The Wealth Report

THE POWER OF THE FEDERAL RESERVE

Overview

In 1913, Congress established the Federal Reserve System, often referred to as simply the Fed. It is the central bank of the United States, represented by three entities: a Board of Governors, often called the Federal Reserve Board; the Federal Open Market Committee (FOMC); and 12 regional banks, which operate independently but under the supervision of the Board of Governors.

The Fed has a very specific function: to promote the effective operation of the U.S. economy. Within this capacity, the Federal Reserve banking system:[1]

- Manages the country's monetary policy to promote maximum employment, stable prices and moderate long-term interest rates
- Monitors the stability of the financial system and individual financial institutions
- Provides services to the banking industry and the federal government to secure facilitation of U.S.-dollar transactions and payments
- Conducts ongoing research and analysis of emerging consumer issues and trends, community economic development activities, and the administration of consumer laws and regulations

It's not unusual to hear the Federal Reserve being bashed or praised — sometimes both in the same day. That's because its ability to stimulate or stifle the economy is powerful but not always popular. Learn why.

Monetary Policy

The Federal Reserve has several levers it uses to influence monetary policy. For example, it can change the federal funds rate, which is the interest rate banks charge to lend money overnight to other banks. This move can trigger a chain reaction that affects short- and long-term interest rates at other financial institutions, foreign exchange rates, the amount of money and credit funneled into the U.S. economic system and, ultimately, economic indicators such as employment and the prices of goods and services.

The Fed also sets reserve requirements, which are the balances that banks are required to hold at Federal Reserve Banks. It can engage in quantitative easing, which is when central banks purchase Treasury bills or mortgage-backed securities in an effort to reduce long-term interest rates. Recent activity includes a lending program for small businesses and purchasing corporate bonds to support market liquidity and the availability of credit for large employers.[2]

The Wealth Report

COVID-19 Response

The pandemic hit the U.S. hard and fast. Initially, 14 million people lost jobs between February and May.[3] Even as employment has begun to recover, overall growth — as measured by gross domestic product (GDP) — has dropped dramatically. By the end of the second quarter, real GDP had decreased at an annual rate of almost 33% (compared to a 5% drop in the first quarter). This is largely attributed to a cliff-like fall in spending by households, businesses and state and local government agencies.[4]

Consequently, over the first half of 2020, the Fed cut interest rates to near zero and launched a diverse array of lending programs designed to help businesses stay afloat during this crisis. Under its $600 billion Main Street lending program, the Fed is set to purchase 95% of loans between $250,000 to $300 million to businesses with fewer than 15,000 employees or less than $5 billion in annual revenue. It is worth noting, however, that as of early August, the program had covered only $95 million in loans.[5] Few businesses seem willing to take on more debt given the uncertain nature of the pandemic and the toll it continues to take on consumer confidence and the economy.

Fed Chairman Jerome Powell has emphasized that the Fed is committed to sustaining its aggressive monetary policy until it is confident the economy can recover on its own.[6]

A recent MarketWatch article quoted Berkshire Hathaway Chairman and Chief Executive Warren Buffett, from the company's annual meeting: "[Warren] Buffett said the Fed's muscular response to a Treasury market that had nearly frozen, and other financial turmoil in March, was crucial to averting deeper carnage. Conditions were sparking fear, and 'fear is the most contagious disease you can imagine.'"[7]

Fed Power Has Its Limits

Much of the power held by the Fed stems from the available economic data that it evaluates on an ongoing basis — and the influence that this knowledge and experience affords. However, there are many factors that affect our economy that the Fed cannot control. These include the status of foreign currencies, the global economy, international trade agreements and fiscal policy.

In recent months, Chairman Powell and other Fed leaders have emphasized the importance of Congress passing legislation to complement the Fed's actions. In other words, the Fed believes lending money is not stimulus enough; Congress needs to send money directly to people and businesses to keep today's economy from sinking any lower.[8]

spectrum advisors

Long-Term Implications

While the Fed is charged with an enormous responsibility and the power to influence current economic indicators, it cannot control the long-term outlook. Both monetary and fiscal policy actions taken this year are likely to have a negative impact on the nation's future growth. That's because, at some point, Americans will have to pay the piper.

The federal deficit is the amount of money the government spends each year above and beyond its annual revenue, which is mainly provided by taxes. After passage of the Tax Cuts and Jobs Act of 2017, the loss of tax revenues increased the annual deficit. In fiscal year 2019 alone, the deficit soared to $984 billion, a 26% increase over the year before.[9]

However, the pandemic has worsened matters considerably — largely due to the stimulus efforts by Congress and the Fed. This year's federal deficit as a percentage of GDP is already the largest in 75 years, since World War II. Not only is the government spending trillions of dollars, but with fewer people in the workforce, there are far less individual and corporate tax revenues coming in during 2020.

To date, pandemic-related government spending has reached nearly $3 trillion, which is on schedule to put this year's deficit at around $4.5 trillion.[10] Every year, the amount of spending that is not covered by revenues is added to the national debt total, which currently stands above $26 trillion. Our debt is financed through bonds, on which the government pays interest. As of the end of July, the interest alone on America's debt cost more than $436 billion.[11]

Final Thoughts

It's easy to see why the Federal Reserve sometimes comes under fire for its aggressive monetary policies.

But it's alternately the subject of praise. The Fed has been credited with the stock market's continued strong performance. That's because when the Fed announces an interest rate cut, that floods more money into the economy so that consumers and businesses increase spending and investment. This, in turn, can cause stock prices to rise.

However, longer term, aggressive easing by the central bank causes a surge in U.S. debt, and that tends to lead to inflation. Individuals should work with their advisors for a long-term plan with regard to their portfolio and consider strategies to help preserve purchasing power in the long run.

The Wealth Report

[1] Federal Reserve. 2020. "About the Fed." https://www.federalreserve.gov/aboutthefed.htm. Accessed Aug. 17, 2020.
[2] Jeff Cox. CNBC. Aug. 10, 2020. "The Fed bought more blue-chip and junk bonds, and has started making Main Street loans." https://www.cnbc.com/2020/08/10/the-fed-bought-more-blue-chip-and-junk-bonds-and-has-started-making-main-street-loans.html. Accessed Aug. 17, 2020.
[3] Rakesh Kochhar. Pew Research Center. June 11, 2020. "Unemployment rose higher in three months of COVID-19 than it did in two years of the Great Recession." https://www.pewresearch.org/fact-tank/2020/06/11/unemployment-rose-higher-in-three-months-of-covid-19-than-it-did-in-two-years-of-the-great-recession/. Accessed Aug. 25, 2020.
[4] Bureau of Economic Analysis. July 30, 2020. "Gross Domestic Product, 2nd Quarter 2020 (Advance Estimate) and Annual Update." https://www.bea.gov/news/2020/gross-domestic-product-2nd-quarter-2020-advance-estimate-and-annual-update. Accessed Aug. 17, 2020.
[5] Rachel Siegel. The Washington Post. Aug. 6, 2020. "Federal Reserve data show little appetite so far for its $600 billion Main Street lending program." https://www.washingtonpost.com/business/2020/08/06/federal-reserve-main-street-program. Accessed Aug. 17, 2020.
[6] Thomas Franck. CNBC. July 29, 2020. "A full recap of Fed Chief Powell's market-moving comments on rates, economy." https://www.cnbc.com/2020/07/29/watch-fed-chair-powell-discuss-the-central-bank-s-latest-policy-decision.html. Accessed Aug. 17, 2020.
[7] William Watts. Marketwatch. May 2, 2020. "Warren Buffett says Fed's Jerome Powell belongs on same 'pedestal' as Paul Volcker." https://www.marketwatch.com/story/warren-buffett-says-feds-jerome-powell-belongs-on-same-pedestal-as-paul-volcker-2020-05-02?mod=home-page. Accessed Aug. 17, 2020.
[8] Thomas Franck. CNBC. July 29, 2020. "A full recap of Fed Chief Powell's market-moving comments on rates, economy." https://www.cnbc.com/2020/07/29/watch-fed-chair-powell-discuss-the-central-bank-s-latest-policy-decision.html. Accessed Aug. 17, 2020.
[9] Benjamin Fearnow. Newsweek. Oct. 26, 2019. "U.S. Deficit Skyrockets 26 Percent Since 2018, Economists Blame Trump Tax Cuts for Massive Spending Gap." https://www.newsweek.com/us-federal-deficit-skyrockets-trump-tax-cuts-blamed-defense-spending-gap-revenues-treasury-1467936. Accessed Aug. 17, 2020.
[10] Lyn Alden. Fedweek. Aug. 12, 2020. "Massive Deficits and Historical Investment Implications." https://www.fedweek.com/tsp/massive-deficits-and-historical-investment-implications/. Accessed Aug. 17, 2020.
[11] U.S. Department of the Treasury. Aug. 6, 2020. "Interest Expense on the Debt Outstanding." https://www.treasurydirect.gov/govt/reports/ir/ir_expense.htm. Accessed Aug. 17, 2020.

spectrum advisors