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Fed Outlook 2018 - Voters rotate, Board is reshaped

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- **Beyond a new Fed Chair, there is changing of the guard taking place among the voting members of the FOMC that likely tilts the committee moderately more hawkish. The turnover is happening at the Board of Governors and regional Fed Presidents. While this does not equate to a large change in the expected gradual pace of rate hikes, the rotation raises the possibility that the pace of hikes could be on the high end of what could be considered a gradual removal of policy accommodation.**

- **The changeover of voting Fed Presidents in 2018 is part of the annual rotation. Additionally, President Trump has the chance to significantly reshape the Fed Board of Governors. The new Governors could swing more hawkish in their views of monetary policy and favor a roll back of some of the post-financial crisis regulation. However, Trump's nomination of Powell as Chair suggests that a sharp swing to the hawkish side of the spectrum may not be in the cards.**

A significant reshaping of the FOMC has started to unfold with the exiting of Fed Vice Chair Fischer, the nomination of Jerome Powell as the next Fed Chair, the addition of Randall Quarles as Vice Chair of Supervision and Fed Governor, and the announced retirement in mid-2018 of New York Fed President Dudley. However, looking ahead to 2018 more changes in make-up of the FOMC voters are in store. Within the Board of Governors, given there are seven seats in total, there are still three more vacancies to fill. There will be a fourth if Yellen steps down as Governor after her term as Chair is complete, which is very likely. Additionally, there will be the annual rotation of voting regional Fed Presidents.

The current consensus among all voters on the FOMC — Governors and District Bank Presidents alike — is for a further gradual removal of accommodation in monetary policy. The question is what constitutes an appropriate pace? It could be the glacial counsels of Minneapolis' Neel Kashkari or St. Louis' James Bullard who agree that low growth and low inflation should keep policy more-or-less on hold until there is decided evidence of a pick-up in both. Or it could be a less gradual series of hikes to prevent overheating in the US economy or imbalances that has been proposed by Boston's Eric Rosengren or San Francisco's John Williams. Most policymakers lean more toward the latter than the former, but all would reiterate that everything depends on how the economic data lines up with the Fed's dual mandate of full employment and low and stable inflation.

A more hawkish tilt is expected among the voting District Bank Presidents

First, we will examine the annual rotation amount the regional Fed Presidents that will take place at the January 30-31, 2018 meeting. The District Bank Presidents are on the whole more to the hawkish side of the spectrum. In 2018, the District Bank voters are the presidents of the New York, Cleveland, Richmond, Atlanta, and San Francisco Federal Banks.

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The big unknowns are the Presidents of the New York and Richmond Feds.

The **New York Fed** has a permanent vote on the FOMC. For now that will be cast by **William Dudley**. However, his retirement by mid-2018 was announced on November 6. Dudley is a **dove** who has consistently voted with the majority since the start of interest rate normalization in December 2016. We would anticipate he will not dissent if another hike is agreed on at the December 12-13 FOMC meeting, or in the first half of 2018. But his successor — the search is only just beginning — is an unknown. Districts rarely select a new President who is at variance with the historical leanings of the Bank. The New York Fed is viewed as closely aligned with the Board of Governors which tends to be moderate-to-dovish in its votes. Nonetheless, the Board is facing some extensive changes. It is possible that a majority of picks by a Trump Administration could lead to some breaks with traditional alignment of outlook between the Board and the New York Fed.

The **Cleveland Fed's Loretta Mester** returns to voting status next year. She has been a **hawk** who is more inclined to hike rates. In her last turn as a voter in 2016, she registered a series of dissents at the meetings of September 20-21 and November 1-2. Mester would have preferred a rate hike sooner than the one likely imposed at the upcoming December 13-14 meeting. Although she is cautious about inflation, she has come down on the side of those more concerned about the risks from too low rates for too long.

The **Richmond Fed** does not yet have a President after Jeffrey Lacker's abrupt departure on April 4, 2017 — although he was previously set to step down in October 2017. Since then Richmond has been represented on the FOMC by Interim President and Chief Operating Officer Mark Mullinix. The search for a President is on-going. It would be surprising if it were not resolved soon. In any case, the Richmond Fed has produced a long series of hawkish Presidents and we would look for a similar philosophy in whomever the Richmond Fed selects.

Raphael Bostic of the Atlanta Fed is the most junior of the District Bank Presidents and entering into his first rotation as a voter. So far his public comments suggest that he is **moderate with a dash of dove** in regard to the inflation outlook. His speeches will get increasingly close reads for hints as to his intentions for interest rates as 2018 nears.

San Francisco Fed President John Williams has often been viewed as a Yellen ally and therefore dovish on monetary policy, but he has emerged as one of the stronger voices for raising rates. He has said that the US economy has exceeded full employment and expressed confidence that inflation will return towards the Fed's 2% objective over the medium term.

With two of the five voters in flux for 2018, we will be cautious in making pronouncements about the group as a whole. But the present and likely composition suggests that broadly speaking there will be **two hawks, two moderates, and one dove voting in 2018**. This is a **shift from the three doves and two moderates** that composed the District Bank voters in 2017 (see table 1 on the next page). Moreover, it comes at a time when the Board of Governors could well evolve from one that is predominantly doves-to-moderates to one that has a minority of doves, a few moderates and a few hawks among the Trump appointees. In combination, it argues that the FOMC in 2018 will be more aggressive in hiking interest rates, albeit incrementally and at the high end of what could be considered a gradual removal of accommodation.

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Table 1

Voting District Bank Presidents on the FOMC in 2018		
William Dudley	New York	Dove, retiring mid-2018
Loretta Mester	Cleveland	Moderate hawk, concerned about overheating
TBD	Richmond	Anticipate a hawk
Raphael Bostic	Atlanta	Moderate leaning dovish on inflation
John Williams	San Francisco	Moderate, concerned about overheating

Voting District Bank Presidents on the FOMC in 2017		
William Dudley	New York	Dove, but supported rate hikes so far
Charles Evans	Chicago	Dove, but supported rate hikes so far
Patrick Harker	Philadelphia	Moderate, supported rate hikes so far
Neel Kashkari	Minneapolis	Dove, dissented on rate hikes in 2017
Robert Kaplan	Dallas	Moderate, supported rate hikes so far

Reshaping of the Board of Governors

By February, five of the seven seats on the Board of Governors could belong to Trump appointees.

A year ago, the election of Donald Trump as President opened the possibility that the Board of Governors of the Federal Reserve — already facing a number of personnel changes — could undergo a transformation from a generally homogenous group of policymakers in the traditional mould to one more inclined to shake up the century-old institution.

The presence of three vacancies on the Board of Governors has not received urgent attention from the new Trump Administration. It took some time to decide on its first candidate for the Board. Randal Quarles was nominated in early July 2017 and confirmed in early October. He was sworn in as Governor and Vice Chair of Supervision on October 13, the same day that Governor and Vice Chair Stanley Fischer retired. On net, there remains three vacancies to be filled.

In the meantime, the necessity to find a successor for the Fed Chair became more urgent with Governor Janet Yellen's four-year term as Chair coming to an end on February 3, 2018. The selection process led to sitting Governor Jerome Powell getting the nod. If he clears the confirmation process as expected, it will still leave at least three vacancies to fill. There will be a fourth if Yellen steps down as Governor after her term as Chair is complete. It would be unusual if she did not, but technically she can remain on the Board as a Governor until her term is done on January 31, 2024. We expect she may stay on for a time if there are still three other vacancies to fill. We cannot remember an instance where the Board was so thinly staffed as to have only three Governors and it would impair the Board's ability to thoroughly handle its responsibilities.

The three or four nominations for Governors should include a Vice Chair and a community banker

There has been some speculation that one of the other candidates considered for the Fed Chair might be nominated as Governor, in particular John Taylor and/or Kevin Warsh. But we think that after being so publically discussed as a possible Chair it would be difficult to consider a Governorship even if it included becoming Vice Chair as well.

The term of a Governor is for 14-years, intervals staggered across the Governor seats. The term of the Chair and Vice Chairs are four years that are served within the term of Governor. At present, the terms are detailed in table 2 on the next page.

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Table 2

Governor	Term ending January 31
Vacant	2020
Vacant	2022
Janet Yellen	2024, term as Chair ends February 3, 2018
Lael Brainard	2026
Jerome Powell	2028, nominated for next Chair
Vacant	2030
Randal Quarles	2032, term as Vice Chair of Supervision ends October 13, 2021

One of the vacant seats is by law designated for a community banker. In spite of the obvious value of such experience to the Board and the prestige of being a Fed Governor, it has been difficult to find anyone from the industry willing to meet the requirements of disclosure and divestment to serve on the Board. This suggests that at least one of these vacancies may remain unfilled for a longer period than is desirable.

What sort of candidate the Trump Administration might put forward for the empty seats is unknown. The selection of Jerome Powell as the next Chair hints that someone moderate — or even a bit dovish — on interest rate policy might be acceptable if his/her other views lean toward reduced regulation and/or supervision., Moreover, an outright iconoclast — such as a proponent of returning to the gold standard — would be a fraught choice. Such a candidate would probably not survive the scrutiny of the confirmation process. However, someone critical of the Federal Reserve's decisions in dealing with the financial crisis and the use of unconventional monetary policy tools could well get the recommendation of a majority of the Senate Banking Committee and pass a full Senate vote. Trump's pool of candidates for the office of Chair also hints that he is more likely to look outside the traditional circles of academics and central bank staffers.

With over three years remaining in his term at this writing, President Trump may reshape the Board beyond recognition. Of the current Governors, only Lael Brainard and Powell are Obama-era appointments. It is possible that Brainard will leave before the end of her term. If so, it means that the Trump Administration could essentially replace the entire Board with people of its choosing. This sets up the potential for greater disagreement on the FOMC.

The Board of Governors vote to decide the changes in reserve requirements, the discount rate, and the interest on excess reserves (IOER) which is a key Fed policy rate. Fed Governors confer with the other current voting members of the FOMC that include regional Fed Presidents to decide whether to vote for a change in the IOER.

Contrary to common perceptions, the Fed’s Board of Governors does not need a quorum to conduct monetary policy decisions. That said, having less than five Governors on the Board will continue to require a unanimous vote to approve policy changes that are uniquely Board decisions. This could present a wrinkle for executing changes in monetary policy if a newly confirmed Governor disagrees with existing Fed Governors. For more on this, see our Research Briefing on "Fed Governors - no room for dissent" from September 25, 2017.

Up to this point, when there have been less than five Governors, the Governors have voted unanimously to implement the decision of the broader FOMC. With President Trump having the power to appoint incoming Fed Governors, there is some risk of a disruption to the unanimity. Currently, this is not our base case, since the candidates purportedly considered for Fed Governor roles do not strike us as being very radical choices.

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