for business loans and go too easy on government debt. Will you insist on changes to the accords before implementing them?

The Chicago Plan, most famously promoted by the University of Chicago's Henry Simons and Yale's Irving Fisher, is essentially a 100 percent reserve requirement, as opposed to fractional reserve banking. A recent IMF working paper endorses the Chicago Plan as a "highly desirable policy."[8] What is your opinion of the Chicago Plan?

Dodd-Frank. The Dodd-Frank financial regulation law directly affects many banks overseen by the Federal Reserve. The Fed is also charged with implementing many of Dodd-Frank's rules.

A federal judge recently ruled the Fed's implementation of Dodd-Frank's Durbin Amendment—which limits the interchange fees banks can charge retailers for using debit cards—has not gone far enough. The Durbin price controls already have resulted in large fee hikes for other bank services, harming low income bank customers. Given bipartisan opposition to the Durbin amendment—including from former Rep. Barney Frank (D-Mass.), after whom the law is partly named—will you ask Congress to relax or repeal it?

Auditing the Fed. Transparency is vital to every aspect of government. The Federal Reserve, which makes multi-trillion dollar decisions, should be as transparent as possible.

There is bipartisan support for a full audit of the Fed by the Government Accountability Office, which conducts such audits for virtually every other agency. Would you support such an audit?

Regulatory Complexity. When rules are complicated, they become harder to comply with. They also become easier to evade. Investors and businesses would be best served by a simple regulatory regime based on universally understood principles, with as few loopholes as possible.

Numerous statutory bodies have varying degree of regulatory power over banks in America. These include the Federal Reserve, Federal Deposit Insurance Corporation, Securities and Exchange Commission, Commodity Futures Trading Commission, and many more. Do you believe that the financial regulatory functions of all these institutions are necessary? If not, how would you approach consolidating their functions?

Causes of the Financial Crisis. The 2008 financial crisis had a lot of moving parts. Government policies encouraged overspending on housing, and thus underinvestment elsewhere. Consumers treated housing as an investment instead of a consumer good.[9] Regulations gave regulators, lenders, and borrowers incentives to behave badly. Yellen's views on this complex web are important for gauging how she might act during the next financial crisis.

> Economists from Christina Romer[10] to Milton Friedman[11] believe that the Great Depression was primarily a monetary phenomenon. But that is only one data point. Different crises have different causes. Recognizing that no phenomenon can be attributed to a single cause, which do you believe was the biggest contributor to the 2008 financial crisis and the sluggishness since: monetary, fiscal, or regulatory policy?

Conclusion. The Federal Reserve has an enormous influence over the economic health not only of America, but of the world. The rules governing—and emanating from—the institution are arguably more important than who the person in charge of it may be.[12] Even so, the Fed Chair has enough discretion that his or her policy views should be an important point of discussion during the confirmation process. Senators should ask questions like the ones laid out above to gain a sense of how Yellen might direct the Fed, during both good times and bad.

Notes

[1] Janet Yellen, official biography, Federal Reserve website, http://www.federalreserve.gov/aboutthefed/bios/board/yellen.htm.

[2] F.A. Hayek, "The Use of Knowledge in Society," *American Economic Review*, Vol. 35, No. 4, September 1945, pp. 519–530.

[3] See "Dove Ascendant," *The Economist*, October 12, 2013, p. 86, http://www.economist.com/news/finance-and-economics/21587798-janet-yellen-will-stick-her-predecessors-expansionary-policies-dove-ascendant, and "Janet Yellen to Be Named Fed Chair on Wednesday: White House," CNBC, October 8, 2013, http://www.cnbc.com/id/101093040.

[4] Federal Reserve Reform Act of 1977, Title 2, Sec. 202.2A, https://www.govtrack.us/congress/bills/95/hr9710/text .

[5] A. W. H. Phillips, "The Relation between Unemployment and the Rate of Change of Money Wage Rates in the United Kingdom, 1861-1957," *Economica*, Vol. 25, No. 100, November 1958, pp. 283-299.

[6] William A. Niskanen, "On the Death of the Phillips Curve," *Cato Journal*, Vol. 22, No. 2, Fall 2002, pp. 193-198, http://www.cato.org/sites/cato.org/files/serials/files/cato-journal/2002/11/cj22n2-1.pdf.

[7] Steve Hanke, "Yellen the Hawk?" *Globe Asia*, November 2013, http://www.financialsense.com/contributors/steve-hanke/yellen-hawk.

[8] Jaromir Benes and Michael Kumhof, "The Chicago Plan Revisited," IMF Working Paper, August 2012, p. 4, http://www.imf.org/external/pubs/ft/wp/2012/wp12202.pdf.

[9] See, among other books, Johan Norberg, *Financial Fiasco*, (Washington: Cato Institute, 2009) and John A. Allison, *The Financial Crisis and the Free Market Cure* (New York: McGraw-Hill, 2013).

[10] Christina D. Romer, "What Ended the Great Depression?" *Journal of Economic History*, Vol. 52, No. 4, December 1992, pp. 757-784.

[11] Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States, 1867-1960*, (Princeton: Princeton University Press, 1963).

[12] Among many other examples of this line of thought, see Douglass C. North, "Institutions," *Journal of Economic Perspectives*, Vol. 5, No. 1 (Winter 1991), 97-112, and Geoffrey Brennan and James M. Buchanan, *The Reason of Rules: Constitutional Political Economy*, (Cambridge: Cambridge University Press, 1985).