First Trust
ECONOMIC RESEARCH REPORT
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Don't Audit It: Rein It In

Some in Congress want to "Audit the Fed." But an audit, unless the word is used in a very broad sense, would be redundant and basically irrelevant. The Fed is already audited, by Deloitte & Touche LLP and it releases an annual report that includes the auditor's opinion, each year.

Wild-eyed conspiracy theories have cropped up that suggest the Fed may not actually own the bonds it says it does or that it pays too much to certain banks when buying them. But none of this is true; there is no evil accounting going on. In a financial sense the Fed is almost certainly squeaky clean. The Fed doesn't need another audit, what it needs is more responsible and effective oversight from Congress, a smaller balance sheet and less ability to interfere with private business decisions.

The Fed has become the biggest financial entity in the world, with bond holdings that have ballooned to $4.25 trillion. Fed assets, six years after the Panic of 2008 ended, exceed the annual budget of the US government and are equal to 24% of GDP.

During the Great Depression, 1930-39, the Fed's balance sheet averaged 13.2% of GDP. It peaked at the end of the Depression, in 1940, at 16% of GDP and then averaged 12.6% from 1941-45, during World War II. If the Great Depression and WWII didn't require balance sheets as large as the current one, then something has gone terribly awry.

What's interesting is that during the boom years of the 1980s and 1990s, the Fed's balance sheet averaged 5.2% of GDP. So, it's impossible to make the case that the Fed needs such a large balance sheet in order for the economy to create jobs with low inflation.

Lest we forget, Congress already has oversight of the Fed, and the past six years happened under its watch. Only a few members of Congress have enough knowledge of monetary policy to be effective at oversight. The same is true of voters. The Fed typically wins political battles because most people find monetary policy boring, complicated and difficult to grasp.

Nonetheless, the simple fact that the Fed is bigger, more powerful and more intrusive than ever imagined by any of its creators in Congress suggests that the Fed needs to answer more questions from more people. This does not mean the press, which has a conflict of interest, due to the fact that it wants access. Critical questioning risks losing access.

Moreover, the Fed is about to embark on a rate hiking campaign even though there are still excess reserves in the banking system. This has never been done before. Typically, the Fed makes reserves scarce in order to drive up interest rates.

But because the Fed wants a bigger balance sheet, it is trying to have its cake and eat it too. The Fed thinks it can pay banks more interest on those reserves and through a process of reverse repos drain money from the system. In other words, the Fed thinks that it can keep the balance sheet huge and manipulate interest rates even though the banking system is swimming in excess liquidity.

The Fed does have a back-up plan. If banks won't let the Fed sop up those reserves, and instead they decide to lend them, potentially creating inflation or bubbles, the Fed believes it can use "Macro-Prudential Policy Tools" to manage the money multiplying process. Macro-prudential tools would allow the Fed to stop banks from lending, by raising capital standards, or by limiting growth in certain types of loans or by certain types of banks. And, it allows the Fed to expand its reach to "systemically important financial institutions" that could potentially include insurance companies, brokerages, money managers and even hedge funds.

It's true that monetary policy should be independent of the political process. Whenever politicians take over the money supply, inflation results. But the corollary argument is just as important. Whenever bureaucrats take over the banking system, everything becomes political. Why? Because the bureaucrats are dependent on the politicians for their existence. The Fed must please enough members of Congress, and the right members, to keep new rules from passing that will limit its power.

The Fed missed the bubble in housing partly because Washington's political mindset was focused on boosting homeownership any way it could. So, bubbles in politically-correct industries, like housing or green initiatives, are tolerated or even encouraged. Also, risk-taking in private decisions is discouraged because bank losses become political problems. In other words, the bigger and more powerful the Fed becomes, the more dependent it is on the political process.

The easiest way out of this mess is for Congress to force the Fed to sell its assets and limit the Fed's power to bank oversight, not bank management and macro-prudential policy tools. Don't audit the Fed, don't create conspiracy theories, but rein in the overreach and force a smaller balance sheet. If we really want an independent Fed, make it smaller and less powerful. The bigger it gets, the more political, and less independent, it becomes.

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