A Choice for Continuity: Jerome Powell Chosen to Lead the Federal Reserve

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Overview

- Jerome Powell's nomination as the next Chair of the Board of Governors suggests a large degree of continuity in monetary policy, though Powell may prefer a slightly faster pace of interest rate normalization compared to Yellen.

- Importantly, Powell is fully committed to the FOMC's announced plan for gradual and passive balance sheet policy normalization. His comments also suggest a preference for an elevated steady-state level of reserves compared to the pre-crisis period.

- Under Powell's leadership, and with Randal Quarles as Vice Chair for Supervision, the Federal Reserve will expand on current efforts to revisit the cost and efficacy of regulations put in place since the financial crisis, but in a methodical and consensus-driven manner.

- A key uncertainty is Powell's willingness to use unconventional measures in the next recession, when in all likelihood the policy rate will again fall to the effective lower interest rate bound.

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INTRODUCTION

Today President Trump announced the nomination of current Federal Reserve Governor Jerome Powell as successor to Janet Yellen as Chair of the Board of Governors of the Federal Reserve System and, by extension, of the Federal Open Market Committee (FOMC). The choice of Governor Powell suggests a large degree of continuity in monetary policy, as Powell has strongly supported the interest rate and balance sheet normalization strategy of the Committee. However, Governors very rarely make public comments that are out of keeping with the direction in which the Chair is steering policy, so it is possible that the overall policy strategy could change on the margins going forward. In particular, Powell may favor a slightly more accelerated pace of policy normalization over the next two years. Still, there is little in his public comments to suggest that policy would shift in a meaningfully different direction under his leadership. The larger shifts could be in regulation and in how Powell would steer policy in a future recession.

MONETARY POLICY PREFERENCES

In his public remarks, not only has Governor Powell strongly supported the Committee's policy normalization process, but it is also difficult to find any areas where his views differ meaningfully from the Committee consensus. My reading of the quarterly Summary of Economic Projections suggest that Powell may have submitted higher policy rate projections than the Chair in the past, particularly at longer horizons as well as for the longer-run equilibrium rate. However, this year his rate projections appear to have converged with Yellen's, and he has fully supported the policy of gradual interest rate normalization, noting in a recent speech that patience in raising rates had "paid dividends" for economic performance.[1] In addition, to the extent that Powell had higher interest rate projections than Yellen in the past, it does not necessarily signal a more hawkish reaction function – Powell may have expected higher inflation and/or a tighter labor market than Yellen, an outcome that, if realized, would have called for additional policy tightening. The fact that Powell's interest rate projections appear to have converged somewhat with the Chair's leads me to attach more weight to this second interpretation.

Importantly for the policy outlook, Powell appears to accept the idea that the current level of the neutral policy rate remains low by historical standards and will likely rise only gradually in the years ahead. Thus even if Powell may have a slightly more hawkish reaction function than Chair Yellen, his belief in a suppressed neutral rate should serve as a meaningful constraint on rate hikes. In addition, he has specifically referenced the Committee's symmetric inflation objective, suggesting that he is attuned to the risk that inflation expectations could slip if the Committee continues to raise rates while inflation remains weak.[2]

The Committee's balance sheet normalization strategy should not change under Powell's leadership. In addition, he has expressed support for a "floor system" for managing short-term interest rates once the process of balance sheet normalization has been complete.[3] The choice of a steady-state operating framework remains the last remaining puzzle of the normalization process, and Powell's endorsement of a floor system suggests a relatively limited amount of balance sheet normalization, as it is associated with a higher level of bank reserves than a corridor system.[4] As a number of core Committee members also appear to be leaning in the direction of a floor system, there is no reason to change estimates of total balance sheet runoff over the next several years. I continue to expect total balance sheet runoff across Treasuries and MBS in the neighborhood of $1.2 trillion, with the process completed early in 2021.

The appropriate response of monetary policy to tax cuts will be an important early challenge for Powell. Like many others on the Committee he has avoided weighing in on the administration's tax proposals, instead stressing the more general need for policies that support business investment and development of the labor force. He may be somewhat more sympathetic than others on the Committee to the view that tax reform will have a

[1] Jerome Powell, "*Thoughts on the Normalization of Monetary Policy,*" June 1, 2017.
[2] Specifically, in his June speech Powell stated, "Nonetheless, it is important that the Committee assess incoming inflation data carefully and continue to demonstrate a strong commitment to achieving our symmetric 2 percent objective."
[3] Referencing the minutes from the November 2016 FOMC meeting in his June speech, Powell stated, "In November 2016, when the Committee discussed using a floor system as part of its longer-run framework, I was among those who saw such an approach as 'likely to be relatively simple and efficient to administer, relatively straightforward to communicate, and effective in enabling interest rate control across a wide range of circumstances.'" He concluded by noting that a floor system would be more robust than a corridor framework over time.
[4] In contrast, Kevin Warsh and John Taylor, two other candidates for the Chairmanship, had advocated a return to the pre-crisis corridor system, which would have implied a roughly 50 percent increase in the required amount of balance sheet runoff.

meaningful impact on trend growth in the years ahead. However, Powell will likely want to see clear supporting evidence before factoring any positive impact of tax reform on trend growth into his assessment of the appropriate policy stance. Thus in the near term, I would still expect Powell to lean against fiscal stimulus with continued policy normalization. This increases the odds I assign to my base case that the target range for the federal funds rate reaches 2.00-2.25 percent by the end of 2018.

REGULATORY OUTLOOK

Under Powell's leadership, and with Randal Quarles as Vice Chairman for Supervision, the Federal Reserve will prove more willing than the current leadership to revisit the efficacy and costs of regulations put in place since the financial crisis. However, it should be noted that the Committee has already been looking for ways to make the regulatory framework less burdensome, without substantially altering the benefits of the regulations put in place since the crisis[5]. Powell and Quarles will largely be continuing this effort, and any movement towards easing the regulatory burden will be methodical and consensus-driven.

FIGHTING A FUTURE RECESSION

One area of uncertainty with a Powell-lead Fed is how the Committee would respond in a future recession. Admittedly, this uncertainty is much less than it would have been if Kevin Warsh or John Taylor had been nominated as Chair. Still, Powell has given lukewarm endorsement of the cost-benefit trade-off of asset purchases. He has rightly pointed out that the worst fears of critics of accommodative policy have not come to pass, namely high inflation or rampant credit expansion, but he has also noted that the evidence of the effectiveness of asset purchases is only "mixed, but positive on balance."[6] Yellen herself, along with Bernanke before her, have acknowledged that asset purchases are a far from perfect policy tool, but still concluded unequivocally that purchases supported the recovery. If Powell has more meaningful doubts about the efficacy of asset purchases, he will need to be willing to resort to other unconventional measures in the next recession, as the central bank will very likely be constrained by the lower interest rate bound. The extent to which he would embrace other measures, such as price level path targeting or other forms of outcome-based forward guidance, remains an open question.

[5] In a June 26 speech, Powell highlighted five areas for regulatory improvements – "simplification and recalibration" of regulations for small and medium-sized banks, a less onerous process for bank submissions of resolution plans, relaxation of portions of the Volcker rule without undermining its goals, improved "transparency of stress testing and the Comprehensive Capital Analysis and Review," and potential recalibration of capital requirements. Quarles has been particularly vocal about what he sees as the lack of transparency in the bank stress testing process.

[6] Jerome Powell, "Thoughts on Unconventional Monetary Policy," June 27, 2013. This endorsement is far short of Chair Yellen's own recent assessment that the combination of forward rate guidance and asset purchases "did help spur consumption and business spending, lower the unemployment rate, and stave off disinflationary pressures." See Janet Yellen, "A Challenging Decade and a Question for the Future," October 20, 1997.

Biography

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Steven is a Senior Economist at BNP Paribas Asset Management. In this role, he is responsible for developing thematic views on the market, economic and policy outlook in the US and other major economies. Steven joined our company in 2013 and is based in New York.

Prior to his current role, Steven was a Director for the Central Banks and Official Institutions team at BNPP AM. Prior to joining us, Steven held various senior positions within the Markets Group at the Federal Reserve Bank of New York, including Director of Market Analysis and Director of Foreign Exchange and Investments.

Steven has over 19 years of investment-related experience. He holds a BA in Government and Russian studies from Wesleyan University, an MA in International Relations from The Paul H. Nitze School of Advanced International Studies at The Johns Hopkins University, and an MBA from Columbia Business School.