Federal Reserve succession

Why the Federal Reserve's job will get harder

Janet Yellen's successor faces a series of political and economic challenges

Lawrence Summers

YESTERDAY by: Lawrence Summers

With the term of Janet Yellen as Federal Reserve chair ending next February, the president will have to nominate and the Senate will have to confirm a new head of the central bank in coming months. There is much discussion of the merits and implications of possible candidates for the job. For Donald Trump and the Senate it will be important to begin by considering the challenges that will face Ms Yellen's successor.

I would have preferred a slower pace in raising rates at a number of junctures. I also think that in its statements the Fed has consistently over-assessed future inflation, growth and monetary tightening at some cost to its credibility. Overall though, it has done very well in recent years. We have not enjoyed so favourable a combination of unemployment and inflation in decades. Markets and finance have been remarkably stable, perhaps too much so, for years now. And by the standards of other institutions in Washington and central banks the Fed is highly respected. This is all a tribute to its leadership but also to fortunate circumstances.

I suspect the Fed's job will be much more difficult over the next few years. Economics, finance and politics will all throw up new challenges that will probably demand creative and unorthodox responses.

If history is any guide, it is more likely than not that the economy will go into recession during the next Fed chair's four-year term. Recovery is now in its ninth year with relatively slow underlying growth for demographic and technological reasons, very low unemployment and high asset prices. Even without these factors, experience teaches that recessions are almost never forecast or even rapidly recognised by the Fed or the professional consensus forecast, but there is at least a 20 per cent or so chance that if the economy is not in recession, it will be so within a year. So the likelihood that the next Fed chair will have to address a recession is probably about two-thirds.

Historically, the Fed has responded to recession by cutting rates substantially, with the benchmark funds rate falling by 400 basis points or more in the context of downturns over the past two generations. However, it is very unlikely that there will be room for this kind of rate cutting when the next recession comes given market forecasts. So the central bank will have to improvise with a combination of rhetoric and direct market intervention to influence longer-term rates. That will be tricky given that 10-year Treasuries currently yield below 2.20 per cent and this would decline precipitously with a recession and any move to cut Fed funds.

Responsible new leadership at the Fed will have to give serious thought to shifting the monetary policy framework

As a result, the economy is probably quite brittle within the current inflation targeting framework. This is under-appreciated. Responsible new leadership at the Fed will have to give serious thought to shifting the monetary policy framework, perhaps by putting more emphasis on nominal gross domestic product growth, focusing on the price level rather than inflation (so periods of low inflation are followed by periods of high inflation) or raising the inflation target. None of these steps would be easy in current circumstances, but once recession has come effectiveness will diminish.

There has not been a major bout of financial instability or a foreign financial crisis in the past four years. Such good fortune is unlikely to continue. There are real risks — from China to signs of overvaluation in parts of US equity markets, from build-ups in leverage after a long period of low rates and tranquil markets to a highly disordered geopolitical situation in which US credibility has fallen off sharply.

In reporting on the last round of bank stress tests the Fed has asserted that even if the stock market loses half its value, the unemployment rate reaches 10 per cent and house and real estate prices fall only as much as they did in the last crisis, the big institutions will all be fine without capital increases. Market evidence suggests otherwise, based on past patterns their equity values would collapse.

The challenge with respect to financial crisis risk will be maintaining the crucial components of Dodd-Frank regulation, such as the requirement to hold higher capital, as well as recognising incipient problems much more quickly than in 2008, when even after Bear Stearns shaky institutions were permitted to make huge dividend payments. If crisis comes the Fed must find ways in a difficult legal and political environment to avoid the kind of unravelling that followed Lehman’s failure.

Perhaps the most profound challenges ahead will be political. There must be more risk now of presidential interference with the Fed than at any time since Richard Nixon. In dealing with international matters, the Fed is partnered with an understaffed and amateurish Treasury and a president who is dissipating US credibility. Most fundamentally, the temper of the times has turned against technical expertise in favour of populist passion and the Fed is the quintessential enduring apolitical institution.

We all have a great stake in the president making and the Senate confirming the right choice.

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