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AMERICAN INSTITUTE *for* ECONOMIC RESEARCH www.aier.org Vol. LXXVI, No. 12, July 6, 2009

Toolkit for Transparency

The Federal Reserve's arcane accounting system may help mask what could become serious problems in monetary policy. A case in point: the Fed's recently published *Annual Report*.

by William F. Ford, Visiting Research Fellow, and Walker Todd, Research Fellow

The scale of the Federal Reserve's extraordinary operations during the past year shows through clearly in its balance sheet and income statement, as recently published in its *Annual Report 2008*. Nevertheless, the new *Annual Report* and associated Fed reporting documents still fall far short of the disclosure standards that any American corporation would be expected to observe.

During 2008, the first full year of the recession, the Federal Reserve System expanded its balance sheet by $1.33 trillion, a 145 percent increase. The Fed also took on hundreds of billions of mortgage-linked assets with high default risks, often in exchange for its own low-risk, short-term U.S. Treasury assets. In combination, the scale and complexity of the Fed's recent activities raise a host of new issues about its mission and responsibilities.

Yet outsiders (including the Congress) face an artificial barrier to understanding in the form of the Fed's distinctive in-house accounting standards. The Fed's monetary and lending operations could be made more transparent, in part through requiring them to use the same accounting standards as commercial banks and other private companies.

Private firms must use Generally Accepted Accounting Principles (GAAP) to comply with the requirements of their annual audits. The Fed uses its own in-house, non-GAAP accounting standards that are defined in the Financial Accounting Manual for Federal Reserve Banks (FAM).

FAM standards make it harder for analysts to evaluate the increased risk to taxpayers from the Fed's recent initiatives.

FAM standards make it harder for outside analysts to evaluate the increased risk to taxpayers from the Fed's recent initiatives. They may also obscure the possible future inflation risks inherent in the Fed's new and sharply revised financial profile.

Prior to their dramatic transformation during 2008, the Fed's financial reports were fairly simple to understand, even though they were non-GAAP compliant.

The lack of GAAP conformity in bookkeeping procedures has hardly mattered in the past because the Fed's annual balance sheet and income statements did not entail serious transparency issues. The asset side of the 2007 balance sheet consisted mainly of U.S. Treasury securities, plus its holdings of (grossly undervalued) gold certificates, a relatively small amount of discount window advances to banks, and the System's real estate premises and equipment. (The balance sheet may

AIER | July 2009 Business-Cycle Conditions

Mild increases in the latest data for several of AIER's primary leading indicators are neither large enough nor of sufficient duration to change the overall picture. They do not yet signal a turnaround.

See our Business-Cycle Conditions section inside for AIER's detailed analysis.

Percentage of AIER Leaders Expanding

18

unchanged

Inside this report Thomas Sowell's new book, *The Housing Boom and Bust,* examines one origin of our current economic troubles. AIER Senior Fellow Richard Ebeling reviews Sowell's critique of the federal government's push to create affordable housing and increased homeownership. See back page.

Also Are web-based legal services useful? Attorney Steven J.J. Weisman weighs in. See page 3.

be viewed online at www.aier.org in the Research Commentary for July 6.)

The liability side of the balance sheet also used to be easy to understand. It consisted mainly of the Fed's outstanding currency issue, the reserve accounts of depository institutions, and the Treasury's general account deposits.

On the same side of the ledger, the Fed's capital account was simple to present—even if never quite free of sensitive political and accounting issues. These concerned, for example, the way that current income was allocated to cover losses or to be used for additions to surplus (which are comparable to a private company's retained earnings).

Until 2008, the Fed's income statements were also transparent. Most income was generated from interest payments earned on huge holdings of U.S. Treasury securities, augmented by some fee income from services delivered to government agencies and depository institutions, plus foreign currency transaction gains or losses. From such holdings, the Fed then subtracted the operating expenses of the twelve Federal Reserve Banks and the Board, and made relatively small additions to capital and surplus.

In 2007, the Fed reported the largest profit ever, $39 billion. This made the Federal Reserve appear to be one of the world's most profitable entities. Most of that 2007 income, $35 billion, was recycled back to its principal source, the U.S. Treasury, as "Interest on Federal Reserve Notes." This recycling of Treasury monies, without Congressional intervention, is the main mechanism that provides the Fed's financial independence from the Congress.

All these accounting matters became much more complicated from mid-2007 on. In practice, the rapid expansion of the Fed's assets took place via some major changes in the credit risk and liquidity profiles of the balance sheet. The net effect was to make financial reports far less transparent. Outside observers now have to read between the lines to be able to estimate the real costs and benefits of the Fed's recession-fighting programs.

Consider two examples of the increased complexity and lack of transparency on the Fed's balance sheet. One is from increased leverage, as measured by the ratio of its liabilities to its reserves. This is a matter of aggregates. The second involves a deterioration in the quality of the newly added assets. As a matter of composition, then, the balance sheet now exhibits a rising share of high-risk (typically mortgage-linked) assets.

The use of leverage increased dramatically during 2008, from 24:1 to 53:1. This left the Fed with about the same tiny capital ratio as Fannie Mae, Freddie Mac, and Bear Stearns just before they all failed. Unlike these firms, however, the Fed cannot fail, regardless of the appearance of capital insufficiency, because its obligations are backed by the full-faith-and-credit of the federal government—in short, by the power to tax.

Outside observers now have to read between the lines to be able to estimate the real costs and benefits of the Fed's recession-fighting programs.

Still, under the Federal Deposit Insurance Corporation Improvements Act of 1991 (FDICIA), any commercial bank with so little capital, below 2 percent of assets, would be subject to prompt corrective action, including seizure by the federal bank supervisory authorities. The Fed would have had to add over $54 billion to its capital accounts during 2008 to maintain the same approximately 4 percent capital-to-assets ratio as at year-end 2007. It added only $2.6 billion. This was actually less than the $3.1 billion added in 2007, when the balance sheet was much smaller.

An important difference between GAAP and the Fed's FAM is the absence of reserves for loan losses stemming specifically from the Fed's large and growing pool of high-risk assets. Commercial banks holding similar assets without sufficient reserves would have been criticized severely by the Fed's own examiners. The general consensus is that the Fed holds these assets primarily because commercial banks, investment banks, and insurance companies do not wish to hold them.

The average amount of year-end reserves for loan losses of all FDIC-insured banks in 2008 was 1.2 percent of assets. A comparable measure at the Fed would have caused an expense provision of $26.9 billion. Instead, a comprehensive loss of only $4.7 billion was recognized and charged against current income. This, despite the Fed's new holdings of a much riskier array of assets than the short-term Treasury securities that formerly dominated the balance sheet.

While not strictly a matter of accounting standards, a further reason for concern about the Fed's lack of transparency is the problem of its so-called exit strategy. In a nutshell, this concerns how and whether Ben Bernanke and company will manage to neutralize the roughly $800 billion in excess reserves that have piled up in commercial banks around the country over the past year or so. The fear is that such excess reserves will eventually lead to excessive lending (once again) and more price inflation.

During 2008, the $1.3 trillion expansion of the Fed's balance sheet

Continued on page 3

Co-author **William F. Ford** holds the Weatherford Chair of Finance at Middle Tennessee State University and was a president of the Federal Reserve Bank of Atlanta.

AIER | Business-Cycle Conditions, July 2009

Upticks Do Not Alter the Trends

Although several leading indicators show mild increases, the long view does not signal a change in the economic climate.

by Polina Vlasenko, Research Fellow

Recent increases in various economic indicators have led many commentators to suggest that perhaps the recovery is in sight. AIER's primary leading indicators, however, do not yet signal a turnaround. To the contrary, revised data indicate that the gross domestic product, which represents the output of goods and services produced in the United States, fell by 5.5 percent in the first quarter of 2009. The national unemployment rate stood at 9.4 percent in May, the most recent month for which data is available.

Several mild increases did appear in the latest data for some of the primary leading indicators. But these increases are very small and have lasted only one or two months. They do not change the overall picture. The percentage of leaders expanding remains at 18, unchanged from last month. The cyclical score of the leaders increased somewhat, from 29 last month to 33 this month. A value below 50 for all of our measures indicates that contraction is more likely than a recovery.

Our methodology leads us to be cautious. Every economic series exhibits random fluctuations from month to month. Meaningful conclusions cannot be drawn from them. We smooth out the fluctuations by averaging data over several months to isolate the cyclical trend. Series

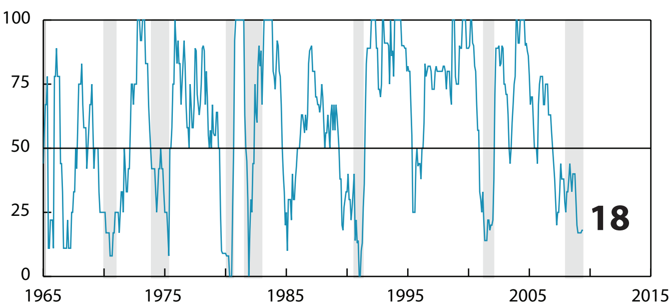
Statistical Indicators of Business-Cycle Changes

Change in Base Data Feb.	Mar.	Apr.	May		*Cyclical Status* Apr.	May	Jun.
				Primary Leading Indicators			
-	+	+	+	M1 money supply	+	+	+
+	+	+	+	Yield curve index	+	+	+
nc	+	+	+	Manufacturers' supply prices	-?	?	?
-	-	+		New orders, consumer goods	-	-	-
+	-[r]	-		New orders, core capital goods	-	-	-
+	-	-	+	New housing permits	-	-	-
+	+			Ratio of sales to inventories	-	-	-
+	-	+	+	Vendor performance	-	-	-?
-	-	+	+	Index of common stock prices	-	-	-
-	-	+	-	Average workweek, mfg.	-	-	-
-	-	+	-	Initial claims, unemplmt. insurance*	-	-	-
-r	-	-		Change in consumer debt	-	-	-
				Percentage expanding cyclically	*17*	*18*	*18*
				Primary Roughly Coincident Indicators			
-	-	-	-	Nonag. employment	-	-	-
-	-	-	-	Index of industrial production	-	-	-
-	-	+		Pers. income less transfer payments	-	-	-
-	-r	-		Manufacturing and trade sales	-	-	-
-	-	nc	-	Civilian emplmt. to population ratio	-	-	-
-	-			Gross domestic product	-	-	-
				Percentage expanding cyclically	*0*	*0*	*0*
				Primary Lagging Indicators			
nc	-	-	-	Avg. duration of unemployment*	-	-	-
-	-			Manufacturing & trade inventories	-	-	-
-	-	-		Commercial & industrial loans	?	-?	-
-	-	-		Ratio of cons. debt to income	?	?	-?
-	+			Chg. in labor cost/output, mfg.	+	+	+
+	-	-	nc	Short-term interest rates	-	-	-?
				Percentage expanding cyclically	*25*	*20*	*17*

nc No change. [r] Revised. * Inverted. Under "Change in Base Data," plus and minus signs indicate increases and decreases from the previous month or quarter and blank spaces indicate data not yet available. Under "Cyclical Status," plus and minus signs indicate expansions or contractions of each series as currently appraised; question marks indicate doubtful status when shown with another sign and indeterminate status when standing alone.

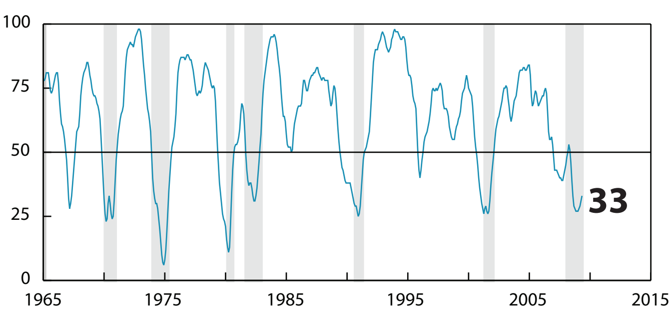
AIER Leaders Expanding and Cyclical Score Charts

Percentage of AIER Leaders Expanding



The percentage of leaders expanding is based on the analysis of 12 statistical series that move reliably in advance of general business activity. The cyclical score is based on a separate, purely mathematical analysis. For each measure, a score below 50 indicates a contraction is likely.

Cyclical Score of AIER Leaders

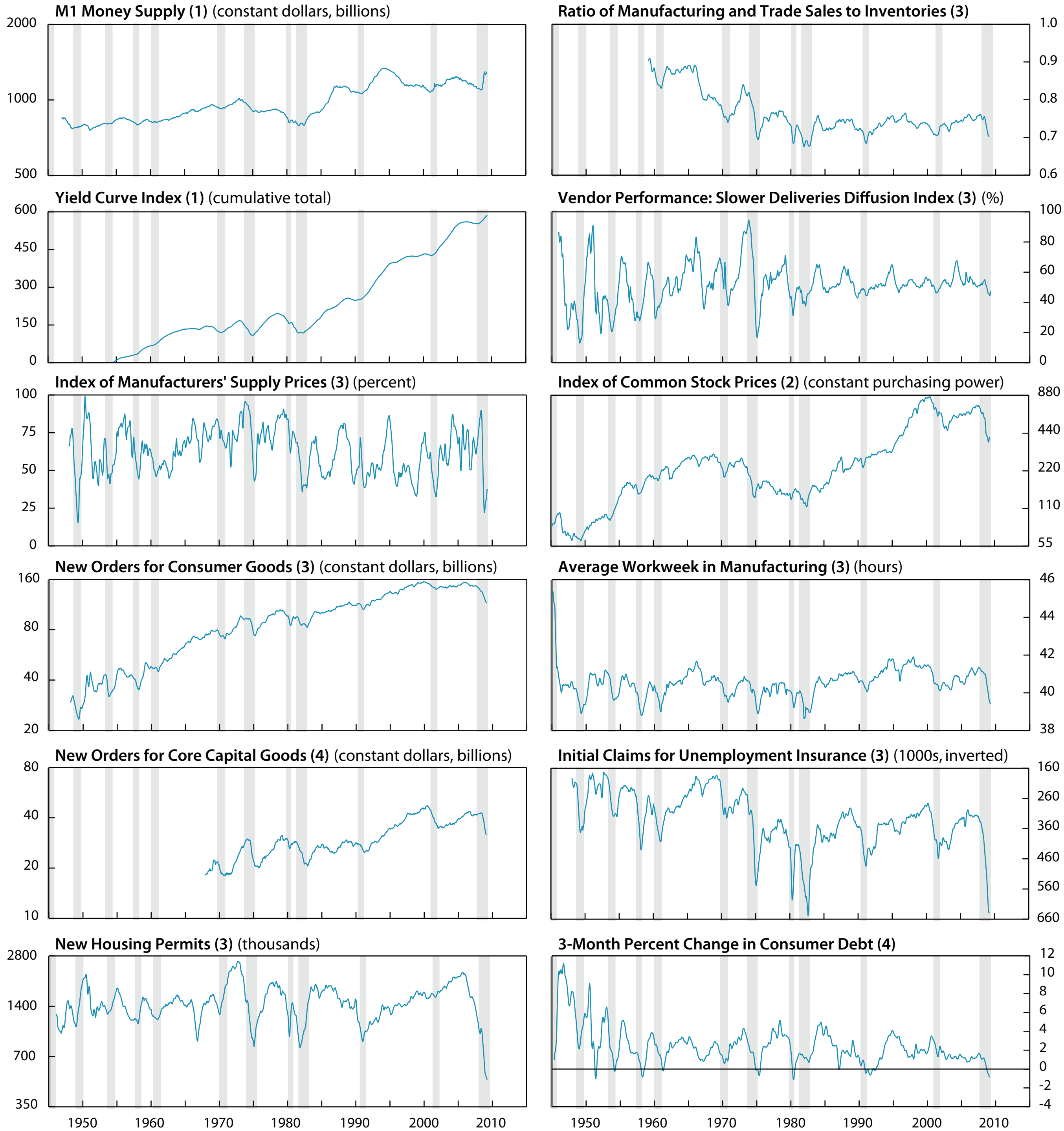


with larger random fluctuations require averaging over more months than do less volatile series. As an example, the chart on page SI—3 shows how the series for *new orders for consumer goods* is smoothed to isolate the cyclical trend.

The most recent data point on the chart shows an increase in April (see the chart's black line). But similar upticks—in June 2008, October 2007, and August 2006, for example—did not reverse the overall downward trend. Therefore, the April increase alone cannot be taken as an indication that a new upward trend has begun.

New orders for consumer goods is a volatile series. We smooth the data by creating a three-month moving average (the blue line on the chart). New orders for consumer goods increased in April, but according to our methodology this increase is indistinguishable from a

Primary Leading Indicators



random month-to-month fluctuation. The overall trend in the series is still downward, and the series remains appraised as clearly contracting.

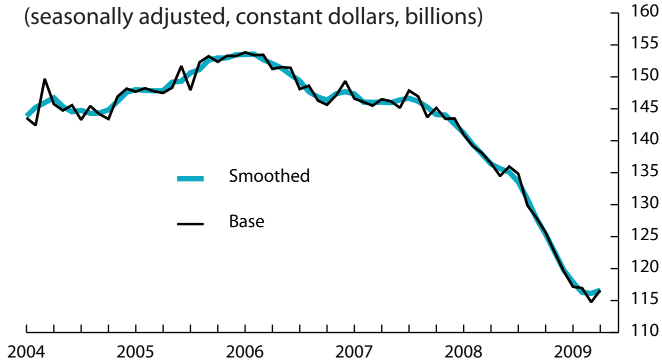
Several other primary leading indicators show similar patterns. There are increases in the data in the last month or two. But the increases are so small that they are indistinguishable from random fluctuations and do not warrant a change in appraisals. These series are: *new housing permits*, *the ratio of manufacturing and trade sales to inventories*, *the index of common stock prices*, *the average workweek in manufacturing*, and *initial claims for state unemployment insurance* (inverted). All these series remain appraised as clearly contracting.

We changed the appraisal of one series among the primary leading indicators. *Vendor performance*—the percentage of purchasing agents who experience slower deliveries in the current month compared with the preceding month—has increased in three out of the past four months. In May, the increase was sizable. This prompted us to upgrade the appraisal of the series from clearly to probably contracting.

The only leaders appraised as expanding are *M1 money supply* and the *yield curve index*. Both these series continue expansions that began at least a year ago.

The index of manufacturers' supply prices has been increasing for five months. However, the series is historically too volatile to conclude that an increase of such duration is a definite sign of an impeding expansion. Thus, the series remains appraised as indeterminate.

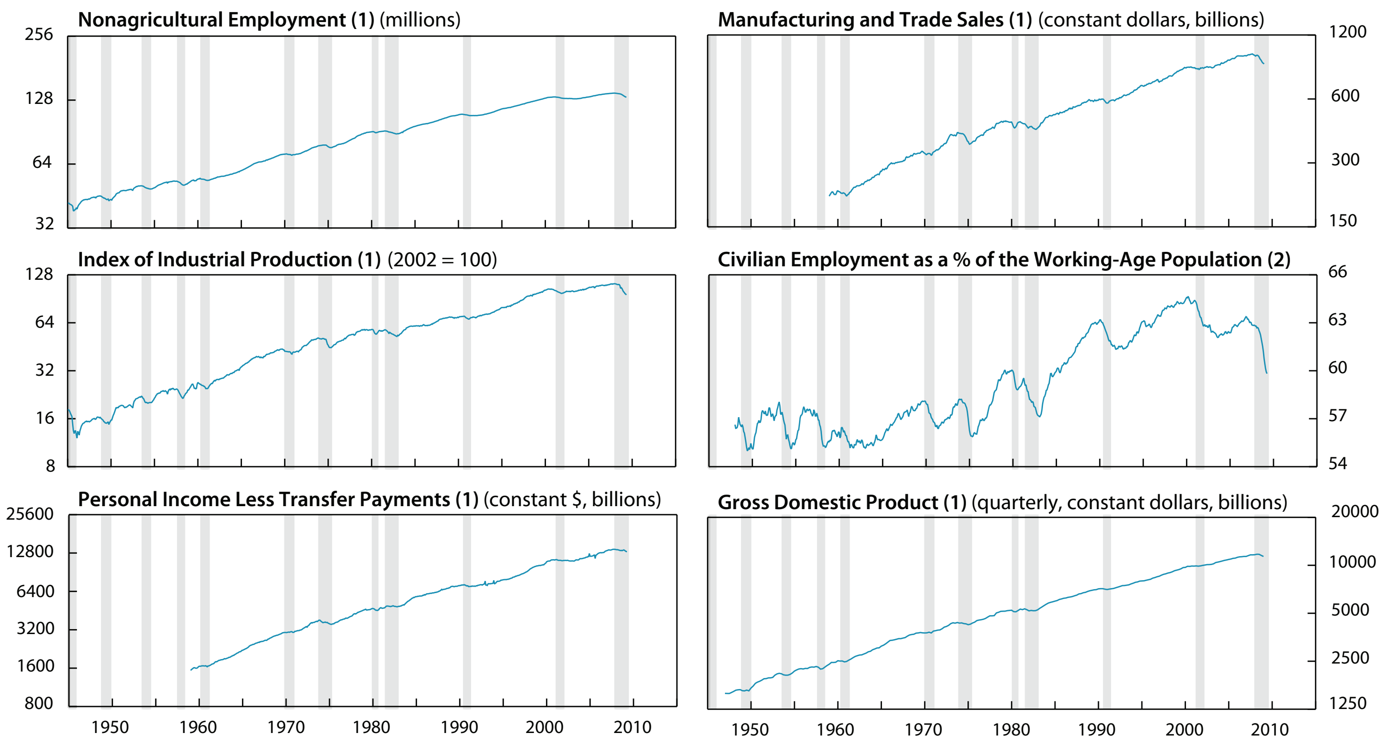
New Orders for Consumer Goods
(seasonally adjusted, constant dollars, billions)



A continued decrease in the three-month percentage *change in the consumer debt* shows that consumers continue to reduce their borrowing. From February to April, consumer debt outstanding fell 1.68 percent, the largest three-month decrease since June 1980. Either consumers are becoming more prudent or credit is becoming more difficult to obtain, but either way the burden of outstanding consumer debt is getting reduced.

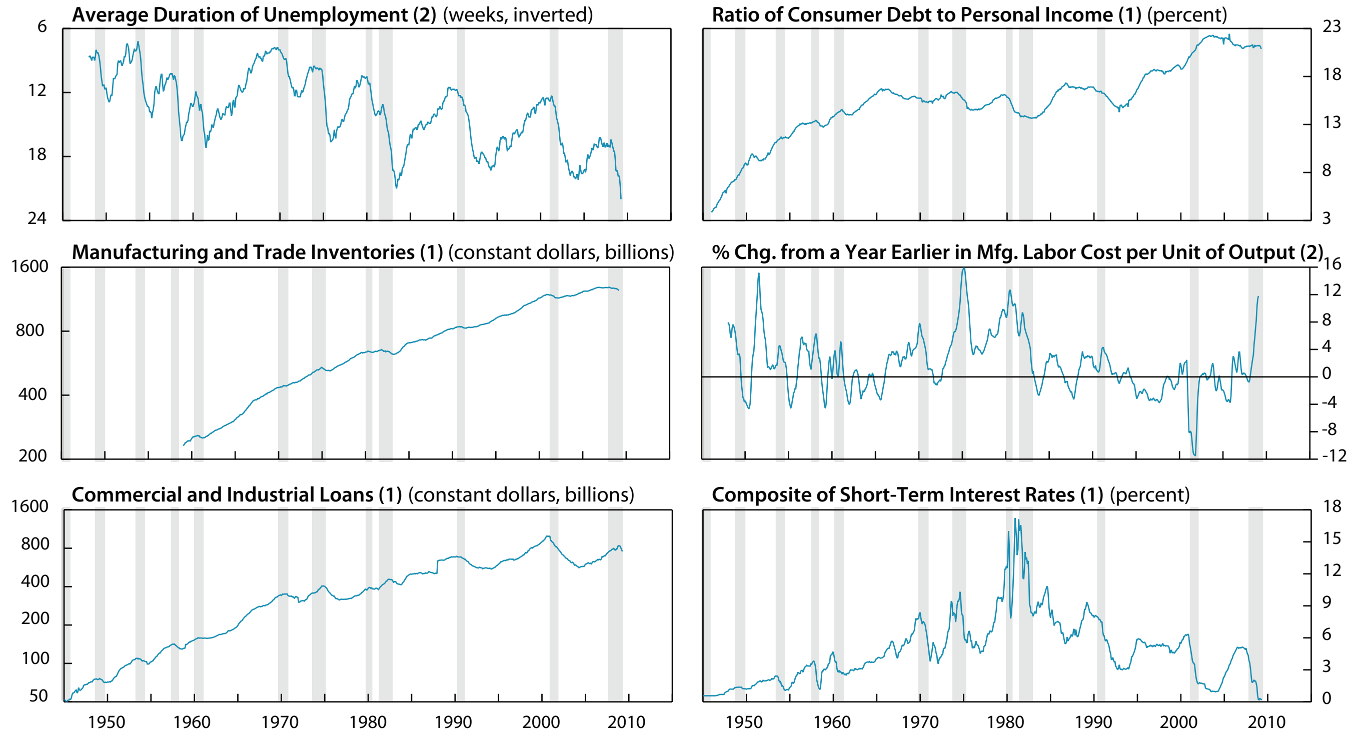
Among the roughly coincident indicators, the only

Primary Roughly Coincident Indicators



Notes: 1) Shaded areas indicate recessions as dated by the National Bureau of Economic Research. 2) The number in parentheses next to the name of a series is an estimate of the minimum number of months over which cyclical movements of a series are greater than irregular fluctuations. That number is the span of each series' moving average, or MCD (months for cyclical dominance), used to smooth out irregular fluctuations. The data plotted in the charts are those MCDs and not the base data.

Primary Lagging Indicators



increase in the data is a tiny, 0.06 percent, increase in *personal income less transfer payments* in April. The increase is so small that it does not warrant a change in the appraisal of the series. The February increase in *manufacturing and trade sales* reported last month has since been revised. The new data show that the manufacturing and trade sales decreased in February.

The percentage of coinciders expanding remains at zero. The cyclical score of coinciders increased, from 2 last month to 11 this month, but still remains very low. The primary roughly coincident indicators strongly confirm that the economy is in recession.

Among the primary lagging indicators, the *average duration of unemployment* increased to 22.5 weeks in May—the longest it has ever been in postwar history. The extension of unemployment insurance payments may have contributed to the lengthening duration of unemployment. The series, inverted for analysis, remains appraised as contracting.

Firms continue to reduce their inventories and their borrowing. Both *manufacturing and trade inventories* and *commercial and industrial loans* continue to shrink. Firms have to bring inventories into alignment with sales and reduce their borrowing to a more manageable level before economic recovery can begin. Commercial and industrial loans have been falling for five consecutive months, prompting us to change the appraisal of the series from probably to clearly contracting.

In recent months, consumer debt has been falling, but so has personal income, making it difficult to see the trend in the *ratio of consumer debt to personal income*. However, since the ratio has been falling for three months, we downgraded the series from indeterminate to probably contracting.

The extreme expansionary monetary policy pursued by the Federal Reserve for the past year has lead to an unprecedented situation with interest rates. The *composite of short-term interest rates*, which is a monthly average of the 30-day commercial paper rate and the 3-month Treasury bill rate, remained constant in May at 0.22 percent, a level essentially not seen in the postwar period. Because interest rates cannot fall below zero, the cyclical status of this series is difficult to determine.

We do not expect the series to decrease much further simply because interest rates do not have that much lower to fall. Appraising the series as clearly contracting seems inappropriate.

At the same time, interest rates are unlikely to rise, especially given that the Federal Open Market Committee left its target for the federal funds rate unchanged at 0-0.25 percent at its most recent meeting on June 24. Therefore, the appraisal of the series was changed to probably contracting.

The three changes among the laggers—for commercial loans, the ratio of consumer debt to income, and short-term rates—brought the percentage expanding down from 20 last month to 17 (one out of six) this month. The cyclical score has fallen from 37 last month to 30. The primary lagging indicators show that the economy is working through some of the imbalances, which is necessary before recovery can begin.

Continued from page 2

was accompanied by a $901 billion addition to the Fed's monetary base (construed as currency in circulation plus commercial bank reserves). As a result, the reserve accounts of depository institutions rose from $21 billion to $860 billion. But the amount of currency in circulation rose by only $62 billion (about 8 percent). That left *excess reserves* on the order of $800 billion above the amounts required for depository institutions to meet their legal reserve requirements.

Currently, the Fed pays depository institutions interest on excess reserves at a rate much lower than 1 percent (100 percent of the Federal funds rate, which is 0.25 percent per year at this writing). When and as the economy recovers from the current recession, the demand for bank loans also will recover. At that point the excess reserves could become the fuel for an explosion of bank lending, with accompanying inflationary pressures.

To be fair, proponents of the Fed's current policy argue that the overall U.S. and global economies are so weak (and will remain so for the foreseeable future) that the inflationary surge either will not occur or can easily be counteracted when it does occur.

In addition, some observers think that the Fed can simply raise short-term interest rates as one step toward neutralizing inflationary tendencies. But there are grounds for skepticism about the Fed's capacity or willingness to raise these rates high enough and fast enough to restrain the inflationary surge that the excess reserves could produce.

Then there is the problem of unloading the toxic assets once financial markets recover more fully from their fear of mortgage-linked assets. But the market is thin for many of the assets that the Fed recently purchased or that secure its recent loans. Selling them to shrink the Fed's balance sheet and mop up some of the excess reserves now in the banking system will not be easy. Even if the Fed could find buyers, it would incur capital losses in selling those assets, both because of their low quality and because of expected higher market interest rates at the time of sale than at the time of purchase.

One further problem on the horizon concerns the differences in liquidity between the Fed's assets and its liabilities. Such duration mismatches arise from the Fed's recently announced program of accumulating $1.25 trillion of federal agency (such as Fannie Mae and Freddie Mac) mortgage-backed securities, $200 billion of agency debt, and $300 billion of long-term Treasury securities. Against these less liquid assets, the Fed holds short-term liabilities in its commercial bank deposit balances subject to withdrawal on demand.

In sum, the Fed appears to be glossing over some serious future monetary policy problems. It has roughly doubled the size of the assets on its balance sheet by accumulating risky, largely mortgage-linked assets.

The Fed should stop using the arcane and non-GAAP accounting protocols embodied in the FAM. Using the FAM in the current financial environment may result in politically expedient misstatements of the true financial costs and benefits of the Fed's recession-driven interventions in risky financial markets.

Congress should consider asking the following three questions while overseeing the Fed's activities: Why *not* subject the Fed to normal, GAAP-compliant accounting standards? Why is the Fed certain that it easily and readily could shrink its balance sheet the next time that inflation rears its head?

Last and not least, why should the Fed not be required to prepare and give Congress and the public financially transparent quarterly GAAP-compliant reports of the Fed's financial operations?

Ask the Expert

Online Lawyering

While driving, the problem with many short cuts is that they merely get you lost and more confused than if you followed the map and directions you knew to be accurate. The same applies to short cuts with legal services.

A number of websites, such as LegalZoom, offer discounted legal services and forms in areas of the law such as wills, trusts, durable powers of attorney, corporation documents, leases, and divorce. Their advertising trumpets the ease and efficiency of their forms, but if you read the fine print disclaimers (which themselves are unintelligible without a lawyer), you will find what they provide is not legal advice, but merely what they call "general information on legal issues commonly encountered."

This is not to say that you cannot do your own legal work sometimes. The problem is that without legal training, it often is difficult or even impossible to know when those times are.

The risk of doing yourself substantial harm by relying on websites for legal advice is great. The mere phrase in a divorce agreement that it shall be "incorporated and merged" into the court's judgment can determine whether the divorce agreement may ever be able to be modified if circumstances change. Non-lawyers and even lawyers who do not practice divorce law will not know this.

You can use these websites to make yourself a better informed consumer when you engage the services of a lawyer, but otherwise, let the buyer beware.

—Steven J.J. Weisman is a lawyer and author. His website is www.stevelaw.net.

To submit questions for future columns, email asktheexpert@aier.org. For guidance on specific situations, consult your lawyer or financial advisor.

A Collapse Made in Washington

In his new book, *The Housing Boom and Bust*, noted economist Thomas Sowell examines the federal government's role in creating the housing crisis.

by Richard M. Ebeling, Senior Fellow

The epicenter of the current economic crisis has been the U.S. housing market.The collapse of the subprime mortgage market and the dramatic fall in home values have sent out shock waves of economic disruption around the world.

Many have interpreted these events as another example of the inherent instability of the free market. There have been loud calls for greater and more detailed government regulation of the mortgage business and financial markets in general.

But before hasty policy decisions are made, it is always useful to step back and carefully look at the facts. How, actually, did this housing market horror story come about, and what government policies may have helped to set this disaster in motion?

The story is told with great persuasive clarity in *The Housing Boom and Bust* (Basic Books, $25) by economist Thomas Sowell, who is a longtime senior research fellow at the Hoover Institution on the campus of Stanford University.

Sowell explains that the federal government began a huge regulatory push to create affordable housing in the 1990s, under the presumption that the cost of acquiring a home was out of reach for a growing number of American families.

However, he shows that in general, average American incomes were keeping up with or even exceeding the cost of buying a home in most of the U.S.

The only problem areas were in places like California, where regulations on land development and home building were making land increasingly scarce and more costly to buy.

Prominent Democratic and Republican members of Congress and both President Clinton and President Bush put pressure on lending institutions to lower their credit rating standards, reduce the minimum down payment requirements (in a growing number of cases, to zero), and introduce short-term flexible monthly payment methods that would only increase later.

> **The tragedy of forcing banks to make home loans to people not financially able to bear the costs is that foreclosure rates are highest for this segment of the population.**

Often under the intimidation of bank and mortgage market regulators, financial institutions greatly increased their lending to targeted socio-economic groups that were less credit worthy because of fears that they might otherwise be hit with anti-discrimination lawsuits.

As Sowell points out, the tragedy of forcing banks to make home loans to people not financially able to bear the costs of a house, once times turned even moderately bad, is that foreclosure rates are highest for this segment of the population.

Two major vehicles for the growth of this unsustainable housing bubble were the semi-governmental agencies, Fannie Mae and Freddie Mac.

Congress and the White House pressured both agencies to extend loan guarantees or buy up the mortgages of these credit-unworthy borrowers, until finally before the housing crash last year these two agencies held or guaranteed around 50 percent of all the home loans in America.

The irresponsibility of Fannie Mae and Freddie Mac, and those in Congress who pressured them to go out on this limb, has been shown by their formal takeover by the government and the huge sums of taxpayer's money that it has cost to maintain their solvency.

What also fed this housing market frenzy, Sowell explains, was the monetary policy of the Federal Reserve.

In 2003 and 2004, the central bank artificially kept interest rates at historically low levels.

Even when adjusted for inflation, for part of the time, interest rates were zero or negative. Mortgage rates were pushed down to barely 2 or 3 percent in real terms.

If there is a lesson to be learned from the facts of the housing crisis, Sowell says, it is that its cause has been misguided and intrusive regulations and political pressures, and not any inherent weakness or instability in the market.

AIER | gold corner

Price of gold, July 2, 2009, London PM fix.

Research Reports (ISSN 0034–5407) (USPS 311–190) is published twice a month (except for combined issues in January and August) at Great Barrington, Massachusetts 01230 by American Institute for Economic Research, a nonprofit, scientific, educational, and charitable organization. Periodical postage paid at Great Barrington, Massachusetts and additional offices. Sustaining memberships $59 per year. POSTMASTER: Send address changes to *Research Reports*, American Institute for Economic Research, Great Barrington, Massachusetts 01230.