Federal Reserve Bank
of Minneapolis

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Annual Report 1980

A New Law, A New Era

A New Law, A New Era

A Message From the President

By virtually any standard, the year 1980 was an extraordinary one in terms of economic and financial developments. One of the more significant of the developments during the year was the enactment of "The Depository Institutions Deregulation and Monetary Control Act of 1980." That legislation will, over a period of time, have major implications for the role and structure of the Federal Reserve and for the role and structure of our banking and related markets more generally. Because of this, most of the *Annual Report* of the Federal Reserve Bank of Minneapolis for 1980 is devoted to a consideration of some of the longer-term implications of this landmark legislation.

However, there was much more to 1980 than the passage of this important new legislation. Early in the year a combination of events including sharply higher oil prices, indications of significant political disturbances in the Mid-East and elsewhere, and uncertainties about the course of fiscal policies here in the United States resulted in a pronounced acceleration of inflation and inflationary expectations. Indeed, while memories are short, it was only a year ago when it seemed to some observers that the economy was on the threshold of a classical inflationary outburst.

Fortunately, that situation was arrested and contained, but at the expense of having to resort to credit controls and levels of interest rates that were unprecedented in this nation's history. And there can be little doubt that the reactions of households and businesses to both credit controls and 20 percent interest rates helped to trigger the very sharp—but short-lived—decline in economic activity that occurred in the second quarter.

Over the second half of the year economic activity rebounded from the second-quarter drop and advanced sharply toward year-end. In fact, virtually all observers were surprised by the strength of the economy in the fourth quarter when real output expanded at an annual rate of 4 percent. However, the resurgence of economic activity combined with sizable borrowing needs by the Treasury—coupled with the Fed's policy of seeking restraint in the growth of money—interacted to produce strong pressures in the financial markets which reflected themselves in levels of interest rates that exceeded the peaks reached in late March and early April.

Obviously, 1980 was a difficult year for monetary policy. Sharp swings in economic activity, highly volatile financial markets, and ever-sharpened and heightened expectational forces interacted to produce an environment in which market perceptions about the Federal Reserve's performance and its intent were subject to recurring questions.

Fundamentally, the Federal Reserve's policy objective has been, and will continue to be, aimed at achieving a continuing reduction in the growth of money and credit. The year 1980 witnessed a further measure of success in achieving that objective as the narrow measures of money (adjusted for deposit shifts arising from ATS and NOW account growth) increased at about a 6.5 percent annual rate, down from the 8 point growth in 1978. And for the year 1980 as a whole, narrow money growth was just a shade above the upper end of the growth targets established by the Federal Reserve for the year.

However, growth patterns in both money and interest rates during the year were subject to considerable short-run volatility. While much of that volatility can be explained by factors such as the imposition of credit controls, the transitory and often simultaneous swings in both money growth and interest rates serve to bring into sharp focus one of the policy dilemmas faced by the Federal Reserve. On the one hand, some would argue that the Fed should work to smooth out even very short-run swings in money growth—a goal that could be achieved only at the expense of even greater short-run volatility in interest rates. Others argue that the Fed has permitted too much variability in interest rates, and in the process has "permitted" rates to reach levels that are unnecessary and have a very uneven impact on various sectors of the economy. Obviously, we can't have it both ways. At the same time, there may be opportunities to improve the mechanics of policy with a view toward trying to minimize these short-run problems. The Federal Reserve is evaluating these enhancements, but as we proceed, I believe that it is important that market participants and others recognize that these transitory developments should be kept in a proper perspective. In this regard, it is worth noting that the short-run variability of money growth in the United States over the past couple of years has been demonstrably *less* than is the case in other countries, including both Germany and Switzerland.

The challenges faced by the Federal Reserve in 1980 will not subside in 1981. Our monetary policy objectives for this year call for a further reduction in the rate of growth in money—a step consistent with our longer-term goal of bringing the growth in money down to levels compatible with a noninflationary economy. Unfortunately, the popular money supply measures will, to an extent, mask the true rate of growth in money. That is, because of sizable shifts in deposits arising from the nationwide introduction of NOW-type accounts, the regularly published statistics on the money supply will give false signals. The Fed will, from time to time, make and publish adjustments in these series, but even so, the opportunities for confusion and misunderstanding are great.

On a more optimistic note, there are growing indications that fiscal policy may be brought to bear in a more decisive way in the fight against inflation. The new Administration has put forth an ambitious program of spending reductions and tax policy changes which, over time, offer some promise for achieving greater discipline in our fiscal affairs. That result, if achieved and maintained, can greatly assist in the difficult but necessary task of beating back inflation. Indeed, cohesive, coordinated, and credible fiscal and monetary policies, working in tandem, are the key to our ultimate success in checking inflation and thereby restoring an overall economic and financial environment that is compatable with achieving sustained prosperity.

E. Gerald Corrigan

E. Gerald Corrigan
President
Federal Reserve Bank of Minneapolis

Contents

A New Law, A New Era

In recent years, a combination of factors, including technological change, inflation, high and variable interest rates, the increased financial sophistication of economic agents, large and small, and our regulatory structure have interacted to promote vigorous and rapid changes in the financial environment. For example, new markets, new institutions, and new financial instruments have sprung up, and the asset and liability management practices of households, businesses, and financial institutions have changed appreciably. Because of these changes, there was a growing realization as the 1970s drew to a close that our existing laws and regulations no longer served the purposes for which they were originally designed.

This pattern of change was a major factor which prompted Congress to develop a series of changes in our national banking laws that were forged together into The Depository Institutions Deregulation and Monetary Control Act of 1980, which the President signed into law in March of that year. It had two main goals: one, to enhance the Federal Reserve's ability to implement effective monetary policy and, two, to promote greater competition, less regulation, and greater efficiency in the provision of banking-related financial services. There can be no guarantee that these goals will be wholly achieved, but there can be no doubt that the new legislation brought our laws into much better alignment with the current realities of our ever-changing financial environment.

Enhancing Monetary Control

Key provisions of the new financial legislation will work to enhance the ability of the Fed to implement its monetary policies. This potential improvement in monetary control will result in large part from the broader and more uniform reserve requirements mandated in the legislation. This reverses a trend in the financial industry which had led to a dramatic deterioration in the number of institutions and the percentage of deposits that were subject to Fed reserve requirements. The shrinkage in Fed membership thus threatened to seriously undermine the already loose and fragile relationship between Fed policy actions and the behavior of money and credit—possibly even over long periods of time.

The decline in the share of the nation's deposit balances held by banks that were members of the

The enactment of the law gave a clear signal—both here and abroad—as to the importance we as a nation place on a strong and independent central bank. In that regard, it is noteworthy that most national banking and thrift industry trade groups supported these broadened powers for the Fed, even though in many instances their affiliated institutions would be, for the first time, faced with the burden of reserve requirements. That affirmation as to the need for a strong central bank represents, we believe, a recognition that solutions to our economic problems—while never easy—would be considerably more difficult if market or other forces altered the "independence within government" that has been a hallmark of our central bank for almost seven decades.

Federal Reserve System and hence subject to Fed reserve requirements reached alarming proportions in the late 1970s. Ironically, the decline in the amount of reserves controlled by the Fed was aggravated by the existence of the Fed's reserve requirements. Since member banks could not earn interest on their required reserves, they were subjected to a cost that was often substantial. Their cost was the amount of interest earnings they had to forego on their reserve balances. Bankers who concluded that this cost was not offset by the benefits of Fed membership would drop out of the Federal Reserve System. In recent years, the cost of Fed membership became increasingly heavy in the climate of high interest rates. This caused a growing number of banks to relinquish their Fed membership, resulting in a decline in the amount of deposits subject to Fed reserve requirements.

Another factor contributing to the unpredictability of the relationship between reserves and deposits was that reserve requirements for Fed members varied according to a bank's deposit size and according to the mix of deposits in individual institutions. If a bank had demand deposits of up to $14 million, it had to keep 7 percent of these deposits in reserve. The more demand deposits it had, the higher percentage it had to keep in reserve. If its demand deposits totaled over $280 million, it had to keep 16¼ percent in reserve—this was the highest reserve bracket. The reserve requirements for savings and time deposits were similarly graduated, with further differences based on maturities. As deposits moved from bank to bank, or as they shifted from one class or maturity of time deposits to another, the amount of money that could be supported by a given amount of required reserves would also change. This was a further source of uncertainty or slippage in the relationship between Fed policy actions and the money supply.

These developments were particularly relevant in view of the Fed's recent decision to control money growth by placing more emphasis on the growth of reserves. That decision, which was made in October 1979 prior to the enactment of the new legislation, was made primarily because the earlier procedures for influencing the growth of money had proven progressively less reliable even over reasonably long periods of time. Money growth had to be effectively controlled; for while there is no universally accepted view of the precise way in which the money supply affects the economy, there is virtual unanimity among policymakers and scholars that restrained money growth is a necessary condition for lower inflation, lower interest rates, and a healthy overall economy.

However, under the new procedure, as under the old procedure, monetary control was further complicated by the fact that the information the Fed received about the deposits of nonmember depository institutions was based on a small sample of such institutions. Further, much of the information was received too infrequently—once a quarter—and too late to be useful—sometimes after it was six months out of date. Clearly, the Fed's understanding of developments relating to the growth of the money supply was hindered by such insufficient and belated data.

Early in 1980, the problems of declining membership in the Federal Reserve System, uneven reserve requirements, and inadequate information on changes in the money supply were addressed by the Depository Institutions Deregulation and Monetary Control Act. The far-reaching changes mandated by this act will be phased in gradually over the next eight years. To rebuild the declining portion of the nation's deposits that were covered by reserves, this law created universal reserve requirements. Now all deposits that can be used for transactions—checking accounts, NOW accounts, share draft accounts at credit unions, and other accounts—must be backed by reserves. Deposits in commercial or nonpersonal savings accounts must also be backed by reserves. Once the law is phased in, it won't matter if these accounts are held by member institutions or not.

To create more even reserve requirements and to make their impact more predictable, the new law makes reserve requirements not only universal but uniform. Financial institutions, regardless of their total deposits, will be required to maintain the same percentage of reserves. When the law is phased in, institutions must maintain reserves of 3 percent for transaction deposits that total $25 million or less and must maintain reserves of 12 percent for the portion of their total transaction deposits over $25 million. Institutions must maintain reserves of 3 percent for commercial or nonpersonal savings accounts, regardless of their total deposits.

To ensure that adequate and timely information is available, the law requires all depository institutions to report their deposit levels directly and promptly to the Fed. From those institutions that weren't directly reporting to the Fed before, the Fed will receive the information on a more timely basis. Institutions holding the majority of the nation's deposits will report weekly, and the Fed will have useful information on the deposits at nonmember institutions in a matter of weeks instead of months as was the case before. While attempts have been made to minimize this reporting burden, especially for small institutions, the expanded information on the money supply and credit will help in the implementation of monetary policy.

Over time, as more deposits are affected by reserve requirements, as reserve requirements become more uniform across depository institutions, and as the data on which it bases its decisions about policy will have been improved, the linkage between the level of reserves and the supply of money should tend to become more serviceable for the purposes of implementing Fed policy than otherwise. However, that result will not be achieved until the phase-in is largely completed. In the meantime, necessarily complex formulas for the phasing down of reserve requirements for current Fed members and the phase-in of reserve requirements for non-members, coupled with the inevitable problems associated with new reporting requirements, will be sources of new uncertainties and "noise" in the relationship between reserves and money.

While the new law should ultimately enhance the Fed's ability to control the money supply as it is currently defined, its longer-term impact on monetary control is by no means certain. The structure of the nation's financial system is not fixed. It will respond to the new environment created by the law. With the passage of the new law, new competitive forces exist—and they will alter the investment decisions of consumers and businesses, perhaps creating new problems. For example, the huge increase in the amount of financial resources flowing into money market mutual funds that has been observed since January 1981 could continue to gain momentum. Lack of a reserve obligation means returns on these funds can be set higher, thus attracting resources away from financial institutions to investment vehicles not subject to Federal Reserve jurisdiction. In short, even before the ink is dry on the new act, new complications are presented to policymakers.

At issue is not whether there will continue to be public constraints on risk within the total financial system, but whether there will be at least an incremental shift away from regulation of individual financial institutions in favor of market-determined investment decisions. That seems to be the promise of the new environment facing the financial system. Systemwide safeguards and regulations will continue to lessen risk for the financial system in total, while individual institutions have more discretion to follow market-based signals for productive investment. As the transition to this new environment proceeds, we must remain vigilant and alert so as to ensure that new and perhaps even unforeseen problems are managed in an efficient and prudent manner consistent with the overriding public interest in a safe and sound banking system.

The transitional problems and the new challenges should not, however, detract from the importance of the new legislation to the Federal Reserve. Indeed, its importance goes well beyond the manner in which it arrested a potentially sharp deterioration in the effectiveness with which monetary policy could be implemented. That is, the enactment of the law gave a clear signal—both here and abroad—as to the importance we as a nation place on a strong and independent central bank. In that regard, it is noteworthy that most national banking and thrift industry trade groups supported these broadened powers for the Fed, even though in many instances their affiliated institutions would be, for the first time, faced with the burden of reserve requirements. That affirmation as to the need for a strong central bank represents, we believe, a recognition that solutions to our economic problems—while never easy—would be considerably more difficult if market or other forces altered the "independence within government" that has been a hallmark of our central bank for almost seven decades.

Economic Efficiency Through Competition

In addition to arresting the potential deterioration in the effectiveness of monetary control, the Depository Institutions Deregulation and Monetary Control Act of 1980 fosters increased efficiency in the nation's financial system. One important way it does this is by reducing the regulatory and legal barriers that prevented one type of institution from competing with another type. These barriers tended to inhibit the free flow of funds to their most productive uses. Thus, by increasing the opportunities for competition, powerful new forces will be working to help us get the most out of our available financial resources.

In the past, the barriers to competition that were created by government regulations and laws were formidable. Classes of financial institutions were restricted to specific types of activities. Savings and loan institutions could not compete with commercial banks in the market for checking accounts. Commercial banks couldn't pay as much interest on saving accounts as savings and loan institutions. In addition, interest rate ceilings effectively prevented institutions of the same class from competing for deposits and loans.

The new banking law allows financial institutions to compete more freely. It expands the lending powers of thrift institutions in order to give them more flexibility in managing their assets. It permits all depository institutions to offer interest earning checking-type accounts to households and certain kinds of businesses. Finally, it phases out, over six years, ceilings limiting the interest that may be paid on time and savings deposits at all depository institutions. Thus, the nation's 15,000 banks—large and small—are in competition with 5,000 savings and loan associations, 500 mutual savings banks, and 22,000 credit unions, all having increasingly similar powers. A basic principle of economics is that expanded competition will, in time, result in a more efficient use of resources. For instance, as interest ceilings are phased out, rates paid to savers will more accurately reflect the value of the investment uses to which those funds will be put. Thus, rates paid to depositors will be better able to attract funds and direct them to their most productive uses. Because of the new competition, every depository institution will soon be feeling the pressure to be more efficient so that it can offer its customers better service and lower prices than the institution down the street.

Exactly how the financial system will evolve under this fresh competition is difficult to foresee, but some speculations are possible:

- The rates that financial institutions pay to depositors will probably go up. The pressure to pay higher rates will exist because institutions can now pay interest on checking accounts and other accounts on which checks can be drawn and because some interest rate ceilings are being phased out. Such a development, it might also be noted, is compatible with the need to increase saving on a national basis.
- Operating margins at depository institutions may narrow. As competition increases, the spread between interest rates on deposits and interest rates on loans—that is, the operating margin—may be squeezed. This could reduce profitability or alter the amount of capital needed in depository institutions.
- The number of financial institutions may be reduced through merger, acquisition, or perhaps even liquidation. In a more competitive marketplace, only the more efficient financial institutions will prosper.
- If the number of financial institutions is reduced, the Federal Reserve and other regulators will have to consider modifying regulations and practices that might impede the orderly consolidation of institutions. Prohibitions against opening branch offices—both within and across state lines—will have to be reconsidered. Similarly, prohibitions that prevent banks and thrift institutions from consolidating may have to be reconsidered.
- In the future, financial institutions could look more alike than different. As banks, savings banks, and savings and loan associations all gain similar powers to choose their assets and liabilities, they will be able to enter the same market arena. Many of these institutions will continue

to specialize by type, location, and size, but all institutions will be better able to compete with others within the markets they have chosen.

- The competition facing depository institutions from money market funds, brokers, and large merchandisers will remain intense. Such businesses, free of much of the regulation governing depository institutions, have been innovative in the past. They will no doubt continue to compete for balances in the future.

Deregulation will mean that financial institutions will, in some cases, be subject to new and different forms of risk. Thrifts, for example, might face higher risk than they used to, particularly during the period when lending officers are acquiring expertise in making types of loans other than mortgages. Similarly, as some interest rate ceilings are phased out, small and medium-sized institutions might face higher risk as they acquire expertise in setting the prices and the maturities of their time and saving deposits.

But if there is higher risk, there is also more opportunity for competitive forces to direct financial resources to the most productive uses. So the new environment brings into clearer focus the trade-off between the benefits of market-directed investment and the costs of added risk for the financial system. This trade-off has always existed, and society has rightly designed safeguards to control and limit risks in the financial system. Because we as a nation have agreed that market discipline alone can't be the sole guide for financial system functions, the financial system has been, and will continue to be, guided in part by publicly imposed safeguards such as supervisory examinations, Federal Reserve discount lending, and deposit insurance.

At issue, however, is not whether there will continue to be public constraints on risk within the total financial system, but whether there will be at least an incremental shift away from regulation of individual financial institutions in favor of market-determined investment decisions. That seems to be the promise of the new environment facing the financial system. Systemwide safeguards and regulations will continue to control and limit risk for the financial system in total, while individual institutions have more discretion to follow market-based signals for productive investment. As the transition to this new environment proceeds, we must remain vigilant and alert so as to ensure that new and perhaps even unforeseen problems are managed in an efficient and prudent manner consistent with the overriding public interest in a safe and sound banking system.

Economic Efficiency Through Market Pricing

The new legislation will move in the direction of promoting efficiency, not only by encouraging competition among private financial institutions, but by compelling the Federal Reserve to set prices for its services in much the same way as any other business. For the first time, the services of an agency in the public sector will be priced and offered in competition with those of private firms. Fees will be charged for check clearing and collection, wire transfer of funds and securities, automated clearinghouse activities (electronic payments), settlements of financial institutions' debits and credits, the safekeeping of securities, and the transportation and insurance of currency and coin. Because of these fundamental changes, the allocation of resources between the public and private sectors will ultimately be governed more by market forces. These two sectors will—based on relative efficiency—allocate the available resources differently.

This new allocation of resources is probable because the incentives now facing depository institutions are quite different than the ones that used to face them. Under former laws, when the Federal Reserve offered its services at no explicit charge, member banks benefited themselves and their customers the most by using the Fed's services even when the services' value fell below the value of the resources that were used in providing them—below the real costs imposed upon the Fed and the nation. This sometimes meant that member banks used the Fed's services even when competing services that used less labor, better technology, or fewer physical resources were available.

Now depository institutions have more incentives to choose the most efficient provider of services. Since most Federal Reserve services will be offered to all depository institutions at explicit prices, these institutions may choose whether to obtain such services from the Fed or from a private correspondent bank. Previously, a nonmember depository institution did not—for all practical purposes—have this choice, since it was not able to receive services directly from the Fed. Thus, under the new arrangements, all institutions will have the incentive to use the service that imposes the least real cost on society because this service will have the lowest price.

Consistent with its congressional mandate to promote efficiency, the Federal Reserve will set its prices so that a truly competitive framework for the delivery of financial services is established. The general pricing guidelines provided in the new legislation plus the more detailed guidelines established by the Board of Governors of the Federal Reserve System require the Fed to determine its prices in the same fashion as a private, competing firm. Its prices must fully cover its costs, including overhead. To avoid unfairly undercutting its competitors' prices, the Fed must even set its prices to cover taxes, profit, and other costs of doing business like a private firm—although it pays no federal taxes and does not try to earn a profit.

The Federal Reserve has contributed and can continue to contribute to achieving the goal of an efficient payments system. The Fed will be a source of constructive competition, both as an active and as a potential participant in the market, even if we, of necessity, define our role in somewhat different terms than would a wholly private entity. In short, while the trappings may differ, we in the Federal Reserve are fully committed to the efficiency goal, and we have every intention of moving forward in a manner consistent with that objective.

The shift from the old system of providing services only to members at no explicit charge to the new system of providing services to all depository institutions at an explicit price entails some major challenges for the Fed. It must formulate rules for billing its customers, establish new accounting systems, and decide the size of the balances it will require for those who use its services. Once it has laid this detailed groundwork, it must effectively communicate it to its potential customers. Every depository institution, large or small, bank or thrift, must have this information in order to select the best alternative for obtaining needed services. Achieving the market discipline and the efficiencies contemplated by the drafters of the legislation requires, among other things, that institutions will make rational choices among alternative suppliers of like services. Thus, one of the Fed's major responsibilities in this environment will be to ensure that all depository institutions have a good understanding of the nature of Fed services, their prices, and the operating rules under which they will be available.

In order to promote that understanding, we at the Federal Reserve Bank of Minneapolis have established an advisory council comprised of a cross section of bankers, officials of savings institutions and credit unions, and representatives of trade associations and bank regulatory agencies to assist us in better anticipating the needs of all depository institutions in the context of the various requirements of the Monetary Control Act.

It is difficult, at this early date, to foresee how events will unfold in this new environment of priced Fed services. Change will certainly occur—perhaps even major change—but it seems that the process will be gradual. Market pricing and service competition will yield substantial rewards for innovation, good management, and technological advance by competing service providers, including the Fed. For wholesale-level customers, including banks and other depository institutions, there will be the important flexibility to match their service needs with market options.

In this setting, Federal Reserve people look forward to pricing, competition, and resolution of the public service obligation issues. There is promise of a new era where market forces will challenge and perhaps change long-standing systems that, however worthy, have nonetheless been shielded from the rigorous testing of the marketplace. Now the system is opened—with risks for all players—but also with promise of efficient allocation of resources, which is the pervasive order of the day. Moreover, in those instances where it is deemed necessary to publicly support the financial system to guarantee minimum service, the public costs will be visible.

The bottom line of this process is clear. We must recover our costs and act in a fashion that is consistent with the goal of promoting efficiency in the payments mechanism. The Federal Reserve has contributed and can continue to contribute to achieving the goal of an efficient payments system. The Fed will be a source of constructive competition, both as an active and as a potential participant in the market, even if we, of necessity, define our role in somewhat different terms than would a wholly private entity. In short, while the trappings may differ, we in the Federal Reserve are fully committed to the efficiency goal, and we have every intention of moving forward in a manner consistent with that objective.

Meeting the New Challenges

The Federal Reserve will, in the 1980s, face new and difficult challenges as the financial system—and the economy more generally—respond to the new forces for change unleashed by the Monetary Control Act. These forces carry with them great promise that our financial system will become even more dynamic, more competitive, and more efficient. But those same forces also bring with them the potential for greater risk and greater uncertainties. Indeed, even the most clairvoyant among us can, at best, foresee only the fuzzy outlines of how events will unfold. Those uncertainties and that inherently fuzzy view of the future must temper our attitudes and our actions as we navigate through previously uncharted waters. Indeed, the drafters of the legislation—sensitive to the need to balance caution with deliberate speed—built into the legislation phasing provisions and elements of regulatory flexibility with a view toward ensuring that the evolution proceeds in an orderly fashion.

While there are many areas of uncertainty associated with this evolution to the new era, one thing is very clear. That evolution will proceed far more smoothly and effectively in an environment of reduced inflation. For example, if inflation were reduced, interest rates would almost certainly be lower and Regulation Q, which sets interest rate ceilings, could be eliminated much more easily—with fewer economic dislocations and with fewer problems for those affected by this regulation. If interest rates were running below the ceilings established in Regulation Q, few would care whether it was gradually abolished or not, and its elimination would have virtually no impact on the financial system. The inevitable conclusion is that economic efficiency cannot be pursued in a vacuum; it must be pursued along with price stability.

1980 Operating Highlights

Planning and implementing an effective response to current and future service demands of the Upper Midwest financial community is the challenge of the 1980s for the Federal Reserve Bank of Minneapolis and its Helena branch. That process began in earnest during 1980 with the installation of service capacity improvements at the Minneapolis office. Changes were needed to assure continued high-quality Fed service in response to expanded business volume in recent years. In addition, management and staff began intensive planning efforts to prepare the Minneapolis and Helena offices for legislatively mandated new service functions and possible requests from the financial community for additional service volume in the future.

Provisions of the Depository Institutions Deregulation and Monetary Control Act of 1980 greatly expanded business contacts between Ninth District financial institutions and the Minneapolis Fed. Some new business relationships—such as deposit reporting and reserve maintenance—are mandated. In addition, Federal Reserve payment services will become available to all financial institutions in the district according to a specified timetable. Services to be affected include wire and securities transfer, check clearing, coin and currency supplies and transportation, safekeeping of securities, and net settlement services. All depository institutions in the district—some 2,400—will have access to Federal Reserve services. Previously the bulk of Fed services were directly available only to the 515 member banks in the district. It is not known how many nonbank financial institutions or nonmember banks will utilize Fed services more intensely, but managers of Fed service departments must analyze and weigh potential changes in service volume and adequately prepare.

Quite apart from the need to prepare for possible service demands from new customers, recent patterns of expanded use have in themselves required a comprehensive update of service capabilities at the Minneapolis Bank. For instance, the volume of checks processed has increased an average of 8 percent per year since 1974, or a cumulative increase of about 50 percent in that period. By year-end 1980, the Minneapolis office was processing about 3.2 million checks a day, which placed it as the second largest check handling office in the entire Federal Reserve System. This growth has brought pressure for expansion and, more importantly, modernization of operating capacity to realize the gains in productivity associated with fast-moving technological changes. New reader/sorters and computers are being installed to increase peak load processing capacity by 70 percent, and the check processing system has been segregated into two distinct operating units. Thus, if equipment failure plagues one of the units, the other can continue to effectively serve customers. The new system also provides greater flexibility in workflow management during periods of heavy volume.

The result of this investment will be more effective and efficient service. The process of converting to new check processing equipment amid a climate of continued rapid growth in volume has proven difficult and was accompanied by some significant operating problems. These problems appear to be coming under control, and during 1981 we expect to regain the timely and high-quality check operation that has characterized the Minneapolis Fed for many years.

Major improvements in the Bank's general data processing hardware and software were made in 1980 in response to ongoing increases in work volume and the added workload associated with provisions of the Monetary Control Act. Changes also were part of the Federal Reserve System's long-range automation program calling for standardization of data processing at Reserve Banks in order to facilitate future resource sharing among districts.

In October 1980, a high-speed currency processor was installed at the Minneapolis office. This equipment permits automated, high-speed processing of 50,000 notes per hour, determines individual note fitness, checks for counterfeits, and destroys unfit currency automatically and securely. The equipment will permit improvement in the quality of the currency stock circulating in the district without inordinate cost increases.

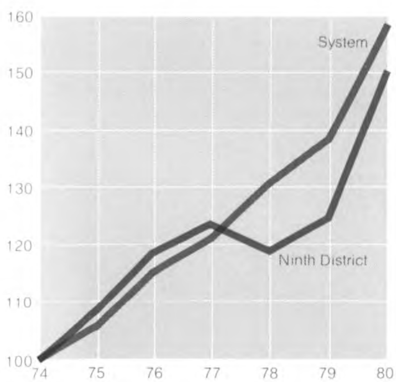
Another notable operational improvement in 1980 was the effort to develop a new Federal Reserve communications network for the transfer funds and securities between financial institutions throughout the country. The new communications system will employ the most advanced technology, replacing the current network by the end of 1981. It will combine the flexibility and increased capacity necessary to meet the expanding requirements of the financial community through the 1980s. Moreover, safety enhancements built into the new system minimize the risks of service disruption.

Bank operating costs increased nearly 20 percent in 1980, as the accompanying charts indicate. This reflects a sharp departure from the five-year trend of expense growth averaging about 5 percent per year. The sharp acceleration in expenses during

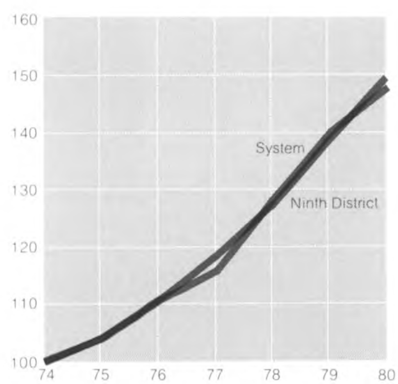
1980 was, in part, associated with a series of "one time" programs and initiatives. Included among these were: (1) the conversion and expansion of check processing facilities and the associated efforts to reduce levels of float; (2) the conversion and upgrading of the Bank's general data processing computer facilities; and (3) the initial costs associated with the implementation of the Monetary Control Act. Once the major thrust of these initiatives is behind us—which should occur in mid-1981—the Bank fully expects that the rate of growth in its expenditures will fall back to approximate more closely that experienced from 1975 to 1979.

Bank management is confident that these operational changes represent important investments in the ability of the Federal Reserve Bank of Minneapolis and the Helena branch to accommodate current demand for Fed services and future growth in demand, if that should materialize. At the same time, the quality of service will be maintained or improved. Thus, planning efforts and new investments will bring improved operating efficiency to Federal Reserve services offered to financial institutions of the Upper Midwest.

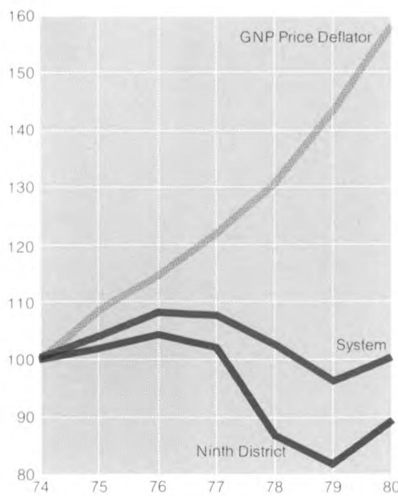
Total Expense
1974=100



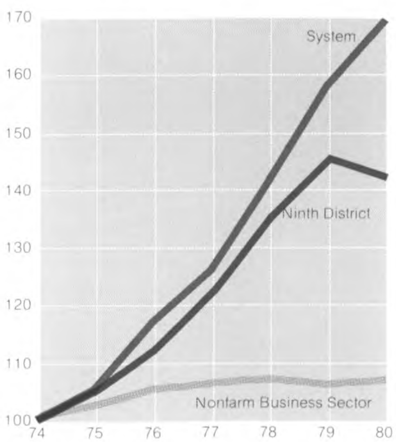
Total Output
1974=100



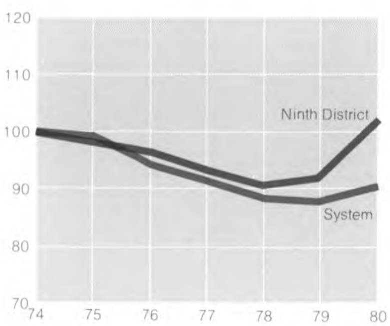
Unit Costs
1974=100



Labor Productivity
1974=100



Employment
1974=100



Statement of Condition
(In Thousands)

	December 31, 1980	December 31, 1979
Assets		
Gold Certificate Account	$ 225,000	$ 231,534
Interdistrict Settlement Fund	(447,588)	(765,306)
Special Drawing Rights Certificate Account	42,000	32,000
Coin	12,028	16,741
Loans to Depository Institutions	34,200	31,440
Securities:		
Federal Agency Obligations	156,091	182,625
U.S. Government Securities	2,130,773	2,585,043
Total Securities	$2,286,864	$2,767,668
Cash Items in Process of Collection	696,147	994,364
Premises and Equipment— Less: Depreciation of $10,988 and $9,538	33,495	30,644
Other Assets	238,084	156,101
Total Assets	$3,120,230	$3,495,186
Liabilities		
Federal Reserve Notes	$1,807,068	$1,908,623
Deposits:		
Depository Institutions	654,858	678,014
U.S. Treasury—General Account		175,017
Foreign	11,392	9,568
Other Deposits	4,293	18,820
Total Deposits	$ 670,543	$ 881,419
Deferred Availability Cash Items	526,940	571,747
Other Liabilities	39,531	60,885
Total Liabilities	$3,044,082	$3,422,674
Capital Accounts		
Capital Paid In	$ 38,074	$ 36,256
Surplus	38,074	36,256
Total Capital Accounts	$ 76,148	$ 72,512
Total Liabilities and Capital Accounts	$3,120,230	$3,495,186

Earnings and Expenses

(In Thousands)

For the Year Ended December 31	1980	1979
Current Earnings		
Interest on Loans to Member Banks	$ 5,049	$ 6,356
Interest on U.S. Government Securities and Federal Agency Obligations	237,725	226,908
All Other Earnings	4,139	2,300
Total Current Earnings	$246,913	$235,564
Current Expenses		
Salaries and Other Benefits	$ 20,893	$ 17,516
Postage and Expressage	3,837	3,238
Telephone and Telegraph	651	572
Printing and Supplies	1,186	1,041
Real Estate Taxes	1,603	1,325
Furniture and Operating Equipment— Rentals, Depreciation, Maintenance	2,275	1,672
Depreciation—Bank Premises	832	873
Utilities	522	466
Other Operating Expenses	2,394	2,010
Federal Reserve Currency	1,348	993
Total Current Expenses	$ 35,541	$ 29,706
Less Expenses Reimbursed or Recovered	2,368	2,409
Net Expenses	$ 33,173	$ 27,297
Current Net Earnings	$213,740	$208,267
Net Deductions	1,367	3,621
Less:		
Assessment for Expenses of Board of Governors	1,975	1,593
Dividends Paid	2,244	2,121
Payments to U.S. Treasury	206,336	198,716
Transferred to Surplus	$ 1,818	$ 2,216
Surplus Account		
Surplus, January 1	$ 36,256	$ 34,040
Transferred to Surplus—as above	1,818	2,216
Surplus, December 31	$ 38,074	$ 36,256

Volume of Operations
(Minneapolis and Helena Combined)

For the Year Ended December 31	Number 1980	Number 1979	Dollar Amount 1980	Dollar Amount 1979
Loans to Member Banks	1,156	1,904	$ 3.3 billion	$ 2.4 billion
Currency Received and Verified	159 million	157 million	1.5 billion	1.4 billion
Coin Received and Counted	383 million	352 million	66 million	65 million
Checks Handled, Total	832 million	770 million	298 billion	281 billion
Collection Items Handled	.4 million	.3 million	.7 billion	.5 billion
Issues, Redemptions, Exchanges of U.S. Government Securities	10.2 million	9.8 million	83.6 billion	99.4 billion
Securities Held in Safekeeping	509,108	520,955	3.1 billion	2.7 billion
Transfer of Funds	1,356,427	1,133,182	1.569 trillion	1.169 trillion

Directors of the Federal Reserve Bank of Minneapolis

January 1, 1981

Terms expire December 31 of indicated year

Stephen F. Keating
Chairman and Federal Reserve Agent

William G. Phillips
Deputy Chairman

Class A
Elected by Member Banks

Zane G. Murfitt (1981)
President
Flint Creek Valley Bank
Philipsburg, Montana

Henry N. Ness (1982)
Senior Vice President
Fargo National Bank
and Trust Company
Fargo, North Dakota

Vern A. Marquardt (1983)
President
Commercial National Bank
L'Anse, Michigan

Class B
Elected by Member Banks

Russell G. Cleary (1981)
Chairman and President
G. Heileman Brewing Company, Inc.
LaCrosse, Wisconsin

Joe F. Kirby (1982)
Chairman
Western Surety Company
Sioux Falls, South Dakota

Harold F. Zigmund (1983)
President
Blandin Paper Company
Grand Rapids, Minnesota

Class C
Appointed by Board of Governors

William G. Phillips (1981)
Chairman
International Multifoods
Minneapolis, Minnesota

Sister Generose Gervais (1982)
Administrator
Saint Marys Hospital
Rochester, Minnesota

Stephen F. Keating (1983)
Retired Chairman
Honeywell Inc.
Minneapolis, Minnesota

Directors of the Helena Branch

Norris E. Hanford
Chairman

Ernest B. Corrick
Vice Chairman

Appointed by Board of Directors
Federal Reserve Bank
of Minneapolis

Lynn D. Grobel (1981)
President
First National Bank
Glasgow, Montana

Harry W. Newlon (1982)
President
First National Bank
Bozeman, Montana

Jase O. Norsworthy (1982)
President
The N·R·G Company
Billings, Montana

Appointed by Board of Governors

Norris E. Hanford (1981)
Wheat and Barley Operator
Fort Benton, Montana

Ernest B. Corrick (1982)
Vice President and General Manager
Champion International Corporation
Timberlands–Rocky Mountain
Operations
Milltown, Montana

Member of Federal Advisory Council

Clarence G. Frame
Vice Chairman
First Bank System, Inc.
Minneapolis, Minnesota

Officers of the Federal Reserve Bank of Minneapolis

January 1, 1981

E. Gerald Corrigan
President

Thomas E. Gainor
First Vice President

Senior Vice Presidents

Melvin L. Burstein
Senior Vice President and General Counsel

John P. Danforth
Senior Vice President and Director of Research

Leonard W. Fernelius
Senior Vice President

John A. MacDonald
Senior Vice President

Vice Presidents

Sheldon L. Azine
Vice President and Deputy General Counsel

Lester G. Gable
Vice President

Phil C. Gerber
Vice President

Gary P. Hanson
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

Arthur J. Rolnick
Vice President and Deputy Director of Research

James R. Taylor
Vice President

Robert W. Worcester
Vice President

Assistant Vice Presidents

Robert C. Brandt
Assistant Vice President

James U. Brooks
Assistant Vice President

Marilyn L. Brown
Assistant Vice President

Richard K. Einan
Assistant Vice President and Assistant Secretary

Richard C. Heiber
Assistant Vice President

William B. Holm
Assistant Vice President

Ronald O. Hostad
Assistant Vice President

Ray L. Hulett
Assistant Vice President

Ronald E. Kaatz
Assistant Vice President

Gerald J. Mallen
Assistant Vice President

Preston J. Miller
Assistant Vice President

James L. Narragon
Assistant General Auditor

Ruth A. Reister
Assistant Vice President and Secretary

Charles L. Shromoff
Assistant Vice President

Colleen K. Strand
Assistant Vice President

Theodore E. Umhoefer
Assistant Vice President

Joseph R. Vogel
Chief Examiner

Norma J. Wuertz
Assistant Vice President

Officers of the Helena Branch

Betty J. Lindstrom
Vice President

G. Randall Fraser
Assistant Vice President

Robert F. McNellis
Assistant Vice President