showdown at the Fed

The recent Beltway brouhaha over the Federal Reserve? We’ve seen this duel before.
ongress is angry again. And this time, they’ve got the Federal Reserve in their crosshairs.

In February, Fed Chair Janet Yellen testified to Congress on the state of the economy. The question-and-answer period of the two-day testimony was dominated by criticism of the Fed by the extreme right and, to a lesser extent, the extreme left.

House Financial Services Committee Chair Jeb Hensarling (R, Texas) contended that “Fed reforms are needed, and Fed reforms are coming.” And U.S. Senator Rand Paul (R, Kentucky) again pushed for a new audit of Fed policies—even though the Fed is already audited annually—as well as for discussions to again address the Fed’s independence.

This kind of Congress/Federal Reserve consternation isn’t new. In fact, it’s a variation on an old and recurring theme. Imbroglios between the Fed and D.C. politicos have erupted with regularity for the entirety of the agency’s century-old existence—and certainly over the last five decades (see sidebar on page 5).

**Sturm und drang, power and money**

As is so often the case in Beltway battles, the recent sturm und drang over the Fed comes down to two familiar factors: power and money.

**Power.** Today’s Federal Reserve wields enormous power and influence over the fate of the U.S. economy. In the absence of strong, responsible fiscal policy—that is, Congressionally led tax reform—monetary policy has been utilized to guide the U.S. economy back to health following the crisis of 2008–2009.

**Money.** The Fed’s balance sheet has caught Congress’ eye, and not in a good way. Resulting from the quantitative easing program that’s been credited with rescuing the economy from the brink of depression, the Fed’s balance sheet has ballooned by more than fourfold, from less than $1 trillion in 2008 to $4.5 trillion today. That kind of money tends to attract attention.

These two factors have some in Congress wondering if such a newly rich and powerful government agency should operate independently of the more stringent influence of the legislative branch.

**Campaign trail heat (if not light)**

Now add one more important factor to this mix: There’s a presidential election campaign brewing. Especially from the expected wide-open field of Republican contenders, the power-of-the-Fed issue may be raised by one or more candidates as a platform differentiator. Expect candidates to ratchet up the rhetoric on whether the Fed has “overstepped its mandates” and wields too much influence over the fate of the economy.

A noteworthy point: the Fed’s power and budget increased as a direct result of a Republican president’s and Republican treasury secretary’s plea to enact TARP. The “too big to fail” cleanup process was initially a plea to the Fed to expand the Treasury’s balance sheet.

Put all this together, and the foundation is in place for a political battle over the Fed’s policies. Over the coming months, Congress will continue to make noises about reining in Fed power and gaining greater control over its policies. Chair Janet Yellen will continue fighting off their advances. And presidential candidates will get involved in the fray, if for no other reason than it’s a safe, ultimately innocuous issue that generates much more campaign trail heat than actual light.

**Chasing headlines**

Clearly, one factor driving the current beat-down on the Federal Reserve is its increased influence on the U.S. economy—and thus, the increasing newsworthiness of its actions—over the past several years.

After the presidential election of 1960, Richard Nixon blamed his defeat on the tight-money policy orchestrated by then-Fed Chairman William McChesney Martin. Years later, during Nixon’s first term, he aggressively lobbied then-Chairman Arthur Burns to increase the money supply to spur economic activity and boost his reelection chances.

The lobbying was successful, and the “easy money” policies of the Burns Fed exacerbated the inflation of the 1970s.

As inflation raged during that decade, Congress took action to change the Fed’s mission. The Humphrey-Hawkins Bill mandated the Fed to reduce both inflation and the unemployment rate—replacing the Employment Act of 1946, which focused on pursuing “maximum employment, production and purchasing power.” The resulting Full Employment Balanced Growth Act, signed into law by President Carter in 1978, explicitly instructed the Fed to strive for a policy that maximizes employment without inciting inflation. The act also required the Fed’s Board of Governors to formally present a report to Congress twice a year outlining its monetary policy.

Upon his election in 1980, President Reagan told new Fed Chairman Paul Volcker to do whatever was needed to reduce inflation. So, Volcker took aggressive tightening actions to limit growth in reserves and money supply. It worked, and halted a steep inflationary spiral. Curiously, though, the administration disliked the hardline stance. And when Volcker’s term came up for renewal, Treasury Secretary Don Regan was instrumental in pushing him out. (One theory posits that the Volcker ouster was payback for the Volcker-induced interest rate spikes in 1979, which caused problems for Don Regan when he was at the helm of Merrill Lynch.)

For the next two decades, the relationship between the Fed and Washington political leadership was one of relatively peaceful coexistence. Then came the financial meltdown of 2008-2009. Despite fears from some politicians that the Fed’s quantitative easing program would fail to stimulate economic activity and would merely spur inflation, it now appears that the U.S. economy is in its sixth year of recovery without spurring a dangerous reacceleration in inflation.
Especially during the course of the current economic recovery, every testimony by Chair Yellen before Congress (and Ben Bernanke’s before her) has been analyzed, and every word parsed (the latest: “patient”) for clues on the timing and size of the long-awaited beginning of normalization.

It’s largely an unproductive exercise. Nearly everyone agrees that the Fed will begin normalizing rates with an incremental bump later this year. It will continue to raise rates over the forthcoming 12 to 18 months until, by January 2017, the federal funds rate sits somewhere between 1.50 and 2.25 percent.

This gradualist approach to a rate path was reinforced by Ms. Yellen in March, when she stated, “If conditions evolve in the manner that most of my colleagues and I anticipate, I would expect the level of the federal funds rate to be normalized only gradually, reflecting the gradual diminution of headwinds from the financial crisis and the balance of risks I have enumerated of moving either too slowly or too quickly.”

In an address in April, Fed Vice Chairman Stanley Fischer reiterated this anticipated trajectory. “An increase in the target federal funds range likely will be warranted before the end of 2015...”

DO WE NEED 12 DISTRICTS?
A MODEST PROPOSAL

If Congress continues to emphasize reducing the Fed’s $4.5 trillion war chest, one area it can focus on is potential redistricting. Today, the Fed comprises 12 geographic districts across the country—districts created 100 years ago when the nation’s business activity was far different than it is today.

As a result, the relative weightings of the districts are misaligned with actual economic activity in those districts. The San Francisco district, for example, now represents an outsized 21 percent of nominal GDP; none of the other 11 districts represent more than 12 percent—and six represent 6 percent or less.

Simply by reassessing this geographical construction, in theory it’s quite possible to consolidate from 12 districts to as few as five or six. That would represent a sizable reduction in the Fed’s cost structure and operating budget all by itself. This kind of consolidation has been achieved successfully by other agencies, such as the Federal Farm Credit System.

FEDERAL RESERVE BOARD DISTRICT NOMINAL GDP ESTIMATES

<table>
<thead>
<tr>
<th>Rank</th>
<th>District</th>
<th>Nominal GDP</th>
<th>GDP %</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Boston</td>
<td>$901bn</td>
<td>5.4%</td>
</tr>
<tr>
<td>2</td>
<td>New York</td>
<td>$1,691bn</td>
<td>10.1%</td>
</tr>
<tr>
<td>3</td>
<td>Philadelphia</td>
<td>$722bn</td>
<td>4.3%</td>
</tr>
<tr>
<td>4</td>
<td>Cleveland</td>
<td>$759bn</td>
<td>4.5%</td>
</tr>
<tr>
<td>5</td>
<td>Richmond</td>
<td>$1,637bn</td>
<td>9.8%</td>
</tr>
<tr>
<td>6</td>
<td>Atlanta</td>
<td>$1,934bn</td>
<td>11.6%</td>
</tr>
<tr>
<td>7</td>
<td>Chicago</td>
<td>$1,787bn</td>
<td>10.7%</td>
</tr>
<tr>
<td>8</td>
<td>St. Louis</td>
<td>$660bn</td>
<td>3.9%</td>
</tr>
<tr>
<td>9</td>
<td>Minneapolis</td>
<td>$487bn</td>
<td>2.9%</td>
</tr>
<tr>
<td>10</td>
<td>Kansas City</td>
<td>$969bn</td>
<td>5.8%</td>
</tr>
<tr>
<td>11</td>
<td>Dallas</td>
<td>$1,575bn</td>
<td>9.4%</td>
</tr>
<tr>
<td>12</td>
<td>San Francisco</td>
<td>$3,579bn</td>
<td>21.4%</td>
</tr>
</tbody>
</table>

Source: Cornerstone Macro
While Washington would like the Fed to be less influential, the irony is that you won’t get an argument from the Fed itself.

of the year,” he said. “It will be appropriate to raise the target range when there has been further improvement in the labor market and we are reasonably confident that inflation will move back to our 2 percent objective over the medium term.”

The only game in town
While Washington would like the Fed to be less influential, the irony is that you won’t get an argument from the Fed itself, which never actively sought increased power and money. Ms. Yellen would surely welcome a less influential Fed. But the fact is, there are two ways to shepherd the U.S. economy: by adjusting fiscal policy and by adjusting monetary policy.

A balance of the two works best. But in the absence of the former—Congress cannot seem to bring itself to discuss modifying the tax code or government spending—that leaves monetary policy as the sole way to keep the U.S. economy on its current road to good health.

Someday, fiscal policy adjustments may emerge again. But certainly not before the election. In the meantime, the Fed’s monetary policy is the only game in town. (If a team has no offense and a great defense, its best hope for victory is for the defense to make a big play.)

Where it will probably net out
So, what is the most likely scenario in the latest Congress-versus-Fed battle? What will probably happen? If history is any guide, there’s a simple answer: nothing.

When all is said and done, it’s very likely that when the next president steps into the Oval Office in January 2017, the Federal Reserve’s independence will stand exactly as it does today.

What will probably change, however, is the size of its balance sheet. Its current war chest will decline gradually, with a portion of its redeeming amounts allowed to mature as the economy continues to heal. And as for the Fed’s influence in driving U.S. economic health? That will depend on Congress’s ability to engage in a meaningful fiscal policy discussion and enact spending and tax reform.

What we can look forward to
In a few months, the next chapter of the battle between the Federal Reserve and Congress, both Republicans and Democrats, will probably unfold. Republicans will contend that the Fed has overstepped its bounds, and Democrats will contend that rate increases are doing damage to the American consumer’s buying power.

It will be interesting to see if some of the same people who have been lambasting the Fed for its quantitative easing programs for several years will switch to the other side and attack the Fed if it starts to normalize the federal funds rate. Stay tuned. |N|
Commonfund Insight for Strategic Investors ("Insight") has been prepared and published by The Common Fund for Nonprofit Organizations and its affiliated companies (collectively, "Commonfund").

Any mention of Commonfund investment fund(s) within Insight is not intended to constitute an offer to sell, or a solicitation of an offer to buy, interests in such fund(s). Offerings of any interests in funds (or any other securities) may only be made by means of formal offering documents, such as Information for Members (for endowment funds) or the applicable confidential placement memoranda. Investors should consult the offering documents and any supplemental materials before investing. Read all materials carefully before investing or sending money.

Statements made by third-party authors, interviewees or by Commonfund authors in Insight that pertain to any class of security, or that of a particular company(s), may not be construed as an indication that Commonfund intends to buy, hold or sell such securities for any fund, or that it has already done so. Mentions of successful companies should not be read to predict the future performance of those companies or of any fund.

Economic and investment views presented by any authors within Insight do not necessarily reflect those of Commonfund. Views advanced by third-party authors may be based on factors not explicitly stated in Insight. Views contained within Insight (including views on asset allocation or spending policies, as well as investment matters) must not be regarded as recommendations or as advice for the reader’s investment use. Additionally, all economic and investment views presented are based on market or other conditions as of the date of this publication’s issuance, or as otherwise indicated. Commonfund disclaims any responsibility to update such views.

Investment managers utilized by Commonfund may or may not subscribe to the views expressed in Insight when making investment decisions for Commonfund funds. The views presented in Insight must not be interpreted as an indication of the trading intent of managers controlling Commonfund funds.

Past performance of any Commonfund fund is no guarantee of future results. References to returns of particular managers or sub-strategies of Commonfund funds are not indicative of the funds’ returns. Securities offered through Commonfund Securities, Inc. (“CSI”), a member of FINRA.