Political Troubles Forecast for the Fed

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With the retirement of Congressman Ron Paul (R-TX), you would think that that the Federal Reserve would face less criticism, political friction, threats of reform, or unwelcome extensions of their responsibilities in the coming 113th Congress. Unfortunately, this is unlikely to be the case. The Federal Reserve will face significant political troubles in the upcoming Congress, as the legislature continues to pare back the central banks' ability to independently set policy goals and take decisions. The Fed has no one to blame but itself for opening the political Pandora's box.

Three elements will drive political conflict between the Federal Reserve and Congress in the new term. First, for over 25 years the Fed has articulated its dual mandate to price stability and maximum employment by lexicographically stating that price stability fosters an environment for maximum employment. Since the end of the Great Inflation, there has been consensus on this point in academia, policy circles, as well as bipartisan political support. The Fed's new communication and policy strategy now scrambles this priority ordering, suggesting that policy now will be geared towards driving down the unemployment rate and supporting the labor market up to some "trigger point", as long as inflation does not accelerate beyond some higher level "trigger point". While there is no systematic evidence that monetary policy operated in this way has ever been successful, allowing monetary policy to be unhinged will reignite the partisan perspectives on monetary policy that characterized the pre-Volcker era. Indeed, in this earlier volatile period, Democratic lawmakers had a higher tolerance for inflation and a lower one for unemployment, and vice-versa for Republicans. The Fed, caught between a Democratic President and Senate and a Republican Congress, could again feel the heat from renewed partisan bickering.

Second, the Federal Reserve's actions have drifted far from the central banking orbit and into the murky fiscal policy world. The Fed has taken actions well beyond what central banks are supposed to do; namely, (a) provide sufficient growth of liquidity in the long run to provide a stable price level and anchor inflation expectations; and, (b) manage temporary increases and decreases in liquidity to support a limited counter-cyclical policy and to be the lender of last resort. Rather, the Fed has now become the lender of first and only resort. The Fed has used its fiat authority to take on a massive, permanent increase in reserves to the liabilities side of its balance sheet while taking on long term government debt and mortgage backed securities to the asset side of its balance sheet. These Federal Reserve assets, however, are private and public sector liabilities incurred from the purchase of goods and services. In the public sector case, we call this fiscal policy. In the private sector case, we call this credit policy. For the private sector loans, we call this credit policy. Public debt management and the funding of private sector liabilities in the conduct of monetary policy are exceptionally unorthodox for an independent central bank. Failure, contrary to what the Fed is championing, is an option – an option that will have serious political repercussions for the Fed.

Of course, the Federal Reserve has partially justified taking these unusual and risky steps, post-financial crisis, because the legislative and executive branches of government have been unwilling to address the federal budget stalemate. But that is an excuse for the Fed's actions, not a reason for it. The current lame duck session of Congress, in an attempt to avoid the consequences from sequestration, may or may not rise to the challenge of fixing the fiscal imbalance in a bipartisan fashion. Regardless of the outcome, political pressure on the Fed will

mount. If the President and the legislature take action, come to an agreement on fiscal policy and avoid the fiscal cliff, then this eliminates the Fed's major justification for engaging in fiscal and credit policy in the presence of a legislative vacuum. However, this won't stop the Fed from pursuing its current strategy. It will, therefore, have to articulate a new justification. And if a deal is not cut, and the automatic spending cuts and tax increases are implemented, then the Fed will surely be tempted to continue to pursue its expansionary policies and further expand its balance sheet. And as its balance sheet grows, so does its political liabilities. The resolution of the fiscal cliff will be no panacea -- the Fed's fiscal and political problems will get worse regardless of the fiscal cliff outcome.

Finally, Ben Bernanke's term as the Chairman of the Federal Reserve Board, expires on January 31, 2014. By the time his potential reappointment is in play, the U.S.'s fiscal position will have taken shape and the European crisis will have brought forth recessionary pressures in Europe and slowed world growth. Together, these forces will put further downward pressure on U.S. activity – never a good thing for a Federal Reserve Chairman's performance evaluation. Congress would certainly be a more hostile place for a re-appointment vote, but the honor of vetting a Presidential nomination goes to the Senate. I would expect that Ben Bernanke would be favorably viewed by the Obama Administration, but if he reasonably decides to take on a new challenge (and who could blame him given his service to the country), almost anything goes. Many internal Federal Reserve officials, including Vice-Chair Janet Yellen, would face the political baggage of the Fed's policy adventurism and its consequences. I don't think the public or Wall Street is ready for another academic. And the public has not quite put away its pitch forks and torches long enough yet to see its way to having someone with extensive Wall Street experience be given the keys to the car. And the baggage carried by Wall Street candidates won't be made lighter given the financial regulatory issues still under review by the Fed. Again, the answer is the same – politics. Expect a political appointment, such as a current or former elected figure, to get the nod if Chairman Bernanke decides to go in a different direction with his career.

The Federal Reserve has, so far, been bruised by the political fallout from its aggressive handling of the financial crisis and for allowing monetary policy to run adrift. There is a current sense of political calm that suggests that the Fed may be in the eye of the storm. Don't expect the calm to last. The Fed's current priority of lowering long term interest rates on government and mortgage backed securities is being expediently tolerated by Congress as it is serves Congress' interests to assist the housing market and lower interest costs on government debt. But when economic growth softens and price stability is jeopardized in the U.S., the spotlight will move to the Fed's risky decision-making. The Fed will quickly become the scapegoat. The Federal Reserve is a political and economic institution. It is well equipped to be the latter. It has only itself to blame for its weakness as the former.