The Right Central Bankers for the Times

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The Globe and Mail
January 21, 2014

Next week, Ben Bernanke will step down as chairman of the U.S. Federal Reserve Board, to be succeeded by Janet Yellen. Although it's easy to be pessimistic about the U.S. government's ability to make important decisions, we should all cheer that system's ability to select its monetary policy leaders. Mr. Bernanke was the perfect choice for the past eight years; Ms. Yellen is an equally appropriate choice for the next four.

The global financial crisis ushered in the world's deepest and most synchronized recession in more than 60 years. But it was no "normal" recession. People who read their economic history know that financial crises produce especially bad recessions. Although the initial panic eventually subsides, the lingering pessimism is for years an obstacle to recovery. Financial crises also involve the collapse of asset prices and the need for pervasive "deleveraging" (in simple terms, the reduction of debt). When households and firms deleverage, their actions become a drag on the economy; when banks do so, they turn into powerful machines of credit destruction. Pessimism and deleveraging is a toxic combination for economic recovery.

Fortunately, Mr. Bernanke's professional expertise is in the events and policy lessons of the Great Depression. He knew what had to be done to avoid a repeat of the 1929-32 calamity, when national income fell by almost a third and the unemployment rate increased to 30 per cent.

His major policy interventions began very visibly in 2008 with the massive capital injections into U.S. banks and other financial institutions. Possibly more important were the many less visible policies designed to keep credit flowing throughout the "shadow" banking system. Mr. Bernanke understood that credit for a modern economy is like electricity: Few of us appreciate its importance until something halts its flow, but it is then immediately apparent that little economic activity can happen without it.

Perhaps Mr. Bernanke's most visible policy action was the massive and ongoing expansion in the Fed's balance sheet, known as quantitative easing (QE). Many have accused him of intentionally debasing the U.S. currency by printing it in such enormous volumes. But the truth is that when banks are hoarding cash, both because the demand for credit has fallen and because they are trying to repair their own damaged balance sheets, the best policy action is for the central bank to purchase existing government bonds with freshly printed money. This action injects liquidity into the financial system, reduces long-term interest rates and helps to restore aggregate demand.

The primary challenge going forward – now to be faced by Ms. Yellen – will be to reverse Mr. Bernanke's QE actions as confidence is eventually restored to the U.S. economy, commercial banks gradually expand their provision of credit, and output approaches the economy's productive potential. Ms. Yellen's policy decisions will require a careful balancing act, and her professional expertise in labour markets makes her the right person for the job.

Some will argue that she needs to tighten policy soon, in order to avoid an increase in inflation. But Ms. Yellen knows that inflation will not be a real danger until the U.S. economy absorbs most of its non-employed workers, and aggregate output gets much closer to its productive potential. Premature monetary tightening would certainly avoid inflation, but it would also prevent the full recovery that the United States so badly needs. Ms. Yellen is not enough of an inflation hawk to make this mistake.

Ms. Yellen also knows that the U.S. unemployment rate, while still too high at 6.7 per cent, is no longer the best measure of labour market slack. So many discouraged Americans have dropped out of the labour force that a better measure is the overall employment-to-population ratio – which is still five percentage points below its pre-recession peak. Also crucial to watch is the incidence of long-term unemployment, now almost literally off the charts – 40 per cent of unemployed Americans have been jobless for more than six months.

Ms. Yellen's long-time professional focus makes her the right person to determine the pace of the Fed's monetary tightening. She will focus on the need to restore economic health to the American labour market. This will be exactly the right call.

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