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Markets, Unlike Media, Aren't in a Lather Over Fed Chair

By Justin Wolfers - Aug 12, 2013

President Barack Obama recently said that choosing the next chairman of the Federal Reserve is "definitely one of the most important economic decisions that I'll make in the remainder of my presidency." The financial media appear to agree, devoting hundreds of column inches to speculation. Senators, overseas pundits and even Bette Midler have chimed in.

But there's one group that considers the decision largely inconsequential: investors in financial markets. At least, that's my initial reading of a revealing natural experiment.

Three weeks ago, Janet Yellen, the current vice chairman of the Fed, was the heavily backed favorite to get the nod. On July 23, Irish betting site Paddy Power listed her odds at 1-4, which means that a $4 bet would only return a $1 profit (above the original stake). Bettors would only take odds like that if they really believed Yellen's nomination to be extremely likely. By contrast, Larry Summers, the president's former top economic adviser, was ranked the third-most-likely candidate at 11-2 (behind Roger Ferguson, a former Fed vice chairman, at 5-1).

Now, Summers is a solid 1-2 favorite and Yellen is perceived as the only real alternative at 2-1. (Ferguson and all others are now seen as remote possibilities.) The only thing that has changed in the past three weeks is that details of a debate within the White House have become public.

Natural Experiment

This episode presents the sort of natural experiment that whets the appetite of economists. It's a bit like having the chance to toss out potential options for a new Fed chief, then seeing how the financial markets respond. Instead of actually installing Summers or Yellen, we did so probabilistically, thanks to a White House leak.

This experiment gives us the opportunity to compare the assessments of forward-looking investors three weeks ago, when they expected a Yellen Fed for the next four years, with today, when they anticipate a Summers-led economy.

Since Washington Post reporter and Bloomberg View columnist Ezra Klein broke the news on July 23 that Summers is increasingly viewed as the leading candidate in the White House, the betting odds for him as the Yellen alternative tumbled from 11-2 to 5-2 on July 30. Yellen remained the favorite, though, at 2-7.

A day later, on July 31, Obama defended Summers in a closed-door meeting of congressional Democrats. That led the Summers boom to further intensify in betting markets, and by Aug. 7, his odds had continued to firm. He is now the clear betting favorite.

How have financial markets responded to the (probabilistic) change? Let's start with inflation expectations. After all, the inflation rate is the economic indicator for which a Fed chief is most likely to be held accountable. Moreover, much of the discussion has revolved around who is the bigger "dove" -- meaning, who is likely to be less focused on keeping inflation low.

The nearby chart shows a market-based indicator of the likely inflation rate under the next Fed chairman. It shows the difference between the yield on a regular five-year U.S. Treasury bond and a corresponding inflation-indexed bond.

Strikingly, inflation expectations have barely shifted, even as the fortunes of Summers and Yellen have reversed. That is, the market appears to expect similar inflation outcomes, on average, under either one.

The movements in expected inflation, moreover, are tiny compared with those generated by even small shifts in policy, such as various statements through late June by the current chairman, Ben S. Bernanke, about how the Fed would taper its asset purchases.

Other Factors

If we had futures markets in gross domestic product or the unemployment rate, we could evaluate whether markets see differences in those variables, too. Unfortunately, we don't. But a very rough indicator of the future of the economy (or at least a part of it) is captured by stock indexes, and those, too, have barely shifted. The exchange rate has also been remarkably stable.

Of course, other factors could be coming into play. Perhaps traders aren't paying attention to the Summers-Yellen race. That seems unlikely, based on even a cursory reading of the financial news. Perhaps a vigorous market response was obscured by other economic news that had an offsetting effect on bond yields. This also seems unlikely given that the past few weeks have been fairly tranquil, with little competing financial news.

All told, the most likely interpretation is that the markets judge the Summers-versus-Yellen race as a nonevent. If so, that would represent a break with history; it is unusual for financial markets to shrug off changes in central-bank leadership. Research by Ken Kuttner and Adam Posen shows that global bond, stock and foreign-exchange markets tend to respond rather sharply to news about the appointment of new central-bank chiefs.

Indeed, bond markets were apprehensive prior to the announcement by President George W. Bush of Bernanke as the new Fed chief in 2005. Worries over the possibility of a weak Fed appointment likely reflected Bush's efforts to name the woefully underqualified Harriet E. Miers, the White House counsel, to the U.S. Supreme Court.

So why is this time different? The answer may lie in the contours of this particular race. The president is thought to be considering Summers, Yellen and Donald Kohn, also a former Fed vice chairman. All are outstanding economists with well-established leadership credentials. The important decision Obama made was in picking his shortlist, and at this point, there are no bad choices. The similarities among Kohn, Summers and Yellen overwhelm any differences.

Who will it be? I don't know. But I'm willing to wager that financial markets are right to bet that whoever it is will continue to deliver low and stable inflation.

(Justin Wolfers is a senior fellow of the Brookings Institution, a professor of economics and public policy at the University of Michigan and a Bloomberg View columnist.)

To contact the writer of this article: Justin Wolfers at jwolfers@umich.edu.

To contact the editor responsible for this article: Paula Dwyer at pdwyer11@bloomberg.net.
