FOCUS · A new Fed Chair: a new attitude?

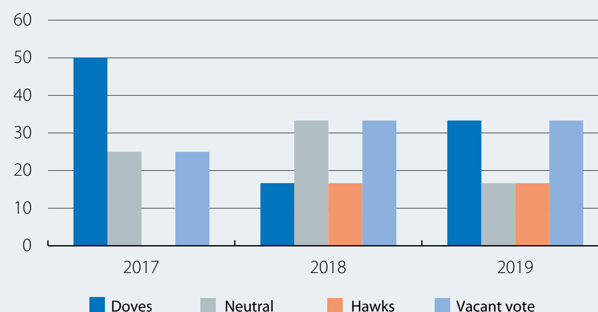
During his election campaign Donald Trump was very critical of the Fed's monetary policy and the regulations implemented in response to the 2007-2008 financial crisis. Now that he is President, Trump has decided not to renew Janet Yellen's position as the Fed Chair and to replace her with Jerome Powell as from February 2018.[1] This article looks at the implications of his appointment in terms of the outlook for monetary policy and potential alterations to financial regulation.

Apparently, Powell, who has been on the Fed's Board of Governors since 2011, is not a change candidate. In fact, this is how the markets interpreted his appointment and Trump's announcement caused few ripples. Throughout Powell's time as a governor, he has consistently voted with Yellen on monetary policy. He has also always taken a view very much in line with the incumbent Chair in his public appearances, both in terms of interest rate strategy and unconventional monetary policy tools. Nevertheless, in the early days he did admit to being uncomfortable with the extent of the quantitative easing programme implemented during Ben Bernanke's term, Yellen's predecessor.[2] But in some ways Powell is an unusual pick. A lawyer by training, most of his career has been spent in investment banking and he will be the first Fed Chair who is not an economist since the brief mandate of William Miller between 1979 and 1981.

The Fed Chair plays a key role, especially in terms of building the framework for discussion and creating a consensus (even more important now that forward guidance has become a vital monetary policy tool). Powell's appointment therefore suggests that the Fed will continue to raise the fed funds rate gradually, provided no disruptive factors appear in the macroeconomic scenario (three hikes in 2018 and two in 2019, according to the Fed's latest main projections published in September 2017). However, the Chair's vote is just one of the 12 that determine monetary policy.[3] There are two factors that could influence the course of monetary normalisation. First, the Board of Governors will have four vacancies[4] (in addition to the recent appointment of Randal Quarles). The Fed's composition could therefore alter considerably depending on who Trump chooses to fill these vacancies. Second, in 2018, the rotation of votes between the regional Federal Reserves could shift the Board in favour of a slightly faster normalisation rate (see the enclosed chart). However, this bias will be more or less accentuated depending on the profiles of Trump's appointments for the aforementioned vacancies.

Breakdown of FOMC voting rights by view of the macroeconomic scenario

Share of FOMC members eligible to vote (%)



Note: *In monetary policy, «doves» are those who prioritise the state of the labour market (typically easier conditions); «hawks» are those who prioritise containing inflation (typically more restrictive conditions) and neutral people are those who take up a position somewhere between the «doves» and the «hawks».*
Source: *CaixaBank Research, based on data from Reuters.*

These changes in the Fed's Board may also have implications for financial regulation. Recall that significant regulatory changes have been implemented since the Great Recession, incorporated into US legislation via the 2010 Dodd-Frank Act (DFA). This gave more prominence to the Fed as a regulator and supervisor.[5] It also introduced reforms to increase financial institutions' loss absorbing capacity (more demanding capital requirements and leverage and liquidity ratios and tougher stress tests) and included measures to regulate shadow banking and make the resolution of large financial institutions more credible.[6] It also set up the Financial Stability Oversight Council (FSOC), a coordinating body made up of representatives from the many different financial regulatory agencies. This is responsible for deciding which institutions are systemic (and therefore come under stricter regulations)

1. The month when Yellen's term ends. Powell's appointment is not expected to encounter any resistance from the Senate.
2. Text analysis techniques confirm, quantitatively, that Powell has taken up a very similar stance to Yellen although certain nuances seem to suggest a slightly less accommodative view of monetary policy.
3. Seven votes from the Board of Governors plus the vote from the Chair of the New York Federal Reserve and four votes which are distributed, on a rotation basis, among the Chairs of the remaining 11 regional Federal Reserves.
4. In addition to the three vacancies at present, another will be left by Yellen, who has already announced she will leave the Board of Governors even though she could continue as governor until 2024.
5. Added to the Fed's usual regulatory and supervisory scope, which was mainly state banks within the Federal Reserve system and bank holdings, were financial institutions deemed systemic (whether banks or not), in addition to giving the Fed authority to set stricter capital requirements and power of decision over the resolution procedures for financial institutions.
6. For example, through the obligation to have a living will that specifies how a possible bankruptcy would be resolved.

and for identifying sources of risk to financial stability (passing on recommendations to the relevant regulatory agency). Finally, the DFA also introduced the Volcker Rule which prohibits banks from using their depositors' funds to trade on their own accounts. In general terms, Powell appears to be essentially committed to these reforms, particularly greater capital and liquidity requirements, stating they are key to achieving a stronger and more stable financial system less exposed to severe crises. However, Powell is in favour of simplifying some of the regulations and especially of reducing the burden imposed on small and medium-sized financial institutions. He also seems open to considering adjustments to the Volcker Rule, focusing it more on institutions with a larger investment volume.

Powell's desire for simplification is coherent with some, but not all, of the proposals made by the US Treasury Department to relax financial regulation. Specifically, based on a document published in June 2017,[7] the Treasury suggests refining capital, liquidity and leveraging standards. This would include raising the asset threshold as from which an institution has to undergo stress tests, more severe prudential measures are applied and a living will is required. The Treasury also proposes readjusting the capital and liquidity standards for institutions deemed systemic,[8] as well as highly capitalised banks being able to opt out of stress tests and certain prudential requirements. Finally, the Treasury is in favour of redefining the type of transactions the Volcker Rule is applied to, possibly excluding banks that do not deal in large trading volumes.

This list of proposals shows that, in financial regulation terms, the agenda of Trump's administration goes far beyond appointing the Fed Chair. In fact, the US House of Representatives has already started to push for a large part of the Treasury's proposals, approving the Financial Choice Act last June. However, these proposals must still be passed by the Senate to become legislation and replace the DFA. Moreover, with regard to the design of regulation for the financial sector as a whole, it should be remembered that the Fed is not the only regulatory body in the US. Other important regulators include the Office of the Comptroller of the Currency (OCC) for most of the banks not regulated by the Fed; the Securities and Exchange Commission (SEC) for stock and options markets and investment companies such as hedge funds and money market funds, and the Consumer Financial Protection Bureau (CFPB), created under the auspices of the DFA to improve consumer protection within the financial sector.[9] Trump's administration has already proposed new Chairs for the OCC (Joseph Otting) and the SEC (Jay Clayton), while the aforementioned Financial Choice Act aims to reduce the CFPB's independence.

In conclusion, the Trump administration's agenda for financial deregulation needs to progress further down the legislative path before it can replace some aspects of the DFA. In monetary policy terms, moreover, Powell's appointment should uphold the existing strategy of gradual normalisation. However, the new Fed Chair has relatively limited experience in the world of economic policy. Hence the uncertainty regarding his true vision and future reaction to the challenges that will face the Fed. These include deciding the ultimate size of its balance sheet and the appropriate fed funds rate in the medium term, as well as handling the next phase in the economic cycle.

7. See the US Treasury Department (2017), «A Financial System That Creates Economic Opportunities: Banks and Credit Unions».
8. Specifically, the Treasury states that US standards for capital surcharges for systemic institutions, the leverage ratio and some ratios within the requirements for total loss absorbing capacity (TLAC) are considerably more demanding than those established internationally by the Basel Committee and the Financial Stability Board.
9. Another key agency is the Federal Deposit Insurance Corporation (FDIC) for deposit-holding institutions. Although, last June, Trump appointed James Clinger as the new Chair of the FDIC, one month later Clinger withdrew from consideration and the Chair's appointment is still pending.