

**Testimony of Mark A. Calabria, Ph.D.  
Director, Financial Regulation Studies, Cato Institute  
Before the  
U.S. House of Representatives  
Committee on Financial Services  
Subcommittee on Domestic Monetary Policy and Technology  
On “Audit the Fed: Dodd-Frank, QE3, and Federal Reserve Transparency”  
October 4, 2011**

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Chairman Paul, Ranking Member Clay, and distinguished members of the Subcommittee, I thank you for the invitation to appear at today’s important hearing. I am Mark Calabria, Director of Financial Regulation Studies at the Cato Institute, a nonprofit, non-partisan public policy research institute located here in Washington, DC. Before I begin my testimony, I would like to make clear that my comments are solely my own and do not represent any official policy positions of the Cato Institute. In addition, outside of my interest as a citizen and taxpayer, I have no direct financial interest in the subject matter before the Committee today, nor do I represent any entities that do.

***The Federal Reserve and the Financial Crisis***

As the Subcommittee is well aware, the events of 2008 witnessed not only unprecedented disruptions to our financial markets, but also extraordinary responses on the part of our financial regulators and central bank. No entity was more deeply involved than the Federal Reserve System (“Fed”), particularly the Federal Reserve Bank of New York.

Yet the Fed has consistently and repeatedly resisted efforts to bring any accountability and transparency to its actions. Congress and the public were regularly warned that if the details of the Fed’s actions became public, further panic would ensue in our financial markets. For instance I distinctly remember, as a staffer for the Senate Banking Committee, listening to then Fed Vice Chair Donald Kohn tell that Committee that making the names of AIG’s derivatives counterparties public would severely harm our financial markets. When those names were eventually released our world did not come to an end. In short, the Fed has a long tradition and strong preference

for secrecy. Despite some notable attempts by the Fed to increase its communications with the public, I believe, given its track record, the public cannot rely on the Fed to voluntarily provide us with sufficient information to monitor its activities and judge the effectiveness of its actions. And while the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), in relation to auditing the Fed’s activities are an important advance, they fall far too short of providing sufficient oversight of the Fed.

What auditing has been conducted has so far been focused on the Fed’s response to the crisis. Among economists, on both the right and the left, there remains considerable concern and debate over the Fed’s role in helping to create the crisis via its easy money policies in the aftermath of the dot-com bubble and the events of 9/11. If we truly wish to end financial crises, then I believe it is absolutely essential that Congress receive a full and objective evaluation of the Fed’s role in fostering the housing bubble, particularly as it relates to monetary policy decisions made between 2002 and 2005.

### ***Federal Reserve Audit Requirements under Dodd-Frank***

The primary audit requirements of Dodd-Frank, as they relate to the Fed’s actions during the financial crisis, are contained in Section 1109, which directs GAO to:

“conduct a onetime audit of all loans and other financial assistance provided during the period beginning on December 1, 2007 and ending on the date of enactment of this Act by the Board of Governors or a Federal reserve bank under the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, the Term Asset-Backed Securities Loan Facility, the Primary Dealer Credit Facility, the Commercial Paper Funding Facility, the Term Securities Lending Facility, the Term Auction Facility, Maiden Lane, Maiden Lane II, Maiden Lane III, the agency Mortgage-Backed Securities program, foreign currency liquidity swap lines, and any other program created as a result of section 13(3) of the Federal Reserve Act.”

That audit was delivered to Congress in July. Importantly, the audit required by Dodd-Frank goes beyond a simple accounting of what was lent to whom, but also requires GAO to evaluate the effectiveness and policies of the

various lending facilities. As GAO's audit makes clear, the Fed, and in particular the New York Fed, exercised considerable discretion in designing these lending programs and often did so in an extremely ad hoc manner. While it does appear that the Fed made attempts to treat all program participants fairly and equally, a lack of appropriate internal controls within these programs left open considerable potential for abuse.

In addition to the audit requirements of Section 1109, Dodd-Frank also requires under Section 1103(b) that the Fed provide:

“disclosure in a timely manner consistent with the purposes of this Act of information concerning the borrowers and counterparties participating in emergency credit facilities, discount window lending programs, and open market operations authorized or conducted by the Board or a Federal reserve bank...”

The importance of Section 1103(b) is that participants in future discount window lending will eventually be identified to the public, along with the terms of such lending. Given that Dodd-Frank gives the Fed approximately two years to disclose such information in relation to discount window lending, I believe the risk that such disclosure will dissuade financial institutions from the use of the discount window has been minimized. Of course, if such disclosure encourages financial institutions to manage their operations in such a way to avoid the need for access to the discount window, then the strength of our financial system would likely be improved.

While Sections 1102, 1103 and 1109 of Dodd-Frank are without doubt improvements in Federal Reserve transparency, and some of the few positive provisions in the Act, they fall short of truly bringing the operations of the Fed into the light of day.

Although I believe it to be a grave mistake to continue to entrust the Federal Reserve with bank supervision and regulation, Congress has chosen to maintain, and extend, that situation. The requirements of Section 1108(b) of Dodd-Frank requiring the Fed's Vice Chair for Supervision to regularly appear before Congress should increase transparency and improve Congressional oversight as it relates to the Fed's bank supervision responsibilities.

## ***The Federal Reserve Needs a Full and Continuous Audit***

The non-monetary actions of the Federal Reserve in 2008 and 2009 will likely be debated for decades among economists and historians. Just as the causes of the Great Depression and the effectiveness of the New Deal remain in contention, so will recent actions. What we all can perhaps agree on, or at least hope, is that the extraordinary measures, by Congress, the Federal Reserve and the Treasury, will not be repeated soon or repeated often. Accordingly, much of the audit requirements in Dodd-Frank have something of an “historical” feel to them. However, it is not enough to just get history right, but also to insure that future mistakes are avoided. I can think of few areas requiring as much mistake-avoidance as monetary policy.

Others have already laid out the case that easy money contributed to the crisis,<sup>1</sup> so I will not repeat that argument here. I do believe, however, that the role of easy money in the fostering a housing bubble demonstrates the need for an on-going GAO audit of the Federal Reserve’s monetary functions. Disagreement as to the appropriate stance of current monetary policy also demonstrates the need for objective, independent analysis.

### ***What’s GAO for?***

GAO, the US Government Accountability Office, states its mission is “to support the Congress in meeting its constitutional responsibilities and to help improve the performance and ensure the accountability of the federal government for the benefit of the American people. We provide Congress with timely information that is objective, fact-based, nonpartisan, nonideological, fair, and balanced.” ([www.gao.gov](http://www.gao.gov)).

Quite simply GAO is not a political organization. As someone who has interacted repeatedly and regularly with GAO over the last decade, including serving as a Congressional staff liaison for requested GAO reports, I can say they are independent, unbiased and non-political. I have not always agreed with the conclusions of GAO, but I have never felt as if such disagreements were the result of politics or bias.

Subjecting the Federal Reserve’s monetary policy function to a GAO audit does not subject the Fed to “politics” – such a claim is not only insulting to

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<sup>1</sup> See John Taylor, *Getting Off Track*. Hoover Institute Press. 2009.

GAO, it is insulting to the very concept of Congressional oversight. GAO exists for the very simple reason that no one member of Congress, or their staff, fully understand and are knowledgeable about the functioning of the various government agencies. GAO exists to inform. And there are few areas less understood by Congress than monetary policy and macroeconomics. Hence there are few areas more in need of a GAO audit than the Fed. While the impact of getting wheat support prices or fair market rents wrong is not insignificant, getting monetary policy wrong can be disastrous for an economy.

### ***On Fed Independence***

A common objection to a GAO audit of the Fed is that such would “compromise” the Fed’s independence and subject its actions to political influence. Such an objection confuses the very nature of Fed independence. The Fed’s authority to regulate the value of money is one delegated from Congress. As Congress can, and has, legislated changes to the Fed, it should be clear beyond a doubt that the Fed is not “independent” of Congress. It is a creature of Congress.

Setting aside the debate over the desirability and legitimacy of so-called independent agencies, it should be clear that their independence, in an operational sense, is from the Executive Branch. It should also be clear, however, that in recent years the Fed has coordinated its actions quite closely with the Treasury Department, eroding any real independence. The revolving door, both at the political and career levels, between the Fed and the Treasury Department further undermines the Fed’s operational independence. A GAO audit could shine a light on this relationship, helping to insulate the Fed from continued interference by the Treasury Department.

### ***Improving Federal Reserve Transparency***

The Dodd-Frank Act made important advances in bringing transparency and accountability to the Federal Reserve. Unfortunately it falls short in allowing Congress, and the public, to truly gauge the effectiveness of the Federal Reserve.

In order to improve Federal Reserve Transparency, Congress should mandate a regular GAO audit of all Fed activities, including monetary policy. Such audits can be performed in such a manner so as to minimize

their disruptions to any on-going deliberations of the Federal Open Market Committee (FOMC). For instance audits can be kept confidential for a year after each FOMC meeting.


Evaluating the effectiveness of any government agency is made all the more difficult when that agency faces a variety of competing and sometimes conflicting objectives. If the Fed feels it is free to abandon price stability in order to achieve other objectives, such as supporting the financial industry or misguided attempts to influence the labor market, then an audit will have limited value. At a minimum Congress should restrict the Federal Reserve to a single goal, that of price stability. Congress should also restrict the Fed's discretion in implementing that goal. A central bank that is free to define price stability as whatever it wants is a central bank without any meaningful constraint.

Chairman Paul, Ranking Member Clay and members of the Subcommittee, I again thank you for the invitation to appear at today's important hearing. I firmly believe our monetary system was a central driver of the financial crisis and that its deep flaws remain in place. In order to both prevent future financial crises and protect our society from the significant harm that results from inflation, a vigorous debate as to the performance of the Federal Reserve is long overdue.

United States House of Representatives  
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

<b>1. Name:</b>  Mark A. Calabria	<b>2. Organization or organizations you are representing:</b>  Cato Institute
<b>3. Business Address and telephone number:</b>  [REDACTED]	
<b>4. Have <u>you</u> received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?</b>  <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No	<b>5. Have any of the <u>organizations you are representing</u> received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?</b>  <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
<b>6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.</b>          	
<b>7. Signature:</b>  	

*Please attach a copy of this form to your written testimony.*