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Looking beyond Yellen: How to build a strong bench at the Fed

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Looking beyond Yellen: How to build a strong bench at the Fed

By Louis D. Johnston | 10/10/13

REUTERS/Kevin Lamarque

President Barack Obama, right, announcing his nomination of Janet Yellen to head the Federal Reserve, at the White House on Wednesday.

It's official: Janet Yellen is President Obama's nominee to chair the Board of Governors of the Federal Reserve System. It's unfortunate that her nomination got caught up in a personality contest rather than a reasoned discussion of the issues, but in the end President Obama made the right choice.

Ben Bernanke's term as chair ends Jan. 31, 2014, and I'm glad the president made the nomination now so that there is plenty of time for the U.S. Senate to vet Yellen. But this is not the only vacancy at the Fed: At least three seats, and perhaps four, will soon be open, including the vice chairmanship that Yellen currently holds.

Obama shouldn't look at the Yellen nomination in isolation but should build a strong team at the Fed. Here's how to do it.

Two jobs

Upon accepting the nomination, Yellen said: "Thank you, Mr. President, I am honored and humbled by the faith you have placed in me. If confirmed by the Senate, I pledge to do my utmost to keep that trust and meet the great responsibilities that Congress has entrusted to the Federal Reserve — to promote maximum employment, stable prices and a strong and stable financial system."

The Federal Reserve conducts monetary policy — changing the quantity of money or targeting short-term interest rates in order to promote maximum employment and stable prices. Monetary policy faces many challenges in the coming months and years as the Fed tapers its policy of quantitative easing and allows short-term interest rates to rise above zero, and this is Yellen's area of expertise.

As a member of the Board from 1994 to 1997 and president of the Federal Reserve Bank of San Francisco from 2004 to 2010, Yellen gained practice in meeting the third goal, a strong and stable financial system. However, the Dodd-Frank Act of 2009 gave the Fed new responsibilities in this area, and Yellen needs a deep bench of talent on the board to help her develop the specific policies necessary to meet these obligations.

Right people for right jobs

Let's start with financial-market supervision. The key problem in this area is the Too Big to Fail Problem: Some financial institutions have grown so big that they cannot be allowed to fail lest they take the entire financial system down with them.

Gary Stern, the former president of the Federal Reserve Bank of Minneapolis, literally wrote the book on the Too Big to Fail Problem. Obama should nominate Stern as vice-chair with a mandate from Yellen to focus on bringing the Fed up to speed on its regulation responsibilities and instituting the reforms he has advocated since the 1990s. In addition, Stern served on the Federal Open Market Committee while he was president of the Minneapolis Fed and brings a wealth of experience in monetary policy to go with his insight on financial market regulation.

Stern needs back-up too, and the perfect person to join the board in this capacity is Anat Admati. In her book "The Bankers' New Clothes: What's Wrong with Banking and What to Do About It" (co-authored with Martin Hellwig), Admati cut straight to the biggest problem in banking today: that the banking business is built on borrowed money to a far greater degree than any other industry, and that the key to reducing the riskiness of the system is to require banks to hold a far greater level of capital than they currently do. Who better than Admati than to put this idea into practice at the Fed?

The third seat should go to someone who can work with Yellen on monetary policy. My first choice is Adam Posen, the president of the Peterson Institute for International Economics. He served from 2009 to 2012 on the Monetary Policy Committee of the Bank of England, a position equivalent to being a Fed governor, so he is familiar with the day-in-day-out workings of monetary policy. More importantly, Posen was a leading advocate of quantitative easing before it was adopted by the Federal Reserve, having proposed its use in Japan in the 1990s.

The Federal Reserve is often portrayed as a one-man band, with the chairman equated as "the Fed." Chairmen such as Paul Volcker and Alan Greenspan did nothing to dispel this view, but Ben Bernanke has worked to change this and make the Fed a more collegial place. Obama should nominate people who can work with Yellen to keep this going and to carry out the difficult monetary policy and regulatory tasks that lie ahead.

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Louis Johnston writes Macro, Micro, Minnesota for MinnPost, reporting on economic developments in the news and what those developments mean to Minnesota. He is Joseph P. Farry professor in the Eugene J. McCarthy Center for Public Policy and Civic Engagement at Saint John's University. He is also a professor of economics at the university.