ASK THE EXPERT

How to Fix the Fed

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Janet Yellen faces a daunting task as chair of the Federal Reserve. "For the past six years the Fed's policy actions have been unprecedented in scope, scale and novelty, as they first sought to stabilize the financial system and then to stimulate more rapid economic growth," says Fisher, a senior director of the BlackRock Investment Institute and a former top Treasury and Federal Reserve Bank of New York official. "Yellen needs to move the Fed out of its post-crisis role." To do so, she must confront four challenges, according to Fisher.

STOP BEING HELD HOSTAGE

The Federal Reserve has been backed into the role of immunizing the economy from the effects of the fiscal policy dysfunction between Congress and the president. Although the central bank will always cast an eye on tax and spending policies and sometimes offset the impact of fiscal stimulus or restraint, the Fed's actions in the last two years have created a moral hazard: Congress and the president can count on the Fed to limit the damage caused by politics. This makes the Fed's policies too focused on the very short term. The Fed needs to focus on the longer run.

FIGURE OUT THE LABOR FORCE

Whether the Fed should be more worried about inflation or unemployment will likely boil down to how it views the declining share of the population working or actively looking for work. If the decline is principally because workers have stopped looking for work because of weak demand, then the Fed should keep stimulating the economy without too much worry for inflation. If, however, the decline reflects enduring changes in the labor force, then the Fed should be more concerned about inflationary pressures caused by a falling unemployment rate.

STAND TOGETHER

The Fed has been promising not to raise rates from their current near-zero level "at least until" unemployment hits 6.5 percent, as long as inflation is under control. But each of the 19 members of the Fed's committee who establish policy has a different view about when rates should come off the floor. Each quarter they publish a grid of dots that shows where each member thinks short-term rates should be at the end of each of the next few years. In effect, each dot is a dissent from the Fed's statement. This needs to be fixed by the new Fed chair.

DEFINE MONETARY POLICY LIMITS

The Fed has repeatedly vowed to keep buying bonds and, effectively, print money at least until the unemployment rate falls below 6.5 percent—perhaps longer if it fears a renewed slowdown in the economy or the risk of deflation. This has created the impression that the Fed thinks monetary policy can always fix the economy. The Fed needs to make clear that it cannot protect us from every harm to the economy by buying more bonds. To help rebuild its credibility, the Fed needs to admit that there are limits to what monetary policy can do—and tell us what they are.