Perspectives on Federal Reserve Independence

Federal Reserve Bank of Minneapolis
Annual Report 1976
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a changing structure for changing times

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To provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes.
Perspectives on Independence...

How Structure Affects the Function of Monetary Policy

Our 200th year, perhaps more than most years, has generated its share of questions about monetary policy and about the role of the Federal Reserve System—the nation's central bank—in solving our economic problems.

Over the past few years, the dual problems of inflation and unemployment have been especially vexing. And questions about how effectively our money managers are responding to such problems reflect the urgency and complexity of the inflation/unemployment dilemma.

These questions also reflect increasing reliance on monetary policy—managing the supply of money and credit—as a means of assuring national economic health. That emphasis has grown as we have had to cope with large deficits and difficult economic events such as the energy crisis, fluctuating foreign currencies, and continuing post-Vietnam adjustments.

The focus on monetary policy has generated questions not only about policy actions, but about the structure and power relationships of the Federal Reserve System—questions about its “independence.”

Differences of opinion over monetary policy actions are to be expected, regardless of how the System is structured. Given the limits of human wisdom and the incomplete state of our economic knowledge, such differences are normal and inherent. That there is such disagreement does not mean the procedures are wrong or the structure inappropriate.

If, on the other hand, the structural make-up of the System, or its procedures, tends to inhibit development and implementation of good policy decisions, then we can try to improve those structures and procedures.

Since our world is changing and issues seem to be getting more complex, it would be surprising if some adjustments in the mechanisms for monetary management might not prove useful. It's against
this background that the various proposals to change the structure and limit the “independence” of the Federal Reserve System deserve to be discussed.

The Semantics of Fed Independence

Quite probably the term “independence” has been over-used. It was a key concept in the design of our central banking system—but in a relative sense, not as an absolute.

What does “independence” mean? Is the Federal Reserve accountable? Is it responsive to changing national priorities?

First, let’s be clear on what independence does not mean.

It does not mean decisions and actions made without accountability. By law and by established procedures, the System is clearly accountable to Congress—not only for its monetary policy actions, but also for its regulatory responsibilities and for services to banks and to the public.

Nor does independence mean that monetary policy actions should be free from public discussion and criticism—by members of Congress, by professional economists in and out of government, by financial, business, and community leaders, and by informed citizens.

Nor does it mean that the Fed is independent of the government. Although closely interfaced with commercial banking, the Fed is clearly a public institution, functioning within a discipline of responsibility to the “public interest.” It has a degree of independence within the government—which is quite different from being independent of government.

Thus, the Federal Reserve System is more appropriately thought of as being “insulated” from, rather than independent of, political-government and banking-special interest pressures. Through their 14-year terms and staggered appointments, for example, members of the Board of Governors are insulated from being dependent on or beholden to the current administration or party in power. In this and in other ways, then, the monetary process is insulated—but not isolated—from these influences.

In a functional sense, the insulated structure enables monetary policy makers to look beyond short-term pressures and political expedients whenever the long-term goals of sustainable growth and stable prices may require “unpopular” policy actions. Monetary judgments must be able to weigh as objectively as possible the merit of short-term expedients against long-term consequences—in the ongoing public interest.

Monetary Power...

Monetary decisions have special importance because of their impact on all other aspects of our economic life. In a very real way, the power to create money also carries the power to destroy its value. Pushed to
Much as they may contribute to the country's progress, monetary powers...are not omnipotent. To be effective...they must be closely coordinated with the other major powers and policies of government which influence the country's economic life.

—President Franklin D. Roosevelt, 1937

extremes of misjudgment or illadvised action, misuse of monetary power can erode values and destroy the economic fabric of the society it serves—by inflation, boom-bust depression, immoderate stimulus, or by excessive restraint.

...And Its Limits
While monetary policymakers have great potential power over the economy, there is misunderstanding about the practical limits of such power. Typically, monetary policy can restrain credit expansion more effectively than it can stimulate borrowing. It can control the supply of money, but not the demand for it. It can influence interest rates, but not control them. The central bank can influence only a few of several factors that determine the course and vigor of economic performance. The problems are complex and constantly changing, our knowledge is never complete, and mechanisms for avoiding harmful policy side-effects are not adequately developed. Finally, the ultimate effects of monetary actions are not precisely known until months later, if at all.

Thus, just as responsible monetary policy must avoid extreme actions—which on balance may be more harmful than helpful to the economy—so must the public be restrained in its expectations as to what monetary policy alone, however well managed, can accomplish.

The Lawmakers’ Role
Politicians, the elected representatives who make our laws and determine public policy, are themselves subject to pressures inherent in our structure of government. They are expected to respond to the desires and needs of their constituents. And constituent expectations tend not to be tempered by such realities as cost and resource limits. In short, politicians are under pressure to accomplish more than available resources permit. That can mean attempting more than we can afford or are willing to pay for. Put another way:
it is easier to vote for needed programs than for increased taxes. Such pressures probably give our national policies and goals an inflationary tilt.

This is especially true in a democracy where the powers delegated to our elected officials must be affirmed by “back home” constituents every two, four or six years. The need for our elected representatives to be responsive and “tuned in” to their constituents is a vital function in our political process. It provides important guarantees to citizens. But it may also limit the extent to which elected representatives can afford to consider the long-term merits of policies. Policy actions that may lead to defeat in the next election, however valid, are not likely to be seen as attractive options.

Balanced policy therefore requires an institutional structure that insulates monetary policymakers from such short-term pressures—which is to say, one that also insulates elected officials from the negative electoral consequences of policy decisions that may be essential but unpopular.

Obviously, not all policy decisions pose this type of conflict. Not all elected officials yield to short-run pressures or would need to. In any case, the merits of a given policy are seldom unambiguous. But the consequences of persistently expansive monetary policy are too severe to risk procedures that compound a bias in favor of short-run options and produce short-sighted results.

Other Money
Historically, we have used a variety of mechanisms to manage money—a stock of silver and gold bullion or currency backed by metals. These mechanisms regulated the money supply according to irrelevant changes in our stock of metals and offered little or no consideration of actual needs of the economy, short- or long-term.

Our own history, and the experiences of other nations, are replete with examples of run-away inflation and economic chaos that developed because the lure of superficial solutions outweighed responsible but less popular policy actions.

Out of long experience, our monetary system has evolved so that the supply of money and credit are “managed” at levels intended to be most conducive to stability, growth, and a high level of production and employment in our national economy. That responsibility requires not only a high degree of technical knowledge about the economy and the interaction of its different elements and forces but also requires objective, “independent” judgments about the best monetary adjustments to help achieve those national goals.

History of Reforms
Over the years the Federal Reserve System has proved remarkably adaptable to changing needs. Both policies and procedures have been altered when the need for change became clear—sometimes
by statutes or amendment to the Federal Reserve Act, often by policy and administrative implementation within the authority of the Act.

The Federal Reserve System was barely in operation when it became apparent that purchases of government securities, now the main mechanism for influencing the money supply, added to bank reserves and thus became an unexpected mechanism for effecting monetary expansion.

The Banking Acts of 1933 and 1935 reaffirmed and strengthened the Federal Reserve's independence from the executive branch—they removed the Comptroller of the Currency and the Secretary of the Treasury from the Federal Reserve Board—and affirmed its independent budget and income procedures. They delegated to the Fed the power to control stock margin requirements and to regulate savings interest rates.

World War II saw the central bank directly supporting the financing of unprecedented war expenditures with subsequent monetization of that debt after the war. In the famous “accord” of 1951, after lengthy debate both public and within government, it was agreed that the Federal Reserve would no longer support (by its purchases of government securities) the artificially low interest rates and par values for financing government debt. Thus ended the domination of monetary policy by the Treasury’s needs to finance its massive war-born debt.

The Employment Act of 1946 affirmed “maximum employment” as one of the goals of Federal Reserve policy, establishing formally that monetary policy has a responsibility to support and help implement national objectives.

In more recent developments, Congress has delegated additional authority to the Fed under the Consumer Protection Act to regulate “Truth in Lending,” “Equal Credit Opportunity” and other consumer interests.

Over the years, it became clear that monetary policy had to be uniform throughout the nation, that regional variations were not possible. Yet the concept of a “federal” system, with input from various regional perspectives, was important in the policy process. The establishment of the so-called Federal Open Market Committee (FOMC), combining the Board of Governors and five Federal Reserve Bank presidents as the major policy-making body, represented a major structural innovation that accommodated the needed change.

**Independent... From Whom**

Representative Carter Glass and his congressional contemporaries worked out the remarkably durable provisions of the Federal Reserve Act within the context of our federal system of structural checks and balances. The terms of the seven Federal Reserve Board members (14 years*) are not so long or unchangeable as the life-time

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*Originally Board terms were 10 years, changed to 12 years in 1933 and to 14 years in 1935.*
Federal Reserve Chairman Arthur Burns testified before congressional committees 13 times in 1976. Other members of the Board also make frequent appearances before Congress.

appointments of justices to the Supreme Court, but are long enough to make the partisan political prospects of a next election substantially irrelevant.

Ultimately the System is accountable to Congress, not the executive branch, even though Reserve Board members and the chairman are president-appointed. The authority and delegated policy powers are subject to review by the Congress—not the president, the Treasury Department, nor by banks or other interests.

Because the Federal Reserve System finances its operations from internally generated income, it does not depend on congressional budget appropriations. This is an essential element of "insulation," since the power to appropriate budgets is the power to control. This principle was reaffirmed in the Banking Act of 1935 and again in the Government Corporation Control Act of 1954.
The check and balance structure extends in other ways. Directors of regional banks are required to represent borrowers and the general public as well as banks and lenders. The regional structure itself ensures the representation of varied regional interests in economic research and policy formulation, as well as directly on the FOMC. Members of the Board of Governors must themselves be geographically representative.

Finally, an important element of insulation results from the ability to have policy deliberations conducted in a manner and climate that ensures maximum candor by all staff and officials involved. Alternative policies cannot be discussed fully and realistically without such candor.

**Pressures for Reform**

Pressures for reform of the Federal Reserve System stem from three kinds of concerns: (a) disagreement with monetary policy, (b) disagreement with how the System functions in a procedural context, and (c) disagreement as to its accountability—to Congress, to the executive branch, to the public.

Disagreements over monetary policy are inherent. Knowledgeable monetary experts and economic professionals can and often do disagree over appropriate action, timing, methods of implementation and degree of emphasis. Typically, there is more disagreement over the precise degree of restraint or stimulus than over the direction of policy, whether restraint or stimulus. But disagreement over policy is normally healthy disagreement. It does not in itself justify reform unless policies are clearly bad, and clearly bad for reasons of structural dysfunction.

Critics of monetary policy often cite the need to coordinate monetary with other national economic policies: the various agencies of government should not work at "cross purposes." Working at cross-purposes can be wasteful and inefficient. It may be an indication of bad policy on the part of one agency or on the part of all. But agreed-upon policy objectives often conflict in implementation—as when we seek more "good things" than limited resources can provide, or when lower interest rates also mean more inflation. The populist goals of readily available credit at low interest on the one hand, and the dangers of rising prices, inflation and subsequent recession on the other, are the classic issues of monetary/economic policy debate, about which there is not only honest argument but also inherent conflict.

At times, rapid increases in federal expenditures—and deficits—have forced over-reliance on monetary restraint to curtail inflation. In the context of checks and balances, it can be prudent to have a system where not all agencies or branches of government are required to arrive at the same judgment concerning the nation's economic needs and prospects.
Other criticisms stem from the fact that the Federal Reserve System, as our central bank, is institutionally related to banking—especially member banks. Member banks elect six of the nine directors of each regional Federal Reserve Bank. And each member bank owns nominal stock in its district Federal Reserve Bank. Boards of regional Federal Reserve Banks have been, de facto, largely representative of banking, financial and business interests—more or less by deliberate policy. Understandably, the boards of regional Reserve Banks must include knowledgeable banking and business leaders, since one of the regional Bank's major functions is to work jointly with and through member commercial banks in providing financial services to business, government, agriculture and the district economy. In practice, this has meant that they have not been specifically representative of the interests of consumers, organized labor, minorities, or women—however those interests may be defined. But this is in process of change.

Recent Proposals

Several suggestions for reform of the Federal Reserve System have been proposed, some of which seem acceptable, even if not offering substantive improvements. Collectively, they might enhance the public's understanding of the Federal Reserve as a public institution and its functioning as the "supreme court" of monetary policy. Among the recent proposals are:

- **The term of the chairman of the Federal Reserve Board should be coterminous with the president's.** Some have suggested that a six or twelve-month overlap would be wise and in the interest of stability, allowing a new president to be deliberate in selecting a new chairman. Others note that the current procedure has not caused problems and may have merits worth preserving.

- **There should be broader representation among district Bank directors.** This proposal seems desirable and in keeping with a legitimate concern for the interests of consumers and minorities. Historically, educators and farmer-ranchers have been well represented on the Minneapolis Bank's Board of Directors. Expanding the number of board members—a proposal that was made last year—would make it possible to add persons with a broader range of backgrounds and experience without losing the contributions of present representation.

- **The member bank stock arrangement should be eliminated.** This suggestion would seem to have little material effect. It may now be regarded as an incidental aspect of membership, thought useful at the time the Federal Reserve Act was enacted. It is not an essential mechanism for Federal Reserve membership, but a useful one and certainly not harmful in symbolizing the stake and the participation that commercial banking has in the central bank process.
In contrast, the issue of Federal Reserve membership is of major significance. Both equity and efficiency require that competing financial institutions be subject to broadly similar reserve requirements. This issue becomes more important as other non-bank financial institutions (such as savings and loans) expand their role.

- **There should be fuller discussions of policy deliberations and more immediate reporting of FOMC policy decisions and plans.** This recommendation has much broader significance. More public knowledge and discussion of Federal Reserve policy would lead to a more informed public and more sophisticated understanding of the issues. Clearly a desirable result. At the same time, reforms should not destroy the freedom of policy makers to explore and discuss all policy options without the inhibiting influence of exposure to public misinterpretation or criticism during the formulative process.

- **There should be full and frequent reporting to Congress of policy actions and expectations.** This proposal would seem to be helpful to all concerned. The current procedure of regularly reporting to Congress on the "targets" of monetary growth has been generally constructive. Time and experience with this procedure may suggest whether more detailed reporting would be useful.

**Insulation... how it works**

Being "independent within" the government means a monetary function that is insulated from, yet fully aware of, other essential needs such as national defense, foreign policy and trade, resource development, housing, and employment. Constructive policy derives from a structure which can be both coordinative and independent, within government and also beyond government.

It will be helpful, then, to examine such cooperative/independent relationships between the Federal Reserve System and the other elements with which it must coordinate. These include:

a. The executive branch, including the president and his advisors, the Treasury Department and other agencies.

b. The Congress.

c. Banking and private financial institutions.

d. Structural relationships within the Federal Reserve System itself.

**With the Executive Branch**

Independence from the executive branch of government was a main concern during the development of the Federal Reserve System, as it has been since. Yet it is essential that the monetary function work in cooperation with the president and his economic advisors and with the major agencies of the executive branch, principally the Treasury Department.

Given the power and influence of the presidency, that office can exert strong pressure and influence on any agency. By and large,
presidents have been careful not to abuse this power, respecting the need for an independent monetary authority.

Following World War II it appears that President Truman did, for a time, support the Treasury Department in its need to finance the public debt and approved the then subordinate role of the Federal Reserve System in supporting that effort. When this impasse was resolved, the Federal Reserve's responsibility and accountability for monetary actions were restored. Since then, the "independent" relationship between the two agencies has functioned well.

There are any number of linkages between the Federal Reserve and the economic agencies of the executive branch. They are formal and informal and they function at both the policy and staff levels. The chairman of the Board of Governors, for example, joins the Secretary of the Treasury, the chairman of the Council of Economic Advisors, and the director of the Office of Management and Budget in meetings of the so-called Quadriad. When the Federal Open Market Committee takes policy actions which it believes to be in the best interest of the nation, it does so with full knowledge of the administration's plans and objectives.
Neither the Treasury nor the Board of Governors should be subordinated to the other. It is vitally necessary, however, that monetary policy, fiscal policy, and all the other economic policies of the government should be coordinated so that they will make a meaningful whole, working in the direction of price stability, high-level employment, and a dynamic, free-enterprise economy.

—from the congressional Subcommittee of the Joint Committee on the Economic Report, 1952

...And the Treasury
The central bank is in constant contact with the Treasury Department which, among other things, is responsible for the management of the public debt and its various cash accounts.

Prior to the existence of the Federal Reserve System, the Treasury actually carried out many monetary functions. And even since, the Treasury has often been deeply involved in monetary functions, especially during the earlier years.

At the beginning of World War II, it appeared desirable that the Treasury be able to issue debt at relatively low interest cost and also on a basis that assured purchasers that securities would be marketable at near face value. Because of the urgency of this need, the policy was agreed to and continued after the war until 1951. During this period, the Treasury was, in effect, deciding the monetary policy of the country as it made its decisions as to how much debt needed to be funded. Because the central bank supported the market for government securities, it was forced to purchase amounts of securities necessary to maintain low interest rates and the par value of securities. Thus, as the Treasury issued additional debt, the central bank was forced to acquire part of that debt. This process resulted in direct addition to bank reserves.

Following the 1951 accord between the Treasury and the Federal Reserve System, the central bank was no longer required to support the securities market at any particular level. In effect, the accord established that the central bank would act independently and exercise its own judgment as to the most appropriate monetary policy. But it would also work closely with the Treasury and would be fully informed of and sympathetic to the Treasury's needs in managing and financing the public debt. In fact, in special circumstances the Federal Reserve would support financing if unusual conditions in the market caused an issue to be poorly accepted by private investors.
The Treasury and the central bank also work closely in the Treasury’s management of its substantial cash payments and withdrawals of Treasury Tax and Loan account balances deposited in commercial banks, since these cash flows affect bank reserves.

**With the Congress**

A second major relationship, of course, is with the Congress—the branch of government that specifically delegated, in the form of the Federal Reserve Act, the responsibility for managing monetary policy in the interests of the nation. At the same time, Congress retained responsibility for the taxing and spending decisions of the federal government.

When the balance between spending and taxation results in government deficits, the Treasury has to issue additional public debt. In a monetary sense, the failure to tax adequately to cover the expenditures of the Federal government is an invitation for “printing money” through the issuance of federal debt. Depending on the phase of the business cycle, this tends to increase the money supply and, without offsetting action by the central bank, can result in an inflationary rise in prices. The result is “hidden taxation”—which takes away from taxpayers in the form of lower purchasing power (higher prices) what they would have paid in additional taxes had the expended funds been obtained through that source.

Thus there is an important linkage between the taxing and spending powers of Congress and the monetary powers as delegated to the Federal Reserve System. In principle, it is the job of Congress and the executive branch jointly to define the economic policy objectives of our national government, and to support those objectives with appropriate fiscal measures. Then the central bank can coordinate monetary policy in a manner which serves those national objectives.

When fiscal policy does not match spending appropriately to tax revenues, then the monetary authority is faced with a difficult choice: (a) how severely should it restrain the inflationary forces that may develop, and (b) to what extent should it permit inflationary forces to have their effect in higher prices? When the failure to provide appropriate tax revenues generates acute forces of inflation, then even the best compromise may require severe monetary restraint. This has the effect of appearing to be at cross-purposes with congressional intent and can also produce severe disruptions in some areas of the private sector such as housing.

Thus, the Congress and the Federal Reserve System may not always appear to agree in their policy actions, but they have a substantial common interest in coordinating such policies. Monetary policy can be less extreme when fiscal policy is doing “its share.”

Another reason for delegating the monetary responsibility to an authority not directly a part of the government is the high degree of
technical expertise required to analyze economic data, trends, and other information related to appropriate monetary decisions. While the Federal Reserve has been called the monetary “agent” of Congress and is subject to its ultimate control, its special responsibilities require a separation in carrying out its unique functions. Congress cannot effectively legislate day-to-day monetary decisions, nor even provide operating mandates.

In the dialogue between the Congress and the central bank, both the intent of the national policy and the rationale for appropriate monetary policy must be communicated. To accomplish this, the Federal Reserve System reports regularly to the Congress with regard to its conduct of monetary policy. Over the years, exhaustive hearings have been held by the Senate and House banking committees regarding the functions and procedures of the Federal Reserve System. The Joint Economic Committee and other committees of Congress frequently call on Federal Reserve representatives to discuss both policy and operational matters.

With Banking

A third area of independence relates to commercial banking and other private financial institutions.

It was no accident that the Federal Reserve System was structured to include direct representation from commercial banking, for without a sound banking system monetary policy could not operate. When the central bank takes action to restrict or expand the money supply, the multipliers set in motion are leveraged through the banking system—often to the discomfort of bankers themselves. When monetary policy is restrictive, the restrictive action takes place at the loan desks of commercial banks where, with greater demand for funds and limited money to lend because of the restrictive policy, bankers are forced to decline some loans that both they and their Congress, recognizing that restrictive monetary policies must sometimes be strongly stated to control inflation, has chosen to endow the System with a considerable degree of independence. But under the Constitution this independence can never rise above the relationships of a faithful and trustworthy servant and a responsible, watchful master, in this case the Congress.

—Representative Wright Patman, 1954
customers might otherwise consider prudent. Thus is expansion of the money supply restrained.

All national banks and many state-chartered banks are members of the Federal Reserve System. It is essential that the majority of bank deposits in the country be subject to Federal Reserve requirements in order that the reserve mechanisms for controlling the money supply can function well and equitably. In addition, the central bank is charged to perform other services for member banks such as supplying coin and currency, clearing checks, transferring funds, and making loans to member banks under special circumstances. These services require direct working relationships with commercial banks. The Federal Reserve’s supervisory role (and also the central bank’s ultimate role as the lender of last resort) reflects both the public need and the monetary need for sound banking.

Through all these close ties and relationships, it is essential that the central bank deal “at arm’s length” with commercial banking in general and that it not be dominated or made subservient to banking interests. This also has been a major concern of Congress over the years and is a concern that is reflected in its design of the Federal Reserve Act. It is one of the reasons why the Federal Reserve’s bank supervision and regulatory functions are structurally accountable to the Federal Reserve Board rather than to regional bank boards.

Within Itself

One other area in which separateness and independence have significant meaning is within the Federal Reserve System itself.

As originally conceived, the regional Federal Reserve Banks were largely autonomous: a federation of regional institutions made up the Federal Reserve System. As time and experience brought changes, it became necessary to coordinate monetary policy on the national level, while continuing to perform central bank services for member banks, including the discount (lending) function at the regional level.

Regional Federal Reserve banks are regularly examined by the Board of Governors to confirm the internal quality and integrity of each Bank’s operations and also to ensure that regional Banks are complying with all statutory regulatory requirements of the System.

An important feature within the Federal Reserve is that the chairman of the Board of Governors, though spokesman for both the seven-man Board and the Federal Open Market Committee, does not have independent authority. He cannot establish policy himself nor control policy decisions. He is subject to and limited by the majority vote of the councils of which he is part.

Thus, there exists within the System itself checks and balances which limit the authority and the power of its different elements. These relationships are significant when structural changes are under consideration.
The Board submits regular and frequent reports to Congress on economic data and financial matters. Indeed, the detail in which financial data are published is greater than for any other central bank in the world.

—Arthur Burns, congressional testimony in January 1976

Perspectives on Independence

Our central bank structure—functioning in an environment reasonably insulated from the day-to-day pressures of partisan politics and short-term expediency—was born out of decades of experience with boom/bust recessions, financial panics, and monetary instability.

Over the years, the System and its vital monetary function have been under constant scrutiny and review by Congress, by professional economists, by banks and financial experts as well as by the public. Hearings by Senate and House banking committees on Federal Reserve responsibilities and procedures have been exhaustive.

Such studies have produced innumerable changes in responsibilities, authority and procedures. It is through such efforts that our monetary mechanisms have kept pace with the changing needs of the times. While many problems persist, it is also true that over the past three decades—and despite some pretty difficult times—recessions have been moderate, and severe panics and disruptions have been largely avoided.

Whether the proposals currently suggested are useful remains to be seen. But the role of the Federal Reserve System in carrying out the exacting responsibilities of managing the nation’s monetary policy requires the best structural and procedural framework possible to do that job. The record suggests that a degree of “independence” is essential for effective execution of its monetary role. There is a recognized need for professionalism in analysis and formulation of policy—free of partisan/expediency considerations and free of distraction from other responsibilities.

Urgent and changing economic needs call for frequent review, evaluation, and suggestions for reform—relying on the tested lessons of past experience as we learn to understand and cope with new changes.
A System that provides responsible policy must serve the broad public interest, remaining objective and removed from special interest, yet ultimately accountable to and in dialogue with the realities of changing times, human values, and economic conditions.

Bruce K. MacLaren
President

*Robert W. Worcester, vice president at the Federal Reserve Bank of Minneapolis, provided valuable assistance in preparing this text for publication.
1976 in Review

Each year the Bank develops a set of objectives to identify those efforts which, in the judgment of management, constitute the Bank's most important new undertakings for the coming year. As a part of this process, a more detailed structure of sub-objectives is developed by the various departments of the Bank which directly supports these management level priorities and in other ways contributes to the Bank's longer-term missions identified in its statement of goals.

Over the past few years, our bank objectives have focused increasingly on the efficiency and effectiveness of internal operations: in 1976 four of five Bank objectives were internally oriented. This emphasis reflects the System's determined effort to make Federal Reserve Banks both efficient and productive in keeping with the best applications of good management and available technology. Such considerations must always be weighed against service needs of the financial community, our role in serving the public interest as the nation's central bank, and our responsibilities for setting national monetary policy.

The stated Bank objectives for 1976 and a summary review of achievement are set forth below.

*To limit the increase in total net controllable expenses for 1976 to 8 percent above net controllable expenses in 1975.*

This objective was achieved as net controllable expenses in 1976 were 7.2 percent above net controllable expenses in 1975. Net controllable expenses are those costs remaining after excluding cost items over which management has very limited short-run control (e.g., real estate taxes, building depreciation, new currency costs, etc.). This was accomplished in spite of increasing costs, normal volume increases which were approximately 7 percent above 1975 levels, and new responsibilities in some functions such as increased activity related to consumer protection legislation.

The primary offset to these factors was the continuing effort on the part of the Bank to hold the line on expenses through productivity and efficiency in the various operating and support areas, mainly by improved technology and procedures. Contributing to this continuing effort has been the development of management talent and tools.

Salary expenses, which constitute over 50 percent of controllable expenses, increased by 7.3 percent — exactly the figure projected. The total Bank staff declined just slightly for the year.
To complete scheduled development and implementation of the new Federal Reserve Planning and Control System (PACS) at Minneapolis and Helena.

The new Federal Reserve Planning and Control System is designed to facilitate planning, budgeting, and expense control throughout the Federal Reserve System. In 1976 efforts were directed to the development and implementation of the internal expense accounting and reporting component of the system. In addition to providing better internal expense and budget information for Bank and line management, the new system will also provide improved comparability among Reserve Banks for expense and productivity data. The expense accounting and reporting components have been implemented during 1976 and began fully functioning on January 1 of 1977. Developmental work on the entire Planning and Control System will continue through 1977.

To rank above the first quartile in all currently monitored production and cost areas according to the 1976 annual System ranking, while allowing no deterioration of System ranking in those areas representing 1.0 percent or more of total controllable costs.

Because of the unique nature of our central bank operations and functions, many of the common ways of measuring organizational achievement—profit, share of market, or return on equity—are not available to us. Thus, we look to other measures and standards as proxies to assess our operational effectiveness. One of these is by comparing our efficiency and productivity with the other 11 Federal Reserve Banks, all of whom are providing essentially the same kinds of services.

At the end of 1975 the Bank's performance, in five of some two dozen operational areas in which we can be compared with other Reserve Banks, showed that we ranked in the lowest quartile—tenth, eleventh, or twelfth—in terms of either productivity or cost. Our objective was to concentrate on improvement in those areas where relative measures indicated most improvement was needed, while experiencing no deterioration in performance elsewhere. Information available in January 1977 indicates that our objective was achieved in four of the five areas.

To develop and implement a comprehensive training and development program for Bank officers and staff which will set guidelines for participation in various types of developmental programs.

During 1976 our efforts toward this objective focused principally upon developing an operating framework for an integrated staff development and training program—one that helps us identify
Bankwide training and development needs and also the best vehicles to meet those needs.

This framework outlines the various levels and types of development programs and their relationship to the identified training needs.

While full development of the total program outlined will extend into 1977 and beyond, a number of important elements were implemented in 1976. These include in-house supervisory and management training, presentational speaking, and better use of various management schools.

During the year we completed the comprehensive redesign of our job evaluation structure and procedures, including a completely new set of job descriptions, new grade structures, and final reevaluation of all non-official jobs. Our Bankwide performance review program, and formalization of job posting procedures, were also modified during the year.

To complete research studies identifying public policy problems relevant to the Ninth District and developing proposals for actions to change laws of regulative procedures affecting:

(a) EFT systems development throughout the District,
(b) state banking structure and performance (Minnesota only, this year) and (c) risk exposure and contingency preparedness of larger banks in the District.

In general, the studies done in furtherance of this objective have provided the public and this Bank with a basis for evaluating current public policy issues.

Four background studies in the area of electronic funds transfer (EFT) were produced by various departments of the Bank during 1976:

1. A Survey of Significant EFT Developments in the Nation and the Ninth Federal Reserve District
2. EFTS: Public Policy Issues
3. Competitive Aspects of Electronic Funds Transfer Systems
4. Legal Dimensions of Electronic Funds Transfer in the Ninth District

Excerpts from the first two studies were published in the Ninth District Quarterly and the first paper was published in full as part of our EXPONENT series, entitled, Electronic Funds Transfer: The Future is Now. A condensed version of the third paper examining changes in the competitive relationships among financial institutions that may result from EFT system developments is scheduled for publication early in 1977. The fourth study remains an internal working document.

Two studies on state banking structure are being published early in 1977. The first—"The Philadelphia National Bank Case Revisited"—
reviews the analysis used by the Supreme Court in its landmark decision (1973) concerning the Philadelphia National Bank. A key aspect of that decision was that commercial banking was considered a distinct line of commerce. The appropriateness of this definition, based on a type of institution rather than a type of service offered, is looked at in light of the changing environment in which financial institutions are increasingly competing across traditional lines.

The second study is a follow-up to an earlier publication by this Bank which characterized Minnesota's banking structure as "exceptional." This follow-up, which takes into account a broader array of financial institutions in the state, and a comparison with different states, generally finds that the structure of financial institutions in Minnesota is not exceptional if compared with states where branch banking is permitted.

Over the past two years we have been in touch with the larger Twin Cities banks concerning contingency plans for dealing with possible runoffs of interest-sensitive funds. A form was devised and tested by a number of these banks that would show the exposure of the bank to such runoffs under various hypothetical situations. Variations of this contingency approach have been adopted by some Twin Cities banks.

Operational Highlights

In addition to the progress achieved on special Bankwide objectives, other operational and staff developments are summarized below.

- Gross earnings of the Minneapolis Federal Reserve Bank for 1976, consisting mainly of interest on U.S. Government and Federal agency securities, were $145.4 million, up $12.5 million from 1975. Net total expenses were $26 million in 1976, up 9.2 percent. This includes an increase of $807,000 in the cost of printing Federal Reserve currency. The statutory 6 percent dividend paid to member banks on their required holding of Reserve Bank capital stock totaled $1,643,000. The Bank's surplus was increased by $2,497,000, and the balance of net earnings, $114 million, was paid to the United States Treasury as interest on Federal Reserve Notes.

- Conventional check volume at Minneapolis increased 6 percent, from 512 million items in 1975 to 542 million items in 1976, averaging about two million checks each working day. Efforts to cope with this growing volume include continued automation of the check clearing process and steps to reduce the growth of checks as a means of money transfer.
During 1976 the Regional Check Processing Center at our Bank was expanded to include an additional 41 Wisconsin banks. It now includes all banks within a 75-mile radius of Minneapolis, plus major cities such as Eau Claire, La Crosse, Rochester, Austin, Willmar, St. Cloud, Duluth, and Superior. More than 70 percent of the dollar volume of checks drawn on banks in the Minneapolis territory are eligible for immediate (same day) credit to the depositing bank.

The Duluth Regional Check Clearing Arrangement, commonly called the Duluth Plan, was in operation for the full year 1976, handling an average of 20,000 items per day which were formerly processed at the Minneapolis Fed. The Duluth Plan, including the Iron Range and northwestern Wisconsin, now serves about 55 banks.

Automated clearing house (ACH) operations in 1976 saw further expansion in both commercial entries and Federal recurring payments. In the latter category, Social Security payments and several other smaller programs were added to our initial program of processing Air Force payrolls.

- District-wide distribution of the new $2 currency denomination was initiated early in the year as part of the national effort to re-institute the use of the $2 denomination. The objective is to reduce the total number of bills in circulation with commensurate reductions in printing and handling costs. The Treasury Department is considering other changes in coin denominations and usage that may further encourage $2 bill usage.

- Minting of bicentennial-designed quarters, half-dollars, and dollars, first issued in 1975, will be discontinued in 1977.

Overall currency and coin volume increased during 1976 by roughly 10 percent for currency handling and by 14 percent for coin.

- The volume of Treasury securities issues and redemption rose markedly during 1976 reflecting the major increase in Treasury financing over the past two years. The dollar volume of issues redemption and exchanges roughly doubled over 1975, and the number of transactions was up one-fifth.

Late in the year, the Treasury Department began issuing 52-week Treasury bills on a book-entry-only basis. This significant step will be extended to other bill issues in 1977 and eventually to other types of Treasury securities.

- With the growing complexity of consumer-related regulations, the Bank has had to increase its efforts to provide information to consumers and others about such regulations. Bank representatives spoke to approximately 1,800 people on the Equal Credit Opportunity Act, Fair Credit Billing Act, and The Federal Trade Commission’s Holder-in-Due-Course Regulation. Our consumer specialists also answered telephone inquiries from bankers and investigated all consumer complaints involving state member banks.

- Late in 1976 two experimental meetings were held with member bankers in Michigan and Wisconsin to (a) update member
banks on recent developments in Reserve Bank services and programs, and to (b) provide a forum for bankers to express their views, suggestions, and criticisms about Fed operations and services. These meetings, which were deemed productive, will be continued in 1977.

Our series of informational conferences for bank directors (started in 1974) was continued in 1976 with meetings in Rapid City and Sioux Falls. Similar conferences are planned for 1977.
Federal Reserve Bank of Minneapolis
Financial Statement

Statement of Condition (In Thousands)

<table>
<thead>
<tr>
<th>December 31</th>
<th>1976</th>
<th>1975</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gold Certificate Account ..................</td>
<td>$221,457</td>
<td>$205,489</td>
</tr>
<tr>
<td>Interdistrict Settlement Fund ..........</td>
<td>229,951</td>
<td>302,139</td>
</tr>
<tr>
<td>Special Drawing Rights Certificate Account ...</td>
<td>24,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Federal Reserve Notes of Other Federal Reserve Banks</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Federal Reserve Banks ..................</td>
<td>26,922</td>
<td>43,486</td>
</tr>
<tr>
<td>Other Cash .......................</td>
<td>13,863</td>
<td>15,109</td>
</tr>
<tr>
<td>Loans to Member Banks ..................</td>
<td></td>
<td>41,875</td>
</tr>
<tr>
<td>Securities ................................</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Federal Agency Obligations ..........</td>
<td>155,333</td>
<td>132,619</td>
</tr>
<tr>
<td>U.S. Government Securities ..........</td>
<td>2,132,514</td>
<td>1,894,025</td>
</tr>
<tr>
<td>Total Securities ..................</td>
<td>2,287,847</td>
<td>2,026,644</td>
</tr>
<tr>
<td>Cash items in Process of Collection ....</td>
<td>454,022</td>
<td>498,571</td>
</tr>
<tr>
<td>Bank Premises Net ..................</td>
<td>30,939</td>
<td>32,399</td>
</tr>
<tr>
<td>Other Assets ...............</td>
<td>43,011</td>
<td>33,044</td>
</tr>
<tr>
<td><strong>Total Assets</strong> ..................</td>
<td>$3,332,012</td>
<td>$3,208,756</td>
</tr>
</tbody>
</table>

| **Liabilities** |        |        |
| Federal Reserve Notes .................. | $1,749,458 | $1,586,070 |
| Deposits ................................ |        |        |
| Member Bank Reserve Accounts .......... | 604,185  | 707,687 |
| Due to Other Federal Reserve Banks Collected Funds | 42,337   |  |
| U.S. Treasury-General Account .......... | 308,245  | 367,412 |
| Foreign ............... | 6,600    | 6,302   |
| Other Deposits ........... | 19,657   | 5,246   |
| **Total Deposits** .......... | 1,071,024 | 1,086,647 |
| Deferred Availability Cash Items .......... | 432,483  | 458,747 |
| Other Liabilities ........... | 21,867   | 25,106  |
| **Total Liabilities** .......... | $3,274,832 | $3,156,570 |

| **Capital Accounts** |        |        |
| Capital Paid In ............... | 28,590   | 26,093  |
| Surplus ............... | 28,590   | 26,093  |
| **Total Capital** .......... | 57,180   | 52,186  |
| **Total Liabilities and Capital Accounts** | $3,332,012 | $3,208,756 |
### Earnings and Expenses (in Thousands)

**For the Year Ended December 31**

#### Current Earnings

<table>
<thead>
<tr>
<th>Description</th>
<th>1976</th>
<th>1975</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest on Loans to Member Banks</td>
<td>$173</td>
<td>$217</td>
</tr>
<tr>
<td>Interest on U.S. Government Securities and Federal Agency Obligations</td>
<td>144,368</td>
<td>132,326</td>
</tr>
<tr>
<td>All Other Earnings</td>
<td>821</td>
<td>347</td>
</tr>
<tr>
<td><strong>Total Current Earnings</strong></td>
<td>145,362</td>
<td>132,890</td>
</tr>
</tbody>
</table>

#### Current Expenses

<table>
<thead>
<tr>
<th>Description</th>
<th>1976</th>
<th>1975</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries and Other Benefits</td>
<td>14,782</td>
<td>13,171</td>
</tr>
<tr>
<td>Postage and Expressage</td>
<td>2,845</td>
<td>2,702</td>
</tr>
<tr>
<td>Telephone and Telegraph</td>
<td>474</td>
<td>355</td>
</tr>
<tr>
<td>Printing and Supplies</td>
<td>874</td>
<td>912</td>
</tr>
<tr>
<td>Real Estate Taxes</td>
<td>1,587</td>
<td>1,500</td>
</tr>
<tr>
<td>Furniture and Operating Equipment—Purchases, Rentals, Depreciation, Maintenance</td>
<td>1,879</td>
<td>1,950</td>
</tr>
<tr>
<td>Depreciation—Bank Premises</td>
<td>1,566</td>
<td>1,566</td>
</tr>
<tr>
<td>Utilities</td>
<td>425</td>
<td>414</td>
</tr>
<tr>
<td>Other Operating Expenses</td>
<td>1,532</td>
<td>1,827</td>
</tr>
<tr>
<td>Federal Reserve Currency</td>
<td>1,522</td>
<td>715</td>
</tr>
<tr>
<td><strong>Total Current Expenses</strong></td>
<td>27,486</td>
<td>25,112</td>
</tr>
<tr>
<td>Expenses Reimbursable or Recoverable</td>
<td>(1,437)</td>
<td>(1,317)</td>
</tr>
<tr>
<td><strong>Net Expenses</strong></td>
<td>26,049</td>
<td>23,795</td>
</tr>
</tbody>
</table>

#### Current Net Earnings

<table>
<thead>
<tr>
<th>Description</th>
<th>1976</th>
<th>1975</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Net Earnings</strong></td>
<td>119,313</td>
<td>109,095</td>
</tr>
<tr>
<td>Net Profit (or Loss)</td>
<td>374</td>
<td>(4,918)</td>
</tr>
<tr>
<td>Assessment for Expenses of</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Board of Governors</td>
<td>(1,176)</td>
<td>(818)</td>
</tr>
<tr>
<td>Dividends Paid</td>
<td>(1,643)</td>
<td>(1,387)</td>
</tr>
<tr>
<td>Payments to U.S. Treasury</td>
<td>(114,371)</td>
<td>(97,610)</td>
</tr>
<tr>
<td><strong>Transferred to Surplus</strong></td>
<td>2,497</td>
<td>4,362</td>
</tr>
<tr>
<td>Surplus, January 1</td>
<td>26,093</td>
<td>21,731</td>
</tr>
<tr>
<td>Surplus, December 31</td>
<td>$28,590</td>
<td>$26,093</td>
</tr>
</tbody>
</table>

### Volume of Operations*

<table>
<thead>
<tr>
<th>Description</th>
<th>Number</th>
<th>Dollar Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>For the Year Ended December 31</td>
<td>1976</td>
<td>1975</td>
</tr>
<tr>
<td>Loans to Member Banks</td>
<td>223</td>
<td>290</td>
</tr>
<tr>
<td>Currency Received and Verified</td>
<td>145 million</td>
<td>128 million</td>
</tr>
<tr>
<td>Coin Received and Counted</td>
<td>538 million</td>
<td>481 million</td>
</tr>
<tr>
<td>Checks Handled, Total</td>
<td>614 million</td>
<td>582 million</td>
</tr>
<tr>
<td>Collection Items Handled</td>
<td>.3 million</td>
<td>.4 million</td>
</tr>
<tr>
<td>Issues, Redeemptions, Exchanges of U.S. Government Securities</td>
<td>9.0 million</td>
<td>7.6 million</td>
</tr>
<tr>
<td>Securities Held in Safekeeping</td>
<td>449,526</td>
<td>432,054</td>
</tr>
<tr>
<td>Transfer of Funds</td>
<td>785,331</td>
<td>627,347</td>
</tr>
</tbody>
</table>

*Minneapolis and Helena combined

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Federal Reserve Bank of St. Louis
Directors of the
Federal Reserve Bank of Minneapolis

January 1977

Term expires December 31 of indicated year

James P. McFarland, Chairman and Federal Reserve Agent
Stephen F. Keating, Deputy Chairman
Class A—Elected by Member Banks
William E. Ryan, President (1977)
Citizens State Bank, Ontonagon, Michigan
John S. Rouzie, President (1978)
First National Bank, Bowman, North Dakota
Nels E. Turnquist, President (1979)
National Bank of South Dakota, Sioux Falls, South Dakota
Class B—Elected by Member Banks
Donald P. Helgeson, Secretary-Treasurer (1977)
Jack Frost, Inc., St. Cloud, Minnesota
Russell G. Cleary, Chairman and President (1978)
G. Heileman Brewing Company, Inc., La Crosse, Wisconsin
Warren B. Jones, Secretary-Treasurer (1979)
Two Dot Land & Livestock Company, Harlowton, Montana
Class C—Appointed by Board of Governors
Stephen F. Keating, Chairman (1977)
Honeywell, Inc., Minneapolis, Minnesota
James P. McFarland, Chairman (1978)
General Mills, Inc., Minneapolis, Minnesota
Charles W. Poe, Jr., President (1979)
Metropolitan Economic Development Association (MEDA)
Minneapolis, Minnesota

Member of Federal Advisory Council
Richard H. Vaughan, President
Northwest Bancorporation, Minneapolis, Minnesota

Directors of the Helena Branch

Patricia P. Douglas, Chairman
Norris E. Hanford, Vice Chairman
Appointed by Board of Directors
Federal Reserve Bank of Minneapolis
Donald E. Olsson, President (1977)
Ronan State Bank, Ronan, Montana
William B. Andrews, President (1978)
Northwestern Bank of Helena, Helena, Montana
George H. Selover, President & General Manager (1978)
Selover Buick-Jeep, Inc., Billings, Montana
Appointed by Board of Governors
Norris E. Hanford, independent grain operator (1977)
Fort Benton, Montana
Patricia P. Douglas, Assistant to President and Professor (1978)
University of Montana, Missoula, Montana
Officers of the
Federal Reserve Bank of Minneapolis

January 1977

Bruce K. MacLaury, President
Clement A. Van Nice, First Vice President

Thomas E. Gainor, Senior Vice President
Roland D. Graham, Senior Vice President
John A. MacDonald, Senior Vice President

Melvin L. Burstein, Vice President and General Counsel
Frederick J. Cramer, Vice President
Leonard W. Fernelius, Vice President
Lester G. Gable, Vice President
Bruce J. Hedblom, Vice President
Douglas R. Hellweg, Vice President
Howard L. Knous, Vice President and General Auditor
David R. McDonald, Vice President
Clarence W. Nelson, Vice President
    and Director of Research
Robert W. Worcester, Vice President

Sheldon L. Azine, Secretary and Assistant Counsel
Earl O. Beeth, Assistant Vice President
James U. Brooks, Assistant Vice President
Phil C. Gerber, Assistant Vice President
Gary P. Hanson, Assistant Vice President
Richard C. Heiber, Assistant Vice President
William B. Holm, Assistant Vice President
Ronald E. Kaatz, Assistant Vice President
Michael J. Pint, Assistant Vice President
    and Assistant Secretary
Ruth A. Reister, Assistant Vice President
    and Assistant Counsel
Charles L. Shromoff, Assistant Vice President
Colleen K. Strand, Assistant Vice President
Richard B. Thomas, Assistant Vice President
Joseph R. Vogel, Chief Examiner

Officers of the Helena Branch

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Ronald O. Hostad, Assistant Vice President
Betty J. Lindstrom, Assistant Vice President
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