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# Powell: The Status Quo Fed Candidate for a Status Quo Economy

Last Thursday, US President Donald Trump nominated Jerome Powell as the next Chair of the US Federal Reserve. Mr. Powell is set to succeed current Fed Chair Janet Yellen when her term ends on February 3, 2018. In this note, our Chief Economist Megan Greene shares her thoughts on what investors can expect from the Fed under Mr. Powell's leadership.

President Trump finally ended months of incessant speculation among analysts and investors about who would succeed Janet Yellen as Chairman of the Fed and announced that Jerome "Jay" Powell would take the helm. Mr. Powell has a varied background and has not followed the traditional academic route to his new role.[1]

Consensus thinking suggests that Mr. Powell will preside over a continuation of the Fed's gradual rate path and that, in my view, is probably correct. But because of Jay's varied path to the Fed, there is some uncertainty about how he might react if the economy were to look significantly different from the one we have today.

After completing law school, Mr. Powell gained experience in both financial services and public service (he was assistant secretary and undersecretary of the Treasury for Domestic Finance under George HW Bush). He was then brought into the Fed by the Obama administration in 2012.[1] Whereas Ms. Yellen had published extensively on the labor market as an academic and therefore had laid her interests bare before she arrived at the Fed, Mr. Powell's monetary policy priorities are not as prominently displayed on his sleeve.

Furthermore, Ms. Yellen's tenure at the Fed was much longer and covered environments when inflation was both relatively high and low. Investors could therefore extrapolate from those experiences to predict how she might react if economic conditions were to change for the better or the worse. This is not the case for Mr. Powell, given that his time at the Fed has been characterized by persistently low inflation.

Still, he has spoken publicly several times as a member of the Federal Open Market Committee (FOMC) and so we are not exactly 'driving blind' as we try to work out his thinking. Here is a 'cheat sheet' of some of his key views:

## On The US Economy:

- Economic growth potential now is "about" 2% ("My baseline expectation is that the economy will

[1] Washington Post: Who Is Jerome Powell, Trump's Pick For The Nation's Most Powerful Economic Position, November 2, 2017.

continue on a path of growth of about 2%, strong job creation and tightening labor markets, and inflation moving up toward our 2% target," he said in a June 2017 speech. "I expect that unemployment will decline a bit further and remain at low levels for some time, which could draw more workers into the workforce, put upward pressure on wages, or cause businesses to invest more as labor costs rise, all of which I would view as desirable outcomes," he said.)[2]

- We are "close to full employment."[2]

- Inflation will move up to 2% as slack tightens, though the Phillips Curve is clearly more flat than we used to think ("The relationship between slack and inflation has weakened substantially over the years," Powell said in June 2016. "In addition, inflation depends importantly on the inflation expectations of workers and firms. A widely shared view among economists today is that, unlike during the 1970s, expectations are no longer heavily influenced by fluctuations in inflation, but are fairly constant, or anchored. For both these reasons, inflation has become less responsive to cyclical changes in the economy." "While inflation expectations seem to me to remain reasonably well anchored, it is essential that they remain so," he said. "The only way to assure that anchoring is to achieve actual inflation of two percent, and I am strongly committed to that objective.")[3]

- Low productivity is depressing wages. ("…average hourly earnings are rising only about 2.5% per year, slower than before the crisis, much of that downshift may reflect the slowdown in productivity growth we have experienced.")[2]

## On Monetary Policy:

- The Fed is very close to achieving its mandates. ("Today, the economy is as close to our assigned goals as it has been for many years.")[2]

- Policy is currently very accommodative. ("Inflation is a little bit below target, and it's kind of a mystery," he told CNBC in August 2017. "You would have expected, given that we're getting tighter labor markets, that we'd have a little higher inflation. I think that what that gives us is the ability to be patient.")[4]

- It is appropriate to "gradually" normalize rates. ("If the economy performs about as expected, I would view it as appropriate to continue to gradually raise rates.")[2]

- The real neutral rate may be lower than it has been traditionally. ("Estimates of that rate are subject to significant uncertainty. The median estimate of its level by FOMC participants in March was 3%, more than a full percentage point below pre-crisis estimates.")[2]

[2] US Federal Reserve: Speech – Thoughts On The Normalization Of Monetary Policy, June 1, 2017.
[3] US Federal Reserve: Speech – Recent Economic Developments, Monetary Policy Considerations & Longer-Term Prospects, June 28, 2016.
[4] CNBC: Fed's Powell Says Weak Inflation Is A Kind Of Mystery, August 25, 2017.

- Shrinking the balance sheet should have a limited impact. ("The shrinkage of the Fed's balance sheet is also expected to proceed quite gradually, with slowly phased-in increases in caps on the monthly reductions in the Federal Reserve's security holdings," he said in a speech last month.[5] "It's hard for me to see the balance sheet getting lower than $2.5 trillion, let's say, $2.5 to $3 trillion," he told CNBC in June. "That assumes we normalize the balance sheet over the course of the next five years and go back to a fairly small number of reserves.")[6]

- Opposes rule-based policy making. ("There is no consensus that any one rule is best, let alone that it would be desirable to require the FOMC to pick and mechanically follow one rule to the exclusion of others.")[7]

- The "Floor" system (Interest rate On Excess Reserves & Reserve Repurchase Agreement Operations or RRP)[8] may be more effective than the current "Corridor" system. This would probably reduce the number of reserves. (Commenting on the Fed's balance sheet, he noted that "as a consequence of QE, however, reserves have been highly abundant and will remain so for some years. To affect financial conditions, the Federal Reserve has therefore used administered rates, including the interest rate paid on excess reserves (IOER) and, more recently, the offering rate of the overnight reverse repurchase agreement (ON RRP) facility. This approach, sometimes referred to as a 'floor system,' is simple to operate and has provided good control over the federal funds rate.")[2]

## On Regulation:

- Mr. Powell worked with Randy Quarles at the US Treasury and is more in favor of fixing/tweaking regulation than repealing it. He is widely viewed as being more lenient on regulation than Ms. Yellen.[9]

- More transparency is needed on the bank stress tests so banks know what the Fed is looking for.[6]

- There should be changes to Volcker Rule for smaller firms with small trading books.[10]

- The SIFI (Strategically Important Financial Institution) Threshold should be raised from $50 billion (though he hasn't specified how high it should be raised).[10]

- Capital and liquidity requirements "are about right."[11]

- May need more regulation of clearing houses and derivatives.[12]

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[5] US Federal Reserve: Speech – Prospects For Emerging Market Economies In A Normalizing Global Economy, October 12, 2017.
[6] CNBC: Transcript – Federal Reserve Governor Jerome Powell Speaks With Steve Liesman, June 1, 2017.
[7] US Federal Reserve: Speech – The Economic Outlook And Monetary Policy, February 22, 2017.
[8] For details, see Federal Reserve Bank of New York: Corridors and Floors In Monetary Policy, April 4, 2012.
[9] Reuters: Fed's Powell Says More US Regulation Is Not Always The Answer, October 5, 2017.
[10] US Federal Reserve: Testimony By Governor Powell On The Relationship Between Regulation & Economic Growth, June 22, 2017.
[11] American Banker: Fed's Powell Says US Bank Capital Is "About Right", October 3, 2017.

We have some idea from Mr. Powell's speeches how he views current conditions in the US. If we saw a sharp spike in inflation or if the US economy went into a downturn, however, it is less clear how he might be inclined to react. Mr. Powell voted for QE3 (quantitative easing) even though he was not in favor of it.[13] That said, I think there will likely be very little room to cut rates the next time the US goes into recession, and so QE may be the only dry powder left for the Fed to employ.

While Mr. Powell's background in business and at the US Treasury means we have less of a sense of his thinking and priorities, this needn't be a negative. A lot of the relationships we have relied on in economics are breaking down given that we have an oversupply rather than scarcity of labor, capital and goods. It could therefore be a real asset to have someone with an untraditional, non-academic perspective leading the central bank to think about these economic relationships differently.



[12] US Federal Reserve: Speech – Central Clearing And Liquidity, June 23, 2017.
[13] Federal Reserve: Press Release, September 13, 2012.