



## Janet Yellen: The Gradual Normalizer

Excerpt from Edward Yardeni's  
[\*Fed Watching for Fun & Profit\*](#)

### **Monetary Policy for Yalies**

On February 3, 2014, Janet Yellen became the 15th chair of the Fed and its first female chair; she served her four-year term until February 3, 2018. She had been vice chair since October 4, 2010. Prior to joining the Federal Reserve Board in Washington, D.C., she had served as the president of the Federal Reserve Bank of San Francisco since June 14, 2004. She had started her government service as the 18th chair of the Council of Economic Advisers (CEA), from February 18, 1997 to August 3, 1999. In some ways, I found her easier to read than her three predecessors. Perhaps that was because we're both Yalies.

On April 16, 1999, CEA Chair Yellen gave a speech at a reunion of the Yale graduate economics department. She declared that the liberal Keynesian orthodoxy preached by Yale's Professor James Tobin had conquered Washington. Tobin was one of the major disciples of John Maynard Keynes in the United States. According to Yellen, who is Tobin's foremost disciple, everyone in the room shared the same goal—they all wanted to be do-gooders: "I suspect that many of us here tonight were attracted to economics and to policy positions in government because we believed in its potential for improving economic welfare."

She said Tobin had suggested that the title of her speech be "Yale Economics in Washington." She readily obliged, saying, "I will try to make the case that the lessons that we learned here at Yale remain the right and relevant ones for improving economic performance, that Yale-trained economists in Washington are succeeding in making their voices heard, and, where Yale economics has been applied, it is working."

Then Yellen claimed that while most economists "appreciate the role of markets and incentives," only Yalies can see when they aren't working properly and know how to fix them: "I have noticed that Yalies often have a sharper eye for identifying market failures and greater concern for policies to remedy them than economists from institutions I will leave nameless." Her comments made me wonder whether at any time in her professional life Yellen considered the possibility that government policies can cause markets to fail, requiring more government policies to fix the failure that the government caused in the first place. At Yale, there were no courses in the unintended negative consequences of well-intentioned macroeconomic policies.

The original sin for macroeconomists, in my opinion, was the passage of the Employment Act of 1946, which established the CEA. As Yellen noted—favorably, of course—the Act mandated that the federal government should moderate the business cycle, thus “promoting balanced and noninflationary economic growth, and fostering low unemployment.” The law has certainly been a full employment act for macroeconomists working for the federal government.

Yellen, like Bernanke, was a Great Moderator. She extolled the “Yale macroeconomic paradigm.” She said that “as I have taught and hopefully practiced it,” the model “combines a Keynesian understanding of economic fluctuations with a neoclassical perspective on long-run growth....The IS-LM and aggregate demand/ aggregate supply models, hopefully still staples in Yale’s classes, provide the simplest description of the short run paradigm.” She believed in this model more than ever as a result of her experience in Washington.

Like a true-blue Yale Keynesian, she claimed that a capitalist economy can’t maintain full employment without the help of Yale macroeconomists:

“The Yale macroeconomic paradigm provides clear answers to key questions dividing macroeconomists along with policy prescriptions. Will capitalist economies operate at full employment in the absence of routine intervention? Certainly not. Are deviations from full employment a social problem? Obviously.”

Rhetorically asking whether “policymakers have the knowledge and ability to improve macroeconomic outcomes rather than make matters worse,” she replied to herself with an unequivocal, “Yes.”

Near the end of her speech, Yellen raised one cautionary flag: “Decades ago, economists recognized an unfortunate implication of the IS-LM model: that the simultaneous attainment of financial market openness, monetary policy independence, and exchange rate stability—three desirable macroeconomic goals—was simply impossible! Countries would have to forego at least one or risk financial crisis.” Less than a year after her pep rally at Yale, the US economy fell into a recession when the technology bubble in the stock market, inflated by Greenspan’s Fed, popped.[120]

As the new Fed chair, Janet Yellen made her first rookie’s mistake during her first press conference on March 19, 2014, when she defined the “considerable time” mentioned in the latest FOMC statement to mean “something on the order of around six months or that type of thing.”[121] That was widely interpreted as suggesting that the Fed might start raising the federal funds rate six months after QE was terminated. The termination was generally expected to happen by the end of 2014 and did occur that year in late October. However, the first hike in the federal funds rate after QE was terminated didn’t occur until the end of the following year.

Yellen seemed to back away from her prediction in an extraordinarily impassioned and personal speech on Monday, March 31, 2014 in Chicago, when she said that the Fed remained committed “to do what is necessary to help our nation recover from the Great Recession.”[122] In her speech, she briefly described the struggle of three workers in the Windy City, implying that she intended to maintain ultra-easy monetary policy until they and people like them had good jobs.

The next day, Jon Hilsenrath reported in *The Wall Street Journal* that one of the three persons named by Yellen “had a two-decade- old theft conviction,” while another one “had a past drug conviction.” Hilsenrath deadpanned: “Academic research suggests people with criminal backgrounds face unique obstacles to employment.” He added that a “Fed spokeswoman said Tuesday that Ms. Yellen knew of the people’s criminal backgrounds and that they were ‘very forthright’ about it in conversations with the chairwoman before the speech. In her remarks, she said they exemplified the trends she was discussing, such as downward pressure on wages or the challenge of finding a job for the long-term unemployed.”[123]

The July 21, 2014 issue of *The New Yorker* included a lengthy article about Yellen. It confirmed that she is an impassioned liberal: Yellen is notable not only for being the first female Fed chair but also for being the most liberal since Marriner Eccles, who held the job during the Roosevelt and Truman Administrations. Ordinarily, the Fed’s role is to engender a sense of calm in the eternally jittery financial markets, not to crusade against urban poverty.

Yellen intended “to help American families who are struggling in the aftermath of the Great Recession.” She and her husband George Akerlof have published numerous papers on why labor markets don’t automatically work to maintain full employment.[124] The government can do the job better: “I come from an intellectual tradition where public policy is important, it can make a positive contribution, it’s our social obligation to do this. We can help to make the world a better place.”[125]

After she became Fed chair in early 2014, the FOMC finally terminated the QE program on October 29 of that year. There was lots of chatter among Fed watchers about rate hikes coming in 2015. Based on my assessment of Yellen, I concluded that she would be very slow and cautious in raising rates. Indeed, during September 2014, I predicted a “one and done” rate hike in the coming year.

Yellen finally delivered that rate increase of 25 basis points at the last FOMC meeting of 2015, raising the federal funds rate range to 0.25%–0.50% (Fig. 23). At the end of that year, I again predicted one-and-done for 2016. Much to my chagrin, Fed Vice Chair Stanley Fischer rattled

financial markets around the world at the beginning of 2016, warning that they hadn't fully discounted the possibility of four rate hikes in 2016.

Adding to the commotion at the beginning of the year was John Williams, who was president of the San Francisco Fed at the time. On January 4, he also predicted that the FOMC would be raising the federal funds rate four to five times during 2016. A week and a half later, on January 15, he said that a slowdown in China spilling over to the US is keeping him up at night. On January 29, he told reporters: "Standard monetary policy strategy says a little less inflation, maybe a little less growth...argue for just a smidgen slower process of normalizing rates."<sup>126</sup>

I stuck with my forecast, and the next rate hike occurred at the last FOMC meeting of 2016. The federal funds rate range was raised to 0.50%–0.75%. There were three more rate hikes during 2017 at the March, June, and December meetings of the FOMC, bringing the range up to 1.25%–1.50%. Yellen had succeeded in gradually normalizing monetary policy without any major incident. The S&P 500 rose 55% while she headed the Fed from February 3, 2014 through February 3, 2018.

### **'The Fairy Godmother of the Bull Market'**

Early on when Yellen became Fed chair (and even when she was vice chair), I noticed that the stock market often would rise after she gave a speech on the economy and monetary policy. She was among the most dovish members of the FOMC, and she now ruled the aviary, which also included a few hawks. So I remained bullish on the outlook for stocks, anticipating that under her leadership, the FOMC would normalize monetary policy at a gradual pace. Indeed, I often referred to Yellen as the "Fairy Godmother of the Bull Market."

On September 29, 2016 in a video conference with bankers in Kansas City, Yellen crossed the line, in my opinion, when she suggested that the Fed should be authorized by Congress to buy corporate bonds and stocks. Yellen and I both learned from Professor Tobin about the "Portfolio-Balance Model."<sup>127</sup> The idea is that assets are substitutable for each other. So if the Fed buys government bonds, reducing their supply, that will drive more demand into other bonds as well as equities. The resulting increase in wealth should stimulate spending. In her video talk, Yellen said:

"Now because Treasury securities and, say, corporate securities and equities are substitutes in the portfolios of the public, when we push down yields—let's say on Treasuries—there's often and typically spillover to corporate bonds and to equities as well [such] that those rates fall or that equity prices rise, stimulating investment. But we are restricted from investing in that wider range of assets. And if we found—I think as other countries did—that [we] had reached the limits in terms of purchasing safe assets like longer-term government bonds, it could be useful

to be able to intervene directly in assets where the prices have a more direct link to spending decisions.”

Got that? If the Fed runs out of Treasuries, “it could be useful” to buy corporate bonds and stocks. Spoken like a true-blue meddler. She strongly suggested that she was all for adding that option to the Fed’s toolkit just in case the other tools used to tinker with the economy didn’t work. She was very blunt about her willingness to distort US capital markets because they clearly weren’t working well enough on their own to achieve the Fed’s goals, in her opinion. (See Appendix 5, Yellen on Fed Purchasing Corporate Bonds and Stocks.)

Yellen noted that the BOJ had been buying corporate bonds and stocks for a while, and the European Central Bank (ECB) had been buying corporate bonds since June of that year. That’s true, but there was no evidence that these purchases were boosting growth or reviving capitalism’s animal spirits in either Japan or the Eurozone. Both have relatively inferior capital markets compared to the vibrant ones in the United States. They still depend too much on their banks for financial intermediation. Their banks have been broken for a long time, and the flat yield curve and negative interest-rate policies of the BOJ and ECB surely weren’t helping their banks.

Yellen concluded her response by saying, “But while it’s a good thing to think about, it’s not something that is a pressing issue now, and I should emphasize that while there could be benefits to, say, the ability to buy either equities or corporate bonds, there would also be costs as well that would have to be carefully considered in deciding if it’s a good idea.”

In my opinion, the costs are considerable. Intervening so broadly in the capital markets would disrupt the process of creative destruction that is integral to capitalism. It would keep zombie companies in business, which would be deflationary and reduce profitability for well-run competitors. Investors wouldn’t get to determine the economy’s winners and losers if the Fed buys simply to prop up stock prices. Depending on the circumstances, such an overreaching “Yellen Put” would result in a huge speculative bubble for sure.

In short, Fed intervention in the corporate bond and equity markets is a bad idea.

### **Limits of Macroeconomists**

On October 14, 2016, Yellen gave a speech at a conference sponsored by the Boston Fed and attended by Fed and academic economists. The topic of discussion: “The Elusive ‘Great’ Recovery: Causes and Implications for Future Business Cycle Dynamics.” Her talk was titled “Macroeconomic Research After the Crisis.”<sup>128</sup> It was a remarkable speech that should have been titled “Macroeconomic Research in Crisis.” The unemployment rate had dropped from a peak of 10.0% during October 2009 to 4.9% in August 2016. The Fed had hiked once at the end

of 2015 and was going to do it again at the end of 2016. Yellen explained why such gradual normalization of monetary policy made sense.

She talked about “hysteresis,” the idea that persistent shortfalls in aggregate demand could adversely affect the supply side of the economy. Then she rhetorically asked: “If we assume that hysteresis is in fact present to some degree after deep recessions, the natural next question is to ask whether it might be possible to reverse these adverse supply-side effects by temporarily running a ‘high-pressure economy,’ with robust aggregate demand and a tight labor market.” My commentary on her speech was titled “Some Like It Hot.” I concluded that Yellen was in no hurry to rush the pace of rate hikes.

What I found unusual about her speech was that she admitted there might be “limits in economists’ understanding of the economy.” Then she proceeded to list several questions that she hoped “the profession will try to answer.” Apparently, on-the-job experiences had moderated the confidence she had expressed at the Yale reunion. She suggested that perhaps macroeconomists need to do more work using “disaggregated data and models.” In other words, they should be microeconomists! Admittedly, I may be putting words in her mouth.

She got into some real meaning-of-life questions for macroeconomists. For example: “How does the financial sector interact with the broader economy?” Now get this one: “What determines inflation?” Remember, this is coming from the Fed chair who, in a sense, wrote the book on macroeconomics, or at least the Tobin notes!

During Yellen’s term as Fed chair, she and other Fed officials were baffled that inflation remained below their 2.0% target, particularly when the unemployment rate suggested that the labor market was close to full employment during 2017. On numerous occasions, Yellen had expressed her faith in the Phillips curve model—which posits that there is a tradeoff between unemployment and inflation—and used it to predict that wage inflation would move higher. I suggested that Fed officials needed to order from Amazon to understand one of the forces keeping inflation down.

In a September 26, 2017 speech, Yellen for the first time conceded the point in public, saying, “The growing importance of online shopping, by increasing the competitiveness of the U.S. retail sector, may have reduced price margins and restrained the ability of firms to raise prices in response to rising demand.” In a speech on October 15, 2017, Yellen candidly stated, “The biggest surprise in the U.S. economy this year has been inflation....Inflation readings over the past several months have been surprisingly soft.”

Yellen’s speech suggested that she was coming around to my strongly held view that economists need to go out and talk to real people instead of tweaking their models and having

heated debates with one another over theories that are divorced from reality. As a wise man once said: "In theory, there is no difference between theory and practice, but in practice, there is."

To be fair, the Fed does attempt to get grassroots perspectives on the economy in several ways. Its *Beige Book* is one; the Fed's website explains:

"Each Federal Reserve Bank gathers anecdotal information on current economic conditions in its District through reports from Bank and Branch directors and interviews with key business contacts, economists, market experts, and other sources. The *Beige Book* summarizes this information by District and sector. An overall summary of the twelve district reports is prepared by a designated Federal Reserve Bank on a rotating basis." [129]

In addition, several of the Fed district banks conduct monthly surveys of business conditions in their regions. I've found that the average of the general business indexes for five of the districts (Dallas, Kansas City, New York, Philadelphia, and Richmond) is highly correlated with the national manufacturing purchasing managers' index. [130] The Fed also surveys senior loan officers of up to 80 large domestic banks and 24 US branches and agencies of foreign banks on a quarterly basis. [131] That doesn't sound very folksy, but at least the Fed is trying to get some feedback on regional economies from the local folks.

Near the end of her term as Fed chair, Yellen faced a challenge launched by a few congressional Republicans to force the FOMC to follow a rules-based approach to setting monetary policy. The concept was originally pushed by Milton Friedman, who believed that the Fed should stick to a set growth rate in the money supply.

The Fed's July 7, 2017 *Monetary Policy Report*, which accompanied Yellen's congressional testimony, included a section titled "Monetary Policy Rules and Their Role in the Federal Reserve's Policy Process." [132] The basic message was that the FOMC does pay attention to simple models such as the Taylor Rule, which prescribes the level of the federal funds rate based on two gaps: (1) the one between actual and targeted inflation and (2) the one between actual and potential real GDP.

However, the Fed's policymakers believe that these models ignore too many "considerations" that require their judgment when setting the federal funds rate. In the "rules versus discretion" debate, they clearly favor the latter approach. For Fed watchers like myself, discretion, rather than rules, in the formulation of monetary policymaking means that we will continue to find gainful employment as profilers of Fed officials.

President Donald Trump did not reappoint Yellen for a second term to chair the Fed. He considered John Taylor, who devised the Taylor Rule, for the post. Instead, he chose Fed Governor Jerome Powell on November 2, 2017. I think Yellen did a good job of managing the gradual normalization of monetary policy and solidifying Bernanke's achievement in reviving the economy. Under both, bond and stock investors enjoyed significant bull markets.

## Endnotes

[120] Janet Yellen, "[Yale Economics in Washington](#)," April 16, 1999 speech at Yale Economics Reunion New Haven, Connecticut.

[121] Janet Yellen, [Press Conference](#), March 19, 2014.

[122] Janet Yellen, "[What the Federal Reserve Is Doing to Promote a Stronger Job Market](#)," March 31, 2014 speech at the 2014 National Interagency Community Reinvestment Conference, Chicago, Illinois.

[123] Jon Hilsenrath, "[Janet Yellen's Human Message Gets Clouded](#)," *The Wall Street Journal*, April 1, 2014.

[124] George Akerlof won the 2001 Nobel Prize in economics mostly for his work on asymmetrical information in an article titled "[The Market for 'Lemons': Quality Uncertainty and the Market Mechanism](#)," published in the *Quarterly Journal of Economics* in 1970. He shared the prize with Michael Spence and Joseph Stiglitz for their research related to asymmetric information.

[125] Nicholas Lemann, "[The Hand on the Lever](#)," *The New Yorker*, July 21, 2014.

[126] Ann Saphir, "[Fed's Williams says sees 'smidgen' slower rate hikes](#)," Reuters, January 29, 2016.

[127] My PhD dissertation at Yale was titled *A Portfolio-Balance Model of Corporate Finance* (1976).

[128] Janet Yellen, "[Macroeconomic Research After the Crisis](#)," October 14, 2016 speech at "The Elusive 'Great' Recovery: Causes and Implications for Future Business Cycle Dynamics" 60th annual economic conference sponsored by the Federal Reserve Bank of Boston, Boston, Massachusetts.

[129] Board of Governors of the Federal Reserve System, [Beige Book](#) webpage.

[130] See Yardeni Research chart book [\*Regional Business Surveys\*](#).

[131] The Fed's website explains: "The Federal Reserve generally conducts the survey quarterly, timing it so that results are available for the January/February, April/May, August, and October/November meetings of the Federal Open Market Committee. The Federal Reserve occasionally conducts one or two additional surveys during the year. Questions cover changes in the standards and terms of the banks' lending and the state of business and household demand for loans. The survey often includes questions on one or two other topics of current interest." See the Fed's "[Senior Loan Officer Opinion Survey on Bank Lending Practices](#)."

[132] See "Monetary Policy Rules and Their Role in the Federal Reserve's Policy Process," pp. 36–39 in the Fed's [Monetary Policy Report](#), July 2017.