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FED SHADOW

Warsh the Reformer, Powell the Plodder

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We'll know in three weeks. Play it safe, or try to drain the Fed swamp?

A new front-runner has emerged for Fed chair – former Federal Reserve Board governor Kevin Warsh (prediction markets here). And a new contestant has entered the race, one who hadn't been on very many short-lists until now – sitting FRB governor Jerome Powell.

- We have said that the biggest risk facing the economy and the markets is the possibility of a dogmatic perma-hawk replacing Janet Yellen as chair (see "Debt! NoKo! Irma! DACA! Cohn! …and Other 4-letter Words" September 7, 2017).
- *Most pundits are saying Warsh is a perma-hawk, but it's not that simple. More reformer than hawk, his objective is economic growth and his deep belief is that the Fed has become too powerful and too inbred. He would be a change-agent. Powell, on the other hand, is very much in the mainstream of the received wisdom of central banking. He would perpetuate the status quo.*

We'll look at them both in detail in a moment. But first, what do we know so far about the state of the race? Early Friday, it was reported Warsh had met with Trump and Treasury Secretary Steven Mnuchin, then as the day went on those reports were amended to include a purported meeting for Powell, too. Late Friday Trump himself told reporters, "I've had four meetings for Fed Chairman and I'll be making a decision over the next two or three weeks." That got spun up into stories claiming that he'd met with Warsh, Powell, National Economics Council Director Gary Cohn, and Yellen.

- Yellen had been our call for front-runner (see "Yellen Gives Conservatives Something to Cheer" February 17, 2017). *But we think she probably deliberately disqualified herself by standing against Trump's agenda with her pro-regulation speech at Jackson Hole in late August* (see "On Yellen at Jackson Hole" August 25, 2017).
- Responding to a question at the press conference following the September FOMC meeting, asking whether she had discussed her possible reappointment with Trump, Yellen seemed agitated and slightly confused (see "On the September FOMC" September 20, 2017). She said,

Update to strategic view

US FED: Warsh has taken the lead in the race for Fed chair, with Powell suddenly on the short-list. Trump says the decision will come within three weeks, and that he has talked to four – reportedly including Yellen and Cohn. Markets will be fine with any of these. Incumbent Yellen is the safest choice. Powell is steeped in the Fed conventional wisdom, but lacks Yellen's economics fluency. Cohn is an unknown quantity, but would likely let Fed staff take the lead. Warsh has a hawkish reputation because he opposed QE2 and QE3, and expressed himself in op-eds in a manner appropriate to op-eds, not FOMC statements. But QE is being unwound anyway by supposedly dovish Yellen. Warsh has credibility from having been Bernanke's partner through the crisis, but he would come to the chairmanship with an ambitious reform agenda, to drain the Fed swamp, motivated by conviction that the right policy mix can pull the world out of secular stagnation.

[Strategy dashboard]

> *"So I have said that I intend to serve out my term as chair, and that I'm really not going to comment on my intentions beyond that. I will say that I have not had a further meeting with President Trump. I met with him early in my term, and I've not had a further meeting with him."*

- Surely she meant *his* term, not *my* term. Either way, reportedly her calendar shows no meeting – but it does show a July breakfast at the Fed with Trump's daughter Ivanka, which she didn't mention. We don't want to overplay our powers of remote diagnosis, but we see this confusion as further evidence that Yellen may be not entirely well. If true, that would argue against her willingness to serve a second term as chair, if asked.
- As to Cohn, we don't put any great reliance on reports that he disqualified himself with his public remarks chastising Trump for his handling of the Charlottesville protests. For that matter, we've always had doubts that he's ever been a very serious contender in the first place (see "On the July FOMC, and Cohn for Fed Chair?" July 26, 2017). *Obviously we can't rule Cohn out. But we think he's unlikely to get the job.*

Let us now turn to Warsh and Powell.

They have much in common. They have both been FRB governors for five years (Warsh former, Powell sitting). They are both graduates of elite universities (Warsh Stanford, Powell Princeton). Neither is a trained economist; they both have law degrees (Warsh Harvard, Powell Georgetown). Both have worked on Wall Street (Warsh at Morgan Stanley, Powell at Dillon Reed and Carlyle Group). They are both Republicans who served in Bush administrations (Warsh for "W" in the NEC, and Powell for "HW" at Treasury). But the resemblance ends there.

Jerome H. "Jay" Powell is 64 years old. His service as an FRB governor began on May 25, 2012, having been nominated by President Barack Obama (who had been forced to pair a GOP nominee with Democrat Jeremy Stein, after Stein's solo nomination had been filibustered by Republicans in the Senate).

- As an assistant secretary and under-secretary at Treasury, Powell focused on financial institutions and debt markets. On the FRB, he led the Board's supervision of the payments system, until in April Yellen appointed him as *acting* head of the Fed's Committee on Supervision and Regulation, replacing departing Daniel Tarullo.
- It may be significant that Trump seems to have passed Powell over – in favor of Randal Quarles – for the *official* position of Vice Chair of Bank Supervision, a role created by the Dodd-Frank Act (see "Trump's New Faces on the Fed" June 5, 2017). This might mean that Trump has been saving Powell for the chairmanship all along. On the other hand, that he sees Powell as unworthy – after all, his deregulatory fervor is weak enough for Yellen to have given him the

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supervision appointment – in which case his sudden apparent emergence as a contender for chair would be so much fake news.

- To our knowledge, Powell has no relationship with Trump. Over the years he has been a consistent donor to Republican candidates and causes, but has made no donations since he joined the FRB in 2012.
- *Nothing in Powell's background reveals any special point of view as to either monetary policy or regulation.* That's something of a feat, considering that he has given 47 speeches since arriving at the Fed a little more than five years ago, only three less than Yellen over the same period.
- *Only 16 of his speeches concerned the economy, or monetary policy. Powell invariably parroted whatever the FOMC was saying at the time, including the usual obeisance to the persistent, though disproven, institutional dogma that full employment leads to inflation.*
- Of special note is his February 2015 speech on "'Audit the Fed' and Other Proposals." He maintains forcefully that, in the global financial crisis and its aftermath, "the Fed's actions were effective, necessary, appropriate, and very much in keeping with the traditional role of the Fed and other central banks." He goes on to argue that various proposals to rein in such actions would dangerously compromise the Fed's independence, by "subjecting the Fed's conduct of monetary policy to political pressure and…limiting the ability of the Fed to execute its traditional role of keeping credit flowing to American households and businesses in a financial crisis."
- As we shall see, *this puts Powell in sharp opposition to Warsh – who has questioned both the propriety and efficacy of the Fed's actions, and has argued that taking those actions has already made the Fed less independent.*
- *Powell won't rock the boat. In this sense, he's a safe choice for chair if Yellen is unwilling to serve a second term, or if Trump doesn't want her to. But we question whether he has Ben Bernanke's courage to act, or Yellen's economic fluency.*
- That's fine if we get four more years just like the last four, in which – quite atypically – a new Fed chair escaped being tested by markets. Usually, it's *not* fine.

Kevin Maxwell Warsh is 47 years old. Surprisingly, he would be only the fourth-youngest Fed chair (iconic and long-serving chairs Marriner Eccles and William McChesney Martin both started at 44). His service as an FRB governor began on February 24, 2006, having been nominated by President George W. Bush at the suggestion of Bernanke. Presently, he offices one day a week with Stanley Druckenmiller, and spends a week each month teaching at the Stanford Business School, and the Hoover Institution.

- Bernanke was a mentor to Warsh. And Warsh was Bernanke's loyal wing-man during the global financial crisis, serving as a knowledgeable link to Wall Street.

- But the November 2010 FOMC decision to launch QE2 – the Fed's first large-scale venture into buying long-term Treasury's – was something of a schism between Warsh and Bernanke.
- According to now-released confidential transcripts of the meeting, Warsh characterized himself as being "increasingly out of step with the views of most people around this table."
- He argued that while an intervention such as QE2 could be seen during a crisis as a favorable risk/reward tradeoff, absent a crisis the risks loom larger and the payoffs are likely smaller.
- He expressed dismay with "risks of interfering in size and in force in the longer-term Treasury market" – QE1 had primarily focused on relieving stress in the dysfunctional market for mortgage-backed securities, and bought Treasurys only to the extent necessary to replenish the Fed's supply that had been diminished during the worst of the crisis. This reflects an abiding concern, expressed in his first speech as an FRB governor: "The more that 'market information' reflects our own actions, the less it is useful as a source of independent information to inform our policy judgments."
- Moreover, as mere stimulus, Warsh argued that QE2 carried the political moral hazard of "putting that onus strangely on ourselves rather than letting it rest where it should lie" – that is, with fiscal policy.
- Warsh didn't dissent at that meeting. He resigned the following April, but we have no reason to think he did so in protest. But since then, he has been an outspoken critic of the two QE programs put in place after the crisis.
- In a June 2014 *Wall Street Journal* op-ed, Warsh and Druckenmiller argued persuasively that QE has been an inadequate and incomplete policy response to the slow-growth economy in the aftermath of the crisis.
- But in an October 2015 *Journal* op-ed, Warsh and Nobel economics laureate Michael Spence do more than critique QE for its inefficacy. They go on to claim that "QE has redirected capital from the real domestic economy to financial assets at home and abroad," blaming this "redirection" for deficient capital investment, sluggish wage growth and poor output growth. We must respectfully say we don't think Warsh and Spence make all the necessary causal links to implicate QE as the culprit.
- But they are right to dare to make the inquiry. Powell, for his part, says, "After I joined the Federal Reserve Board in May 2012, I too expressed doubts about the efficacy and risks of further asset purchases. But let's let the data speak: The evidence so far is clear that the benefits of these policies have been substantial, and that the risks have not materialized."
- Warsh has the reputation for being a hawk because of his strongly expressed views on QE. But we don't think there's anything so hawkish about believing that QE2 or QE3 didn't do much good. We'd say about the same thing. In fact most Fed statements about their benefits are pretty equivocal – with Powell's "substantial" anchoring the fringe of praisefulness.
- And it's not so hawkish for Warsh to have wanted to unwind QE. If it didn't help in the first place, it won't hurt to unwind it, as we

ourselves have argued (see, among many, "Time for Taper Tantrum Two?" April 6, 2017). In fact, the unwind is starting right now – thanks to supposedly dovish Yellen – and markets seem to be taking it in stride.

- *Warsh's hawkishness was more in the way he and his co-authors expressed themselves than in the actual policies they espoused.* A Fed chairman must be just as careful in his utterances as his policy choices – but remember, Warsh was writing advocacy editorials as a private citizen, not policy decisions as a Fed chair.
- Warsh got plenty of strong pushback on those *Journal* op-eds. *In the two years since the second one, he has repositioned himself as less of a critic of specific policies, and more of an institutional reformer.*
- In an August 2016 *Journal* op-ed, Warsh emerged as a voice for reining in the Fed's regulatory over-reach, warning that

> *"…central bank power is permissible in a democracy only when its scope is limited, its track record strong, and its accountability assured…*
>
> *"With the enactment of the Dodd-Frank Act, the Fed claims the mantle of reform. It now micromanages big banks and effectively caps their rate of return. The biggest banks' growth in market share corresponds to that of their principal regulator. They are joint-venture partners with the Fed, serving as quasi-public utilities. As the dispenser of fault and favor, the Fed is contributing to the public perception of an unfair, inequitable economic system. Real reform this is not…*
>
> *"The Fed is vulnerable."*

- Next Warsh summed up his monetary policy reform agenda in a January 2017 *Journal* op-ed. Coming a week after Trump's inauguration, it can be read as a job application, or a business plan.

> *"First, the Fed should establish an inflation objective of around 1% to 2%, with a band of acceptable outcomes...*
>
> *"Second, the Fed should adjust monetary policy only when deviations from its employment and inflation objectives are readily observable and significant.*
>
> *"Third, the Fed should elevate the importance of nonwage prices, including commodity prices, as a forward-looking measure of inflation. It should stop treating labor-market data as the ultimate arbiter of price stability.*
>
> *"Fourth, the Fed should assess monetary policy by examining the business cycle and the financial cycle. Continued quantitative easing—which Fed leaders praise*

unabashedly—increases the value of financial assets like stocks, while doing little to bolster the real economy.

"Fifth… Central bankers who vow allegiance to 'data dependence' find themselves lurching to and fro according to undistilled, short-term noise. Instead, the Fed should adhere to a concept I would term 'trend dependence.'"

- *Warsh leaves a very important element out: how, in the decision framework he enumerates, does one arrive at an actual policy decision?* For example, we are right now in the 1% to 2% "band of acceptable outcomes" for inflation. Does that mean to Warsh that today's policy must, then, be exactly right because it seems to be producing the desired inflation outcome? We would say "yes" to that – as would have Knut Wicksell 118 years ago – but Warsh hasn't made it clear that *he* would.
- *What ultimately gives us the greatest comfort about Warsh – for all the risks and uncertainties that always attend reform – is that we think we understand his most important policy touchstone: economic growth.* He has never given in to the groupthink at the Fed – and for that matter, in the world – that we are in "secular stagnation" with no way out. His conviction that, with the right tax, regulatory and monetary policies, we can return to 3%-plus real output growth is on display in an excellent July 2017 Hoover Institution paper co-authored with John F. Cogan, R. Glenn Hubbard and John B. Taylor – the last two often cited as competing Fed chair candidates.
- Other than last week's meeting with Trump, Warsh's only involvement with him has been to participate on a now-disbanded panel of economists and businessmen who periodically briefed the president. Warsh has contributed exclusively to GOP candidates and causes. He supported Jeb Bush in the 2016 GOP primaries, and was neutral during the general election. Nevertheless, we hear from sources that Warsh was offered a high-level position in the Trump administration early on. He turned it down – which may count against him now.
- *But at a time when Trump needs to hold the GOP together to get tax cuts done, Warsh could be a unifer, an ideal choice for Fed chair.* Despite the nuance we have put on it here, he has the reputation for being a Fed skeptic who would seem quite attractive to Senate GOP dissidents like Rand Paul (KY) and Mike Lee (UT). At the same time, his growth advocacy is exactly the message Trump wants to send now – the Hoover paper by Warsh, Cogan, Hubbard and Taylor was surely intended as a briefing book for the GOP to support the idea that tax cuts can stimulate growth, an idea very much under attack now in the media as tax cuts are beginning to get real (see "Tax Cuts Start to Get Real" September 28, 2017").

It's still (at least) a four-way race. *In order of probability as we see it, it's Warsh, Yellen, Powell and Cohn.* Yellen would have been the easy choice because she's the trusted incumbent, but we fear she has disqualified herself. No one else is the incumbent, so Trump is picking among shades of difficult – in which case we think his optimal play is to go with the difficult choice that might make a difference: Warsh, the one who could drain the Fed swamp, and whom the GOP can rally behind.

What will markets think?

- *We think markets will be generally comfortable with any of these choices.*
- Yellen and Powell are the choices with the least uncertainty, again because Yellen is incumbent, and with Powell because he is boring and uncontroversial.
- Cohn is only a little more risky. Yes, his monetary policy views are completely unknown. But presumably he's a sensible person, having run Goldman Sachs. So with no personal agenda for policy, and being a sensible person, he'd probably let the Fed staff do most of the driving – which, in prospect, converges him with Yellen and Powell.
- Warsh was a very steady hand for Bernanke during the crisis – which gives him a great deal of credibility with markets and within the Federal Reserve System itself. But he has been an outspoken critic – perhaps a couple times a bit over the top – and he has an ambitious and not fully-articulated reform agenda. *So Warsh is both a known and an unknown at the same time.*
- *There is some downside risk with Warsh. But in truth there is downside risk with any Fed chair, even an incumbent one. What differentiates Warsh from Yellen, Powell and Cohn is, with Warsh, there is an upside. Today's risk-tolerant markets should be fine with that trade-off.*

Bottom line

Warsh has taken the lead in the race for Fed chair, with Powell suddenly on the short-list. Trump says the decision will come within three weeks, and that he has talked to four – reportedly including Yellen and Cohn. Markets will be fine with any of these. Incumbent Yellen is the safest choice. Powell is steeped in the Fed conventional wisdom, but lacks Yellen's economics fluency. Cohn is an unknown quantity, but would likely let Fed staff take the lead. Warsh has a hawkish reputation because he opposed QE2 and QE3, and expressed himself in op-eds in a manner appropriate to op-eds, not FOMC statements. But QE is being unwound anyway by supposedly dovish Yellen. Warsh has credibility from having been Bernanke's partner through the crisis, but he would come to the chairmanship with an ambitious reform agenda, to drain the Fed swamp, motivated by conviction that the right policy mix can pull the world out of secular stagnation.