By Prabhu Palani (Chief Investment Officer)

Owing to the generosity of friends I spent a few gorgeous days off the Georgia coast last Fall, in remote Jekyll Island. I won't blame you if you've not heard of this wonderful gem, home to warm waters of the Atlantic, gorgeous beaches, and a population of only 866. The only viable dinner option is Tortuga Jack's, which perpetually overflows with the island's residents and its lucky tourists. But Jekyll hides a great secret, one that has earned it a place on the Starbucks "Been Here" coffee mug of Georgia and has had profound consequences for the global economy.

At the beginning of the last century, the island was home to the Jekyll Island Club, rumored to account for a sixth of the world's wealth among its exclusive membership. JP Morgan, Nelson Rockefeller, and Joseph Pulitzer were members as were the Goulds, Goodyears, and Vanderbilts. Munsey's Magazine called it, "the richest, the most exclusive, the most inaccessible club in the world." It was at this Club that one of the most consequential meetings for US monetary policy ever took place. In 1910, Nelson Aldrich, Senator from Rhode Island and a member of the Club, hosted a weeklong meeting of six people to hatch a plan to form a central bank for the rapidly growing United States. The meeting was so secretive that the six gentlemen only used their first names during the train journey from Philadelphia to Jekyll under the guise of a duck hunting trip.

The battle over federalism is as old as the United States. The origin of the US Federal Reserve was no different. Paul Warburg, a German immigrant and banker, and one of the six who attended that meeting was an early proponent of a European-style central bank that would grease the wheels of the US economy . Equally potent forces existed on the other side of the ledger. In fact, the Federal Reserve was preceded by two experiments in central banking more than a century earlier. In 1791, the Bank of the United States opened for business in Philadelphia. Proposed by Alexander Hamilton, this was the New World's equivalent of the Bank of England. Thomas Jefferson opposed the creation of the bank fearing the concentration of financial power in the hands of a few wealthy elites, and the subsequent growth of such sentiment ensured that it was doomed. In 1816 a Second Bank of the United States was formed, but this too was killed for the same reason.

In his veto message of 1832 declining the extension of the charter of the Second Bank to Congress, then-President Andrew Jackson, of a Jeffersonian mold, and a vigorous opponent of the Central Bank, had this to say: "It is to be regretted that the rich and powerful too often bend the acts of government to their selfish purposes. …when the laws … grant titles, gratuities, and exclusive privileges, to make the rich richer and the potent more powerful, the humble members of society…have a right to complain of the injustice of their Government. There are no necessary evils in government. Its evils exist only in its abuses."

From the meeting of 1910 in Jekyll, Aldrich and his five co-conspirators set in motion a series of events that culminated in Woodrow Wilson signing the Federal Reserve Act of 1913, thus creating the modern Federal Reserve Bank. [1]

Fast forward to the 21st century and you have an all-powerful Federal Reserve Bank that heralded an era of unprecedented free money and near zero interest rates for so long, that the idea of earning any interest on a staid old bank savings account almost sounded quaint. Granted, the Fed in using these monetary tools had to twice save a dying economy, first during the Great Financial Crisis of 2008-09 and secondly at the onset of a deadly pandemic in 2020, a crisis that brought the global economy to an abrupt halt almost overnight. And yet, in the intervening years during these crises and even after the economy roared back to life in 2021, the Fed persisted with its easy money policy, convinced that its new-found tool of quantitative easing would create prosperity without the accompanying evil of inflation. Both real and paper wealth ensued, though at the cost of the more "humble members of society" who had very little exposure to risk assets.

The US Federal Reserve has a dual mandate – maximum employment and price stability. Of these it takes the former less seriously. After all, isn't there an executive branch to blame for unemployment? On the other hand, the Fed has very real and crippling tools to tackle high inflation. If there was one lesson that Central Bankers learnt after the Volcker era, it was to ensure that they can never be blamed for high prices. If you fail on both your mandates, you may as well dismantle the institution.

It should be no surprise that inflation would rear its ugly head when least expected. The extraordinary era of easy money coupled with the supply side shortages of the pandemic was a double whammy that started showing up in numbers in 2021. With inflation finally making an appearance in the data, the Powell Fed began a crusade to crush an old enemy with a vigor and speed that would've made Mr. Volcker blush. As Jackson feared in rejecting the Second Bank, "it is easy to conceive that great evils to our country and its institutions might flow from such a concentration of power in the hands of a few men irresponsible to the people."

A consequence of such power is reflected in the underlying chart:

US Treasury Yield Curve (1/1/22 yellow line vs 3/15/23 - green line):

Source: Bloomberg

In the short span of fifteen months, not only has the short end of the curve steepened dramatically, the yield curve has also inverted, and there has been no shortage of Fed rhetoric on the need for continued increases in short-term rates. Even if one were to assume that inflation readings as reported by the government are accurate as well as forward looking (both of which are suspect), the trajectory of such numbers certainly suggests a cooling down of prices.

A dramatic rise in short-term interest rates and a steeply inverted yield curve have had unintended consequences. The demise of Silicon Valley Bank is one of them. It is not fair to blame the bank's failure entirely on the Federal Reserve—the bank's own risk management practices, a lack of proper bank oversight, and a panicky public all share some responsibility for what happened last week. However, the Fed's own lack of accountability for inducing booms and busts is at least partly to blame (while they try to 'engineer' soft landings). A spreading banking crisis also puts into question both the credibility of the Fed as well as the efficacy of its tools.

An independent central bank is important for the smooth functioning of an economy, especially one as large and complex as the United States. The need for such a central bank is no longer in question. However, the fear that Jefferson and Jackson had, of large, unchecked institutions, is as relevant today as it was in their times. In the graveyard of the deceased financial institutions of the recent past, the ghost of Andrew Jackson lives on. It may be time to clarify the Fed's dual mandate.

[1]Aldrich would blame the critics of the idea of a Central Bank for conjuring the ghost of Andrew Jackson.