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Statement by

Philip E. Coldwell

Member, Board of Governors of the Federal Reserve System

before the

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I am pleased to present the views of the Board of Governors of the Federal Reserve System on H.R. 2176, a bill that would direct the General Accounting Office to conduct audits of the Federal Reserve Board and all of the Federal Reserve Banks. The Federal Reserve opposes enactment of this legislation--as it has opposed similar proposals over the past 25 years--for two principal reasons: First, it would constitute, in our view, the first significant step toward compromising the ability of the Federal Reserve System as the Nation's central bank to render objective independent judgments on the course of monetary policy. Second, the Federal Reserve Banks, which account for almost 95 percent of the expenditures of the System, are already subject to extensive audit by the Board of Governors pursuant to an express mandate in the Federal Reserve Act, and maintain an independent audit staff for day-to-day review of expenses. The General Accounting Office itself has recognized the effectiveness of this audit procedure and there have been no significant challenges to the expense control of the System. Furthermore, for almost 25 years the Board itself has been audited annually by a leading national firm of independent auditors. The results of this audit work are available to the Congress. Accordingly, we submit that there is no need for legislation that would impose an additional audit upon the System.

The Federal Reserve System is the creation of the Congress, and the Congress has the authority to change the nature of the central bank in any manner it sees fit. We are concerned, however, that by significantly altering one of the primary protections to the System's independence--its authority to establish its own budget and audit its expenditures--Congress may, without intending to do so--and notwithstanding supposed safeguards in the legislation-- profoundly change the concept of an independent monetary authority that has served the country well for over 60 years. Our fears in this regard are not based upon mere speculation, for it is no secret that a principal objective of many proponents of a GAO audit of the Federal Reserve over the past quarter century has been to achieve control over monetary policy through that means. Indeed, little over a year ago when this very issue was before the 94th Congress in H.R. 7590, a leading consumer advocate argued quite bluntly that if the public would rally behind a GAO audit bill "they could help substantially to reduce interest rates in the coming years." Reduction of interest rates may or may not be in the broad public interest at any particular time, and it was precisely because Congress recognized that political expediency should not determine the course of interest rates, that it created the Federal Reserve as an independent monetary authority. While H.R. 7590 failed of passage in the 94th Congress, it was clearly perceived by the opponents of an independent Federal Reserve as a means of bringing outside influence to bear upon the System's monetary policy judgments.

Congress has carefully constructed the Federal Reserve System in such a way as to be free from day-to-day political pressures. As the House Banking Committee stated emphatically in its 1913 report on the original Federal Reserve Act, the Board was created "as a distinctly nonpartisan organization whose functions are to be wholly divorced from politics." To achieve this purpose Congress has insulated the Board from control by the Executive Branch by providing its members 14-year terms, staggered so that one term expires every two years, and by excluding the System from the classified Civil Service. It has also insulated the System from the continuing operational control that might be exercised by Congress itself through the appropriations process. The Reserve Banks fund their operations through the earnings realized on their securities portfolios, and under the provisions of the Federal Reserve Act the Board's expenses are met through periodic assessments levied upon the Reserve Banks.

As a part of that non-political structure, Congress deliberately created a quasi-private status for the Reserve Banks. The concern over concentration of power, credit control, and regional diversities, led Congress to give semi-autonomous powers to the Banks with their own Boards of Directors and with their Presidents participating in the formulation of national monetary policies. General supervision of the Banks was assigned to the Board of Governors, including approval of budgets and examination of expenses. Changing this arrangement to inject the GAO into Reserve Bank oversight could shift the fundamental roles of the Banks and upset that fine balance of control and participation which has brought valuable regional input to national policy.

Congress has repeatedly rejected proposals to alter this structure. Indeed, on those few occasions since 1913 when Congress has made changes in the original structure of the System it has moved toward providing greater protection of the System's independence. In 1933, for example, Congress repealed that portion of the Federal Reserve Act that designated the Secretary of the Treasury and the Comptroller of the Currency as *ex officio* members of the Board, because of its concern that the formal participation of these Executive Branch officials in the policy deliberations of the System could impair the independent judgment of the Federal Reserve.

Significantly, it was also in 1933 that Congress took action to exclude the Federal Reserve Board from the audit jurisdiction of GAO. As I have mentioned, the original Federal Reserve Act provided that the Board's expenses should be paid from assessments levied by the Board upon the Federal Reserve Banks, rather than from appropriated funds. Shortly after the creation of the Federal Reserve System the Attorney General ruled that the funds raised through these assessments on the Reserve Banks were "public monies" within the meaning of the Federal auditing statutes. As a result of that opinion the funds of the Board were audited by Treasury Department auditors until 1921, when the General Accounting Office was established. From that time until 1933, the Board's funds were audited by the GAO.

In the Banking Act of 1933, however, Congress amended the Federal Reserve Act to state explicitly that funds derived from such assessments on the Reserve Banks "shall not be construed to be Government funds or appropriated monies," and it specified that "the Board shall determine and prescribe the manner in which its obligations shall be incurred and its disbursements and expenses allowed and paid." As a result of this amendment, which was enacted for the explicit purpose of increasing the independence of the Federal Reserve, the Board was no longer subject to audit by the General Accounting Office.

Exclusion of the System from GAO's audit jurisdiction has not by any means meant that the System's operations are free from careful scrutiny and accountability. In the original Federal Reserve Act Congress expressly charged the Board of Governors with responsibility for exercising supervisory authority over the Banks and directed the Board to examine "the accounts, books and affairs" of each Reserve Bank at least once each year. To accomplish this task the Board's Division of Federal Reserve Bank Examinations and Budgets, composed of about 50 auditors and managers, performs a detailed annual financial examination of each Reserve Bank, as well as periodic operational reviews of all major operations of the Banks. The financial audit includes verification of the accuracy and reliability of the balance sheet, verification of cash and securities, evaluation of the propriety of expenditures and the effectiveness of internal control systems, and a review of compliance with established procedures, regulations and policies. The operational reviews are in-depth studies of methods and procedures followed by the Banks in carrying out their principal functions. At the conclusion of each examination or review detailed oral and written reports are rendered, documented responses are requested, and a final report is prepared. A comprehensive oral report is presented annually by the Division to the Board of Governors and to the Directors of each Bank on the results of all reviews and examinations in the respective Districts.

Another part of this control of expenses is the audit department in each Reserve Bank. These professionals, acting independently of Bank managements, are responsible directly to the Board of Directors for enforcement of System guidelines and policies.

The Board of Governors' examiners review the procedures and activities of the audit departments as well as check a portion of their audit work in detail. The Board's examiners also appraise the competence and independence of the Federal Reserve Bank auditors and report their findings to both the Board of Directors and the Board of Governors.

The other two parts of the overall control program involve the managements and Boards of Directors of the Reserve Banks. The senior officers exercise their best judgment in managing the Reserve Banks and compete among themselves for the best rank in the System in productivity, cost efficiency, and quality of service. As a former President of a Federal Reserve Bank, I can assure you that the Bank Presidents do exercise careful control over the costs of the banks and view the audits not as a self-audit, but instead as a searching examination by informed personnel.

The Boards of Directors, which include experienced businessmen and bankers, also contribute their knowledge of organization, methods and procedures to the efficient operation of the Banks. Moreover, through their audit committees the Boards of Directors receive the reports of the auditors and counsel with managements to insure adherence to System policies. The Chairman of each Reserve Bank Board meets personally each year with the Board's Committee on Federal Reserve Bank Activities to review and appraise the operating efficiency of the Bank and the performance of its senior officers. The conferences permit frank exchanges about the strengths and weaknesses of each Bank and the relative position of each against the ever-improving position of others.

Thus the Federal Reserve has four distinct lines of control to assure adherence to System policies and to promote steady improvement in productivity and cost efficiency. The managements, Boards of Directors, and auditors of the Reserve Banks and the examiners of the Board of Governors are all part of an elaborate system of formal and informal surveillance over Reserve Bank efficiency, costs, and services.

As a result of this whole procedure of audits, reviews, and consultation, the Reserve Banks have been making significant gains in efficiency. As measures of this progress, the following may be cited:

--Checks processed in 1976 totalled 12.3 billion items up 23% from 1973 but handled with almost 9% fewer employees and with total costs increasing only 15 cents per thousand or 1.5% over 1973 costs.

--Currency sorted and counted rose 4.5% from 1973 to a 1976 total of 7.0 billion pieces handled by 19% fewer employees and with only an 8 cent increase in cost per thousand or 5.8% over 1973 costs.

--Just in the past two years the personnel needed to handle Reserve Bank operations have declined by 1,374 or 5.4%.

We do not see what advantage there is to be gained either in requiring the General Accounting Office to duplicate the audit of the Federal Reserve Banks that has been carried on by the Board for decades, or in substituting GAO for the Board as the auditor of the Banks. Indeed, the GAO itself has repeatedly recognized the effectiveness of the Board's audits of the Reserve Banks, and in past years has represented to Congress that there was no need for GAO to audit the Banks. In 1945, when Congress was considering general legislation to bring government corporations generally within the scope of GAO's jurisdiction the question arose whether the Federal Reserve System should be subject to GAO audit. At that time the GAO supported exclusion of the Federal Reserve, based upon its judgment that there were already strong controls within the System and that the Reserve Banks were audited "frequently and thoroughly" under the direction of the Board of Governors. In 1952, when a Subcommittee of the Joint Committee on the Economic Report, under the Chairmanship of Congressman Patman, once again considered this issue, the Acting Comptroller General of the United States informed the Subcommittee that nothing had occurred since the enactment of the Government Corporation Control Act in 1945 that would require any different view as to the need for a GAO audit of the Federal Reserve. Twenty-five years later, I can state emphatically that at no time in the history of the Federal Reserve System has the Board's program of financial and operational audit and review of the Reserve Banks been stronger or more effective than it is today. While the GAO has now apparently departed from its historical position with respect to an audit of the System, that change cannot have been based upon an informed judgment that the Board's audit has deteriorated or is inadequate for today's environment.

As I have indicated, since the Reserve Banks account for almost 95 percent of the expenditures of the System, an audit of the System essentially implies an audit of the Reserve Banks. The Board's expenses for its own operations during 1976 were only $39.5 million, of which 76.8 percent was expended for salaries and related personnel expenses. While the Board of Governors itself is not subject to an audit by another governmental entity, its accounts are audited annually by a leading firm of independent public accountants and the results of that audit have been furnished regularly to the Congress. In addition to auditing the accounts of the Board, these outside auditors conduct a review and evaluation of the examination and auditing procedures employed by the Board itself in its own audit of the Reserve Banks. The auditor's report of that review have also been provided to the Congress along with the Board's Annual Report which makes public the expenses of each Reserve Bank and the Board.

We are, of course, aware that H.R. 2176 would exclude monetary policy transactions and deliberations from the scope of GAO's audit authority. Thus, the bill itself appears to reflect recognition of the need to protect the independence of the monetary authority and to limit the potential for intrusion into policy matters through a GAO audit. While we warmly endorse this objective, we believe that as a practical matter the enforcement of such limitations would be extremely difficult and that even a carefully circumscribed audit would be likely to encroach upon--or would at the least provide a means for encroaching upon--those judgments of the System that Congress intended to be independent. There is no clear and easy demarcation between "monetary policy deliberations" and the many other functions performed by the Board. Monetary policy concerns inevitably become intertwined with bank regulatory and supervisory matters. Our current deliberations, undertaken at the request of Congress, include questions of whether banks should be permitted to pay interest on demand deposits and whether the Federal Reserve should pay interest on reserves.

These questions exemplify the difficulty of neatly segregating our functions. Although they appear to involve matters of regulatory policy, monetary policy considerations have permeated our discussions of these questions. Similarly, Federal Reserve Bank operations cannot be neatly pigeonholed. Administration of the discount window, for example, is traditionally viewed as a monetary policy function, yet the proper performance of that function involves considerations of regulatory policy and matters relating to the soundness and condition of member banks. Similarly, our conduct of the process of bank supervision frequently gives rise to concerns that relate to the Board's responsibilities as the monetary authority. Even the System's work of clearing checks and processing government securities has important impacts on policy implementation. For example, if check float rises sharply because of a computer malfunction, the open market desk must take this into account in planning its reserve operations.

The difficulty of segregating monetary policy functions so as to keep them outside the scope of a GAO audit is compounded by the fact that virtually every administrative expenditure or procedure of the System can be related ultimately to a policy function. No matter how carefully the scope of the audit may be limited, the potential will always exist that the audit may be used to impinge upon policy matters. Indeed, as we understand the GAO's new position on this subject, it believes that it must have access to monetary policy deliberations and transactions in order to perform its audit and program review function properly. In light of this we believe that the Federal Reserve's frequently repeated fear that even a limited GAO audit would constitute an "entering wedge" for the contol of monetary policy is not unrealistic. Moreover, the Congressional oversight embodied in House Concurrent Resolution No. 133 clearly provides the vehicle for monetary policy review and obviates the need for this new legislation from that standpoint. Under this Resolution the Chairman of the Board appears before the Congress every three months to report on the System's monetary policy targets and to review the condition of the economy. Similarly, the planned oversight hearings on the condition of the banking industry should supply the information Congress needs for this aspect of the System's work.

We do not suggest that the Federal Reserve System is or should be beyond the scope of Congressional oversight or that it should not be held accountable to Congress for its expenditures. We do suggest--as GAO itself recognized over 30 years ago--that a detailed and effective audit of the System's expenditures and procedures is already being performed by the Board in response to a mandate from Congress. Before the Congress takes steps such as those contemplated by H.R. 2176, which may fundamentally alter the nature of the System, it should consider evaluating the Board's performance of its statutory duty as the auditor of the Reserve Banks. The generally favorable results of the hearings under House Concurrent Resolution No. 133, through which we communicate with Congress on monetary policy matters, has led Congress to adopt this procedure as a means of facilitating Congressional oversight on the condition of the banking industry. To achieve a similar relationship and understanding with Congress with respect to the Board's performance of its statutory duty as the auditor of the Reserve Banks we suggest that Congress consider holding annual oversight hearings on this subject. We are confident that if Congress were to conduct such hearings it would conclude, as the GAO itself concluded in 1945 and 1952, that this function is being performed well and that there is no need for a separate or duplicative audit by GAO.

In this uncertain and inflation-prone world, it is worth noting that the lowest rates of inflation among the developed nations are evident in the countries which have relatively independent central banks. The abilities to restrict the growth of the money supply, to neutralize heavy inflows of foreign capital, or to insist upon public marketing of government deficit financing, are tests of the independence of a central bank. Similarly, the freedom to exercise an independent judgment on the credit needs of an economy, to resist the short-run expedient clamors for easy credit, and to make the hard long-range impact decisions so necessary for improving our opportunities for economic stabilization are hallmarks of objective central bank policy formulation. Determination of its own budget needs and freedom from outside audit and influence on its allocation of expenses are indispensable elements in this fabric of independence.

In our opinion, Congress should consider carefully the implications of this proposed legislation which will begin the process of compromising the objectivity and impartiality of central bank judgments. Congress already has an oversight of monetary policies pursuant to House Concurrent Resolution No. 133, but could easily under this proposed bill slip into a dominantly influential position on monetary policies through audit criticisms or budget comments without the responsibility for those policies, and thereby, severely weaken the central bank's position.

Central bank independence has been eroded or extinguished in a number of countries over the postwar period by subjugating the banks either to Finance Ministers' domination or parliamentary control. I am convinced that this loss of independence has been a significant factor in the weakening of monetary control and has led to a heavy stimulus to inflation. If Congress is concerned about the rate of money supply growth as an important element in inflation, it should look with special care upon the monetary growth in countries where central banks cannot exercise relatively independent policy judgments.

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