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How Fed's Cold War with Congress could harm the U.S. economy

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Federal Reserve Chair Janet Yellen's relations with Congress look as strained as those of her predecessor, and that could undermine the central bank's ability to confront the next crisis.

At a time when it may require congressional support for new powers should the U.S. economy stumble, the Fed is fending off lawmaker criticism of its policies, while enduring attacks from candidates campaigning to be the next president.

With its benchmark interest rate likely to remain low for years, and a balance sheet bloated to $4.5 trillion by quantitative easing, U.S. central bankers may need to resort to extraordinary measures once again if the economy tilts toward recession.

The Fed is independent. Yet its freedom to go all-in to defend the U.S. economy depends on a sometimes-fragile consensus in Congress that it is doing the right thing. Without that, the central bank's ability to seek new tools could be limited.

"The most urgent question right now is about the limits on the Fed's powers: Are they justified, and what will they do" if another recession looms and officials want to act while rates are still near zero, said Joe Gagnon, a senior fellow at the Peterson Institute for International Economics in Washington and a former Fed Board economist.

"The Fed is the most restricted central bank that I am aware of," he said. "It will be even harder for them to respond" in the next downturn without proper authority from Congress.

Yellen was quizzed on negative interest rates and the Fed's payment of interest on excess bank reserves, or IOER, by skeptical lawmakers from both parties during two days of congressional testimony earlier this month.

IOER is a critical tool to steer Fed policy when it has a massive balance sheet. The ranking Democrat on the House Financial Services Committee, Maxine Waters, expressed dissatisfaction with the Fed's payment of interest to banks. Committee Chairman Jeb Hensarling, a Republican from Texas, called the payments a "subsidy." Republican Sen. Patrick Toomey of Pennsylvania asked Yellen to clarify if she had authority to push IOER negative and effectively charge banks for parking reserves at the Fed.

Yellen said she was "not aware" of legal restrictions, a view that was later doubted by Senate Banking Committee Chairman Richard Shelby, a Republican from Alabama.

"Lawmakers' criticisms seem to go beyond the Federal Open Market Committee's policy choices — they go straight to the Fed's monetary policy tools," said Sarah Binder, a senior fellow at the Brookings Institution in Washington. Weak support for unconventional tools "raises questions about the Fed's capacity to fight a future recession."

Yellen tried to improve relations with Capitol Hill when she took over the top Fed job two years ago from Ben S. Bernanke, who had been slammed by Republican lawmakers over the Fed's extraordinary policy action during the 2008 financial crisis.

That effort did not succeed in removing post-crisis distrust of the central bank among lawmakers in both parties, who have criticized its ultra-easy monetary policy and for being too close to the big banks that it regulates.

As the climate turned more hostile, Yellen has also dug in. When congressional Republicans subpoenaed documents in an investigation of a 2012 leak, Yellen responded on her own timetable, riling lawmakers. When questions come up about the Fed's 100-year old structure, Yellen says it is ultimately up to Congress while adding, "I don't think it is broken the way it is."

Aaron Klein, a director at the Bipartisan Policy Center in Washington who has worked as a senior adviser to Senate Democrats, said defending the status quo of the Fed's structure is "untenable."

"On the flipside, when Congress has recently looked at the Federal Reserve system it has become preoccupied with taking unwise steps that would reduce Fed independence," he added. "If you could have a reasonable conversation, you could produce a better system."

Federal Reserve spokesman David Skidmore decline to comment on the state of relations between the central bank and Congress.

Now, in an election year, anything the Fed does can become populist bait for a presidential field that includes Vermont Sen. Bernie Sanders, the self-described socialist who seeks the Democratic Party's nomination, and Ted Cruz, a Republican senator from Texas. Both have called for government audits of the central bank, while Republican front-runner Donald Trump said a Fed audit was "so important" on his official Twitter account.

Former congressional and Fed staff regret that there isn't a more productive forum to discuss monetary policy, the Fed's structure, and supervisory matters.

The current state of play — where the Fed acts and Congress objects and vice versa — probably isn't sustainable, said Mark Calabria, a director of financial regulation studies at the Cato Institute in Washington.

"This failure and unwillingness to engage has hurt the Fed and has made them look tone deaf and unresponsive," said Calabria, a former Republican staff member on the Senate Banking Committee. "You don't know where this is going to go."

Even former Fed insiders, such as Donald Kohn, who served as vice chairman under Bernanke, suggests the Fed should find ways to improve dialogue.

Writing on Bloomberg View, Kohn, with co-author David Wessel, a senior fellow at the Brookings Institution, said the Fed should release its semi-annual Monetary Policy Report days before the hearing, allowing time for congressional and Fed staff to brief each other before hand.

The implication, of course, is that the report becomes a more transparent description of the Fed's planning and strategy. Kohn and Wessel said the Fed should also include more information about how it decides interest rates, defusing Republican concerns that policy is too discretionary.

Kohn and Wessel also recommended outside peer reviews "to periodically evaluate" the models that produce staff projections and how the policy makers describe their own forecasts and policy path.

Unlike the Bank of England, the Bank of Canada, or Sweden's Riksbank, the Federal Reserve Board has never had an outside review of its policy process with results published for the public.

"Tense relations between Congress and the Fed aren't entirely new in the long aftermath of the financial crisis," said Binder. "But the consequences for the Fed seem particularly acute to me this time."