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Clashes, Dissent Over Key Policies Reveal Fed's Growing Fault Lines

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Recent Federal Reserve activities suggest that Chairman Ben Bernanke went from being in charge to losing control of the Federal Reserve in the span of a few days.

As for the longer-term direction of monetary policy and the Federal Reserve? It could be up for grabs after the elections this fall.

Credit markets have been sending a signal that economic conditions might improve later this year, and the dollar value appeared to be in the process of finding a bottom against the overvalued euro.

At least it appears that is what Bernanke thought. Central bank officials typically don't say much about the dollar, but Bernanke gave a talk on June 3 in which he touched on the importance of a stable or stronger dollar in anchoring inflationary expectations.

No Fed chairman would do that if he didn't think market conditions might be shifting in the direction of supporting a stronger dollar.

Bernanke would not have said what he did if he expected fundamentals to push the value of the dollar lower against the euro. The dollar responded favorably, and all seemed well at the Fed.

Then on June 5 Richmond Federal Reserve President Jeffrey Lacker stuck a knife in Bernanke's back when he publicly voiced his concerns about Fed actions surrounding the Bear Stearns debacle in March.

In referring to recent Fed actions, Lacker said: "The danger is that the effect of recent credit extension on the incentives of financial market participants might induce greater risk taking, which in turn could give rise to more frequent crises, in which case it might be difficult to resist further expanding the scope of central bank lending."

The idea of a current Federal Reserve Bank president publicly critiquing past monetary policy decisions so openly suggests fault lines within the Federal Reserve.

To compound problems, the European Central Bank met on June 5 and decided not to make any changes in its main policy rate — it has been the same for the past year. So far, so good.

But at the ECB's press conference later that day, President Jean-Claude Trichet indicated there was discussion of hiking the interest rate later in the year.

In particular he said, "A number of us thought that, all things being taken into account, all information and analysis of risks, we had a case for increasing rates. A number of us considered that there was a case for increasing rates, but at a later date."

Trichet was asked about Bernanke's June 3 comments.

His response: "As regards the U.S. dollar and what Ben said, I have always appreciated what has been said by Ben, and particularly what he said last Monday about what he considered opportune from the U.S. standpoint. It has been noted by markets as something important, and I have frequently told you that I consider what has been said by Ben and by Hank Paulson, as regards the fact that a strong dollar was in the interests of the United States, to be very important."

Trichet's comments at the press conference about lifting ECB interest rates pushed the dollar sharply lower.

Clearly Bernanke had no inkling what the ECB was thinking about saying, otherwise he would not have discussed the dollar in his talk.

Don't the Fed and the ECB communicate?

The timing of recent events hardly could have been worse. It looks like Bernanke, an academic, is attempting to run the Federal Reserve like an academic institution.

Open disagreement and dissension in an academic environment is expected.

Academics give talks outside of their university that sharply differ with other professors at their university or with university policies. It's the norm.

Bernanke can't run the Fed like an academic institution. He needs to learn that quickly, or he will be leaving the Federal Reserve when his term is up in 2010. It may already be too late.

Bernanke supposedly wanted a more open environment in the Fed after Greenspan left. Now he has it, and the Richmond Fed president felt comfortable in publicly voicing his criticisms of Fed actions.

Lacker might just have given Bernanke a push out the door in 2010, and, in addition, he didn't help the independence of the Fed by his own actions. The dollar appeared to be in the process of finding a bottom, and Lacker and the ECB undercut what the market seemed to be doing.

Another Fed problem: Fed Gov. Fredric Mishkin is leaving in August, so that will make three Fed governor vacancies.

Senate Democrats don't seem to want to fill them, as they expect a Democratic president after November and prefer to wait.

That was an issue, but Lacker's public talk may have also placed Bernanke in the cross hairs.

In addition, Fed Gov. Randall Kroszner hasn't been reconfirmed.

So a new president could appoint a new chairman and four Fed governors within the next two years.

The Fed is an independent agency, but a president could wield considerable influence if he chose five easy-money governors in two years, with one of the five being chairman.

The list of concerns for capital markets after the fall election grows longer.

So we could see sharply higher tax rates on capital and earned income along with movement to a less open trade policy — plus a shift toward appointing people with an easy money bent to help lessen the real debt burden of the U.S. government.

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