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Statement by

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before the

Committee on Banking, Housing and Urban Affairs

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My appearance before this Committee today represents an opportunity to present and discuss the expenditures and budgets of the Federal Reserve Banks and Board of Governors. In this statement I shall supplement the statistical information already sent to the Committee by providing a broad-based review of the amount and character of System expenditures and of the progress achieved in improving productivity, cost effectiveness, and quality of service.

The Federal Reserve System serves the nation, its Government, the banks, and the general public, in a variety of ways. First, as the nation's central bank, the Federal Reserve formulates and implements national monetary and credit policy. Second, as the banker to the Government, the Federal Reserve issues, redeems, and exchanges Government securities, handles most of the Government cash balances, and provides processing capability for tax payments and food stamps. Third, as a service to the banking system and the general public, the Federal Reserve issues and redeems currency and coin, and clears and processes personal and business checks. Finally, as a part of the bank regulatory structure of the nation, the Federal Reserve examines, regulates, and supervises bank holding companies, state chartered member banks, and all Edge Act Corporations. The Federal Reserve provides these various services through a network of 50 offices employing over 26,000 people.

The System operating budget for 1977 amounts to $753.4 million[1/] or 7.6 percent over 1976 expenditures. Of this current year budget, the Board's assessment accounts for $48.6 million or 6.5 percent, while the Federal Reserve Bank expenses are expected to reach $704.8 million. System expenditures have increased at an annual average growth rate of 11.5 percent from 1970 to 1977 and at an 8.5 percent rate from 1974 to 1977. For comparison, it should be noted that expenditures of the Federal Government have risen at an annual average rate of 15.9 percent in this recent 3-year period.

While maintaining this relatively good cost control position, the System has undertaken new responsibilities assigned by Congress, has met sharp increases in bank supervisory work and rising volumes of operational work at the Federal Reserve Banks, and has absorbed the impact of inflation upon wage, material, and service costs.

Among the principal changes in System responsibilities resulting from Congressional action, have been the new supervisory activities required by the 1970 Amendments to the Bank Holding Company Act. All one-bank holding companies formerly exempt from provisions of the Act were brought under the System's jurisdiction

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1/ Net 1977 operating expenses (after reimbursements and recoveries) are expected to be $698.6 million.

by those Amendments. Thus, in 1971 the System's regulatory responsibility was increased to cover all 1,500 bank holding companies contrasted with the 121 multi-bank holding companies supervised by the System at the end of 1970. Since then, the number of bank holding companies has increased to slightly more than 1,900 which control about two-thirds of the bank deposits of the nation. This increase in the number of holding companies in conjunction with the new requirement to apply for permissible nonbank activities led to a mushrooming application load for the System. From May 1956, when the Bank Holding Company Act was first implemented, through December 1970, the System acted on 470 bank holding company applications, an average of 32 per year. From 1971 through 1976, the System acted on 5,079 applications, an average of 846 per year.

In addition to the processing of holding company applications, the System was assigned on-going supervisory responsibilities for bank holding companies. The Federal Reserve has had to monitor the activities of these firms, and to do this has increased its examination staff, expanded training for examiners, and has created an extensive financial reporting arrangement to support a computer-based surveillance system.

Turning to another bank supervisory area, there has been a dramatic growth in the international activities of U.S. banks in the past few years. The total assets of foreign branches of U.S. banks increased from $52 billion in 1970 to over $180 billion by year-end 1976. U.S. banks were also expanding through foreign subsidiaries. By year-end 1975 these subsidiaries had total assets of $30 billion. Federal Reserve approval is needed for both the opening of foreign branches and the investment in foreign subsidiaries. The Federal Reserve also has on-going supervisory responsibility over the operations of foreign subsidiaries and the foreign branches of State-member banks.

The Federal Reserve also has supervisory authority over State-chartered banks which are members of the Federal Reserve System. In the past six years, total assets held by State member banks have increased sharply, and the scope and complexity of their operations have increased as well. Such growth has placed a greater burden on the System's examination resources.

Another major area of responsibility assigned by the Congress is the enlarged System role in the consumer credit field. The Board is the principal agency charged with writing regulations to implement Federal legislation to protect consumers and prevent discrimination in consumer credit extensions. The Board first became involved in writing consumer protection regulations with passage of the Federal Truth in Lending Act in 1968 and since 1969, there have been four major Amendments to Truth in Lending, including the Fair Credit Billing Act of 1974 and the Consumer Leasing Act of 1976, all of which required extensive rule-writing by the Board. In addition, the Board has the responsibility for drafting regulations implementing five other consumer protection Acts: the Equal Credit Opportunity Act of 1974, the Real Estate Settlement Procedures Act of 1974 (RESPA), the Federal Trade Commission Improvement Act of 1975, the Home Mortgage Disclosure Act of 1976, and the 1976 Amendments to the Equal Credit Opportunity Act.

The System has experienced increases in volume in all functions, but especially in wire transfers of funds, currency distribution and destruction, and food stamp and check processing. The volume of wire transfers handled by the Reserve Banks increased 182 percent from 1970 to 1976. The wire transfer system, in conjunction with the Federal Reserve's book-entry system, supports the trading of Government securities by providing a convenient mechanism for transferring ownership of these securities. In addition, the wire system handles nearly 75,000 funds transfers each day, representing more than $150 billion in bank-to-bank transfers. This wire system provides the means by which the nation's financial system settles its business transactions each day in Federal Funds and facilitates better cash management, thereby improving services to customers and the general public.

Currency processed rose 33 percent in the period from 1970 to 1976. New innovative methods are under development to meet this increasing volume. For example, the System is currently developing new high-speed currency equipment that should result in further gains in productivity in handling currency volumes as well as yielding improvements in the currency verification and destruction process.

In 1971, legislation extensively revising the Food Stamp program resulted in a 44.8 percent increase in the volume of food stamps processed and destroyed by the Federal Reserve over 1970 levels. The 2.0 billion food stamps processed and destroyed in 1976 represent a 58.2 percent increase over the 1970 level, requiring additional personnel, destruction equipment, and storage facilities.

The System presently handles about 50 million checks per day or 85 percent more than in 1970. While computer processing has materially improved productivity, the problems of handling this increased volume have required additional personnel and raised costs since such operations remain labor-intensive. A concentrated search for new and better ways of dealing with this rising flood of paper has paid off in better service to the public and a slower rate of growth in expenses over the past few years. To improve the payments mechanism, the System has established 11 new regional check processing facilities since 1970 and has adjusted operating schedules and transportation arrangements to provide for more rapid clearing of checks and a reduction of check clearing float. Concurrent with these service improvements, the System undertook an extensive operations improvement program which has kept unit cost increases for check processing below the rate of inflation.

The Federal Reserve has taken positive steps to encourage conversion from costly paper checks to more efficient electronic payment. Together with the U.S. Treasury, the System has established a program of Direct Deposit of Recurring Federal Payments which allows recipients of Government payments to have their paychecks, benefit payments, and welfare payments deposited directly to their accounts at any financial institution through the use of the Federal Reserve data processing and communications facilities. Approximately 5.5 million government payments are currently made this way each month, providing a high level of security, convenience, and reliability, while reducing Government disbursement costs by approximately $7 million annually.

As an alternative to making commercial payments by check, the System in conjunction with its member banks has implemented a program called the Automated Clearing House. This program, endorsed by the National Commission on Electronic Fund Transfers, allows payments to be made in electronic form rather than paper check. It is expected that substantial savings to the private sector as well as to the Federal Reserve will result as more payments are made by electronic means.

Of course, a major cause of increased System expenditures since 1970 has been the very sharp runup in prices that we have been forced to pay for our resources. Since 1970, the Consumer Price Index has advanced at a compounded annual rate in excess of 6 percent and in the last three years the average rate has exceeded 7 percent. Advancing wage rates which stem in large part from inflationary trends have a dramatic impact on System expenditures.

Other costs for such items as machinery and equipment, office supplies, vehicles, and other business-related items have also increased rapidly in this decade. According to the Gross Business Product Fixed Weight Price Index, which is a good indicator of cost increases in the business sector for such resources, these costs have increased by approximately 50 percent since 1970, or at an average annual rate of more than 6 percent.

Let me now turn your attention to our expense categories, especially those for personnel; for postage and expressage; for original cost, shipping, and redemption of Federal Reserve Notes; for heat, light, power, water, and taxes; and for rental of furniture and operating equipment. These five categories account for about 86 percent of the 1977 budgeted expenses of both the Reserve Banks and the Board.

Personnel costs represent the largest object of expense in the System and account for 58 percent of Bank costs and 81 percent of Board operating expenses. Employment in the Federal Reserve System in 1977 is budgeted at 25,178 persons in the Federal Reserve Banks and 1,476 at the Board of Governors, for a total staffing of 26,654, five less than the 1976 level. From 1970 through 1977, the average annual growth rate in employment is estimated at 2.8 percent for the System, but since 1974, employment at the Federal Reserve Banks has declined by 1,389 persons or 5.2 percent. In terms of the 1977 budget for the System, personnel costs are expected to be about 8.8 percent above comparable expenses for 1976. This increase reflects both the rising costs of retirement funding and medical benefits, and allowance for merit and promotional, as well as cost-of-living increases.

The postage and expressage costs of the Reserve Banks are expected to increase about 3.7 percent from 1976 to 1977 and now represent about one-tenth of total costs. Although the System has made intensive efforts to hold down courier and carrier expenses, the impact of rising postal rates and of gasoline, wages, and security costs to the contract courier companies, has led to some increases.

The third major object of expense, the cost of Federal Reserve currency (representing about 7 percent of the Reserve Banks' expenses) is one largely beyond the control of the System since the Bureau of Engraving and Printing sets the price for printing. Such costs are expected to advance about 8 percent over 1976, with both a higher unit price from the Bureau and a larger demand for currency accounting for the advance.

Utilities and taxes paid by the Reserve Banks are also mainly beyond the control of the System. These expenditures have increased as a result of rising energy prices and sharply increasing real estate taxes. Such expenses account for nearly 4 percent of total Bank costs and are expected to advance about 10 percent in 1977.

Finally, rental of furniture and operating equipment, representing over 5 percent of System expenses, is expected to decline slightly from 1976 to 1977. This reduction stems primarily from the conversion of rented to purchased equipment. While such capital purchases are separate from the operating budgets, the depreciation charge is reflected in the budget.

It may be helpful to describe the budget and cost control process which enables the System to plan for efficient use of resources in meeting its responsibilities. The Reserve Bank budget process begins with the development of the System-wide budget objective for the forthcoming year. This percentage rate of increase is set after extensive discussions between the Board of Governors and Reserve Bank Presidents. Factors considered are the specific goals and objectives for the coming budget year, expected inflationary impacts, the current and projected level of Federal Reserve operations and the estimated productivity and cost performance. Approval of the budget objective by the Board of Governors occurs before mid-year.

With the help of a highly competent group of Directors, the Reserve Banks develop their budgets in light of the budget objective. In recent years, a competitive atmosphere on productivity and cost reduction has pervaded the Banks' budget efforts and has resulted in major savings in operating expenses. This Bank budget process culminates in a careful review by the Bank Boards of Directors, who take an intense interest in the progress and relative performance rankings of the Banks.

Receipt of budget information from the Banks begins in September with submission of revised current year expenses and Budget Overviews depicting total budget projections by output service, object classification, and capital outlay. Information is also provided on personnel costs and budget-year and multi-year objectives. The budgets are analyzed by the Board staff and presented to the Board's Committee on Federal Reserve Bank Activities, which is composed of three Board Members. The Committee meets with each Federal Reserve Bank President for intensive review, analysis, and redirection where necessary. Following the budget meetings and with the Committee's guidance in hand, the final detailed budgets are prepared and submitted to the Board for final action in early December.

The budgets of the Federal Reserve Banks include an assessment for the operating and construction expenses of the Board of Governors. These expenditures which form the basis of the assessment are subjected to a separate but similar budget process.

Both the Reserve Bank and Board budget processes include an intensive screening of proposed capital expenditures. Approval of the budgets, however, does not mean final approval of land, buildings, computers or large equipment purchases. Each of these must be separately justified and specifically approved by the Board of Governors.

An added feature of the System's control over expenses is attributable to the sharing of the effort with the Federal Reserve Banks' Boards of Directors. The Chairman of each Reserve Bank Board meets personally each year with the Board's Committee on Federal Reserve Bank Activities to review and appraise the operating efficiency of the Bank and the performance of its senior officers. These conferences permit frank exchanges about the strengths and weaknesses of each Bank and the relative position of each against the performance of others.

Efforts to improve productivity and decrease costs are in the forefront in all of the budgeting and planning guidelines and procedures followed by the Board and Reserve Banks, and we believe that these efforts have succeeded. As an indication of this improvement, actual output per manhour in our measurable output functions was estimated to have increased by almost 12 percent in 1976 following an increase of 6 percent in 1975.

In the conventional check processing area, which accounts for more than 20 percent of Reserve Bank employment, output per manhour increased by 20 percent in 1976, and unit costs for check processing declined by more than 4 percent in spite of higher prices for resources and higher charges for usage of automated equipment. Currency operations have also reflected sharp efficiency gains with unit costs in 1976 declining by more than 5 percent.

Some of the gains in output per manhour, of course, result directly from substitution of capital for labor. However, the unit costs reflect an amortization charge for the cost of capital and the unit costs have been declining in many of our operating areas since 1974.

The Board's staff has made an estimate of the increase in total factor productivity in the measurable functions since 1971. This measure of productivity compares output to the sum of labor and capital inputs and thus weighs the increased cost of capital against the decrease in personnel costs as capital substitution takes place. The System estimate of total factor productivity for 1971 through 1974, matches the estimates that leading economists have calculated for the private sector. Since 1974, however, the System's total productivity has been considerably larger than that estimated for the private sector.

To improve the System's performance, the Federal Reserve Banks have developed and implemented a new expense monitoring and reporting system that will be used, in part, to assess the efficiency of the Banks. With the introduction of PACS (Planning and Control System) in January 1977, the Federal Reserve Banks greatly expanded the number of operational measurements available through their expense accounting system. In addition, for over a year, we have been in the process of testing and evaluating the feasibility of adopting zero-base budgeting in the Federal Reserve System. This budgeting approach entails a thorough review and analysis of all spending decisions regardless of prior year commitments. Although it is too early to predict the outcome of our two pilot tests, we believe the information and analysis generated by using zero-base budgeting may develop alternatives with cost-saving implications and afford decision-makers a wider choice of budget options.

The Board believes that its review and budget processes have created a cost-consciousness throughout the System and that this has resulted in better productivity, cost efficiency, and service to the public. Our developing technological improvements and new budgeting programs offer the possibilities of further progress in the years ahead.

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