After Charlottesville, Fed chair race wide open

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Current Federal Reserve Chair Janet Yellen's term expires in February 2018. President Trump attacked Chair Yellen vigorously during the presidential campaign, then praised her after his election and now seems to be considering alternative candidates.

For her part, Yellen gave a vigorous defense of both the Fed's monetary policy and the efforts to strengthen financial regulation at her speech in Jackson Hole, Wyoming, last month.

Her remarks about financial regulation underline her opposition to Republican proposals circulating in Congress to water down the Dodd-Frank financial reform bill, proposals that appear to have support from the White House as well, plus or minus some details.

So will the president nominate Yellen for another term? Every Fed governor, starting with Paul Volcker (1979-1987), has gotten at least two terms.

Presidents of both parties have reappointed Fed chairs nominated by the other party: President Reagan reappointed Paul Volcker, President Clinton reappointed Allan Greenspan, and President Obama reappointed Ben Bernanke. But precedent may not be predictive in this case.

Fed chairs most important and controversial tasks are to shape monetary policy and to manage the Fed's activities in regulating bank holding companies and guarding financial stability. Most likely, the regulatory and financial stability aspects will determine the president's decision.

To start with the monetary policy piece: Yellen inherited a slowly-recovering economy from the previous chairman, Ben Bernanke. Her immediate task was to decide when and how quickly to end the bond-buying programs the Fed had used to help drag the economy out of the hole created by the Great Recession.

Under her leadership, the Fed has moved very cautiously, ending bond-buying and eventually raising the federal funds rate, which dictates the course of most other interest rates in the economy, in very small increments.

The road forward remains foggy, to say the least. With unemployment rates quite low, one would normally expect labor markets to tighten and wages to rise. The Fed, always vigilant about inflation, would then raise interest rates to prevent wage increases from spilling over into broad-based inflation.

However, so far, wage increases have been modest and inflation remains just below the Fed's 2-percent goal. The Fed has signaled a return to more "normal" monetary conditions, raising interest rates and announcing a plan to reduce its bond holdings later this year.

The reduced bond holdings should raise long-term interest rates, making home mortgages and other long-term loans more expensive.

There have been some indications in the media that the White House would like to see interest rates rise faster. This might satisfy some inflation hawks in Congress and the administration, but it would also make it more expensive to finance an expanded federal deficit.

With Congress approving $14 billion dollars for hurricane recovery and with tax cuts under discussion, chances of an increase in the deficit are very good indeed. Will the White House really choose an inflation hawk under these circumstances?

Turning to the financial regulation issues, the situation is clearer. Like most congressional Democrats, Yellen sees the Dodd-Frank Act as strengthening the stability of the financial system, lowering the chances of another crisis and providing more tools to contain the next crisis.

In her Jackson Hole speech, she forcefully rebutted the assertion that regulations have slowed down bank lending and therefore hurt economic growth. Both Congress and the administration have clearly indicated that they see Dodd-Frank as overly restrictive, creating unnecessary costs for financial institutions.

Yellen is an experienced Fed insider and has proven a steady hand at the Fed. It would make a great deal of sense to allow her to complete the task of "normalizing" monetary policy. However, it seems quite possible that President Trump will seek a new Fed chair.

The Wall Street Journal reported that Trump and his advisers have discussed Stanford University economist John Taylor, former BB&T Bank Chief Executive and past Cato Institute President John Allison and former Fed Governors Lawrence Lindsey and Kevin Warsh as possible appointees to the Fed's Board of Governors.

Former Goldman Sachs CEO and National Economic Council head Gary Cohn, once supposedly a front-runner, seems to be out of the running after expressing disagreement with President Trump's handling of the Charlottesville protests.

On monetary policy, Allison, a harsh critic of Fed monetary policy in the past, would represent the most radical change. He has voiced support for a return to the gold standard, a view popular on some parts of the political right.

Taylor, a distinguished academic economist and former President George W. Bush Treasury Department official, is famed for his “rule” for setting interest rates. He strongly criticized the Fed’s actions in 2008, claiming that its massive injections of liquidity were unnecessary.

He also wrote several articles claiming that the 2009 fiscal stimulus was ineffective. He favors greater monetary policy predictability and less active use of the Fed’s power to manage interest rates, popular views on the Republican right.

Lyndsey and Warsh have less clear monetary policy agendas. Lyndsey must be credited for being one of the first officials to spot the stock market euphoria of the late 1990’s, presciently warning about wild price increases that would sooner or later come crashing down.

On regulatory policy, it seems that Allison and Warsh would both strongly support rolling back many aspects of the Dodd-Frank Act. Lyndsey and Taylor, long-time Republicans, probably would also.

In short, other than Yellen, the candidate offering the greatest continuity with recent policy is probably Lyndsey, while Allison would represent the most radical change. Since predicting the actions and moods of the man in the White House is a notoriously thankless task, I will have to leave it at that.