The Fed Works in (Not So) Mysterious Ways

Joshua Kaplan, CFA, CPWA, Vice President of Advisory Services

It seems that all anyone can talk about is the Federal Reserve 'the Fed', its current chairperson Jerome Powell, and the impact of their policy decisions on the markets and economy. Since last January, the Fed has raised their benchmark interest rate, the Federal Funds rate, from 0.00% - 0.25% to 4.5% - 4.75% in an effort to combat inflation. This has led to volatility in the markets and higher overall borrowing costs. What is the origin of this institution, what are their main goals and why are they now raising interest rates?

Brief History

The Federal Reserve banking system was originally established in 1913 with the passage of the Federal Reserve Act by Congress. The original purpose of the Fed was to address the 'bank panics' of the late 1800s and early 1900s: financial crises that led to mass withdrawals of deposits from one bank, causing a domino of failures across other institutions and economic turmoil. The Fed was created in part to serve as the lender of last resort – providing short-term loans to cover shortfalls at one institution and avoiding a contagion impact on other banks.

Dual Mandate of the Federal Reserve

The role of the Federal Reserve has evolved since its creation. Their main purpose is the dual mandate Congress has charged them with: to promote both maximum employment and maintain price stability (low and consistent inflation).

Structure of the Organization

Although Congress oversees the Federal Reserve system, the Fed operates independently of the government in carrying out its duties. The Federal Reserve system has three parts: the Board of Governors, the regional reserve banks, and the Federal Open Market Committee (FOMC).

Board of Governors – Composed of seven members (including the chairperson of the Fed), as well as a large number of support staff, these individuals:

- Write regulations to govern the dealings of commercial banks, thereby limiting speculative practices and encouraging a stable national financial system.
- Assess the health and trends of the US economy and forecast its future direction.
- Oversee the twelve regional reserve banks (see below).
- Participate in the Federal Open Market Committee (FOMC) (see below).

Regional reserve banks – There are twelve districts and regional banks, each with their own president, that are part of the Federal Reserve system. The reserve banks:

- Provide financial services (i.e., managing deposits, withdrawals and transfers from commercial banks and the US government, recycle old currency and check for counterfeit bills, put new currency into circulation, facilitate electronic transfers between institutions, assisting the US Treasury, etc.).
- Contribute to monetary policy (i.e, conduct and publish research, collect economic and market data from their regions to aid in policy making decisions, prepare regional presidents for meetings, etc.); and,
- Supervise and rate commercial banks through enforcement of the published regulations by the Board of Governors.

Federal Open Market Committee (FOMC) – Composed of the seven members of the Board of Governors and the twelve presidents of the regional reserve banks. This body meets eight times a year and sets monetary policy in the interest of carrying out the Fed's dual mandate. Although all members provide input, only the seven members of the Board of Governors, the president of the Federal Reserve Bank of New York, and four rotating members of the other regional reserve banks participate in the final vote that sets monetary policy coming out of the meeting.

How does Monetary Policy work?

The Federal Reserve implements its desired policy actions primarily through the Federal Funds Rate – the short-term interest rate on overnight loans between banks and the regional reserve banks. This rate can be thought of as the tide that directly influences other rates in the economy (for example: mortgages). Indirect impacts can also be seen in the stock markets and foreign exchange markets.

At each meeting of the Federal Open Market Committee, a target range for this rate is set – currently at 4.5% - 4.75%. To carry out changes to this rate, the Fed engages in open market operations by buying or selling securities. Buying securities from member banks injects cash into the system – expanding the money supply and lowering interest rates (expansionary monetary policy). Selling securities to member banks takes cash out of the system - shrinking the money supply and raising interest rates (restrictive monetary policy).

Often the phrase 'printing money' is used when describing the Fed stimulating the economy. The Fed does not physically print money, but instead electronically deposits funds into the reserve accounts of member banks when it buys securities from them – expanding the supply of money to borrow, spend or invest in the economy.

Linked to this is the Fed's reserve requirements – or cash buffer that all banks are required to maintain on hand at all times. Depending on what level the Fed dictates, this can lead to more or less lending by banking institutions in order to keep the required capital on hand.

Outside the scope of the traditional monetary policy tools, the Fed also uses (1) forward guidance and (2) large-scale asset purchases, otherwise known as quantitative easing. The former helps the public understand policymakers' intentions about the future direction of monetary policy and shapes market expectations of interest rates. The latter is used in emergency situations - injecting stimulus and liquidity into the markets during turbulent times such as the Global Financial Crisis of 2008 or the COVID-induced selloff and liquidity crunch seen in March 2020.

How is the Fed impacting things today?

As discussed, half of the Fed's dual mandate is price stability. This is measured through inflation – or the change in prices over a given period (typically a year). For example, January 2023 inflation figures would compare the rate of price changes for a basket of goods from January 2022 to January 2023. The Fed targets inflation in the range of 2 – 3% annually, this is viewed as a healthy level of price stability. The Fed's preferred inflation indicator is the Personal Consumption Expenditures Price Index (PCE), although the Consumer Price Index (CPI) is more widely cited.

Coming out of 2020, we have seen rising prices for many goods and services. Inflation, as measured by the Consumer Price Index hit 9.1% in June 2022 before moderating to 6.4% in January 2023 – still far above the 'healthy' range the Fed seeks to maintain.

To combat inflation, the Fed has raised interest rates sharply (starting in March 2022). This has raised borrowing costs, mortgage rates, and is designed to slow economic activity - all to bring down the rate of inflation. Although this has led to high levels of volatility in the Equity and Fixed Income markets, and slowing economic growth which could lead to a recession, the alternative of letting inflation stay at elevated levels would lead to a worse long-term outcome for the economy and investors.

There is often a lagged impact between when the Federal Reserve implements policy and its impact on the economy – sometimes between six and twelve months. Actions taken by the Fed last year are now beginning to show up in slower economic activity and a moderating pace of inflation. Although there may be future interest rate increases by the Fed in 2023, it is more likely we are getting closer to the end of their interest rate increases. Once we hit that point, the Fed will likely pause any future increases for a period of time, holding rates at their current levels, and letting the cumulative actions they have undertaken work their way through the system to return prices to a more sustainable and healthy level.

***Sources**: stlouisfed.org, atlantafed.org, federalreserve.gov*

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