U.S. Fed Flash

Yellen Stays the Course in First Testimony as Fed Chair

- **Testimony confirms monetary policy continuity and emphasis on labor market data**
- **Regulatory reform remains a key issue that will gain notoriety throughout Yellen's term**
- **Given the novelty of these tools, we will likely see further adjustment in Fed communication**

Janet Yellen's first testimony as Federal Reserve Chair fit the mold for continuity in monetary policy accomodation. As expected, Yellen's comments were consistent with the dovish tone established in Bernanke's term, emphasizing her support for the Fed's dual mandate of maximum sustainable employment and price stability. In discussing the economic outlook, Yellen appears mostly encouraged by the latest improvements in overall activity but is hesitant to accept that we are completely out of troubled waters, particularly when it comes to the employment situation. Not surprisingly, she highlighted the importance of monitoring other labor market indicators given that the "unemployment rate is still well above levels that FOMC participants estimate is consistent with maximum sustainable employment." On the inflation front, she acknowledged that prices have been running below trend but that much of this reflects transitory factors, ultimately suggesting that much of her concern still remains focused on unemployment.

On quantitative easing and forward guidance, Yellen reiterated what we already knew to be true: asset purchases remain data-dependent and are not on a present course, and that "a highly accommodative policy will remain appropriate for a considerable time after asset purchases end." Furthermore, she emphasized the fact that the 6.5% unemployment rate threshold is not an automatic trigger for increasing the federal funds rate but merely an indicator for the FOMC to consider the "broader economic outlook" and whether this would warrant any change in their strategy.

While most focus on the Fed has been related to the monetary policy tools discussed above, Yellen's testimony made sure not to sidestep important regulatory responsibilities. She touched on the progress made in strengthening the financial system, including the Volcker Rule and Dodd-Frank act. As with other aspects of the Fed's responsibilities, Yellen noted that they will continue to monitor these reforms to ensure that they are implemented effectively.

Questions following Yellen's prepared statement appeared to be quite critical of the Fed's activities, in regards to both monetary policy and financial regulatory reform. The overarching theme of questions and concerns related to the lack of clarity stemming from Fed communication: What specifically consistutes a negative change in the economic outlook that would slow or stop tapering? Is the 6.5% unemployment threshold still relevant? For how long will the Fed monitor regulatory reforms and allow for any disruption to the banking system before stepping in? Unfortunately, Yellen's answers didn't provide any more clarity and were very much in line with how Bernanke would have responded. First, she confirmed that slowing or stopping tapering would involve a "notable change in the outlook" when considering a broad range of labor market, spending, and inflation data. However, she did not commit to any specific data point that would push the Fed's outlook over the edge. When asked about the disappointing job growth in December and January, Yellen remains cautious in interpreting those reports, noting that the unusually cold weather and other temporary factors may have played a role. On forward guidance, Yellen received some crisiticm regarding the seemingly abandoned 6.5% unemployment rate threshold that was introduced in December 2012. When asked whether this could stand as a rule or if the Fed was just improvising, Yellen merely re-emphasized the novelty of this monetary policy tool and sidestepped any commitment to the threshold via consideration of other labor market data. Finally, Yellen maintained her composure when asked about the potential disruption in competitiveness for U.S. banks as a result of the latest regulatory reforms, but still, she did not commit to any firm timeline for how and when the Fed will assess the effectiveness of the rules.

Despite the detail-oriented and sometimes unrelenting questions that Yellen faced in her first semiannual monetary policy report to Congress, her remarks remained consistent with our expectations for a smooth transition to a new Fed Chair. As we have highlighted in prior Fed Watches, 2014 will be a significant year for the Federal Reserve, with the end of QE3 slated for 4Q14 and the initial moves toward monetary policy normalization in the years to follow. Yellen's first FOMC meeting as Fed Chair will take place in mid March, where the committee will have another month's worth of data to assess whether the current pace of tapering remains appropriate. While Yellen certainly has her hands full moving through unchartered waters, her testimony today confirmed her commitment to staying the course and upholding the Fed's dual mandate.

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