1979 Annual Report

FEDERAL RESERVE BANK OF CLEVELAND

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Federal Reserve Bank of Cleveland

Contents

February 29, 1980
Cleveland, Ohio

To Member Banks in the Fourth Federal Reserve District:

We are pleased to present the *1979 Annual Report* of the Federal Reserve Bank of Cleveland. This is a period of unusual change and uncertainty in the nation's economy. Our economic structure is threatened by soaring inflation that erodes savings, penalizes thrift, and distorts our economic decisions. Rising interest rates and sweeping changes in the structure of financial markets have narrowed the membership base of the Federal Reserve System. These problems demand immediate attention and remedy. The president's message in this report discusses the need to respond to the changing financial marketplace and suggests the alterations necessary to resolve the economic problems that confront us.

We wish to take this opportunity to thank all of our member banks, their directors and officers, and the bank personnel for their continued support. All of you have enabled us to meet our commitments for 1979, and we look forward to your assistance and co-operation in the future.

R.E. Kirby
Chairman of the Board

Willis J. Winn
President

A Message from the President

The critical need for a central bank—to assure effective monetary policy and a uniform nationwide payment system—is the same now as when the Federal Reserve System was established in 1913. Now, as then, the nation needs a mechanism that will enable the supply of money to grow at a suitable rate—a rate rapid enough to facilitate full employment and growth of the economy, but not so rapid as to add to inflationary pressures. The Federal Reserve is charged with this responsibility. Now, as then, the nation needs a mechanism that will facilitate payments between buyers and sellers. Although currency can be used for payments, transfers of account balances are a much more efficient and common means of payment. The Federal Reserve provides a mechanism for clearing and settling those transfers among a multitude of local banks so that such payments are uniformly acceptable everywhere in the nation.

The nature of the financial marketplace, however, has changed radically since 1913. Nonbank institutions have developed deposit and deposit-like accounts with payment features closely competitive with those of commercial banks. Electronic transfer and computerized storage of account balances have multiplied the available means of making payments and expanded the range of short-term interest-bearing assets that can be substituted for payment account balances. Soaring interest rates have made noninterest-bearing deposits decidedly less attractive assets, both for bank customers and for banks themselves.

As a result of these developments, the beginning-of-the-century membership structure of the Federal Reserve System has become incompatible with end-of-the-century financial needs. A growing proportion of money is in accounts at institutions that are outside the direct control of the System. Nonbank issuers of payment accounts are denied both membership in the System and direct access to free Federal Reserve services. Voluntary commercial bank membership in the Federal Reserve System is becoming increasingly unprofitable, because the value of free clearing and settlement services is far outweighed by the revenues foregone on required reserve deposits.

The Federal Reserve is caught in a vicious circle. The critical central banking policies necessary to assure noninflationary money growth and a nationwide uniform payment system worsen inequities between member and nonmember banks, causing an exodus of banks from the System. Dwindling membership weakens the foundations required for an effective anti-inflation monetary policy.

The Monetary Policy Problem

Inflation has been accelerating for almost 15 years. In a continuing effort to come to grips with the problem, we have gradually shifted emphasis from traditional control of interest rates toward measures that focus more directly on control of money growth. Our October 6, 1979, policy actions represent another significant step in this direction, but they also highlight the monetary policy problem.

The restrictive policies adopted in October were intended to slow money growth, and slower rates of growth were achieved. However, the actions that slow money growth (higher interest rates and broadened reserve requirements) lift member banks' opportunity cost of holding noninterest-bearing required reserves. This unavoidable by-product of the October 6 policy actions further increases the competitive disadvantage of member banks.

Re-orientation of System procedures toward more direct control of the quantity of reserves supplied to member banks was intended to strengthen our control of money growth. For these new procedures to be effective, however, additional moves involving reserve accounting and the discount mechanism may be required. Such actions may further increase member banks' inconvenience and costs relative to nonmembers, making Federal Reserve membership even less attractive.

Declining membership has become a major problem. Board of Governors Chairman Paul A. Volcker testified before the Senate Committee on Banking, Housing, and Urban Affairs, "During the fourth quarter of 1979 and the first few weeks of 1980, 69 banks with about $7 billion in deposits have given notice of withdrawal from membership. The loss of deposits in this short period exceeds that of any full year. The recent withdrawals by two very sizable banks in Pennsylvania, with more than $3 billion in deposits between them, seems to me especially significant. They show that much larger institutions than before are now prepared to take the step. . . ."

"In more and more areas of the country, continued membership has to be justified to stockholders and customers. Even banks conscious of the importance of a strong central bank and reluctant to give up a national charter find that justification increasingly difficult or impossible in the light of the heavy burden involved."

In addition to declining membership, another factor that weakens monetary control is development of new monies by nonbanks. Regulatory rigidities (such as the prohibition of interest on demand deposits), technological advances (such as computerized account management and telecommunications), and high interest rates have encouraged nonbanks to devise interest-bearing money substitutes over which we have no direct control. Periodically redefining money to include new monies—as we have just done—is only a partial response. The Federal Reserve remains in a reactive position, constantly trying to catch an evolving quarry.

The overall effect of declining membership and proliferating monies is erosion of the basis for our monetary policy control. Without legislation to restructure the Federal Reserve System, we cannot expect to halt the erosion.

The Payment System Problem

When the Federal Reserve System was established, the payment system *was* essentially the banking system. Even though not all banks joined the System, the Federal Reserve has provided the core of a uniform national payment mechanism for more than 65 years. We are responsible for distribution and quality of all coin and currency, for operation of the inter-bank wire transfer service, and for processing more than half of all checks collected.

The unique contribution of Federal Reserve services to the payment mechanism results from certain guarantees:

- nationwide access to a uniform set of payment system services,
- nationwide maximum two-day availability of funds in check collection and next-day availability of funds in automated clearinghouse transfers,

- nationwide collection of any item, regardless of its size and the location of the paying bank,

- nationwide transfer of same-day funds to and from anyone, anywhere.

Direct access to these guarantees, however, is provided only for member banks. As membership declines and new types of money proliferate, most money issuers can access our core services only through remaining member banks.

Competitive equity in the marketplace requires that our services be made available to *all* money issuers on equal terms. To do so while reserve requirements remain a burden borne exclusively by member banks would surely speed their exodus from the System. We cannot broaden access to our services without a legislative restructuring of the Federal Reserve System.

Who Should Pay for Central Bank Services?

During the past year, both the U.S. House of Representatives and the Senate considered legislation dealing with monetary control and payment system problems. Some of the proposed bills would have improved the competitive positions of members by reducing reserve requirements or by paying interest on reserves. Other bills would have extended reserve requirements to all money-issuing institutions. Unfortunately, none of these bills has yet been enacted.

A recurring theme in attempting to restructure the Federal Reserve System is the simple question of who should bear the costs of central-bank monetary and payment system control.

Monetary Policy. With the shift in policy emphasis toward control of money growth, the role of reserve requirements becomes more important. Reserve requirements could limit the quantity of money to a simple multiple of the number of "tickets" supplied by the Federal Reserve in the form of bank reserves. Currently, however, this link between reserves and money is not a dependable basis for implementing monetary policy. Still in place are institutional arrangements that were more suitable for implementing policy based on interest rates:

1. Reserve requirements are not uniform, making it difficult to predict how much money would be associated with a given supply of reserves.

2. Reserve accounting allows member banks to issue money first and then acquire reserves to cover that money two weeks later. Banks thereby predetermine the amount of reserves they receive.

3. The discount mechanism allows banks to borrow—frequently below market rates—reserves needed beyond those supplied through open market operations.

These factors prevent full reliance on the reserve requirement link to guide money growth, but the System is reluctant to modify these arrangements lest it intensify the vicious circle that is eroding the membership base.

A factor external to the Federal Reserve that weakens the role of reserve requirements in controlling money growth is the ability of nonmember money issuers to avoid these requirements. Legislation that would spread reserve requirements among all money issuers would still leave the Federal Reserve in a reactive position, because new kinds of money are continually being developed. As long as technological change, regulatory rigidities, and high interest rates provide continuing incentives, we will have to periodically redefine money and redraw reserve requirement boundaries.

An immutable monetary policy process should not be expected in a changing world. For the foreseeable future, however, effective monetary policy requires that the reserve requirement costs of central bank control be spread among *all* current money issuers, both bank and nonbank.

Federal Reserve Services. Pricing is the preferred basis for distributing Reserve Bank services. Advantages are many. Pricing would prevent overuse of "free" services; stimulate use of new, cheaper payment devices; promote competition in the private sector; maintain efficiency in Federal Reserve Banks themselves; and offset the loss of revenue from a reduced reserve requirement burden.

Financial services of the Federal Reserve embody unique guarantees and, for this reason, form the core of the uniform national payment system. At the heart of the question of how to price is the difficult decision: should only those who directly use Federal Reserve services pay for these guarantees, or should a broader public pay?

If each user were charged the actual cost of each transaction, high-cost users would pay more (either in money or in payment delays) for access to national markets than low-cost users. On the other hand, if total costs were distributed uniformly among all users, Federal Reserve users would pay more for access to national markets than private-service users. In fact, in this case, private suppliers would be able to specialize in serving low-cost users, leaving the Federal Reserve to guarantee service to high-cost users.

A third and clearly the most equitable way to price is uniformly, but at less than full cost. In this case, the broadest possible group—the general public—would share the cost of the subsidy required to guarantee a nationwide uniform payment system.

For more than 65 years, membership and reserve requirements have blended the cost of monetary control with the cost of Federal Reserve services and have passed that cost on to member banks in return for free services. Now it has become imperative to spread the cost of monetary control more equitably among all money issuers. Efficiency and equity require that our services be priced explicitly, although carefully, lest our public service guarantees be priced out of the market. Effective monetary policy and a uniform nationwide payment system demand a restructuring of the Federal Reserve System in these directions.

COMPARATIVE STATEMENT OF CONDITION

ASSETS	December 31, 1979	December 31, 1978
Gold Certificate Reserves	$646,050,000	$921,035,900
Special Drawing Rights Certificates	149,000,000	112,000,000
Coin	42,406,758	32,976,197
Loans to Member Banks	54,700,000	31,050,000
Federal Agency Obligations - Bought Outright	660,000,825	657,107,398
U.S. Government Securities:		
Bills	3,634,652,454	3,508,654,478
Notes	4,538,501,435	4,565,303,131
Bonds	1,169,091,069	1,037,381,316
Total U.S. Government Securities	9,342,244,958	9,111,338,925
Total Loans and Securities	10,056,945,783	9,799,496,323
Cash Items in Process of Collection	662,390,056	808,062,973
Bank Premises	23,224,790	23,137,140
Other Assets	370,470,917	298,083,638
Interdistrict Settlement Account	(627,877,934)	(437,629,820)
Total Assets	$11,322,610,370	$11,557,162,351
LIABILITIES		
Federal Reserve Notes	$9,026,664,652	$8,551,157,177
Deposits:		
Member Bank Reserve Accounts	1,101,192,467	1,797,890,606
U.S. Treasurer - General Account	358,145,019	388,312,886
Foreign	25,415,000	17,229,500
Other Deposits	73,075,781	35,640,685
Total Deposits	1,557,828,267	2,239,073,677
Deferred Availability Cash Items	375,999,179	445,532,329
Other Liabilities	172,330,472	137,838,568
Total Liabilities	$11,132,822,570	$11,373,601,751
CAPITAL ACCOUNTS		
Capital Paid in	$94,893,900	$91,780,300
Surplus	94,893,900	91,780,300
Total Liabilities and Capital Accounts	$11,322,610,370	$11,557,162,351

COMPARISON OF EARNINGS AND EXPENSES

	1979	1978
Total Current Earnings	$823,249,108	$694,814,242
Net Expenses	44,108,648	41,962,628
Current Net Earnings	**779,140,460**	652,851,614
Additions to Current Net Earnings:		
All Other	634,945	25,033
Total Additions	**634,945**	25,033
Deductions from Current Net Earnings:		
Loss on Sales of U.S. Government Securities (Net)	12,540,229	10,852,014
Loss on Foreign Exchange Transactions (Net)	310,439	42,982,973
All Other	29,006	58,019
Total Deductions	**12,879,674**	53,893,006
Net Deductions	12,244,729	53,867,973
Assessment for Expenses of Board of Governors	4,288,000	4,522,400
Net Earnings before Payments to U.S. Treasury	762,607,731	594,461,241
Dividends Paid	5,622,240	5,408,170
Payments to U.S. Treasury (Interest on F.R. Notes)	753,871,891	584,291,421
Transferred to Surplus	3,113,600	4,761,650
Total	$762,607,731	$594,461,241

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