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FED FOCUS-U.S. job market politics may tilt Fed to doves

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By Mark Felsenthal

WASHINGTON, Nov 12 (Reuters) - Ugly U.S. unemployment data and Republican Party political momentum could set the stage for a Federal Reserve next year that leans more toward putting workers back on the job rather than scaring off inflation.

President Barack Obama, a Democrat, has two seats yet to fill on the Fed's seven-member board and may also get to name a replacement for Vice Chairman Donald Kohn, whose term expires in June and who has not said whether he wants to stay on.

Fed board members, and the head of the New York Federal Reserve Bank, vote at every policy-setting session. Votes among the other regional Fed bank chiefs rotate on an annual basis.

The annual shift among regional bank presidents in early 2010 does not look likely to alter the balance of power between full-employment favoring doves and anti-inflation hawks.

As a result, the president's picks to the Washington-based board could tip the scales in favor of doves in deliberations over when and how fast to raise interest rates as the United States emerges from recession.

With the U.S. unemployment rate at a 26-1/2 year high of 10.2 percent and likely heading higher, the dismal state of the jobs market could punish the Democrats who control Congress in mid-term elections next November, raising the possibility Obama may want to shape the board with politics in mind.

"I think they're going to go out of their way to get somebody they can have a lot of faith in," said Mark Calabria, a former Senate Banking Committee aide who is now with the free market Cato Institute. "They're going to try to find somebody who's at least a proven dove."

RATE DEBATE EMERGES

The Fed dropped rates to near zero in December, and has pledged to keep them ultra low for an extended period to nurture a recovery. It has also injected more than $1 trillion into financial markets to try to spur economic activity.

This easy-money policy has fueled greater risk-taking, pushing stock markets higher, while undercutting the U.S. dollar and helping lift prices for oil and gold. With the global economy awash in U.S. dollars, some analysts warn asset bubbles are building.

As signs mount that an upturn is taking root, a lively debate has erupted at the Fed over how soon to withdraw the central bank's emergency support for the economy.

Some officials worry money the central bank has pumped into financial markets to counter a paralyzing credit freeze could end up as dry tinder for inflation if the Fed waits too long.

However, the slow recovery has become a political liability for the White House and its fellow Democrats. Obama's advisers may be tempted to find Fed governors who will lobby to hold rates lower for longer.

Democrats lost two state governorships in elections earlier this month in which the ailing job market was a big issue. Both states, New Jersey and Virginia, were in the Obama electoral column in 2008.

"I would think that Obama would take advantage of the opportunity and try to drum up support for the Democrats by trying to encourage a more dovish policy," said Thomas Simons, a money market economist for Jefferies & Co. in New York.

FOMC VOTING SHIFT

The central bank's roster of voters will change no matter what in 2010 as regional Fed bank presidents rotate in and out of ballot-casting slots on the policy-setting Federal Open Market Committee.

While the Fed has historically been a consensus organization that follows the lead of the chairman, all participants in policy meetings have the power to steer debate and influence expectations with their public statements.

To be sure, packing the Fed with overtly ideological political appointees could rattle markets if observers begin to doubt its commitment to hold inflation in check. The White House will no doubt take this into account.

"Whoever you appoint, you want it to be somebody that doesn't have a lack of credibility in the markets," said Jim O'Sullivan, chief economist at MF Global in New York.

Even if the White House were to move swiftly to put forward nominees for the open seats, it could take several more months for them to win the needed Senate confirmation.

With the change in voters next year, the FOMC gains one known outspoken inflation-fighting hawk, Kansas City Federal Reserve Bank President Thomas Hoenig, while losing another, Richmond Fed chief Jeffrey Lacker.

At the other end of the spectrum, the panel adds a voter with a reputation for concern about the fragility of the recovery, Boston Fed President Eric Rosengren. Another like-minded voter, San Francisco's Janet Yellen, relinquishes her ballot.

The committee will add two voters who are likely to fall in the middle of the hawk-dove scale, St. Louis Fed Chairman James Bullard and Sandra Pianalto of the Cleveland Fed. Departing are two other centrists: Atlanta Fed President Dennis Lockhart and Chicago Fed President Charles Evans.