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LEO A. PITRE, MBA, CFP®, CEP® • WILLIAM S. BORDELON, JR.

Why is the Federal Reserve So Controversial?

The world's first central bank offered unprecedented convenience. It gave 17th century Swedes the option to pay with paper notes rather than 40-pound copper plates, which were the currency units of the Swedish empire at the time. Historically, it may have been one of the few actions taken by a central bank that has been relatively uncontroversial.[1]

It seems as though central banking in the United States always has been hotly debated. Early in our nation's history, there was tremendous disagreement about whether a central bank was necessary or even constitutional. In fact, disagreement on the subject led to political divisions with President George Washington's administration and the formation of the Federalist and the Democratic-Republican parties.[2]

Today, the debate has expanded. There are still some who argue the Fed should be abolished and others who say it is critical to our country's economic health. However, the extraordinary monetary policies adopted by the Fed in recent years have raised questions about its goals, governance, and accountability.[3]

The First Bank of the United States, and the Second

Alexander Hamilton, the first Treasury Secretary, believed the newly formed United States needed a central bank to help stabilize the country's currency and retire debt from the Revolutionary War. He envisioned the bank as "a profit-making institution, with private shareholders holding four-fifths of its stock and electing four-fifths of its directors."[2]

Despite its private ownership, the bank would be a repository for federal funds and act on behalf of the government in financial matters.[2] The idea provoked serious debate:[1]

> "What was it drove our forefathers to this country?" said James "Left Eye" Jackson, a fiery little congressman from Georgia. "Was it not the ecclesiastical corporations and perpetual monopolies of England and Scotland? Shall we suffer the same evils to exist in this country?...What is the general welfare? Is it the welfare of Philadelphia, New York, and Boston?"

In fact, Humanities Magazine reported banking, currency, and finance were topics that inspired violent political debate during the late 18th and early 19th century. Thomas Jefferson and James Madison were among those who opposed a central bank; however, in 1791, Congress granted the Bank of the United States a 20-year charter.[2]

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When the bank's charter came up for renewal in 1811, Madison was President and Congress decided not to extend it. Critics said the bank was too conservative, which was holding back economic growth. Also, there were concerns British interests held two-thirds of its stock.[4]

A close call with bankruptcy during the War of 1812, when there was no central bank to provide funding, led President Madison to change his mind about the value of a central bank. He endorsed the Second Bank of the United States, which was established in 1816. It was structured similarly to the first bank and served the same function until 1832 when President Andrew Jackson refused to extend its charter.[2]

The Federal Reserve System

The Federal Reserve System – a decentralized central bank – was signed in to law in 1913 and began operations in 1914. It was a response to decades of bank panics and failures.[5] Neil Irwin described it like this in his book, *The Alchemists: Three Central Bankers and a World on Fire*:[1]

> "Without a central, government-backed bank able to create money on demand, the American banking system wasn't able to provide it. The system wasn't elastic, meaning there was no way for its supply of money to adjust with demand. People would try to withdraw more money from one bank than it had available, the bank would fail, and then people from other banks would withdraw their funds, creating a vicious cycle that would lead to widespread bank failures and the contraction of lending across the economy. The result was economic depression. It happened every few years. One particularly severe panic in 1873 was so bad that until the 1930s, the 1870s was the decade known as the "Great Depression.""

Today, the Fed is deeply ingrained in the economic fabric of the United States. It is tasked with conducting the nation's monetary policy by influencing money and credit conditions in pursuit of full employment and stable prices, supervising and regulating banks, protecting the credit rights of consumers, maintaining the stability of the financial system, and providing certain financial services to the U.S. government.[6]

The Fed and its leaders are often a source of controversy. While the vast majority of Fed Chairmen and Chairwomen have been experts in the fields of public policy, finance, and economics, many have made controversial decisions about how to influence the U.S. economy. While many of the Fed's decisions have proved effective, not all have proved sound.[7] The most

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notable Fed failure was the Great Depression (1930s) when the Fed's monetary policies – pushing rates higher and making less cash available – caused a downturn to become a depression.[8]

Fortunately, economists have learned a fair amount since then. In modern times, Fed leaders have established a more successful, but no less controversial, record. For example:

Paul Volcker (1979-1987) took over during the early 1980s, when U.S. inflation was 14 percent and unemployment reached 9.7 percent. Volcker unexpectedly raised the Fed funds rate by 4 percent in a single month, following a secret and unscheduled Federal Open Market Committee meeting. His policies initially sent the country into recession. The St. Louis Fed reported "Wanted" posters targeted Volcker for "killing" so many small businesses. By the mid-1980s, employment and inflation reached targeted levels.[9, 10]

Alan Greenspan (1987-2006) was in charge through two U.S. recessions, the Asian financial crisis, and the September 11 terrorist attacks.[11] Regardless, he oversaw the country's longest peacetime expansion. In the late 1990s, when financial markets were bubbly, critics suggested, "...Mr. Greenspan's monetary policies spawned an era of booms and busts, culminating in the 2008 financial crisis."[10]

Ben Bernanke (2006-2014) took the helm of the Fed just before the financial crisis and Great Recession. When economic growth collapsed in 2007, the Fed lowered rates and adopted unconventional monetary policy (quantitative easing) in an effort to stimulate economic growth.[10] In 2012, economist Paul Krugman called Bernanke out in *The New York Times*, "...The fact is that the Fed isn't doing the job many economists expected it to do, and a result is mass suffering for American workers."[12]

Janet Yellen (2014-Present) is the current Chairwoman of the Fed. Under Yellen's leadership, after providing abundant guidance, the Fed raised rates for the first time in seven years. The International Business Times reported several prominent economists think the increase was premature, in part, because there are few signs of inflation in the U.S. economy.[13]

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We won't know whether Bernanke and Yellen have made the right choices for many years, possibly even decades. In the meantime, it seems quite likely the Fed will remain a controversial institution.

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