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Statement by

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and

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Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Monetary Policy

of the

Committee on Banking, Finance and Urban Affairs

of the

House of Representatives

May 3, 1988

We appreciate this opportunity to discuss and review the Federal Reserve System's 1988 expenses and budget with this Subcommittee. Governor Kelley will be discussing the Board's budget and my comments today will focus primarily on the Reserve Bank budgets and on several major initiatives that I believe will assist the Reserve Banks in controlling costs and in improving the quality of their services in the future. I will also have some brief comments on the Federal Reserve System as a whole.

The Board has recently made available to the public and to this Subcommittee copies of our publication entitled Annual Report: Budget Review, 1987-88 presenting detailed--but readable and convenient--information about spending plans for 1988. Some of the attached tables have been updated for 1987 actual experience and therefore, small variations exist from data in that document.

For 1988, the Federal Reserve System has budgeted operating expenses of $1,335.7 million, an increase of 4.5 percent over 1987 actual expenses. Before getting to the substance of our 1988 budget, I would remind the Subcommittee of two aspects of Federal Reserve System operations that affect our budget in unusual ways. First, 40 percent of System expenses arise from services provided to depository institutions for which, by law, we charge fees adequate to cover all costs. Since additional costs of these services are more than covered by additional revenues, any increases in costs do not result in reduced earnings returned to the U.S. Treasury. In fact, since fees cover actual costs plus imputed taxes and return on capital (what we call the private sector adjustment factor) and the cost of float, our revenue from priced services offsets 49 percent of all our spending. Second, many fiscal agency operations are provided to the Treasury Department and other agencies on a reimbursable basis. Altogether, 58 percent of our total expenses are either recovered through pricing or are reimbursable (see Table 1).

Historical Overview

It may be helpful to put the budget for 1988 in perspective by sketching the 10-year history of System expenses. Since 1978, Federal Reserve expenses increased at an average annual rate of 6.6 percent (see Table 2 and Chart 1); System employment decreased by 442 or 1.8 percent (see Table 2); and volume increased 36 percent through 1987 (see Chart 2). Unit costs did increase as Federal Reserve volumes adjusted to pricing following implementation of the Monetary Control Act (see Chart 2).

Since 1983, when the transition to pricing was completed, unit cost for the composite of all functions has declined 1.4 percent per year on average even while improvements have been made in the quality of services.

For priced services the decline has been particularly sharp, especially in the electronic payment areas where equipment is more readily substituted for human resources and where volume growth has been the greatest. In Commercial Checks, where there has been a significant effort to improve the quality of services, there has been an increase in unit cost of 1.0 percent per year since 1983, although in the most recent year over year comparison unit cost fell 2.2 percent.

For non-priced cash operations--involving the distribution of currency and coin--the decline in unit cost has also been sharp; since 1983 the average decline has been 5.2 percent per year. In fiscal agency operations, also non-priced, there has been an increase of 1.2 percent per year since 1983, but a significant decline in unit cost of 4.1 percent in the past year.

Recently, 1987 over 1986, we have seen a decrease in unit costs in all individual service areas as well as in the composite.

The impact of the long term productivity gain is perhaps best seen in our trend in total Reserve Bank employment, which is shown in Table 3. In spite of significant growth in volumes of operations, major transition adjustments following new legislation, and rapid changes in the banking industry, actual employment has decreased from 1978 to 1987 by 469 employees.

In presenting our spending plans for 1988, I would like to mention that both the Reserve Bank budgets and the Board's budget must be approved by the Board of Governors, Reserve Bank budgets must first be reviewed by the Committee on Federal Reserve Bank Activities. Governor Kelley oversees the Board's budget and I will turn to him for that discussion.

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Board Budget

I am happy to discuss with you today the 1988 budget of the Board. Since the budget process of the Board has been discussed in testimony provided in earlier years, and since it is thoroughly covered in the Annual Report Budget Review for 1987-1988, which was distributed to you earlier this year, I will not go over the process in detail.

Instead I will limit myself to the major themes of the 1988 budget, some trend information you may find useful, and a discussion of one of the more significant problems facing the Board.

The Board's budget is very carefully reviewed by my colleagues on the Board and I am even more deeply involved in its preparation. I mention this to assure you that we have a very thorough process and that we use the budget as a key planning tool for operations. We think this effort is justified by the low levels of growth in the Board's expenses during a decade in which there has been significant growth in the volume of our work.

In this regard I would like to go over some basic data about the Board's budget. In December 1987 the Board approved a 1988 budget of $90.6 million. This amount was 5.0 percent greater than our 1987 expenses. While this increase was somewhat higher than the increases in the two preceding years, it was necessary in light of new initiatives facing the Board and some areas where it was necessary to commit additional resources. There was no net increase in the number of positions in the 1988 budget.

Over the last ten years the Board's expenses have grown an average of 6.4 percent per year. In real terms the increase has been less than one percent per year. The numbers of positions and employees provided in the 1988 budget are virtually identical to the numbers at the end of 1978 in spite of dramatic increases in the Board's workload. Charts 3 and 4 display this information. Examples of legislation that have affected the workload include the Financial Institutions Regulatory and Interest Rate Control Act (FIRA), the International Banking Act, and the Monetary Control Act, the latter of which probably had the greatest impact. A legislative item affecting the 1988 budget was the Expedited Funds Availability (EFA) title of the Competitive Equality Banking Act. Concerns, such as problems in the banking industry, the debt situation in less developed countries, and our growing foreign involvement, have also had an impact on our workload.

We have been able to hold the line on expenses and employment because of the dedication of our staff and an aggressive program to improve productivity through automation. As I mentioned earlier, the 1988 budget is 5.0 percent more than 1987 expenses. Much of this increase was for initiatives that could not be deferred. Factors leading to the increase in expenses included: continuing our efforts to automate key functions to improve productivity and our ability to respond rapidly to certain situations; investing in a program to reduce the costs of our currency distribution procedures; conducting special surveys to update and expand the volume of information available for monetary and economic policymaking; implementing the Competitive Equality Banking Act; and continuing our efforts to enhance the supervision function.

During 1987 the Board formally created an Office of the Inspector General (IG). This Office has nine positions; however, five of these were formerly assigned to our Internal Audit and Operations Review Programs. These programs were consolidated under the control of the IG. The creation of the IG Office was another factor in the size of the 1988 budget increment; however, we feel the Office will further strengthen the management control system at the Board.

The 1988 increment was not spread evenly throughout the Board's four functional areas. While some expenses, like the two percent general pay increase and increases in health insurance rates, affected all four functions evenly, the initiatives approved in the budget had an uneven impact on the four areas.

In the Monetary Policy area the budget increment was 6.2 percent higher than 1987 actual expenses. This is identical to the average annual rate of increase from 1978 to 1988. The main causes of the 1988 increase were the surveys discussed earlier and incremental operating expenses for a workstation network that was installed during 1987 in our Division of Research and Statistics. There was a net increase of one position in this area to absorb some of the increasing workload associated with the debt problems of less developed countries and with the nation's trade deficit.

The budget for the Supervision and Regulation area increased by 2.1 percent. This is less than the 6.1 percent average annual rate of increase from 1978 to 1988. This increase supports three new positions to provide enhanced data management and analysis in the supervision area. The increasing complexity of the nation's financial industry requires that we take every opportunity to improve our ability to respond to complex questions rapidly.

The Board's budget to provide Services to Financial Institutions and the Public increased by 31.8 percent in 1988 which is substantially higher than the average annual increase of 5.2 percent per year from 1978 to 1988. This is the smallest functional area at the Board. The major factor causing the 1988 increase is an automation initiative to improve the management of currency purchases and distribution. This improved management will allow us to reduce the volume of currency we purchase and lower transportation costs. Annual savings in the Currency Budget will more than offset the one-time cost of this increase. There are also costs associated with the Board's implementation of the provisions of the Competitive Equality Banking Act for improved funds availability.

The budget for System Policy Direction and Oversight increased by 2.4 percent. This is substantially lower than the 7.6 percent average annual rate of increase experienced over the last ten years. The 1988 increase is tied to the incremental costs associated with establishing the Office of the Inspector General in late 1987.

Overall, it has been our objective to limit expenses while ensuring that we are able to carry out our very important responsibilities. I believe that through careful management we have struck an appropriate balance.

A problem discussed in our testimony last year was our ability to attract and retain a high quality staff. While we remain convinced that at this time we have such a staff, the growing disparity between our salary structure and that of competing institutions poses a threat to our long-term ability to maintain that quality.

As an interim step to combat the problem, we recently extended the salary ranges for several of our Federal Reserve grades. To date these adjustments have been quite limited, applying primarily to economists' and attorneys' entry salaries. At the same time, to avoid an unacceptable degree of compaction in the salary ranges for these job families between new hires and current staff, we have made some modest salary adjustments. We will continue to monitor this situation so that in the future we can, with confidence, assure this committee that we remain able to recruit and retain the first rate staff that America's central bank must have.

At this point I would return the presentation to Governor Angell for a discussion of the Reserve Bank budgets.

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Reserve Bank Budgets

Planning for 1988 Reserve Bank budgets began early in 1987, when staff developed a budget objective based on forecasts of Reserve Bank workloads and productivity. An objective to increase System expenses by no more than 4.9 percent, excluding expenses associated with EFA and a special research project that will be discussed later, was approved by the Board in July and was used by the Reserve Banks in developing their plans and budgets. At each of the 12 Reserve Banks, the proposed 1988 budget was given rigorous review (with the budget objective as guidance) by a committee of senior Bank officials, the First Vice President and the President. The budget, as modified by these reviews, was also reviewed and approved by the Reserve Bank's Board of Directors, many of whose members are responsible in their private capacity for managing large organizations. In the fall, Reserve Bank budgets were submitted to the Board of Governors where they were analyzed and reviewed by the Committee on Federal Reserve Bank Activities which held a separate meeting with each Reserve Bank President on the proposed budget. Both Governor Kelley and I serve on this Committee.

As a result of the review process, the total budgeted expense of the Reserve Banks--both priced and non-priced--was held to an increase of 4.3 percent over estimated 1987 expenditures. (Over actual 1987 expenses, the increase is now expected to be 4.5 percent since actual expenses for 1987 were less than estimated at the time budgets were reviewed.) Again these increases exclude the cost of EFA and the special research project. The Reserve Banks' 1988 budgets are affected by the following System initiatives (see Table 4):

1) Automation. Automation initiatives in the System will add $3.9 million to operating costs in 1988. These initiatives are a direct result of the System's decision to put more emphasis on improving the reliability of its electronic payments services.

2) Another part of this effort is contingency arrangements. Back-up facilities are being established to handle data processing contingencies for critical operations including the transfer of funds and securities; such facilities will cost $2.9 million more in 1988 than they did in 1987. The most significant project is in the New York District and accounts for $2.6 million of the increment.

3) Increased supervision. The guidelines of the Board of Governors regarding the frequency of examinations and inspections of banks and bank holding companies and the demands for oversight of these institutions will continue to require more staff and higher operating costs in supervision and regulation: costs will rise $3.5 million in 1988, and employment in the supervision service will increase 66 average number of personnel (ANP), to 2,213 ANP.

4) Improved cash operations. Growth in the volume of currency handled by the Reserve Banks has provided an incentive for the Federal Reserve to seek more efficient ways of processing currency. These initiatives will result in an increase in the 1988 budget of $2.0 million and 50 ANP.

5) Programs for the U.S. Treasury. Expenses for centrally provided Treasury services are budgeted to increase $4.7 million, or 24.3 percent, with an

increase of 82 ANP. Much of the increase is due to the first full year of operations of the Treasury Direct Access Book-Entry System (Treasury Direct) and the addition of reinvestment activity to that system. Also, the Federal Reserve is continuing the development of a Public Debt Accounting and Reporting System at an increase in cost of $.3 million and is managing two savings bonds projects at a total cost of $.4 million in 1988.

6) Facilities. Building projects will cost $6.6 million in 1988. Most of these expenses are associated with decisions made prior to 1987. New building projects account for about $1.4 million.

The total increase in 1988 expenses for these major initiatives is $23.6 million in 1988. If we were to exclude costs for these projects, the 1988 budget for Reserve Banks would be only 2.5 percent greater than expenses for 1987 (see Table 4). Budgeting for these initiatives and at the same time keeping bottom line expense growth low (4.3 percent) was achieved by restrained growth or decreases in other areas. Indeed, staff increases for these initiatives were more than offset by staff decreases achieved through early retirement programs approved by the Board of Governors at seven Reserve Banks.

For a look at 1988 budgeted expenses on a program basis, I will discuss our four service lines in the order of their size (see Table 5).

Expenses for Services to Financial Institutions and the Public total $827.5 million and account for almost two-thirds of the Reserve Banks' 1988 budgets. Expenses are budgeted to increase 3.5 percent over actual 1987. Employment is budgeted to decline by 29 persons or 0.3 percent from 1987, even though volume increases are expected in all major operations.

Commercial check processing accounts for almost half of the budgeted expenses in this area and, at 5,150 ANP, about 60 percent of the staff. The increase in expenses in 1988 is expected to be only $7.3 million, or 1.8 percent, over actual 1987, with a decrease of 57 ANP. Even with a smaller staff, the System expects to handle a 2.7 percent increase in the annual number of checks processed, projected at 15.3 billion. Expenses associated with implementation of the Expedited Funds Availability Act are not included in these data.

Restraining the growth of check processing expenses are early retirement programs, the consolidation of operations, incentive pay for productivity increases, and a new contract for interdistrict shipping.

Expenses for currency processing ($121.5 million), which are expected to increase $6.0 million, or 5.2 percent, in 1988, will constitute nearly 15 percent of the budget in this area. Changes in staffing are expected to result in a net increase of 55 ANP, or 3.5 percent, because of sharp volume increases in some Districts. Overall volume is anticipated to increase 6.3 percent, with unit cost projected to rise 0.1 percent. New contracts for maintenance on the high-speed currency sorting machines will also raise costs in 1988. The increase in staff arising from higher volumes at some Districts is partially offset by a new currency handling process that will permit a reduction of 19 ANP.

Expenses for the automated clearinghouse service are budgeted to rise $5.2 million, or 8.4 percent. The change reflects a 16.6 percent expansion in volume and an adjustment in accounting to distribute the costs of data processing and data communications more accurately. A decrease of 3 ANP is budgeted.

The costs for funds transfer are expected to increase $1.9 million, or 3.3 percent, on balance, reflecting a 6.1 percent rise in volume, an additional 6 ANP, and a decrease due to a data processing and data communications accounting change.

Expenses for <u>Supervision and Regulation,</u> which total $183.4 million, are expected to increase $13.0 million, or 7.6 percent, over 1987. This area now accounts for 14.7 percent of total System expenses, compared with 12.8 percent in 1983. A staff level of 2,213 ANP is budgeted, an increase of 66, or 3.1 percent, over 1987.

The increase in costs is driven by changing circumstances in the banking industry. In some Districts, the condition of banks and bank holding companies subject to our supervision continues to require added supervisory resources. In addition, deregulation has led bank holding companies to develop new service and product lines, which call for more and better-trained examiners; moreover, firms throughout the industry are becoming larger and more complex.

As in the past, the Reserve Banks are attempting to use resources more efficiently by increasing the use of personal computers in the field and in the office, by accelerating the development of examiners, and by hiring persons with relevant experience.

Expenses for <u>Services to the U.S. Treasury and Other Government Agencies</u> are budgeted at $142.5 million, an increase of $6.8 million, or 5.0 percent, from 1987. This area accounts for approximately 11 percent of operating costs. Staffing is budgeted to decrease 36 ANP, or 2.0 percent, to 1,800 ANP.

Consolidation of operations and higher levels of automation contribute to controlling these costs. Several Districts are consolidating operations at one office. The Banks are seeking greater efficiency through the substitution of electronic ("book-entry") records for paper ("definitive") securities and through the use of high-speed sorting machines to process food coupons and savings bonds.

The most significant initiatives are in centrally provided Treasury services; expenses here are budgeted to increase $4.7 million, or 24.3 percent, and 82 ANP will be added to the staff. Much of this increase ($4 million and 54 ANP) occurs because 1988 is the first full year of operation for the Treasury Direct system and because reinvestment activity has been added to that system. Treasury Direct, which handles all purchases of government securities by individuals in book-entry form, is managed in Philadelphia with local operations in each District. Its expansion permits an offsetting decrease in the operation that handles definitive securities--"other

Treasury issues"-for which staff is decreasing 52 ANP and expenses $1.6 million.

Besides Treasury Direct, the increase in centrally provided Treasury services includes three programs in the Cleveland District which will increase costs by $.7 million in 1988 but will, we expect, lead to long run efficiencies.

Expenses for Monetary and Economic Policy at the Federal Reserve Banks total $91.7 million and account for approximately 7 percent of their 1988 budgets. Expenses are expected to increase $5.3 million, or 6.1 percent, over 1987. Employment will increase 13 ANP or 1.7 percent to 788.

The rise in cost reflects a net addition to staff, salary actions, and improvements in office automation. Staff members were added in New York for testing the replacement of an eight-year-old system used for open market trading, intensifying the monitoring and analysis of debt in less developed countries, and studying the feasibility of receiving data electronically from reporting institutions; in Atlanta for continuing a special effort to improve the quality of economic research; and in Dallas for supporting a Southwestern economic development program.

A brief review of Reserve Bank expenses on an object of expense basis also might be useful to the Subcommittee (see Table 6).

Personnel expenses consist of salaries for officers and employees, other expenses to compensate personnel, and retirement and other benefits. The major resource of the Reserve Banks is their people, and total personnel costs account for 62 percent of total Federal Reserve expenses. Personnel costs are expected to increase $32.6 million, or 4.4 percent, in 1988. Salaries--the major component of this category--are budgeted to increase 4.7 percent.

Salaries and other personnel expenses account for nearly 52 percent of the Banks' budgeted expenses and are expected to increase $23.3 million, or 3.7 percent, in 1988. Salaries are expected to increase 4.7 percent, while other personnel expenses are expected to decline 33.3 percent, primarily resulting from a reduction in the use of computer programmers on contract.

Each Federal Reserve office bases its salary structure for staff members other than officers on annual surveys of compensation offered by major employers in its community. Nationwide surveys are used to adjust the structure of officers' salaries.

Expenses for retirement and other benefits, which account for 10 percent of the Banks' budgeted expenses are projected to increase $9.3 million, or 7.7 percent, in 1988. This increase reflects higher costs for hospital, medical, and dental insurance, along with the effect of large claims in several Districts; an increase in the tax rate for social security; an increase in benefits, reflecting payments to employees accepting early retirement; and resumption of normal group life insurance premiums (the Districts did not have to pay any in 1987).

Nonpersonnel expenses account for 38 percent of the Banks' expenses and are projected to increase 4.6 percent in 1988. Within this category:

Equipment expenses account for 13 percent of the Banks' expenses and are budgeted to increase 3.7 percent. Developments in priced services are mainly responsible for the rise in equipment costs: initiatives to meet the changing needs and demands of check collection; efforts to standardize automation and communication systems in response to the consolidation of financial institutions; progress toward encrypting communication links for various users of priced services; and continued work to expand and upgrade electronic networks that provide information to financial institutions.

Building expenses, which account for 9 percent of total expenses, are expected to increase 9.9 percent in 1988. Building renovations and repairs at Chicago, New York, Cleveland, and Dallas contribute to increases in depreciation, taxes on real estate, and utility expenses. Rental expenses are 21.6 percent higher, primarily because of a $2.8 million increase at New York. These increases will be partially offset by a decline in other building costs, as the majority of Districts incurred one-time, outside contractual expenses in 1987.

Shipping costs, which account for nearly 7 percent of 1988 budgeted expenses, will increase only 1.6 percent, as savings from a renegotiated contract for interdistrict transportation will offset an increase in postal rates.

Other nonpersonnel expenses will rise only 2.9 percent.

Table 7 depicts the plans of the Reserve Banks for capital spending in 1988. By their nature, capital outlays vary greatly from year to year. Outlays for buildings and for data processing and communications equipment continue to dominate Reserve Bank capital budgets.

Special Budget Emphasis

Before concluding my testimony I would like to mention briefly four initiatives that are of great importance to the Reserve Banks and which will have a major impact on Reserve Bank expenditures and operations into the next decade. The cost of the first two initiatives are outside of the budget objective set for the Reserve Banks in 1988.

As you are aware, the Expedited Funds Availability Act (EFA) gives the Federal Reserve Board regulatory authority to improve the check collection and return systems. As a result of the EFA, the Reserve Banks are planning to implement a number of new services to expedite the handling of returned checks. The Board has proposed that the Reserve Banks begin to offer the new services to speed the return of unpaid checks beginning September 1, 1988. The costs associated with the implementation of EFA are not included in the 1988 Reserve Bank budgets because at the time the budget was approved the cost impact was unknown. Proposals from each Reserve Bank for operating and capital resources to implement EFA are currently under review. The operating expense impact of EFA is expected to be less than $15 million in 1988, with an increase of about 350 positions. An additional $15 million of capital expenditures will also be required. The costs of providing these return item services are to be recovered through fees charged to users. Later this year the Board will approve prices for the new return item services.

In addition to the efforts to speed up the return of checks, the Board of Governors has authorized further research and development of digitized image processing of checks. The technology being developed, which relies on capturing check images electronically for computer storage and retrieval, has the potential for significant improvements in the handling of check and return item processing both for the Federal Reserve and for depository institutions. Research since 1985 has demonstrated the feasibility of making a computerized image on one side of a check at high speed under laboratory conditions. The next phases will test the high-speed capture of both sides of checks plus the ability to store and retrieve the image data. These phases will be conducted under laboratory conditions with a limited volume of checks and then at a Reserve Bank under production conditions. Results will be shared with the financial community, where it might also offer widespread benefits in the storage and exchange of check images. This special project is budgeted to cost $6.2 million in 1988. These costs are recovered through check collection fees, and the costs of implementing digital image technology in the Reserve Banks on a full scale-permanent basis would also be recovered through check collection fees.

These two initiatives, $15 million for EFA implementation and $6.2 million for the check image project, bring the total budget for the Reserve Banks to $1,266.3 million, an increase of $74.5 million or 6.3 percent over actual 1987 expenses.

During the 1980s, the Federal Reserve System has placed increasing emphasis on the quality and reliability of its electronic payment services. This increasing emphasis is due to a number of factors, including the rapid growth in the volume and value of funds and securities transfers, the Payment System Risk Reduction Program, and the disruption caused by the 1985 operating outage at a money center bank in New York. The emphasis on improving the reliability of Fedwire operations has achieved results. During the first quarter of 1988, the Reserve Banks have improved their up-time performance for the critical hours of the funds transfer service and the book-entry securities transfer service. Work will continue on this effort and Reserve Bank initiatives to increase reliability of electronic payment services will cost the Reserve Banks an additional

$2.9 million in 1988. These expenditures will be recovered through fees for electronic payment services. Significant expenditures to improve reliability will also be incurred in 1989 and beyond.

Since the late 1970s, the Federal Reserve has focused its efforts on providing contingency processing facilities to address both non-catastrophic and catastrophic operating outages. Procedures to address non-catastrophic outages are an integral part of Reserve Bank procedures. Each Reserve Bank has acquired redundant hardware--both mainframes and critical components, such as communications controllers. This redundancy permits Reserve Banks to transfer processing from failed, primary equipment to back-up equipment. To address software related outages, the Reserve Banks have developed thorough testing procedures for both applications software that the System develops and environmental software supplied by vendors.

To address catastrophic operating outages, all Reserve Banks, except the New York Reserve Bank, currently rely upon the Contingency Processing Center (CPC) at Culpeper. The Reserve Banks have demonstrated that critical operations can be restored at the CPC and each Reserve Bank tests its capability twice each year. The time required to restore operations ranges from nine to forty-one hours. These timeframes are due to the time required to travel to Culpeper (two to sixteen hours) and the time required to load software, reestablish data bases, and reestablish communication connections with depository institutions (six to thirty-two hours). As a result, many Reserve Banks would not be able to restore operations on the day an outage occurred.

To have same day capabilities the Federal Reserve Bank of New York has implemented a dedicated contingency processing center in Rockland County, New York. For the same reason other Reserve Banks have undertaken a study to determine the feasibility of providing back-up for each other. This approach, called the "buddy system," is expected to permit operations to be restored at a "buddy" site within four hours after a catastrophic outage is declared. In 1985 the Federal Reserve began a multi-year study on developing the Federal Reserve's electronic payment services in the 1990s and identifying a production system that would permit the Federal Reserve to satisfy the future needs of users of these services.

The Reserve Banks have made a major effort to improve the quality of currency in circulation and to reduce the cost of printing currency. The cost to the Reserve Banks for printing new currency is expected to decline from $164.2 million in 1987 to $156.3 million in 1988. This results from the improved ability of Reserve Banks--through improved sensors on currency processing machines--to recover substantial amounts of fit currency that previously would have been destroyed. This initiative has allowed the Reserve Banks to reduce the production demands being placed on the Bureau of Engraving and Printing, while simultaneously improving the quality of currency in circulation. Beginning in 1985 the System focused on developing a second generation of high-speed processing equipment. Installation of the second generation processing equipment will begin in 1989 and the results should be improved Reserve Bank capability to detect fit from unfit currency, and faster processing of currency volume which is currently growing at an annual rate of 9.0 percent. The budget for the Currency Equipment Development Program is $1.5 million in 1988.

Given the expanding volumes and new initiatives that we are currently undertaking, a particular concern of the Federal Reserve at this time is the depletion of its authorized fund for branch Federal Reserve buildings. The cumulative statutory limit on these funds is $140 million and has not been changed since 1974. Completion of the current building in Helena will, for all practical purposes, exhaust the fund and inhibit the Federal Reserve from undertaking modernization, renovation, expansion, or new facilities planning.

Our planning suggests that funds will be needed in the relatively near future to meet space requirements in Birmingham, Nashville, Salt Lake City, Houston, San Antonio, and El Paso. The expenditure of funds for branch buildings is largely recovered by the Federal Reserve through pricing of its services to financial institutions, as required by the Monetary Control Act. Thus, the building costs will be financed in large part by the private sector.

The House Banking Committee approved an increase in the branch building fund in 1984, but the provision was included in a bill that ultimately was not passed by the Congress. We believe that it is critical that the limitation be changed in the near future to allow the Federal Reserve to meet its future building needs for Branch facilities.

<u>Conclusion</u>

In closing, both Governor Kelley and I thank you for this opportunity to address the Subcommittee on the Federal Reserve System budget. I would like to reemphasize that the existing budget processes are working well in controlling costs, while at the same time encouraging quality improvements. We welcome your comments and would be pleased to address any questions you may have on our budget.

Operating Expenses of the Federal Reserve System, Net of Receipts 1986-88 1/

Millions of dollars, except as noted

Item	1986	1987	1988 Budget	Change 1986-87 Amount	Change 1986-87 %	Change 1987-88 Amount	Change 1987-88 %
Total System operating expenses............	1,245	1,278	1,336	33	2.7	58	4.5
Less:							
Revenue from priced services	628	650	658	22	3.5	8	1.2
Other income	1	15	12	14	1/	-3	-20.0
Reimbursements	112	109	110	-3	-2.7	1	0.9
EQUALS							
Net System operating expense	504	504	555	0	0.0	51	10.1

1. Beginning in 1987, about $10 million charged to depository institutions for Treasury services has been recorded as Federal Reserve income rather than transferred directly to the U.S. Treasury and claimed as a reimbursement.

Table 2

Federal Reserve System Expenses and Employment, 1978-88 Budget

Millions of dollars

	Expenses		Personnel	
	Amount	Percent Change	Amount	Percent Change
1978	703	4.7	24,948	(3.2)
1979	747	6.2	24,551	(1.6)
1980	852	14.1	25,198	2.6
1981	948	11.3	25,480	1.1
1982	1,041	9.8	24,755	(2.8)
1983	1,100	5.7	24,466	(1.2)
1984	1,145	4.0	24,257	(0.9)
1985	1,199	4.8	24,609	1.5
1986	1,245	3.8	24,721	0.5
1987	1,278	2.7	24,483	(1.0)
1988 budget	1,336	4.5	24,506	0.1

Table 3

Federal Reserve Bank Employment by Service Line

Year	Monetary and Economic Policy	Services to the U.S. Treasury and Gov't Agencies	Services to Financial Institutions	Supervision and Regulation	Support	Overhead	Total	Percent Change
1978	610	2,087	9,682	1,337	4,146	5,616	23,479	
1979	597	1,883	9,790	1,411	4,055	5,367	23,104	-1.6%
1980	618	1,946	9,614	1,589	4,238	5,680	23,682	2.5%
1981	717	1,881	9,480	1,733	4,434	5,745	23,989	1.3%
1982	743	1,851	8,566	1,796	4,599	5,676	23,230	-3.2%
1983	804	1,838	8,424	1,862	4,367	5,589	22,883	-1.5%
1984	826	1,798	8,395	1,885	4,340	5,424	22,669	-0.9%
1985	816	1,781	8,754	1,912	4,398	5,323	22,984	1.4%
1986	791	1,819	8,799	2,087	4,469	5,274	23,239	1.1%
1987	775	1,836	8,775	2,147	4,452	5,024	23,010	-1.0%
1988 BUDGET	788	1,800	8,746	2,213	4,541	4,945	23,033	0.1%
Growth Rate 1978-87	2.7%	-1.4%	-1.1%	5.4%	0.8%	-1.2%	-0.2%	
Recent Year 1986-87	-2.0%	0.9%	-0.3%	2.9%	-0.4%	-4.7%	-1.0%	
Budget Year 1987-88	1.7%	-2.0%	-0.3%	3.1%	2.0%	-1.6%	0.1%	

Increase in the Operating Expenses of the Reserve Banks, Excluding the Increases from Major Initiatives, 1987-88

Thousands of dollars, except as noted

Expense item	Amount
Operating expenses	
1987 total, actual	1,191,833
1988 total, budget	1,245,102
Increase, 1987 to 1988	
Thousands of dollars	53,269
Percent	4.5
Less	
Major 1988 intiatives	
Facilities	6,563
Programs for the U.S. Treasury	4,748
Automation	3,918
Increased supervision of banks and bank holding companies	3,460
Contingency back-up	2,916
Improved cash operations	1,961
Total	23,566
Equals	
Increase excluding major 1988 initiatives	
Thousands of dollars	29,703
Percent	2.5

Operating Expenses of the Federal Reserve Banks, by Operational Area 1986-88

Thousands of dollars, except as noted

Operational Area 1/	1986	1987	1988 Budget	Change 1986-87 Amount	%	Change 1987-88 Amount	%
Monetary and Economic Policy...............	90,570	86,484	91,742	4,086	-4.5	5,258	6.1
Supervision and Regulation...........	163,915	170,428	183,397	6,513	4.0	12,969	7.6
Services to Financial Institutions and the Public...........	770,016	799,227	827,458	29,212	3.8	28,231	3.5
Services to the U.S. Treasury and Other Government Agencies..	136,789	135,693	142,504	-1,076	-0.8	6,811	5.0
TOTAL	1,161,290	1,191,832	1,245,102	30,543	2.6	53,270	4.5

1/ Including the cost of support and overhead services.

Employment at the Federal Reserve Banks, by Activity, 1986-88
Average number of personnel, except as noted

Activity	1986	1987	1988 Budget	Change 1986-87 Amount	%	Change 1987-88 Amount	%
Operational areas:							
Monetary and Economic Policy...............	791	775	788	-15	-2.0	13	1.7
Supervision and Regulation...........	2,087	2,147	2,213	60	2.9	66	3.1
Services to Financial Institutions and the Public...........	8,799	8,775	8,746	-23	-0.3	-29	-0.3
Services to the U.S. Treasury and Other Government Agencies..	1,819	1,836	1,800	17	0.9	-36	-2.0
Support and overhead:							
Support................	4,469	4,452	4,541	-18	-0.4	89	2.0
Overhead..............	5,274	5,024	4,945	-250	-4.7	-79	-1.6
Total	23,239	23,010	23,033	-230	-1.0	23	0.1

Operating Expenses of the Federal Reserve Banks, by Object, 1986-88

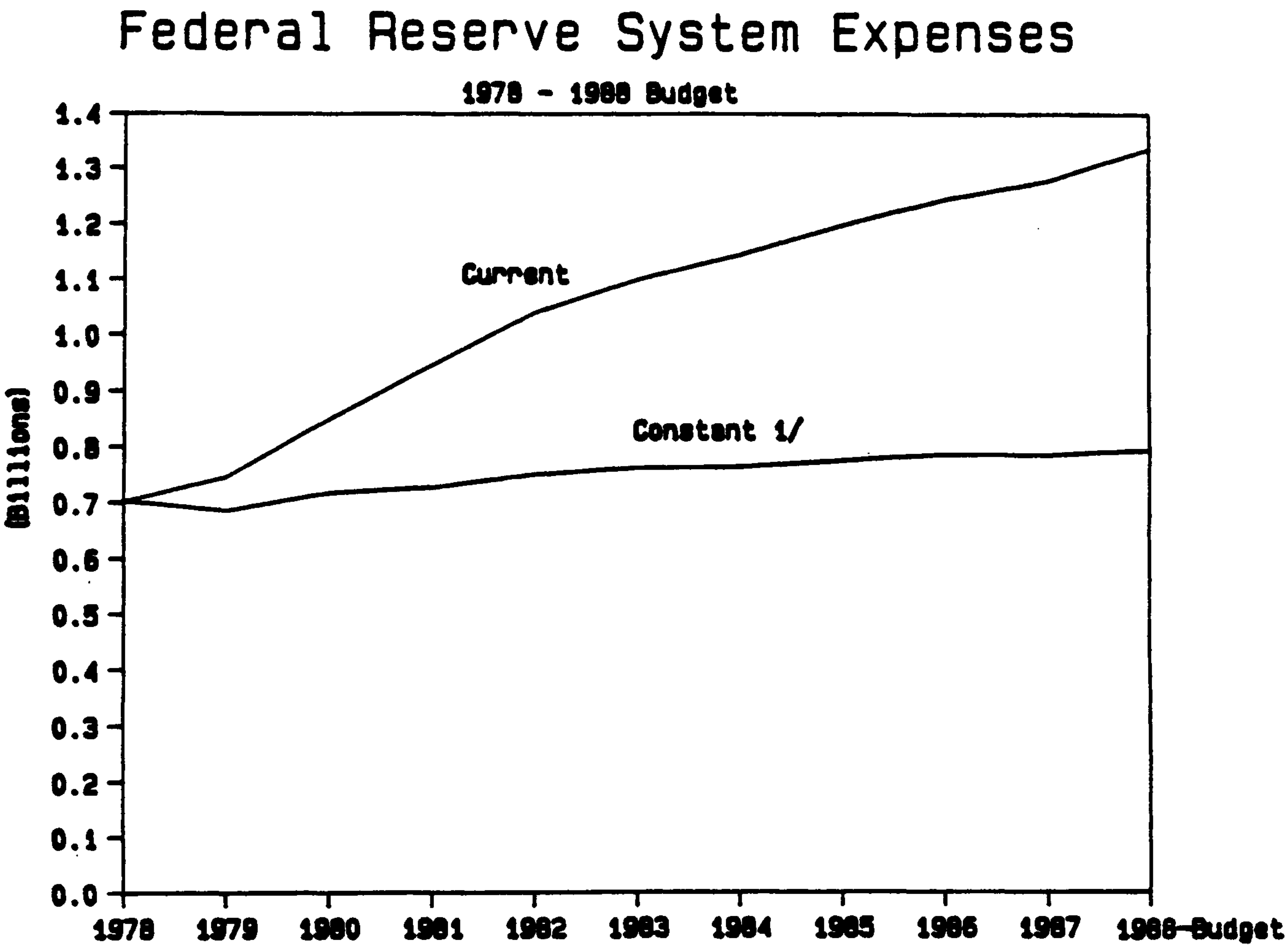
Thousands of dollars, except as noted

Object	1986	1987	1988 Budget	Change 1986-87 Amount	Change 1986-87 %	Change 1987-88 Amount	Change 1987-88 %
PERSONNEL							
Officers' salaries......	56,168	60,010	62,272	3,842	6.8	2,262	3.8
Employees' salaries.....	523,309	545,358	571,833	22,049	4.2	26,475	4.9
Other personnel.........	16,693	16,335	10,896	-358	-2.1	-5,439	-33.3
Retirement and benefits.	133,360	121,465	130,804	-11,895	-8.9	9,339	7.7
Total personnel.......	729,531	743,168	775,805	13,637	1.9	32,638	4.4
NONPERSONNEL							
Equipment:							
Purchases...............	3,096	4,694	2,820	1,598	51.6	-1,874	-39.9
Rentals.................	40,665	33,857	27,416	-6,808	-16.7	-6,441	-19.0
Depreciation............	68,000	75,802	82,874	7,801	11.5	7,073	9.3
Repairs and maintenance.	38,998	42,467	49,511	3,470	8.9	7,043	16.6
Total equipment.......	150,760	156,820	162,621	6,061	4.0	5,801	3.7
Buildings:							
Insurance...............	610	842	917	232	38.0	75	8.9
Taxes on real estate....	22,213	21,710	24,666	-503	-2.3	2,956	13.6
Property depreciation...	23,549	26,078	29,525	2,529	10.7	3,446	13.2
Utilities...............	22,809	22,906	24,127	97	0.4	1,221	5.3
Rent....................	14,976	17,118	20,814	2,143	14.3	3,695	21.6
Other...................	13,607	18,726	17,949	5,119	37.6	-777	-4.2
Total building........	97,765	107,381	117,997	9,616	9.8	10,616	9.9
Shipping:							
Postage.................	13,464	12,150	13,275	-1,315	-9.8	1,125	9.3
Other...................	68,416	69,200	69,351	785	1.1	151	0.2
Total shipping........	81,880	81,350	82,626	-530	-0.6	1,276	1.6
Other:							
Supplies..............	46,005	47,282	47,952	1,277	2.8	670	1.4
Travel..................	19,775	22,155	22,965	2,380	12.0	810	3.7
Communications..........	15,255	12,291	12,602	-2,964	-19.4	310	2.5
Fees....................	11,207	11,357	9,577	150	1.3	-1,780	-15.7
Other...............	9,114	10,029	12,957	915	10.0	2,928	29.2
Total other	101,356	103,114	106,053	1,758	1.7	2,939	2.9
Total nonpersonnel....	431,761	448,665	469,297	16,904	3.8	20,632	4.6
Total..................	1,161,290	1,191,833	1,245,102	30,543	2.6	53,269	4.5

Capital Outlays of the Federal Reserve Banks, by Class of Outlay, 1986-88

Thousands of dollars, except as noted

Capital class	1986	1987	1988 Budget	Change 1986-87 Amount	Change 1986-87 %	Change 1987-88 Amount	Change 1987-88 %
Data processing and data communications equipment	68,246	45,162	92,833	-23,084	-33.8	47,671	105.6
Furniture and other equipment	19,623	22,394	24,435	2,771	14.1	2,041	9.1
Land and other real estate	432	1,759	7,137	1,327	307.2	5,378	305.7
Buildings	69,930	58,715	86,209	-11,215	-16.0	27,494	46.8
Building machinery and equipment	3,697	6,163	12,296	2,466	66.7	6,133	99.5
Leasehold improvements	3,389	4,121	3,008	732	21.6	-1,113	-27.0
Total	165,317	138,314	225,918	-27,003	-16.3	87,604	63.3



1/ Deflated by GNP Deflator (1978 = 100)

Trends in Volume, Unit Cost, and Employment

All Measured Functions 1977 - 1987

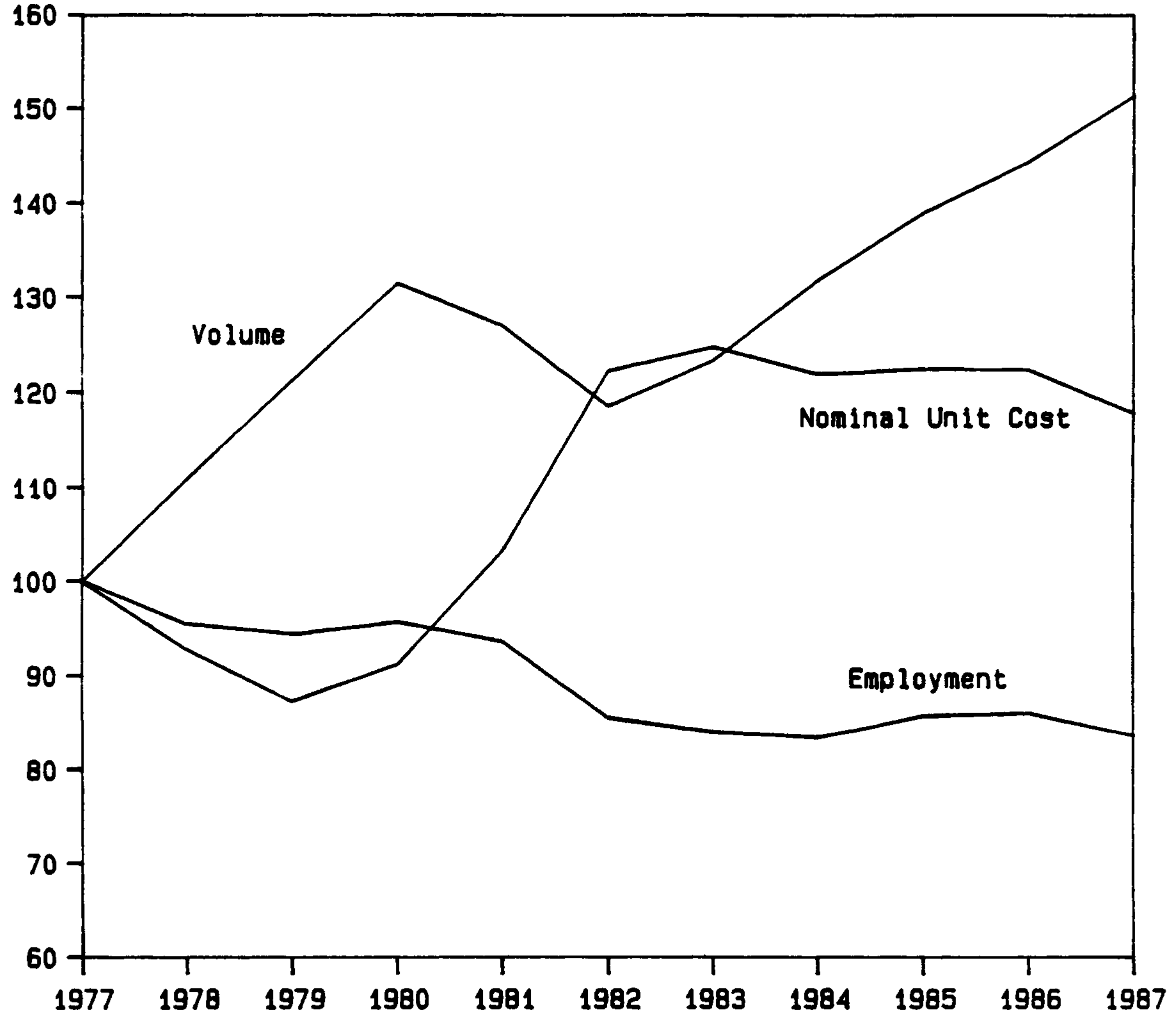
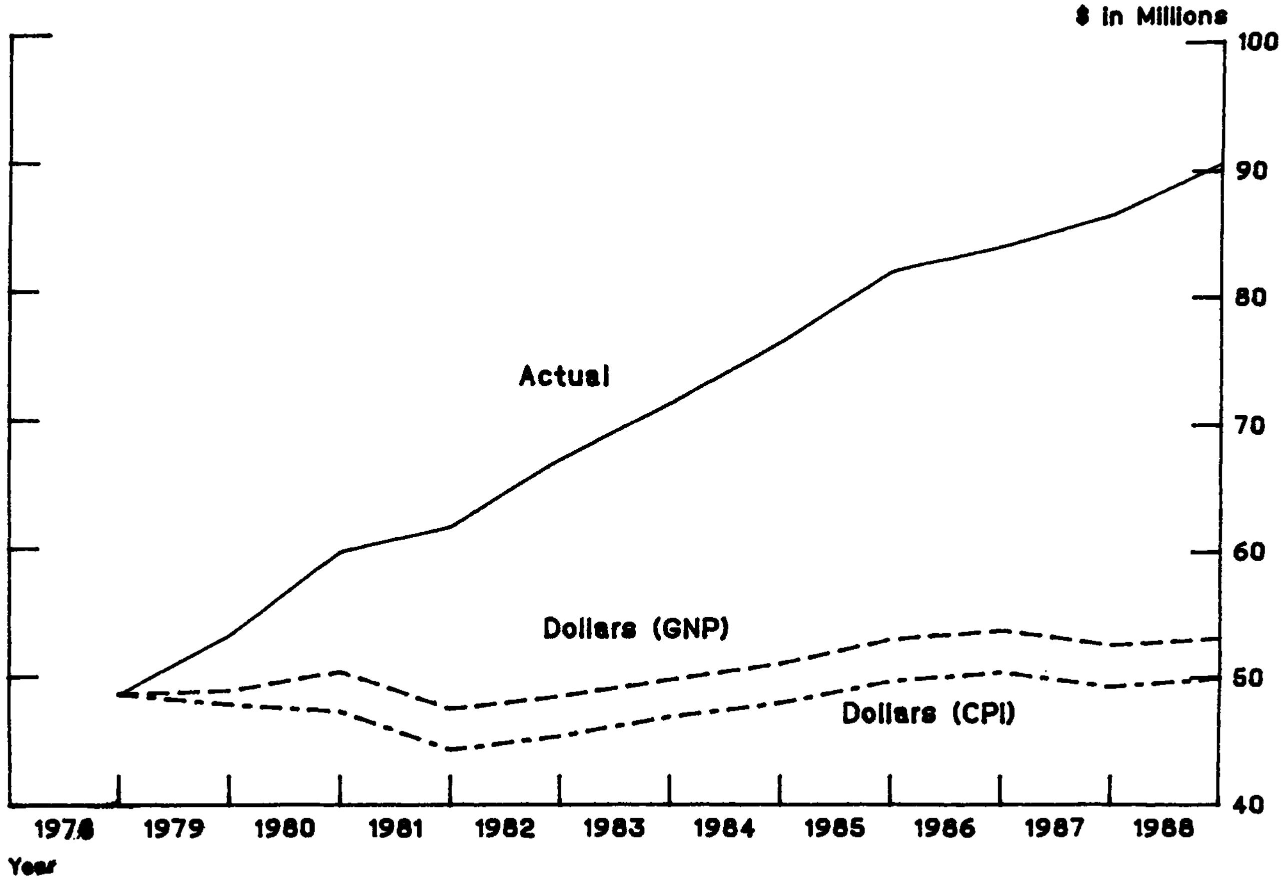


Chart 3

BOARD OPERATING EXPENSES
in Actual and Constant Dollars

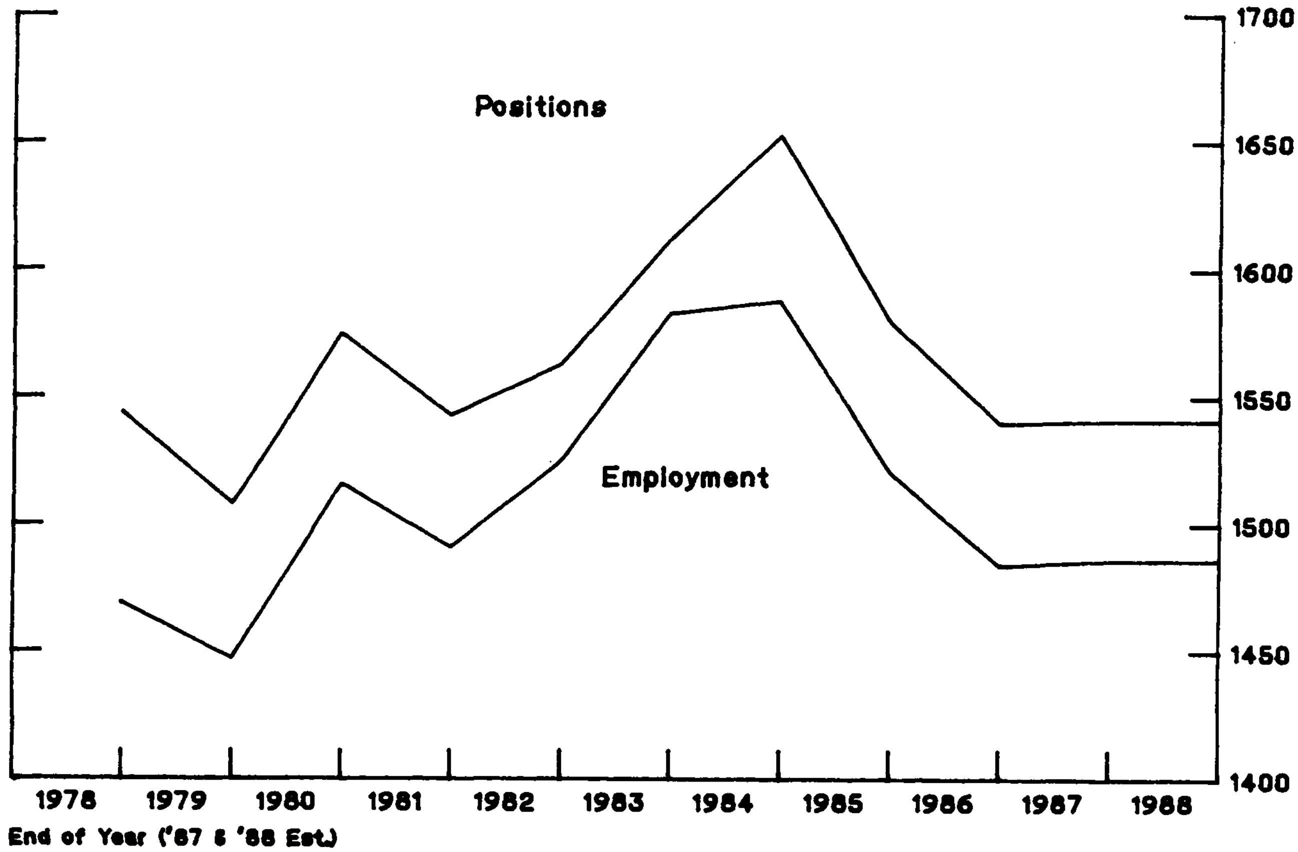


Board Expenses Expressed
in Actual $ and Constant 1978 $
(Millions of Dollars)

Year	Actual Expenses	Expenses in Constant 1978 Dollars (CPI)	Expenses in Constant 1978 Dollars (GNP)
1978	48.6	48.6	48.6
1979	53.2	47.8	48.9
1980	59.8	47.3	50.4
1981	61.8	44.3	47.5
1982	67.2	45.4	48.5
1983	71.6	46.9	49.8
1984	76.5	48.0	51.1
1985	82.0	49.7	53.0
1986	84.0	50.4	53.7
1987	86.3	49.2	52.5
1988	90.6	49.9	53.1

Chart 4

BOARD EMPLOYMENT AND POSITIONS



Board Employment and Positions
1978-1988

Year	Year-End Employment	Authorized 1/ Positions
1978	1,469	1,544
1979	1,447	1,508
1980	1,516	1,575
1981	1,491	1,543
1982	1,525	1,563
1983	1,583	1,612
1984	1,588	1,653
1985	1,521	1,580
1986	1,484	1,540
1987	1,486	1,541
1988	1,486	1,541

1/Does not include 11 summer intern and 17 youth summer hire positions