Fed Faces Regime Change: Inside and Outside

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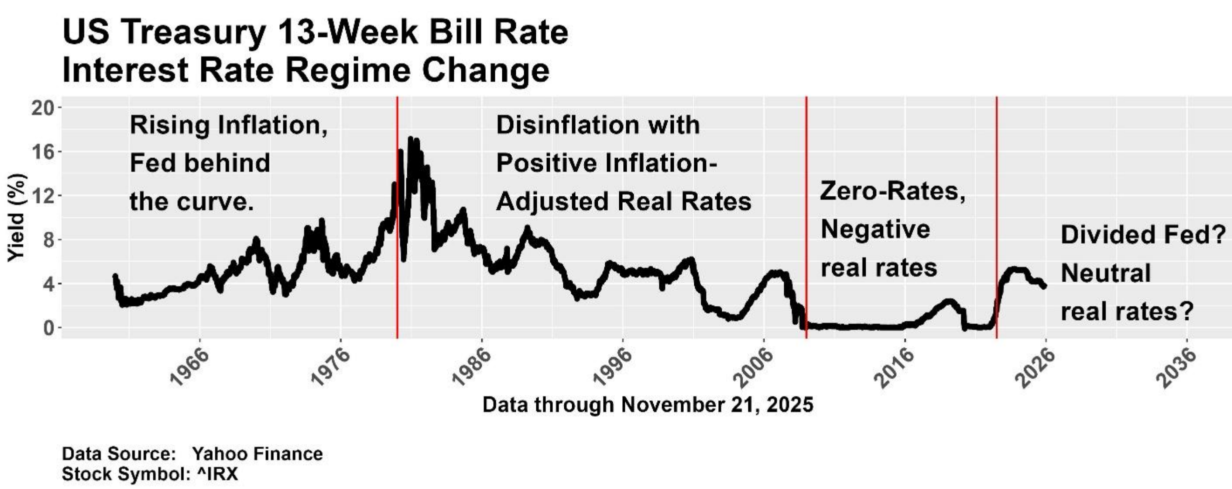
Regime change is happening, and major transitions are always difficult to interpret and analyze, especially if there are several major yet independent transitions occurring simultaneously. The Federal Reserve (Fed) is facing an internal transition to new leadership that promises to change its culture. At the same time, the Fed must confront external transitions that impact its dual mandate of encouraging full employment and price stability while managing a payments system being challenged by crypto-currencies, stable coins, and central bank digital currencies (CBDC).

In this report, we will first examine how the Fed culture has already changed dramatically in 2025 as well as discussing what a new chair of the Fed may mean for interest rate policy going forward. And then, with the Fed decision-making context in mind, we will examine three key questions that are sure to stimulate considerable debate within the Federal Open Market Committee (FOMC) as well as uncertainty among traders and investors.

- **Protectionism** and implications for inflation.

- **Artificial Intelligence (AI)** and impact on productivity and job growth.

- **Crypto-currencies**, stable coins, and central bank digital currencies to alter the payments system.



To anticipate our conclusions, we are likely entering a new era for US interest rate policy. Inflation and employment goals may be conflicted for years to come. The evolution of the payments system may disrupt some of the current key players. And the political polarization of the decision-making process at the Fed has already meant the demise of forward-guidance with the longer-term concepts for setting interest rate policy in considerable doubt. Our base case (65% probability) is for the Fed to migrate toward a neutral rate policy meaning that the federal funds interest rate target would be set only modestly above long-term inflation expectations. But we cannot dismiss the possibility that the Fed opts to return to negative inflation-adjusted real rates (25% probability) to help finance the fiscal deficit and stimulate sluggish job growth or conversely worries about tariff-induced inflation pressures and keeps rates higher than a neutral rate approach would dictate (10% probability).

Fed Culture in Transition

Over the last two decades, since Ben Bernanke became the Chair of the Fed in 2006, the Fed has exemplified a very strong culture of disciplined, consensus-oriented decision-making and a commitment to forward guidance, especially as concerns the interest rate policy decision to be made at the very next FOMC meeting. Prior to the Bernanke-Fed, both Paul Volcker (1979-1987) and Alan Greenspan (1987-2006) were strong-willed and typically led the FOMC to the interest rate decisions they favored. And neither the Volcker nor the Greenspan Feds were particularly interested in forward guidance. Indeed, Greenspan is infamous for his quote in a press conference (paraphrasing): "If you think you understood me, then I mis-spoke".

Times they are a-changing. In the waning months of Jay Powell's term as Chair, he no longer leads a consensus-oriented FOMC, but one that is increasingly politically divided, just like the country. In his press conference following the FOMC October decision to cut rates, Powell made it clear that the interest rate decision in all future FOMC meetings was in play, and no particular outcome should be assumed as a given. That is, Powell unofficially declared the end of forward guidance.

Where Fed culture goes from here is very much dependent on the personality and management style of whomever is appointed and confirmed as the new Fed Chair, taking over at the end of May 2026, for a new four-year term in that role. Once President Trump appoints the new Chair, and in the months before May 2026, the Fed will effectively have a shadow Chair who will likely be in favor of lower rates, as advocated by President Trump.

There are also more changes coming to the FOMC and the Board. Periodically, there may be vacancies on the Board of Governors or for regional Fed Bank

Presidencies that sit on the FOMC. Steve Miran, a Trump appointee, sees his term expire on January 31, 2026. President Trump will probably use that opening for his appointment of a new Chair, but that is yet to be decided.

It is unclear whether Jay Powell will leave the Board of Governors once his term as Chair has ended. Powell's seat on the Board runs until January 31, 2028. While not typical, there is precedent for an ex-Chair to remain on the Board, especially during times of great controversy. Marriner Eccles was not re-appointed by President Truman in 1948. President Truman was an advocate of low rates and for the Treasury to exert influence over Fed decisions. Eccles remained in his seat on the Board of Governors to advocate for Fed independence from the Treasury, which was gained with the "Accord of 1951", after which Eccles retired from the Fed. Notably, the main Fed building in Washington, DC, is named after Eccles.

We should also note that the Federal Reserve Board and FOMC each have its own Chair. By tradition, the FOMC typically elects the Fed Chair to also Chair the FOMC, but this is an option and not a requirement. It is highly improbable and would be quite divisive for the FOMC not to elect the new Fed Chair as its Chair, but we live in interesting and unpredictable times.

Of course, these culture and leadership considerations will evolve in the context of several key transitions in the economy that would make for difficult interest policy decisions regardless of who is leading the Fed. Let's turn our attention to these critical transitions impacting inflation, employment, and the payments system.

Protectionism and Inflation

The debatable issue with moving to a regime of higher tariffs is whether they cause general inflation or just result in the prices of the most tariff-impacted goods rising, while other goods and services rise by less or even fall. That is, does a transition to a protectionist era herald higher average inflation rate over time, or is the impact mostly in terms of the relative prices of goods with little impact on long-run inflation.

Eight months after the April 2025 "Liberation Day" announcements of the initial round of higher tariffs, the jury is still out. Relative to pre-announcement expectations, importing companies, manufacturing companies, and retailers have been willing to absorb more of the new tariff costs than was initially thought. This may not last, since the tariff policy remains in flux, and many companies felt that buffering the initial impact was the best way to maintain market share while waiting on more certainty as to the final tariff rates.

Also, many companies aggressively imported critical goods ahead of the "Liberation Day" tariff initiative. This has caused a major jumbling of real GDP data. Imports are subtracted from real GDP. [Remember from Economics 101, GDP is equal to private consumption (C), plus investment (I), plus government expenditures (G), plus net exports which are exports (X) minus imports (M).] Strong imports in Q1 flattened GDP, while reduced imports in Q2 and Q3 raised GDP. To make any sense of the GDP numbers in 2025, don't look at the pattern, just take the three-quarter average and do not apply too much confidence to interpretation.

Our view is that tariffs are taxes, and so they are net restrictive for the economy on average and over time. The modestly restrictive nature, however, is partly offset by domestic protectionism leading to less competition and thus a slower growth in supply than might have otherwise occurred. Our assessment is that if 2% was the long-run inflation expectation that characterized the globalization period (1990s through 2020), we are now possibly in a 3% inflation environment for the protectionist era. This long-run view of inflation is critical to Fed decision-making because it anchors the debate about what is the neutral rate of interest that is neither restrictive nor accommodative.

Artificial Intelligence (AI) and Employment

The AI revolution is here, and it is powerful. But the long-run impact on the economy, and specifically job creation, is highly debatable. If AI results in slower job growth, then this may bias the Fed to opt for lower interest rates than it might have otherwise.

Our view is that the trend toward more sluggish job growth that has been experienced in 2025 is not all about AI, but AI is playing a role. There are two possibilities we are examining. First, if a company desired to cut expenses but did not want to do so in fear of sending a message that it was having profitability challenges, then laying off workers using the AI excuse is attractive. The company can argue that implementing AI adds to productivity and allows for a leaner workforce. Whether this is true or not remains to be seen.

We also feel that AI is already changing the workforce in real ways. The best AI tools for use in businesses are highly specialized and clearly save time and effort, such as the AI apps for computer coding and programming, AI tools for search, AI tools for medical diagnostics, etc. The challenge, and this is typical of technological change, is that the jobs lost are often very different from the jobs being created. A coder that loses a job is not likely to retrain to be a construction worker in building the new AI data center. Technology transitions usually bring powerful benefits long-term along with some negative impacts and frictions during the implementation and acceptance phase.

Payments System confronts a Digital World

We are increasingly living in a digital payments world. And the digital payments world itself is in transition. People want their money to move faster and at a lower cost. While crypto-currencies have begun to enter the mainstream, it is the stable coin intermediaries that are impacting the payments system. There are two major players in the stable coin realm: Tether and Circle. Their business model involves holding reserves in very short-term and safe securities to back their liabilities, and that means they now hold some 2% of all US Treasury bills, with that share on the rise. Locking up Treasury bills in the vaults of the stable coin providers has the potential to impact liquidity to the banking system, a major challenge for the Fed.

The rise of crypto-currencies and stable coins also involves the challenge of how a central bank should connect to stable coins. Virtually all central banks are studying, considering, or possibly planning to create their own central bank digital currencies (CBDC). The Bahamas has already done this, with its "SandDollar" whose infrastructure was engineered in part by MovMint.io, a Canadian innovator in the CBDC space. Brazil has effectively created its links to digital currencies. Digital currencies tied to a sovereign currency are an evolving landscape, but they are on the radar of every central bank. The major credit cards companies, as well as international FX transfer system (SWIFT) are in play. A digital world at least offers the promise of lower transactions costs and near real time money transfers.

The Bottom Line

How will all these transitions impact the Fed? We have a few thoughts.

- US interest rate policy is entering new era. The dual mandate of low inflation and full employment goals are likely to be conflicted for years to come. The job constraining process of adopting AI may dominate Fed interest rate decisions and create a bias for lower rates, but inflation worries related to the protectionist era will be part of the debate and may constrain some impulses for low rates.

- The polarization of members of the Fed's FOMC has already rendered forward guidance a thing of past.

- The evolution of the payments system may disrupt some of the current key players in the payment process and may also cause challenges for short-term liquidity in the financial markets. At the same time, more central banks may move forward with the creation of their own digital currency.