Why Janet Yellen, Not Larry Summers, Should Lead the Fed

By JOSEPH E. STIGLITZ

The controversy over the choice of the next head of the Federal Reserve has become unusually heated. The country is fortunate to have an enormously qualified candidate: the Fed's current vice chairwoman, Janet L. Yellen. There is concern that the president might turn to another candidate, Lawrence H. Summers. Since I have worked closely with both of these individuals for more than three decades, both inside and outside of government, I have perhaps a distinct perspective.

But why, one might ask, is this a matter for a column usually devoted to understanding the growing divide between rich and poor in the United States and around the world? The reason is simple: What the Fed does has as much to do with the growth of inequality as virtually anything else. The good news is that both of the leading candidates talk as if they care about inequality. The bad news is that the policies that have been pushed by one of the candidates, Mr. Summers, have much to do with the woes faced by the middle and the bottom.

The Fed has responsibilities both in regulation and macroeconomic management. Regulatory failures were at the core of America's crisis. As a Treasury Department official during the Clinton administration, Mr. Summers supported banking deregulation, including the repeal of the Glass-Steagall Act, which was pivotal in America's financial crisis. His great "achievement" as secretary of the Treasury, from 1999 to 2001, was passage of the law that ensured that derivatives would not be regulated — a decision that helped blow up the financial markets. (Warren E. Buffett was right to call these derivatives "financial weapons of mass financial destruction.” Some of those who were responsible for these key policy mistakes have admitted the fundamental “flaws” in their analyses. Mr. Summers, to my knowledge, has not.)

Regulatory failures have been at the center of previous crises as well. At Treasury in the 1990s, Mr. Summers encouraged countries to quickly liberalize their capital markets, to allow capital to flow in and out without restrictions — indeed insisted that they do so — against the advice of the White House Council of Economic Advisers (which I led from 1995 to 1997), and this more than anything else led to the Asian financial crisis. Few policies or actions have greater culpability for that Asian crisis and the global financial crisis of 2008 than the deregulatory policies that Mr. Summers advocated.

Supporters of Mr. Summers argue that he is exceptionally qualified to manage crises — and that, while we hope that there won’t be a crisis in the next four years, prudence requires someone who excels at those critical moments. To be fair, Mr. Summers has been involved in several crises. What matters, however, is not just “being there” during a crisis, but showing good judgment in its management. Even more important is a commitment to taking actions to make another crisis less likely — in sharp contrast to measures that almost ensure the inevitability of another one.

Mr. Summers’s conduct and judgment in the crises was as flawed as his lack of commitment in that regard. In both Asia and the United States, he seemed to me to underestimate the severity of the downturns, and with forecasts that were so off, it was not a surprise that the policies were inappropriate. The performance of those in the Treasury who were responsible for managing the Asian crisis was, to say the least, disappointing — converting downturns into recessions and recessions into depressions. So, too, while the banking system was saved, and the United States avoided another depression, those responsible for managing the 2008 crisis cannot be credited with creating a robust, inclusive recovery. Botched efforts at mortgage restructuring, a failure to restore the flow of credit to small and medium-size enterprises, and the mishandling of the bailouts have all been well documented — as were the failure to foresee the severity of the economic collapse.

These issues are important to anyone concerned with inequality for four reasons. First, crises and how they are managed are real creators of poverty and inequality. Just look at what havoc this crisis wrought: median wealth fell by 40 percent, those in the middle still have not seen their incomes recover to pre-crisis levels, and those in the upper 1 percent enjoyed all the fruits of the recovery (and then some). It is ordinary workers who have suffered most: they are the ones who face high unemployment, who see their wages cut, and who bear the brunt of cutbacks in public services as a result of the budget austerity. They are the ones who lost their homes in the millions. The Obama administration could have done more, far more, to help homeowners, and to help localities maintain public services (for instance, through the kind of revenue sharing with states and localities that I urged at the beginning of the crisis).

Second, deregulation contributed to the financialization of the economy. It distorted our economy. It provided greater scope for those who manipulate the rules of the game for their benefit. As James K. Galbraith has forcefully argued, as we look around the world, bloated and underregulated financial sectors are closely linked with greater inequality. Those, like Britain, that emulated America's deregulation have seen inequality soar, too.

Third, the most invidious aspect of this deregulation-induced inequality is that associated with the abusive practices of the financial sector — which prospers at the expense of ordinary Americans, through predatory lending, market manipulation, abusive credit card practices or taking advantage of its monopoly power in the payments system. The Fed has enormous powers to prevent these abuses, and even more since the passage of the Dodd-Frank Act of 2010. Yet the central bank has repeatedly failed at this, systematically focusing on strengthening the banks' balance sheets, at the expense of ordinary Americans.

Fourth, it is not only the case that America's financial sector did what it shouldn't have done, but it also didn't do what it was supposed to do. Even today, there is a dearth of loans to small and medium-size enterprises. Good regulation would shift banks away from speculation and market manipulation, back to what should be their core business: making loans.

Whoever succeeds Ben S. Bernanke as the Fed's leader will have to make repeated judgment calls about when to raise or lower interest rates, the levers of monetary policy.

Two elements enter into these judgments. The first is forecasting. Wrong forecasts lead to wrong policies. Without a good sense of direction of where the economy is going, one can't take appropriate policies. Ms. Yellen has a superb record in forecasting where the economy is going — the best, according to The Wall Street Journal, of anyone at the Fed. As I noted earlier, Mr. Summers's leaves something to be desired.

Ms. Yellen's superlative performance should not come as a surprise. Janet Yellen, whom I taught at Yale, was one of the best students I have had, in 47 seven years of teaching at Columbia, Princeton, Stanford, Yale, M.I.T. and Oxford. She is an economist of great intellect, with a strong ability to forge consensus, and she has proved her mettle as chairwoman of the President's Council of Economic Advisers (she succeeded me in that role), as president of the Federal Reserve Bank of San Francisco, from 2004 to 2010, and in her current role, as the Fed's No. 2.

Ms. Yellen brings to bear an understanding not just of financial markets and monetary policy, but also of labor markets — which is essential at a time when unemployment and wage stagnation are primary concerns.

The second element of Fed policy making is risk assessment: if one steps on the brakes too hard, one risks excessively high unemployment; too gently, one risks inflation. Ms. Yellen has shown herself to be not only excellent in forecasting, but balanced. Legitimate questions have been raised: Would Mr. Summers, with his close connections with Wall Street, reflect financiers' single-minded focus on inflation, and be more worried about the effects on bond prices than on ordinary Americans? In the past, central banks have focused excessively on inflation. Indeed, this single-minded focus, with little regard to financial stability, not only has contributed to the crisis, but as I argued in my book "Freefall," it has also contributed to the declining share of total income that is earned by ordinary workers.

Though the willingness to take actions to prevent crises, and good judgments in a crisis, are undoubtedly critical in the choice of the next Fed chair, there are other important considerations. The Fed is a large organization that has to be managed — and Ms. Yellen demonstrated her management skills at the San Francisco Fed. One has to obtain consensus among a diverse group of strong-minded individuals, some more worried about inflation, some more worried about unemployment. One needs someone who knows how to build consensus, not someone who excels in bullying, who knows how to listen to and respect the views of others. When I was chairman of Economic Policy Committee of the Organization for Economic Cooperation and Development, I saw how effectively Ms. Yellen represented the United States, and the respect in which she was held. In the ensuing years, she has gained in stature, and today has the enormous respect of central bank governors around the world. She has the stature, wisdom and gravitas one should expect of the leader of the Fed.

Finally, the Fed is an enormously important institution, but regrettably, its conduct in the years before Ms. Yellen took up her role in Washington — both its failures in dealing with the bubble and certain aspects of its conduct in the immediate aftermath of the crisis (like the lack of transparency) — has undermined confidence in it. It is important that Mr. Obama's nominee not be — or even be seen to be — acting at the behest of financial markets. That person cannot be someone who can be tainted even by an accusation of conflict of interest, which is inevitable with the "revolving door" that has too often been associated with the regulation of this sector. Nor should it be someone who suffers from "cognitive capture" by Wall Street. At the same time, the person has to have the confidence of the financial markets, and a deep understanding of those markets. Ms. Yellen has managed to do this — an impressive achievement in its own right.

One might say that the country is fortunate to have two candidates who, as the Harvard economist Kenneth S. Rogoff, a former chief economist at the International Monetary Fund, writes, are "brilliant scholars with extensive experience in public service." But brilliance is not the only determinant of performance. Values, judgment and personality matter, too.

The choices have seldom been so stark, the stakes so large.

No wonder that the choice of the Fed leader has stirred such emotion. Ms. Yellen has a truly impressive record in each of the jobs she has undertaken. The country has before it one candidate who played a pivotal role in creating the economic problems that we confront today, and another candidate of enormous stature, experience and judgment.