FED SHADOW

The Trouble with Taylor

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He's hung up on a rule named after him – a back-test based on the Phillips Curve myth.

Three weeks ago when we wrote about the race for Fed chair, Kevin Warsh was in the lead (according to betting markets and economist polls), and John Taylor wasn't even among the group that had been interviewed by President Donald Trump and his team (see "Warsh the Reformer, Powell the Plodder" October 3, 2017). Days later, Warsh was hit with a coordinated smear campaign from both the left and the right. Then two weeks ago Trump interviewed Taylor, and typical thinly sourced reports say the president is impressed. Late Thursday, Trump interviewed incumbent chair Janet Yellen for a second time.

On Friday, Trump told Fox Business:

> "Most people are saying it's down to two – Mr. Taylor and Mr. Powell. I also met with Janet Yellen, who I like a lot, I really like her a lot. So I have three people that I'm looking at, and there are a couple of others. I'd say I will make my decision very shortly."

And then yesterday it was reported that Vice President Michael Pence met with Warsh at the White House the same day last week as Yellen met with Trump. *In other words, we still know nothing – except that the skies over the Marriner Eccles Building in Washington DC are full of trial balloons.*

- *But one thing has changed: Taylor is now under serious consideration.*
- *We had him in mind two months ago when we wrote 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).
- We're not worried about someone who thinks that interest rates ought to move higher as the economy continues to improve and inflation picks up. We're not worried

Update to strategic view

US FED: Taylor has emerged as a leading contender for Fed chair. His eponymous Rule has the funds rate at 3.74%, but in practice he would have as little chance of imposing that on the FOMC as Bernanke had of imposing his pet idea of "inflation targeting." The real risk is that, in a systemic event, he would cling to his Rule in a doctrinaire way that would prevent a necessary crisis response. Fundamentally he is a Fed insider, with his Rule embedding the Fed's deepest superstition: the Phillips Curve. The only true reformer being considered is Warsh, who has been subjected to a brutal smear campaign, but is still in the running, and our favorite. Powell is the market's favorite now, and that would be a safe choice for Trump. But Trump makes unsafe choices, and Warsh the reformer is the only candidate who offers any real economic upside.

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about someone who thinks the Fed's balance sheet should shrink. Almost everyone thinks those things at this point and indeed those things are already well progressed under the stewardship of the supposed ultra-dove Yellen.

- We're not worried about someone who is concerned that inflation will move higher. Some of the candidates were wrong about that when quantitative easing first began, but worrying about inflation is something that central bankers need to do. And today nobody predicts more often that inflation will rise than the supposed ultra-dove Yellen (the only difference is that she wishes it rather than fears it.)
- *Today everyone's a hawk. But we're worried about a rigid and dogmatic one, who will tighten too much and too quickly, or who in the face of a crisis will lack the intellectual flexibility to deal with it.*
- *That's why we are especially worried about Taylor, who would come to the chairmanship with a famous monetary policy rule named after him.*
- We don't want to be unfair to Taylor, but we have to ask whether there is a certain amount of hubris that would come with that. How must Taylor feel when his Stanford econ students celebritize him by entering intercollegiate athletic competitions wearing T-shirts bearing his face and autograph and the slogan "WE RULE" (please see the image on the first page).
- Surely with such concerns in mind as he is considered for Fed chair, Taylor said 11 days ago at a presentation at a Boston Fed conference, more than once and in several ways, "I don't think of policy rules as reasons to tie central bankers' hands…never. To me they are ways to make monetary policy better."
- *Yes, but how – especially when the world changes in ways that your model didn't anticipate?*
- Consider this. What is now called the Taylor Rule was first put forth in a 1993 paper by Taylor. The original version required two inputs: inflation, and the difference between recent GDP growth and a "target" rate, which happened to be GDP growth from 1984 to 1992. One issue is that the results for the rule in, say, 1990 required knowledge of GDP in 1991 and 1992, which would not have been available (no wonder the curves fit so well). But the deeper issue is that the rule subtly depended on the relevance of relative GDP growth *rates*, as opposed to relative GDP growth *levels*.
- The distinction didn't matter until the Great Recession, when for the first time trend GDP *levels* weren't quickly re-attained in the following recovery. In fact even today the *level* of real GDP is 7.1% *below* the trend *level*. Yet the 2.2% YOY *growth rate* of real GDP is *above* today's trailing 35-quarter average, the interval used in the original Taylor Rule. *Thus the original Taylor Rule has a critical blind-spot for the real world in which the Fed now finds itself – it doesn't know how to deal with the Not So Great Recovery following the Great Recession.*
- In May 2009, Glenn Rudebusch at the San Francisco Fed published what he called "a Taylor Rule" that took *levels* into account, and produced a policy rate of about negative 6%. This

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was part of the intellectual background against which the Fed had made its heroic save-the-world asset purchases now known as QE1. Taylor, for his part, was still arguing a year later that his rule – still *rate*-driven – was showing a policy rate of about positive 1%.

- Political conservatives like the idea of rules – which is why they like the idea of constitutions, and the idea of "strict constructionists" on the US Supreme Court to interpret the US Constitution. That's why Taylor, with his eponymous rule, has always been a darling of Republicans. Indeed, in the prior Congress, the House passed with overwhelming GOP support the Fed Oversight Reform and Modernization Act of 2015 calling for the Fed to announce a policy rule, and explain why if it ever failed to follow it.
- But rules are tricky things. One wants them to constrain arbitrary power, but not to constrain best-efforts responses to conditions that couldn't have been anticipated when the rules were set in stone. So rules need meta-rules within them, by which the rules can be overridden in certain circumstances, or amended.
- How may meta-rules for modifying the rules – and meta-meta-rules for modifying the meta-rules, and so on *ad infinitum* – does it take before rules degenerate into pure discretion?
- And when a Fed chair who has had the rule named after him resists any changes at all, what happens?
- And what would Taylor do at his first FOMC meeting? *According to the version of the Taylor Rule that comes up on a Bloomberg terminal when you enter TAYL <GO>, he'll recommend that the funds rate be hiked to 3.74%.* We trust that no clients will need us to explain why we believe that would be a disaster.
- And let's be clear what really motivates this rule that calls for a funds rate *today* that's higher than even the highest "dot plot" that any FOMC participant sees as the *long-run* norm (see "Data Insights: Federal Reserve" September 19, 2017). *It's just a back-test*, calibrated to the halcyon days of the nearly recession-free and inflation-free Great Moderation of the 1980s and the 1990s. It's a rule based not on reality, but on nostalgia. It casually assigns a causal role to Fed policy in creating the Great Moderation, and then posits that if the Fed just does again whatever that was, we'll get the good times back. That's just too simple.
- *In practice, Chair Taylor would probably not be able to impose the strict observance of his Rule upon the FOMC – any more than Ben Bernanke was able to impose his pet notion of "inflation targeting." So our worst fears – that any rigid rule would guide policy in a literal way, with little chance of modification under exigent circumstances – would likely not materialize.*
- So if Taylor ends up being Trump's nominee, we wouldn't automatically see that as a mortal blow to the ongoing bull market (see "Global Bull Market: Still Not Loved and Still Not Over" October 16, 2017). But it would be a risk-factor that we would have to watch very closely.
- *We would see Taylor's nomination as mostly a missed opportunity for true reform.*
- Yes, his idea of rules is appealing as a means of reining in an unaccountable central-planning agency. But Taylor is not an

outsider. He is, through and through, an establishment economist, who has spent his life on the Fed lecture circuit. Any debate about his rules would take place within the existing construct of the Fed's role. *Indeed, perhaps the harshest critique of the Taylor Rule is that it fundamentally embeds the deepest superstition of establishment monetary policy: the Phillips Curve.*

- *There's no true reform here. Taylor is not about taking power away from the Fed, or overcoming its fundamental conceptual errors. He's about the conceit that the Fed's power can be more effective if only it will listen to his notions of what amounts to enshrining bad ideas into seductively simple rules.*
- *The only true outsider – the only true reformer – being considered is Kevin Warsh.* Yes, he was an FRB governor for five years under Bernanke – serving as his wing-man for Wall Street during the global financial crisis. But as the crisis ebbed, and Dodd-Frank came into effect, Warsh came to oppose the Fed's growing power. Shortly before he resigned, he privately opposed QE2, even while voting for it so as not to undermine public confidence in it, or his mentor Bernanke.
- Warsh thinks that the central banks of the world should stop allowing governments to pretend that perpetual monetary accommodation can relieve them of the burden of carrying out difficult structural reforms in their labor and product markets, and in their tax and spending policies.
- Warsh believes that, at the same time, central banks have let governments off the hook in this period of slow growth by peddling a pessimistic doctrine of secular stagnation, arguing that better growth is not possible. Warsh is a strong believer that better growth *is* possible (he is the co-author, with Taylor among others, of a recent paper about it).
- Warsh is completely opposed to the hegemony of the Phillips Curve superstition.
- And Warsh would be a strong and active supporter of deregulation. We find that clients often forget that the Fed, aside from its high-profile monetary policy role, affects financial conditions just as much or more by the way it chooses to apply its vast bank-supervision powers, quietly, one meeting at a time, between a Fed examiner and a poor quivering bank compliance officer.
- The war on Warsh – the barrage of hit-pieces that all came out within a few hours of each other on October 6 – are about what you would expect to be directed at a true reformer.
- The attacks all focused on the same few points. Warsh is not a credentialed economist (either was Paul Volcker, and either is Powell or Cohn); Warsh is too young (he is 47, older than Marriner Eccles or William McChesney Martin were when they began their decade-plus service as iconic chairs); Warsh is the son-in-law of billionaire Ronald Lauder, a friend of Trump (Warsh supported Jeb Bush in the primaries, and was neutral during the election); and Warsh opposed QE2 in 2010, when the unemployment rate was still above 9% (he voted *for* it, but warned privately that it would be

ineffective relative to its risks, which the Fed now admits was correct).

- The purpose of all this fake news is to make Trump – and Warsh himself – fear a difficult and dirty confirmation process. But it must no have succeeded, if Warsh is still going to the White House for interviews.
- *Trump's revealed preference is for swamp-draining change-agents – people like Rick Perry at the Department of Energy, Scott Pruitt at the Environmental Protection Agency, and even more so Betsy DeVos at the Department of Education. This president seems unafraid to shake things up, and to grasp political third-rails to do so.*
- *So if Warsh is nominated, markets will have to deal with a period of fear-mongering while Warsh undergoes confirmation. We don't see that as fundamentally different than the period of uncertainty markets had to endure in the face of other recent events portending fundamental reform – such as the Brexit referendum, and the election of Trump.*
- If Yellen is re-nominated, markets will be comfortable with expected continuity. But she is the first Fed chair in two generations not to have faced a severe test during the first term, so if there is a crisis in her second term, there's no telling what she'd do.
- Of all the candidates, she is probably the one with the most dovish instincts – or, at least, the most cautiously hawkish ones. Trump said in June, "I'd like to see rates stay low. She's historically been a low-interest-rate person."
- But for all that, and even though Trump is said to have interviewed her again last week, we continue to think that Yellen doesn't want the job.
- Her August speech at Jackson Hole was an "up yours" to Trump's deregulation agenda (see "On Yellen at Jackson Hole" August 25, 2017). And her speech last week, "A Challenging Decade and a Question for the Future," had a valedictory "farewell to the troops" feel about. And it was more than a little muddled – never even getting to that tantalizing "question about the future" – suggesting, as we have feared, that she may not be entirely well.
- Jerome Powell, the sitting FRB governor of five years, is presently the front-runner in the betting markets. If he is the pick, markets may see him as an unthreatening nobody who, in virtue of his five years on the board, and his dependence on Fed staff to do his thinking for him, will be a force for continuity.
- But with Powell, continuity is illusory – even more than it is for re-appointing Yellen, who was never really battle-tested. Powell hasn't been tested either – and he will be a nobody in a critical global leadership position that very much requires a somebody.
- National Economics Council Director Gary Cohn is hardly mentioned any more. We were always suspicious of the extremely poorly sourced stories over the summer that seemed to promote his candidacy (see "On the July FOMC, and Cohn for Fed Chair?" July 26, 2017).
- No one can accuse the former Goldman Sachs president of being a nobody. At least he's a tested leader. But like Powell, he's not an

economist – and has even less exposure to monetary policy. So he, too, would have little choice but to be strongly influenced by Fed staff. So in that sense he, too, would a force for continuity, even though it appears at first blush to be an outsider.

There's not a lot of downside with Yellen, Powell or Cohn – though none is battle-tested. The most downside risk is with Taylor, if a crisis emerges and he sticks with his Rule in a doctrinaire way – or bullies through its application now, while we're still struggling out of secular stagnation. And there's a special risk with Warsh, because reform is always difficult and unpredictable. But in our view Warsh is the only candidate with whom there is any *upside*. Our fundamental secular thesis is that we are in a generational "turning" toward pro-growth reform (see, among many, "2017: It's Bigger than The Donald" December 30, 2016). Warsh would fit right in. ***And given Trump's penchant for making bold and controversial appointments, we think Warsh just might get his chance.***

Bottom line

Taylor has emerged as a leading contender for Fed chair. His eponymous Rule has the funds rate at 3.74%, but in practice he would have as little chance of imposing that on the FOMC as Bernanke had of imposing his pet idea of "inflation targeting." The real risk is that, in a systemic event, he would cling to his Rule in a doctrinaire way that would prevent a necessary crisis response. Fundamentally he is a Fed insider, with his Rule embedding the Fed's deepest superstition: the Phillips Curve. The only true reformer being considered is Warsh, who has been subjected to a brutal smear campaign, but is still in the running, and our favorite. Powell is the market's favorite now, and that would be a safe choice for Trump. But Trump makes unsafe choices, and Warsh the reformer is the only candidate who offers any real economic upside.