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'Helicopter' Ben offers clues to how a Yellen Fed would look

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INSIGHT

What can we expect from a Federal Reserve led by newly nominated chair Janet Yellen? Unlikely as it may sound, we can draw insight from a decade-old misinterpreted remark.

In November 2002, as the US economy was emerging from recession, Federal Reserve Governor Ben Bernanke delivered his now infamous "helicopter" speech – during which he recalled Milton Friedman's jocular depiction of dropping money from helicopters as a last-ditch means to fight deflation.

"A money-financed tax cut is essentially equivalent to Milton Friedman's famous 'helicopter drop' of money," Mr Bernanke said, using the analogy to combat fears of imminent deflation, which had driven the yield on the 10-year US Treasury note below 4 per cent, the lowest since the early 1960s.

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The witty but obscure reference to Friedman's 1969 paper "The Optimum Quantity of Money" was largely misinterpreted, both on Main Street and Wall Street. Derided as "helicopter Ben", Mr Bernanke saw his commitment to price stability drawn into question as he was viewed as championing easy money. Nevertheless, it appeared that his comments serendipitously contributed to ending the deflation scare. Interest rates stabilised and the market's concerns on price deflation were successfully allayed.

Inflation fighter

The helicopter speech continued to haunt Mr Bernanke, even upon his confirmation as chairman of the Federal Reserve. With his commitment to price stability in doubt, the chairman found it hard to take pre-emptive and decisive action in the subprime crisis he encountered soon after taking office. It was imperative to him that he reaffirm his mantle as an inflation fighter, even though maintaining a restrictive monetary policy before the housing collapse would prove only to further exacerbate the crisis.

Ultimately, the chairman relented. He dramatically reversed course and flooded the financial system with unprecedented amounts of monetary liquidity. Future historians will ultimately judge whether the chairman's actions in the early days of the crisis – marked by a reluctance to reduce rates – are responsible for the depth of the collapse.

More pressing, however, is the similar series of questions that looms large for Ms Yellen. Like Mr Bernanke, she is haunted by a history of dovish monetary sentiment; her reputation for favouring easy money is virtually ubiquitous. But this characterisation may be unfair.

Her long and established career at the Fed renders her one of the most seasoned and highly informed central bankers in the world. Ms Yellen has an impeccable resume, and is arguably one of the best qualified candidates in recent history for the position. She has previously served as chair of the president's Council of Economic Advisors, was an FOMC governor for two years, and president of the San Francisco Fed for five-and-a-half years. Over the past three years, she has served as vice-chairman of the Fed, and is known for her cautious and methodical leadership style. She is well regarded for excellent communications skills and is a leading advocate of Fed transparency. Nevertheless, the spectre of easy money advocacy with which she is associated could potentially complicate her life as Fed chair.

Will she face the same challenges as Mr Bernanke? Will her dovish legacy cause her to act in ways inconsistent with promoting economic recovery? Will she exit QE too soon or too quickly – causing rates to rise and potentially damaging the housing market – to establish inflation-fighting credibility?

Hard course to steer

Or will Ms Yellen embrace earlier comments which suggest the Fed might tolerate higher levels of inflation than the stated 2 per cent ceiling – assuming such price pressures were deemed to be transient? Either way, it will be hard for the chairman to steer a middle course in trying to fulfil its dual mandate.

I take Ms Yellen at her word. I believe in the long run she will use monetary policy, including inflation, as a tool to reduce unemployment. She may, in the short run, feel a need to establish her anti-inflation credentials – resulting in an earlier exit from QE than expected. If that path were to result in dramatic rises in interest rates, similar to the aftermath of Mr Bernanke's June conference when he raised the notion of tapering, I believe she would quickly reverse course.

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The ultimate normalisation of post-crisis monetary policy will be tricky. Policy makers will find it difficult to pace the reduction in monetary accommodation to assure both price stability and full employment. Given the significant possibility for a policy error, the odds favour betting on lower unemployment and higher inflation in a Yellen Fed.

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