The Fed: What Does It Do?

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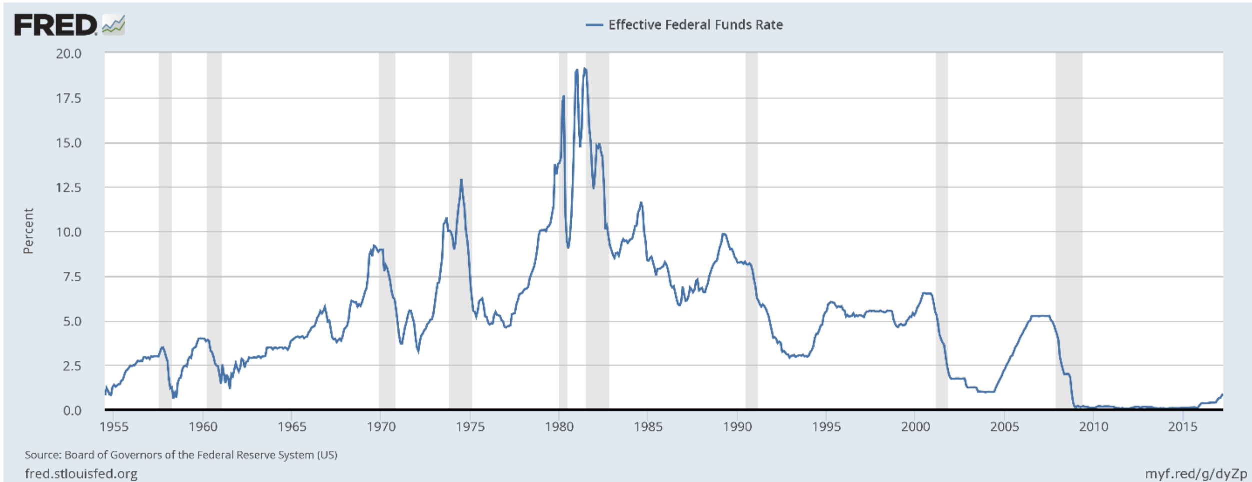
Since the financial crisis in 2008, the Fed has been front-and-center when people talk about the financial markets and the economy. The Fed has played a significant role following the last recession and made headlines with its zero-interest rate policy and expanding balance sheet. But what is the Fed and why is it important?

The Federal Reserve System, also known as the Federal Reserve or simply the Fed, was established as the central banking system of the United States in 1913. It was created in response to a number of panics to create confidence in the financial system, and its role expanded further following the Great Depression. The Fed has two primary mandates, price stability and full employment. Since the financial crisis, their duties have expanded to also include the supervision and regulation of banks.

The Board of Governors of the Federal Reserve System is the governing body and charged with overseeing the Federal Reserve Banks and helping implement monetary policy. The seven members are nominated by the President and confirmed by the Senate. While all members play an important role on the Board, the Chairman (or Chairwoman) is the member that sets the agenda and policy.

The Fed controls and implements the monetary policy of the United States primarily through open market operations that are overseen by the Federal Open Market Committee (FOMC). When you hear about the Fed raising rates, it's the FOMC that takes action to force rates higher.

How Does the Fed Raise or Lower Interest Rates?
You may think that the Fed simply publishes an interest rate and the market follows. Unfortunately, the process is more complicated than that. Depending on the economic conditions, the Fed can raise or lower interest rates known as the Fed Funds Rate. Over time, the Fed Funds Rate has ranged from as low as 0% to over 19% (see chart below).



When inflation is getting too high or the economy is running hot, the Fed's mandate of price stability would push them to raise interest rates in order to cool the economy and prevent hyperinflation. On the other hand, if we are in a recession and inflation is very low, the Fed will drop interest rates in order to stimulate economic growth.

The Fed has recently begun hiking interest rates, or tightening monetary policy. So what do they do to get interest rates moving higher? Generally speaking, it's a function of supply and demand. To get rates to move higher, they have to create enough supply by selling bonds into the market. As the supply increases, the price of bonds falls. Since bond prices are inversely related to yields, the yield will go up as prices go down. As the Fed is selling bonds into the market, money is being pulled out of the financial system. With fewer dollars in the system chasing goods and services, the inflationary pressures are reduced and economic activity starts to slow.

If the Fed wants to lower rates, or loosen monetary policy, they will go into the market and start buying bonds to reduce the supply. Bond prices will go up, and yields will come down. Since the Fed is buying bonds, they are putting money into the financial system. With more money chasing goods and services, inflationary pressures start to build and economic activity picks up.

The Fed's Balance Sheet

Up until the financial crisis in 2008, the Fed's balance sheet had about $800 million in assets. When the financial crisis hit, the FOMC got interest rates down to zero, but the Fed felt it wasn't enough to stimulate economic activity, so they started to expand their balance sheet significantly. In addition to their normal open market operations, they began buying everything they could including mortgage-backed securities and other financial assets. As the chart below shows, the Fed grew its balance sheet nearly 5 times to over $4.4 trillion as of May 17, 2017.

The expansion of the balance sheet has flooded the system with money. This money was expected to make its way through the economy and boost inflation as well as economic growth. While economic activity has been slow since the bond buying began, expectations are that economic activity will pick up. The challenge for the Fed is to manage the inflationary pressures to avoid runaway inflation. It's a delicate balancing act because if they raise rates too fast, they can cause the economy to slow too much and push us into another recession. On the other hand, if they wait too long, they run the risk of high inflation.

There are differing opinions among market participants on whether or not the Fed is helping or hurting the overall economy. Only time will tell, but if history is any indication, the Fed's track record has been less than impressive. The Fed did step in after our last crisis to provide liquidity and confidence. Their actions were necessary and helped stabilize the financial system. The question today is whether or not they stayed at the party too long.

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