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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, on behalf of the Board of Governors, I am pleased to comply with your Committee's request to testify on the Federal Reserve System's 1979 budget. In my closing remark last February at the 1978 hearings, I stated: "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." This testimony on the results for 1978 and the planned 1979 budgets of the Federal Reserve Banks and the Board of Governors, in our view, provides confirmation of that statement.

1978 Experience

You will recall that the 1978 Reserve Bank operating budgets were set at \$722.2 million or 5.4 percent over estimated 1977 expenses. I am pleased to report that preliminary results for 1978 were \$718 million or 5.3 percent above the year earlier. Similarly, the Reserve Banks reduced employment by 650 people compared to our budget estimate of a 486-person decline. All of this occurred despite an estimated 7 percent increase in volume of measured activities and enlarged responsibilities in supervision and regulation.

The Board of Governors' operating expenses estimated for 1978 were below the operating budget by \$750,000 or 1.6 percent. Here again, volume increases and new programs were implemented by internal reallocations of personnel and funds.

We estimate that unit costs of measurable production at the Reserve Banks declined sharply during 1978 despite the 8 percent inflation rate and rising labor costs. Such increases in productivity reflect the System-wide commitment to operational improvements and the intensified cost competition among the Reserve Banks. While the dramatic improvements of 1974-78 seem likely to slow in coming years, there are still some improvements which we hope to realize in the period ahead.

1979 Budget for the Federal Reserve Banks

The Board of Governors approved a budget of \$754.0 million for the operating expenses of the Federal Reserve Banks in 1979, an increase of \$36.0 million or 5.0 percent over estimated 1978 expenses, but this amount has been reduced by \$1.3 million due to a recent decision on retiree benefits. The adjusted 4.8 percent increase in operating expenses compares with an average annual growth rate of 13.6 percent from 1970 through 1974; 7.5 percent from 1974 through 1977; and a 5.3 percent increase in 1978.

Capital outlays are estimated to be \$72.5 million in 1979, increasing \$4.8 million from the 1978 estimate and providing primarily for data processing/data communications equipment; new building projects at Baltimore, Miami and San Francisco, and renovations; high-speed currency equipment; and building machinery and equipment. Total outlays of funds (capital plus operating expenses adjusted for depreciation) are expected to reach \$802.7 million, representing an increase of 4.4 percent over estimated 1978 outlays.

In 1979, the Federal Reserve Banks anticipate operating with a staffing level of 23,161, a decrease of 489 employees or 2.1 percent from the 1978 estimated level which was 650 employees or 2.7 percent below the 1977 level. During the five-year period beginning in 1974, employment has been reduced by 3,482, an average annual decline rate of 2.8 percent. Productivity gains, adjusted to reflect the costs of substituting capital for labor, average 9.9 percent per annum from 1974 through projected 1979-- a rate considerably higher than estimates for the private sector. The 1979 budget year estimate of this productivity measure is 8.3 percent.

Having reviewed the Federal Reserve Banks' expense and employment records, I would now like to describe the activities for this year by four groups of expenses which represent the ongoing Federal Reserve Bank responsibilities expressed in terms of the broad categories of output generated by the System. These groups are on a fully costed basis, reflecting reallocations from support and overhead services necessary to ensure the continuity and/or the efficiency of operations.

Expenses for Services to Financial Institutions and the Public and for Services to the U. S. Treasury and Government Agencies constitute 75 percent and 11 percent, respectively, of the budgeted 1979 expenses. With a projected volume increase from 1978 to 1979 of 6.9 percent, expenses for Services to Financial Institutions and the Public are projected to increase 4.8 percent or \$26.0 million and expenses for Services to the U. S. Treasury and Government Agencies are projected to increase 3.6 percent or \$2.9 million. In these volume related areas, unit costs are projected to decline 2.2 percent without adjusting for inflation.

Services to Financial Institutions and the Public primarily relate to the payments mechanism function and the cash function. During 1979, the production of payments services will be most affected by the promotion of the automated clearing house program. This program involves expanding automated payments as an alternative to paper checks. These automated payments will be faster, cheaper and more reliable than paper entries. The major components of the program will be to stimulate the growth of automated clearing house volume by working with the Treasury and the National Automated Clearing House Association to plan new programs and improved operating schedules, and to improve System automated clearing house operations. Increased governmental electronic payments and increased private debit and credit transactions in 1979 are expected to raise substantially automated clearing house volume.

Before leaving our plans for the payments system, I should mention something about Federal Reserve float which has had an upward trend over the past few years, particularly in 1978. Part of this trend is due to the rising dollar volume of checks processed through the Federal Reserve, up about 57 percent since 1974. As this Committee is aware, the System has been concerned with reducing its operating costs, and this has involved a learning process to balance properly cost reductions, float, quality of service, and our regulatory and supervisory responsibilities. The cash concentration and cash management practices of corporations interested in maximizing the time value of funds have increased the potential for exploiting the Federal Reserve's deferment schedule and its float. Remote disbursement is an abuse of the check collection system that the Board is

working to eliminate and you have been provided with a report on this matter. Another cause which has had an impact on System float, particularly during the past two years, is severe weather and its effect on the movement and clearing of checks. The System is very concerned with the causes and effects of its rising float and is taking steps to reduce it. I anticipate improvements in this area and believe that the System will be successful in reducing its float this year.

In the cash function, the one-dollar coin will be introduced in 1979 and more high-speed currency equipment will become operational. The high-speed currency equipment will count the currency, detect counterfeit notes, sort mixed denominations, determine the fitness of notes and destroy notes deemed unfit for circulation, all at the rate of about 50,000 notes per hour. Utilization of these machines will provide a better quality of currency to return to circulation, provide a greater degree of accuracy and reduce the level of manual involvement.

Services to the U. S. Treasury and Government Agencies are primarily concerned with savings bonds, other Treasury issues and food stamp activities. Two developmental projects in this area are expected to be completed in 1979. Both relate to the marketing, safekeeping and servicing of U. S. Government securities. One project involves identifying future control safeguards and other operational factors which must be considered in transferring Government securities among Federal Reserve Banks by automated means. These findings will be coordinated with those from other areas, such as funds transfers, in the final design

specification for the Federal Reserve communications requirements in the 1980's. The second project involves the joint development and installation of computer programs by San Francisco, Kansas City and St. Louis to automate the transferring of securities and the accounting for collateral. This pilot resource sharing project is designed to achieve more cost reductions through joint planning, development and implementation of transportable computer software.

Expenses for activities involving Supervision and Regulation constitute 9 percent of the budgeted 1979 expenses and are expected to exceed the estimated 1978 level by \$4.9 million or 7.8 percent. This area has been heavily impacted in recent years by the added responsibilities of consumer regulations, bank holding company supervision and processing of holding company applications. In 1979, the workload will be further intensified due to the passage of the International Banking Act, the development and expansion of data surveillance systems, the added applications processing requirements established by the Community Reinvestment Act, and the implementation of various sections of the Financial Institutions Regulatory and Interest Rate Control Act. A major project expected to be completed in 1979 involves the review of all Federal Reserve regulations to determine the organizational scheme and framework within which all Federal Reserve regulations should be issued; and to determine the extent to which they are meeting current policy goals. In addition, the review will require that we redraft all Federal Reserve regulations to incorporate changes in policy, format and style.

The expenses of the final expense group, Monetary and Economic Policy, constitute 5 percent of the budgeted 1979 expenses and are expected to exceed the estimated 1978 level by \$2.2 million or 6.0 percent. This service area provides economic information and analysis necessary for effective conduct of monetary policy and for bank regulatory policy decisions both at the District and System levels. During 1979, expanded programs will encompass evaluation of new market developments, research on various aspects of monetary control, and regional and local research together with reviews of many statistical collection and reporting requirements.

The adjusted \$34.7 million increase in 1979 budgeted Federal Reserve Bank operating expenses over 1978 estimated expenses is primarily attributable to salaries and benefits which account for 58 percent or \$20.3 million of the total increase. Retirement and other benefits expenses are expected to increase 7.4 percent due to increased contributions for both personnel in current service and retired personnel. Current service benefits will increase due to higher rates for Social Security, group life insurance, and hospital and medical insurance, and due to the higher salary base.

Officers' and employees' salary expenses are budgeted to increase 4.3 percent reflecting the planned 2.1 percent decrease in employment and a 6.5 percent increase in average salary per capita. This personnel compensation program is within the President's guidelines for wage and benefit increases. The Federal Reserve Banks' policy for salary

programs is to set wage levels on the basis of salary movements within the respective communities. These movements are estimated through periodic surveys of salaries of both financial and non-financial corporations that represent major employers within each market. This broad-gauged reference is maintained so the Federal Reserve Banks can draw from a pool of workers with experience in several different industries.

Increased equipment expenses represent 14 percent of the total budget increase with an increase in equipment depreciation, repairs and maintenance being partially offset by a decrease in equipment rentals. The rise and fall in these expense categories reflect the transition from rental to owned equipment, equipment upgrading, and the acquisition of high-speed currency processing equipment.

The increased cost of Federal Reserve currency accounts for another 13 percent of the advance in the total budget of the Federal Reserve Banks. This expense is largely beyond the control of the Federal 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 increase more than \$4 million over 1978 reflecting a higher unit price from the Bureau and a larger demand for currency.

Building related expense increases include higher property depreciation primarily reflecting completion of the new Richmond Federal Reserve Bank building. In addition, utility expenses are expected to increase due to higher rates.

The \$1.7 million increase in postage and other shipping expenses reflects a 6.2 percent and a 1.5 percent increase, respectively. The relatively low increase in other shipping expenses is attributable to the pursuit of favorable contractual arrangements with carriers. There are recent developments, however, which may reverse these gains. Decisions by the Department of Labor with confirmation by the Department of Justice may force the System to comply with the Service Contract Act for all these services. Courts, in prior years, have held that Federal Reserve Banks were not agencies of the Federal Government for purposes of legislation of this kind. If this new position is sustained, we expect millions of dollars to be added to the cost of our transportation services since we will have to pay union scale wages, even in areas of the country where market alternatives are available at considerably lower prices.

1979 Budget for the Board of Governors

The 1979 approved operating budget for the Board of Governors is \$49.9 million, representing an increase of \$2.9 million or 6.2 percent over 1978. This increase compares with the Federal Government's fiscal year 1979 budget increase of 9.3 percent over fiscal year 1978 and the projected fiscal year 1980 budget increase which is 7.7 percent over fiscal year 1979.

The Board's 1979 year-end authorized position level is projected at 1,510, a reduction of 68 from the 1978 year-end authorized level of 1,578. Staffing projections in 1979 comply with the hiring constraints of the Federal Government. The significant reduction in authorized positions

at the Board will be accomplished by continuing improvements in productivity and efficiency and by eliminating or reducing low priority functions. In making these reductions in staff the Board is accepting some risk of reduced responsiveness to new tasks, but feels this action is appropriate to government policy.

The Supervision and Regulation of Financial Institutions, including their role in consumer affairs, is the only area of Board responsibility where significant 1979 growth is expected. The resources allocated to this area will increase by 9.7 percent as we move to strengthen compliance review, and our ability to meet new requirements imposed by Congress in the Community Reinvestment Act, the Financial Institutions Regulatory and Interest Rate Control Act, and the International Banking Act. The resource impact of this legislation has not been completely assessed, and additional funding is likely to be required. For example, the Financial Institutions Regulatory Council established by FIRA has not been activated. Therefore, associated support requirements have not been determined and no budget provision has been made. A budget supplement probably will be needed to cover these costs.

The increase in the Board's operating budget mainly reflects a 5.5 percent increase in salaries, retirement, and employee insurance (excluding lump sum payments for retiree cost of living increases and cost of new legislative mandates). These personal services account for 80 percent of the Board's operating budget. Non-personal services are being held to an increase of 1.5 percent. This low rate is attributable to: (1)

savings in rentals resulting from a move of elements of the Board's staff from rented to Board-owned facilities, and (2) economy measures taken throughout the Board's operations.

The Board's capital budget totals \$1.2 million, representing a reduction from 1978 estimated capital outlays of \$8.1 million. The funds in this capital budget were previously approved by the Board to cover the renovation of the main Board building and construction of additional offices in our Annex building. Both projects will be completed in mid-1979.

Summary

The System policy of reducing resource expenditures has been expressed and achieved through setting objectives, adapting established budgeting procedures to meet the organization's framework, and emphasizing operations improvements. The 1979 budget objective for the Federal Reserve Banks limited the increase in total expenses to 4.5 to 6.5 percent while providing for continued high quality in all System services and continued investment in improvement of System activities. The projected 4.8 percent increase in total expenses over the 1978 estimate conforms with the Board-approved budget objective which assumed total salary expenses would not exceed 5.0 percent System-wide, while employment would decline 1.5 percent. This assumption compares with a budgeted increase of 4.3 percent in total salary expenses and a decline of 2.1 percent in employment.

Similarly, the Board's 1979 budget was developed under tight constraints. The Board established an initial 7.35 percent limitation on the increase in total operating costs over the 1978 estimated expense base, and a 5.5 percent limitation on the increase in personnel costs. Since the costs of continuing Board operations at the 1978 resource level would have required an increase of over 9 percent, the effect of these constraints is a marked reduction in resource levels below 1978.

In the preparation of the 1979 budgets, the Federal Reserve Banks experimented with the use of zero-base budgeting in their planning and budgeting systems. While there were widely varying applications of zero-base budgeting, the consensus is that the process did assist the Banks in their 1979 planning processes by concentrating on the re-evaluation of existing programs, reviewing program and resource alternatives, and redirecting resources between new initiatives and programs in place. During 1979, several Banks intend to integrate ZBB concepts further into their management processes and to test the possibility of establishing a rotating zero-base review process.

As with the 1978 budget, the Board's divisions used zero-base budgeting procedures to develop their program budgets including data processing resource requirements. The zero-base decision packages were used as the basis for budget reviews conducted by staff and Members of the Board serving on various oversight committees. The effect of these reviews was to reduce already constrained budget requests by some \$1.9 million and to eliminate 68 positions, bringing the projected 1979 authorized staffing down to near the 1974 level.

In summary, the performance record of the Federal Reserve Banks and the Board of Governors in 1978 and their operating plans for 1979 indicate continued improvement in efficiency. While the volumes of existing services are expected to rise approximately 7 percent and substantial new regulatory requirements face the System in 1979, further staff reductions are anticipated and expense increases are expected to be held significantly below the rate of inflation. I can assure you, however, that the System firmly intends to maintain the high quality of services it provides to the public.