Successes and Drawbacks of the Federal Reserve and the Impact on Financial Markets.

Muhammad Mustafa Rashid

University of Detroit Mercy, University of California Davis

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Authors Note

Muhammad Mustafa Rashid

University of Detroit Mercy

Email: admin@muhammadmustafarashid.com

Orcid ID: https://orcid.org/0000-0001-6651-9161

Abstract:

The purpose of this paper is to provide an outline of the success and draw backs of the Federal Reserve and the consequent impact on financial markets. A review of the relevant literature from Hubbard (2008) and Dowd & Hutchinson (2010) will provide insights into the success and failures of the Federal Reserve and the impact on financial markets. Further insights will be drawn from; Gorton & Metrick (2013) and their interpretation of the Federal Reserve's actions since its formation, Romer & Romer (2013) on the pessimism of monetary policy and Dyugen-Bump (et. al 2013) on their assessment of the effectiveness of emergency liquidity measures.

Keywords: Federal Reserve, Financial Markets, Financial Crises, Financial Regulations.

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Introduction.

Since the its inception in 1913 the Federal Reserve has been through quite a few turbulent times. Although when compared to other central banks that have been in place such as the central bank of England with a 300-year history, the Federal Reserve is young. Since its inception the Federal Reserve has been able to prevent many a crisis but at times it has also failed. This paper will examine the relevant literature to outline the success and drawbacks of the Federal Reserve and its impact on financial markets and will take the position that the Federal Reserve is and can be an integral part of the economy.

Literature Review.

The Formation of the Federal Reserve System.

In Hubbard's (2008) review of the banking industry it is stated that before the formation of the Federal Reserve the only regulation that existed was the National Banking Act (1863). Hence, banking runs and collapses were inevitable, and this had a devastating effect on the country's financial system. There were bouts of panics which led to recessions and private arrangement through the New York Clearing House financed by private bankers such as J.P. Morgan and George F. Baker were not sufficient to stem the tide. Hence, what was missing was a lender of the last resort, a banker's bank that would ensure prevention of general banking panics and thus the Federal Reserve System was created by the Congress and President Woodrow Wilson. (Hubbard, 2008, p.314-316).

Success of the Federal Reserve and the Impact on Financial Markets. According to Hubbard (2008) during the years of 1960-1987 the Fed a variety of crises. The crises include; The Penn Central Railroad Crises 1970, The Franklin National Bank Crises 1974, The Hunts

Brother's Silver Speculation Crises and The Stock Market Crash of 1987, Harlem's Freedom National Bank in 1990 and the 9/11 attacks. The Fed responded in kind through measures such as; increasing the availability of credit, loans, discount loans, acting as a lender of last resort, providing risk-sharing and liquidity services, and regulatory response. The back and forth over the years has led to the development and refining of both the regulatory and financial structure and innovations such as; NOW accounts, DIDMCA 1980, Garn-St.Germain Act of 1982, MMDA's, Brokered Deposits, FIRREA 1989, FDICIA 1991 and Basel I & II 1997. (Hubbard, 2008, p. 339-360).

Gorton and Metrick (2013) provide us with a similar time-line of the Federal Reserve and its role as a Lender of the Last Resort. The period from 1933-1978 is titled the "New Deal Legislation and the Quiet Period". During this time, financial legislation changed the regulatory system as well as the role of the Federal Reserve. The most important legislation that affected the Federal Reserve and the Financial Markets was the Bank Holding Company Act of 1956. According the act the Fed was given oversight responsibility oversight responsibility over holding companies and the largest of commercial banks. The period from 1979-2006 is titled "The Transformation of Banking". This is mostly because this period saw banking sector trying to work around the regulations that were imposed. It is during this time that the setting of capital standards was introduced. Since the banks had access to government safety nets such as deposit insurance and lender of last resort, there existed an incentive for the banks not to internalize the social cost of failure. Alas the setting of capital requirements was a slow-moving process and it did not provide any indication from any country of the oncoming crises. (Gorton and Metrick, p.45-64).

A study conducted by Bump (et.al 2010), examines the effectiveness of the Feds Emergency Liquidity Facilities, from the Evidence gathered from Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) during the financial crises of 2007-2008. Their finding indicate that the facility was effective as measured against its dual objectives: it helped stabilize asset outflows from money market mutual fund and it improved liquidity in the ABCP market. Even though the lending under AMLF reached $150 billion in the first 10 days, the Federal Reserve did not suffer any credit losses on its operation of the AMLF. (Duygan-Bump et.al, p.1-43). (Refer to Appendix I for a technical and insightful analysis of the exponential growth in government lending and the growth of the financial sector.)

Failures of the Federal Reserve and the Impact on Financial Markets. During the earlier years of the Federal Reserve of bank failure rate was effectively reduced. But the Fed has made many an error during its 100-year history. According to Romer and Romer (2013), “the most significant error in the history of the Federal Reserve surely occurred in 1929-1933, when the money stock fell 26 percent, the price level decline 25 percent and output decreased 27 percent”. Another major failure occurred in the 1960’s and 1970’s when inflation rose to 10 percent. In the years of 2007-2009 the unemployment level was consistently high. Most of these errors were in part due to the pessimistic view of monetary policy. (Romer and Romer, p.55-60).

In the Aug of 1971 it was announced that the US government would no longer peg its currency to Gold. According to Dowd and Hutchison (2010), “The results were entirely predictable. The growth rate of money supply accelerated, and inflation mounted”. (249). Trouble started brewing in the early 2000’s with the advent of the dot com bubble, the housing bubble, the growth of shadow banking, sub-prime mortgages and complex slow to form financial regulations. The Fed would see a major crisis in 2007-2008 soon after the retirement of Alan

Greenspan, with the failure of Lehman Brothers, Bear Stearns, Fannie Mae, Freddie Mac and AIG. (Dowd and Hutchison, p. 245-269).

The events of the 2007-2008 financial crises have led to further regulatory responses. Most importantly is the Dodd-Frank Act. According to Gorton and Metric (2013), the Act targeted several of the faults that existed in the regulatory system. The Dodd-Frank extended the role of the Fed as a supervisor and lender of last resort. The Financial Stability Oversight Council was created which made the Fed the regulator of all large financial institutions no matter what their main function, hence dealing with the shadow banking problem. One of the main concerns of the Dodd-Frank was to limit the bailouts of the largest firms. The focus was now more on pre-emptive measures rather than post crises measure. (Gorton and Metric, p. 45-64)

An interview conducted with Janet Yellen through UPenn provides additional insights to the financial crises of 2008 and the era that followed. According to Janet Yellen, the 2008 financial crises was due to lack of regulatory and supervisory controls over financial institutions and that too much faith was put into the financial firms to appropriately manage their risks. Furthermore, Ben Barnanke responded to the financial crises with innovations such as quantitative easing and reducing the federal funds rate. The era that ushered in Janet Yellen was follow by a period of 'normalization' with an increase in interest rates and renewed focus on financial regulation and stability. The current era of Jeromoe Powell is one with low unemployment and low inflation. (J.Siegel, UPenn, personal communication, Mar, 20, 2018).

Discussion

Romer and Romer (2013) state that it is too early reach a conclusion about recent monetary policy. This is mostly because the data and the thinking of the recent policymaker's is not yet accessible. Even more so going through the data presents a significant econometric challenge and not enough time has passed to effectively gauge the recent monetary policy decisions.

Limitations of these studies. Furthermore, as mentioned earlier the history of the Federal Reserve is quite young when compared to that of comparable institutions such as the Bank of England which has a history going back to the 16th century. Hence, when the System is studied the timeline starts from early 19th century. Although many significant events have taken place during this time such as; two World Wars, The Great Depression, exponential growth of the regulatory system and the financial markets, globalization and terrorist threats, the system has persevered. These events of the past 100 years are very significant with their effects to be felt for many a year. Hence, it is only with a due time and a sincere focus toward public interest will further studies of quality be produced.

Conclusion and Future Study

In light of recent circumstances, the current Federal Reserve is operating in favorable circumstances. The Federal Reserve is faced with an economic climate which has low inflation and low unemployment. Since the current Fed operates under a very politically charged environment, it has to make careful use of monetary policy in favor of public interest and avoid any principal agent problems. Furthermore, learning from past failures is an important exercise that the Fed must undertake. It should follow and address complex regulatory issues that exist and strengthen the financial system. The Federal Reserve now has further oversight capabilities focused on preemptive measure. The Federal Reserve System has been successful in the mitigating past crises and can continue to work in the favor of public interest and be an integral part of the economy.

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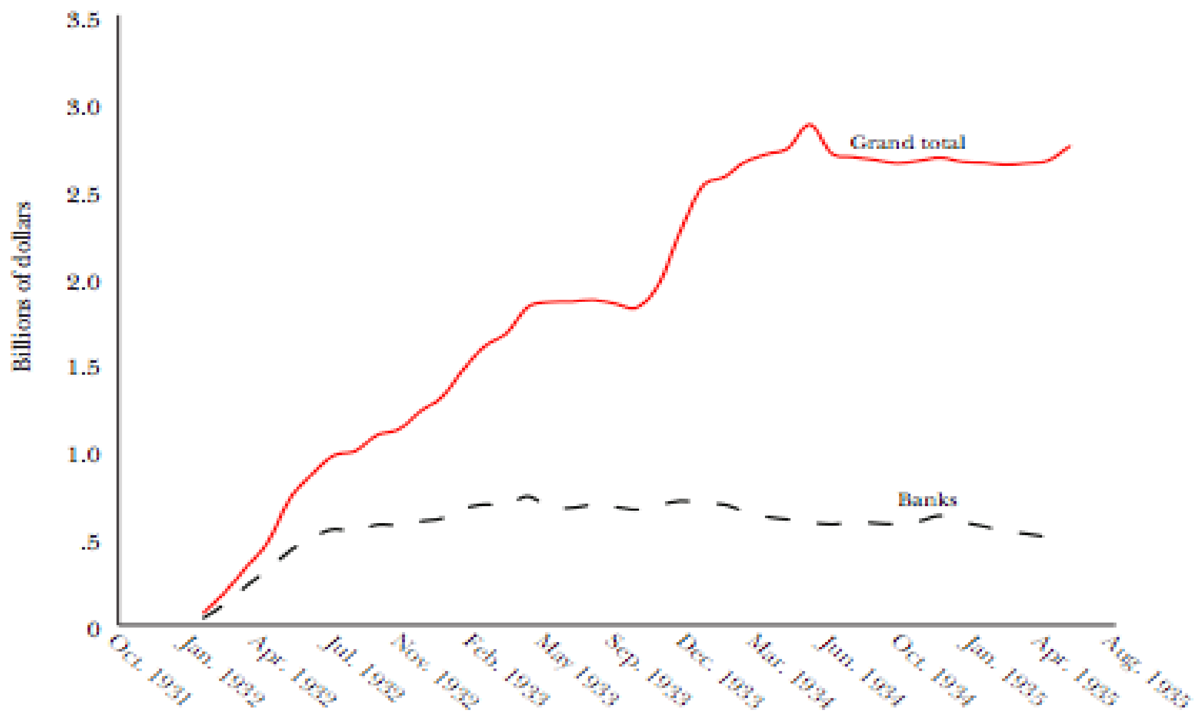
Appendix I

Gorton, G., & Metrick, A. (2013). The Federal Reserve and Panic Prevention: The Roles of Financial Regulation and Lender of Last Resort. *The Journal of Economic Perspectives*, *27*(4), 45-64

Duygan-Bump, Burcu, Parkinson, Patrick, Rosengren, Eric, Suarez, Gustavo A., & Willen, Paul. (2013). How Effective Were the Federal Reserve Emergency Liquidity Facilities? Evidence from the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility. (Report). *Journal of Finance*, *68*, 715.

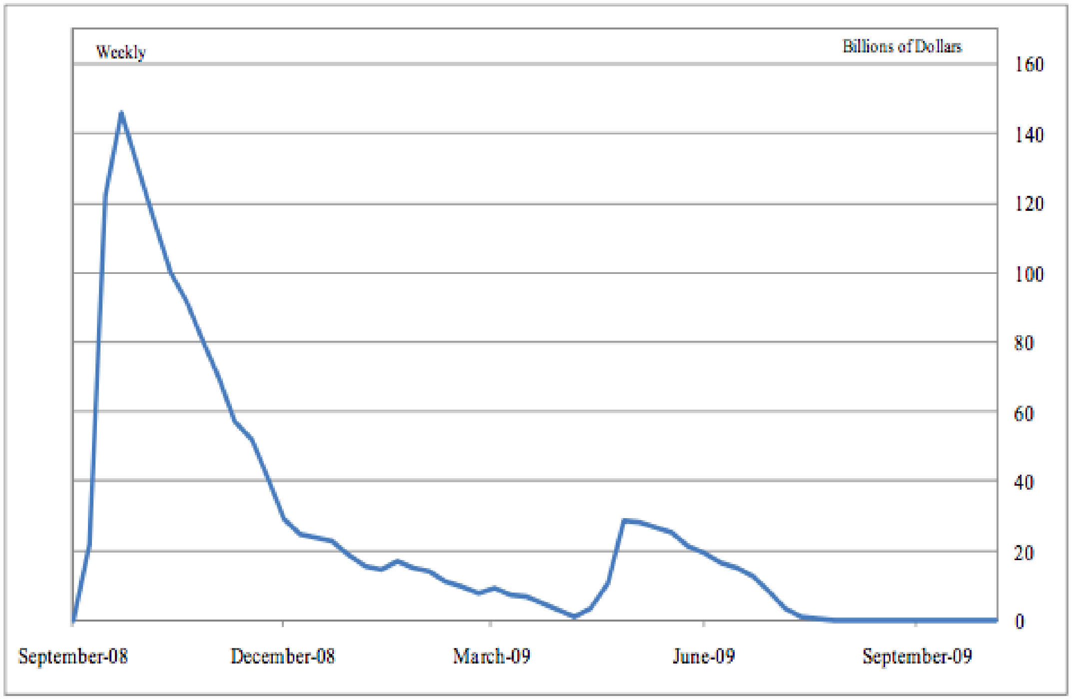
Figure 2
Reconstruction Finance Corporation Loans Outstanding



Source: Federal Reserve, Flow of Funds.
Note: Figure 2 illustrates the scale of loans from the Reconstruction Finance Corporation to banks as well as to other institutions like state and local governments, railroads, and mortgage institutions.

Figure 7: Loans extended through the Asset-Backed Commercial Paper Money Market Liquidity Facility (AMLF), September 2008 to September 2009

Loan balances (weekly average)



Notes: The figure plots the volume of loans outstanding at the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) in billions of dollars. Data are measured at a weekly from September 2008 to September 2009. Source: Factors Affecting Reserve Balances (H.4.1), Federal Reserve Board.

The comparison of these graphs provides detail regarding the exponential growth of the financial sector as well Reconstruction Finance Loans. In 1935 the Grand Total stood at $3 billion, while in September 2008 the first week saw lending of $150 billion during the first 10 days.