Fed Leader Doubt Erodes Low-Rate Message as QE Taper Looms

By: Craig Torres & Caroline Salas Gage - September 16, 2013

Why Did Larry Summers Quit Fed Chair Race?

Federal Reserve officials will gather in their Washington board room this week to decide on policies that will unfold over the next two to three years without knowing who will lead the institution during that time.

Federal Reserve Board Chairman Ben Bernanke prepares to deliver remarks at the Federal Reserve on September 15, 2011 in Washington, DC. Photographer: Chip Somodevilla/Getty Images

Simon Smith, chief economist at FxPro Group Ltd., discusses candidates for Federal Reserve chairman after Lawrence Summers withdrew. He speaks with Mark Barton on Bloomberg Television's "Countdown." (Source: Bloomberg)

Ric Spooner, chief market analyst at CMC Markets in Sydney, talks about Federal Reserve monetary policy leadership change and its effect on markets, and Reserve Bank of Australia monetary policy He speaks with Zeb Eckert on Bloomberg Television's "First Up." (Source: Bloomberg)

Richard Jerram, chief economist at Bank of Singapore Ltd., talks about the outlook for Asia's financial markets and economies, and the prospects for Federal Reserve chairmanship after the withdrawal of Lawrence Summers. He speaks with Zeb Eckert on Bloomberg Television's "First Up." (Source: Bloomberg)

Chris Rupkey, chief financial economist for Bank of Tokyo-Mitsubishi UFJ Ltd. in New York, talks about Former Treasury Secretary Lawrence Summers's decision to withdraw his name from consideration to be chairman of the Federal Reserve, possible replacements and the implications for the markets. He speaks with Zeb Eckert on Bloomberg Television's "First Up." (Source: Bloomberg)

Allan Meltzer, a professor at Carnegie Mellon University's Tepper School of Business, talks about the challenges facing the next Federal Reserve chairman and U.S. inflation risk. Meltzer speaks with Tom Keene and Sara Eisen on Bloomberg Television's "Surveillance." (Source: Bloomberg)

The Marriner S. Eccles Federal Reserve building stands in Washington, D.C. Photographer: Andrew Harrer/Bloomberg

Lawrence Summers, who served as Treasury Secretary under President Bill Clinton and was Obama's top economic adviser in his first term, would have tightened Fed policy more than Yellen, according to a Bloomberg Global Poll last week. Photographer: Jerome Favre/Bloomberg

With Lawrence Summers out of the picture, investors are betting that Federal Reserve vice chairman Janet Yellen, seen here, is now the top contender for the job, according to Brian Jacobsen, chief portfolio strategist at Wells Fargo Advantage Funds in Menomonee Falls, Wisconsin. Photographer: Pete Marovich/Bloomberg

Yesterday's announcement that Lawrence Summers has withdrawn his name from Obama's list of candidates to succeed Fed Chairman Ben S. Bernanke threatens to weaken the central bank's policy message by leaving the succession unsettled just as it considers scaling back record accommodation.

Policy makers will decide at their Sept. 17-18 meeting whether the economy is strong enough to begin tapering $85 billion in monthly bond purchases. As they do so, they will use so-called forward guidance to convince investors they can keep interest rates low for as long as it takes to bring down unemployment so long as prices remain in check.

"The biggest problem with this period of indecision about Bernanke's successor is that it does have an effect on the Fed's ability to conduct monetary policy," said Ward McCarthy, chief financial economist at Jefferies LLC in New York and a former Richmond Fed economist. "The market rightfully questions forward guidance, and that reduces the effectiveness of monetary policy."

At this week's meeting, officials will probably lower their estimates for growth for this year and next for the third consecutive time. To keep bond yields from rising and threatening growth, officials will need to emphasize their message that the benchmark interest rate is likely to remain low.

Yields Jump

Ten-year Treasury yields have jumped almost 1 percentage point since May 21, the day before Bernanke said the central bank could "take a step down in our pace of purchases," in the "next few meetings." The rise in yields in turn has pushed up interest rates on home loans, threatening to sap a housing revival that has helped drive the economic expansion.

In July, Obama mentioned three possible nominees for the chairmanship: Summers, 58, Fed Vice Chairman Janet Yellen, 67, and Donald Kohn, 70, a former Fed vice chairman who is now a senior fellow at the Brookings Institution.

With Summers out of the picture, investors are betting that Yellen is now the top contender for the job, according to Brian Jacobsen, chief portfolio strategist at Wells Fargo Advantage Funds in Menomonee Falls, Wisconsin.

Stocks Rise

The Standard & Poor's 500 Index rose 0.7 percent to 1,700.48 at 9:57 a.m. in New York. The yield on the 10-year Treasury note dropped 10 basis points, or 0.10 percentage point, to 2.79 percent, according to Bloomberg Bond Trader data. The dollar slumped against all of its Group of 10 currency peers.

Summers, who served as Treasury Secretary under President Bill Clinton and was Obama's top economic adviser in his first term, would have tightened Fed policy more than Yellen, according to a Bloomberg Global Poll last week.

"Markets were priced for the likelihood of a Summers nomination, primarily for the notion that he might raise interest rates sooner than perhaps other candidates, including Janet Yellen," Tony Crescenzi, a portfolio manager and strategist at Newport Beach, California-based Pacific Investment Management Co., which manages the world's biggest bond fund, said in an e-mail.

Yellen isn't necessarily the "de facto nominee," said Mark Calabria, a former top aide on the Senate Banking Committee and now director of financial regulation studies at the Cato Institute in Washington.

Senators' Letter

Twenty U.S. senators, including 19 Democrats and one independent, signed a letter of support for Yellen in July. If nominated and confirmed, she'd be the first woman to be chairman of the Fed. Three Democrats on the Senate Banking Committee explicitly opposed Summers.

Montana Senator Jon Tester, a member of the Banking Committee, last week declared opposition to Summers. Senator Jeff Merkley, an Oregon Democrat, said he was "extraordinarily skeptical." Sherrod Brown, an Ohio Democrat who circulated the letter in support of Yellen, said last week that he was a "likely 'No" vote.

"The save-face maneuver is to pick someone like Don Kohn," Calabria said. "To pick Yellen at this point is to basically admit you got rolled. If you pick somebody besides Yellen, the president can claim he doesn't lose. If you're someone like Don Kohn, this kind of ups your chance."

Geithner's Role

Former Treasury Secretary Timothy F. Geithner isn't interested in serving as chairman, according to a person familiar with Geithner's thinking. Geithner has consulted with Obama on whom to nominate.

Allan Meltzer, a professor of political economy at Carnegie Mellon University's Tepper School of Business in Pittsburgh and the author of a history of the central bank, said the frenzy surrounding Summers' possible nomination was unprecedented.

"We've never seen anything like it," he said. "What is missing from the discussion all along is: What are the main challenges that the Fed has to face?"

More than four years after the recession ended, unemployment stood at 7.3 percent in August, and the annual inflation rate has been at least a half percentage point below the Fed's 2 percent target since December.

Policy makers have pledged they won't consider raising the federal funds rate, now near zero, as long as unemployment is 6.5 percent or higher. In July, they discussed lowering that unemployment rate threshold even more before any decision on raising borrowing costs, according to minutes of the meeting.

The Fed's balance sheet has exploded to a record $3.66 trillion as it has bought up hundreds of billions of mortgage-backed securities and U.S. Treasury bonds to try and keep long-term interest rates low.

Asset-Price Bubbles

Policy makers, including Kansas City Fed President Esther George, are concerned the Fed risks creating asset-price bubbles and unmooring inflation expectations.

In June, 15 of 19 Fed officials said it would be appropriate to keep the benchmark lending rate near zero until 2015 or later.

If Yellen were the nominee for chairman, such forward-looking policy statements would have "perfect credibility," said Stephen Oliner, who worked as an economist for more than 25 years at the Fed Board of Governors.

"She is the candidate of continuity," said Oliner, a senior fellow at the UCLA Ziman Center for Real Estate in Los Angeles. If there is no nominee by Sept. 18, when policy makers conclude their meeting, "there will be questions about how much faith to put into the forward guidance" on monetary policy.