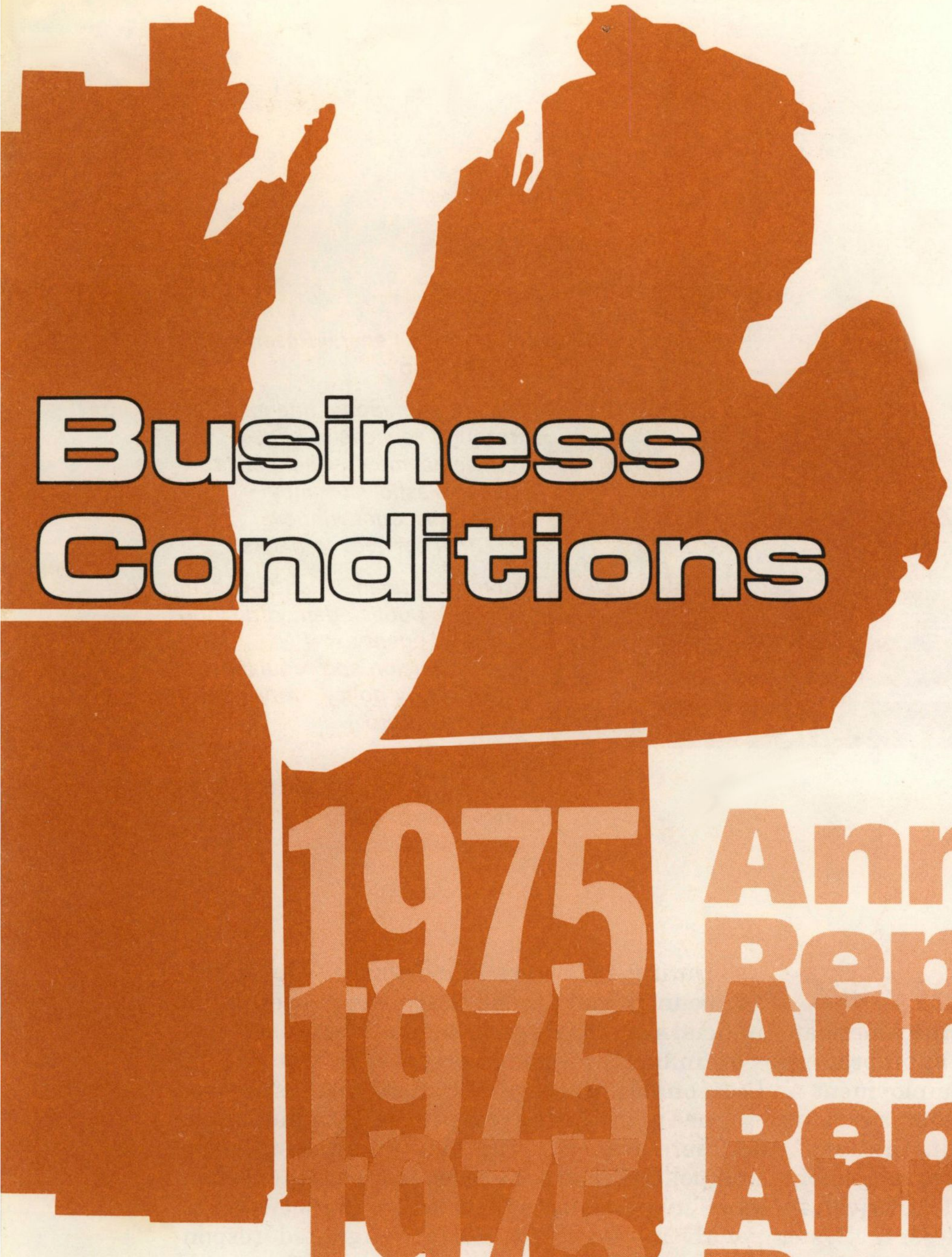

Business Conditions

1975 Annual Report

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Federal Reserve Bank of Chicago

january 1976

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Foreword

During 1975 economic developments in this country and abroad sharply increased public interest in the American financial system. Vigorous public debate developed about the appropriateness of financial measures proposed to restore high levels of employment and reasonably stable prices; there was heightened concern about programs designed to insure the stability and viability of our financial institutions; and there was a rising tide of interest in the regulatory arrangements and policies that are needed to insure the responsiveness of American financial institutions to the needs of the society. The Federal Reserve System, with its Congressionally designated responsibilities in economic stabilization and financial regulation, was frequently the center of attention.

This myriad of issues must be resolved and numerous proposals for modification and change undoubtedly will result from the public debate. Informed evaluation of the proposals will require increased public knowledge about achievable financial objectives and understanding of the existing system. To facilitate that understanding, our annual report is devoted to an examination of one part of the nation's financial structure, the Federal Reserve Bank of Chicago.

The monetary policy actions and the regulatory role of the Federal Reserve System has been given extensive coverage in the national media, but little information has been reported on the individual Reserve Banks. All too often public knowledge about the responsibilities and performance of a Reserve Bank is confined to those activities with which individuals, businesses, or banks have direct contact—the redemption of a savings bond, the purchase of a Treasury security, or check clearing. The peculiar nature of a Reserve Bank—its private character on one hand with commercial banks as its stockholders and with public responsibilities and direction on the other hand—is not widely understood.

Our monthly review, *Business Conditions*, as the vehicle for presenting the 1975 Annual Report of the Federal Reserve Bank of Chicago,provides an opportunity for a more complete description of this bank's responsibilities and activities. The officers and staff of this bank hope it will provide useful information to those interested in the American financial system, the Federal Reserve System, and the Federal Reserve Bank of Chicago.

What is the Federal Reserve Bank of Chicago?

A casual pedestrian along LaSalle Street noting the location, facade, and even name of Chicago's Federal Reserve Bank could easily suppose it to be a commercial bank no different from any other bank. A stroll into the building's lobby, with its high ceilings and bronze teller's cages framed by marble pillars, would reinforce this misconception. Even a glance at the Chicago Fed's balance sheet, dominated by investments in loans and securities on one side and deposits on the other, or an examination of its organizational structure—charter, stockholders, directors, and officers—would do little to contradict the appearance that the Chicago Fed is simply another commercial bank.

While fewer and fewer people hold this view, a number of misconceptions of the Chicago Reserve Bank are likely, each based upon a different perspective of the institution. For example, some bankers may regard the Chicago Fed as a correspondent bank or as an alternative source of such services as check collection, investment, and safekeeping. For these bankers the Reserve Bank's performance or value would be measured in terms of its ability to provide services sufficient to compensate for the balances (reserves) they are required to maintain there. To some critics, the Chicago Fed appears to be a trade association. Not only does it gather and disseminate information on industry operations and performance, but in their view, it promotes and even serves as an advocate for the interests of the commercial banking industry. Interestingly, to some bankers and financial people this is the Fed's appropriate but much neglected role.

Even those who focus more properly on the Chicago Fed's public agency status could easily hold different notions as to the nature of that role. A prospective investor in government securities or a corporate financial officer required to deposit withholding taxes might regard it simply as a division of the U.S. Treasury or as the government's bank. In legal circles the Chicago Fed could be viewed as a part of the federal regulatory structure similar to the Federal Power Commission, the Interstate Commerce Commission, or other bodies established to substitute administrative decrees for the decisions of the marketplace in determining the prices and manner of operations of the various firms comprising an industry. From the reports on the evening news one could gather the impression that the Chicago Fed is simply the local administrative office of the Washington-based Federal Reserve Board, which might in turn appear to be a component of the federal government's executive machinery responsible for national economic policy.

While each of these perceptions is understandable, each captures only one aspect of the Chicago Fed and, as a result, misrepresents the whole. But even a complete catalogue of all these diverse aspects of the Chicago Reserve Bank would not describe it adequately. A truly representative image of the Chicago Fed emerges only with an understanding of the relationship that unifies its various parts. The factor critical to understanding the Chicago Fed is its overall purpose—the mission it seeks to accomplish through the variety of roles it portrays.

What then is the Federal Reserve Bank of Chicago? A textbook could define it as a public institution established (along with 11 similar banks) to serve as this nation's central bank with responsibility for a specific geographic area—the state of Iowa, plus the upper two-thirds of Illinois and Indiana, and the lower two-thirds of Michigan and Wisconsin. But this "central bank" identity only provides a Reserve Bank with another label (albeit a correct one). It was established as a central bank *to promote the nation's financial and economic goals.* Through its central bank powers and activities, it seeks to ensure a smooth flow of money and credit—a flow consistent with the needs of a dynamic economy, thereby facilitating orderly economic growth, high levels of employment, and a stable dollar domestically and abroad. The Chicago Fed's specific dealings with banks, with the government, and with individuals serve only as the avenues through which it can fulfill its broad responsibility to the public at large. And since it is this public purpose which provides the one meaningful answer to what a Reserve Bank is, a Reserve Bank's diligence in pursuing it is the yardstick against which to measure its performance.

Promoting national financial goals through services to banks

The vast majority of Chicago Fed employees—at the head office, at the Detroit branch, and at the Des Moines, Indianapolis, and Milwaukee facilities—are engaged in activities that interact with the operations of commercial banks. Direct service is provided primarily to the 926 member banks in the Seventh Federal Reserve District—the largest number in any Reserve district. Nonmember banks as well as nonbank financial institutions may gain access to services through dealings with their correspondent banks that are members. This extensive interaction with one industry within the private sector undoubtedly gives rise to misperceptions of the Fed as an institution which serves a particular private interest rather than the general public interest, i.e., to views of it as a special type of correspondent bank or even trade association. But those who hold such views fail to comprehend that services provided to commercial banks are only a channel through which the Chicago Fed serves the financial needs of the public. It is this public service function that determines whether a service should be offered as well as the basis on which it should be provided.

Member banks, required by law to maintain non-interest bearing balances (reserves) with their Federal Reserve Bank, tend naturally to evaluate Federal Reserve membership in terms of the comparative worth of services received against the cost of balances maintained—as they would evaluate any correspondent relationship. Should that comparison prove unfavorable, member banks may opt to withdraw from membership or press for additional services. Understandably, they raise objections to those instances where nonmember banks are provided comparable access to Federal Reserve services.

But in order for the Chicago Fed to effectively and efficiently serve the financial needs of the entire public, such functions as check collection must be provided to nonmembers as well as members. Nevertheless, it is hardly inconsistent with the Fed's public service role to restrict other Reserve Bank services to members—given the inequities arising from the current voluntary membership arrangement combined with the nonpayment of interest on reserve accounts members must maintain at the Fed. After all, the Fed's capacity to fulfill its public responsibility is dependent upon its ability to maintain members.

Payments mechanism activities at the Chicago Fed

	Dollar amount		Number of items	
	1975	1974	1975	1974
Checks collected:				
Commercial bank checks	713.9 billion	703.2 billion	1.6 billion	1.5 billion
U.S. Government checks*	41.9 billion	33.4 billion	120.0 million	103.2 million
Noncash items collected	1.3 billion	1.3 billion	1.1 million	1.6 million
Transfers of funds	4,948.5 billion	4,729.2 billion	2.8 million	2.4 million

*Includes postal money orders.

The payments mechanism

The U.S. payments mechanism, broadly defined, is that set of procedures and regulations that permit the smooth settling of financial claims that arise out of every transaction occurring within the largest and most complex economy in the world. The Federal Reserve Bank of Chicago is an essential part of that mechanism.

Check clearing and collection is the most familiar Reserve Bank activity in the payments mechanism. (It is also the major source of Reserve Bank expense.) Over 30 percent of the total workforce at the Chicago Fed's five offices is involved in the check collection function. Each day, more than 3 million checks move through the Chicago head office alone. They are proved and forwarded to 1,600 drawee banks, and appropriate accounting entries are made. Roughly 8 million checks yearly, returned unpaid by the drawee banks, must be retraced to the depositing institutions. Successful execution of this voluminous task requires a substantial allocation of human resources, the most up-to-date processing equipment, a major effort in planning, organizing, and scheduling check operations. The Chicago Fed plays a unique role in System check collection activities in that it houses the Interdistrict Transportation System, a unit which evaluates and seeks to improve—in terms of both costs and timeliness—the movement of checks and other items between all Federal Reserve offices.

Significantly, a Reserve Bank's role in the nation's payments system extends beyond commercial bank checks. Government checks—Social Security payments, VA insurance dividends, etc.—and postal money orders also clear through the Fed. Such noncash items as acceptances and notes, as well as maturing municipal obligations, are also collected by Reserve Banks. But most important in the context of the payments system of the future is that Reserve Bank involvement in our nation's payments system extends beyond transfers evidenced by pieces of paper.

As early as 1918, Federal Reserve Banks began to transfer funds between member banks by sending messages via a System-wide communications network. (The Federal Reserve Bank of Chicago served as the main relay or "central switch" for this original Morse code system.) Today, all Federal Reserve offices, and through them a steadily increasing number of member banks have "on-line" computer capacity which connects them in a high-speed communications network. The Federal Reserve's "Culpeper Switch" (in Culpeper, Va.), capable of processing in excess of 25,000 messages each hour, serves as the heart of this network. This hardware, in combination with ongoing efforts of each Reserve Bank to expand and improve communications within its district, will permit the Federal Reserve Banks to play an important role in this nation's evolving electronic funds transfer system (EFTS).

Specific EFTS projects already under way at the Chicago Fed include processing of the Air Force direct-deposit payroll implemented during 1975. By December all states in the Seventh District were brought onto the system. During 1976, when the Treasury Department implements the second phase of the Social Security direct-deposit program, checks no longer will be mailed to depository institutions, but rather electronic information will be sent to the Reserve Banks. Preparation is under way at the Chicago Fed to meet the third-quarter target date for this conversion in the Seventh District.

The Chicago bank has been working closely with local clearing house asociations in the district in the planning and implementing of Automated Clearing Houses (ACHs), which exchange electronic payments data. ACHs became operational in Des Moines and Detroit during 1975. Implementation of ACHs in Chicago, Milwaukee, and Indianapolis is proceeding on schedule. With the addition of ten banks during the year, a total of 14 district banks were linked "on-line" to the Fed communications network through the Chicago office. As a result, 75 percent of funds transfers are now processed "on-line." In the midst of these developments efforts to improve the traditional paper payments function continued. During the third quarter of 1975, for example, the Milwaukee office, the third off-site check processing center to be opened in the Seventh District, became operational. As a result, nearly all the district is now provided with overnight check collection.

Currency activities at the Chicago Fed

	Dollar amount		Number of items	
	1975	1974	1975	1974
Currency received and counted	6.5 billion	6.6 billion	874.9 million	814.0 million
Coin received and counted	230.0 million	201.0 million	1.7 billion	1.5 billion
Unfit currency withdrawn.........	1.2 billion	1.3 billion	278.7 million	291.2 million
Food stamps received and processed.	870.3 million	667.6 million	282.7 million	309.2 million

An "elastic" currency

Only a small fraction of total dollar transactions in the United States are accommodated by currency transfers. But regardless of the extent to which currency is utilized in commerce, we take for granted that available supplies of currency correspond to circulation needs. This was not always so. Prior to 1914 the availability of currency was limited by the stock of metal available for coinage plus the volume of outstanding government bonds required as collateral to issue national bank notes. Not only was the supply of currency relatively inflexible, but it was even possible for that supply to contract while the need for it increased. This situation exacerbated and perhaps even precipitated many of the economic downturns that occurred frequently into the early years of this century. Today, while we may experience temporary deficiencies in particular denominations—the penny shortage of 1974—such occurrences are inconveniences with no potential for destabilizing the level of economic activity.

The establishment of an apparatus to assure that currency would be issued into as well as withdrawn from circulation as the needs of commerce dictated—i.e., an "elastic" currency—was an important objective of the Federal Reserve Act. The act created the Federal Reserve note, which is, for practical purposes, the only circulating paper currency being issued in the United States today. The Federal Reserve Bank of Chicago satisfies the currency needs of the public by supplying currency and coin in the volumes and denominations required by its member banks—which in turn correspond to the demands of their customers—and charging member banks' reserve accounts for the currency supplied. Conversely, when the stock of currency or coin held by the public exceeds its needs, that excess flows into commercial banks and ultimately to the Federal Reserve Bank, where it is stored for reissue or withdrawn if unfit for further circulation.

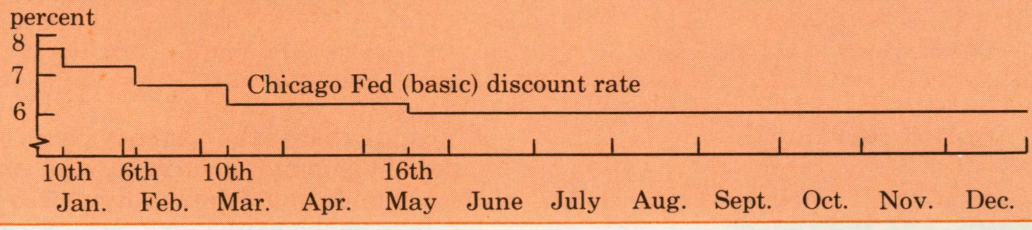
Currency operations at the Fed today also include the receipt (and disposal) of food stamps from participating banks. Because of their cash-like transferability, food stamps must be accorded comparable security.

In addition to its routine activities in the currency function the Fed of Chicago enjoyed the unique honor in August 1975 of introducing the bicentennial quarter into circulation. The quarter, designed by Mr. Jack Ahr, a resident of the Seventh District, was one of three coins specially designed to commemorate the nation's 200th birthday.

In April 1976 this bank, along with all other Reserve Banks, will once again begin to issue $2 bills. Unlike past issues of this denomination, these bills will be Federal Reserve notes. Given an expected annual issue of $800 million, it is believed that the bills will circulate freely, increasing the convenience and efficiency of the public's use of currency.

Credit activities at the Chicago Fed

	1975	1974
Loans to member banks	$5.0 billion	$22.4 billion
Number of banks accommodated	166	318



The discount window

Once the operation of the discount window was regarded as the Fed's paramount tool for controlling general money and credit conditions. While no longer the primary control device it remains an important, and at times, a vital function of Reserve Banks. The credit facility of the Chicago Reserve Bank still serves its initial stabilization role. In essence, the availability of credit from the Chicago Fed enables a member bank to replenish its liquid funds in time of need (possibly occasioned by heavy deposit withdrawals, strong local credit needs, or other unexpected developments) without impinging upon the liquidity of other commercial banks. Thus, disruptions in the financial system can be contained, and as a result, the general welfare is promoted—not merely the welfare of the bank accommodated. Credit activities represent an integral complement to other System monetary tools. Indeed, the complementary relationship is a practical necessity since the extension of Reserve Bank credit increases the availability of credit in the economy.

Access to Federal Reserve credit still represents a major inducement for membership. But while banks may join the System to avail themselves of its credit facilities, credit is not an automatic right of membership. In every instance, an extension of credit by the Chicago Reserve Bank is a discretionary matter, entirely within its own preserve. This principle is consistent with the public responsibility of the discount window, and indeed, of the System as a whole. In fact, the Federal Reserve Bank is legally charged with assuring that utilization of the window accrues to the benefit of the public at large—regardless of whether the window is used as a source of member bank adjustment credit or seasonal credit or as a source of "last resort" (emergency) credit for banks or others.

In the System's earliest days credit was extended only on a short-term basis, as temporary relief so that the borrowing bank could make necessary adjustments in its assets and liabilities on an orderly basis. Then, as now, adjustment credit, the predominant activity of the Chicago Fed discount window, is not to be used to finance speculation in securities, to serve as a substitute for bank capital, or to take advantage of interest rate differentials.

Longer-term credit is now extended under the seasonal borrowing privilege adopted in 1973. It is available on a prearranged basis to member banks that lack reliable access to national money markets as a means of accommodating their recurring contrary swings in assets and liabilities. In light of the importance of agriculture in the Seventh District, the adoption of this program had special regional significance. The provision of seasonal credit, like adjustment credit, serves to overcome imperfections in our financial markets and thereby promotes a smoother flow of money and credit.

The public interest orientation of the Chicago Fed's discount window is perhaps illustrated most clearly by its function as a "lender of last resort." Such emergency credit is extended only where immediate failure of the borrower could be expected to have a severe adverse impact on the economy. It is intended that emergency credit serve to meliorate failure (not prevent it) to prevent attendant dislocations in the money markets. In other words, its objective is not to bail out specific stockholders, corporations, or municipalities, but only to protect the public from the side effects arising from a failure. To emphasize this point the Federal Reserve System has applied a penalty rate in its loans to problem banks since 1974.

Every two weeks the Chicago Fed's Board of Directors votes on the bank's discount rate. Rate changes, reflecting desired as well as prevailing conditions in money and credit markets, represent an important monetary policy tool. As regional differences in credit conditions have been blurred by the evolution of national money markets, the discount rates of the 12 Reserve Banks tend to be uniform, with only brief exceptions. Nonetheless, the directors of the Chicago Fed recognize fully the role which they play and act independently in carefully evaluating local and national financial conditions before determining the rate. The (basic) discount rate of the Federal Reserve Bank of Chicago was 7¾ percent at year-end 1974, was reduced on four separate occasions in the early months of 1975, and remained at 6 percent from May 16 through the balance of the year.

Other bank service activities at the Chicago Fed

	Dollar amount		Number of items	
	1975	1974	1975	1974
Safekeeping of securities				
Definitive securities	7.2 billion	7.0 billion	1.6 million	1.6 million
Book-entry Treasury securities	21.3 billion	9.7 billion		
Purchases and sales of securities for member banks	852.7 million	508.0 million	12.7 thous.	12.7 thous.

Other services to banks

The payments, currency, and lending functions of the Chicago Federal Reserve Bank emanate from specific provisions of the original Federal Reserve Act. Through time, the Fed has taken the opportunity to increase the efficiency of its member banks by expanding the range of its "bank service" activities. Among considerations that underlie decisions to provide additional services are: the service largely utilizes Fed facilities or expertise developed in the promulgation of its major public responsibilities; given the voluntary membership system, provision of a service primarily to induce or maintain membership can be regarded as consistent with the general public interest; providing services not readily accessible from alternative sources in the private sector tends to enhance member bank efficiency and the operation of financial markets generally, thereby contributing to a smooth flow of money and credit in the economy.

In the aggregate, the Federal Reserve Banks represent the largest and most active investment account in the government securities market; thus, the purchase and sale of government securities for the accounts of member banks is easily accommodated. For many small member banks, the ability to buy and sell securities through the Chicago Fed represents improved access to the market.

Safekeeping facilities, including the processing of maturing coupons and securities, are necessarily maintained for securities deposited as collateral for loans from the Chicago Fed discount window, for U.S. Treasury Tax and Loan deposits at commercial banks and as otherwise required by public authorities for pledging purposes. As a convenience to member banks Chicago Fed safekeeping facilities also are extended to unpledged U.S. Government and municipal obligations owned by member banks and their customers. As a result, the transfer of such securities to pledged accounts is obviously facilitated. At the same time the aggregation of securities at one of a limited number of distribution points linked by a well-developed transportation and communications network facilitates the transfer of these securities to other parties, which benefits all participants in the securities markets.

Especially important in this regard is the conversion to a "book-entry" system for safekeeping U.S. Government securities. Instead of holding these securities in "definitive form,"—i.e., physically storing a paper certificate—custody is represented by a simple accounting entry. The book-entry system in combination with the development and expansion of the Chicago Fed's on-line (Fed-to-member bank computer link) security transfer system greatly improves the safety and efficiency of trading in government securities. Transfers between bank customers as well as between banks can be processed instantaneously, and the risk attendant to physically transporting securities is entirely eliminated.

Another important bank service offered by the Chicago Fed is the functional cost analysis program, which provides member banks with relevant comparative data as well as a functional breakdown of their own cost figures. At present, 215 district banks participate in the program, the largest participation within any Federal Reserve District. The Chicago Fed also conducts seminars at its offices and other locations around the district at which the operations of the Fed are discussed, and member banks are visited regularly by Fed representatives. Through these various sessions member banks receive counsel on how they can derive maximum benefits from the proper utilization of Federal Reserve services. As in the securities activities, these services are provided by the Chicago Fed with the ultimate intent of promoting a smoothly operating financial system.

Promoting financial and economic goals through public agency functions

The public purpose of the Chicago Federal Reserve Bank is readily apparent when one focuses upon any of its various public agency functions—its activities as fiscal agent for the U.S. Government, as a supervisory and regulatory authority, or as a participant in the formulation of monetary policy. The beneficial consequences of combining these various functions in each of the institutions that comprise the Federal Reserve System may not be as readily apparent. Therefore, in discussing each of these public agency functions, it is important to consider as well the attributes of this structural arrangement.

Fiscal agency activities at the Chicago Fed

	Dollar amount		Number of items	
	1975	1974	1975	1974
Marketable government securities issued, serviced, redeemed:*				
Definitive securities	43.9 billion	62.0 billion	1.3 million	1.9 million
Book-entry securities	379.3 billion	243.1 billion	204.8 thous.	171.8 thous.
U.S. savings bonds issued, serviced, redeemed	3.6 billion	3.6 billion	53.0 million	56.3 million
Fed tax receipts processed	35.7 billion	36.8 billion	6.6 million	6.5 million

*Includes transfers of securities.

Fiscal agent

The fiscal agency activities of a Reserve Bank are frequently confused with the System's responsibilities for economic policy leading to mistaken views of the Reserve Bank's functional relationship to the federal government, particularly its relationship to the executive branch. The Chicago Fed's identification as the government's bank may be warranted in view of the extensive financial services it provides to the U.S. Government. But in performing this role, the Fed does not function as a division of the U.S. Treasury or as a component of any other executive department of the government. Rather, the Chicago Fed acts in the capacity of an agent—not a subordinate. In view of the reimbursement it receives, it might fairly be said that these services are purchased or contracted for by the government. The role of the Fed may be most accurately described as functioning as a conduit through which financial transactions between the public and private sectors take place. Because the Reserve Bank is at the same time a quasi-banker's bank and the government's bank it can promote efficiency and security in the substantial flows of funds between these sectors. By tracing a marketable government security from the time of its issue to its maturity, insight can be provided into the manner in which Chicago Fed operations accommodate both the public and private sectors.

Every Treasury debt financing—the weekly Treasury bill issues and periodic offerings of longer debt maturities—is processed through the Federal Reserve Banks. After distributing an announcement of the issue, the Fed of Chicago receives from the public applications (tenders) to purchase the securities. These bids are ranked by price or yield, as are those received at other Reserve Banks, and securities are thereby allotted among the bidders. (Full allocation is made to all noncompetitive tenders—i.e., those bids to purchase at whatever price the market determines.) Payment is collected from the purchasers—principally by charging reserve accounts of member banks whose purchases for their own accounts and for their customers' accounts represent the vast majority of total dollar subscriptions. A corresponding credit is made to the Treasury's checking account held at the

Reserve Bank. The Chicago Fed in turn effects delivery of the security either from its own stock of debt certificates or, primarily, through its book-entry system (which includes custodial accounts for member bank customers).

After the security reaches the hands of the public, the Chicago Fed's activities with respect to it would not necessarily cease. If it is a note or bond, the Reserve Bank would pay the interest coupons as they come due. The Treasury's account would be charged and, if applicable, a corresponding credit would be made to a member bank reserve account. On request the Chicago Fed processes denominational exchanges of the security, converts it to book-entry form, registers it in its owner's name, or processes wire-transfers of it between banks (and the customers of those banks) possibly through the on-line security transfer system. Finally, when the security matures the Fed would redeem it. Because of the Fed's unique posture as a conduit between the public and private sectors, the security's issue, transfer, and redemption in all likelihood might have proceeded without ever entailing the risk involved in the exchange of cash, checks, or negotiable certificates.

But the Chicago Fed's fiscal agency activities are far more extensive than those relating to marketable Treasury securities. It services financial institutions and other organizations that it has designated as qualified to issue savings bonds. It also redeems savings bonds either directly for individuals or through financial institutions it has designated as qualified paying agents. The Fed qualifies banks to serve as special depositories for public monies and processes the collateral required to maintain these Treasury Tax and Loan Accounts. Since the Treasury can only make disbursements through its checking accounts at Federal Reserve Banks, the Chicago Fed must process the Treasury's calls on its accounts at private depositories. The Fed receives and processes federal taxes of various types from authorized federal tax depositories and accepts direct deposits from corporate taxpayers. The destruction of unfit currency and the disposal of canceled food stamps also come under the Fed's fiscal agency responsibility. Certain financial services are also provided to a number of federal and federally sponsored agencies.

The expansions of the book-entry and the on-line security transfer systems are prime examples of efforts of Chicago to upgrade the service it provides as the government's fiscal agent. During 1975 special efforts were also required to accommodate the thousands of individuals who came directly to the Fed to purchase Treasury securities.

Supervision and regulation

Federal Reserve supervisory activities are concerned primarily with the conduct of individual institutions, specifically with respect to their soundness and their compliance with applicable laws and regulations. To carry out this function, the Federal Reserve Bank of Chicago maintains a staff of 63 who examine 247 state-chartered member banks in the Seventh District on the basis of unannounced visits. Periodic reports are also required to provide a more continuous flow of supervisory information.

Regulation by the Federal Reserve, as distinct from supervision, is primarily concerned with the performance of the industry as a whole—to assure that it remains viable, competitive, and efficient. In short, the industry's performance must be consistent with the general public interest. As a result, regulation overlaps supervision to a degree in that the conduct and safety of individual institutions are necessary concerns of regulatory policy.

As a general rule, the Federal Reserve Bank of Chicago is responsible for administering regulatory policy with respect to the institutions in its district, subject to the oversight of the Board of Governors of the Federal Reserve System, which has primary responsibility for formulating that policy. But policy also may emanate from System-wide committees on which the Chicago Fed participates, and the Chicago Fed has authority to render final decisions on certain regulatory questions.

The Federal Reserve System does not, however, have exclusive responsibility for bank regulation. It has no authority to charter institutions. In certain areas (e.g., in bank examination, in bank merger and branch analysis, in the imposition of interest ceilings on deposits) it shares responsibility with the Comptroller of the Currency and the Federal Deposit Insurance Corporation. In a number of instances regulation by state banking authorities overlaps the Fed's jurisdiction. In other areas the Federal Reserve has primary authority for formulating regulations but shares responsibility for insuring compliance with those regulations (truth-in-lending, equal credit opportunity). The Federal Reserve is vested with sole federal responsibility in certain areas of regulation (setting reserve requirements and margin requirements, executing the provisions of the Bank Holding Company Act, regulating the foreign activities of U.S. banks).

The present system of bank regulation has been the subject of active debate recently. Various organizational schemes have been proposed, ranging from significantly expanded Federal Reserve responsibility in the supervisory and regulatory function at one extreme to total elimination of such activities for the Fed.

Whatever the ultimate conclusions may be concerning the appropriate role of the Federal Reserve System, the Fed's current simultaneous involvement in regulatory and monetary policy has enabled it to take into account the inevitable ramifications that each policy has for the other. Monetary policy cannot be implemented without impacting upon individual institutions. Executing policy without regard to such side effects could produce undesirable consequences, especially in the short run. Moreover, while the Fed would not modify its supervisory standards for purposes of monetary control, cognizance of changing financial conditions leads to an increased awareness of areas of banking activity that require special supervisory attention. On the other hand, certain aspects of regulation—reserve requirements, interest ceilings on time deposits, and margin requirements for purchases of securities, for example—influence the overall flow of money and credit in the economy. Were the administration of such regulations solely in the hands of another agency, the Fed's ability to implement effective monetary policy might be impaired. Nonetheless, valid arguments can be posed on either side regarding the merits of the current division of regulatory authority. The future of Federal Reserve involvement in the regulatory and supervisory function will remain uncertain until this public debate is resolved.

In the meantime, there has been a discernible tendency on the part of Congress to increase the System's responsibilities in this area. As an example, the Federal Reserve System was granted exclusive authority to promulgate policy under the Bank Holding Company Act. The 1970 amendments to the act significantly expanded its coverage and greatly increased the System's workload. The Chicago Fed alone is responsible for supervising the operations of over 400 bank holding companies in the Seventh District.

The System's responsibilities in the areas of truth-in-lending and equal credit opportunity (a new area of responsibility in 1975) serve as additional illustrations of this expansionary trend. Particularly noteworthy in these instances was that the System was charged with formulating regulations applicable to all credit vendors, not solely commercial banks.

Given this expanding range of responsibility combined with current overlaps in jurisdiction between the various agencies, the Chicago Fed has been particularly mindful of opportunities to improve its performance in the regulatory sphere. An Office of Consumer and Savers Affairs was opened at the Chicago Fed during 1975 to clarify and explain regulations, particularly the newer ones, and to resolve consumer complaints regarding financial institutions subject to Federal Reserve regulation. The Chicago Fed has also been concerned with reducing unnecessary duplication in effort. For this reason, in an experiment currently under way in Indiana, the Chicago Fed relies for the most part on the state authority for on-site bank examinations.

Monetary policy formulation

The public has become increasingly concerned with national economic policy as well as increasingly knowledgeable about the mechanics of its execution. As a consequence, many members of the public—although they may never have occasion for direct contact with a Reserve Bank—are cognizant of the Federal Reserve System's monetary policy responsibility. Because the Washington-based Board of Governors of the Federal Reserve System (and especially its chairman) naturally serves as the media's primary focal point for monetary policy, many people may be unaware that participation by the individual Reserve Banks is a fundamental principle of monetary policy formulation in our country.

In essence, the System implements monetary policy through actions which affect the availability and cost of bank reserves. The impact of these actions spreads to the supply of money and credit, market interest rates, and the liquidity of the public in general. Ultimately, total spending, output, employment, and prices are affected. As already indicated, the Chicago Fed affects reserve availability through changes in its discount rate. Changes in reserve requirements (at the discretion of the Board of Governors) also affect the supply of bank reserves significantly. But System open market operations—that is, direct participation by the system in financial markets through purchases and sales of government securities for its own account—must be regarded as the System's most potent and flexible tool for affecting general credit conditions, especially since such operations can be adapted on a more or less continous basis to suit constantly changing financial and economic conditions.

Open market operations are based upon directives issued by the Federal Open Market Committee (FOMC), the System's most important policy-making body. The structure of this committee, comprised of the members of the Board of Governors and presidents of the individual Reserve Banks, highlights a fundamental characteristic that distinguishes our nation's monetary authority from all others in the world.

Instead of having a single central bank, we have 12 regional Reserve Banks; the operations of each, while coordinated through the System's Board of Governors, are to an important degree autonomous from those of the others. Each Reserve Bank reports to its own directors, who represent banking and nonbanking interests in its district. Because of its relative independence, each Reserve Bank can gear its operations to suit the special needs and problems of its geographic and economic region. This autonomy serves to encourage innovation which can improve the operations of all Reserve Banks. But most importantly, the regional structure of our central banking system has important ramifications for national monetary policy. The formulation of that policy is based upon a variety of inputs (including a grass roots appraisal of our needs and resources). The diffusion of power (through Reserve Bank participation) that characterizes the monetary policy formulation process serves to insulate policy from the narrow economic and political considerations that could influence it where power concentrated in the hands of a few.

The role of a Reserve Bank in implementing and executing monetary policy might best be described by focusing on events at the Chicago Fed relating to an FOMC meeting. (The FOMC meets about once each month to determine general policy direction and objectives for the succeeding period.) The president of the Chicago Fed, Mr. Robert P. Mayo, is the bank's representative on the FOMC. During 1975 Mr. Mayo was one of five Reserve Bank presidents who served as voting members of the FOMC. While he serves in this capacity every other year only (alternating with the Cleveland Fed president) he attends all FOMC meetings and actively participates in all policy deliberations regardless of his voting status.

On the Thursday preceding the normal Tuesday FOMC meeting, Mr. Mayo receives two reports. One, called the "Green Book," is prepared by the Board staff in Washington and provides information on current and expected future national economic trends. The other report, called the "Red Book," contains evaluations of district economic conditions submitted by the 12 Reserve Banks.

On the next day Mr. Mayo meets with Chicago Fed senior research staff members to discuss both district and national trends in greater depth. Developments in the business, financial, international, and agricultural sectors are covered in the analyses and are summarized in written form for Mr. Mayo's use by Chicago Fed economists. The extent to which district developments coincide with national trends is an important aspect of these discussions, and economic sectors of particular importance in this district, such as capital goods, automobiles, and agriculture, receive special attention.

Over the weekend Mr. Mayo receives a report from the Board's staff which provides estimates on the consequences of various policy alternatives. Similar projections are produced independently by Chicago Fed economists.

At the FOMC meeting Mr. Mayo presents his view as to the appropriate course of monetary policy in light of his assessment of the economic outlook. Once all 12 Reserve Bank presidents and the seven members of the Board of Governors have voiced their viewpoints, a consensus emerges and a directive can be formulated for the manager of the System Open Market Account, who has responsibility for carrying out the Committee's decisions by purchasing and selling securities. Each day prior to executing these transactions, however, the manager confers with one of the voting Reserve Bank presidents. Mr. Mayo served in this capacity during three months in 1975.

But while policy activities at the Chicago Fed may center around the monthly FOMC meetings (and biweekly directors' meetings at which the discount rate is voted on), economic analysis and policy studies are necessarily continuous functions. A constant flow of economic and financial information—some of it even on a daily basis—is generated at the Federal Reserve Bank of Chicago through a wide variety of regular reporting programs and special mail and telephone surveys. This day-to-day analysis is supplemented by longer-term research projects intended to enhance the ability of both the bank and the System to formulate effective monetary policy.

A final word

This review has touched only upon the major functions of the Federal Reserve Bank of Chicago. By providing an overview of these functions, however, it is hoped that the reader has a more complete understanding of the public responsibility that underlies all the activities of the Chicago Fed and has a better basis for evaluating the performance of the Chicago Reserve Bank given that responsibility.

"It should never be lost to sight that the Reserve Banks are invested with much of the quality of a public trust. They were created because of the existence of certain common needs and interests, and they should be administered for the common welfare—for the good of all." So advised the Federal Reserve Board in its first annual report. This view is as valid today as it was in 1915.

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as of December 31, 1975

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Statement of earnings

(In thousands of dollars)

	1975	1974
Current earnings:		
Advances and discounts	$ 1,588	$ 14,400
U.S. Government securities	927,614	957,846
Foreign currencies	842	1,072
All other	255	449
Total current earnings	$930,299	$973,767
Current expenses:		
Operating expenses	$ 71,844	$ 65,696
Federal Reserve currency	4,112	2,828
Assessment for expenses of Board of Governors	5,168	6,423
Total	$ 81,124	$ 74,947
Less reimbursement for certain fiscal agency and other expenses	6,919	6,574
Current net expenses	$ 74,205	$ 68,373
Current net earnings	$856,094	$905,394
Additions to current net earnings:		
Profit on sales of U.S. Government securities (net)	$ 5,828	$ —
All other	317	395
Total additions	$ 6,145	$ 395
Deductions from current net earnings:		
Loss on sales of U.S. Government securities (net)	$ —	$ 6,682
Loss on foreign exchange transactions (net)	37,236	5,332
All other	33	1,905
Total deductions	$ 37,269	$ 13,919
Net deductions from (-) or additions to current net earnings	- 31,124	- 13,524
Net earnings before payments to U.S. Treasury	$824,970	$891,870
Dividends paid	$ 8,453	$ 8,131
Payments to U.S. Treasury (interest on Federal Reserve notes)	812,186	878,638
Transferred to surplus	$ 4,331	$ 5,101
Surplus account		
Surplus, January 1	$137,523	$132,422
Transferred to surplus—as above	4,331	5,101
Surplus, December 31	$141,854	$137,523

Most annual reports provide owners and creditors with information necessary to evaluate an organization's performance. The financial statements of private enterprises—balance sheets and statements of income—are statistical indicators of current and future capacity to generate earnings and stay in business. By contrast, Federal Reserve Banks do not operate under an earnings objective although substantial earnings are incidental to the functions performed. Changes in their major asset, liability, and income items reflect developments in the economy and actions undertaken in support of System monetary objectives. Income consists mainly of interest on this bank's share of the System's portfolio of Treasury securities. Most of this is returned to the Treasury after expenses and statutory dividends to member banks are paid.

In 1975 the major factor accounting for the decline in earnings from 1974 was lower interest rates on the securities held in the System Open Market Account. Fewer loans to member banks and reductions in the discount rate also resulted in less income. Expenses rose, reflecting expanded facilities and continued inflation. The resulting decline in current earnings, plus this bank's share of exchange transactions losses entailed in currency stabilization operations, reduced payments to the Treasury compared with the record 1974 amount, but they were still well above any previous year.

Through purchases of securities and loans to member banks, the Reserve Banks increase the base for expansion in currency and deposits in accord with the economy's growth needs. Additions to member bank reserve deposits that result from this process are either withdrawn as currency or used to support the public's deposits at commercial banks. Last year all of the net increase in Reserve Bank credit was absorbed by the payout of currency (Federal Reserve notes outstanding) in response to public demands.

Although total deposits rose last year, member bank reserves declined, mainly because the required percentages of reserves to deposits were lowered.

Statement of condition

(In thousands of dollars)

	Year ending December 31	
	1975	1974
Assets		
Gold certificate account	$ 1,767,736	$ 1,946,093
Interdistrict settlement account*	324,257	—
Special drawing rights certificate account	79,000	70,000
Federal Reserve notes of other banks	71,867	77,583
Other cash	29,167	24,271
Loans:		
Secured by U.S. Government securities	46,000	13,400
Other	—	14,950
Total loans	$ 46,000	$ 28,350
Federal agency obligations, bought outright	914,637	767,912
U.S. Government securities	13,062,300	13,074,207
Total loans and securities	$14,022,937	$13,870,469
Cash items in process of collection	1,460,522	1,290,589
Bank premises	15,651	15,970
Other assets	206,022	153,339
Total assets	$17,977,159	$17,448,314
Liabilities		
Federal Reserve notes	$12,464,478	$11,373,962
Deposits:		
Member bank reserves	3,744,954	4,196,057
U.S. Treasury—general account	493,323	279,631
Foreign	40,440	45,530
Other	58,306	90,587
Total deposits	$ 4,337,023	$ 4,611,805
Deferred availability cash items	739,575	1,014,602
Other liabilities	152,375	172,899
Total liabilities	$17,693,451	$17,173,268
Capital accounts		
Capital paid in	$ 141,854	$ 137,523
Surplus	141,854	137,523
Total liabilities and capital accounts	$17,977,159	$17,448,314
Contingent liability on acceptances purchased for foreign correspondents	$ —	$ 154,300

*Included in gold certificate account until April 30, 1975.