



Congressional Oversight of the Federal Reserve

Marvin Goodfriend
Carnegie Mellon University and
National Bureau of Economic Research

Shadow Open Market Committee
March 25, 2011

Introduction

On February 17th *The Economist* published an extended essay on the current state of central banking entitled “A More Complicated Game.” The essay described how the West’s financial crisis has shaken public confidence in its leading central banks. Yet the crisis has also led to an expansion of central bank duties and powers. The article described how the Federal Reserve, the Bank of England, and the Eurosystem have expanded their “remits,” either at their own initiative or at governments’ behest, well beyond ordinary monetary policy, and that they are taking on more responsibility for the supervision of banks and the stability of financial systems. The essay pointed out that for better or worse the world is relying more than ever on its central banks, and that the relationship between the central bank and the government is going to become more difficult and more political.

The Economist essay describes well the nature of the predicament that central banks confront today. This essay presents a diagnosis of that predicament and proposes a solution.¹ Briefly, the perplexing situation arises because central banks must pursue monetary policy independently, yet their capacity for independent action draws them into expansive credit policy initiatives whose fiscal policy implications threaten their independence. The solution involves setting the priorities for independent monetary policy and clarifying the boundaries for expansive credit policy.

In the United States, the solution requires an overhaul of congressional oversight of the Federal Reserve. The oversight process must (1) enforce a low inflation priority for independent monetary policy, (2) limit independent credit policy, and (3) authorize any expansive Fed credit initiatives. The overhaul is needed to discipline the oversight process to preserve a workable and sustainable division of responsibilities between the Fed and the fiscal authorities, especially with respect to the stabilization of banking and credit markets.

Fed Independence Needs Priorities and Boundaries

Fed independence on interest rate policy and limited credit policy is essential to enable the central bank to react promptly to macroeconomic and financial shocks without the getting the approval of the Treasury or the Congress. However, independent policy has lasting effectiveness only if the public is confident that the Fed’s actions are free of political influence or manipulation and seek consistently to advance attainment of the Fed’s priorities of price stability and sustainable economic growth. Without clear priorities and boundaries agreed by the legislature, an independent central bank is handicapped in a variety of ways. It is exposed to political manipulation behind the scenes which, whether real or imagined, degrades the credibility and effectiveness of its policy initiatives. For instance, the absence of a legislative priority for low inflation increases the likelihood of destabilizing “inflation scares” in periods when interest rates must rise to stabilize inflation. Alternatively, central bank operations lack credibility and effectiveness when they reach beyond boundaries ordinarily regarded as legitimate by the legislature and the public. Expansive operations rightly draw the scrutiny of the legislature and undermine the central bank’s overall actual or perceived independence.

¹ The essay draws on M. Goodfriend, “Central Banking in the Credit Turmoil: An Assessment of Federal Reserve Practice,” *Journal of Monetary Economics*, January 2011, pp. 1-12.

A Framework for Congressional Oversight of the Fed

The priority for low inflation is today regarded as an indispensable foundation for macroeconomic policy. Monetary policy can be delegated to an independent Fed in part because the objectives of monetary policy—low inflation and sustainable economic growth—are reasonably clear and coherent and they lend themselves well to objective oversight criteria.

Congress allows the Fed to finance itself outside the congressional appropriations process—from interest earnings on the Fed’s portfolio of securities—so the political system does not abuse the central bank’s money-creating powers. Prior to the credit turmoil, the Fed managed monetary policy with a “Treasuries only” asset acquisition policy to avoid carrying credit risk on its balance sheet. The Fed returned all the interest income on its Treasuries (net of expenses) to the fiscal authorities to allocate as they chose. Thus, monetary policy with Treasuries only is well-suited for delegation by Congress to an independent Fed.

Credit policy initiatives, especially expansive credit initiatives undertaken by the Fed and other central banks during the credit turmoil, are another matter entirely. No clear overall macroeconomic objective exists for credit policy. Credit policy inherently favors one borrower or one sector of the economy over another. And credit policy involves the fiscal allocation of public funds.

Fed credit policy involves lending to particular institutions or acquiring non-Treasury securities financed with freshly created bank reserves or proceeds from the sale of Treasuries. To prevent future inflation, reserve finance eventually must be replaced with sales of Treasuries, or else the Fed must pay market interest on the reserves. Either way credit policy involves the lending of public funds to particular borrowers financed by securities issued against future taxes. Moreover, all financial securities other than Treasuries or their equivalent carry some credit risk and involve the Fed in potentially controversial disputes regarding credit allocation.

By its very nature then, credit policy creates friction between the Fed and the Congress. Ordinary central bank “last resort lending” to supervised, solvent depository institutions, on a short-term basis, against good collateral provides multiple layers of protection against ex post losses and ex ante distortions. However, expansive credit initiatives that extend the Fed’s credit reach in scale, maturity, and collateral to unsupervised, potentially insolvent institutions, or the purchase of non-Treasury securities, inevitably carry substantial credit risk and have significant allocative consequences.

The ambiguous boundary of expansive Fed credit policy responsibilities is problematic for both the Fed and the Congress. And it creates an unhelpful ambiguity in financial markets. By virtue of its very independence, without circumscribed credit policy powers the Fed faces a no-win situation in a financial crisis. A decision to commit substantial taxpayer resources in support of the financial system or one that denies taxpayer resources is inherently a highly charged, political, fiscal policy matter. Whatever the Fed decides will lack political legitimacy and undermine its credibility for further action. The independent Fed cannot be responsible itself for delivering or deciding upon the delivery of fiscal support for the financial system.

In practice, as the recent credit turmoil amply demonstrated the Fed is inclined to expand its lending reach in a crisis. The Dodd-Frank Act recognized the problem and requires Fed lending extended beyond depositories to be approved by the Treasury Secretary and to be part of a broad program not directed to any particular borrower. The Dodd-Frank requirements do not address the problem adequately, however, because the Administration is no more authorized to commit taxpayer resources than the independent central bank--only the Congress can do so. And the Treasury is as likely as the Fed has been to favor expansive credit policy in a financial crisis rather than risk an immediate financial collapse.

To deal effectively with what appears to be an expanding and ultimately self-destructive Fed lending reach, taxpayer representatives must be involved more prominently in congressional oversight of Fed credit policy. Expansive Fed credit policy initiatives must be authorized explicitly by Congress via its oversight of the central bank. The congressional oversight process must alert taxpayers in a clear and explicit way to the potential fiscal cost of expansive Fed credit initiatives. Taxpayer reluctance to bear the risk of expansive Fed credit policy could then credibly bend down market expectations of the Fed's lending reach. Banking and credit markets would reduce their dependence on short-term liquid finance, and the Fed's resort to expansive credit policy would diminish.

Strengthening Congressional Oversight of the Fed

Genuine, effective congressional oversight must begin with a clarification by Congress of the Fed's mandated responsibilities and priorities.

The Fed has many "mandates," including maintaining price stability, promoting high employment and sustainable growth, maintaining macro-financial stability and dealing with financial crises when they arise. Some of these mandates are imposed by law; others reside in broad, unlegislated public expectations regarding what the Fed will do in particular situations. In these circumstances there is a woeful lack of clarity regarding what the Fed's priorities should be and the boundaries of its responsibilities. This ambiguity is not in the interest of the Fed, the Congress, or the economy.

Absent clarity, the Fed must guess what is expected of it, risking too little action in some areas and too much in others, which exposes it to political attacks and—as in the extraordinarily popular "The Bernanke" spoof attracting thousands of viewers on You Tube early this year—public ridicule after the fact.

Congress cannot reasonably and reliably hold the Fed accountable for exceeding its authority or for a dereliction of duty after the fact without clarifying Fed responsibilities before the fact.

Markets are left guessing what the Fed will do in particular circumstances, increasing uncertainty and impeding long-term business planning to invest and create jobs.

Congressional oversight of the Fed should be strengthened as follows:

- 1) Since price stability is essential to facilitate a recovery from the Great Recession and only monetary policy can guarantee price stability, Congress should explicitly establish a

longer run priority for price stability as a 2 percent inflation objective. It should allow the Fed to conduct its daily monetary policy operations to this end independently and then hold the Fed accountable if it fails to keep inflation within a prescribed tolerance range around 2 percent. Perpetuating price stability will deter lenders from demanding inflation premia in longer-term bond rates which would derail the recovery and put additional stress on the nation's fiscal resources.

- 2) The oversight process should discipline the Fed to justify short-term policy actions to stabilize employment and output against the longer run 2 percent inflation objective. For instance, the Fed might be asked to justify its short-term interest rate policy actions against a Taylor Rule.
- 3) The distinction between monetary policy and credit policy should be recognized for the purpose of congressional oversight. The Fed can implement monetary policy without incurring credit risk by dealing only in US Treasury securities. Fed credit policy involves lending to the private sector or acquiring non-Treasury securities. Credit policy works by putting taxpayer funds at risk to facilitate the flow of credit to particular firms or sectors of the economy. Hence, Fed credit policy invades the territory of the fiscal authorities. Congressional oversight should require the Fed to return to a Treasuries only acquisition policy.
- 4) Occasional Fed lending to solvent, supervised depositories on short term, against good collateral is reasonably well protected against loss and so deserves a degree of operational independence from Congress.
- 5) Expansive Fed lending beyond solvent, supervised depositories at longer maturity, against weaker collateral, such as occurred in numerous instances during the recent financial crisis, incurs greater fiscal risks for taxpayers ex post and distorts credit allocations ex ante. Hence, Congress in its oversight role should clarify the boundary of the Fed's responsibilities for taking expansive credit actions and correspondingly restrict its independence in doing so.
- 6) Expansive Fed lending should be authorized before the fact by Congress in its oversight role only as a "bridge loan" accompanied by a "take out" arranged and guaranteed in advance by Congress. The authorization process should include a clear, explicit, public discussion of the fiscal risks with informed taxpayer representation involved in the decision.

Bottom Line

Ambiguous Fed responsibilities and unclear priorities are not healthy for the Fed, the Congress, or the economy. They make genuine, effective oversight impossible. They are a prescription for political manipulation of the Fed behind the scenes. They put the Fed at risk by forcing it to guess congressional intent ex ante; and they allow Congress to scapegoat Fed actions ex post. Weak and ineffective congressional oversight undermines the Fed's legitimacy and credibility over time and diminishes the effectiveness of its policies.