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Next in line in the Federal Reserve team

By: Ben Potter – March 7, 2013

Though under scrutiny for some of her decisions, Janet Yellen, with her string of prestigious degrees and jobs, is a favourite to succeed Fed Reserve chairman Ben Bernanke, writes Ben Potter in Washington.

Janet Yellen, the 66-year-old heir apparent to Ben Bernanke 's job as chairman of the Federal Reserve next January, has never been afraid to step into the fierce fray over Fed policy.

On Monday Yellen backed her chairman to the hilt. She said the Fed could press on with its policy of keeping interest rates near zero and showering trillions of dollars on Wall Street even after unemployment fell below the nominated 6.5 per cent threshold for retreat.

Less than 24 hours later, the Dow Jones Industrial Average breezed past its all-time high, fuelling arguments the Fed is doing more for Wall Street investors than the Main Street Americans it's meant to help.

Yellen dismissed the views of dissidents such as Richard Fisher of the Federal Reserve Bank of Dallas who say the policies incite risky investing, distort markets and store up trouble for the future.

The dissidents will have their say this week in scheduled speeches and meetings. But the Fed will confirm its ultra-easy policy stance when it meets next week.

Yellen's claim to fame is that she saw the subprime mortgage crisis coming before her colleagues on the Federal Reserve board.

She warned in June 2007 of "a vicious cycle in which a further deceleration in house prices increases foreclosures".

Six weeks later Bernanke told the Fed: "The odds are that the market will stabilise."

The distinction - and a blue-chip resume - have made Yellen an early favourite to succeed Bernanke in one of the world's most contentious jobs when his time is up next year.

Her record is not without fault. Yellen ran the San Francisco Fed - when it was right in the eye of the sub-prime storm - from 2004 to 2010, before Barack Obama promoted her to her current role of vice-chairman.

Two huge mortgage lenders - Countrywide and WAMU - collapsed under her watch.

Critics say her regulatory lapse was second only to that of Timothy Geithner, who supervised Wall Street as New York Fed president until Obama made him treasury secretary.

Nonetheless, Yellen is superbly qualified, with a string of prestigious degrees and jobs. She's served two terms as a Fed governor and six years at the San Francisco Fed. In between - like Bernanke - she chaired the President's Council of Economic Advisers.

Economics is in her bones. She fell in love with her husband, future Nobel Prize winner George Akerlof, debating issues in the staff cafeteria in the Fed's Martin building in Washington. Akerloff would introduce himself as "Janet Yellen's husband" at dinner parties during her CEA term, and people would look for someone more interesting. Even their son's an economist.

"She's been engaged in public policy longer than Bernanke has," says Justin Wolfers, an economist at the University of Michigan who toiled at the San Francisco Fed under Yellen.

"She's been enormously accomplished as a scholar, and has worked in policy making at the highest level, and has shown herself to be an incredibly ethical, driven and effective public servant."

Her resume "seems about as much preparation as you could do" for the role of Fed chairman, Wolfers adds.

Or not, if you see banking regulation as equally important - if not more important - to a central banker's mission than monetary policy.

Yellen is unlikely to enjoy the virtually unanimous vote that confirmed Bernanke in 2006. Bernanke himself drew 30 "nos" when he was re-confirmed in 2009.

More than four years after the collapse of Lehman Brothers, the Fed still divides Washington, Wall Street and Main Street.

In January it confirmed QE3, or the third tranche of a quantitative easing program. It aims to buy $US85 billion of Treasury and mortgage securities each month and to keep short-term interest rates near zero until unemployment falls to 6.5 per cent.

The policy aims to ginger up the Main Street economy - housing, factories and stores - by lowering interest rates paid by businesses and home buyers.

But that takes time, and investors anticipate the economy's response. They've driven stock prices to all time highs while the jobs market and the economy are yet to fully recover.

Meanwhile, in spite of failures that fuelled tech and sub-prime booms, culminating in an economic collapse, the Fed has become ever more powerful.

Through QE the Fed is the largest buyer of US Treasury and mortgage securities. Thanks to the Dodd-Frank Act, it has great - and yet to be defined - regulatory powers.

To her critics, Yellen's blemishes are difficult to ignore.

"I am not laying the failure of Countrywide and WAMU at her feet but it seems she only did a slightly better job as a banking regulator than Tim Geithner did," says Mark Calabria, head of financial regulatory studies at the libertarian **Cato Institute.**

"You could argue that no two regulators have done worse than the San Francisco and New York Feds," says Calabria, who worked at the Senate banking committee when it was chaired by Republican Richard Shelby.

Calabria suspects Yellen's stellar academic credentials make some people pull their punches when it comes to her regulatory record.

Conservatives criticise Bernanke and Yellen and the whole thrust of Fed policy for being too "dovish" and heedless of the risk that QE will trigger inflation and distort financial markets.

Still, appointing a "dove" is a President's prerogative, says Simon Johnson, a professor at Massachusetts Institute of Technology and former chief economist at the IMF.

The "critical issue", Johnson says, is where Yellen stands on financial regulation and stability. He advocates breaking up too-big-to-fail banks, a tough version of the so-called Volcker rule which would stop large-scale speculative betting by banks, and tighter capital and regulatory rules for big banks.

"The thing is we just don't know. She hasn't really spoken out on that, it hasn't been her primary focus either from her historical research or at the San Francisco Fed or on the board," he says.

Yet the Fed is "more powerful than it's ever been" in regulation and the chairman can have a huge impact.

"Going forward we should know this about chairmen of the Fed. Just like we know or we think we know where they are on the dovish to hawkish monetary policy dimension, we should know where they are on too-big-to-fail, on the Volcker rule, on financial stability," Johnson says.

Yellen has spoken about the need for tighter regulation of the financial system, but only in passing. Johnson contrasts her with Fisher, president of the Dallas Fed. Fisher is an emphatic opponent of QE and ultra-low rates. He argues they distort financial markets, defy an orderly exit and could fuel inflation.

Fisher would be Johnson's first choice based on his views on those two key issues, though he concedes the job's likely Yellen's if she wants it.

Johnson thinks it will be hard for the Fed to disengage from its current policy stance in time to prevent some inflation. How much inflation is the question. There are those who want more inflation, in order to get more jobs, though you never hear a Fed person saying that, he says.

"That's why I prefer the Richard Fisher approach, frankly. [He'd be] less likely to make the same mistake in the recovery."

Wolfers, an unabashed Yellen fan, offers two lines of defence.

As far as her stewardship of the San Francisco Fed during the sub-prime boom goes, the entire economics profession is to blame, he says. With the exception of Ned Gramlich, a former Fed governor whose early warnings weren't heeded before he died, not one leading monetary economist saw it coming.

"Ben Bernanke didn't see it coming, [Greg] Mankiw didn't see it coming, Bob Lucas didn't see it coming, you know, God himself didn't see it coming," Wolfers says.

"You could say there are some who are especially guilty and I think arguably New York should have been on top of this given their role overlooking financial markets.

"Certainly there's robust bank supervision going on at each of the major Feds but I think all 12 of them sort of missed what happened here.

Wolfers concedes that if experience of the banking system and supervision are requirements then you'd look for another. But given her vast experience on the Fed, it's not obvious who that other would be. And he makes a case for Yellen as a "reliably watchful" person of high integrity.

"They are perfectly fair and valid questions and I'm sure questions the White House are asking before they would appoint someone and also questions that would come up in confirmation. But there's no a priori reason to think she's in anyone's pocket, and indeed quite the opposite which is I have found her in my dealings to be incredibly ethical and certainly not at all reliant on Wall Street for finances."

As for the claim that she's too dovish, that's absurd, Wolfers says.

"I understand it comes from someone who sees inflation everywhere. It just hasn't been in the US data for 30 years," he says.

"An alternative way of saying that, given that unemployment is still above 7 per cent, is that she's been on the right side of every decision over the past six years.

"She will talk tough talk about inflation as well when the time's appropriate. It just turns out that the time is not now, and it hasn't been for the past six years."

There are other names in the frame, but Yellen is the frontrunner.

"I don't think the President sees any need to change direction with the Fed," Calabria says. "Yellen is as close as you can get to essentially keeping Bernanke without keeping Bernanke. "