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Fed Thoughts: Swipe Right or Left on Chair Powell?

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Another meeting of the Federal Reserve's (Fed's) policy setting group, the Federal Open Market Committee (FOMC) came and went early this month, long on substance but short of drama. This was precisely the plan of Chair Jay Powell. The main business was to announce the gradual slowing of asset purchases, to be trimmed $15 billion per month from a starting level of $120 billion per month and brought to a halt by the middle of next year. Burned by his experience as governor in the tantrum following a prior Fed feint toward the slowing of asset purchases, Powell made sure there was no element of surprise this time round. They talked and talked through the plan over the past nine months, sending enough smoke signals to risk censure from The Network for Greening the Financial System (the central bank forum on climate change).

The beginning of the end was set last December, when the FOMC asserted that tapering would start when the Fed had achieved substantial further progress in meeting its dual objectives of maximum employment and stable prices. At the time, the risks to price stability seemed to be all on the downside. Moreover, Fed officials created upside room to run by promising that they would assess inflation as a backward-looking average and would tolerate some overshooting of that measure from their goal. That put concerns about the other goal, employment, front and center. If that were still so, the Fed would not have announced the onset of the taper, as payroll employment is still 4-1/4 million short of its prior peak.

What is different is that inflation has considerably overshot the 2 percent goal, surprising Fed officials in the scope, scale, and apparent persistence of the rise in prices. Look under the hood of the employment report for October for the reason why, which was released just after the FOMC announcement but almost surely met the expectations of monetary officials. With more than ½ million jobs added to payrolls, on net, we know demand is still expanding briskly, albeit not as fast as during the heady days of widespread re-openings and knocked back a bit by the spread of the Delta strain of the coronavirus. Also evident, though, is that supply is filling in only hesitantly and incompletely to meet added demand. A durable expansion that does not put excessive pressure on labor costs requires the return of workers to the labor force. In the event, the labor force participation rate is off 1-3/4 percentage points from early last year and has moved sideways along that bottom over the past few months, most likely because of lingering governmental disincentives to work, a skills mismatch among those seeking work, and permanent exits to retirement.

The pressure on available resources is evident in further increases in the growth of average hourly earnings, now clocking in at a 4.9 percent rate of increase on a twelve-month basis. With higher labor costs likely to add further lift to inflation, FOMC participants want the option to raise the policy rate in the second half of 2022—or at least to be seen able to do so. This requires putting a sell-by date on unconventional policy accommodation—starting the tapering of asset purchases. As with everything the FOMC does—outside of crisis management—that change is slow and incremental. When completed at midyear 2022, the announced plan would put the Fed's System Open Market Account almost $1/2 trillion above its current level. All the while, the federal funds rate will be deeply negative in real terms (or adjusted for inflation).

The current decision of note on monetary policy is not about action but personnel. An announcement appears imminent on who will be nominated as Fed chair for the term beginning February. Meanwhile, another governor has fallen away, with Randy Quarles announcing he will resign at the end of the year. With Richard Clarida's term ending in January, this presents President Biden with three open Fed Board positions by early next year—and possibly four if Jay Powell were not reappointed chair. This is a majority of the seven-member Board of Governors and, adding in the two Fed Bank president positions open (which are not political appointments), one half of the twelve-member FOMC might look different in six months.

One job matters more, of course, which is why financial market participants are fixated on whether the incumbent Powell will be reappointed. Focusing on three features of the process helps tune out the static.

First, nobody except those in a close circle around President Biden has much real insight on the call. Market opinion mostly answers the question "Who should be appointed?" not "Who will be?" As for the former, there is a compelling case to build for Jay Powell earning another four years in the job. He has kept Fed policy extremely accommodative—to the delight of two presidents—and will be able to play out that string longer than someone new in the job. Powell has framed monetary policy choice inclusively, viewing its mandate broadly, emphasizing that the transmission of policy has an uneven incidence, and consulting widely. And Powell speaks with more elected officials more often than any of his predecessors, and is viewed, by and large, with little partisan distrust despite having served in one administration of a Republican president and appointed chair by another. The sour note among some on Capitol Hill is not about political party but world view. Progressives, notably including Senator Elizabeth Warren, believe that the incumbent Fed chair is too comfortable with the light hand of financial regulation.

While the race is not always to the swift nor bread to the wise, especially in politics, Damon Runyon's advice that this is the best way to bet still holds. Powell is the favorite, but probably less a frontrunner than commonly understood.

Why? The **second** feature of the process is that filling a premier post always comes down to a contest between affinity and convenience. A president would prefer someone from their own side for a big job, especially one potentially stretching beyond their term in office. The bench depth of Democratic contenders is considerable, and rewarding loyalty makes those on your team more loyal. Early on, the Biden White House showed itself to have sharp elbows in filling as many agency positions as quickly as possible—even firing the incumbent head of a housing one fifteen minutes after the Supreme Court ruled that it could.

Why might the premier economic appointment differ? Convenience. A majority of the Senate must ratify the choice, which helps Powell's prospects given his good standing on the Hill. And investor discomfort with a change raises the specter of a messy market correction. The latter rationale featured prominently in the reappointment of three Fed chairs (Volcker, Greenspan, and Bernanke) by presidents of parties across the aisle from the ones who originally appointed them.

Third, precedent matters, but only so much. This is the first Democratic administration in thirty years that does not contain a member of the Rubin-Summers-Geithner axis in its inner circle. That is, strenuous advocacy of tilting personnel choices toward reassuring financial markets appears to be lacking. True, Janet Yellen has the commanding presence of Secretary of the Treasury and has publicly praised Jay Powell, but her role more seems to be an outside champion of the president's cause, not an intimate inside the Oval Office.

Complicating matters, the headline choice may be made after a bit of horse trading on the other open Fed jobs. For one, four more years for Powell may go down easier with Progressives if he stands at a Rose Garden podium for the announcement ceremony with Lael Brainard tabbed as vice chair for supervision and two left-of-center economists as governors. For another, the top job could go to someone else with reassurance offered to financial markets by a nod given to a more conventional monetary policymaker to fill Clarida's position.

How it shakes out will leave US monetary policy more dovish and regulatory policy more restrictive. The question is not whether, but by how much?

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Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

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