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Money Strong

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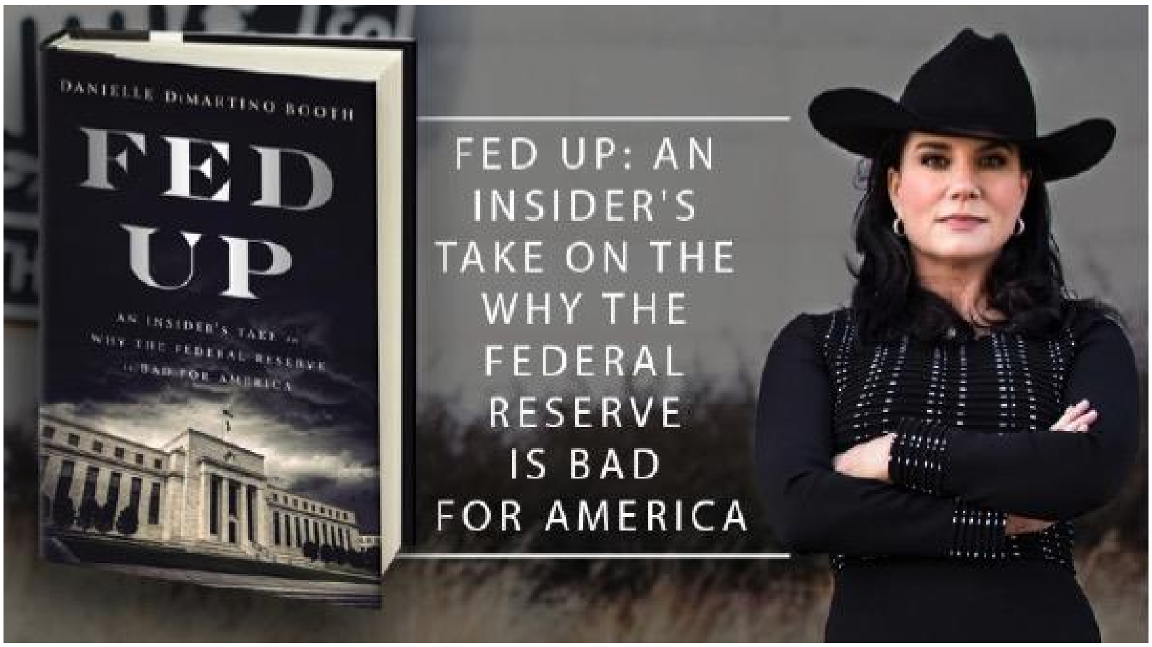


# Fed Up: Culture Shock

"If it were possible to take interest rates into negative territory, I would be voting for that."
— Janet Yellen, February 2010
As her fame has grown, Janet Yellen is recognized in restaurants and airports around the world. But her world has narrowed. Because the Fed chairman can so easily move markets with a few casual words, Yellen can't get together regularly and shoot the breeze with businesspeople or analysts who follow the Fed for a living. She must rely on her instincts, her Keynesian training, and the MIT Mafia.

"You can't think about what is happening in the economy constructively, from a policy standpoint, unless you have some theoretical paradigm in mind," Yellen had told Lemann of the New Yorker in 2014.

One of Lemann's final observations: "The Fed, not the Treasury or the White House or Congress, is now the primary economic policymaker in the United States, and therefore the world."

But what if Yellen's theoretical paradigm is dead wrong?

The woman who "did not see and did not appreciate what the risks were with securitization, the credit rating agencies, the shadow banking system, the SIVs . . . until it happened" has led us straight into an abyss.

It's time to climb out. The Federal Reserve's leadership must come to grips with its role in creating the extraordinary circumstances in which it now finds itself. It must embrace reforms to regain its credibility.

Even Fedwire finally admitted in August 2016 that the Federal Reserve had lost its mojo, with a story headlined "Years of Fed Missteps Fueled Disillusion with the Economy and Washington." In an effort to explain rising extremism in American politics in a series called "The Great Unraveling," Jon Hilsenrath described a Fed confronting "hardened public skepticism and growing self- doubt."

Mistakes by the Fed included missing the housing bubble and financial crisis, being "blinded" to the slowdown in the growth of worker productivity, and failing to anticipate how inflation behaved in regard to the job market. The Fed's economic projections of GDP and how fast the economy would grow were wrong time and again.

People are starting to wake up. A Gallup poll showed that Americans' confidence that the Fed was doing a "good" or "excellent" job had fallen from 53 percent in September 2003 to 38 percent in November 2014. Another poll in April 2016 showed that only 38 percent of Americans had a great deal or fair amount of confidence in Yellen, while 35 percent had little or none — a huge shift from the early 2000s when 70 percent and higher expressed confidence (however misguided) in Greenspan.

In early 2016, Yellen told an audience in New York that it was too bad the government had leaned so heavily on the Fed while "tax and spending policies were stymied by disagreements between Congress and the White House." Maybe if she hadn't been throwing money at them, lawmakers might have gotten their house in order.

"The Federal Reserve is a giant weapon that has no ammunition left," Fisher told CNBC on January 6, 2016.

The Fed must retool and rearm.

First things first. Congress should release the Fed from the bondage of its dual mandate.

A singular focus on maintaining price stability will place the duty of maximizing employment back into the hands of politicians, making them responsible for shaping fiscal policy that ensures American businesses enjoy a traditionally competitive landscape in which to build and grow business.

The added bonus: shedding the dual mandate will discourage future forays into unconventional monetary policy.

Next, the Fed needs to get out of the business of trying to compel people to spend by manipulating inflation expectations. Not only has it introduced a dangerous addiction to debt among all players in the economy, it has succeeded in virtually outlawing saving.

Most seniors pine for a return to the beginning of this century when they could get a five- year jumbo CD with a 5 percent APR, offset by inflation somewhere in the neighborhood of 2 percent. Traditionally, 2 to 3 percentage points above inflation is where that old relic, the fed funds rate, traded. The math worked.

Under ZIRP, only fools save for a rainy day. The floor on overnight rates must be permanently raised to at least 2 percent and Fed officials should pledge to never again breach that floor. Not only will it preserve the functionality of the banking system, it will remind people that saving is good, indeed a virtue. And that debt always has a price.

Limit the number of academic PhDs at the Fed, not just among the leadership but on the staffs of the Board and

District Banks. Bring in more actual practitioners— businesspeople who have been on the receiving end of Fed policy, CEOs and CFOs, people who have been on the hot seat, who have witnessed the financialization of the country and believe that American companies should make things and provide services, not just move money around.

Governors should be given terms of five years, like District Bank presidents, with term limits to bring in new blood and fresh ideas.

Grant all the District Bank presidents, not just New York's, a permanent vote on the FOMC. Why should Wall Street, not Main Street, dominate the Fed's decision making?

While we're at it, let's redraw the Fed's geographical map to better reflect America's economic powerhouses.

California's economy alone is the sixth biggest in the world. Add another Fed Bank to the Twelfth District to better represent how the Western states have flourished over the last hundred years.

Why does Missouri have two Fed banks? Minneapolis and Cleveland can be absorbed into the Chicago Fed. Do Richmond, Philadelphia, and Boston all need Fed District Banks? Consolidate in recognition of the fact that it isn't 1913 anymore.

Slash the Fed's bloated Research Department. It's hard to argue that a thousand Fed economists are productive and providing value-added insight when their forecasting skills are no better than the flip of a coin and half of their studies cannot be replicated.

Send most of the PhD economists back to academia where they belong. Require the rest to focus on research that benefits the Fed, studying how its policies impact American taxpayers and citizens. (Did the Fed do any studies about how ZIRP and QE would impact banking and consumers before it imposed them? No.)

Now take all the money you've saved and aim it squarely at Wall Street investment banks intent on always staying one step ahead of the Fed's regulatory reach. Hire brilliant people for the Fed's Sup & Reg departments and pay them market rates. Rest assured this will be ground zero of the next crisis.

And mix it up. One of Rosenblum's students applied for a job at the New York Fed. He came from a blue- collar background, spent seven years in the military, and earned his MBA from SMU on the GI Bill. Smart guy. But he couldn't get to first base at the New York Fed. They hire people from Yale and Harvard and NYU—people just like themselves. Others need not apply.

Then the top Ivy Leaguers stay for two years and move on to bigger money at Citibank or Goldman Sachs. It's a tribe that's been bred over ninety years and slow to change.

But if the culture of extreme deference at the New York Fed (which also exists in District Banks to a lesser degree) is not quashed, regulatory capture will continue with disastrous results. The Fed must give bank examiners the resources they need to understand the ever-evolving financial innovations created by Wall Street and back them up when they challenge high- paid bankers who live to skirt the rules.

Regulators must focus on the big picture as well as nodes of risk. Interconnectedness took down the economy in 2008, not just the shenanigans of a few rogue banks.

Focus on systemic risk and regulation around the FOMC table. Create a post with equal power and authority to that of the chair to focus on supervision and regulation. Yellen talks about monetary policy ad nauseam, but when challenged by the press or Congress on regulatory policy she stumbles and mumbles and does her best doe-in- the- headlights impersonation. Markets need predictability and transparency when it comes to Fed policy, not guesswork, parsing of the chair's words, and manipulation of FOMC minutes.

Finally, let nature take its course. Reengage creative destruction. Markets by their nature are supposed to be volatile. Zero interest rates prevent the natural failures of weak companies, weighing down the economy with overcapacity for generations.

Recessions might have been more frequent, the financial losses greater for some, but if the Fed had let the economy heal on its own, America would have been stronger in the end and the bedrock of our nation, capitalism, would not have been corrupted.

I could never have imagined how my near decade-long journey at the Federal Reserve would play out.

In the beginning, I had been a "risk radar" to benefit myself and those closest to me. I wanted to stay out of debt and make certain that my children had great educations and a foundation of financial savvy so that they could pursue their versions of the American dream.

But I realize now the stakes are much higher.

We've become a nation of haves and have-nots thanks to Fed policies that benefit the wealthiest investors, punish the savers and the retired, and put the nation's balance sheet at risk.

As consumers on the receiving end of Fed policies, we must reform our education system so that the American dream can be accessible to everyone. We must campaign for Congress to stop hiding behind the Fed's skirts.

And we must demand that the Fed stop offering excuse after excuse for its failures. Short- term interest rates must return to some semblance of normality and the Fed's outrageously swollen balance sheet must shrink in size. And most of all, the Fed must never follow Europe by taking interest rates into negative territory.

No more excuses. The Fed's mandate isn't to have a perfect world. That only exists in fairy tales, dreams, and the Fed's econometric models.