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The Fed in the changing room

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- President Trump will soon nominate new members to the Board of Governors of the Federal Reserve and the Federal Open Market Committee. The new nomination could lead to a change in the Fed's approach to monetary policy.
- Consistency and predictability are not the strengths of this US president. Hence, his appointments may well induce some market volatility.

The US Federal Reserve is in a changing room. Three out of seven positions on its Board of Governors are vacant. Moreover, the term of Janet Yellen chairing the Board and thus the Federal Open Market Committee (FOMC) expires on January 31, 2018. President Donald Trump could grasp the opportunity to shape the US monetary policy in the foreseeable future and nominate candidates – both for the Board of Governors and among them for the FOMC-chair – who best suit his policy preferences.

There are some uncertainties in the process. Most importantly, it is difficult to figure out which exact policy priorities would drive the president's choice. Whereas he has already revealed his preference for deregulation through the recent nomination of Randal Quarles for vice-chair of supervision, his view on monetary policy is less clear. His loud critique of the Fed over low interest rates during the campaign has not been heard since. The president has even turned to "like low rates".[1] This leaves a good chance for a candidate promising a continuation of the cautious monetary policy course under Janet Yellen. But other options remain on the cards.

How might the FOMC change in 2018?

The FOMC consists of twelve members: seven members of the Board of Governors of the Federal Reserve System; the president of the Federal Reserve Bank of New York; and four of the remaining eleven Reserve Bank presidents, who serve one-year terms on a rotating basis.[2]

[1] See Donald Trump's interview with The Wall Street Journal on April 12, 2017.
[2] For more details on the FOMC and its rotating principle see Gehringer, Agnieszka „The Fed between doves and hawks", Flossbach von Storch Economic Policy Note 12/6/2015.

Table 1. FOMC and alternate members with their positions and monetary policy views during 2017

		Fed member	Position	Views on monetary policy[a]
FOMC members voting 2017	Fed Board of Governors	Janet Yellen	Chair, permanent voter	Dove/neutral
		Jerome Powell	Governor, permanent voter	Neutral
		Lael Brainard	Governor, permanent voter	Dove/neutral
		Stanley Fischer	Governor, permanent voter	Neutral/dove
	Regional Reserve Bank Presidents	William Dudley	New York, FOMC Vice Chair, permanent voter	Dove/neutral
		Charles L. Evans	Chicago, alternating voter	Dove/neutral
		Patrick Harker	Philadelphia, alternating voter	Hawk
		Robert S. Kaplan	Dallas, alternating voter	Neutral
		Neel Kashkari	Minneapolis, alternating voter	Dove
Alternate FOMC members, voting 2018		Raphael Bostic	Atlanta, alternating voter	Dove/neutral
		Loretta J. Mester	Cleveland, alternating voter	Hawk
		Mark L. Mullinix*	Richmond, alternating voter	Newcomer (?)
		Michael Strine**	New York, alternating voter	Orthodox
		John C. Williams	San Francisco, alternating voter	Neutral/dove

[a] The views tend to evolve over time. While in 2016 Yellen, Brainard, Dudley and Evans were clearly dovish, they are now more inclined towards interest rate hikes and thus more neutral in their views.

* Mullinix is an interim appointment for the president of the Reserve Bank of Richmond – uncertain whether he will actually remain. As a newcomer it is unclear which exact views he represents.

**Alternate for the President of the Federal Reserve Bank of New York, who is a permanent FOMC-voter.

Source: US Federal Reserve System, Own elaboration Flossbach von Storch Research Institute based on Gehringer, Agnieszka „The Fed between doves and hawks“, Flossbach von Storch Economic Policy Note 12/6/2015.

The FOMC is at present a mix of different views with a bias towards "dovishness" (Table 1). But the members of the Committee can all together be put under the roof of discretionary New Keynesianism. This means that differences of views might influence the speed of the monetary policy implementation – with "hawks and "doves" being respectively more or less prone to tighten the policy stance. But the overall frame of monetary policy consists to a large extent of an assessment of labor market and inflation data on the basis of the New Keynesian theory. With this, the Fed was able to raise interest rates gradually four times since December 2015 – with another hike expected in December – and it gently prepared market participants for a gradual reduction of its balance sheet.

The market's current understanding of Fed policy could soon be shaken for at least three reasons. First, Janet Yellen's term as Fed (and thus FOMC) chair expires on January 31, 2018. Second, there are three positions on the Board of Governors vacant which need to be filled through nomination by the president and subsequent vote by the Congress. And third, as previously explained, the views of president Trump on monetary policy and hence his choice of candidates are unpredictable.

Table 2 shows the possible FOMC composition in 2018. For each member it reports his/her

Table 2. Possible FOMC and alternate members with their positions, as well as expected monetary policy and financial regulation views

		Fed member	Position	Views on monetary policy	Views on financial regulation
FOMC members voting 2018	Fed Board of Governors	Janet Yellen	Potential chair, permanent voter	Discretionary	Regulate
		Jerome Powell	Potential chair, permanent voter	Discretionary	Regulate
		Randal Quarles	Potential chair, permanent voter	Rule-based	De-regulate
		Lael Brainard	Governor, permanent voter	Discretionary	Regulate
		To be potentially filled	*Potential chair, permanent voter*	?	?
		To be potentially filled	*Potential chair, permanent voter*	?	?
		To be potentially filled	*Potential chair, permanent voter*	?	?
	Regional Reserve Bank Presidents	William Dudley	New York, FOMC Vice Chair, permanent voter	Discretionary	Regulate
		Loretta Mester	Cleveland, alternating voter	Discretionary	Regulate
		Mark Mullinix*	Richmond, alternating voter	?	?
		Raphael Bostic	Atlanta, alternating voter	Discretionary	Regulate
		John Williams	San Francisco, alternating voter	Discretionary	Regulate
Alternate FOMC members, voting 2019		Michael Strine**	First Vice President, New York, alternating voter	?	?
		Charles L. Evans	Chicago, alternating voter	Discretionary	Regulate
		Eric Rosengren	Boston, alternating voter	Discretionary	Regulate
		James Bullard	St. Louis, alternating voter	Discretionary	Regulate
		Esther George	Kansas City, alternating voter	Discretionary	Regulate

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**Alternate for the President of the Federal Reserve Bank of New York, who is a permanent FOMC-voter.

Source: US Federal Reserve System, Own elaboration Flossbach von Storch Research Institute.

monetary policy and financial regulation biases. Regarding the former, we depart from the standard hawk vs. dove classification. It makes more sense here to assess the possible balance between the currently dominating New Keynesianism mainstream with a preference for discretionary policies, and the newly emerging orientations. Among the latter, the preference for a rule-based monetary policy approach is the most likely to be represented in the new FOMC. At present, with the exception of the newly elected governor Randal Quarles, all the current Governors and all but one Reserve Bank presidents can be classified discretionary New Keynesians as none of them has taken issue with the current monetary policy approach.

What is known about the new governor, Randal Quarles, is that he prefers a more rule-based approach to the current discretionary Fed policy. He also wants to deregulate the US banking system. However, while it is probable that he will continue to plead for a deregulated financial system, he might be willing to compromise on the monetary policy approach.

Who else might be nominated for the Board? Based on the past records of meetings with president Trump and announcements of his staff, there is a short-list of candidates from which decisions will be taken in the near future.

Three names seem to be the frontrunners:[3]

1) Kevin Warsh – served on the Fed Board under Ben Bernanke up to 2011. He was firmly critical over quantitative easing, which in his view would lead to inflation. He has also called for reforms at the Fed, including, among others, the abandonment of the heavy data-dependency of policy and forward guidance for market participants. He favors a stronger focus on financial developments and a lower inflation target of around 1-2 per cent. This places him on a more rule-based end for policy, with no attachment to a particular economic theory.

2) Gary Cohn – is a former Goldman Sachs president and currently serving as the director of the National Economic Council and chief economic advisor to president Trump. As an investment banker he has an extensive market experience, but no relevant monetary policy experience. Not much is known about his monetary policy views. But given his business background, he may well align with the discretionary approach so far followed by the Fed. However, his recent disapproval of president Trump's assessment of the events in Charlottesville could have diminished his chances to be nominated.

3) Marvin Goodfriend – is a mainstream macroeconomist and a supporter of the real business cycle theory. As such, he focusses less on labor market developments and advocates instead more emphasis on inflation targeting, with an inflation goal set by the Congress instead of the Fed. He prefers the Fed to rely on interest rates as a policy instrument and less on security purchases.

All three are also potential candidates to chair the FOMC. Janet Yellen and Jerome Powell have also been mentioned as chairs.

What to expect from US monetary policy in 2018

Depending on Trump's picks, three outcomes can be imagined:

Case 1: Janet Yellen or Jerome Powell elected to become the next Fed chair. Given the past experience, this would imply a high probability for the continuation of the current policy stance. Consequently, this would be the least revolutionary outcome from the viewpoint of market participants.

Case 2: Gary Cohn elected to chair the Fed. His business background could be taken to expect the continuation of the discretionary and pragmatic policy conduct of the recent past. However, since he is relatively unknown to market participants, there is potential for surprises.

Case 3: Marvin Goodfriend, Randal Quarles, Kevin Warsh or still another yet unknown newcomer elected as the new Fed chair. Given their – for the time being – non-mainstream monetary policy views, surprise potential is quite high here.

[3] This list is by no means exhaustive. Among other noteworthy names is Stanford Professor John Taylor who is a strong advocate of a rule-based monetary policy conduct. According to his own rule, the Fed would be far behind the curve at present. However, his model has been fiercely criticized in the past for being too simplistic and backward looking. As the chance is high that Taylor would pledge for the introduction of his monetary policy rule, it is doubtful whether Taylor would be able to find the necessary consensus to conduct the Fed.

President Trump is expected to announce his picks for the Fed's Board of Governors and for the next Fed chair within a few weeks. So far, Trump has preferred people with business experience over those with public sector or academic experience for important positions. But consistency and predictability are not the strengths of this US President. Hence, his appointments may well induce some market volatility.

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