November 24, 2021

To: Members of the MDP Class of 2021-2022
Fr: Andy Davies

This is a good 'primer' on Reappointment of Chairman Powell (FYI)

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Jerome Powell, President Biden's pick to continue as Fed chairman, with Lael Brainard, his nominee for vice chairwoman

Bank Chief Faces Changed Economy

By Greg Ip

ANALYSIS

Over his first term in office, Jerome Powell became arguably the most dovish chairman in the Federal Reserve's modern history, giving priority to full employment in an era in which inflation seemed extinct. In his second term, he might have to execute the reverse: giving priority to inflation at the risk of sacrificing jobs.

The pivot could be painful for both Mr. Powell and President Biden. On Monday, Mr. Biden praised Mr. Powell for his commitment to "maximum employment" so that "American workers get steady wage increases after decades of stagnation, and...the benefits of economic growth are broadly shared." Yet economic conditions have been substantially reordered in just the past year. Inflation, at 6.2%, is its highest in 31 years. While employment remains 4.2 million below its pre-pandemic peak, labor shortages are widespread and wage growth is accelerating. All that threatens the Fed's 2% inflation target.

For now, Mr. Powell and his colleagues including Gov. Lael Brainard, whom Mr. Biden plans to nominate as vice chairwoman, hope and expect inflation to drop, as pandemic-related obstacles recede. But the risk is growing that the assumptions that undergirded Mr. Powell's dovish turn are out of date. If so, interest rates might need to rise a lot, threatening a recession and Mr. Biden's political fortunes.

Mr. Powell, who goes by

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Jay, was no one's pick for monetary revolutionary. A former private-equity executive and Treasury official under George H.W. Bush, he was appointed a Fed governor in 2012 by then-President Barack Obama, who needed a moderate Republican for partisan balance. His first instincts were hawkish, expressing discomfort with the Fed's buying bonds to hold down long-term rates.

But Mr. Powell is also open-minded. In conversation he calls himself a fox rather than a hedgehog, a nod to philosopher Isaiah Berlin's taxonomy of hedgehogs, driven by a single overarching principle, and foxes, who draw upon disconnected and changing information.

By 2018, when then-President Donald Trump had made Mr. Powell Fed chairman, he had shed his hawkish instincts. Central banking models, he said in a speech that year, relied on economic concepts that were imprecise or unobservable, a natural unemployment rate below which inflation accelerated or a neutral interest rate that perfectly balanced unemployment and inflation. Events bore him out: Unemployment steadily fell, reaching a 50-year low of 3.5%, with no sign of troubling wage and price inflation. In fact, inflation persistently undershot the Fed's 2% target, prompting Mr. Powell in 2019 to reverse a modest increase in interest rates.

Covid-19 reinforced this dovish tilt last year, as unemployment shot to a post-Depression record of nearly 15% and inflation plummeted to 0.2%. The Fed slashed interest rates to near zero, restarted buying bonds and lent vast sums to companies and market participants to stave off a financial crisis, efforts in which Ms. Brainard played a key part.

That summer, Mr. Powell and his colleagues overhauled the Fed's monetary framework. The Fed would now aim not just to return inflation to 2% but to a bit above the target, so that over time, inflation would average 2%. The central bank would no longer regard any level of unemployment as too low, reflecting a newfound "appreciation for the benefits of a strong labor market, particularly for many in low- and moderate-income communities," Mr. Powell said in a speech.

The Fed also pledged to keep interest rates near zero until inflation was headed above 2% and the labor market had returned to maximum employment.

Many progressives had urged Mr. Biden to replace Mr. Powell, a Republican, with Ms. Brainard, a Democrat who has been more proactive on climate and bank regulation. Mr. Trump had set the precedent, replacing Democratic economist Janet Yellen, now Mr. Biden's Treasury secretary, with Mr. Powell as Fed chief. But others said Mr. Powell's commitment to full employment mattered more. "Jay is about as dovish as a 68-year-old white Republican can go," said Tim Duy, chief U.S. economist at SGH Macro Advisors.

But the economy today doesn't look like the one that drove the Fed's dovish makeover. Fearing that demand would be chronically weak as it was after the 2007-09 financial crisis, Mr. Powell backed Congress in passing $5.9 trillion in relief and stimulus. Demand now is red-hot, fueled by that stimulus, low interest rates, the reopening of businesses and vaccinations. Meanwhile supply has been hobbled by shortages of key components and millions of workers' exit from the labor force because of retirement, Covid-19 and other factors. As a result inflation has gone from undershooting to vastly overshooting the Fed's 2% target.

Mr. Powell assumed from the previous economic recovery that the inflationary consequences of a tight job market were overblown. Yet today, with unemployment of 4.6%, still well above its pre-pandemic low, strong demand and labor shortages have propelled wage growth to around a 6% annual rate in the third quarter. If sustained, that wage growth isn't compatible with inflation falling back to near 2%, Goldman Sachs economists said. (They think it won't be sustained.)

The Fed concluded from the previous recovery that "preemptive" tightening—raising interest rates ahead of inflation actually accelerating—unnecessarily choked off job growth. The central bank thus has kept rates near zero and increasingly negative when adjusted for inflation as the economy boomed and inflation accelerated. "While the Fed has raised rates too much too soon in the past, this alternative timing may result in the opposite error," said Jason Furman, who chaired Mr. Obama's Council of Economic Advisers, in a Nov. 18 analysis.

Inflation should ease next year, as supply chains normalize and energy prices stop rising; the big question is where it levels out. Fed officials, and most private economists, think inflation will stabilize between 2% and 2.5%, a welcome offset to years of sub-2% inflation. Markets are less sanguine: On Friday, inflation-indexed securities were projecting consumer price inflation at 3% through 2023 before falling to between 2% and 2.5% in later years. (Those figures would be slightly lower using the Fed's preferred price index.)

If inflation stays at 3% or higher, Mr. Powell would, fox-like, have to amend his assumptions and weigh sharply higher interest rates to cool off the economy. Such a strategy carries multiple risks. It could undermine stock and real-estate values that have been underpinned by exceptionally low rates. As interest on the massive federal debt mounts, the budget deficit could soar. Sharply higher rates could also push up unemployment, which historically has always ended in recession. If the inflation scare proves a false alarm, the Fed might inadvertently pitch the economy back into the pre-pandemic status quo of low growth, low inflation, and ultimately low interest rates.

The risks include political blowback, for the Fed and Mr. Powell personally. The public hates inflation, but won't thank the Fed for higher unemployment, either. "People underestimate the political challenge of being a central bank that lets inflation get too high and then has to unwind that quickly," Mr. Duy said. Whereas Mr. Trump repeatedly pressured Mr. Powell to adopt easier monetary policy, Mr. Biden has promised to respect the Fed's independence. Indeed, some analysts warned that nominating Ms. Brainard, with her more dovish reputation, would imply inflation wasn't being taken seriously. Nonetheless, Mr. Biden has other ways to influence monetary policy. He could fill three coming vacancies on the Fed's seven-member board with governors less aligned with Mr. Powell's priorities. Conversely, Mr. Powell could face attacks from Republicans if he fails to rein in price pressures.

While Mr. Powell, a lawyer by training, lacks his predecessors' economic credentials, he makes up with exceptional political acumen. He resisted Mr. Trump's pressure without alienating other Republicans. He meets regularly with legislators from both parties and is likely to be confirmed with widespread bipartisan support. Whether or not reappointing Mr. Powell ultimately helps Mr. Biden, the decision has shored up the Fed's reputation for nonpartisanship, a commodity in short supply these days.

STREETWISE | By James Mackintosh

With Powell Sticking Around, Markets Refocus on Inflation

Markets climb a wall of worry, and the renomination of Jerome Powell as Federal Reserve chairman takes away one important uncertainty.

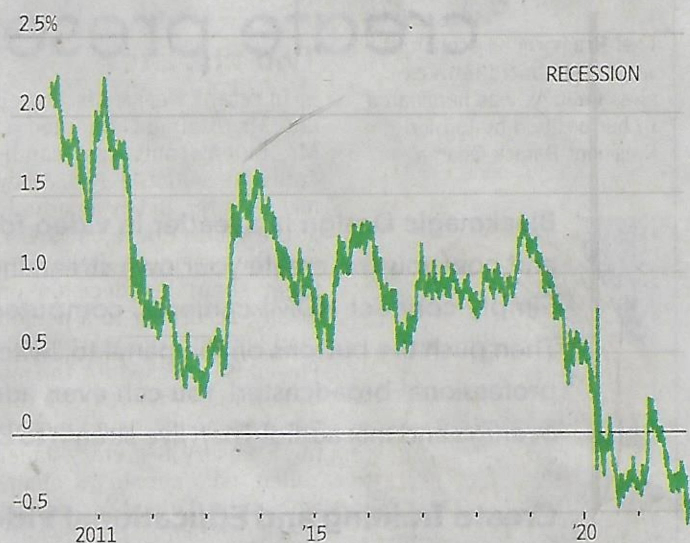
It was possible that President Biden would pick Lael Brainard, who was nominated as Mr. Powell's deputy instead, and her approval process might have hit trouble in the Senate. By leaving Chairman Powell in charge, that worry was removed, meaning policy stays on its previous, exceptionally easy, course.

The market response to taking away a risk is easy to predict. Stocks and other risky assets go up, and bonds, gold and other safer assets go down. So it was, if not to a huge extent. How prices react is one way to define an asset, and on this basis, bitcoin is a risk asset, since it jumped while gold fell.

It is unlikely that senators will stop Mr. Powell. True, progressives dislike him, despite his focus on inequality and full employment and his dropping of predicted inflation as the main determinant of monetary policy. And former President Donald Trump had a very public falling out with Mr. Powell, albeit for raising interest rates, something the Fed has now reversed. But Mr. Powell was backed by a solid majority last time, and rejecting a mainstream pick for Fed chair would upset Wall Street without helping Main Street.

The market will now get back to its main preoccupation: Is Mr. Powell right to think that inflation is transitory? If he is, there is an important secondary issue: Will the economy be strong enough to allow rates to return to something like normal over the next few decades?

30-year TIPS yield, before adding inflation



Note: Data as of Nov. 18

Source: Federal Reserve via St. Louis Fed

> **The bond market is priced for inflation to average over 3% in the next five years.**

At the moment investors are answering yes, it will be transitory, and no, the economy won't be strong enough to raise rates back to normal.

The bond market is priced for inflation to average more than 3% over the next five years, well above the Fed's 2% target. But most of that is in the very near term, with inflation expected by investors to moderate back to the goal in the following five years, as the economy returns to its pre-pandemic normal of low growth.

Investors are betting that the economy won't grow strongly enough to support much of a rise in real, after-inflation interest rates in the long run. The yield on Treasury inflation-protected securities for the next 30 years hit its lowest in data back to 2010 earlier this month, and remains negative—implying rates below inflation for decades to come.

Whether this is right or wrong isn't in the gift of Mr. Powell. But by the time those bonds mature we will know whether his Fed managed the difficult trick of preventing the current inflation becoming entrenched far above target while avoiding the usual Fed mistake of slowing the economy too much in an attempt to bring inflation back down.