Issue: The Federal Reserve

The Federal Reserve

By: Victoria Finkle

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Can it find the economic sweet spot?

Executive Summary

Federal Reserve policymakers are confronting multiple challenges as they seek to guide the economy on a path of sustainable expansion while maintaining stable prices. The U.S. central bank must strike an elusive balance on monetary policy that wards off any inflationary pressure without suppressing an economic growth rate that is historically subpar. The Fed must determine when and how to reduce a balance sheet that has been inflated by $3.7 trillion in asset purchases as it attempted to reduce long-term interest rates. And it must cope with these issues at a time when lawmakers are sharply questioning the bank’s independence and President Trump is about to reshape the leadership by appointing a new chair and several governors.

Among the key takeaways:

- The Fed is edging its benchmark interest rate upward in small increments after holding it at near zero for seven years as the economy struggled to recover from the 2007-09 recession.
- U.S. economic growth since the end of the recession has been stuck at around 2 percent annually, unlike in previous expansions when it averaged 3 to 4 percent.
- The Fed gained significant new powers to regulate the financial industry under the 2010 Dodd-Frank Act, but the Trump administration and Congress may curtail some of this authority.

Overview

The Washington headquarters of the U.S. Federal Reserve, which adopts policies aimed at promoting maximum employment with stable inflation and plays a major role in regulating banks.

In late 2015, the Federal Reserve finally achieved liftoff.

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That was what Fed-watchers called the U.S. central bank's first increase in a decade to its target interest rate, known as the federal funds rate. The Fed had lowered this benchmark to near zero in December 2008, during the depths of the financial crisis, and kept it there in an attempt to spark growth throughout the halting recovery that followed. At last, in December 2015, the bank's rate-setting Federal Open Market Committee (FOMC) concluded that the economy was hale enough to withstand the tiniest of increases: one quarter of 1 percent.

Even the prospect of this modest move had generated skittishness in financial markets in the run-up to liftoff. But market reaction was relatively placid, the Fed proclaimed its move a success, and it has gone on to execute two more quarter-point hikes, the most recent on March 15.

"There were many people who believed it was not possible to do this," said Simon Potter, head of the Markets Group at the Federal Reserve Bank of New York and the overseer of the Fed's interest rate changes, speaking about the initial move off zero. [1] "One of the things that surprised us and that surprised some of the market participants was how well it worked from the first day."

But despite these positive developments, the Fed faces growing questions regarding its future. The uncertainties include the Fed's continued political independence, its ability to transition away from the unorthodox measures it adopted in recent years – and ultimately whether it will be able to effectively guide an economy that is evolving and is increasingly interconnected with the rest of the world.

Setting the federal funds rate – the interest that banks charge each other to borrow reserve funds overnight – is one of the Fed's primary tools to influence the U.S. economy in pursuit of its dual mandate to maximize employment and hold inflation steady. The funds rate in turn affects longer-term rates for mortgages, car loans and other forms of lending throughout the economy. [2]

After the latest increase, which set the funds rate at 0.75 percent to 1 percent, Federal Reserve Chair Janet Yellen cast the decision as a vote of confidence in the economy – and by extension the Fed's stewardship of it. "The simple message is, the economy is doing well," Yellen said in a press conference after the announcement. [3] The FOMC added in a statement that the labor market continues to "strengthen" while "economic activity has continued to expand at a moderate pace." [4] The unemployment rate fell in February to 4.7 percent, while the economy grew by 2.1 percent in the fourth quarter of 2016. [5]

For all of that optimism, the realm in which the Fed operates seems to grow more complex every day.

"We're in a global world now," says James Chessen, executive vice president and chief economist at the American Bankers Association (ABA). And that means the Fed's decisions are "reflected in every other major central bank."

That's because, in an increasingly interconnected world, the Fed and its counterparts in other countries are part of what amounts to a global feedback loop. If a Fed decision, such as an interest rate hike or a new banking regulation, has a negative impact on another economy, the effects can ripple back and exert an influence on the United States.

The economy is also undergoing deeper, structural changes as more Baby Boomers retire and Millennials come of age, shifting patterns in consumer spending, a major economic driver. Millennials on average have less income and higher debt than previous generations and are putting off major life decisions such as getting married and buying homes. [6] Technological advances, meanwhile, are changing the nature of work. Measures of the economy's productivity have been lagging since the 2007-09 financial crisis, along with wage growth, and politicians in Washington have been slow to offer the fiscal stimulus needed to help jumpstart economic activity. [7] The central bank must contend with a host of factors beyond its control as it sets monetary policy.

Even with the recent rate increases, the Fed's monetary policy is still what economists consider "accommodative" or "easy," with inflation – currently at 2.7 percent annually – running above the nominal interest rate set by the central bank. That means it's relatively cheap to borrow money and pay down debt.

"By the nature of inflation, you basically pay back the debt that you owe in a quicker way with inflated dollars – it makes debt servicing much easier," says Jason Ware, chief investment officer and chief economist at Albion Financial Group, an investment advisory firm in Salt Lake City, Utah.

The Fed is also continuing to grapple with the fallout from the unconventional steps it took during and after the financial crisis. It bought trillions of dollars in assets in the years following the crisis, a process known as quantitative easing or QE. The goal was to lower longer-term interest rates, which don't automatically respond directly to changes in the short-term rates the Fed had pushed to zero. Fed policymakers now face the question of how to unwind these purchases of Treasury bonds and mortgage-backed securities without knocking markets off-balance.

The change of administration in Washington is likely to have a profound impact on the central bank's future. President Trump will have the opportunity to reshape the Fed's leadership. He has frequently criticized Yellen, saying that he will likely replace her when her term as chair expires next February. [8] (She can remain on the Board of Governors until 2024.) During the presidential campaign, Trump called Yellen "very political," adding that she "should be ashamed of herself." He said that holding rates low was a political act designed to boost the economy for President Barack Obama before he left office – a charge Fed officials vigorously denied. [9]

Unemployment Rate Returns to Prerecession Level

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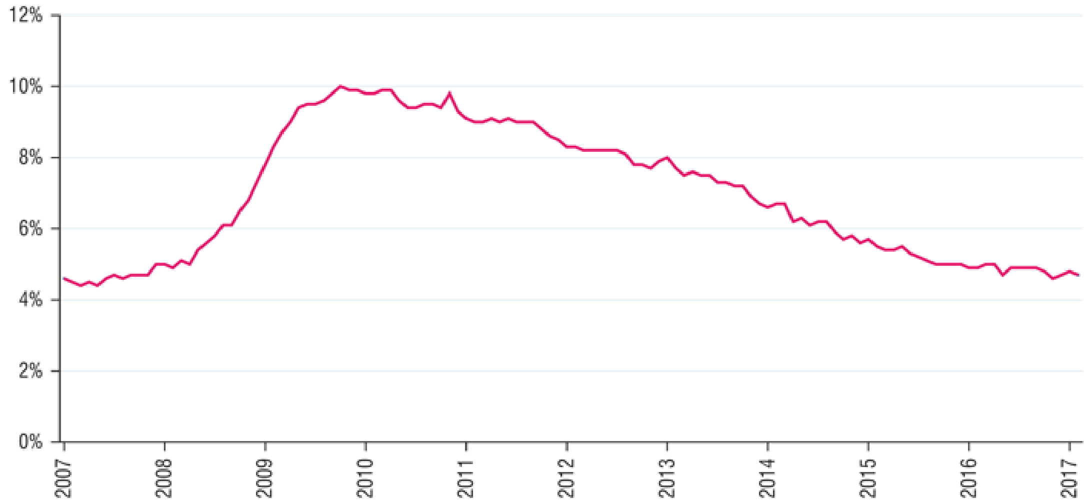
About 4.7 percent of Americans were jobless in February



Note: Only data points from January and June of each year are listed in the table.

Source: "Labor Force Statistics from the Current Population Survey: Unemployment Rate," U.S. Bureau of Labor Statistics, http://tinyurl.com/zyq5xlx

U.S. joblessness has been declining since the recession, with unemployment rates back at prerecession levels at the beginning of 2017. The unemployment rate peaked at 10 percent in October 2009, but fell to 4.7 percent in February 2017.

In addition to appointing a new chair, the president will soon have the opportunity to fill at least three open slots on the seven-member Federal Reserve Board. The board oversees and works with the Fed's 12 regional reserve banks in supervising financial institutions and setting monetary policy. Two board seats are vacant because the Republican-controlled Senate did not confirm nominees selected by Obama. [10] Fed Governor Daniel Tarullo, who has overseen much of the central bank's work regulating the financial industry, is stepping down, opening up another crucial spot. [11] In addition to overseeing monetary policy, the central bank is charged with supervising some of the country's biggest banks and maintaining financial stability. Also, Stanley Fischer's term as Fed Vice Chairman expires in June 2018; he can remain on the board as a governor until January 2020. (Two additional governors, Lael Brainard and Jerome H. Powell, serve under terms that extend to 2026 and 2028, respectively.)

"Sooner or later, we're going to have a majority of the board be Trump appointees," says Brandon Barford, a partner at Beacon Policy Advisors, a consultancy in Washington. The president's picks "could be traditional types, but they could also be unorthodox, like some of his Cabinet picks, and be quite aggressive and in opposition" to current Fed leadership.

These leadership changes come at a pivotal moment. The Fed will be charged with determining whether to raise rates more sharply to tamp down on rising inflation and counteract any fiscal stimulus from the tax cuts and infrastructure spending Trump has promised. It will also decide whether post-financial crisis rules designed to prevent another crash will remain on the books.

The tasks facing Yellen and the rest of the Fed are extensive. Over the coming years, the central bank must continue to keep watch over the economy's performance, unwind some of the extraordinary measures taken during the crisis, try to secure the Fed's legacy on bank regulation and stave off congressional attacks on its independence, all while keeping an eye on what other central banks around the world are doing.

As policymakers, academics and advocates consider the Fed's role in the modern economy, here are some of the issues up for debate:

Weighing the Issues

Is the Fed still able to influence economic growth and drive markets?

In the wake of the 2008-09 financial crisis, one of the biggest questions facing the Fed is whether it still has the tools to steer the economy effectively.

In the face of critics, Yellen has long defended the central bank's actions following the crisis to keep interest rates low and hold trillions of dollars in assets.

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Testifying before Congress in February, she pointed to the fact that the economy had added 16 million jobs since 2010 and that the unemployment rate had fallen to less than half of its post-crisis peak of 10 percent as evidence that the central bank has contributed to improving economic conditions. [12] The Treasury Department has estimated that 8.8 million jobs were lost due to the crisis. [13]

But Fed opponents, including some conservative lawmakers, have repeatedly challenged the Fed's strategies. Rep. Jeb Hensarling, R-Texas, chairman of the House Financial Services Committee, asserted in February that "there is zero evidence that zero interest rates and a bloated Federal Reserve balance sheet leads to a healthy economy." [14]

Critics on the left argue the opposite case: that the Fed would be more effective if it put more emphasis on obtaining full employment as a way to address stagnant wage growth. "This Fed vigilance in ensuring that the economy never sees wage growth rapid enough to push up price inflation is a deeply damaging example of fighting the last policy war (the war in this case was the wage and price inflation of the 1970s)," wrote Josh Bivens, director of research at the Economic Policy Institute, a liberal Washington think tank, in December 2016. [15]

Some suggest that while the Fed is still able to influence the economy to a degree, it would be more successful it if modified its approach so that it could respond more dynamically to economic trends.

"There are still things in its toolbox that the Fed can do on the margins to make a difference," says David Beckworth, a senior research fellow at George Mason University's Mercatus Center. "But I am more skeptical, or worried, that the Fed is not as effective as it thought it was or that it's being constrained by certain features of the framework in which it operates."

He argues that the central bank would benefit from adopting a more flexible approach to inflation-targeting. The Fed in 2012 set a goal of holding inflation at 2 percent annually to meet its price stability mandate. [16] Beckworth calls for moving to a so-called "price-level" target, in which the Fed would focus on inflation's growth over time instead of simply looking at the annual rate.

"We're never able to grow the economy a little bit hotter to make up for the collapse," he says. Under price-level targeting, "if one year you hit zero percent inflation, to make things right again, you'd need to have 2 percent the next year plus another 2 percent for the missed year."

Even those who defend Yellen and the Fed's efforts say that challenges remain for the central bank.

"I think she's done a masterful job," says Albion's Ware, while adding that Yellen is in "a very tricky situation" as the central bank adapts to a new political climate. Trump has called for tax cuts, a big boost in infrastructure spending and other actions that could potentially help jumpstart the economy, changing the calculus for the central bank.

"They don't want to be preemptive with their monetary policy. That is, they don't want to raise interest rates too quickly, because we're still sitting in a sluggish economic growth environment," Ware says. "Meanwhile, they're trying to predict in some crystal-ball kind of way what we're going to get on the fiscal side, because we may actually see some stimulus."

Consumer Price Index Rises in 2017

Inflation level increased to above 240

Note: Only data points from January and June of each year are listed in the table. The data are not seasonally adjusted.

Source: "Consumer Price Index – All Urban Consumers," U.S. Bureau of Labor Statistics, http://tinyurl.com/lwe9myc

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The Consumer Price Index (CPI) for all U.S. urban consumers, one of the most closely followed gauges of inflation, increased at the start of 2017.

The question is whether increased government spending leads to higher inflation, which could push the Fed to raise rates more quickly than planned. The president has called for pushing annual economic growth to 3 or 4 percent, potentially putting the White House at odds with a more cautious Fed that could be watching carefully to cool an economy that begins to grow too fast. [17]

Additionally, the central bank will eventually need to shed some of the additional $3.7 trillion of assets on its books that it bought as part of its QE program. [18] Yellen signaled to lawmakers in February that while reducing the balance sheet is a priority, she's in no rush to sell off the assets anytime soon, calling it a "longer-run goal." [19]

Some commentators note that when the bank does start to sell off some of those assets, it could have ripple effects in the markets, especially if the sale is completed too quickly. [20] That could cause the price of the asset to tumble, spooking investors. "It's put us in a world where we really don't know what's ahead. We don't know what will happen if the Fed tries to unwind all the actions they took to save the economy," says Joel Naroff, president of Naroff Economic Advisors, a consulting firm in Holland, Pa.

But others, including Ware, argue that the Fed will most likely be able to achieve "a slow and steady descent back down to a less inflated balance sheet" without major turmoil.

The central bank must also contend with growing challenges related to globalization. "The state of the U.S. economy is significantly affected by the state of the world economy," Fischer, the Fed vice chairman, said in a 2015 speech. "And of course, actions taken by the Federal Reserve influence economic conditions abroad. Because these international effects in turn spill back on the evolution of the U.S. economy, we cannot make sensible monetary policy choices without taking them into account." [21]

While each country's central bank is still expected to make decisions based on economic conditions at home, global discussions hold increasing sway, as changes to rates in the United States affect the flow of funds into and out of other countries. For example, higher U.S. interest rates attract investment from other countries; this causes the dollar to strengthen in value in relation to other currencies – and thus makes foreign imports cheaper and U.S. exports more expensive. [22]

"My guess is there's quite a bit of conversation between the central banks about the policies and the decisions they're making, so while it may not be coordinated, there's understanding about what the strategy is," says Chessen.

Should other policymakers in Washington have more authority over the Fed?

The Fed has maintained its independence from other governing powers for nearly 70 years, basing its case on the argument that it should be free from political pressures as it sets monetary policy. But its opponents have begun stepping up efforts to put the central bank under tighter control.

"The whole point of having a democratic government is to have checks and balances on the various bodies," says Alex J. Pollock, a distinguished senior fellow at the R Street Institute, a free-market think tank based in Washington. "So should the Fed be independent? No, because no one should be independent."

One of the most high-profile efforts to reduce the Fed's autonomy is a long-standing bill called "Audit the Fed." The measure, reintroduced in January by two Kentucky Republicans, Sen. Rand Paul and Rep. Thomas Massie, would direct the Government Accountability Office (GAO) to review the central bank's monetary-policy deliberations, among other activities. The bill was previously sponsored by Paul's father, former Rep. Ron Paul, and was originally introduced more than 60 years ago by Rep. Wright Patman, a Democratic populist from Texas. [23]

"It is time to force the Federal Reserve to operate by the same standards of transparency and accountability to the taxpayers that we should demand of all government agencies," Massie said at the time of the reintroduction. [24]

A similar provision is also included in legislation backed by Hensarling, the House Financial Services chairman, along with a measure that would require the Fed to establish a mathematical formula that would be used by the FOMC in setting its benchmark interest rate, potentially reducing some of the central bank's discretion to set monetary policy. The Fed says its decisions are already "data-dependent," but Hensarling doesn't buy it.

"The Fed's so-called 'data dependent' monetary policy of today says nothing about which data matter, let alone how they matter," Hensarling said in February. [25] "This severely compromises the kind of policy transparency and predictability that is necessary for household wealth to grow and American companies to create jobs."

Top Fed officials and the central bank's supporters call for maintaining the Fed's independence, particularly when it comes to monetary policy. [26]

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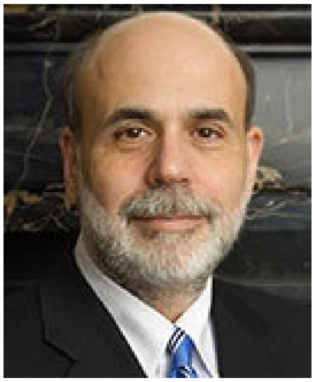
Requiring the Fed to conform to a rules-based policy for setting interest rates would “severely damage the U.S. economy,” Yellen warned in a 2015 letter to lawmakers, charging that such a measure would reduce the central bank’s room for maneuver and slow its ability to react in times of crisis. [27]



Former Fed Chairman Ben Bernanke

Ben Bernanke, who chaired the Fed during the depths of the financial crisis, said in a series of university lectures looking back on that period that “there is a very strong consensus that central banks that operate independently will deliver better results than those that are dominated by government.”

“In particular, a central bank that is independent can ignore short-term political pressures, for example, to pump up the economy before an election, and in doing so, it can take a much longer perspective and get better results,” he said. [28] “The evidence for this is quite strong.”

Bernanke, now a distinguished fellow in residence at the Brookings Institution, a centrist Washington think tank, further concluded in a 2016 blog post that legislation to audit the Fed is actually intended to open the central bank up to pressure from lawmakers.

“The principal effect of the bill would be to make meeting-by-meeting monetary policy decisions subject to congressional review and, potentially, congressional pressure,” he wrote. [29] “The bill would do this by repealing existing restrictions, imposed by Congress nearly 40 years ago, on what the GAO can examine when reviewing the Fed.”

Naroff, adds that the Fed already acts as a sort of check on the legislative and executive branches by balancing its monetary policy against any fiscal stimulus – or lack thereof – provided by the White House and Congress. Taking away this function by giving policymakers more influence over the Fed could be damaging, he argues.

“The purpose of the Fed is to be a balance when Congress and the president are fiscally irresponsible, and when they just don’t do anything, to take the lead,” he says. Removing the Fed’s independence is “a prescription for total disaster.”

It’s also crucial, supporters say, that the Fed maintain its ability to act decisively in moments of crisis. In addition to its role deciding monetary policy, the Fed serves as a “lender of last resort” to financial institutions to help maintain a stable banking system.

“Having an independent central bank that can take action quickly and identify systemic risks early and move to make sure there’s protections and remediate any problems as they arise is really important,” says Chessen.

In the midst of the 2008 crisis, the Fed was “very creative and acted very quickly” to put programs into place to help stem the downturn, he adds. At the same time, Congress struggled to pass bailout legislation to help prop up the banks, with the first draft of a plan failing to get the necessary number of votes in the House. [30]

“There’s no way that Congress would be able to come up with an emergency plan and implement it quickly,” Chessen says. “You needed people at the central bank who were being creative, coming up with projects and making sure that it was understood internationally, thought about the consequences and could act.”

Is the Fed up to the task of protecting the economy from another financial crisis?

In addition to its charge to help the economy achieve stable growth, the Fed has long been tasked with supervising and regulating financial institutions, a responsibility it shares with several other agencies. The central bank oversees bank holding companies, foreign banking operations located in the United States and state-chartered banks that belong to the Federal Reserve System. [31]

Despite the fact that some critics view the Fed as partially responsible for the financial crisis – they argue the Fed held interest rates too low in the early 2000s and failed to keep close watch on the banks, spurring the housing bubble – the central bank has taken on a host of new supervisory responsibilities under the Dodd-Frank Act of 2010.

The law required the Fed to establish new standards for the largest bank holding companies, those with more than $50 billion in assets, to help ensure they would be more stable in the face of another downturn. It also gained new powers to write standards for the riskiest non-bank financial institutions, such as large insurance companies, and to conduct “stress tests” on the country’s largest banks designed to model whether they could withstand another economic shock. [32]

“It is fair to say that Dodd-Frank has made the Fed our nation’s most powerful bureaucracy,” Hensarling’s committee said in a summary of the chairman’s legislation designed in part to reduce the Fed’s powers, including some of its responsibilities to monitor banks. [33]

The banks have taken a mixed view of the Fed’s work under Dodd-Frank.

“I don’t think there’s any disagreement that there needed to be an increase in capital levels, because the severity of the crisis was a reminder that losses can mount up quickly and you need sufficient capital to weather that,” says ABA’s Chessen. But he says that the aggressiveness of new rules put into place by the Fed – and their timing – have caused trouble for banks in recent years.

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James Chessen of the American Bankers Assocation

He notes that regulators were piling up new capital requirements at the same time they were hoping that banks would dial up their lending, which would in turn spur greater economic activity.

"In many ways, the regulatory side was working to counter to what the monetary policy side was doing," Chessen adds. "It was kind of a bad brew that made it difficult to get the economy back on its feet more quickly."

Fed officials, have largely defended their efforts to stabilize the banking system as necessary and effective.

"I think financial regulation has resulted in a stronger financial system and less risk than we had before the crisis," Yellen told lawmakers in February. [34] "It's allowed us to have stronger growth and a faster recovery."

But looking ahead, it's unclear how new appointments to the central bank and deregulatory efforts in Congress will transform the Fed's banking regime.

Trump has repeatedly called for undoing the Dodd-Frank law, calling it a "disaster." [35]

Tarullo, the Fed governor who is departing, informally served as the Fed's vice chair for supervision, a new regulatory position created under Dodd-Frank, even though he was never confirmed by the Senate to serve in that role. The banking industry is keeping a close eye on who might take over that position in the Trump administration, though no one has been nominated yet.

For consumer advocates, the prospect of a Dodd-Frank rollback or a strict deregulatory stance by Fed officials is worrisome.

"Our primary concern is that we will face another crisis if the people who are put in key financial regulatory posts, like at the Treasury and like the Federal Reserve vice chair for supervision, are people who profited from the last financial crisis and didn't experience the pain that so many Americans did," says Jordan Haedtler, manager of a Federal Reserve watchdog group called "Fed Up," organized by the Center for Popular Democracy, a progressive group.

Still, Ian Katz, a policy analyst at Capital Alpha Partners, a Washington-based investment firm, says that "the new vice chair [for supervision] won't be able to change everything overnight."

"The big change will be when there is a new chair. Then it will clearly be Trump's Fed," he says. "Getting actual regulations passed that reverse post-crisis rules might have to wait until a new chair is confirmed."

At the same time, it's unlikely that the Fed under new leadership will be as active in regulating non-bank financial institutions, the so-called shadow banks that are playing an ever-larger role in the financial industry. The central bank was mandated by Dodd-Frank to create rules for those non-banks designated by a council of regulators as "systemically important financial institutions" – organizations that could harm the broader economy if they failed. The designating council is led by the Treasury Department. Observers predict that no new firms will be named under Trump and that those who have been named could have their designations rescinded, eliminating the need for new Fed rules governing those institutions.

"The Fed, at the end of the day, will end up back in the precrisis position of primarily regulating bank holding companies," says Daniel Crowley, a partner at the law firm K&L Gates. "I don't think it's going to be in the position of extending its regulatory regime to non-banks."

Background

The Founders Divided

After winning its war for independence, the United States found itself on rocky footing. It needed to recharge the economy and pay back the debts accrued by the new nation and the individual states during the conflict.

As part of that effort, Alexander Hamilton, the country's first Treasury secretary, proposed the idea of a national bank, modeled after the Bank of England, in 1790.

This new institution would issue currency, collect taxes and government revenue and store public funds. It would simultaneously act as a commercial bank, making loans and accepting deposits from private citizens. [36]

"Though serving public purposes, the Bank was to be a profit-making institution, with private shareholders holding four-fifths of its stock and electing four-fifths of its directors," wrote Daniel Feller, a history professor at the University of Tennessee, Knoxville. [37] "It was, said Hamilton, 'an essential ingredient' in inspiring confidence in its prudent management that a national bank 'be under a private not a public direction, under the guidance of individual interest, not of public policy.' "

The First Bank of the United States was established in Philadelphia in 1791, despite fierce opposition from critics, including Secretary of

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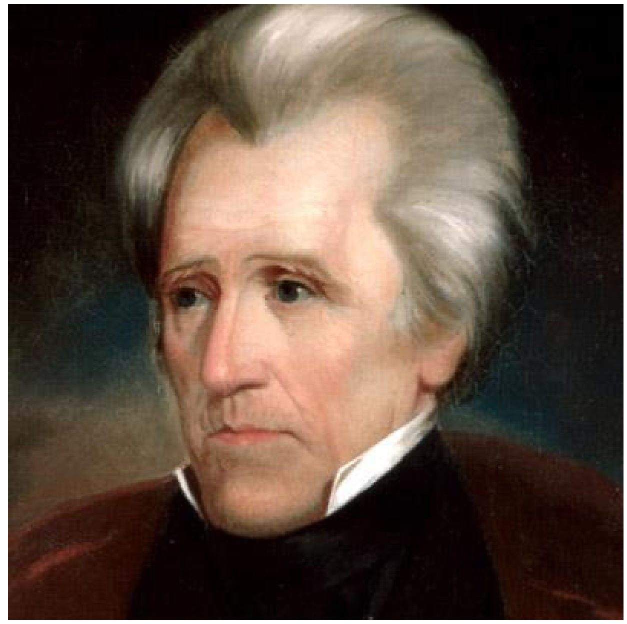
State Thomas Jefferson. He feared that establishing a national bank would drive the country away from its agrarian roots and undermine state-chartered banks. He also believed it would be unconstitutional.

When the bank's charter came up for renewal 20 years later, in 1811, leaders remained divided about it. With Hamilton's Federalist Party, which had supported the bank, now out of power, Congress failed to renew its charter. [38]

The decision to shutter the national bank occurred on the eve of another major conflict with Britain, the War of 1812. With the economy again in shambles after the war, some of the country's leaders pushed for recreating a national bank. The Second Bank of the United States, also headquartered in Philadelphia, was established in 1816 with a 20-year charter. Its functions were similar to those of its predecessor, though it would grow larger in size. [39]



President Andrew Jackson killed the Second Bank of the United States by vetoing a renewal of its charter.

But the fight over the government's role in the financial affairs of the country was far from over. President Andrew Jackson, another strong critic of the bank, vetoed a renewal of the bank's charter in 1832, four years before it was set to expire, and Congress failed to override the veto. The country would not experiment with a central bank again for nearly 80 years.

"The problem was disagreement between what today we would call Main Street and Wall Street," former Fed Chairman Bernanke said in his series of university lectures. [40]

He added: "The folks on Main Street – farmers, for example – feared that the central bank would mainly be an instrument of the moneyed interests in New York and Philadelphia and would not represent the entire country, would not be a national central bank. Both the first and second attempts at creating a central bank failed for that reason."

Creation of the Fed

After the Second Bank of the United States folded in the 1830s, the country operated without a central bank until the founding of the modern Federal Reserve System in the early 20th century. The interlude was punctuated by bank panics, economic crises and recessions, including damaging downturns in 1837, 1857, 1873, 1893 and 1907. [41] No federal deposit insurance existed at the time, which meant that if a bank collapsed, depositors were unlikely to ever recoup their funds. As a result, fears about a bank's ability to remain solvent often led to runs, in which customers withdrew their money as quickly as possible.

It was the Panic of 1907, sometimes called the Knickerbocker Crisis, that ultimately spurred creation of the Fed. A series of bank runs once again destabilized the markets. Legendary financier J.P. Morgan ultimately stepped in to organize a group of bankers to bail out the financial system.

"Morgan had lived through perhaps half a dozen anguishing financial crises and … he understood the extraordinary disruptions panics could cause," Robert F. Bruner, dean of the University of Virginia's Darden Graduate School of Business Administration, told Smithsonian magazine in an interview. [42]

In response to the panic, Congress eventually passed the Federal Reserve Act, signed into law by President Woodrow Wilson in December 1913. It established a new central bank led by a board, known as the Federal Reserve Board, to oversee its activities. The system would also include a number of regional reserve banks. The structure had its roots in the fight going back to the days of Hamilton and Jefferson – the desire to strike the right balance between centralized and dispersed power in government. The country would now issue a new national currency, known as Federal Reserve notes, and all nationally chartered banks would be required to hold reserves with their regional reserve bank.

The intent of the law was that the central bank would be able to provide much-needed liquidity to banks in times of crisis to help avert future panics. [43] The central bank would also be charged with managing the gold standard, under which the value of the dollar was fixed to a certain amount of gold. The gold standard was largely in effect from after the Civil War until the Great Depression. [44]

The Fed gained support throughout World War I and the economic expansion of the Roaring '20s, but when the stock market crashed in 1929, helping to precipitate the Great Depression, the cascading events exposed certain weaknesses at the central bank that led to additional changes. [45]

Many economists, including Bernanke, have argued that its actions in the early 1930s worsened the crisis. The central bank failed to act as a so-called "lender of last resort" in some cases, failing to provide necessary liquidity to struggling banks. At the same time, it didn't act to cut interest rates and expand the money supply, in part out of concern that lowering rates would force the U.S. off the gold standard.

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"They argued that keeping interest rates high would make U.S. investments attractive and prevent money from flowing out of the United States," Bernanke said in his university lectures about the crisis. [46] "But that was the wrong thing to do relative to what the economy needed."

A series of laws passed in the 1930s refined and expanded the Fed's powers. The laws established the FOMC, which directs monetary policy, and strengthened the power of the Board of Governors in Washington over the regional banks. [47] Although this consolidation of authority in Washington strengthened the Fed's hand, it was still not fully independent. During World War II, the Fed held interest rates low, at the Treasury Department's urging, to help the government finance the war more cheaply. The Treasury also pressured the central bank to keep rates low after the war ended, despite the risk that doing so could lead could lead to high inflation. [48]

"The inability of Federal Reserve officials to persuade the Treasury to let the System abandon the government bond support program (in view of other policy considerations such as price stability) clearly demonstrated that the Federal Reserve System was effectively under Treasury control," wrote Daniel Sanches, an economist at the Federal Reserve Bank of Philadelphia. [49]

Growing Influence

It wasn't until 1951 that government officials struck a deal, known as the Treasury-Federal Reserve Accord, giving the Fed independent control of monetary policy. The agreement was critical because "it was the first clear acknowledgement by the government that the Federal Reserve should be allowed to operate independently," Bernanke said in his lectures. [50]

While the 1960s was a decade of relative calm for the Fed, the loose monetary policy it pursued in that period combined with increased spending on the Vietnam War and other government programs ultimately spurred an intense period of inflation that plagued the country throughout the 1970s. [51] Oil shocks in 1973 and 1979 exacerbated the problem, sending energy prices sky high. [52]

The Federal Reserve System and its 12 regional banks.

Frustrated with economic conditions and the Fed's handling of monetary policy, lawmakers re-codified the central bank's mission, which had previously called on officials to establish "conditions under which there will be afforded useful employment for those able, willing, and seeking work, and to promote maximum employment, production, and purchasing power." As of 1977, Congress required the Fed to meet three standards: setting stable prices, reaching maximum employment and maintaining moderate long-term interest rates. Despite the fact that the new marching orders contained three provisions, it's now often referred to as the dual mandate, with the focus on stable prices and full employment. [53]

Paul Volcker, who became Fed chairman in 1979, finally put a stop to the country's double-digit inflation, although he did so by a severely tightened monetary policy that led to two recessions in the early 1980s. The next quarter-century, until the 2008-09 financial crisis, was characterized by a period of mostly steady economic growth known as the Great Moderation. Volcker and his successor Alan Greenspan, who held the Fed chair for nearly two decades, were lauded for their handling of monetary policy – although Greenspan's policies have more recently come under fire from critics who argue they helped to trigger the financial crisis. During the last few decades of the 20th century, the Fed began to apply monetary policy more systematically and stepped up its efforts to communicate with the public, strengthening the impact of its decisions. [54]

Central Bank in Crisis

Although the financial crisis had numerous causes, the Federal Reserve bears some responsibility, many observers now argue.

"Despite the expressed view of many on Wall Street and in Washington that the crisis could not have been foreseen or avoided, there were warning signs," the Financial Crisis Inquiry Commission, a government body organized to investigate the causes of the crash, concluded in its 2010 report. [55] "The prime example is the Federal Reserve's pivotal failure to stem the flow of toxic mortgages, which it could have done by setting prudent mortgage-lending standards. The Federal Reserve was the one entity empowered to do so and it did not."

Greenspan, who presided over the Fed from 1987 to 2006, has narrowly conceded that errors were made in the run-up to the crisis, although he's famously refused to accept blame. [56]

His successor, Bernanke, who took over as the housing bubble began to burst, has been widely credited with acting quickly and decisively in the face of the crisis. As an economic historian and scholar of the Great Depression, Bernanke is considered to have been uniquely suited to avoid making the mistakes of leaders in previous financial crunches. Under Bernanke, the Fed responded to the crisis in the fall of 2008 by slashing interest rates, expanding the scope of its short-term lending to a wide swath of financial institutions and instituting three rounds of quantitative easing. [57]

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"In the midst of this perfect storm, it is hard to imagine anyone other than Ben Bernanke at the helm of the Federal Reserve," Victor Li, an associate professor of economics at Villanova University and a former academic colleague of Bernanke's, wrote in a 2013 op-ed. [58] "He was simply the right person at the right time for the job."

At the same time, the Fed is often criticized for its role in the bailouts of Bear Sterns, an investment bank that ultimately failed anyway, and insurance giant American International Group; and for its inability with other government leaders to forestall the 2008 bankruptcy of the financial services firm Lehman Brothers, which sent financial markets into a tailspin. [59]

With the passage of Dodd-Frank in 2010, the Fed, as the primary regulator for bank holding companies, was directed to write new regulations for the largest banks. Those rules included increased capital reserves, stress tests to measure banks' ability to withstand crises and so-called living wills requiring banks to establish plans for an orderly liquidation. The goal was to make the economy more stable. The central bank was also charged with writing new rules for non-bank financial institutions.

The central bank held rates at near-zero through the end of 2015 before beginning to inch them upward. The goal has been to avoid throwing the economy into another recession. But as conditions stabilize, less accommodative monetary policy may be on the horizon.

Current Situation

How Many Rate Hikes?

Over the next few years, market observers say, it's not a matter of whether the Fed will raise short-term interest rates again, but when.

With the change in administration, Fed officials are preparing for the possibility of increased government spending, which could in turn boost inflation that would require additional rate hikes. [60] Many economists are predicting a handful of interest rate increases this year, in the range of two to four. The FOMC says it is now predicting three rate hikes in 2017 instead of two, according to minutes from its December meeting. Committee members cited what they call "upside risks" from possible fiscal policies put forth by the Trump White House and Congress and low rates of unemployment. [61]

"We may now finally get that under the new administration with a GOP Congress," says Albion's Ware, speaking about the potential for renewed fiscal activity. "We're talking about tax cuts down the pike, we're talking about potential spending on things like infrastructure, we're talking about things like deregulation."

The timing of additional rate hikes will likely be tied to the impact of any government spending or tax cut initiatives. "That's the big unknown in terms of the pace – how big is the fiscal stimulus going to be, how inflationary is it going to be and how quickly does the Fed feel it needs to get ahead of that curve," says Chessen.

Yellen and her predecessor Bernanke had previously signaled that fiscal stimulus would be beneficial for bumping up economic growth.

"The Fed has been using easy money because the economy has needed a lot of support," Bernanke told CNBC in the fall of 2015. [62] "A better policy would be a better mix of monetary, fiscal and other policies. The fact that the Fed is the only game in town means the Fed has to do too much."

But as the economy has continued to strengthen and unemployment has fallen, the need for short-term stimulus has given way to longer-term needs. Yellen told reporters in December that spending plans should focus on boosting productivity and longer-term economic growth.

"Fiscal policy is not obviously needed to provide stimulus to help us get back to full employment," she said. [63]

Americans Feeling Upbeat About Economy in 2017

Gallup's Economic Confidence Index has been positive under Trump

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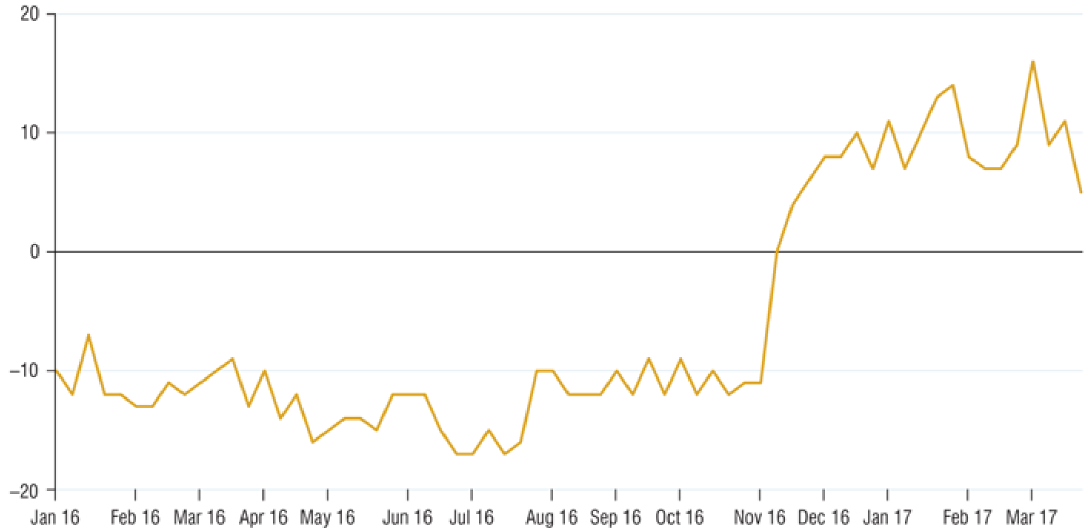

Note: Only data points from the first week of each month are listed in the table. Gallup's Economic Confidence Index is based on the combined responses to two questions, the first asking Americans to rate economic conditions in the country today, and second, whether they think economic conditions in the country as a whole are getting better or getting worse.

Source: "U.S. Economic Confidence Index (Weekly)," Gallup, http://tinyurl.com/95l3osb

Gallup's U.S. Economic Confidence Index (ECI) has continued its rise into 2017. Since President Trump won the election in November 2016, the ECI has remained positive, hitting +16 in the first week of March 2017.

Productivity, a measure of economic output, has remained stubbornly low in the developed world in recent years, which economists suggest could be due to the rise in service sector jobs, where output is more difficult to measure. [64]

Regardless of the precise cause of the downturn in productivity measures, the impact could be significant. "This halving of productivity growth, if it were to persist, would have wide-ranging consequences for living standards, wage growth, and economic policy more broadly," Fischer, the Fed's vice chair, said in November. [65]

James Bullard, president of the Federal Reserve Bank of St. Louis, has noted that annual economic growth has hovered around just 2 percent since the recession, which officially ended in the summer of 2009. By comparison, the economy has grown at 3 or 4 percent annually during prior expansions.

"As a nation, we need to think about what kinds of public policies are needed to encourage higher productivity growth – and, in turn, higher real GDP growth – over the next five to 10 years," Bullard wrote in October. He argued that in the longer term, monetary policy is not effective for spurring economic growth, again calling for government officials to explore greater investments in technology, worker education and infrastructure projects. [66]

Wage growth, meanwhile, has also remained paltry in recent decades, holding back economic growth and contributing to inequality.

"You really can't get any firm inflation going in the economy if you don't have wage increases," said Bernard Baumohl, chief global economist at The Economic Outlook Group, a research and forecasting firm based in Princeton, N.J., in an interview last year. [67] "You need wage inflation to get consumer price inflation up."

Legislative Tensions

The biggest congressional threat to the Fed in the current term is the sweeping regulatory reform bill backed by Hensarling, the House Financial Services Committee chairman, which includes several measures affecting the Fed. The legislation would direct the GAO to audit the Fed and would mandate that the FOMC adopt a mathematical formula for setting monetary policy. It would also provide banks with a regulatory "off-ramp"; those that meet a higher capital ratio set in the bill would be able to bypass some of the Fed's other rules. Additionally, the legislation would force the central bank to adopt new requirements for conducting its annual stress tests on banks. [68]

But while the legislation, called the Financial Choice Act, has the potential to dramatically influence the inner workings of the central bank, observers say that the odds of passing some of the core proposals regarding the Fed are slim, despite the fact that Republicans now control both the White House and Congress.

"At the end of the day those efforts are unlikely to be successful," says Crowley of law firm K&L Gates. "A lot of the reform proposals

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embodied in the Choice Act are really messaging. They're intended to focus attention on perceived shortcomings, and the Fed is a favorite whipping boy."

According to Barford of Beacon Policy Advisors, "The fact that the chatter keeps ramping up is bad for the institution's independence. It's bad to have even the appearance of an adversarial relationship with the legislative branch."

Still, he agrees that the prospects for the Fed proposals are not good. "I don't put a lot of stock in the law changing anytime soon," Barford says.

The legislation is hardly the first attack the Fed has withstood. [69] In fact, it's been surviving legislative challenges for decades.

A Brookings Institution report last year by Sarah Binder, a senior fellow in the think tank's governance studies program, and Mark Spindel, chief investment officer at Potomac River Capital, a hedge fund, examined legislation introduced in Congress to affect the Fed's power, structure and governance between 1947 to 2014. They found that 879 such bills had been introduced over that period, and concluded that the central bank's "rocky relationship" with Congress will continue. Notably, Democrats have actually introduced twice as many audit measures as Republicans over the years. [70]

"Persistent low inflation, growth and interest rates confound Fed policy makers and their congressional overseers, raising doubts about the efficacy of the Fed's unconventional (and unprecedented) monetary policy innovations," they wrote. [71] "At the same time, many lawmakers remain skeptical of the Fed's policy objectives."

Looking Ahead

Yellen's Remaining Challenges

Although Yellen has less than a year left in her term as chair, she still has in front of her "a massive to-do list to create her legacy," says Beacon Policy Advisors' Barford.

That includes decisions about any interest rate hikes over the rest of the year, along with forging relationships with newly installed members on the Board of Governors and protecting the Fed against major reforms being debated in Congress.

Lawmakers have also asked the Fed to hold off on finalizing any additional bank rules until new governors, including the vice chair for supervision, are installed. Yellen has said that the regulatory schedule for the coming period is "light," with just one rule involving additional capital measures for the largest banks close to being completed. [72]

The Fed will also have to navigate its growing role in the world economy, while watching to see whether the new administration, an ardent opponent of free trade, enacts more protectionist policies, which could have an impact on exchange rates and inflation. [73] "One could argue that maybe we've hit peak globalization for a while," Albion's Ware notes.

After three years under Yellen's leadership, the Fed's direction is fairly predictable. The biggest outstanding questions instead center around her successor and the Fed board's makeup. New members of the central bank team will play in an important role in trying to kick the tepid economy into a higher gear.

But like all central bank officials, they will face a crucial test in doing so: They must avoid efforts that tighten monetary policy too quickly, potentially sending the country back into a recession.

About the Author

Victoria Finkle is a freelance journalist based in Washington, D.C., who focuses on business, banking and public policy. She has written for the New York Times, Inc. magazine, Bloomberg BNA and Washington Monthly, and previously worked as a staff writer for the American Banker newspaper, covering Capitol Hill and consumer finance. Her previous reports for SAGE Business Researcher were on behavioral economics, financial technology and shadow banking.

Chronology

1660s-1830s	**U.S central banking puts down roots.**
1668	Sweden establishes the world's first central bank.
1694	The Bank of England opens; it becomes the model for early U.S. attempts at central banking.

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1790	Alexander Hamilton, the first U.S. Treasury secretary, proposes the idea of a national bank.
1791	Congress approves the First Bank of the United States.
1811	Congress fails to renew the bank's 20-year charter.
1816	In the wake of the War of 1812, the United States again establishes a national bank, the Second Bank of the United States.
1832	President Andrew Jackson vetoes a bill to renew the bank's 20-year charter.
1830s-1930s	**Congress establishes and refines the Federal Reserve System.**
1837	A series of financial panics and economic crises punctuates the 19th century, including in 1837, 1857, 1873 and 1893.
1907	Another financial panic, the Knickerbocker Crisis, leads to numerous runs on banks and trusts; the episode spurs government leaders to consider anew the need for a central bank.
1913	The government creates the Federal Reserve System to stabilize the financial system and oversee the money supply.
1929	The stock market crashes on Oct. 29, otherwise known as Black Tuesday, beginning a chain of events that leads to the Great Depression.
1933	Congress passes several changes to the Federal Reserve between 1933 and 1935, improving its ability to lend to banks in times of trouble and centralizing the decision-making power of the board of governors in Washington.
1940s-2007	**The Fed gains independence and oversees a decades-long economic expansion.**
1942-1945	At the urging of the Treasury Department, the Federal Reserve holds interest rates low and provides other support measures for the government during World War II.
1951	The central bank gains independence from Treasury Department directives as part of an agreement known as the Treasury-Fed Accord.
1971	President Richard M. Nixon announces that foreign governments can no longer trade gold for dollars and imposes a 90-day freeze on wages and prices in an effort to check inflation.
1973	Energy prices soar after the Organization of Arab Petroleum Exporting Countries announces an oil embargo. A second oil crisis occurs in 1979.
1977	Congress amends the Federal Reserve Act to clarify what is now known as the dual mandate, which calls on the Fed to balance the goals of maximum employment and stable prices.
1980	The country enters the first of two recessions, partially in response to efforts by Federal Reserve Chairman Paul Volcker to tighten the nation's money supply and reduce double-digit inflation; a second recession hits in 1981-1982.
1987	Economist Alan Greenspan takes over as head of the central bank, a position he will hold for nearly two decades; although his management of the economy was lauded at the time, his actions have since come under fire for potentially contributing to the 2008 financial crisis.
2006	Ben Bernanke, an economic historian, takes over as Fed chair as the housing market begins to deflate.
2007	The housing market continues to decline, soon spurring the worst financial crisis since the Great Depression … economic growth turns negative and the country descends into recession in December.
2008-present	**The central bank responds to the financial crisis and its aftermath.**
2008	Lehman Brothers files for bankruptcy, sending the markets spinning.… The Fed slashes short-term interest rates to near zero and begins the first round of asset purchases known as quantitative easing.… The economy tumbles and jobs are slashed.
2010	Congress passes the Dodd-Frank Act, a major banking bill that expands the powers of the Federal Reserve to regulate the financial industry.
2012	The Fed formally adopts a 2 percent target rate for inflation.

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2014 Economist Janet Yellen is confirmed as the Fed's first female leader.… The European Central Bank adopts a negative interest rate for bank reserves.

2015 The Fed raises its benchmark interest rate, by a quarter of a percentage point, for the first time since the financial crisis.

2016 Rep. Jeb Hensarling, R-Texas, chairman of the House Financial Services Committee, introduces a bill to unwind parts of Dodd-Frank and impose new restrictions on the Fed.… The Fed raises the benchmark rate for a second time, by a quarter point.… Several presidential candidates, including eventual winner Donald Trump, criticize the Fed's actions; Trump argues that Yellen has politicized the Fed and says he would likely replace her.

2017 Trump is sworn in as president.… The Fed raises interest rates for the third time since the financial crisis.… Governor Daniel Tarullo, who oversaw new Fed rules for banks under Dodd-Frank, leaves the central bank.

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events.

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Organizations

American Bankers Association
1120 Connecticut Ave., N.W., Washington, DC 20036
1-800-BANKERS (226-5377)
www.aba.com
Trade association for the banking industry.

Bank of England
Bank of England, Threadneedle St., London, EC2R 8AH
+44 020 7601 4878
enquiries@bankofengland.co.uk
www.bankofengland.co.uk/Pages/home.aspx
Central bank for the United Kingdom.

Center for Popular Democracy (New York office)
449 Troutman St., Suite A, Brooklyn, NY 11237
cpd@populardemocracy.org
1-347-985-2220
https://populardemocracy.org
Nonprofit that organizes the "Fed Up" campaign advocating for the central bank to enhance its focus on full employment and wage growth.

European Central Bank
60640 Frankfurt am Main, Germany
+49 69 1344 1300
info@ecb.europa.eu
https://www.ecb.europa.eu/home/html/index.en.html
Central bank for the 19 countries in the European Union that have adopted the euro.

Federal Reserve
Constitution Avenue and 20th Street, N.W., Washington, DC 20551
1-202-452-3000
www.federalreserve.gov
Headquarters for the U.S. central bank.

Federal Reserve Bank of New York
33 Liberty St., New York, NY 10045
1-212-720-5000
general.info@ny.frb.org
www.newyorkfed.org
The most influential of the Fed's 12 regional reserve banks and the location where monetary policy is implemented through a series of trades known as open market operations.

Financial Services Forum
601 13th St., N.W., Suite 750 South, Washington, DC 20005
1-202-457-8765
http://financialservicesforum.org
Financial and economic policy trade group for large financial institutions.

Shadow Open Market Committee
e21@manhattan-institute.org
www.shadowfed.org
An independent group of academics and other economic experts that meets semiannually to critique the policy decisions of the U.S. central bank's Federal Open Market Committee.

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