

To: SOMC members

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The Enron debacle has produced an out-pouring of soul-searching by Congress and the media about the state of corporate governance and remedies for perceived ills. While this dithering continues, corporate boards and CEOs as well as their accountants and lawyers already are reacting to pressures in the marketplace for more transparency in financial practices and accounting. To the extent such information is sought by investors, corporations with clear and informative financial reports along with corporate structures with clear business purposes will receive a premium in equities markets relative to those with obscure or misleading reports and complicated corporate structures with no obvious business purpose. Excesses in the private sector are policed and ultimately corrected by market forces, just ask Enron.

The Federal Reserve is largely immune to such self-corrective forces thus, in this post Enron environment, now is an appropriate time for officers, directors and governors of the Fed to examine their practices with an eye towards improving transparency and public understanding of Fed operations. The Fed's responsibilities for monetary policy, financial stability, and its own operations

could be productive areas of examination and helpful in avoiding potential Fedrons

Monetary Policy. The Greenspan Fed has had substantial success in pursuing an objective of low inflation in order to achieve long-term sustainable growth in the economy. Yet more work needs to be done on this objective. Two huge blunders in the past with respect to this objective make Enron problems seem small. The Great Depression was, if not caused by the Fed's lack of focus on price stability, certainly exacerbated by it. The Fed caused or allowed significant deflation rather than providing price stability. During the 1970's the Fed produced sharply rising inflation and unemployment as it tied monetary policy to fine tuning the economy. The costs to the economy were huge in both cases.

Price stability (zero inflation) overtime should be the objective and a time frame for achieving it should be announced. Such a commitment by the Fed would further enhance its credibility. However, a problem remains in that the Greenspan Fed cannot bind the next Fed chairman to such a commitment. Congressional action is needed to make price stability the dominant monetary policy objective. Chairman Greenspan should expend some of his significant political capital to achieve this result. The hallmark of the Greenspan Fed has been its pursuit of low inflation to achieve sustainable economic growth but it

has yet to institutionalize price stability as the dominant objective of monetary policy.

The Greenspan Fed also has made progress in making the policy process more transparent by immediately releasing the FOMC decision, by dropping the “bias” in favor of the balance of risks statement and by releasing the voting record immediately after each FOMC meeting. The Fed should experiment with releasing the minutes of an FOMC meeting before the next meeting. It should also start releasing transcripts of the meetings in a shorter time frame. Start with a four-year release date and move on to shorter periods if no market impacts occur. The tapes from which the transcripts are made should be turned over to the national archives.

It has been alleged that the taping machines at FOMC meetings are being turned off when there is a view that the discussion should be off the record. If that is the practice it should be stopped. Until 1993 most of the participants at FOMC meetings did not know that tapes were being kept. The disclosure that tapes were retained was not only embarrassing to the Fed but also engendered distrust on the Hill. Turning off taping machines to go off the record for conversations that are required to be on the record should be considered inappropriate and perhaps illegal.

Financial Stability. For decades the Fed and the Treasury have had a “warehousing” arrangement for foreign currency intervention. This arrangement allows the Treasury to continue to acquire foreign currency when funds in the Exchange Stabilization Fund are exhausted. Treasury “warehouses” previously acquired foreign currency with the Fed and receives funds to continue to acquire foreign currency. In the early 1990’s Congress held hearings on this practice and its use was discontinued but the arrangement is still in place. The arrangement should be terminated for it smacks of accounting gimmickry and circumvents the intent of Congress with respect to the Exchange Stabilization Fund. The Secretary of Treasury may want to recommend termination of the Fund for the uses to which it has been put have proved embarrassing to more than one Administration.

The entire issue of intervening in currency markets by the Fed and Treasury should be revisited. Intervention is initiated by the Treasury and conducted by the Fed as its agent. Reasons often given for intervention are to insure orderly markets, to stabilize markets or to influence the price of an “over” or “under” valued currency. World financial markets set the price of a currency and they are so large and efficient that no central bank or group of central banks bent on intervening can have other than an ephemeral impact on the value of a currency. Intervention is destabilizing because it induces market participants to

exploit the action for their own profit thus adding to volatility in currency markets. At a minimum, the Fed as agent should not book half of the foreign currencies purchased. That is not the job of an agent but of a principal and the Treasury is the principal. In the early 1990's the Fed had more than \$20 billion of unhedged foreign currency on its books.

Another area Fed officials might take a look at is the discount window and the assumption of power by the Board of Governors. The Board has the authority to review and determine discount rates and to resolve disputes, but the Reserve banks always have had principal responsibility for making loans, secured by acceptable collateral. "Systemic risk" often has been the principal rationale supporting the centralization of discount window administration. Yet, the statutory structure and the underlying economic rationale for the discount window argue for decentralized administration. Thus, the existing institutional structure is inconsistent with the Board's current perception of systemic risk. Perhaps the statutes (sections 10(b) and 13) should be changed. Keeping insolvent financial institutions open might avoid systemic risk but only at the risk of large costs to taxpayers and to economic efficiency. The reduction of systemic risk can be better achieved by market-oriented reforms of supervisory policies, combined with decentralized administration of district Reserve banks discount windows. Risk of loss to the Fed is increased significantly when the

Board crosses the statutory barriers around policy issues and attempts to direct discount window policy and loan administration.

In the interest of providing more information to market participants, the Fed should consider publishing total assets of bank holding companies in aggregate by examination rating categories. This information would give investors the opportunity gauge changes in the health of the banking system over time. Also, the Fed should publish more on the extent of the use of derivatives by banks. Derivatives are valuable tools for banks in managing risk but they can be abused. Publishing on a regular basis the gross notional amounts and net amounts of derivatives, marked to market, would be a good start. Later, a breakdown by Reserve bank district would be useful information.

Operational Issues. Fed official might want to examine the role of Reserve bank directors with respect to governance. Over the years the role of directors, has been whittled down by the assumption of powers by the Board of Governors and its staff. Directors represent the private sector component of the public-private partnership that comprises the Fed. This arrangement is extremely important for monetary policy for it helps keep Congress and the Administration from having an undue influence over the appointment of monetary policy makers by assuring that five of the voting members of the FOMC are not political appointees. Yet even here the role of directors is diluted. Directors are responsible for choosing the president of their Reserve bank subject to approval

by the governors. But directors are required by the governors to name three candidates, which allows the Governors to choose the president if they so desire. Directors should pick the president and require the governors to vote that person up or down. The Fed was set up with these checks and balances in place and to slip them weakens the Fed.

Directors have little say in the budget, business practices, personnel policies, and lending programs of Reserve banks because of a centralization of control at the Board of Governors. Yet, the statutes make it clear that directors should have primary responsibility for overseeing the management of Reserve banks. One result is inefficient micro-management, stifling innovation and failing to use the expertise of the directors. A Fed management meeting focusing on the decentralized governance structure required by the statutes would be a good starting point.

The Fed may want to take a look some accounting issues in this post Enron-Andersen environment. The accounting for the Fed and Treasury government bond and foreign exchange portfolios sheds little light on what is going on in the portfolios. Perhaps both cash and accrual accounting should be done for all trades and realized gains and losses as well as book and marked –to-market value accounting for the portfolios. Also the Fed’s dealer community could be

assured of the fairness of the trading operations if the volumes done with each dealer were made public.

Many major corporations are currently reviewing their governance structure and financial reporting. With no major problems on its plate, the Fed ought to take the opportunity to review its governance and accounting practices.