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The Case for Auditing the Fed Is Obvious

by Arnold Kling

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Executive Summary

Recently, the Federal Reserve has significantly altered the procedures and goals that it had followed for decades. It has more than doubled its balance sheet, paid interest to banks on reserves held as deposits with the Fed, made decisions about which institutions to prop up and which should be allowed to fail, invested in assets that expose taxpayers to large losses, and raised questions about how it will avoid inflation despite an unprecedented increase in the monetary base.

We should document why the Fed took each step, what the expected results were, and whether those results were achieved. What is surprising is not that many congressional colleagues support Rep. Ron Paul's (R-TX) bill calling for an audit of the Fed. Remarkably, there is significant opposition to such oversight, and the political prospects for undertaking such an audit are relatively bleak.

This paper has three main sections. The first section looks at opposition to the audit. Although audit opponents express concern over keeping the monetary authority insulated from political pressure to inflate, one could argue that the larger threat to Fed independence comes from its departure from standard operating procedures. The second section looks at the *processes* on which an audit should focus. How did Fed officials undertake to determine whether this was primarily a liquidity crisis or primarily a solvency crisis? The third section looks at the *outcomes* on which an audit should focus. The profit or loss of the Fed's investments would provide a very helpful indicator of whether the Fed's actions served the economy as a whole or merely transferred wealth from ordinary taxpayers to bank shareholders.

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Why Oppose an Audit?

In congressional testimony on July 21, 2009, Federal Reserve Board Chairman Ben Bernanke said:

> The Congress has recently discussed proposals to expand the audit authority of the Government Accountability Office (GAO) over the Federal Reserve. As you know, the Federal Reserve is already subject to frequent reviews by the GAO. The GAO has broad authority to audit our operations and functions. The Congress recently granted the GAO new authority to conduct audits of the credit facilities extended by the Federal Reserve to "single and specific" companies under the authority provided by section 13(3) of the Federal Reserve Act, including the loan facilities provided to, or created for, American International Group and Bear Stearns. The GAO and the Special Inspector General have the right to audit our TALF program, which uses funds from the Troubled Assets Relief Program.
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> The Congress, however, purposefully—and for good reason—excluded from the scope of potential GAO reviews some highly sensitive areas, notably monetary policy deliberations and operations, including open market and discount window operations. In doing so, the Congress carefully balanced the need for public accountability with the strong public policy benefits that flow from maintaining an appropriate degree of independence for the central bank in the making and execution of monetary policy. Financial markets, in particular, likely would see a grant of review authority in these areas to the GAO as a serious weakening of monetary policy independence.[1]

Similarly, a petition signed by a broad spectrum of prestigious economists emphasizes the importance of maintaining both the appearance and the reality of independence of monetary policy decisions from political pressure. The petition states:

> Amidst the debate over systemic regulation, the independence of U.S. monetary policy is at risk. We urge Congress and the Executive Branch to reaffirm their support for and defend the independence of the Federal Reserve System as a foundation of U.S. economic stability. There are three specific risks that must be contained.
>
> First, central bank independence has been shown to be essential for controlling inflation. Sooner or later, the Fed will have to scale back its current unprecedented monetary accommodation. When the Federal Reserve judges it time to begin tightening monetary conditions, it must be allowed to do so without interference. Second, lender of last resort decisions should not be politicized.
>
> Finally, calls to alter the structure or personnel selection of the Federal Reserve System easily could backfire by raising inflation expectations and borrowing costs and dimming prospects for recovery. The democratic legitimacy of the Federal Reserve System is well established by its legal mandate and by the existing appointments process. Frequent communication with the public and testimony before Congress ensure Fed accountability.[2]

I find it difficult to connect the threat of political pressures for inflation with the actual content of H.R. 1207, the proposed Federal Reserve Transparency Act of 2009. The bill states, in part:

> The audit of the Board of Governors of the Federal Reserve System and the Federal reserve banks under subsection (b) shall be completed before the end of 2010.[3]

From my perspective, this language seems to call for a specific audit by a specific date, not for an increase in congressional power over monetary policy. The deadline for the audit is well before the date when most economists think that the economy is likely to have emerged from a recession and inflationary pressures will again be paramount.

It is difficult to see how an audit would make it more likely that Congress would put pressure on the Fed to undertake inflationary monetary policy. If the members of Congress want to see more inflation, they have many opportunities to apply pressure on the Fed, including during hearings where the Fed makes regular reports to Congress (Chairman Bernanke's testimony was at just such a hearing). The main reason that Congress does not demand faster money growth is that the American public has shown, particularly in the late 1970s, a strong aversion to inflation. President Carter was thrown out of office and President Reagan was reelected in part because the former's first term coincided with rising inflation and the latter's first term coincided with falling inflation. One could argue that we have had low inflation in this country for the past 25 years because of, not despite, the political pressures on the Fed.

Meanwhile, Chairman Bernanke is showing little concern with the threat to Fed independence that is posed by changes that his Fed has initiated to its place in our society. The Fed itself created a new political-financial reality as it played a direct role in the fate of Bear Stearns, Lehman Brothers, AIG, Merrill Lynch, Citigroup, and other major financial institutions. The Fed has taken on unprecedented responsibilities for capital allocation with its new facilities to purchase long-term Treasuries, GSE securities, and illiquid assets from troubled institutions. The Fed chairman has appeared on popular television programs, such as *60 Minutes*. Was concern over Fed independence factored in when making any of these decisions?

In characterizing the audit as a threat to monetary stability, Chairman Bernanke and others are ascribing unseen motives to the supporters of the audit. To my knowledge, none of the supporters of the bill has even hinted at wanting to see faster monetary growth.

At the same time, I believe I can detect some unseen motives on the part of the opponents of the audit. I think that what is presented as a concern about threats to the political independence of the Fed is in fact a concern about a threat to the myth of the Fed's technocratic competence. The opponents' goal is that no one should be seen as having the knowledge to raise doubts about Fed policy. It is one thing to play the game of guessing whether the Federal Funds rate should be inched up or down by a quarter of a percent or so. It is quite another to pose fundamental concerns about whether the broad public interest is being served by the conduct of the Fed.

However, the recent financial crisis has raised serious questions about the closeness of the relationship among large financial firms, banking agencies, and politicians.[4] It is legitimate to examine the Federal Reserve's actions during the financial crisis in light of these questions.

Creation of the Federal Reserve System, established by law in December of 1913, was a landmark of the Progressive Era. It is characteristic of progressives to see the flaws of individuals and markets as requiring intervention by elite technocrats. To the extent that progressives pay lip service to democratic processes, it is because they have faith that "the people" truly want technocratic protection from predatory corporations, market failures, and their own individual weaknesses.

Contemporary progressives have proposed an independent agency to oversee Medicare reimbursement policy.[5] Former Sen. Tom Daschle (D-SD), who was nominated by President Obama to become secretary of health and human services (Daschle subsequently withdrew from consideration), described a similar proposal by saying that "the Federal Health Board would resemble our current Federal Reserve Board for the banking industry."[6]

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Conservatives and libertarians do not share this faith in independent technocrats. Conservatives doubt that even a wise technocrat knows enough to overturn the wisdom embedded in existing norms and institutions. Libertarians doubt that even a wise technocrat can substitute for the information processing and evolutionary pressure embedded in the market.

The debate over the bill to audit the Fed is colored by these ideological biases. The idea that the Fed is seriously fallible represents a significant threat to the progressive outlook. However, resisting an audit seems to amount to asking people to accept on faith that Fed officials have superior wisdom and judgment of what constitutes the public interest. An audit might help to confirm this very hypothesis. At the same time, if an audit were to uncover serious flaws in decisions made by the Fed, it is difficult to see why we are better off remaining ignorant of such flaws.

Certainly, there may be individual communications and records that ought not to be widely disseminated to the public. However, reasonable requirements for confidentiality can be maintained while conducting a thorough audit. Not every document used in the audit needs to be placed into the public domain.

Overall, it should be feasible to conduct a complete audit without threatening either monetary stability or the needs of policymakers and staff for confidentiality. What an audit might threaten is the myth of technocratic expertise. That myth may serve an important ideological function for progressives, but it should not preclude undertaking an audit.

Auditing the Fed's Processes

The main concern of those of us who are skeptical of Federal Reserve conduct during the crisis is that the Fed saw the crisis from the perspective of large financial institutions, to the detriment of the general public interest. As a result, we suspect that management and shareholders of banks and other financial institutions fared better than they would have without the extraordinary actions by the Fed, while the economy as a whole fared no better, and ordinary taxpayers fared worse.

The first step in determining whether the Federal Reserve approached the crisis correctly is to audit the *process* by which decisions were made. The purpose of this portion of the audit would be to assess how the Fed staff gathered information about the financial crisis, how this information was presented to policymakers, and what considerations drove the choices that were made.

The decisions that should be analyzed include the following:

- the creation of the Term Auction Facility and its use in 2007 and 2008,
- the provision of central bank liquidity swaps in 2007 and 2008,
- the purchase of assets from Bear Stearns,
- the creation of the commercial paper lending facility following the failure of Lehman Brothers,
- the acquisition of assets for the purpose of stabilizing AIG,
- the decision to pay interest on bank reserves held at the Fed,
- the purchase of long-term Treasuries,
- the purchase of securities from the GSEs (Freddie Mac and Fannie Mae), and
- the Term Asset-backed Securities Loan Facility, designed to purchase securities backed by various consumer and commercial loans.

Basically, starting in 2007, and particularly after the failure of Lehman Brothers, the Federal Reserve shifted from undertaking general monetary expansion and instead focused on purchasing specific assets from specific institutions.[7] Why was this done? What did the Fed hope to accomplish using these techniques that it did not think it could accomplish with ordinary monetary expansion?

The decision to purchase specific assets from specific institutions raises the issue of whether this serves the broader public interest or just the narrow interest of the selling institution. Specifically, an audit should look into the following questions:

- What did the Federal Reserve believe was the true value of each asset?
- What did the Federal Reserve believe was the true capital position of each institution?
- Did the Federal Reserve believe that all of the institutions from which it purchased assets suffered only from temporary illiquidity, or did it believe that some of the institutions were insolvent?
- Were any institutions that the Federal Reserve believed to be insolvent nonetheless considered "too big and too interconnected to fail?" In the thinking of the Fed at the time, what other institutions would have been damaged by the failure of one of these large, complex financial firms?
- Did the Fed consider alternative approaches that would have aimed at preserving only the most sound banks? What were the reasons for instead choosing the strategy of attempting to preserve so many troubled institutions?

One concern that I have is that the Fed staff gets so much of its information from the banks themselves. In my experience, businesses that are in trouble provide very distorted pictures of their situations. The CEO of a failing firm is like someone who is drowning. Lifesaving courses teach that drowning people are so desperate to save themselves that in their flailing they will grab and push the rescuer, endangering themselves even more in the process. Similarly, CEOs of money-losing firms will flail about irrationally in an attempt to keep the business going.

In my experience, the founder of a failed start-up always thinks he could have succeeded if only his investors had shown more patience and been more forthcoming with funding. I have never heard of a bankrupt real estate developer who thought that his banks made the right decision to curtail their loans. And my guess is that every CEO at a bank that ran into difficulty as a result of the mortgage crisis thinks that his firm suffered only from a loss of confidence, not an actual insolvency due to bad investment decisions.

Accordingly, one aspect of the audit should be an independent assessment of the extent to which banks were suffering from short-term liquidity breakdowns or else from fundamental problems with their assets. To the extent that the Fed took the view that the problem was short-term liquidity, was this view justified?

Profits and Losses

The audit should provide the best estimate possible of the profits and losses to the taxpayers from the Fed's new strategy of purchasing specific assets from specific institutions. This is more than just a point of curiosity. It can help answer the question of whether the banks were suffering from a liquidity squeeze or from bad investment decisions.

Suppose that the audit finds that the Fed's investments made a profit for the taxpayers, as was sometimes forecast by pundits and officials. If so, then the Fed was playing the part of a speculator or hedge fund of last resort, snapping up undervalued assets in a dysfunctional market. This would indicate that the problem in the banking system was a liquidity squeeze. In that case, it is likely that the Fed correctly diagnosed and solved the problem.

At the same time, suppose that the audit finds that the Fed's investments incurred losses for the taxpayers. In that case, the Fed was providing subsidies to the sellers of assets. If so, then this is more problematic. Did the Fed intentionally overpay for assets from troubled financial firms? Or was the Fed more like a "greater fool," mistakenly thinking that it was buying assets at artificially depressed prices when it turns out that it was buying them for artificially high prices?

If the Fed lost money on its asset purchases, then it is unlikely that the institutions

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were suffering only from a short-term liquidity squeeze. Instead, it would be more likely that some of the institutions were insolvent and that the special Fed programs were propping up "zombie banks."

The results of this audit would go a long way toward answering the ultimate question about the Fed's actions: did they make the overall economic situation better than it would have been otherwise? If the Fed showed a profit, then this would imply that a liquidity squeeze was a major factor. If liquidity was scarce, then by injecting liquidity through its asset purchases the Fed was mitigating a problem that could potentially have gotten much worse.

At the same time, if the Fed took a loss, then the overall economic impact of its actions is less clear. If the Fed took a loss, then it may have only postponed and transferred the impact of the bad investments made by banks and other financial institutions. Less of the loss was borne in 2008 by the firms that undertook those investments, and more of the loss will be borne in later years by taxpayers. The overall economy is less likely to have reaped a benefit.

The only way to really know for certain whether the Fed's actions were constructive or not is to run a controlled experiment in which we set up the same economic conditions and have the Fed undertake a different strategy. Obviously, it would be impossible to conduct such an experiment.

In the absence of a definitive experiment, it is likely that historians and economists are bound to argue whether the Federal Reserve helped or not to stabilize the economy. The less evidence there is, the more the argument will be grounded in ideology. Libertarians and conservatives will claim that the Fed did not help, and progressives will claim that the Fed prevented an even worse calamity.

An audit of the Fed could provide useful evidence for assessing the success of Fed policy during the crisis. How can anyone be so certain of their views on these matters that they would not like to see the facts brought to light?

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Notes

1. Ben Bernanke, "Semiannual Monetary Policy Report to the Congress," Testimony before the House Committee on Financial Services, July 21, 2009, http://www.federalreserve.gov/newsevents/testimony/DBBB5C9F26B6440AA4A21E104A61577A.htm.

2. Ricardo Caballero et al., "Open Letter to Congress and the Executive Branch," https://survey.chicagobooth.edu/ViewsFlash/servlet/viewsflash?cmd=showform&pollid=gfm!FedIndependence. For a list of signatories as of July 15, 2009, see the report on the "Real Time Economics" Web site of the *Wall Street Journal* at http://blogs.wsj.com/economics/2009/07/15/petition-for-fed-indepen dence/.

3. H.R. 1207, Federal Reserve Transparency Act of 2009, 11th Cong., 1st sess., http: //frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h1207ih.txt.pdf.

4. For example, Simon Johnson, in "The Quiet Coup," *The Atlantic*, May 2009, wrote, "elite business interests—financiers, in the case of the U.S.—played a central role in creating the crisis, making ever-larger gambles, with the implicit backing of the government, until the inevitable collapse. More alarming, they are now using their influence to prevent precisely the sorts of reforms that are needed, and fast, to pull the economy out of its nosedive. The government seems helpless, or unwilling, to act against them."

5. Peter R. Orszag, "IMAC, Ubend," the OMB weblog, July 17, 2009, http://www.whitehouse.gov/omb/blog/09/07/17/IMACUBend/ and "Another Look at IMAC," the OMB weblog August 4, 2009, http://www.whitehouse.gov/omb/blog/09/08/04/AnotherlookatIMAC/.

6. Tom Daschle, "Progressive Solutions to America's Health Care Crisis," *The Huffington Post*, March 3, 2008.

7. Indeed, from the standpoint of conventional monetary policy, the decision to pay interest on reserves was contractionary, a point made by Scott Sumner. See Tyler Cowen, "How a Little Inflation Could Help a Lot," *New York Times*, August 1, 2009. Similarly, James Hamilton wrote that "Indeed, most of the new reserve deposits created by the Fed ended up simply being held as excess reserves...the more than doubling in the size of the Fed's balance sheet has so far had limited effect on the total currency in circulation." James Hamilton, "Concerns about the Fed's New Balance Sheet," in *The Road Ahead for the Fed*, ed. John D. Ciorciari and John B. Taylor (Stanford: Hoover Institution Press, 2009).

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