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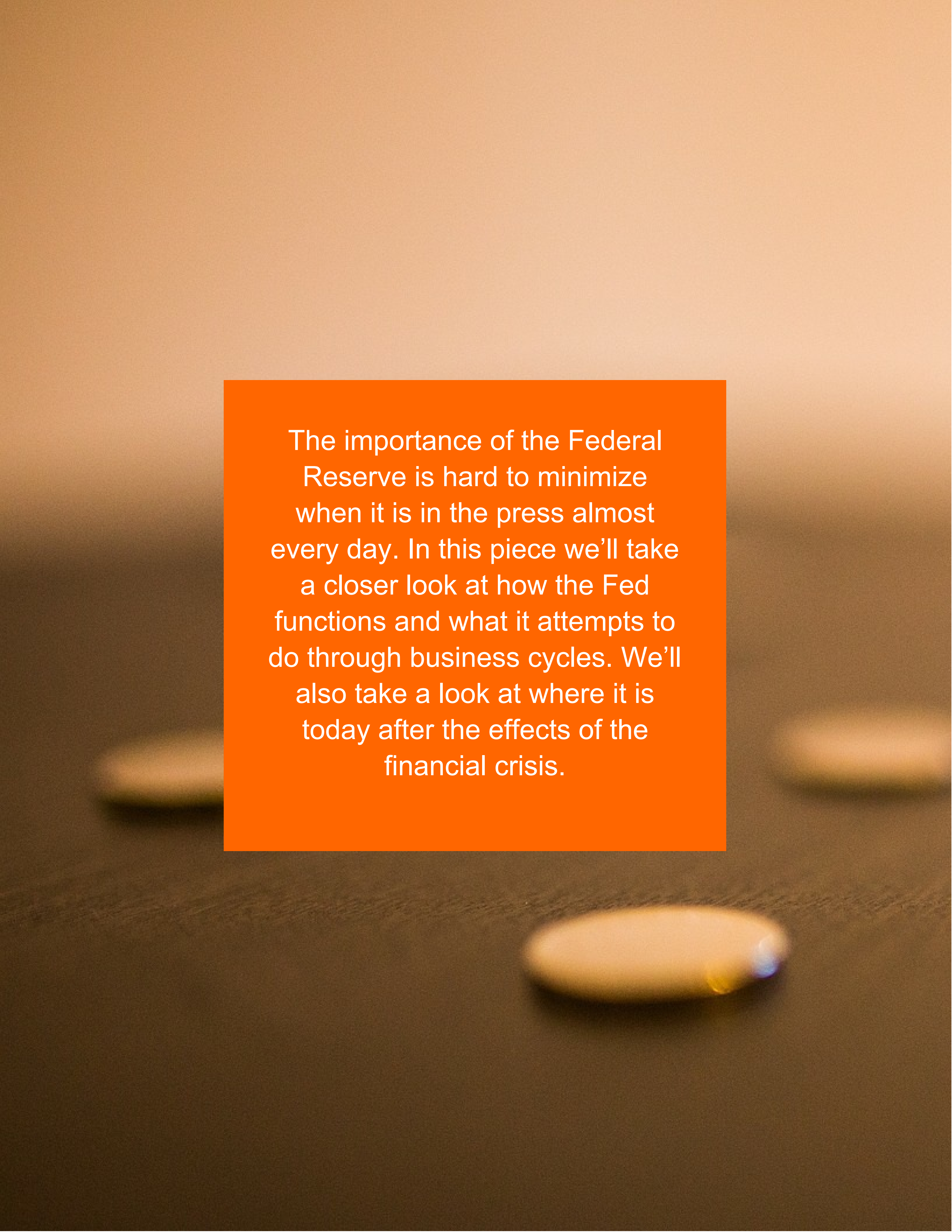
They’re in the Money: Why We Have the Fed



The importance of the Federal Reserve is hard to minimize when it is in the press almost every day. In this piece we'll take a closer look at how the Fed functions and what it attempts to do through business cycles. We'll also take a look at where it is today after the effects of the financial crisis.

“The bank, Mr. Van Buren, is trying to kill me. But I will kill it.”

– Andrew Jackson

When Andrew Jackson vetoed the charter for the Second Bank of the United States, a central bank was regarded as an over-powered behemoth that could stomp any political enemy. That was in 1832. While other countries blossomed under new federal banks, the U.S. struggled with a loose network of mostly unstable private banks.

In the crash of 1907 a surge of speculation on Wall Street ended badly for banks and J.P. Morgan himself rescued the American banking system. Reform was required. After a great deal of analysis and debate The Federal Reserve Act was signed by Woodrow Wilson in 1913.

Since the Fed was started, it has changed as our economy and economic research has evolved. Currently, the main goals of the Fed are: (1)

- Conducting monetary policy: Congress has given the Fed a mandate to promote maximum employment, stable prices and stable long-term interest rates.

- Supervising financial institutions: The Fed monitors financial institutions' stability.
- Providing financial services: The Fed acts as a clearing house for many transactions, including checks, wires, etc. It also acts as the bank for the U.S. government, assisting with the Treasury's cash management and securities sales.

How the Fed accomplishes its goals is often debated. This is no surprise given the complexity of our modern economy and its place in the world. To more fully understand, we need to take a look at how the Fed is structured and why. While the Fed is overseen by Congress, it is also independent in order to minimize, as much as possible, political influences.

The Fed is semi-public in that it is partially held by its member banks, and non-profit in that it gives most of its profits to the Treasury Department. Some of the Fed's activities are audited by the Government Accounting Office and an outside auditor. Congress often debates expanding the audit program.

Much of what the Fed does is determined by its various committees. Here's a look at the basics:

- The Fed's primary body, its Board of Governors, consists of seven people who are appointed by the president and confirmed by the Senate. Governors serve 14 year terms. The Chair and Vice-chair are also presidential appointees requiring Senate confirmation. There are currently 3 open seats on the Board of Governors.
- Janet Yellen is the current Chair of the Federal Reserve Board of Governors. Chair people serve four-year terms that are staggered two years from presidential terms in order to minimize political influence.
- The primary functions of the Board of Governors are to direct monetary policy and to lead

committees that study and report on a constantly changing set of issues. These may include topics from consumer banking, electronic payments, international economic conditions, etc.
- The Board also oversees the Fed’s 12 Reserve Banks (of which the San Francisco Fed is one). These banks are regional so that they can more closely serve each area’s unique economy (the Minneapolis district has different needs than the New York district).
- The Fed’s most watched committee is the Federal Open Market Committee, (FOMC). Its voting members consist of the seven members of the Board of Governors, the president of the Federal Reserve Bank of New York (regarded as being the most important banking region), and the presidents of four other regional reserve banks, serving on a rotating basis. The chair of the Board of Governors (Janet Yellen) is also the chair of the FOMC. The FOMC meets eight times per year when they discuss the outlook for the economy and what policy options are necessary.

(1). Board of Governors of the Federal Reserve System website.

Keeping the Economy Properly Fed

The most complex function of the Fed is conducting U.S. monetary policy within our global economy. The complexity stems from the often conflicting goals and myriad variables.

For example:

- How can the Fed promote maximum employment while keeping prices and interest rates stable in a growing economy? Increasing inflation, which harms all consumers, is the concern here.
- When our economy slows, how can prices be kept stable while increasing liquidity to improve employment? Deflation, which can shut down an economy if consumers hold off on purchases for lower prices, is the concern here.

Controlling these elements with certainty is impossible. Some even argue that the Fed should just regulate banks and let business cycles run their course without Fed intervention.

To understand the Fed's current situation and its effects, we need to delve a little deeper into the tools the Fed uses. We'll do this by taking a look at the Fed's actions through a typical business cycle.

- When the economy is doing well, the Fed will look for signs that it is overheating, i.e. that inflation may be growing too fast for comfort (note that the Fed's current goal is 2% per year). Inflation is a normal requirement of a growing economy. When things are good, people expect to earn and spend more. When the economy is growing too fast, the Fed's standard response is to increase interest rates in order to lessen borrowing and slow the economy down.
- In a declining economy, the Fed's aim is generally to increase liquidity in the economy in order to increase lending so that households and companies will spend more.

Since we basically have an independent Fed working in a free market economy, the Fed cannot control rates directly, it can only influence them. The Fed's main tool for influencing interest rates is to set a target for the Federal Funds rate. The Fed Funds rate is not something the Fed charges, instead it is the rate that member banks pay to borrow from each other in their own special market. The Fed sets a Fed Funds Target Rate and then attempts to maintain it by altering the money supply.

The money supply is changed by the activities of the FOMC. When the Fed wants to pump money into the economy, the FOMC approves the purchase of bonds. Banks hold a lot of bonds and if the Fed is buying, those banks tend to sell. Now the banks get an influx of cash to lend. More cash means lower borrowing costs so, theoretically at least, people and businesses will borrow money from the banks so they can spend it on homes, factories, etc. The economy gets an influx of production, companies hire workers, and all becomes well again.

Money, Fish, and Low Liquidity

In most times, when the economy is either slowly improving or slowly declining in its cycles, the Fed can administer its functions with fairly slight tweaks in the money supply.

However, what happens when interest rates are already low, and the economy appears to be slowing down? Or, what if the economy slows down so quickly that merely lowering interest rates may not revive it quickly enough?

In 2008, when Bear Stearns and then Lehman Brothers had severe liquidity problems, the economy slowed very rapidly. In fact, the economy slowed down so fast that there was a danger of deflation. Deflation is one of the worst possible economic scenarios. If prices decline enough, people anticipate further falls and stop spending, waiting to buy goods when they're cheaper. In a consumer-led economy, such as in the U.S., if consumers stop spending, business failures can begin to cascade and the economy begins acting like a fish washed ashore.

The Fed's response in the crisis was to aggressively purchase bonds, thereby pumping money into the economy, and removing bad credits from member banks' balance sheets. Now, the issue is that the Federal Reserve's balance sheet has grown from

$900 billion in 2007 to about $4.5 trillion today. Putting this into perspective, the total assets of all U.S. commercial banks is about $16.2 trillion, compared to about $11 trillion in 2007. While commercial bank assets grew by about 50%, the Fed's assets multiplied approximately five times.[(1)]

(1). Board of Governors of the Federal Reserve System website.

Awash in Liquidity…What Now?

What should the Fed do?

Reduce its balance sheet by selling bonds, which takes cash out of the economy?

Continue to carry the bonds and purchase new ones as they mature?

Or, let the bonds mature and retain some cash for future purchases while returning the rest to the Treasury?

While the numbers are large enough to make headlines, we need to always keep in mind the function and structure of the Fed. When the Fed aggressively bought bonds, it accomplished its intended purpose of reducing interest rates, although as we've seen, the effect was indirect since it was in a mostly free market. In fact, there is a very compelling argument that the bond purchases were merely symbolic: the Fed was willing to pump cash into banks by buying their bonds (most of which were Treasury bonds). When investors saw that the Fed was acting aggressively, confidence came back into the economy and consumers spent while businesses started hiring again.

Now what we have a semi-public entity with a big holding of Treasury bonds. This doesn't appear to be a cause for alarm because the linkage between the Treasury Department and the Federal Reserve is fundamentally tight. In fact, Ben Bernanke, former Fed Chair, recently wrote that it would probably be best if the Fed let its balance sheet slowly decline to somewhere around $2.5 to $4.0 trillion by just letting its bonds mature (and in effect returning the cash to the Treasury). In his words:

"To minimize such risks, it seems more prudent, once the end of reinvestment is announced, to allow that process to continue without further management—that is, to simply allow the balance sheet to run down until it reaches the desired size, barring some major deterioration in the outlook."(2)

The risks he was referring to were from taking more aggressive action to reduce the balance sheet by selling bonds. As we've explained earlier, if the economy starts to overheat, the FOMC can authorize the sale of some of its bonds, which would take liquidity out of the economy. Otherwise, letting the balance sheet slowly decline is not only what Bernanke recommends, but it also appears to be what the Fed will be doing. Politicians and the press may continue to bemoan the large balance sheet, but the stronger argument tends to be that it is a benign issue that will slowly dissolve. Once again, keeping a long-term perspective removes a lot of anxiety.

Some pundits also argue that the Fed has been almost the sole driver in recent stock market returns due to its increasing liquidity in our economy ("printing money"). However, the counter argument is that if the Fed was printing all of this money, we would have an inflation problem by now (the Fed's balance sheet stopped increasing almost 3 years ago). Alas, there is currently no inflation problem. In fact, one of the reasons the stock market is high now is because the outlook for inflation remains low (witness the 1970’s when inflation was high and stock returns were mostly low).

Investors closely watch the Fed and quickly react, sometimes dramatically, to its announcements. However, market prices are not reflecting a large inflationary risk at this time. Perhaps the crystal balls are a bit cloudy again.

(2). Brookings Institution: “Shrinking the Fed’s Balance Sheet” by Ben Bernanke, January 26, 2017.

Thanks

As an important element of our modern economy, we mention the Federal Reserve often. We hope that this has brought a useful light to some of its structure, functions, and current issues. As always, we look forward to any questions or feedback you may have.

Thank you for your trust in Vista.

Your Vista Wealth Management Team