CREATION OF THE ALL-POWERFUL FED

The Federal Reserve has played many roles over the last 100 years. Is there long-term concern in its latest role — the all-powerful Fed?

BEFORE THE FED

In the early months of 1895, President Grover Cleveland faced an existential problem. The U.S. economy was collapsing under the burden of falling prices and rising unemployment that began with the Panic of 1893. Eighteen months later, millions of workers were unemployed, and the situation continued to worsen. At that time, the U.S. had neither a central bank — the Federal Reserve would not be created until 1913 — nor a currency backed by gold. The Treasury's reserves were dropping quickly, and a run on the Treasury could have thrown the U.S. government into insolvency. Cleveland's plan was to raise $60 million by selling government bonds to the public, but since faith in the financial system was decreasing each day, a large bond sale was not possible. The government held reserves of just $9 million and owed one creditor $10 million. If that draft were to be redeemed, the Treasury would be insolvent. The U.S. government needed a bailout — and quickly.

J.P. Morgan was the original Wall Street shark. A secretive, surly, foul-mouthed man with a reputation for ruthlessness, Morgan had interests in railroads, banking and steel. Morgan also used his vast connections to claim board seats on many of corporate America's largest companies, where he learned the secrets and vulnerabilities of some of the country's top business and political leaders. He also understood in detail the inner financial weaknesses of the U.S. government in 1895. With this knowledge, Morgan boarded a train to Washington D.C., that spring, with his hat in one hand and a financial billy club in the other. Morgan knew that his vast business holdings would be greatly harmed by the failure of the government and the economy. He also knew that he was President Cleveland's only hope. And Morgan never let a chance to make money and wield power slip through his fingers.

GuideStone Capital Management

President Cleveland knew of Morgan's ruthless reputation and held out as long as he could from a messy entanglement in Morgan's financial web. Cleveland was shocked to learn that Morgan knew the exact desperation of the government's financial plight, down to the last dollar. Cleveland had no choice but to listen to Morgan's offer — a large sale of government bonds to him and his syndicate. In exchange, Morgan would give the Treasury the gold it needed to meet its current and anticipated obligations, which would serve to calm investors and the markets. Confidence in the financial system began to increase even before the deal was announced, as word of Morgan's trip to the White House was whispered around town. The great J.P. Morgan had cosigned as an investor on the reputation and financial future of the United States. And that signature was all the market needed to recover and thrive.

This type of financial panic was not uncommon in the U.S. at that time. More than 100 years after its founding, the country still had no central bank. This absence of a central federal monetary planning authority led to frequent crises and a lack of liquidity for the financial system that stunted economic growth. Many Americans, however, resisted the idea of a central bank because they did not want to emulate the country that they had fought so hard to gain independence from. The Royal Crown and its Bank of England was not a model that politicians wanted to copy. However, the Bank Panic of 1907 was the final straw that led to the creation of a central bank.

That year J.P. Morgan was once again forced to step in and save the country's financial system from ruin. This time, he brought his powerful Wall Street banker friends to the table. The group provided the liquidity that the government needed to survive the panic, but also demanded the creation of a central bank. The 1913 Federal Reserve Act gave the 12 newly created Federal Reserve banks the ability to print money to ensure economic stability. The Federal Reserve System was also charged with the dual mandate of maximizing employment and keeping inflation low. The Federal Reserve was thus given power over the money supply and, by extension, the economy. The fledgling central bank would not be given much time to learn on the job before the onset of its first crisis in 1929. It would prove itself not up to the task.

THE FEDERAL RESERVE ACT OF 1913 AT-A-GLANCE

WHAT DID IT DO?

Established the Federal Reserve System as the central bank of the U.S. Created 12 Federal Reserve Banks, which comprise the Fed's Board of Governors.

WHAT WAS THE MANDATE?

Facilitate maximum employment and keep prices and long-term interest rates stable.

WHAT WAS THE OBJECTIVE?

Provide America with a safer, flexible and stable monetary and financial system.

WHAT AUTHORITY WAS GRANTED?

Three primary responsibilities of the Fed:

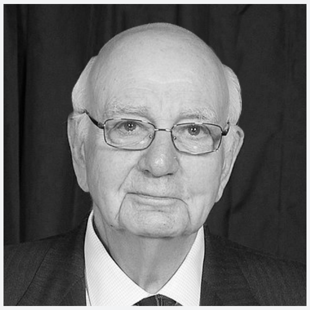
- Conduct the nation's monetary policy
- Provide and maintain an effective payment system
- Supervise and regulate banking operations

KEY PLAYERS IN THE FED STORY

WILLIAM G. McADOO

Chair: 1913–1918

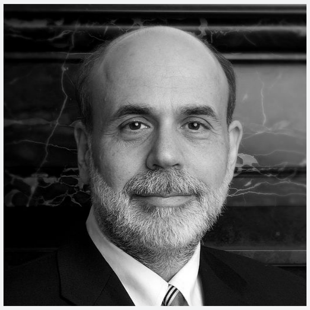
- First chair of the Fed
- Simultaneously served as treasury secretary
- McAdoo's actions during WWI helped prevent financial collapse in the U.S.



PAUL A. VOLCKER

Chair: 1979–1987

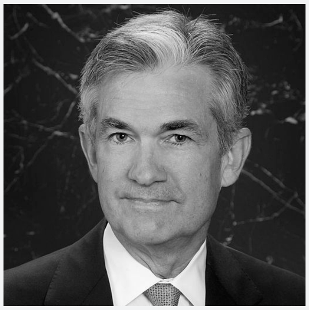
- Waged war against soaring inflation
- Protected authority of Fed and prevented banks from "risky" activities
- Created the "Volcker Rule" following the Great Financial Crisis of 2008



BEN S. BERNANKE

Chair: 2006–2014

- Led Fed response to the Great Financial Crisis (2006–2010)
- Architect of Fed's Quantitative Easing program and expansion of Fed's economic stimulus efforts
- Enhanced transparency and communication of Fed



JEROME H. POWELL

Chair: 2018–Present

- Fed chair during COVID-19 Crisis
- Significantly increased the Fed's balance sheet
- Expanded Fed activities into private markets and broadened ability to serve as "backstop" for the U.S. economy

THE ABSENT FED

While the Great Depression is thought to have begun with the crash of the stock market in late 1929, it is now widely accepted among economists that the crippling economic damage that would plague the country for most of the 1930s was instead caused by the inaction of the Fed. In late 1930, a slowing economy, rising unemployment and a lack of confidence in the financial system caused a widespread run on banks. Depositors withdrew large amounts of money from their savings institutions, causing the money supply to plunge by nearly one-third by 1933. The Fed could have stepped in to carry out its assigned role as lender of last resort and guardian of liquid financial markets, but it remained on the sidelines — with disastrous consequences.

Rather than providing liquidity through loans, the Fed merely watched as bank after bank closed their doors, seemingly oblivious to the effect this would have on the money supply. The Fed could have offset the decrease in money by engaging in bond purchases to flood the market with liquidity — but it did not, and the economy paid the price for this lack of fortitude. Total GDP declined by at least 10% for three straight years and created an economic downturn that would scar an entire generation.

After the experience of the Great Depression, policymakers would demand that the Fed take a larger role in preventing or curing future financial crises. That desired increase in influence was first used in a bold attempt to cure economic ills after Paul Volcker assumed the role of chairman in 1979.

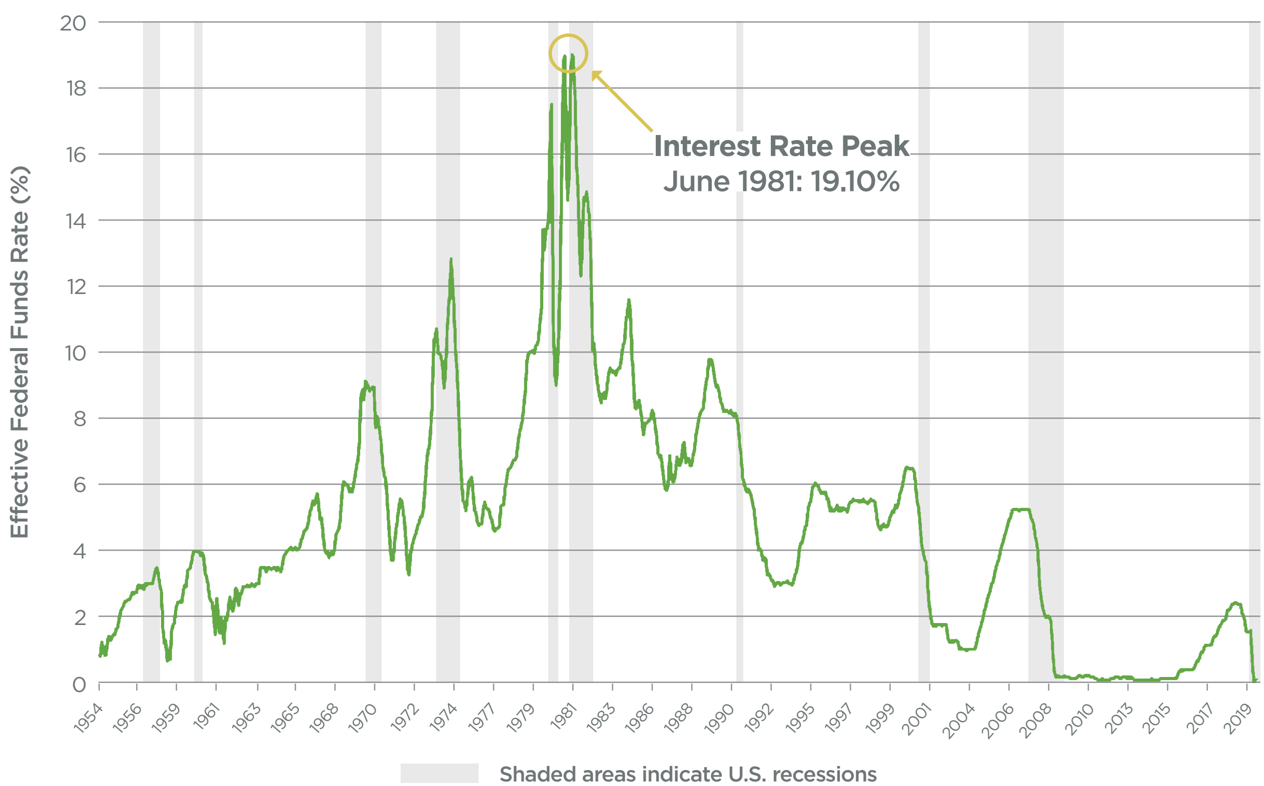
THE FED AS THE BAD GUY

In October 1980, Paul Volcker's assistant stopped dropping the daily mail on his desk. The new chairman regularly received chunks of two-by-four boards sent by angry new home developers. Car keys were sent by auto dealers whose sales were plummeting. And tractor pistons arrived from enraged farmers who could not afford to purchase new equipment. Volcker had ascended to the top job at the Fed a year before. He took the job with an unabashed commitment to cure the country of the inflation that had hobbled the economy over the previous decade. In his many years of public service, he did not desire to be popular, just highly competent. In 1980, he was not popular at all. But his actions would prove highly effective.

Volcker was tall, at six feet seven inches, and many said that his confidence and ego were taller still. He had a penchant for cheap cigars, rumpled suits and not backing down from a fight. But the struggle to end inflation was proving to be a grueling battle, even for Volcker. When he assumed the chairman post in 1979, the inflation rate exceeded 12% per year. The Fed had been promising to crack down on inflation for more than a decade, but it had repeatedly caved to intense political pressure to avoid policies that would cause a recession.

Volcker decided that a very public declaration of war on inflation was necessary to convince the country that this time would be different. On October 6, 1979, Volcker held a news conference at the Fed's headquarters — the first time in memory that a Fed chairman had addressed the news media. While many in Washington argued that the Fed could reduce inflation gently, and without causing a recession, Volcker knew that such actions would not cure this disease.

EFFECTIVE FEDERAL FUNDS RATE (%)
(1954 TO PRESENT)



Data source: Federal Reserve Bank of St. Louis

Volcker felt that inflation had become a self-fulfilling prophecy. People had come to expect prices and wages to rise, so they borrowed and spent more and demanded larger pay increases, which caused prices and wages to rise further. This expectational inflation was a more formidable foe than primary inflation, which is caused by increases in market demand. Volcker knew that the only way to crush expectational inflation was to cut the supply of money and let the market set interest rates based on a lower monetary base.

The cost to the economy proved temporary but steep. High interest rates — higher than even Volcker had anticipated — caused consumers to stop buying homes and cars, and millions of workers lost their jobs. The prime rate, which banks charge their most creditworthy customers, nearly doubled within a year and peaked at 19.10%.

A high and unpredictable inflation rate encourages unnecessary spending, as consumers purchase today what will cost more tomorrow. Inflation also discourages investment, as future business profits decline in present value. The combination of high spending and low investment creates economic and, very often, political instability. President Carter knew of Volcker's brash and bold reputation but desperately needed to set the economy on the right path before the upcoming election. Carter's appointment of Volcker may have cost him greatly in the short term, as he lost the 1980 election to Ronald Reagan. Looking back, however, Volcker's stubborn fight against inflation would prove a monumental win for the economy and its long-term growth potential. Volcker managed to wring most inflation from the economy, and by 1983, the inflation rate had dropped to 3.2%. It has remained low and manageable in the four decades since.

Volcker was an ornery monetary sheriff, but he defeated the insidious virus of inflation. As such, his legacy at the Fed has been profound and long-lasting. Prior to Volcker's service as chairman, Congress wielded considerable influence on Fed policy and actions. His victory against inflation inaugurated a new era in which the leaders of both political parties largely defer to the central bank. Post-Volcker, the Fed has acted much more as an independent body and has been given wide latitude by both Congress and the president. This expansion of its purview has allowed Fed committees to effect monetary policy with little political interference, which was fully on display in 2008.

FIVE KEY FUNCTIONS OF THE FED

1 Conducting U.S. monetary policy

2 Maintaining stability of financial system

3 Supervising and regulating financial institutions

4 Safely and efficiently fostering payment and settlement

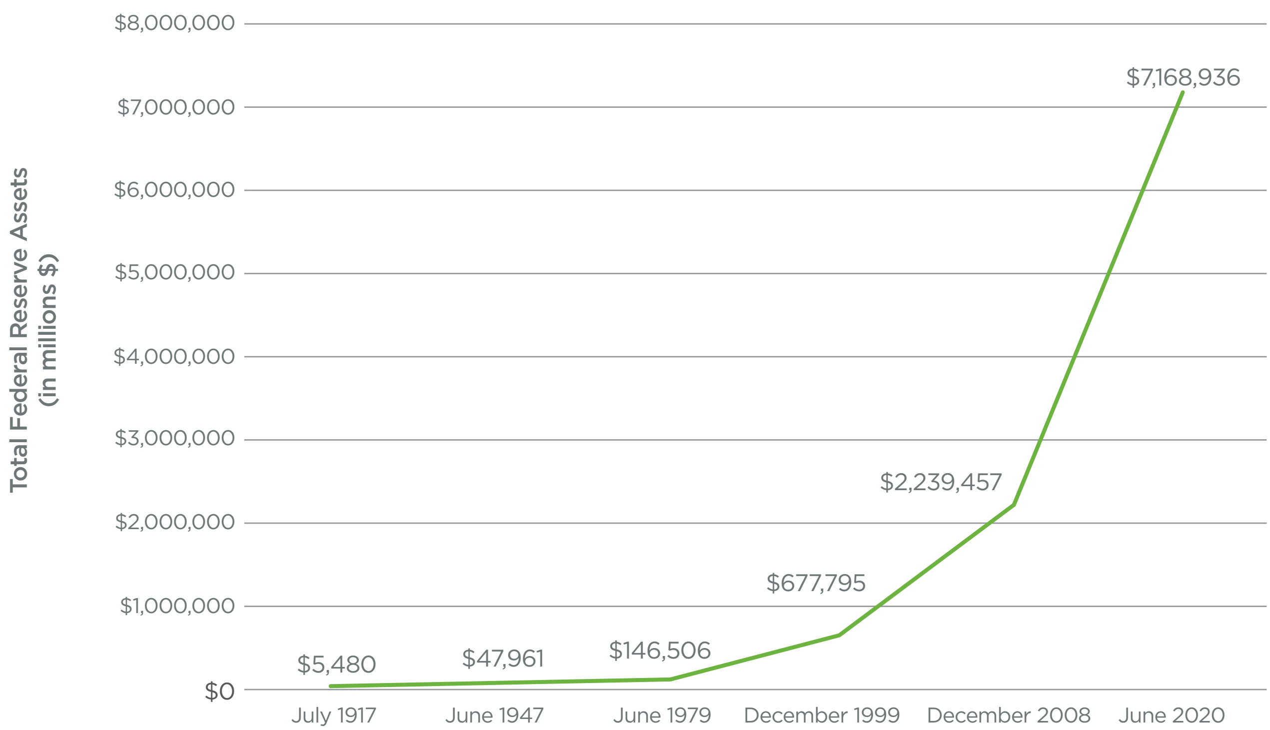
5 Consumer protection and community development

THE FED AS THE FINANCIAL GUARDIAN

"Madam Speaker, if we don't do this plan," Chairman Bernanke implored, "we may not have an economy on Monday."

This blunt warning from the cerebral and soft-spoken Fed chairman sucked the air and optimism out of the hastily convened meeting in the conference room of House Speaker Nancy Pelosi. At that meeting, Bernanke and Treasury Secretary Hank Paulson presented to congressional leaders, in the starkest terms imaginable, the outline of a $700 billion financial market rescue plan. For the first time in modern U.S. history, political and economic officials were not dealing with a slow-motion crisis. The financial meltdown train was careening at full speed down the tracks, and without the Fed's help, the path would lead over an economic cliff.

THE FED'S BALANCE SHEET THROUGH THE YEARS



Data source: Federal Reserve Bank of St. Louis

September 2008 was a long month for Bernanke. Lehman Brothers had collapsed into bankruptcy and the U.S. financial sector was in chaos. Fannie Mae and Freddie Mac were placed into the conservatorship of the U.S. government. AIG, one of the world's largest insurance companies, was suffering a liquidity crisis following the downgrade of its credit rating — faced with impending insolvency, 80 million customers could soon be left without insurance. Without insurance, planes would not fly, construction sites would shut down and McDonald's restaurants would not open their doors.

In 2008, the Fed needed to quickly stanch a financial market breakdown that was deep, harrowing and a great example of a systemic crisis — one in which the economy's financial gears and levers shut down. Strong and unprecedented actions were necessary by both the Fed and Treasury Department to ensure the financial system itself did not grind to a halt. The movement of money and the availability of credit in an economy is akin to the value of oil in an engine. When it is available, its presence is barely noticed. But when it is missing, the vast economic engine shuts down.

The Fed in 2008 was forced to move from its historical mandate of maximizing employment and keeping inflation low to serving as the primary guardian of the financial system itself. Past recessions were caused by a weakening economy, followed by higher unemployment and decreased economic activity. Rescue plans typically focused on fiscal stimulus programs to keep workers and businesses afloat until sunnier days returned. But the 2008 financial crisis was very different. A highly connected financial system was in danger of collapse. Nothing less than the full power of the Fed could allay the carnage.

The Fed had never before seemed so powerful, and so necessary, in a crisis. With the Fed's power on full display, the president, Congress and American populace would now look to the central bank as the cure for any economic calamity in the future.

THE FED AS THE ALL-POWERFUL ENTITY

In the spring of 2020, a different and more tangible contagion began plaguing global economies and financial markets. Word of a new coronavirus was first mentioned in *The New York Times* on January 8. While some investors had seen the technology bubble of 2000 or the housing crisis of 2008 coming, no one had imagined this virus becoming a global pandemic that would bring the world's economy to its knees — and so quickly. From its high on February 19, the S&P 500® Index cratered by 34% in just a few weeks — the quickest and deepest correction from a market high in history. Investors only wanted to hold cash, and a run on the stock and bond markets was in full swing. Trust and faith in the effective functioning of world financial markets could have quickly eroded in the economic storm brought on by the pandemic.

The U.S. economy effectively shut down in mid-March as the pandemic spread rapidly. Global economic activity plunged, and 40 million workers were forced onto unemployment rolls. Financial market liquidity was quickly drying up, and even high-quality corporate bonds were finding few buyers. Millions of shuttered small businesses would fail without access to credit. Consumers might not be able to make rent or mortgage payments. Fear and uncertainty were rampant as the situation grew grimmer by the day. While the Fed had used its considerable power and influence over the financial system for short periods before — such as in the financial crisis of 2008 — never had the Fed's power been employed or implemented in such a major display of monetary support as it was in March 2020.

INTEREST RATES AND THE FED

26	28	1% CUT	.25%	11 CUTS	8 HIKES
RATE HIKES	RATE CUTS	BIGGEST CHANGE	MOST COMMON	MOST CUTS IN SINGLE YEAR	MOST HIKES IN SINGLE YEAR
Since 2000	Since 2000	12/2008 and 3/2020	36 times since 2000	2001	2005

The Fed was created in part as a fire department for the financial markets, and the virus-induced panic called for the largest fire hoses the Fed could bring to the emergency. In 2008, the Fed was late to the game and provided less aid than the crisis demanded, which prolonged the market and economic pain. After this lesson, the Fed vowed to move decisively and aggressively in the next financial crisis. And they certainly did this time around.

In March, the Fed cut interest rates to zero, enacted a vast series of new monetary aid programs for both financial markets and businesses, and printed large amounts of new money to purchase fixed income securities in an effort to stabilize credit markets. The Fed's balance sheet ballooned from $4 trillion in 2019 to more than $7 trillion today. Like J.P. Morgan's trip to Washington in 1895, merely the announcement of a large and committed Fed presence served to calm investors and lenders and stabilize markets. The Fed was in effect cosigning on the future fate of the financial markets, corporate America and tens of millions of workers. The Fed's backstop of the entire financial system provided much-needed investor confidence and led to a large rally in financial markets in the second quarter of 2020. As the second half of the year is now underway, the path forward for the financial system and global economy remains highly uncertain. But the heavy hand of the Fed's powers has never proven as vast, or as unnerving, as it has in 2020.

THE FUTURE OF THE FED'S POWER

After the massive amount of Fed support this year, many questions remain. Will the positive results of the Fed's actions in this crisis lead to an expectation that they will act similarly in all future market or economic dislocations, both large and small? How will the Fed decide whether to intercede in the normal fluctuations of the economy and capital markets in the future? If the Fed can simply print a large amount of money to solve the country's short-term economic problems, how much is too much aid? And when does all this government largesse lead to a spike in inflation and a large devaluation in the dollar as the world's reserve currency? The Fed's actions in 2020 will surely affect economic, monetary and political thought and theory for decades to come.

This information is prepared by GuideStone Capital Management, LLC®, a controlled affiliate of GuideStone Financial Resources®. This material is provided for educational purposes only and should not be construed as investment advice or an offer or solicitation to buy or sell securities. Diversification is not a guarantee against loss. This information does not represent any GuideStone® product. Special risks are inherent in international investing, including those related to currency fluctuations and foreign, political and economic events. The material represented has been obtained from sources we consider reliable, but which we cannot guarantee. It is subject to change without notice and is not intended to influence your investment decisions. This information discusses general market activity, industry or sector trends or other broad-based economic, market or political conditions and should not be construed as research or investment advice.

All indices are unmanaged and not available for direct investment. Index performance assumes no taxes, transaction costs, fees or expenses. **Past performance is no guarantee of future results.**

GuideStone® Capital Management