

Statement of
Rudolph G. Penner
Director
Congressional Budget Office

before the
Subcommittee on Domestic Monetary Policy
Committee on Banking, Finance, and Urban Affairs
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NOTICE:

This statement is not available for public release until it is delivered at 9:30 a.m. (EST) on Wednesday, January 29, 1986.

Mr. Chairman, I am pleased to testify before this Subcommittee on the presentation and oversight of the Federal Reserve System's budget. The Congressional Budget Office (CBO) has prepared a report on the budgetary status of the Federal Reserve at the request of the Joint Economic Committee. That report was released in February 1985, and has been distributed today to Members of this Subcommittee.

In Western democracies, a long-standing tradition confers considerable day-to-day independence on the execution of monetary policy by central banks. This may seem anomalous since elected representatives directly formulate fiscal policy. But the two macroeconomic policy tools differ importantly. Fiscal policy strategies tend to be developed within the context of an overall plan debated at specific times. Ideally, these policies are modified only at discrete intervals, although, as a practical matter, the budget debate in the United States has recently absorbed much of the year.

Monetary policy decisions have to be made continuously throughout the year and overall monetary strategy both guides and is the cumulative result of that series of decisions. It would not be practical for the legislature to manage those day-to-day decisions, even if it wanted to. Moreover,

debates over policy could disrupt financial markets. The legislature has many opportunities to influence overall monetary strategy, however, as central bank officials spend many hours testifying before legislatures and often meet informally with officials of the legislative and executive branches.

Clearly, this process of interaction builds a set of restraints on monetary policy. Just as clearly, the central bank has considerable independence within these restraints. Scholars debate the relative importance of these restraints and I cannot resolve this scholarly dispute here. Nor is it appropriate for the CBO to take a position on what the desirable degree of monetary independence ought to be. The important point is that some degree of independence exists and historically this has been considered to be desirable in this country. The desire to provide some degree of independence has, in turn, affected the budgetary treatment of central banks throughout the free world.

The power of the purse is a crucially important tool for legislative control over the policies of most government agencies. Because of the desire to provide some independence, it is not used as vigorously to control

central banks as it is to control most other activities of government. Moreover, central banks are in the business of creating money. Because this activity provides far more than enough profits to finance their operations, there is no technical need to rely on legislatures for funds. Nevertheless, fiscal control over the Federal Reserve System could be exerted in a number of ways, each implying different degrees of independence for the monetary authorities.

CURRENT TREATMENT

The current budgetary presentation of the Federal Reserve's finances is incomplete compared with that of other independent government agencies. Currently, the main budget document includes an entry for Federal Reserve net earnings transferred to the Treasury. For 1985 these so-called "miscellaneous receipts" from the deposit of Federal Reserve earnings amounted to \$17 billion. The miscellaneous receipts are the net result of gross income less operating expenses, dividend payments to member banks, and other adjustments. Gross income and expenses, however, are not shown separately in the budget; only the net receipts appear.

The *Budget Appendix*, but not the main budget document, reports operating expenses for the Board of Governors. Reserve Bank expenses--accounting for about 95 percent of the System's expenses--are not shown in the federal budget, but are provided in annual reports. Further, the expenses of the Board of Governors are reported only for the current calendar year rather than for the projected fiscal year, as are all other government agencies. To the extent that the System's accounts are available to the public, they are generally not comparable with budget data. For example, purchases of capital goods are handled in Federal Reserve accounts more as they would be in a private firm rather than on the cash-flow basis used in the federal budget.

OVERSIGHT AND CONTROL

The Federal Reserve System clearly uses public resources to perform its functions. Any increase in its expenditures reduces its profits and so reduces its annual payment to the Treasury. These expenditures include the administrative costs of developing and conducting monetary policy, of providing financial services to the Treasury and the banking system, and of supervising and regulating banks and their holding companies. In addition,

its discount lending to the banking system often contains an element of subsidy. But, conversely, the Federal Reserve imposes costs on commercial banks through the requirement that they maintain reserve deposits in Federal Reserve Banks on which no interest is paid.

The Congress properly is interested in the amount of economic resources used in these activities and in whether the Federal Reserve is using these resources efficiently. Ideally, the Congress should be able to compare the use of resources in these activities with other possible uses of the same resources.

The question asked in this hearing is whether reforms in the Federal Reserve's budgetary display or in budgetary control mechanisms would aid the Congress in carrying out its oversight and control responsibilities.

Budgetary Display

At first sight, it would appear useful for the Federal Reserve System to adopt the budget accounting conventions used by the rest of the federal government. This method would include use of the following common

budgetary devices: displaying both gross receipts and operating expenses; adopting a cash-flow accounting approach; projecting outlays and receipts for five years into the future; and shifting from a calendar to a fiscal year.

While comparability may be useful for its own sake, each of these reforms does, however, create problems. One problem involves asset transactions. The cash-flow approach used in the federal budget is not well-suited to revealing the economic costs imposed by agencies that engage in lending, other asset transactions, or possess a large quantity of real assets. In particular, it does not reveal the true cost to the economy, if any, of loans made by an agency. In the case of the Federal Reserve, this problem is particularly serious because many of the asset transactions of the System result from its efforts to influence the money supply and are not comparable to the asset transactions of other agencies. Moving to a cash-flow approach only for the operating expenditures of the Federal Reserve would mitigate these difficulties.

Projecting cash flows that include asset transactions would pose special problems for the Federal Reserve System, because some would deem it an announcement of future monetary policy. Projecting only operating

expenses and receipts would not create the same difficulty, although the projections would probably be studied diligently by those seeking abstruse clues regarding future policy directions.

Budgetary Control

The issue of budgetary control is theoretically separable from that of how the budget is displayed, since the Congress could exercise more control using the information now provided. Conversely, the display of additional information need not imply more control, although some observers might interpret any increased requirements imposed on the Federal Reserve as a signal that the independence of monetary policy is about to be lessened.

The CBO report on the Federal Reserve Reserve's budgetary status discusses three methods of controlling System spending: oversight, authorizing legislation, and the appropriations process. The first two activities have traditionally been the responsibilities of the House and Senate Banking Committees. On occasion, the Committees have reviewed the System's budget, most recently in the Senate Committee under Chairman Proxmire from 1977-1980. The Committees have also written

important authorizing legislation, such as the Monetary Control Act of 1980, which required that the Federal Reserve provide its payments services to private financial institutions on a full-cost recovery basis.

Both the oversight and authorizing approaches provide opportunities for review and control of Federal Reserve spending without greatly increasing the danger of undesired reductions in its independent stance on monetary policy. For example, the Committees might adopt Senator Proxmire's former practice of holding annual oversight hearings on the System's budget. This oversight function could be carried out more effectively if the System's finances were displayed in the government's budget documents.

The Committee could also consider whether deficit reductions could be accomplished legislatively by requiring reductions in the administrative overhead of the Federal Reserve and the other banking agencies, or by requiring further cost recovery for System services. For example, the Committee might study whether supervisory and regulatory costs could be recovered from state member banks and bank holding companies, much as the Comptroller of the Currency recovers its costs from the national banks it supervises.

Alternatively, the Federal Reserve operating expenses could be explicitly subject to Congressional limitation through the appropriations process. While this approach might suggest an increase of Congressional influence over monetary policy, that perception could be minimized by restricting coverage of the appropriations limitation to functional expenses other than those incurred in the design and execution of monetary policy. The use of the appropriations process, however, does risk the attachment of legislative riders for the purpose of influencing monetary policy. Moreover, the separation of monetary policy expenses from all other expenses cannot be easily accomplished because of shared support and overhead costs.

Another approach to controlling spending--and one that has been applied to the administrative expenses of other agencies--is the sequestration of funds. In the initial CBO/OMB report, we concluded that the Balanced Budget and Emergency Deficit Control Act of 1985 did not affect the Federal Reserve, largely because there was no legislative history to support the act's application to the System. Consequently, the Federal Reserve System will not have to reduce its administrative expenses for fiscal year 1986, although all other government agencies will be required to do so.

CONCLUSION

There is an international tradition of allowing considerable independence for central banks in the formulation of monetary policy. At the same time, the Federal Reserve System provides financial services and carries on regulatory and business-type activities that create benefits and costs for the entire economy. While the Congress is responsible for the efficient use of the public's resources in these activities, it also must be sensitive to the effect of increased control on whatever degree of independence it wishes to preserve for the Federal Reserve in carrying out its monetary policy functions. Slight changes in oversight procedures and budget displays could be accomplished with a minimal threat to the independence of monetary policy. Subjecting the Federal Reserve to the appropriations process would pose the greatest threat. The choice of methods for implementing the appropriate degree of control is not easy, nor is it one that CBO is equipped to make. It is, rather, a matter for Congressional judgment.