

REVIEW & OUTLOOK

A Fed for a Growth Economy

Trump needs a leader at the central bank who supports faster growth.



Federal Reserve Chair contenders Jerome Powell and present chair Janet Yellen in Washington. PHOTO: REUTERS

By The Editorial Board

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President Trump is finishing his interviews to choose the next Federal Reserve Chairman, and the same voices who oppose him on everything are chanting in unison—reappoint Janet Yellen or choose her Republican running mate, Jerome Powell. Mr. Trump should consider the implications for the economy, which will be a major part of his legacy.

The Yellen-Powell advocates are telling the President that they have avoided big monetary mistakes, that they favor low interest rates, and there is no reason to take a risk on someone new. Some in the Trump Treasury are also saying that Mr. Powell is someone they can dominate. So go with the status quo.

But what someone should also tell Mr. Trump is that the monetary status quo won't hold

no matter who is Fed chair. Ms. Yellen has presided over an unusually placid financial period, not least because economic growth was so slow through the Obama Presidency.

That isn't likely to last—at least not if Mr. Trump's tax and deregulatory policies succeed in spurring faster growth. The Yellen Fed is already raising rates and unwinding the \$4.5 trillion balance sheet it built over eight years. The question Mr. Trump should ask is who should run the Fed during this uncertain monetary transition, especially if the economy leaves its slow-growth doldrums.

One certainty is that the Yellen-Powell Fed believes in the Phillips Curve trade-off between unemployment and inflation. Once the economy hits what the Fed staff considers to be “full employment,” its economic models signal the need for higher interest rates. With the jobless rate already at 4.2%, the Fed staff are worried that rising wages will push up prices, and so interest rates will have to rise to prevent inflation.

Yet as Ms. Yellen has acknowledged with some puzzlement, inflation has been remarkably contained. She can't explain why because it doesn't fit the Fed's current economic models. Another issue is how much labor slack exists despite the low jobless rate. The labor participation rate remains at low levels not seen since the 1970s, and one reason is the departure of prime-age males from the workforce. Faster growth and rising wages might coax them out of dad's basement or too-early retirement.

The Yellen-Powell Fed also appears to doubt that the economy can grow faster. Each quarter Fed Governors and regional bank presidents release estimates for future growth. At the Sept. 20 meeting, they raised their projection to 2.4% for this year. But their median estimate for 2018 is a mere 2.1%, followed by 2% in 2019 and 1.8% in 2020 and beyond. In other words, they are anticipating little growth impact from Mr. Trump's deregulation or tax reform.

This fits with the Fed's dominant neo-Keynesian worldview that tax cuts aren't pro-growth and the U.S. is fated to a long era of “secular stagnation.” That isn't what Mr. Trump campaigned on, and the question is whether a Yellen-Powell Fed would accommodate faster growth or feel it must rapidly increase interest rates. Unless it changes its economic models or expectations, the current Fed won't.

All of which argues for new leadership. Ms. Yellen is tied to the current models and assumptions, and nothing in Mr. Powell's six years as a Fed Governor has suggested a different point of view. His many speeches have gone along with the status quo at the

time, even as many of his colleagues have dissented in word or vote. He is not likely to override the staff.

The White House has leaked that two of Mr. Trump's finalists are Kevin Warsh and John Taylor. Both would be change agents at the Fed. Both are also frequent contributors to our pages and have been right in their diagnoses of the slow-growth policies of the Obama era.

Mr. Taylor, a Stanford economist who has a monetary rule named after him, would bring academic respect to the Fed's Open Market Committee. He worked in the George W. Bush Treasury and prevented currency panics in Argentina and postwar Iraq from spreading.

Mr. Warsh is a former Fed Governor who was part of Ben Bernanke's inner circle during the 2008 financial panic. He correctly diagnosed the weak capital and liquidity positions of the banking system, even as regulators at the New York Fed said the problem was confined to Bear Stearns.

This crisis experience is a major recommendation for the Fed chair because we may face financial turbulence as the Fed raises rates and unwinds its bond portfolio. As Mr. Warsh warned when he left the central bank in 2011, the Fed has pushed investors into riskier assets with uncertain consequences. Who knows what might show up naked as the tide recedes? Mr. Warsh also has credibility with the leading central bankers in China, Europe and Japan that would be essential in any new currency or financial panic.

More even than Supreme Court Justices, predicting the performance of a Fed Chairman is difficult. But the best guides are experience and bedrock economic principles. Mr. Trump and the country will do better with a fresh voice who knows how to manage in a crisis and believes that faster economic growth without inflation is possible and necessary.

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