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Powell's Federal Reserve

With the appointment of Jerome Powell as the next Fed's chairman, President Trump break a tradition of bipartisan re-nomination and chooses someone who is not an economy by formation. Silvia Merler reviews economist's opinions on this choice and the challenges ahead

Kenneth Rogoff argues that with the appointment of Jerome Powell as the next Fed Chair, Donald Trump has made perhaps the most important single decision of his presidency. It is a sane and sober choice that heralds short-term continuity in Fed interest-rate policy, and perhaps a simpler and cleaner approach to regulatory policy. Powell will face some extraordinary challenges at the outset of his five-year term. By some measures, stock markets look even frothier today than they did in the 1920s and with today's extraordinarily low interest rates, investors seem ever more willing to assume greater risk in search of return.

At the same time, despite a strongly growing US and global economy, inflation remains low, which has made it difficult for the Fed to normalize policy interest rates so that it has room to cut them when the next recession hits, which it inevitably will. Rogoff identifies three areas that will be important for the Fed going forward. First, given that monetary policy is the first and best line of defence against a recession, an urgent task for the new chair is to develop a better approach. Second, bank regulation is also part of the Fed's mandate, and the costs of compliance with Dodd-Frank financial-reform legislation will be an important topic. Third, the threat to the Fed's independence posed by a president seemingly intent on challenging all institutional norms.

Joseph Stiglitz wonders whether Trump has captured the Fed. President Trump chose a non-economist a time when the Fed will face great challenges, as it reverts to more normal policies. Higher interest rates could give rise to market turmoil, as asset prices undergo a significant 'correction', and many are expecting a major downturn in the next five years. While the Fed's tool kit has been greatly expanded in the last decade, the Fed's low interest rates and huge balance sheet – and the possibly massive increase in debt, should Trump get his tax cuts – would challenge even the best-trained economist.

Most importantly, there has been a bipartisan (and global) effort to depoliticize monetary policy. Even in the absence of direct politicization, the Fed always faces a problem of 'cognitive capture' by Wall Street. That's what hap-

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pened when Alan Greenspan and Ben Bernanke were in charge and the consequences were the greatest crisis in three quarters of a century, mitigated only by massive government intervention. The Trump administration seems to have forgotten what happened less than a decade ago, or it would be difficult to explain its efforts to rescind the 2010 Dodd-Frank regulatory reforms, designed to prevent a recurrence. Fortunately, it appears that Powell recognizes the importance of well-designed financial regulations.

Scott Summer writes on the *Washington Post* that there are a few reasons to be concerned about this appointment. The past four Fed chairs have all been economists, with a deep understanding of monetary policy. Putting a lawyer in charge of the Fed is roughly analogous to naming an economist to be chief justice of the Supreme Court. First, there's much more to monetary policy than adjusting interest rates, which is why we should want a highly qualified

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specialist to lead the central bank. Even many economists can get confused by the connection between interest rates and monetary policy, but the problem is even more severe among non-economists.

The last non-economist to serve as Fed chair was G William Miller. Interestingly, his problems were quite similar to what experienced during the financial crisis, but in the opposite direction. Miller thought that to fight the high inflation of the time it was enough to keep interest rates high, but rates were high because of inflation. Another concern is that Powell believes the Fed should focus not just on macroeconomic stability, but should also try to prevent financial market excesses. Many economists are sceptical of this view — for good reason. In 1929, the Fed tightened policy to try to stop a stock market bubble, tipping the economy into the Great Depression. In the long run, a stable macroeconomic environment is most conducive to a stable financial system. Financial excesses are better addressed through regulation, not the blunt instrument of monetary policy.

Tim Duy writes on *Bloomberg* that the next Fed Chair will contend with a slow-growth economy. The recent pace of growth exceeds the Fed's estimated longer-run pace of 1.8 percent. Given that the Fed believes the economy is operating at or somewhat beyond full employment, a sustained 3 percent pace would stretch capacity too far and generate excessive inflationary pressures. To counter these forces, the Fed anticipates continue tightening of policy, on the order of 100 basis points between now and the end of next year.

The next Fed chair will need to deftly handle the transition to a slower-growth economy. One big challenge will be gauging the pace of any slowdown. During the early stages of an expansion, the picture told by most economic data is usually one of stronger growth. As the expansion matures and slows, however, the data become more muddle and this shift could be misinterpreted as a recessionary signal. At the same time, the transition to slower growth could leave the economy more vulnerable to negative shocks and actual recession, making it all the more important that the Fed is able to switch from tightening to easing should the need arise.

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Moreover, the Fed may face a different challenge. It may be that companies operating near capacity take the plunge and expand their operations, boosting growth. Alternatively, Congress may manage to agree on a substantial tax cut, supporting consumer spending. Or, with the economy already operating above full employment, more inflationary pressures exist than currently evident. These circumstances might require a more aggressive pace of rate hikes. And then there is the possibility of an acceleration of productivity growth, which, in turn, would boost the Fed's estimate of the longer-run growth rate and could place policy makers in a tricky position because, in the near term, it might argue for a slow pace of rate increases, but over the longer run we would expect faster productivity growth to push the neutral rate higher.

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Glenn Hubbard writes on the *FT* that the appointment of Powell is just the start. The Trump administration's ability to make a number of key Fed appointments brings an opportunity — and the responsibility — to ask far-reaching questions about the central bank's mission. Under Paul Volcker, the Fed grappled with how to tame destructive inflation. During the tenure of his successor, Alan Greenspan, it asked how fast the economy could grow without igniting inflation. The central bank led by Ben Bernanke explored how to stem the economic effects of financial instability.

Under Janet Yellen, the Fed still struggles with how to exit ultra-loose monetary policy as the economy expands at a rate consistent with many estimates of potential gross domestic product growth and full employment. The Federal Reserve board shaped by Trump and Powell now faces three big questions about what a 'normal' monetary policy looks like in today's economic environment, what the scope of the Fed's role in financial regulation should be, and how it can safeguard the independence of monetary policy in a hostile political climate.

Tho Bishop at *Mises Wire* argues that with the nomination of Powell the 'swamp wins again'. Donald Trump gets what he wanted, a 'low interest rate person' who also happens to be a 'Republican.' Bishop believes that Powell's

nomination serves as a particularly useful illustration of how little has changed in Washington since the Bush Administration. The administration has signaled that its plans to form a policy consensus with its remaining Fed choices – as opposed to opening FOMC meetings into some truly spirited debate.

Going forward, it will be interesting to see how Republicans in the House and Senate proceed. For years now, House Financial Services Committee Chairman Jeb Hensarling has been pushing Fed reform which would have included requiring the Fed to adopt rule-based monetary policy. While this would have complemented the nomination of John Taylor or Kevin Warsh, Powell has made it clear that he opposes such limits being placed on the Fed. Going forward, we should expect to see the Fed continue slow normalization of its balance sheet.

Whether the Fed continues with its projected interest rate hike in December may itself depend on Congress. The legislature's knack for kicking the budgetary can down the road as led to yet another 'fiscal cliff' scenario at the end of the year. While we can be ensured that outcome will be more spending (and more debt), the bout of yet another round of arbitrary drama may give the Fed enough of an excuse to follow their lead and hold off until 2018. ■

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This article was originally published on Bruegel

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