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Statement by

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before the

Committee on Banking, Housing and Urban Affairs

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Mr. Chairman, I am pleased to present a review of the expenditures of the Federal Reserve Banks and the Board of Governors for 1977 and the budgets of the System for 1978. As you may recall from our testimony last April, I discussed the programs and progress of the System in improving productivity, cost effectiveness, and the quality of Federal Reserve services. These programs yielded even better results than expected during 1977, and our projections suggest that further improvements should be forthcoming in 1978.

1977 Results

Let me begin today by reviewing the financial and operating results of the System during 1977. The approved operating budgets for 1977 totaled \$704.8 million for the Federal Reserve Banks, but estimated expenses are \$685.4 million, an increase of only 4.1 percent over 1976 operating expenses. This modest growth in expenses at the Reserve Banks was achieved despite an expansion in the volume of our operations of more than 7 percent and increases in resource costs also in the 7 percent range.

The 1977 operating budget of \$43.9 million for the Board of Governors compared with estimated expenses of \$43.8 million. This represented 6 percent of total System operating expenses.

Both the Reserve Banks and the Board of Governors achieved significant savings in operations resulting primarily from accelerated programs to achieve cost reductions. Estimated budget

savings at the Banks totaled \$19.4 million, or 2.8 percent below the approved budget, and the Board's underrun was \$92 thousand, or 0.2 percent below its approved budget.

Reserve Bank employment dropped below the 25,000 level for the first time since 1973. Estimated employment for 1977 is 24,493, a decrease of almost 800 employees from 1976 and more than 2,000 employees since 1974.

Employment at the Board as measured by authorized positions has remained relatively steady for the past two years and for 1977 amounted to 1,587. Continued increases in requirements in the regulation areas of bank supervision and consumer affairs and sunshine legislation have been absorbed with little change in employment through improvements in productivity and careful reallocation of resources.

Major developments in 1977 affecting System expenses included a new program for consumer compliance examinations, educational programs to familiarize bankers with consumer laws and regulations, an expanded bank holding company inspection program and a new reporting format, volume increases in the operating areas of the Reserve Banks, and inflationary cost increases for the purchase of resources.

In April 1977 the System adopted a new program providing for special consumer affairs examinations of State member banks and a broad educational program for all member banks. The Board has

provided specialized training to groups of examiners from all of the Reserve Banks, placing emphasis on examination procedures, and has also provided training programs to Reserve Bank staff covering techniques for familiarizing commercial bank staff with consumer regulations.

Regarding the impact of volume increases on Reserve Bank operations, we estimate that in 1977 the volume of measurable Federal Reserve output increased by approximately 7 percent, while the aggregate unit cost of operations decreased by more than 2 percent. These estimates are based upon operations in all Reserve Bank services, with the exception of functional groupings for Monetary and Economic Policy and Supervision and Regulations, and account for approximately 88 percent of total expenditures in the Reserve Banks.

Based upon preliminary information, Reserve Bank output per manhour in 1977 rose sharply with some of the gain achieved through substitution of capital for labor. Our estimate of the increase in total factor productivity, which measures changes in the use of both capital and labor against changes in output, is 10 percent for 1977.

Capital expenditures totaled an estimated \$71.8 million at the Reserve Banks and \$4.1 million at the Board during 1977. Construction of new buildings at Richmond and Boston and purchase of automation equipment accounted for most of the outlays of the Reserve Banks. Renovation of the Board building and a computer upgrade accounted for most of the outlays at the Board.

1978 Budget

I would now like to review our budgets and plans for this year. The 1978 Reserve Bank operating expense budgets total \$722.2 million, an increase of \$36.8 million or 5.4 percent over estimated 1977 expenses. Capital outlays are estimated to be \$64.8 million, declining \$7.0 million from the 1977 estimate primarily due to the completion of the new Boston and Richmond Federal Reserve Banks by early 1978. Total outlays of funds (capital plus operating expenses adjusted for depreciation) are expected to reach \$765.6 million, representing an increase of 3.0 percent over 1977 expenses.

The 1978 Reserve Bank budgets reflect the continuation of efforts to improve the efficiency of operations. In 1978 the Reserve Banks expect to operate with 24,007 employees, a staff reduction of 486 or 2.0 percent below the estimated 1977 level.

Output per manhour is projected to increase by more than 10 percent, a rate similar to that in each of the previous two years. This productivity gain, adjusted for the substitution of capital for labor, yields a total factor productivity increase of 8.3 percent, which is considerably larger than estimates of productivity growth for the private sector.

The principal portion of the cost increases is expected in expenses for employees' and officers' salaries, and retirement and other benefits. These increased expenses constitute 55 percent of the \$36.8 million increase in total expenses. Even so, salary

expenses are expected to rise by only 4.1 percent, as Reserve Banks reduce further their number of employees and continue to exercise firm control over salary increases. With a salary policy based on performance, the Banks are able to reward outstanding performers while keeping salary expenses to a minimum. Benefits expenses are increasing 8.8 percent, reflecting the cost of a fully funded retirement program for current employees, adjusted pension rates for currently retired employees, and the upward movement in insurance costs and Social Security rates.

The increased cost of Federal Reserve currency represents 15 percent of the total expense increase and is an expense largely beyond the control of the Reserve Banks since the Bureau of Engraving and Printing sets the price for printing and the public demand determines the volume to be issued. Such costs are expected to advance 9.8 percent over 1977 reflecting a higher unit price from the Bureau and a larger demand for currency.

Increased depreciation expenses on property and equipment account for another 20 percent of the advance in total expenses of the Reserve Banks. Property depreciation will increase \$4.1 million, primarily reflecting the completion of the new Boston and Richmond Federal Reserve Bank buildings. Equipment depreciation will rise \$3.4 million. The primary causes of the increase in equipment depreciation expense are computer upgrading, the acquisition of high-speed currency processing machines, and the installa-

tion of new equipment in the Boston and Richmond Federal Reserve Banks.

The projected 6.1 percent increase in volume of operations affects primarily the expenses for Services to Financial Institutions and the Public (increasing \$26.6 million or 5.1 percent) and for Services to the U.S. Treasury and Government Agencies (increasing \$3.6 million or 4.6 percent). These output costs reflect full distribution and allocation of support and overhead services. In these volume-related areas, unit costs are projected to decline nearly one percent from 1977.

In 1978 the Federal Reserve Banks will continue to experience increased expenses associated with expanding regulatory responsibilities and revisions to examination procedures. The latest program instituted in this area is the annual inspection of most bank holding companies with consolidated assets over \$300 million and the implementation of a standardized "Report of Bank Holding Company Examination." The Supervision and Regulation function shows an expense increase of \$5.8 million or 10.6 percent and 90 additional staff or a rise of 7.0 percent. As these programs reach full-scale implementation, additional costs may need to be funded.

Other System projects scheduled for 1978 include the automated clearing house program, Treasury check truncation, and the Bankwire settlement. The automated clearing house program, in which

both government and commercial payments are processed, is planned to include interregional clearings of commercial payments. We anticipate that this expansion will facilitate long-run economies. That is, it will act as an incentive for the conversion of check payments to electronic payments, which will ultimately reduce unit processing costs. As you may know, the Treasury estimates this program now saves approximately \$1 million per month.

The Treasury check truncation effort entails the conversion of the data on the check to magnetic tape, with the tapes and a microfilm of the paid checks being sent to the Treasury for processing and the checks being sent to a GSA storage facility. The Treasury expects this truncation procedure to improve reconciliation of Social Security and welfare payments and to accelerate responses to beneficiaries when questions arise.

As you will recall, during this Committee's hearings on Federal Reserve payments mechanism activities last year, inquiries were made concerning access to System settlement facilities by Bankwire. I am pleased to report that the Board announced plans, late last year, to provide such facilities to Bankwire in order to encourage private alternatives in electronic funds transfers.

The anticipated capital outlays during 1978 primarily relate to building programs, computer acquisitions and upgrades, and purchase of high-speed currency processing equipment. The \$17.9 million in the Buildings account reflects the completion of the

Boston and Richmond Bank buildings and the initial phases of new building construction at Miami and San Francisco. Outlays will also be made to consolidate New York Bank operations now located in several outside facilities, and preliminary costs will be incurred for site and architectural plans for the new Baltimore building. Outlays for Data Processing/Data Communications equipment are expected to account for about one-fifth of the capital spending.

Of special interest are the planned purchases of high-speed currency machines. After a five year research and development program, our efforts are coming to fruition. We expect these new machines to sort currency, separate fit from unfit and counterfeit from genuine as well as destroy the unfit notes. Our costs of handling currency are expected to decline on a per unit basis and output per manhour will increase sharply.

The 1978 Board operating budget totals \$47.6 million, an increase of \$4.0 million or 9.3 percent over 1977 estimated operating expenses. The approved capital budget is projected at \$10.5 million, bringing the total 1978 approved outlays to \$58.1 million.

The authorized staff positions at the Board are projected to decline slightly in 1978 to a level of 1,568. This decrease is a direct result of the Board's program to reduce its overall position complement while reallocating resources to high priority areas such as surveillance of banks and bank holding companies.

The increase in the Board's operating budget is reflective of its labor-intensive environment and, measured in real resources, shows a slight decline. Expenses for personnel services including the full-year effect of the 1977 Government-wide general pay increase, the annualized cost of 1977 salary actions, expected 1978 salary actions and a cost-of-living increase in pensions to our retirees, account for 93 percent of the total operating budget increase over 1977. New initiatives are planned in the regulatory area to strengthen bank and bank holding company inspection and surveillance programs and the examination of trust activities. Volume increases are also expected in the areas of Freedom of Information requests, and material distributed for consumer education and information.

The Board's capital budget includes \$9.1 million to complete the renovation of the Board building and \$1.4 million to permit more intensive use of the Annex building. Both of these projects are expected to be completed in 1978 and are designed to provide for the accommodation of all our staff in the two adjacent buildings. We expect to realize annual savings of nearly \$1 million in lease costs.

1978 Budget Process

The basic philosophy governing the formulation of the Reserve Banks' budget is established early in the year as the

Conference of Presidents of the Federal Reserve Banks and the Board of Governors begin the annual budget process with the development of budget objectives and guidelines. Following discussions and modifications of underlying assumptions between the Conference and the Board, a budget objective based upon these assumptions is approved by the Board, usually in the second quarter of the year.

The 1978 budget objective for the Federal Reserve Banks established a permissible range of expenditure increases between 5.5 and 7.5 percent. Since salary expenses represent over 45 percent of Bank budgets, the most restrictive assumption was the 6.0 percent increase in total salaries with a slight decline in employment. Productivity gains were assumed to average 7.3 percent Systemwide and volume was projected to increase by 7 percent.

As in prior years, the Board's Committee on Federal Reserve Bank Activities reviewed the preliminary budgets of the Banks for compliance with the budget guidelines. Following meetings between the Bank Presidents and the Committee and the careful review by the Boards of Directors at each Bank, the final 1978 budget proposals were reduced by \$7.9 million.

The budget guidelines for 1978 consisted, in part, of offsetting new initiatives with reductions elsewhere. Both the Banks and the Board achieved this objective in their approved budgets primarily through improvements in productivity. Staff increases necessary to meet the new initiatives were offset by decreases in

other staff areas at the Board and by decreases in operating personnel at the Reserve Banks.

This year's budget development process for the Board included the adoption of zero-base budgeting concepts to prepare and review the 1978 budget. The Board's divisions were required to review all existing and proposed new programs and submit for management review a budget in the form of discrete program levels of effort with a division ranking. Each division's budget was reviewed by the Office of the Controller, the Staff Director for Management, a Committee of Board Members, and by the Vice Chairman of the Board. In the course of these reviews, \$1.5 million was deleted from the 1978 budget proposals after making room for high priority items. A conscientious effort was made during the review process to stress improvements in productivity and eliminate all but the most essential expenditures.

The Federal Reserve Banks have been experimenting with the zero-base budgeting process since 1976. During 1977, the Federal Reserve Bank of Minneapolis implemented zero-base budgeting in three staff areas in order to assess the effectiveness of this management tool for the budget decision-making process at the Bank. In addition, the Federal Reserve Bank of Chicago used zero-base budgeting to prepare the Bank's Research, Bank Relations and Public Information departments' 1978 budgets. The Board is presently assessing the Board's and Banks' experience in the use of zero-base budgeting.

Summary

In summary, the Board's 1978 budget represents a 9.3 percent growth over 1977 estimated expenses. This number implies no additional use of real resources and requires the achievement of additional productivity gains in 1978. The overriding constraint to fund new initiatives and volume increases through decreases in current activities and gains in productivity has been met.

Budgets of the Federal Reserve Banks also reflect the continuation of efforts to improve the efficiency of operations. The projected 5.4 percent increase in operating expenses compares with an average annual growth rate of 13.6 percent from 1970 through 1974 and 7.7 percent from 1974 through 1977. Total employment at the Reserve Banks has declined by 2,156 employees or 8.1 percent over the last three years, and an additional reduction of 2.0 percent is projected for 1978.

Our weighted unit cost of clearing checks, processing currency and coin, issuing and redeeming Treasury and other Government agency securities, and performing all other measurable output activities has increased by about 1 percent per year over the three-year period from 1974 through 1977 projections. If unit costs are adjusted for higher prices paid for resources--that is for inflation--real unit costs have declined by approximately 7 percent per year.

The performance record of the Federal Reserve System over the past few years clearly indicates the high degree of success the

System has achieved through its internal efforts to improve operational efficiency. The Board believes that its review and budget processes have created an atmosphere of cost-consciousness that has resulted in better productivity, cost efficiency, service to the public, and ultimate savings to the tax-paying public.