The Federal Reserve in a Time for Doves

By Kenneth Rogoff *Mon, Aug 5, 2013*

"If normal times call for a conservative central banker who helps to anchor inflation expectations, now is the rare time when we need a more unorthodox central banker who will fight deflation expectations," writes the professor of economics and public policy at Harvard.

The battle is on to replace current US Federal Reserve Chairman Ben Bernanke. One might expect the Fed chairmanship – arguably the second most powerful official position in the United States, and certainly the world's most powerful financial position – to be determined by a conclave of central bankers. In fact, the choice is largely at the discretion of the US president. So let us consider two of the leading candidates, Lawrence Summers, a former US treasury secretary, and current Fed Vice Chair Janet Yellen.

Both Summers and Yellen are brilliant scholars with extensive experience in public service. Whereas the mainstream press seems intent on exploring their candidacies as a contest of contrasting personalities, the fact is that both candidates are extremely well qualified. Moreover, both have a reputation for believing that the Fed should not place excessive weight on price stability relative to unemployment. Normally, this dovish bias would be a handicap; nowadays, it is an advantage.

The importance of technical competence in monetary policy has been proved repeatedly by central banks around the world. According to research published in 2003 by the economists Christina Romer and David Romer, the quality of monetary policy depends critically on whether central bankers have a clear and nuanced understanding of policy making and inflation. The 1920's, 1930's, and 1970's are replete with examples of central bankers who did not understand the basics, and whose economies paid the price.

What this means is not just competence in setting interest rates, but also competence in regulatory policy. Some are criticizing Summers's ardent pursuit of financial deregulation during the 1990's, when he headed the US Treasury under President Bill Clinton. But these critics overlook his role in helping to fight that decade's sovereign-debt crises, and his insistence that the US begin issuing inflation-indexed bonds.

In a complex and ever-changing policy setting, it is almost impossible to get every call right, and the important thing is to learn from one's mistakes. Winston Churchill famously regretted overseeing the United Kingdom's catastrophic return to the gold standard in 1925, when he was Chancellor of the Exchequer. His performance, needless to say, improved in later years.

As for Yellen, it is true that she was President of the San Francisco Federal Reserve during the last years of the massive US housing bubble – which was particularly acute in her district. But Yellen's speeches on financial risks showed more foresight than those of most of her peers.

Typically, one looks to the head of the central bank to serve as a bulwark against political pressure to push down interest rates and raise inflation. My own research in 1985 on inflation and central bank independence showed that, in normal times, one generally wants a central banker who places greater emphasis on price stability relative to unemployment than an ordinary informed citizen might do. Installing a “conservative” central banker helps to keep inflation expectations in check, thereby holding down long-term interest rates and mitigating upward pressure on wages and prices.

For the past 25 years, the mantra of “inflation targeting” (introduced in my 1985 paper) has served as a mechanism for containing inflation expectations by reassuring the public of the central bank’s intentions. But excessive emphasis on low inflation targets can be counterproductive in the aftermath of the worst financial crisis in 75 years.

Rather than worrying about inflation, central bankers should focus on reflating the economy. The real problem is that they have done such a good job convincing the public that inflation is the number-one evil that it is difficult for them to persuade anyone that they are now serious about reflation. That is why appointing a “dove” would not be a bad thing at all.

Yellen has already developed a reputation as a dove within the Fed, with speeches consistently showing strong concern about today’s high unemployment. And, though many on the left regard Summers as suspiciously conservative, that is hardly the case when it comes to inflation. His 1991 paper on monetary policy is widely cited as among the first to make the case for avoiding very low inflation targets, in part to give the central bank more room to lower interest rates. Back then, Summers clearly viewed himself as a monetary-policy dove: “I would support having someone in charge of monetary policy who is more inflation-averse than I.”

But now Summers’s dovishness is not a problem. In the face of downward nominal-wage rigidity, higher inflation would facilitate sectoral adjustment and achieve a small but useful impact on reducing debt burdens.

If normal times call for a conservative central banker who helps to anchor inflation expectations, now is the rare time when we need a more unorthodox central banker who will fight *deflation* expectations. A central-bank version of the Vatican’s papal conclave would have a hard time deciding whether to send up the *fumata bianca* for Yellen or for Summers – or perhaps for someone else (another former Fed vice chair, Donald Kohn, now appears to be in the mix) with similar inclinations.