Dinner with Janet

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On April 4, I joined a group of 15 private sector investors for dinner with former Federal Reserve Chairwoman, Dr. Janet Yellen.

It was a delightful, insightful, interesting, and informative evening. Below is a mix of her thoughts on the economy, Fed policy, and where we are headed. I am also noting important policy nuances raised by a couple of her core economic policy principles.

Yellen has a positive outlook on the economy. She sees economic growth in 2018 and 2019 at +2.5% and +2.8%, respectively. She described the economy and the labor market to be in excellent shape and expects tax cuts and spending to lift real GDP in 2018 and 2019 by one-half to three-quarters of a percentage point above the economy's current growth rate of 2.6%. The labor market is almost at full employment, with the potential for the unemployment rate to drop another 0.6% to a level of 3.5%. However, the labor force participation rate may not improve because of structural reasons.

Absent extraordinary circumstances, the Fed will continue on its current path and pursue a total of three increases in the Fed Funds rate this year. What might those extraordinary circumstances be? While Yellen believes there is not a lot of pressure on margins from wage costs and thus no present inflation problems, overheating from all the stimulus is a possibility. Faster growth and a tighter labor market could cause the Fed to make a

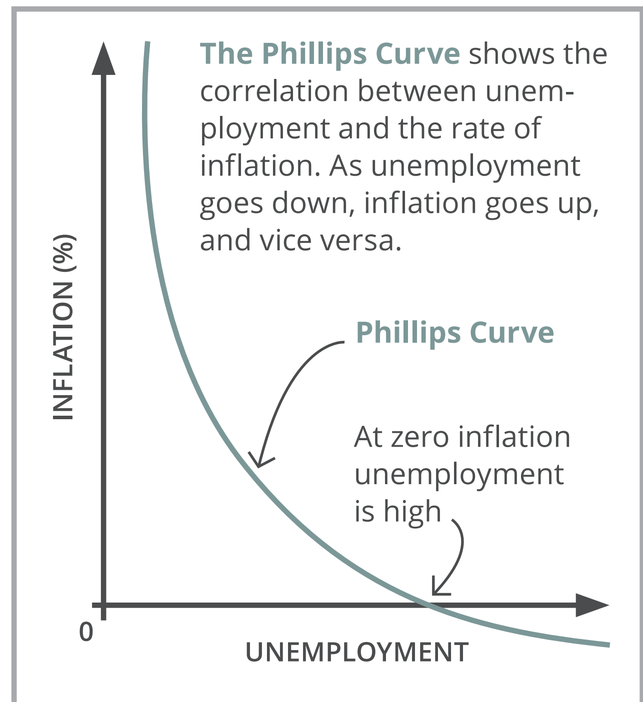
policy mistake. Significantly faster and greater increases in interest rates could (and they have in the past) chill growth and lead to a recession.

In discussing the economy and Fed policy-making, Yellen showed appealing humility. She acknowledged that our monetary leaders bring their best judgment, not an absolute certainty, to making policy choices. For example, while commenting on the natural rate of interest, she observed, "What if it's higher than I/we anticipate? While I have a view on what it is, I do not have absolute certainty." Humility combined with significant intellectual talent is always an appealing character trait.

So, what are the nuances? Two points stood out. First, her emphasis on the Phillips Curve as the only actual framework for understanding the relationship between inflation and unemployment, and second, her view that tax reduction and full capital expensing will have little supply-side effect on economic growth. Both raise important policy distinctions between Keynesian and supply-side economics.

Keynesian economists put greater emphasis on the Fed's ability to fine tune the economy than supply-siders. In contrast, supply-siders favor letting the natural forces in a market economy do their thing. Yellen's emphatic statement endorsing the Phillips Curve as the only framework for predicting the tradeoffs between unemployment and inflation is quite Keynesian. For example, if unemployment is high, the policy choice is to reduce interest rates and increase the money supply to create demand and thereby reduce the unemployment rate with little impact on inflation. This is fine-tuning through government intervention.

Yellen similarly sees the tax reform's rate reduction as increasing demand and thereby spurring demand because consumers have more to spend. Tax reform and full capital



expensing will provide only a small spur to economic growth through increased production by businesses.

Supply-side economists, like the new Chair of the President's Council of Economic Advisors Larry Kudlow, beg to differ. They believe when businesses produce and sell more because they have more after-tax cash, they create more demand through the purchases they make and the increased wages they pay. Supply-siders really aren't interested in the demand side of the supply-demand equation because supply will create its own demand. Therefore, there is not much need for the Fed to "fine tune" the economy. Market forces will balance and grow the economy naturally.

These are important nuances. They reflect an economist's view on the extent to which the Fed (and the federal government) should intervene in the economy.

The reality is there is something to each of these frameworks. The emphasis on application is, and should be, a matter of degree. There are very few absolutes in economics. The pragmatic application of theory works best.

Chart source: The Economics Book: Big Ideas Simply Explained. DK Publishing, 2012. pg.203

Below are a few additional pieces of information from our discussion with Dr. Yellen.

- For the GFC (Global Financial Crisis) there is plenty of blame to go around. The Fed failed to supervise the banking system and the shadow banking system. Our banking system engaged in poor practices and pursued unaligned incentives (bad behavior). And, the markets demanded high cash returns through CDAs and mortgage-backed securities.
- The safety net placed under the financial system post-GFC has not been endangered by the deregulation pursued by the new administration.
- Current worries are on the upside. An "overheating" economy is of more concern than undershooting the Fed's inflation target.
- Another worry is the Fed continues to conduct an accommodation experiment. As it increases rates, it must balance the different risks of slowing the economy and stoking inflation.
- The Fed is now trying to engineer a "soft landing from below."
- Bitcoin is speculative excess according to Yellen. One dinner guest suggested interested investors should consult the 17th Century Dutch tulip bulb mania when considering bitcoin investments.

Yellen is to be thanked for her public service and her leadership as Chair of the Federal Reserve. A record of good stewardship by a personable, highly intelligent public servant offers a refreshing reinforcement of public trust in a vital US institution.

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