

ECONOMIC VIEWPOINT



Who Will be the Next Chair of the Federal Reserve?

The current term of Janet Yellen at the head of the Federal Reserve (Fed) will end in early 2018. It is up to Donald Trump to decide whether to ask her to remain for a second term or to choose a successor. In this case, there are several options, and a few names are often mentioned, notably that of Jerome Powell, a Governor of the Fed since 2012, and that of Kevin Warsh, a former Fed Governor (from 2006 to 2011) and John B. Taylor, a professor at Stanford University. President Trump's choice may have a significant impact on the future direction of monetary policy in the United States, just as the Fed is facing several challenges.

Janet Yellen's Term Ends

Appointed by President Obama to succeed Ben Bernanke, Janet Yellen became Chair of the Fed on February 3, 2014. Her four-year term was marked by the start of the normalization of monetary policy, which had barely begun under Bernanke in the fall of 2014, with the tapering of the bond-buying policy. It was under her leadership that the Fed began to increase interest rates, with the first hike in December 2015. The Fed subsequently implemented three more increases of 25 basis points each. The current term also ends just as the process to normalize the balance sheet is beginning; the Fed decided last September to no longer completely reinvest the bonds on its balance sheet as they mature.

Janet Yellen's term as Chair of the Fed ends on February 3, 2018. There is no limit to the number of terms that a Chair may carry out¹. For example, Alan Greenspan chaired the Fed between 1987 and 2006. Fed chairs are often reappointed for more than one four-year term. Since World War II, only Thomas B. McCabe (1948–1951) and William Miller (1978–1979) did not serve at least two terms. Miller left the Fed to be appointed Secretary of the Treasury.

Therefore, it is possible that Donald Trump will reconfirm Janet Yellen as chair of the Fed. However, past criticisms by

Donald Trump during the 2016 election campaign, and the fact—revealed by Janet Yellen during a press conference held on September 20, 2017, that she had not met with the President for some time—suggest that her time at the helm of the Fed may be coming to an end. However, the announcement that she will meet with President Trump has recently changed the situation.

The Process

Similar to a member of cabinet, a Supreme Court justice or an ambassador, Federal Reserve Board members are appointed by the President of the United States. This appointment must also be confirmed by the Senate. The confirmation process can be fairly quick if there is consensus regarding the candidate. It can also be long and complicated in the event influential senators block the appointment for partisan or ideological reasons. Candidates for the Fed must be approved by the Senate Banking Committee, followed by the Senate as a whole. Some gubernatorial appointments have already been blocked by the Committee or the Senate.

In 2006, Ben Bernanke was appointed by President Bush on October 24, and the Senate confirmed his appointment on January 31 (a day before he was to take office). In the case of Janet Yellen, the process began on October 9, 2013, and ended on December 20.

The fact that the Senate majority and the President share the same political affiliation is expected to make the confirmation process easier. Nonetheless, the current political climate in Washington casts some doubt on this. In addition, a kind of "waiting list" still exists for appointments by the Trump administration to be confirmed. Several appointments to

¹ However, there is a limit to the term of a Fed Governor, namely 14 years with no possibility of renewal. Note that someone who takes office after a term has begun and completes it can be reappointed for an entire 14-year term. Alan Greenspan completed a partial term as governor from 1987 to 1992 and a full term from 1992 to 2006. He was chair of the Fed during this entire time period.

key positions within important departments have not been confirmed. The chairmanship of the Fed is, without a doubt, a priority, but risks remain.

Donald Trump vs. the Fed

While a candidate, Donald Trump sometimes was a fervent critic of the Fed's monetary policy. During the debate televised on September 26, 2016, he said, "We have a Fed that's doing political things—this Janet Yellen of the Fed—by maintaining interest rates at this level," thus suggesting that the monetary policy is mostly trying to ensure President Obama's term ends well, while also favouring the election of Hillary Clinton. This accusation of partisanship against the Fed recalls an earlier charge made in November 2015. During a press conference at that time, Trump stated that "Janet Yellen should have raised the rates. She is not doing it because the Obama administration and the President don't want her to."

Nonetheless, during the campaign, this time in May 2016, he claimed, with respect to the Fed Chair: "I have nothing against Janet Yellen whatsoever. I think she's doing her job. I don't know her. She's a very capable person. People that I know have a high regard for her. But she's not a Republican."

The prudent policy to gradually normalize interest rates appears, however, to be gaining favour with President Trump. According to the Wall Street Journal, during the initial weeks of his term, President Trump is alleged to have said to Janet Yellen that he thought she was a "low-interest rate" person like him. In April 2017, he indicated in an interview that he does "like a low-interest rate policy, I must be honest with you."

Therefore, in terms of monetary policy, Donald Trump seems to be more of a "dove." This is in contrast to a number of Republican politicians who strongly criticized the unconventional policy put in place by Ben Bernanke. Donald Trump's line of thinking could significantly influence his choice for the next Chair of the Fed.

Main Candidates

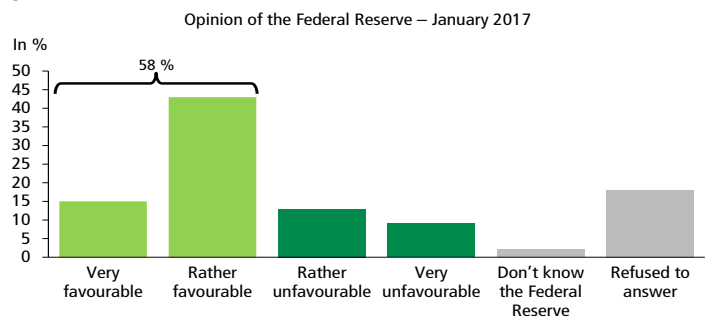
The names of several candidates have been circulating over the last few months for the chairmanship of the Fed. The following people have been mentioned the most often up until now:

Janet Yellen

Regarded as a low-interest rate person by Donald Trump, Janet Yellen could easily continue to be in charge of U.S. monetary policy. If she wants to, of course. Her career is closely linked to the Fed. With a PhD in Economics and a professorship at the University of California at Berkeley, she was a Governor of the Fed from 1994 to 1997, President of the Federal Reserve Bank of San Francisco from 2004 to 2010, and Vice Chair of the Fed from 2010 until her appointment as Chair of the institution in 2014. Under Clinton, she was Chair of the Council of Economic Advisers from 1997 to 1999.

Notwithstanding Trump's occasional criticisms while he was a candidate, Janet Yellen's reign at the Fed has been viewed positively. She began normalizing monetary policy after the extraordinary measures implemented both during and after the financial crisis. In a public opinion poll conducted in January 2017, 58% of the respondents had a fairly favourable or very favourable opinion of the Fed, versus 22% who had a fairly unfavourable or very unfavourable opinion (graph 1).

GRAPH 1
Public opinion with respect to the Federal Reserve is fairly positive



Sources: Pew Research and Desjardins, Economic Studies

In the context of the current political situation in the United States, the main arguments against a new term for Janet Yellen are that she was initially appointed by Barack Obama and that she is not a Republican. Historically, the White House has often reappointed Fed Chairs appointed by a different administration, and even by political opponents. Reagan reappointed Paul Volcker (a Carter appointee), Clinton did the same with Greenspan (a Reagan appointee), and Obama reappointed Bernanke (a Bush appointee).

Kevin Warsh

Appointed by George W. Bush, Kevin Warsh became a Governor of the Fed in February 2006. Thirty-five years old at the time, he was the youngest governor in the history of the Fed. His appointment was criticized because of his lack of experience. Prior to that, he was executive director in the mergers and acquisitions department at Morgan Stanley (1995–2002), and a White House adviser (2002–2006). During his term as Governor, Kevin Warsh was critical of many of the Fed's decisions, but never openly voted against them. In 2008, he was more concerned about inflationary risks than the deterioration of the economy that was already evident. In 2009, he argued in favour of withdrawing some of the measures the Fed had implemented in response to the crisis. At the end of 2010, he opposed the implementation of a second bond-buying program (he did, however, vote in favour of it). He resigned as Governor in March 2011.

In light of his time at the Fed, Kevin Warsh would probably be a "hawkish" candidate, especially when compared to

Janet Yellen. In this context, even Donald Trump may find that he may be too quick to raise rates or reduce the balance sheet. There are nonetheless arguments in his favour. His loyalty to the Republican party is undeniable. He often served as a link between Bernanke's Fed and the Republican members of Congress during the financial crisis. He advised Trump during his election campaign, and he sat on various economic committees (now dissolved) set up at the beginning of Trump's term. Given that personal connections seem to be especially important under the current administration, it should be noted that Kevin Warsh's father-in-law is a long-time personal friend of the President.

Jerome Powell

Appointed by Barack Obama, Jerome Powell has been a Governor of the Fed since May 2012. A Republican, Powell's appointment was due to President Obama selecting both Powell and Jeremy Stein, a more palatable candidate for the Democrats, in order to remove Republican opposition. After taking office to fill an unexpired term, he was reappointed in 2014, and his current term as Governor will end in 2028. Trained as a lawyer, he worked in the banking sector and as Under Secretary of the Treasury in the George H. W. Bush administration. Next, he worked at think tanks and consulting firms, as well as at investment firms.

His interests while at the Fed seemed to focus more on the way the financial system works, on regulation, and on capital flows. It is difficult to discern any ideological tendency between "dove" and "hawk." He always voted with Chairs Bernanke and Yellen, as Governors generally do.

Gary Cohn

Director of the National Economic Council for the Trump administration and close adviser to the President, Gary Cohn was mentioned for the first time as a possible Fed Chair in the spring. Before joining the Trump team, he was one of the highest-ranking executive officers at Goldman Sachs. Along with Treasury Secretary Gary Mnuchin, he guided the tax reform file for the White House. However, his chances of being promoted to Janet Yellen's job dimmed during the summer when he distanced himself from some of Donald Trump's contentious statements.

John B. Taylor

John B. Taylor's name is put forward for Governor or Chair of the Fed each time a Republican occupies the Oval Office. A professor at Stanford University in California, he is a leading authority in academic circles focused on monetary policy. He proposed the Taylor rule, which stipulates a key-rate target based on the difference between the GDP and its potential on the one hand, and the difference between inflation and its target on the other. He often criticized the way the Fed's monetary policy was being managed whether under Greenspan, Bernanke, or Yellen. A Republican, John B. Taylor worked on the Council of Economic Advisers under the administrations of Ford, Carter, and

Bush senior. He was also Under Secretary of the Treasury for International Affairs under George W. Bush.

Taylor would contrast with the Fed's current policy. The Fed allows the monetary policy committee significant room to manoeuvre when it comes to deciding if the key interest rates are appropriate. Taylor's more dogmatic approach would, without a doubt, be less flexible. Apart from times of crisis, when a drop in inflation or output calls for very low rates, the policy risks being less accommodating, in general.

Other

Neel Kashkari's potential as a candidate for Chair of the Fed is seen more favourably by market stakeholders than the White House. President of the Federal Reserve Bank of Minneapolis since November 2015, Kashkari previously worked at Goldman Sachs, then at the Treasury department (2006-2009). In 2014, he ran as the Republican candidate in the election for Governor of California.

The names of other Republican figures or economists are sometimes mentioned as potential candidates to run the Fed. For example, there is Glenn Hubbard, a professor at Columbia who was Bernanke's predecessor as Chair of the Council of Economic Advisers under George W. Bush. Gregory Mankiw of Harvard University, another economic adviser under Bush, is also a possible candidate. Former Republican Governors of the Fed or former regional Fed Presidents are also occasionally mentioned as potential successors to Janet Yellen.

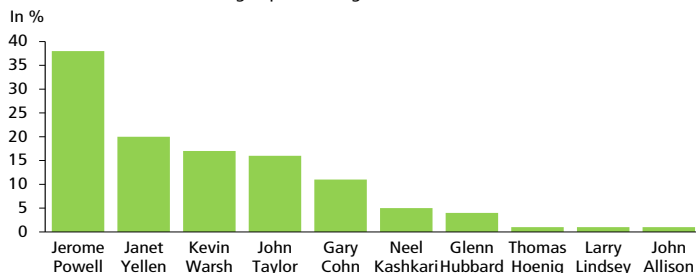
Speculation as to Who Donald Trump Will Choose and Their Chances

Who will Donald Trump choose? The wait continues and, for the moment, one can only speculate as to whom the President will select. There is, however, a market based on the chances of certain individuals becoming Chair of the Fed. The price of each candidate reflects their chances as perceived by those participating in this market. These prices change based on the rumours, events, and statements that can affect this "race" for chairmanship of the Fed. Graph 2 (on page 4) shows the chances on October 17, while graph 3 (on page 4) shows how the chances of the main candidates have changed since July. It is clear that, as soon as it was known at the end of September that Trump had met with Warsh, his chances increased, just as in the case of Powell, Taylor and now Yellen when it was their turn. Gary Cohn's drop in popularity can be explained by the unease felt with respect to Trump following the events in Charlottesville.

Surveys also show where the chances of some candidates lie. Between October 6 and 11, Bloomberg surveyed the opinions of the participants in its monthly consensus on the U.S. economy. The results are shown in graph 4 (on page 4). In this case, Kevin Warsh appears to have the greatest chance of becoming the Chair of the Fed.

**GRAPH 2
Powell, Yellen and Warsh lead**

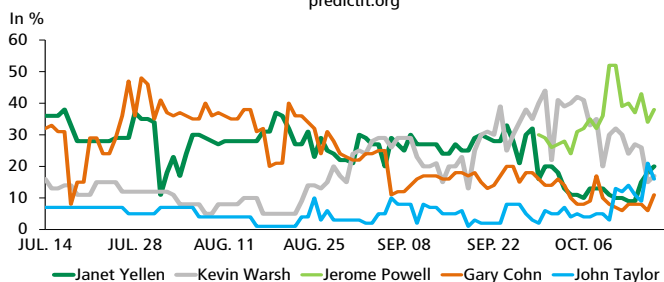
The chances of the candidates in the running for the position of chair of the Federal Reserve according to predictit.org as at October 17, 2017



Sources: predictit.org and Desjardins, Economic Studies

**GRAPH 3
The most recent rumours favoured Powell, Yellen and Taylor**

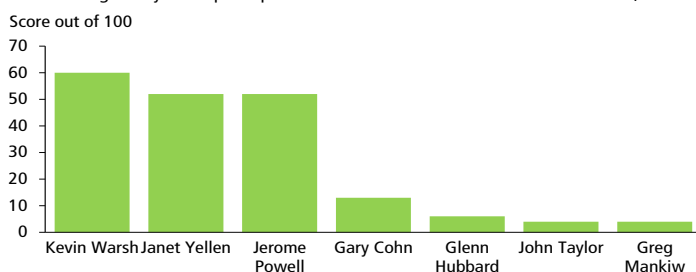
The chances of the candidates for the position of chair of the Federal Reserve according to predictit.org



Sources: predictit.org and Desjardins, Economic Studies

**GRAPH 4
According to a Bloomberg survey, Warsh would be in the lead, followed by Yellen and Powell**

Ranking of the candidates for the position of chair of the Federal Reserve according to a Bloomberg survey of the participants in the economic consensus as at October 12, 2017



Sources: Bloomberg and Desjardins, Economic Studies

These expectations are subject to change as we get closer to an actual decision by Donald Trump. On October 12, the Secretary of the Treasury, Steven Mnuchin, said in an interview that the President had no specific deadline in mind, but that a decision is expected this month. For his part, John Kelly, White House Chief of Staff, explained, on the same day, that the process was ongoing and that a decision is "some time away."

The Challenges Facing the New Chair of the Fed

Regardless of who it is, the next Chair of the Fed will face several challenges. How successful he or she is at the head of the institution, and the possibility of a second term in four years, will depend on their ability to overcome them. The health of the U.S. and the global economies are also at stake. The major challenges include:

The Normalization of Monetary Policy

After stagnating at a floor of only 0.25% for seven years, the Fed's key rates are now on an upward trajectory. There have already been four increases, and another one is widely anticipated in December. Currently sitting at 1.25%, the rates are still far from a long-term, "normal" level that the Fed itself feels will be around 2.75%. Therefore, the process to normalize the key rates is far from over, and the path to get there, as well as the pace of the next increases, may largely depend on the direction indicated by the next Chair of the Fed.

Since the last financial crisis, monetary policy has become much more than a question of interest rates. The Fed has also played with its balance sheet, inflating it by buying federal bonds and mortgage agency bonds. Its outstanding assets increased by US\$4,000B. The Fed has now started to deflate its balance sheet very gradually by ceasing, in part, to reinvest bonds that have matured. Under a new Chair, the Fed may change its strategy and accelerate the downsizing.

Communications

During the waning years of the Bernanke era, and under the aegis of Janet Yellen, the Fed undertook to reform its communications. Since then, the Fed established an official inflation target, began publishing the leaders' economic and key interest rate forecasts every quarter, and implemented quarterly press conferences. The next Chair is expected to have to weigh the pros and cons of this strategy.

Regulations

During the financial crisis, the Fed was the target of numerous attacks on its role in regulating the financial system. The financial regulation act adopted in 2010 under Obama gave it new powers. Nonetheless, it seems that seven years later, some points remain to be decided. In addition, President Trump and those around him seem to want to review this regulation. This could become a hot topic once again.

The Next Recession

The recovery of the U.S. economy after the financial crisis has often been described as slow and modest. However, it is starting to drag on. The last trough was back in June 2009, so the cycle will soon be 10 years old. Therefore, a new slowdown, even contraction, is expected to occur at some point. The reaction of the Fed and the handling of monetary policy during a possible recession will probably be the main issues on which the next Chair of the Fed will be judged.

It's Up to Donald Trump to Choose

Like a Supreme Court justice, choosing the Chair of the Fed is an important issue for the White House. It does not happen often, and once in office, the Chair of the Fed is practically entrenched. Moreover, a poor choice can have very serious consequences for the economy and the financial markets, two factors that also help to judge the success of a presidential administration.

After Greenspan, the choice of Bernanke and Yellen was fairly calm, as both embodied a kind of continuity with their predecessor. If the objective of minimizing uncertainty were a requirement, the choice of Yellen (or Powell to a lesser extent) could be called for. More “hawkish” and critical opinions regarding past actions of the Fed that Kevin Warsh or John B. Taylor may favour would lead to greater differences and perhaps greater market turbulence, at least in the short term. It is now up to Donald Trump to decide whom he wants to hire for this crucial job for the U.S. and global economies.

Francis Généreux, Senior Economist