Audit the Federal Reserve?

Barnett, William A.

University of Kansas

26 February 2010

Audit the Federal Reserve?
by William A. Barnett

Abstract: *An independent institute for monetary statistics is needed in the United States, says William Barnett. Expanded Congressional audit would be a second best alternative, but would not fully address the needs and would carry risks.*

Federal Reserve Chairman Ben Bernanke has spoken out against Congressional bills to audit the Federal Reserve. Why? Proponents argue that the purpose of the audits is to increase the transparency of Federal Reserve policy and improve the quality of data from the Federal Reserve. Aren't these both in the public interest? There is growing evidence that defective Federal Reserve data played a role in producing the misperceptions of systemic risk that led up to the current recession. In the popular media, it has become fashionable to blame banks and Wall Street for having irrationally taken excessive risk out of "greed." But banks and Wall Street firms believed that increased investment risk was prudent, as a result of the widely held view that systemic risk had decreased permanently. Even Nobel Laureate Robert Lucas had written in his Presidential Address to the American Economic Association that the Federal Reserve had gotten so good at its job that macroeconomists should cease research on countercyclical policy and re-focus their research solely on long term economic growth.[1] But as I have shown in my research, better Federal Reserve data would have revealed that Federal Reserve policy had not greatly improved, and hence the widespread confidence in the "Greenspan Put" and the permanent end of the business cycle was misguided.[2]

A recent Rasmussen-reports survey found that 75% of Americans favor auditing the Federal Reserve and making the results available to the public, while only 9% oppose it, with 15% being unsure. After all, as a previous New York Federal Reserve Bank President remarked, the Fed is independent *within* the federal government, not *of* the federal government.[3] Since the Federal Reserve was created

[1] Robert Lucas (2003), "Macroeconomic Priorities," *American Economic Review*, vol. 93, no. 1, pp. 1-14.
[2] See William A. Barnett and Marcelle Chauvet, "How Better Monetary Statistics Could Have Signaled the Financial Crisis," *Journal of Econometrics*, forthcoming; and William A. Barnett, *Getting It Wrong: How Faulty Monetary Statistics Undermine the Fed*, MIT Press, forthcoming.
[3] The statement was by Federal Reserve Bank President Allan Sproul in an April 1952 hearing before the Joint Economic Committee of Congress.

by Congress, the Fed is inherently accountable to Congress. Isn't, therefore, an audit in the interests of good government?

The current debate needs to be set against the background of long-running tensions between the central bank, legislative and executive branches of government. When, in 1978, Congress passed a bill mandating audits by the Government Accountability Office (GAO) (then, the General Accounting Office) for most government agencies, the bill excluded from audit a vast sweep of the Federal Reserve System's activities. However, operations of some Federal Reserve activities, including monetary policy, were addressed in the same year in the Humphrey-Hawkins Act. The following year, Chairman Paul Volcker made major policy changes to lower the inflation rate. Bernanke has stated that the 1978 audit exclusions were necessary to allow Chairman Volcker's ability to act decisively. Personally, I doubt this. I was on the staff of the Federal Reserve Board in Washington, DC at that time. Paul Volcker was a determined chairman, whose actions were based upon his own strong convictions. Since the GAO has no policy-making authority, the GAO could not have prevented him from implementing his chosen policy.

Certainly, the Federal Reserve has some strong arguments. The biggest danger, of course, is that the granting of increased audit authority to Congress would allow politicians to second-guess unpopular policy actions. However, audit authority is hardly necessary for them to poke their noses into the Fed's business, as has been demonstrated time and again by the actions of past Congressmen, Senators, and Presidents. In fact, from its point of view, Congress created the Federal Reserve and thereby has the responsibility for oversight of what it created.

There are well-known examples of such pressures. When I had lunch with Arthur Burns, following his term as Federal Reserve Chairman (1970-78), I asked him whether any of his decisions had ever been influenced by Congressional pressure. He emphatically said no --- not ever. On the other hand, Milton Friedman, reported that Nixon himself believed he had influenced Burns.[4] Similarly, Fed Chairman William M. Martin (1951-70) discussed pressures from President

[4] William A. Barnett and Paul Samuelson (2007), *Inside the Economist's Mind,* Wiley/Blackwell, Malden, MA, p. 116. Also see Burton A. Abrams (2006), "How Richard Nixon Pressured Arthur Burns: Evidence from the Nixon Tapes," *Journal of Econ Perspectives*, Fall 2006, pp. 177-188.

Lyndon Johnson.[5] Chairman Martin emphasized that, in his views, the Congress and the President set the nation's economic priorities, including spending, taxes, and borrowing. The role of the Federal Reserve, in Martin's view, was to assist in fulfilling those policies, including facilitating Treasury borrowing at reasonable interest rates. In 1966, when he led a sharp contraction of monetary policy to offset aggregate demand pressures from President Johnson's policies, Martin was sharply reprimanded by President Johnson. In 1969 the FOMC did respond unwisely to administration pressures to ease policy (Meltzer, forthcoming). Occasionally, presidents have been supportive. President Reagan's support was important to the success of Chairman Volcker's anti-inflation policy. None of the above dramatic moves had anything to do with Federal Reserve accountability to Congress.

Perhaps the closest antecedent to current Congressional audit proposals was the upswell of monetarist sentiment in the Congress in 1975-8 following puzzling phenomena in money markets in 1974. Later analysis revealed flaws in the published monetary aggregates data during that period. Those flaws contaminated economic research for years afterwards and remain a source of misunderstanding to the present day.[6] Two Congressional measures—House Concurrent Resolution 133 in 1975 and the Humphrey-Hawkins Act of 1978—subsequently required that the Fed chairman appear twice each year before Congress to report the FOMC's target ranges for money growth (if any had been set).[7] The Federal Reserve bristled under such supervision. Never before in the Fed's history had the Congress imposed a reporting requirement on Fed policymakers—and a

---

[5] See, e.g., Robert P. Bremmer (2004), *Chairman of the Fed: William McChesney Martin and the Creation of the Modern American Financial System*, Yale Univ Press.

[6] The bad data produced extensive confusion in academic research and led to the erroneous belief that the demand for and supply of money had, without reason, mysteriously shifted in 1974 and were unstable. But the seemingly unexplainable economic structural shifts were shown to disappear, when the data flaws were corrected. See William A. Barnett, Edward K. Offenbacher, and Paul A. Spindt (1984), "The New Divisia Monetary Aggregates," *Journal of Political Economy*, vol 92, pp. 1049-1085. Reprinted in William A. Barnett and Apostolos Serletis (2000), *The Theory of Monetary Aggregation*, Elsevier, Amsterdam, ch. 17.

[7] One widely held theory is that the Congressional actions were precipitated by overtightening by the Fed in 1974 in response to faulty monetary data. There is controversy about precisely what precipitated these Congressional actions. See, e.g., William Poole, "Monetary Policy: Eight Years of Progress?" *Journal of Finance*, vol 34, no 2, May 1979, pp. 473-484. But what is well established is that the structural shifts that the Fed and the profession believed occurred in 1974 did not occur and were inferred from defective data, as shown by Barnett, Offenbacher, and Spindt (1984).

requirement far less invasive than a GAO audit. The Humphrey-Hawkins Act reporting requirement came up for renewal in 2003, but quietly was allowed to expire. Semi-annual reports to the Congress continue, but without the force of law.

There are several instances when faulty monetary data led policy makers astray. My research suggests that Volcker's disinflationary policy (similar to 1974-5) was overdone and produced an unnecessarily severe recession. Poor data on the monetary aggregates, having improperly weighted components, led Volcker inadvertently to decrease monetary growth to a rate that, appropriately measured, was ***half*** what he thought it was.[8] Volcker wrote to me years later that he "still is suffering from an allergic reaction" to my findings about the actual monetary growth rate during that period. Suppose a GAO audit had investigated whether the data being published were best-practice among monetary economists concerned with measuring monetary aggregates, and concluded that it was not. Would Volcker have selected a more gradual disinflationary policy? Perhaps. Without unbiased external reviews of Federal Reserve measurement practices, we can never know—nor can we avoid the possibility of future mistakes.

Focus, for a moment, on the Federal Reserve's monetary published data. Is its quality the best possible? Are the items reported constructed appropriately to the task of operating and understanding the path of monetary policy? Unfortunately, no. Consider, for example, the important and widely monitored data on banks' "nonborrowed reserves." Every analyst understands that banks hold reserves at the Federal Reserve to satisfy legal requirements and to settle interbank payments, such as wire transfers and check clearing. The total of such reserves may be partitioned into two parts: the portion borrowed from the Federal Reserve and the portion that is not (non-borrowed). Clearly (or so it would seem to most persons) the borrowed portion of reserves cannot exceed total reserves, so non-borrowed reserves cannot be negative. Yet recent Federal-Reserve-reported values of non-borrowed reserves were minus 50 billion dollars! How can this happen? In its definitions, the Federal Reserve chose to omit from "total reserves" large amounts of funds borrowed from the Fed and included in published figures for borrowed

[8] William A. Barnett (1984), "Recent Monetary Policy and the Divisia Monetary Aggregates," *American Statistician*, American Statistical Association, vol. 38, pp. 165-172. Reprinted in William A. Barnett and Apostolos Serletis (2000), *The Theory of Monetary Aggregation*, Elsevier, Amsterdam, ch. 23.

reserves. Those term auction borrowings should be included in both borrowed and total reserves or in neither, depending upon whether they are or are not held as reserves. It is unlikely that such confusing accounting practices would survive scrutiny by an outside audit, assuming it were competently performed.

There are other serious defects in the data currently published. According to Section 2a of the Federal Reserve Act, the Federal Reserve is mandated to "maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential…." Neglecting these instructions, Federal Reserve policymakers have stated that monetary aggregates currently are unimportant to their decisions. Whatever the merits or otherwise of this attitude, external analysts and researchers continue to depend on monetary aggregate data to obtain an accurate picture of the stance of policy, and many other central banks throughout the world continue to report data on multiple monetary aggregates.[9] During the 30 years since the Congress excluded monetary policy from GAO audits and mandated reporting of money growth in the Humphrey-Hawkins Act, two of the then four published monetary aggregates have been discontinued: M1 and M2 remain, but M3 and L do not. In quiet times, perhaps this is of little importance, but these broad monetary aggregates and the underlying data detail have been greatly missed during the financial crisis.

Further, the M1 aggregate is severely biased downwards. Since 1994, banks have been permitted by the Federal Reserve to reclassify, for purposes of calculating legal reserve requirements, certain checking account balances as if they were MMDA saving deposits; banks supply to the Federal Reserve only the post-sweeps checking account (demand deposit) data. The resulting published data on checking deposits understates, ***by approximately half***, the amount of such deposits held by the public at banks. Why doesn't the Federal Reserve require banks to report the complete data? Does such published monetary data satisfy the requirement of the Federal Reserve Act? Again, it seems unlikely that such an omission would survive an unconstrained audit by persons qualified in economic index number theory.

[9] A particularly admirable example is the Bank of England, which includes among its officially published monetary aggregates a properly weighted broad M4 "Divisia" monetary aggregate, based on my research.

Now we come to the bills currently under debate in the Senate and the House to expand upon GAO audit authority. The House bill was introduced by Texas Republican Congressman Ron Paul and has 317 cosponsors, including over 100 Democrats. The Senate bill was introduced by Vermont Independent Senator Bernie Sanders; bipartisan co-sponsors include Kansas Republican Senator Brownback and Wisconsin Democratic Senator Russell Feingold. In Washington, DC, I recently met with a Senator and his staff who support the Senate bill, and with a Federal Reserve Board Division Director, who opposes part of it. Since my conversations in Washington were about the Senate bill, I shall comment on only that bill.

Current law contains four audit exclusions for the Federal Reserve. That Senate bill would remove all four of the current audit exclusions. The four exclusions are:

> "(1) transactions for or with a foreign central bank, government of a foreign country, or nonprivate international financing organization;
>
> (2) deliberations, decisions, or actions on monetary policy matters, including discount window operations, reserves of member banks, securities credit, interest on deposits, and open market operations;
>
> (3) transactions made under the direction of the Federal Open Market Committee; or
>
> (4) a part of a discussion or communication among or between members of the Board of Governors and officers and employees of the Federal Reserve System related to clauses (1)–(3) of this subsection."

Exclusions 1 and 3 are arguably not in the public interest and could be removed. I do not support unconditional removal of the other two exclusions, because they appear to overlap roles that could be interpreted to be outside the GAO's primary areas of expertise. If those exclusions, 2 and 4, are nevertheless removed, I would favor their subsequent reintroduction in an amended form, focused more explicitly on aspects of the exclusions subject to relevant concern.

Many economists have signed a "Petition for Fed Independence," which is often interpreted as opposing audit of the Federal Reserve. However, the petition makes no mention of auditing the Federal Reserve. The petition opposes possible infringements on Federal Reserve policy independence, and I support that view. Audits ask whether a firm or organization is following best-practice and existing regulations in its business dealings; they do not tell management how they should run a business or conduct policy.

With respect to the collection and publication of accurate data, creation of an independent data institute for monetary and financial data would be preferable to expanded audit, since such institutes possess specialized expertise in economic measurement, including the latest advances in index number and aggregation theory. There is an obvious potential for a conflict of interest in having data reported by the same agency that influences that data through its own policy actions. Perhaps there is an economy of scale in such collection, but the risks outweigh any benefits.

Expanded audit authority is only a reasonable "second best" alternative to an independent federal data institute. Such separation is clear elsewhere in the government, with the Bureau of the Census, Bureau of Economic Analysis, and Bureau of Labor Statistics collecting data that later are used for policy purposes by the administration and the Congress. An "independent" federal data institute need not be outside the Federal Reserve System. Varying degrees of independence exist within the admirably decentralized Federal Reserve System, with, for example, regional bank presidents free to vote against the Federal Reserve Board's positions at Federal Open Market Committee meetings in New York. The deeply respected Bureau of Labor Statistics is within the Department of Labor, but has sole responsibility for production of Department of Labor data and employs a staff of formidable experts in economic aggregation and index number theory. Expertise in those areas within the Federal Reserve System is minimal and is not centralized into any single group anywhere within the system.

Regarding Federal Reserve independence, commentators' concern should be focused on the recently renewed "coordination" of Federal Reserve monetary policy with the Treasury's fiscal policy, which is in conflict with the 1951 Treasury-Fed Accord that established independence of the Federal Reserve from the Treasury. Unwise Federal Reserve actions in support of Treasury bond prices during periods of heavy Treasury borrowing have ignited inflation twice before: once following World War II (a trend that ended with the 1951 Accord) and once following Chairman Martin's capitulation to President Johnson's Great Society pressures, as already mentioned.

To conclude, Federal Reserve spokesmen are right to warn of the risks and dangers that expanded audit would entail. The best solution would be to set up an independent institute for monetary and financial data. The Federal Reserve could create such an institute on its own within the Federal Reserve System, without the need for Congressional intervention. Failing that, however, the potential risks entailed by an expanded audit role for Congress are outweighed by its potential benefits, since good reason exists to question the quality and quantity of economic data available from the Federal Reserve. The cause of these inadequacies is the failure of the original design of the system to recognize the conflict of interests inherent in having a system with policy authority report the data that it itself influences. However, it should be observed that expanded audit would be a much inferior solution to the creation of an independent data institute. While the GAO has expertise in accounting, the GAO is not known for its expertise in economic aggregation and index number theory. Those are the forms of expertise of greatest importance to any federal economic data institute, such as the excellent Bureau of Labor Statistics.

Finally, and paradoxically, Senate audit bill critics frequently are advocates of Congressional imposition of an interest-rate (e.g., Taylor) or inflation-targeting policy-rule on the Federal Reserve, with heavy penalties for missing the target. Such a rule would constrain the Federal Reserve's discretionary policy authority far more than any audit.

William A. Barnett is Oswald Distinguished Professor of Macroeconomics at the University of Kansas; Editor, Cambridge University Press journal, Macroeconomic Dynamics; Editor, Emerald Press monograph series, International Symposia in Economic Theory and Econometrics; Co-author with Paul Samuelson of the book, Inside the Economist's Mind