Fed's credibility on the line with interest rate call

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With an interest rate hike looming, the Federal Reserve's credibility is on the line.

Chair Janet Yellen has professed unflinching confidence in the Fed's ability to steer policy back to normal. That confidence will now be put to the test as the central bank sifts through a pile of economic data to find the right time to act.

The transition carries huge economic consequences, but major political ones too, because Fed skeptics would seize on any misstep to justify tightening the leash on the bank.

The big question at the Fed is when to pull the trigger on the first interest rate increase since 2006.

Ideally, the central bank will allow the unemployment rate to drop as far as it can without keeping rates low for so long that inflation begins to grow more than expected.

It's a bit of a moving target for the Fed, which has to pump the brakes before hitting its goals.

On Friday, Yellen said "policymakers cannot wait until they have achieved their objectives to begin adjusting policy."

"Doing so would create too great a risk of significantly overshooting both our objectives … potentially undermining economic growth and employment," she warned.

And while the unemployment rate is one of the most prominent measures of economic health, the Fed has to rely on many other pieces of competing data to form the most complete picture it can.

"It's much harder to make an assessment," former Federal Reserve Chair Ben Bernanke said Monday, following remarks at the Johns Hopkins School of Advanced International Studies.

"The unemployment rate used to be the only number you had to look at. Now of course there are many dimensions."

How smoothly Yellen is able to steer through the first interest rate hike in nearly a decade could significantly affect the brewing debate in Congress about altering how the Fed operates.

For years, Republicans have criticized the Fed's extremely accommodative policy, arguing it is sowing the seeds of damaging inflation and encouraging bad habits in financial markets. Lawmakers have begun pushing to more tightly restrict the Fed's policymaking and bring it under closer congressional scrutiny.

Diane Swonk, chief economist of Mesirow Financial, said Yellen and Fed officials are cognizant of the political pressure as they try to lay a path for a smooth series of rate increases.

That pressure stems from the Fed's move to stop the collapse of AIG and Lehman Brothers as the 2008 financial crisis took hold.

"The Fed has zero experience with doing what they're doing right now because they've never done it before," said Andrew Busch, editor of the political and financial newsletter The Busch Update.

Historically, Busch said, the Fed has acted late. The concern now, he said, is that the Fed will ultimately get too aggressive and go too far.

In response, Yellen and her Fed colleagues have insisted they are carefully weighing all the risks and scrutinizing all the new data. She has dismissed proposals to reform the bank as handcuffs for an institution that needs flexibility to do what is best for the economy.

But with an interest rate hike expected sometime in the coming months, the notion that the Fed is an expert body that deserves a wide berth from Congress could be put to the test.

"To the extent that it looks like she bungled the exit … then I do think it makes it harder for her to fight reform," said Mark Calabria, director of financial regulation studies at the Cato Institute. "The more they can project that kind of expertise, the better insulated they are from questioning."

Prominent Republicans in both chambers have indicated that they will pursue some form of Fed reform, whether it be tying the bank to a formal monetary policy rule, changing the number of Fed districts nationwide or reforming how the system is audited.

Rep. Bill Huizenga (R-Mich.), who chairs the Financial Services subcommittee on monetary policy, told The Hill the Fed is in need of reform, "regardless of market conditions."

"A more transparent, predictable rules-based approach to monetary policy is essential, rain or shine," he said.

But if an interest rate increase leads to havoc in financial markets, it could lead to some "I told you so" from Fed skeptics who have criticized its decisions for years.

At its last policy meeting, the Fed updated its policy statement to remove language saying it would be "patient" in raising rates. At a subsequent press conference, Yellen emphasized that the change did not suggest a rate hike was imminent but that the central bank was beginning to monitor the landscape for the appropriate moment to do so. She ruled out a rate hike when the Fed next sets policy in April.

While Yellen has been at the Fed since long before the central bank embarked on its stimulus efforts, the tricky business interest rates is her first major challenge since taking the reins of the institution a little over a year ago.

Yellen got the nod from President Obama to lead the Fed thanks to a significant push from a group of Democratic lawmakers who publicly advocated for her ahead of Lawrence Summers, the president's former economic adviser and preferred pick.

Like Bernanke, Yellen has exuded steadfast confidence in the Fed's ability to raise rates without disrupting the overall economy. But now her reputation as an expert among experts will be put to the test.

"Unfairly or not, if the exit goes poorly, she's going to certainly bear some of the blame," said Calabria.

And there are plenty of Fed-watchers who believe the reform chatter will remain just that, because many policymakers ultimately will want to leave the steering of the economy to an independent central bank.

"Imagine if Congress had to determine the best way to manage the economy," said one financial lobbyist. "I love these guys, I deal with them all the time. But I would be terrified."