

# Federal Reserve costs come under fire

by Anthony K. Wikrent

The U.S. Senate Banking Committee held hearings on July 26, to review a recent General Accounting Office report on the operations of the U.S. Federal Reserve System. Acting upon a request by Sens. Byron Dorgan (D-N.D.) and Harry Reid (D-Nev.), the GAO undertook the most comprehensive review ever of the Fed's operational management, and found that there is much room for improvement. The GAO also found that the Fed has amassed a \$3.7 billion "slush fund," which the GAO believes should be turned over to the U.S. Treasury. While the report and the hearing carefully avoided any examination of the constitutionality and efficacy of the Fed's control of monetary policy, Fed Chairman Alan Greenspan was clearly on the defensive.

The GAO report begins by discussing the "unique" structure of the Federal Reserve System, which is comprised of the Board of Governors and 12 regional Federal Reserve banks. The governors and chairman are appointed by the President of the United States, and confirmed by the Senate, but the 12 regional banks are private corporations, the stock of which are wholly owned by the commercial banks in each region.

The GAO reported that it had "identified several inefficiencies in the Federal Reserve's policies and practices that have increased the cost of providing its current services, including its costs for travel, personnel benefits, building acquisition, and contracting and procurement. Many of these inefficiencies relate to the decentralized nature of the Federal Reserve, which allows each Reserve Bank to set many of its own policies, and to the absence of traditional cost-minimizing forces that are commonplace in entities that are either purely private or public sector in nature."

From 1988 to 1994, the Fed's average annual revenue was \$22 billion, about nine-tenths of which is the interest earned on the U.S. government securities the Fed holds, as backing for over \$380 billion in Federal Reserve notes, which in turn serve as our nation's paper currency. Fees that the Fed charges financial institutions for providing services, such as check clearing and electronic fund transfers, account for most of the Fed's other revenues.

The operating costs of the Fed totaled \$2 billion in 1994, an increase of 48% from 1988 to 1994. The GAO noted that this 48% cost increase, exceeded the 25% increase in general price inflation during the same period, and the 17% increase in the total discretionary spending by the federal government,

but was somewhat less than the 51% increase in federal non-defense discretionary spending.

About 70% of the Fed's operating costs were incurred in running and supervising the payment system (which handles over \$1.5 trillion a day in payments and transfers), and other financial services provided to banks and government agencies; about 20% is accounted for by regulatory activities, such as bank examinations; only about 10% is accounted for by activities related to the Fed's formulation and implementation of the nation's monetary policies.

Pay and benefits for the Fed's workforce of over 25,000 employees accounted for about 70% of the Fed's operating expenses. The GAO found that the Fed's benefits are "generous," when compared to other, comparable federal agencies, such as the Securities and Exchange Commission.

The \$20 billion or so in revenues that are left over, are returned to the U.S. Treasury each year. However, the GAO found that the Fed has retained a few hundred million dollars each year, in a special "surplus account." This surplus account grew 79% from 1988 to 1994, rising from \$2.1 billion to \$3.7 billion.

## A secretive institution

Testifying before the committee, Senator Dorgan explained that he had requested the GAO study, because the Fed "has become an institution sitting there alone on a hill, a fence around it. You can't see much inside. The doors are locked when they make decisions. The minute someone begins talking about the Fed in any way other than glowing terms, you are immediately viewed as some sort of 'Fed-basher.'"

While noting that "it's not my intent that monetary policy should be conducted by the United States Congress," Senator Dorgan complained that "federal funds rates are now a full half percentage point . . . above where they ought to be by historical standards under the stewardship of this Federal Reserve Board, and there is no excuse for it. And we're not talking, however, about reducing them. We're hearing talk about increasing it. The prime rate ought to be 6% and the federal funds rate ought to be a full one-half of 1% below where it is now, given the rate of inflation."

In his testimony, Federal Reserve Board Chairman Greenspan stated that "we take exception to the broad implication of the GAO report that the Federal Reserve has not exercised appropriate budget constraint and that it has not adequately addressed the changing technological and financial environment in which it operates. In my opinion, however, the general tenor of the report does not reflect the high level of effectiveness with which the Federal Reserve has fulfilled its mission."

Sen. Paul Sarbanes (D-Md.) reacted to Greenspan's statement by noting, "I'm a little concerned by the defensive reaction to the GAO report. . . . I want to somehow break out of that mold."