Elections matter, especially when the choice offers distinct and unpredictable governing outcomes. This note mostly covers how the November contest in the United States has mattered and will matter for the Federal Reserve. It has mattered already because we think the advantage of waiting until after the ballots were counted to move a little further in renormalizing monetary policy importantly influenced the decision of the Federal Open Market Committee (FOMC) not to act at its September meeting.

It will matter in the future because an FOMC that waits in September because of the shadow of the election will surely take another pass at its November meeting, which is scheduled a week before the popular vote.

And the result of that vote will quickly determine the composition of the Federal Reserve Board and the likelihood Janet Yellen has a second term starting in February 2018. Despite some recent talk that she would resign early were Donald Trump to be elected, expect Yellen to be in office for at least a full four years. To think otherwise misunderstands the Fed’s history and its chairwoman’s determination.

To set all this up, we first turn to a prediction market to ask the important question, which is not who wins the presidency. The important question is who governs next year, which is about the executive and legislative branches.
Predicting Control of the U.S. Government

No doubt, the headline bout on the November ticket, Hillary Clinton versus Donald Trump, is the focus of searing attention. We, however, find more productive entertainment in the undercard, which we handicap using the Iowa Electronic Market, an exchange set up by the business school of the University of Iowa.¹ Admitted, trading volumes may be light and positions small, but arbitrage opportunities with deeper betting markets keep prices in line with major national and statewide polls. Particularly of interest, there is a winner-take-all (WTA) contract for each candidate at a market clearing price at any time that pays $1 in the event of victory. The price of the WTA contract is the subjective probability of winning.² This is more informative than polling results of current inclinations, as the probability of winning incorporates a prediction of voting shares in the future, November 8, adjusted for the relative confidence in that prediction. After all, a small lead in current polls may be associated with a high probability of victory if investors are confident that the lead will widen by Election Day.

The lines in the chart below plot the varying fortunes of the candidacies of Hillary Clinton (the blue line) and Donald Trump (the red dashed line), at least as assessed by the IEM participants.

Winner-take-all price on the U.S. Presidential election from the Iowa Electronic Market

Note: These are based on the winner-take-all contract for president on the Iowa Electronic Market and represent the current prices of returning $1 in the event of the victory of each candidate.

Source: https://tippie.biz.uiowa.edu/iem/ accessed October 6, 2016

¹ Available at http://tippie.biz.uiowa.edu/iem/
As is evident, fortune favors the Democratic contender, in that it costs 74¢ to buy a claim that pays $1 on her victory. The price of the Republican contender topped out at 42¢ in late May and is now 27¢.

Of note, the first presidential debate apparently mattered more to commentators than investors, as the Trump contract only edged lower after September 26. This is consistent with the view that debates usually do not change hearts and minds but, rather, make potential voters more comfortable with their extant intentions. Indeed, in a recent Gallup survey on who “won” the debate, self-identified Democrats preferred their candidate by nine-to-one. On the other side of the coin, Republicans favored Donald Trump eleven-to-six.

The race for president provides high-level drama, but control of the Congress determines the policy traction available to the next resident of the White House. The IEM provides what we need to assess the key question—contracts for Congressional control that fill out the two-by-two table associated with Democratic or Republican control of the Senate and the House. The table below gives the prices of those WTA contracts, normalized to one.

### Winner-take-all price on Congressional control

<table>
<thead>
<tr>
<th></th>
<th>House of Representatives</th>
<th>Senate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Democrat</td>
<td>Republican</td>
</tr>
<tr>
<td>Democrat</td>
<td>0.12</td>
<td>0.39</td>
</tr>
<tr>
<td>Republican</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: Adjusted to sum to 1.

Source: Iowa Electronic Markets as of October 6, 2016

One cell can be dismissed outright. Overturning control of the House of Representatives is an uphill battle for Democrats, given their 248 to 192 disadvantage, and the remarkable fact that, in the modern era, artfully drawn House districts imply that the incumbent party stays in power more than nine-out-of-ten times. As a consequence, dismiss the lower-left cell, because if Republicans have enough national momentum to retain control of the Senate, then they will keep the House, too.

More interesting are the remaining three boxes, which are associated with four distinct outcomes if we line them up with the presidential contest.

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Given the advantage of incumbency, the most likely outcome is a divided government, where President Clinton has to work with a Republican House.

(1) President Trump and a Republican House and Senate

Investors on the IEM put a 48% probability that the Republicans retain control of both the House and Senate, the lower left cell. Around the Democratic Convention, there was only 20% weight on that outcome, indicating considerable progress in state-by-state contests as well as increasing comfort among traditional Republicans with the top of the ticket. Tying in the presidential payouts, that 48% of a Republican Hill divides into a 28% of a solidly Republican government and 20% that a Democratic president faces a hostile Congress.

Under the all-Republican outcome, the same party controls the White House, the House of Representatives, and the Senate, but the president, speaker, and majority leader are not really on the same page about policy. The need to show progress will drive them to some compromises, picking the low-hanging fruit common to all involved. Fiscal stimulus kicks in quickly, with more spending on defense and infrastructure and a restructuring of corporate taxes. After that, expect the slow crawl of tax reform, designed by the speaker to be acceptable to the president. Meanwhile, the White House will be using its executive authority to scale back the nation’s position in international trade.

(2) President Clinton and a Democratic House and Senate

A uniformly Democratic District of Columbia will probably reveal how quickly the gears of the government can mesh. The last time this happened, President Obama signed the American Recovery and Reinvestment Act the month after his inauguration in February 2009. Capitol Hill most likely tugs the White House left of the president’s more centrist leanings, a process that already began during the nomination contest.

Legislation widening the federal deficit will be a feature of the first one hundred days, combining increased transfer payments and infrastructure spending not paid for entirely by tax increases. Some of the expansion of executive authority in the Obama administration will be given the force of law, especially regarding the environment and labor relations. As in the prior case, a hostility to trade will be manifest in abandoning ongoing negotiations and backpedaling on some existing ones.

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4 The Clerk of the House’s count, available here: http://clerk.house.gov/member_info/cong.aspx, includes delegates. There are currently three vacancies.
(3) President Clinton and a Split Capitol Hill

Given the advantage of incumbency, the most likely outcome is a divided government, where President Clinton has to work with a Republican House. An advantage is that she will have leverage that comes from a Senate run by a Democratic majority. Control of the Senate provides the president with some freedom in nominating appointees to her liking, but the voting margin there seems likely to be sufficiently slim that procedural maneuvering will make some of those nomination battles dramatic.

The composition of the Congress gives scope for compromise for the second President Clinton in the manner of the first President Clinton in 1995-96. If so, expect progress on corporate tax reform given the hope that there is a $2 trillion pot of money offshore to be taxed, some spending on infrastructure across 435 districts and 50 states, and a preservation of the regulatory infrastructure erected over the past eight years. Where the Congress goes slow, the White House and its agencies will use executive orders, anticipating anger but no effective countermeasures from the divided Congress.

(4) President Clinton and a Solidly Republican Capitol Hill

With Capitol Hill run by the opposition party, President Clinton will have to curb her party’s ambitions on appointees and compromise on legislation. Look to key appointees, whenever they are finally confirmed, to be well right of the Clinton campaign’s talking points. Even so, there is a real risk that the president may be the trapeze artist who goes past mid-arc, mid-air, to find no one there. The overwhelming tendency among senior Republicans, if their party won most races but lost the big one, will be to position for the next election. Indeed, some of the early movers looking to 2020 may attempt to build their candidacy on obstructing the use of executive authority and rolling back some of the programs enacted by President Obama. In such circumstances, the major legislative initiatives of the White House may well be the exercise of veto power. Tighter gridlock than we have known before makes it likely that there will be no meaningful progress on tax reform nor an increase in infrastructure spending.

The fact is, by gritting it out, especially if an ill wind blows strongly from the White House, Chair Yellen establishes herself as an icon of institutional rectitude.
Turnover at the Federal Reserve

Major economic policymaking positions are typically PASCs—Presidential appointees that are Senate confirmed—which is what makes understanding the likely outcomes on control of the White House and Capitol Hill so important.

On the surface, more drama might be expected to be forthcoming from President Trump, who would have a same-party Senate and has already complained that, because of the Fed, “We are in a big, fat, ugly bubble.” Indeed, there have been some reports that Fed Chair Yellen would resign immediately on the victory of someone who has no confidence in her. Consideration of both the supply and demand for Janet Yellen’s services makes this seem extremely unlikely.

Supply. Among the mechanisms protecting the Fed from political interference is that governors’ terms are long (14 years) and staggered (coming up every two years) and that the chair’s term is not coterminous with that of the president. Because of the former, a president does not appoint a majority of the seven-member Federal Reserve Board in one term under statutory turnover. Because of the latter, the president’s most important economic appointment is not part of the horse-trading of positions typically taking place at the start of an administration.

Perhaps even more importantly, Janet Yellen cares about her institution and her place in history. By resigning early, Yellen would strip away important political insulation for her institution. For herself, she would be placing an asterisk next to her name in the list of Fed chairs, denoting not having served out one full term. And history has not judged the prior Fed head with an asterisk, G. William Miller, favorably. The fact is, by gritting it out, especially if an ill wind blows strongly from the White House, Chair Yellen establishes herself as an icon of institutional rectitude.

Demand. The two most senior, glass-breaking appointees in Washington, Fed Chair Janet Yellen and Supreme Court Justice Ruth Bader Ginsburg, were both born in Brooklyn. Two important differences should separate them when viewed from the White House. Yellen will have only one year left in her appointment, not one for life, at the start of the president’s term and has scrupulously avoided commenting about politics. Viewed from Pennsylvania Avenue, there is more than enough to do in the first year in office to bother burning political capital on the remaining twelve months of Yellen’s service.

This holds with particular force because the White House has a lever to shape monetary policymaking from the outset. Two of the seven board governor slots have been open for some time. The administration has the option to use one of those positions to appoint a plausible successor to Yellen, perhaps even on January 21st. (Remember that Yellen was added to the board in Ben Bernanke’s second term and tipped as a potential successor, suggesting that there is nothing inappropriate in moving early.) This would create a second gravitational center attracting other policymakers and market participants. If the administration really wanted to fire an early shot across the Fed’s bow, the second name sent to the Senate on January 21 could be the new...
board governor who would also serve as the vice chair for supervision. (That title was introduced in the Dodd-Frank legislation, but the White House never fulfilled this particular letter of the law.) Governor Tarullo has had the supervisory role in fact but not in title and may well not stick around as governor without portfolio. Thus, there is a real possibility that the President could make three appointments reshaping the Fed in a hurry. But even more follows, as one year later, the terms of Janet Yellen and Stanley Fischer expire, opening up the possibility of naming a majority of the board within two years of office.

Briefly considering the other possibilities. If Senate control turns to Democratic hands, the new Clinton administration might satisfy the leftward tug of the Senate Banking Committee with governor designees who were more diverse and tending toward a more accommodative slant than the current median Fed official. There would also likely be pressure to work toward more diversity at the Federal Reserve Banks. Chair Yellen’s tenure would seem to be secure, in that most incumbent Democratic Senators signed a letter urging President Obama to appoint her four years earlier.

A Republican Senate confronting President Clinton makes a world of difference because it is not clear whether enough members would support the Fed incumbent. Perhaps, but perhaps not, in which case the White House has two options. First, it could delay sending any name to be considered, leaving Yellen to serve as acting chair, which has few material consequences for the work of the Fed and ample precedent. Second, the President could make a new first by appointing an African American or Hispanic who was right of the incumbent, potentially satisfying the Senate, but assuaging the feelings of her base.

None of this is easy or assured. We end with a cheat sheet spelling out likely policy direction under the four plausible electoral outcomes.

<table>
<thead>
<tr>
<th>Potential Policy Scenarios Given Various Electoral Outcomes</th>
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<tbody>
<tr>
<td><strong>President Clinton</strong></td>
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<td><strong>President Trump</strong></td>
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<tr>
<td><strong>(1)</strong> All Democratic</td>
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<tr>
<td><strong>(2)</strong> Split Congress</td>
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<td><strong>(3)</strong> All Republican Hill</td>
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<td><strong>(4)</strong> All Republican Hill</td>
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<tr>
<th>Current probabilities (%)</th>
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<td>Defense spending</td>
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<td>Federal Reserve slant</td>
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