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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Economic Goals

and Intergovernmental Policy

of the

Joint Economic Committee

June 27, 1985

I appreciate the opportunity to appear before this Committee to discuss issues involved in the budgetary treatment and procedures of the Federal Reserve System. Attached to my statement are several appendices which discuss these questions more completely. I request those materials be included in the record.

The appropriate budgetary treatment of the Federal Reserve has been considered a number of times. Each time Congress has examined the issue, it has concluded that the Federal Reserve's functional independence is inextricably intertwined with its budgetary independence. I believe the ability of the Federal Reserve, as provided by the Congress, to conduct its monetary policy with relative freedom from day-to-day political pressure has served the nation well over the years. Maintaining the independence necessary to accomplish that objective should remain in the forefront of any consideration to change our budgetary treatment.

I realize, Mr. Chairman, that you are sensitive to those concerns. I understand that it is not your intent to propose that the Federal Reserve be subjected to the regular budget control processes of the Administration or to Congressional appropriations. Your concern, as I understand it, is to assure adequate information is available to permit and encourage appropriate Congressional review and public understanding of Federal Reserve spending.

In approaching that problem, we share the common ground that the Federal Reserve is accountable to the Congress, and through the Congress ultimately to the American public, for its spending. The fact is we do make available substantial and detailed information on our spending and operations. Budgets for both the Board of Governors and the Reserve Banks are discussed and approved in open meetings of the Board. I would submit, in those respects, our accounts and budget process are already an "open book," as they should be.

Mr. Chairman, following my earlier discussions with you I have reviewed this matter in detail. I would readily agree the "open book" is hard to read -- sometimes confusing and enormously complex. I believe there are changes we can implement to make our budgets more conveniently accessible and more generally useful. For instance, with that objective in mind this year's Annual Report of the Board of Governors to the Congress includes a chapter reviewing Federal Reserve spending over the last ten years and our budgets for 1985. We intend to present similar information in each Annual Report in the future.

The burden of my comments this morning is that the legitimate objectives of disclosure and public accountability can be best achieved by retaining independent budgetary reporting for the Federal Reserve (with our net earnings, as at present, reflected in the regular budget document). Integrating Federal Reserve expenditures into the Federal Budget, contrary to our

entire history and earlier Congressional decisions, would, I fear, be interpreted as a clear step toward Executive influence and control over the Central Bank. I am convinced that, in the end, the effect would be to make our operations less intelligible and "transparent" rather than more. At the same time, I believe we can better achieve your objectives by working with the Congress to improve procedures for reporting and oversight.

The Federal Reserve as a Self-Funding Central Bank

The Congress established a central bank for the United States much later in the nation's history than has been the case in most other industrialized countries. To a considerable extent this reflected long and strongly felt concerns about concentration of economic power. At the same time, the Congress clearly wished to insulate the Federal Reserve from partisan politics. These concerns led to the creation of a regional system, with operational responsibilities diffused among 12 Reserve Banks,

each with its own board of directors and with the entire system supervised by the Board of Governors in Washington.

In that connection, Congress plainly understood that the ability to make considered monetary judgments, independent of day-to-day pressures of the political arena, required freedom from outside fiscal control. These concerns were also evident in the important revisions of the Federal Reserve Act in 1935, which cast the System in essentially the form it has today.

The desirability of independent funding of the Federal Reserve and freedom from potential domination by the Executive Branch has been reaffirmed each time questions have been raised. And it has not been a partisan or parochial position. For instance, in 1975 six former Secretaries of the Treasury, in a letter to Senator Proxmire, stressed how important they felt it was that the Federal Reserve retain its status as a nonappropriated agency in these words:

"We all feel that the Congressional reasoning of 60 years ago which purposely insulated the Federal Reserve from immediate political pressures is even more valid today. It is probably more difficult today than 60 years ago for the Congress to take a long view that may well appear to conflict with immediate problems. And yet, this is precisely what the Federal Reserve must do each day and why we feel that its independence must be preserved.

"We all agree from a combined total of many years of experience in government that the independence of the Federal Reserve would inexorably be eroded by the appropriations process exposing our country to great potential danger."1/

I should also point out that the budgetary status of the Federal Reserve is hardly unique; it is indeed the norm for central banks around the world. For instance, whatever other arrangements surround their functional independence, all the central banks of the G-10 countries finance their expenditures out of their own income. Typically, they return all or major parts of their income in excess of expenses to the national treasury, as is the case in the United States, but in no instance is a budget statement for the central bank included in the budget for the central government. That approach by other major industrialized countries reflects widely held concerns about assuring

1/ Federal Reserve Reform and Audit Hearings, 1975, hearings before the Senate Committee on Banking, Housing and Urban Affairs, on S. 2285; and S. 2509, 94th Congress (October 20, 1975), p. 140. (Appendix A discusses the history of Federal Reserve budgetary independence more fully.)

operational autonomy for central banks. (Appendix B discusses financing of the Central Banks of other major countries in more detail.)

I recognize and appreciate that the stated aim of H.R. 1659 is not to disturb the present method of Federal Reserve funding or expense control, much less to change the status of the System within government. My concern, nonetheless, is that the proposed inclusion of Federal Reserve expenditures within the Executive's budget document could be the first step down a slippery slope, encouraging those who clearly would wish to impair our functional independence by bringing the System more fully into the budgetary and appropriation process or otherwise.

Federal Reserve System Budget

The objective specifically sought by H.R. 1659 can, in my judgment, be reached more effectively and more cheaply by other approaches consistent with present procedures and budgetary

treatment. To help place this issue in context, I would like to summarize the existing budget process and results.

The Process

The Federal Reserve has an intensive planning budget and control process for both the Reserve Banks and the Board of Governors. That process reflects throughout strong concern with both economy and efficiency.

Initial general guidelines for System spending are approved by the Board of Governors on the basis of analyses and projections of expected workloads, trends in prices and wages, and productivity gains in each area of Federal Reserve responsibility. Within each of the Reserve Banks, Directors drawn from the private sector, participate in the budgetary process, bringing to bear a great deal of business experience. They must approve the budgets of their banks.

I would emphasize too that more than 40 percent of Reserve Bank budgets represent expenditures for "priced services". As a matter of law and principle, these services must meet a market test in that all expenses (including overhead, and the imputed cost of capital and taxes) are covered by charges.

As a last step, budgets for both the Reserve Banks and for the Federal Reserve Board operations are presented to the Board of Governors for its review and approval at meetings that are open to the public. (The internal review process is outlined in Appendix C.)

The Results

In the end, the effectiveness of the process must be measured by results. In the ten-year period from 1974 to 1984 Federal Reserve spending has increased at an average annual rate of about 0.7 percent in constant dollars (Chart 1). In the same period, total System employment has fallen by about 13 percent,

from roughly 28,000 to 24,000 (Chart 2). Over the same decade, the principal measures of operational workload have increased by 50 to almost 400 percent (Table 1). The long-term decline in Federal Reserve employment in face of persistent increases in output reflect in large measure persistent efforts to improve productivity in the operating functions of the Federal Reserve Banks.

For 1985 the Federal Reserve Banks and the Board of Governors have budgeted total operating expenditures of approximately \$1.2 billion.^{2/} Of this amount, some \$900 million reflects operational services to financial institutions, the public, the Treasury and Government agencies, most of which is recovered by charges or reimbursements. Overall, this will represent an increase of about 5 percent, in nominal terms, over the 1984 spending level (Table 2).

^{2/} This does not include another \$175 million which will be paid to the Bureau of Engraving and Printing for Federal Reserve notes to be distributed to the public. This sum is not usually included in analyses of Federal Reserve spending because it represents simply the cost of providing currency.

As I indicated a few moments ago, under the provisions of the Monetary Control Act, the System must recover the full cost of most services (including an adjustment for imputed taxes and the cost of capital) it makes available to depository institutions. In this area -- clearing checks, providing wire transfers, and other payments services -- the Federal Reserve effectively has to compete in terms of price and quality with other actual and potential suppliers of such services. In 1984 the Federal Reserve met this test and recovered the full cost of priced services.

As fiscal agent for the U. S. Government, the Federal Reserve is responsible for issuing and redeeming a variety of Treasury and other government debt instruments ranging from savings bonds and food stamps to large denomination Treasury bills, notes and bonds. We are reimbursed in whole or in part for these services by other agencies, bringing our receipts for services to

more than \$600 million this year, about half of total expected Federal Reserve expenditures budgeted for 1985.

While this may not be the time or place to review the spending record in great detail, I have attached relevant material in Appendix D and would, of course, be glad to respond to any questions you may have. But I do want to affirm that I believe that further analysis will confirm a disciplined budgetary process and a consistent pattern of economy and efficiency in our actual spending. Indeed I am not aware that our record in these respects has been challenged in any material before the Committee.

Information Now Publicly Available on Federal Reserve Spending

The Federal Reserve now makes available detailed information on its spending. Much of this data is drawn directly from the Federal Reserve's accounting and management information system (Planning and Control System, or "PACS") used for internal

control. That system contains data on spending by every Reserve Bank and branch office by service and subservice line and by object of expenditure (i.e., salaries, materials and supplies, equipment, travel and others). All in all, the "PACS" reports provide data on 96 services and subservices by 71 detailed objects of expenditure, as well as productivity and service quality measures. These data are publicly available on a quarterly basis with a six-week time lag, and I know of no other governmental body that provides publicly so much detail about its spending and productivity so promptly.^{3/}

PACS information by its nature is retrospective. However, the Federal Reserve also makes available late in each year information in the form of tables and analyses of anticipated expenditures for the forthcoming year. These are released to the public prior to the open Board meetings at which spending levels for the Board and the Reserve Banks are set.

^{3/} I have included with my statement a Summary PACS report for the first quarter of 1985 for your information.

Whether we have provided all available information in as readily convenient a form as possible is another question. I believe improvements can be made. We are working to that end.

Difficulties with the Approach of H.R. 1659

Our Federal Reserve budgeting generally follows business accounting principles, including depreciation of capital assets. The budgets are on a calendar year basis, and we do not regularly make multi-year expenditure forecasts.

H.R. 1659 would require changes in that approach. All budget information would be provided in the same format, and with the same accounting conventions, as used for "on budget" agencies. The data would then be included in the Federal budget documents, although without provisions for Executive Branch review or Congressional appropriations.

Technical issues, as well as fundamental philosophical concerns, would need to be resolved before such an approach could

be adopted. And, I do not believe the results would effectively achieve the limited aims sought -- that is, improved understanding and review of our expenditures by the Congress or the public.

The technical concerns are threefold: first, problems arising from differences in the accounting procedures used by the Federal Reserve and those employed by budgeted agencies; second, the costs that would be associated with the necessity of maintaining a dual accounting system, and third, the difficulties of meaningfully forecasting Federal Reserve earnings several years ahead.

With respect to accounting conventions, the Federal Reserve is a "business-like" organization that basically keeps its books as would a private concern -- that is using generally accepted accounting principles (GAAP). The primary difference in approach from Federal budget concepts is that the Federal Reserve

capitalizes and depreciates major assets rather than expensing them in the year that they are acquired.^{4/} Indeed, we could not sensibly price our services on any other basis, given that the production of these services is highly capital intensive and that our prices, by law, must be set in a manner consistent with methods used by private sector providers. Specifically, expensing computers and other equipment in the year acquired -- rather than following GAAP -- would result in widely fluctuating prices for Federal Reserve services, rendering the pricing approach stipulated by the Monetary Control Act practically impossible. More generally, from the standpoint of budgetary management of both the Board of Governors and the various Federal Reserve Banks -- and the comprehensibility of those budgets to the public -- GAAP accounting seems more sensible.

^{4/} The GAAP approach used by the Federal Reserve is particularly recommended by the accounting profession for organizations that must cost and price products. See, for instance: Comptroller General of the United States, Report to the Chairman, Committee on Banking, Housing and Urban Affairs, United States Senate, "An Examination of Concerns Expressed about the Federal Reserve's Pricing of Check Clearing Activities;" and Arthur Andersen & Co., "Federal Reserve System: Report on Priced Services Activities," September 1984.

These problems implicit in Federal budgetary treatment could be overcome only by maintaining dual accounting systems, which would involve some sizable developmental and maintenance costs if done with precision. And, two parallel accounting systems are more likely to contribute to confusion than clarity.

H.R. 1659 also would require the Federal Reserve to forecast our revenues. The great bulk of the Federal Reserve's earnings are a by-product of the implementation of monetary policy. Earnings on our portfolio of securities account for more than 95 percent of Federal Reserve receipts and reflect mostly the amount of currency outstanding, Congressional and Federal Reserve decisions as to the level of reserve requirements, decisions on open market operations, and the level of interest rates. Meaningful forecasts of those variables are simply not feasible and would be liable to gross misinterpretation if considered indicative of future monetary policy. I would also point out

that forecasts of costs and receipts in the priced services area would also be subject to market uncertainties, and necessarily be somewhat speculative.

Policy Concerns

My greatest concerns about the approach proposed in H.R. 1659 transcend these technical considerations.

We plainly have the obligation to report to the Congress fully on our policies and operations. My sense is the arrangements for such reporting have, in most respects, worked relatively well over the years. As you know, as a matter of law, I testify four times each year before the Congress on the general conduct of monetary policy. Altogether, other Governors, Federal Reserve officials and myself appeared formally before the Congress on 34 occasions last year, and 34 times so far in 1985, testifying on a variety of subjects.

The question raised is whether, in this testimony, in other reports, or otherwise, there is enough focus on our "house-keeping" responsibilities -- running an economical, cost-effective operation. Appropriate Congressional oversight of Federal Reserve spending can and should contribute to that process. I believe this can be done in a manner that does not raise questions about the independence of our budgetary processes and which contributes to public understanding.

To those ends, I would suggest:

- 1) Within the Federal Reserve, we take steps to assure that the mass of information now available in several documents about our spending and budgetary process be presented at times and in a manner more accessible to public and Congressional oversight. We are taking steps in that direction, and would welcome further suggestions you may have.

2) We retain our present accounting format, using GAAP concepts rather than shifting to the Federal budget accounting conventions. My strong belief is that Federal Reserve spending is likely to receive more, and better informed, Congressional and public scrutiny as part of a separate report consistent with GAAP accounting.

The net fiscal impact of Federal Reserve operations is already fully and accurately reported in the Budget. Forcing the full array of supporting material into the dark recesses and precise format of a budget presentation developed for quite different purposes -- a presentation that already runs to thousands of pages -- could hardly be a service to public understanding. It would, I suspect, become just another hard-to-understand "special analysis," alongside a number of others virtually incomprehensible to those untutored in the intricacies of budget accounting for government or government-sponsored enterprises.

3) Finally, the appropriate oversight committees in the House and Senate might wish to resume a practice, followed for some years in the Senate, of annual hearings directed specifically toward the Federal Reserve budget and internal management. I believe we, as an organization, benefitted from that procedure in the past, and would be glad to cooperate in the future.

In closing, Mr. Chairman, I appreciate the careful way in which you have undertaken a reexamination of these questions. Our goals are congruent -- to achieve effective cost containment and appropriate accountability. I believe those aims can be accomplished in ways fully consistent with our traditional role in Government, and without raising unintended questions about whether the conduct of monetary policy will continue to be free from partisan and passing political pressures.

* * * * *

CHART 1

TOTAL EXPENSES FEDERAL RESERVE SYSTEM

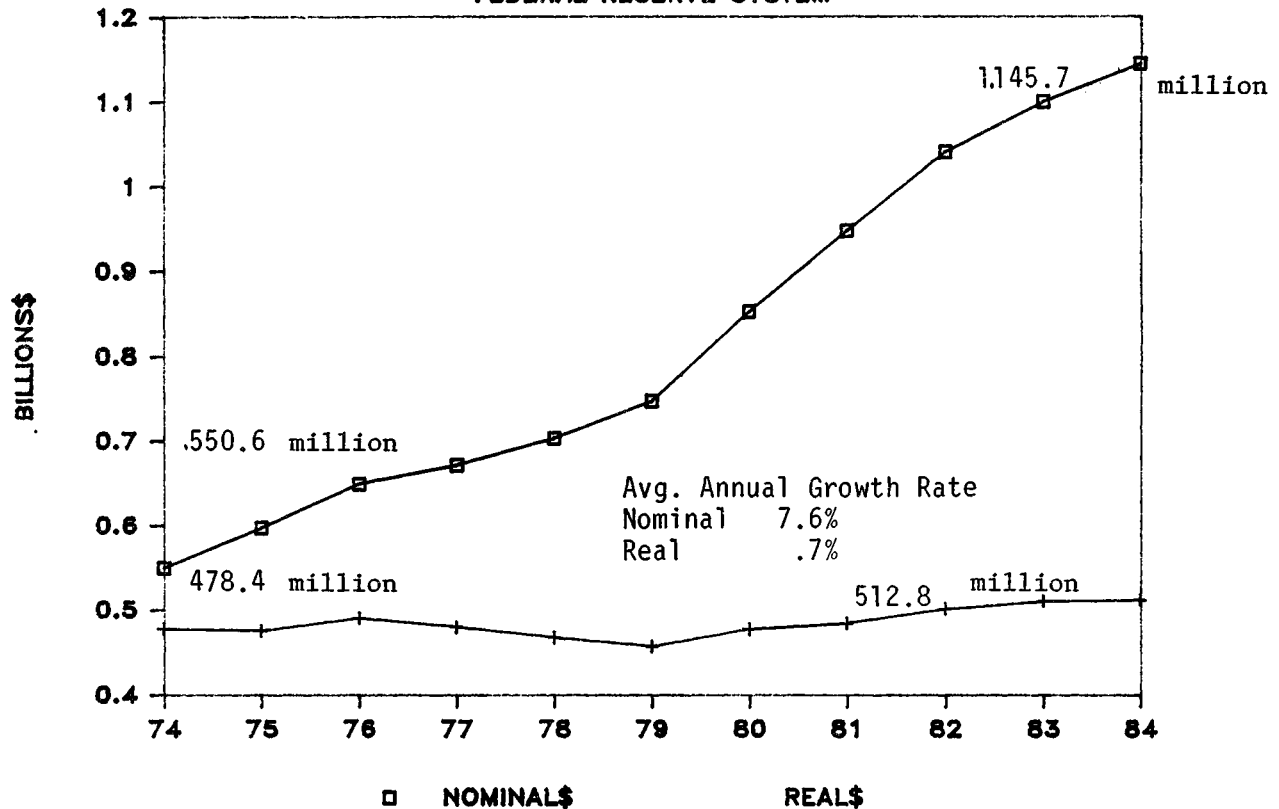
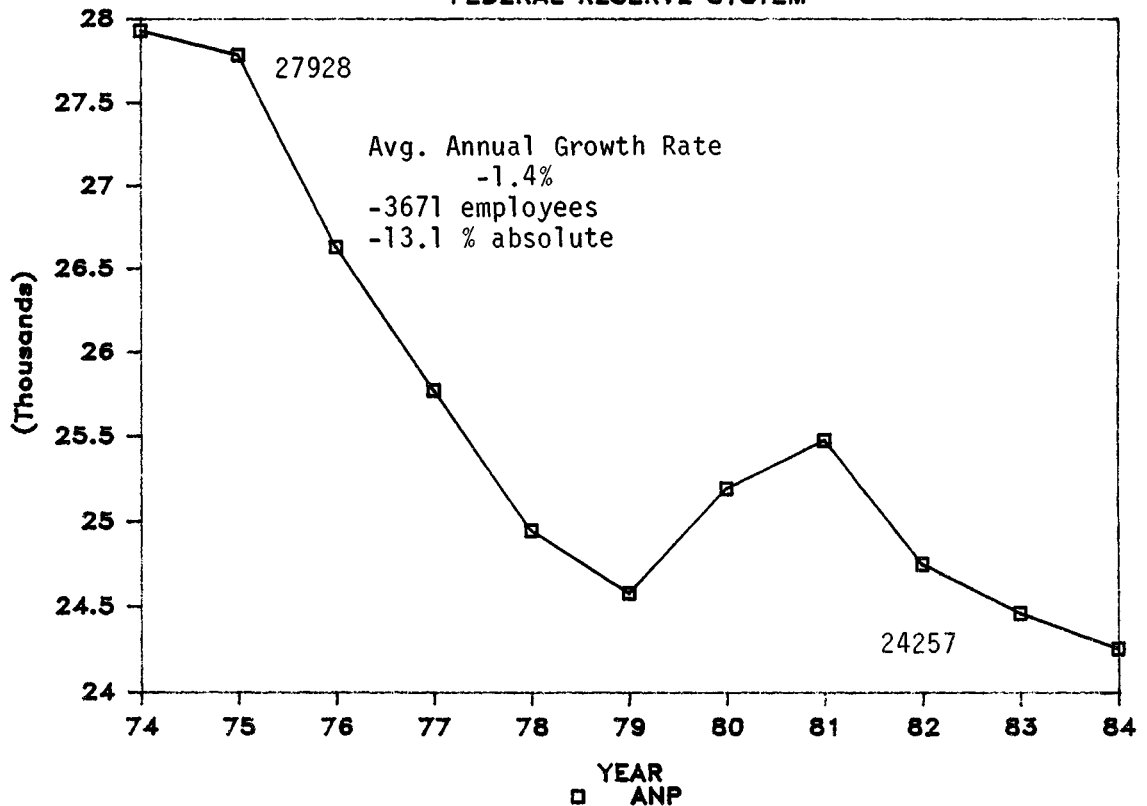


CHART 2

TOTAL EMPLOYMENT FEDERAL RESERVE SYSTEM



Note: These data include Reserve Bank and Board expenses, excluding currency costs, because the Fed reimburses the Bureau of Printing and Engraving for their total costs of producing Federal Reserve notes. Constant dollar data calculated using the GNP implicit price deflator 1972=100.

Table 1
Federal Reserve System
Expenditures, Employment and Volume Measures
1974-1984
% Change

	<u>1974/1984</u>	<u>Average Annual Rate</u>
Expenditures		
Real	7.2%	0.7%
Nominal	108.0%	-7.8%
Employment	-13.1%	-1.4%
Operating Volumes		
Funds Transfer	386%	17.1%
Currency	99%	7.1%
Check Collection	53%	4.3%

Table 2
Federal Reserve Expenditures
1984 Actual - 1985 Budget

	Federal Reserve System <u>1/</u> 1984 Actual - 1985 Budget (in millions)			Reserve Bank Expenses <u>2/</u> 1984 Actual - 1985 Budget (in millions)			Board of Governors Expenses <u>3/</u> 1984 Actual - 1985 Budget (in millions)		
	<u>1984</u>	<u>1985</u>	<u>% change</u>	<u>1984</u>	<u>1985</u>	<u>% change</u>	<u>1984</u>	<u>1985</u>	<u>% change</u>
Monetary & Economic Policy	130.2	131.7	1.1	99.4	98.4	- 1.0	30.8	33.3	8.1
Services to Treasury & Government Agencies	129.4	140.6	8.6	126.3	137.0	8.5	3.2	3.5	9.3
Services to Financial Institutions	728.2	757.9	4.1	701.5	730.3	4.1	26.7	27.6	3.3
Supervision and Regulation	158.1	174.4	10.3	140.7	156.7	11.4	17.4	17.7	1.7
Total	1145.7	1204.4	5.1	1067.8	1122.3	5.1	78.1	82.1	5.1

1/ These data are for Reserve Banks and Board of Governors expenses excluding currency costs. The data are derived from two separate accounting systems, for comparability over the time periods estimates were made to allocate expenses into major programs and for the Board of Governors which accounts for 7 percent of the total system expenditures.

2/ Includes support and overhead allocation.

3/ Includes depreciation expense. Figures may not add due to rounding.

Table of Contents

Page

Appendix A: HISTORICAL SUMMARY: FEDERAL RESERVE SYSTEM STRUCTURE AND BUDGETARY TREATMENT

Introduction

The Federal Reserve's Budgetary Independence • 2

Major Legislation 3

World War II and the Federal Reserve/Treasury Relationship 4

Congressional Proposals 5

Other Reviews of the Federal Reserve's Budgetary Status 7

Chronology of Federal Reserve Legislation 9

Appendix B: FINANCIAL INDEPENDENCE OF CENTRAL BANKS OF THE G-10 COUNTRIES

Appendix C: PLANNING, BUDGET AND CONTROL PROCESSES OF THE FEDERAL RESERVE SYSTEM

I. Reserve Banks 1

II. Board of Governors 13

Appendix D: FEDERAL RESERVE SYSTEM EXPENDITURES, EMPLOYMENT AND PRODUCTIVITY

Overview

I. Total System Expenses and Employment by Program 6
A. Monetary and Economic Policy 6
B. Services to the Treasury and Government Agencies 8
C. Services to Financial Institutions and the Public 9
D. Supervision and Regulation 12

II. Reserve Bank Expenses and Employment 14
Reserve Bank Expenses and Employment by Service Line 17
A. Service Line I: Monetary & Economic Policy 19
B. Service Line II: Services to the Treasury
and Government Agencies 23
C. Service Line III: Services to Financial
Institutions and the Public 27
D. Service Line IV: Supervision and Regulation 31

III. Board of Governors' Expenses and Employment 33
Board Expenses and Employment by Program Structure 35

IV. PACS Performance Measures 37
Productivity 39

V. 1985 Federal Reserve Budgets 41

HISTORICAL SUMMARY
FEDERAL RESERVE SYSTEM STRUCTURE AND BUDGETARY TREATMENT

Introduction

The budgetary independence of the Federal Reserve is part of a carefully constructed Congressional design to ensure the independence of the nation's monetary authority from day-to-day political influence. The Federal Reserve is not isolated from the Congress that created it: frequent testimony enables the Congress to oversee the Federal Reserve, to communicate its views, and to alter the Federal Reserve's operating functions, as it did in the Monetary Control Act of 1980, and in many previous legislative acts.

However, while the role of the Federal Reserve--and its budgetary independence--have been frequently reviewed both by the Congress and other groups, the conclusion has always been that it is in the nation's interest to retain the budgetary arrangements as the Congress originally framed them.

Background

The United States created its central bank much later in the nation's history than most other major industrial countries. The Federal Reserve System was established in 1913 following a string of bank failures and money panics. Six such economic crises had occurred in the preceding 30 years. With the most severe shock of 1907 still in mind, the 62nd Congress acted to create an institution that would preserve the value of U.S. currency and promote a stable economy.

The Federal Reserve Act, signed into law by President Woodrow Wilson on December 23, 1913, provided 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.¹

The Federal Reserve Act was crafted by Senator Carter Glass under the guidance of President Wilson. President Wilson made clear his desire for a decentralized central bank, composed of a system of regional reserve banks in which national banks, and voluntarily participating state banks, would be required to hold stock and maintain their reserves. He was equally adamant on the matter of dispersion of power and control stipulating that while six of each regional Reserve Bank's proposed nine directors would be chosen by banks, only three of these could themselves be bankers. The remaining three directors, including the Chairman, would be chosen by a separate Federal Reserve Board located in Washington and designed to be the capstone of the System.

The Federal Reserve's Budgetary Independence

Since the System's early years its independent status and its relationship to the Congress and the Executive have been the subjects of widespread discussion. The Congress carefully provided sufficient independence to enable the System to pursue the goal of maintaining a stable currency and economy insulated from day to day political influences and from the private banking community. The legislative history of the original Federal Reserve Act indicates that Congress was adamant on that point. Its exemption from the congressional appropriations process was seen as an essential part of this insulation, and the debate surrounding the passage of the Act is replete with

¹ Preamble to the Federal Reserve Act, December 23, 1913.

statements reflecting this concern. The Federal Reserve Act specifically states that the Federal Reserve Board is to pay its expenses out of the earnings on Reserve Bank assets. It was clearly understood that the Reserve Banks themselves would not be subject to appropriations.²

Major Legislation

o The Banking Act of 1933

The Congress passed the Banking Act of 1933 in an effort to strengthen the Federal Reserve Board and implement programs for economic recovery. It further clarified the Federal Reserve Board's and the Reserve Banks' independence by adding a new paragraph to section 10 of the Federal Reserve Act:

...The Board shall determine and prescribe the manner in which its obligation shall be incurred and its disbursements and expenses allowed and paid, and may leave on deposit in the Federal Reserve Banks the proceeds of assessments levied upon them to defray its estimated expenses and the salaries of its members and employees, ...; and funds derived from such assessments shall not be construed to be Government funds or appropriated moneys. (12 U.S.C. Section 244.)

According to both the House and Senate Banking Committee reports, the purpose of the amendment was to leave "to the Board the determination of its own internal management policies."³ The Senate Report specifically states (pp. 11-12) that one of the purposes of the Act was to strengthen the Federal Reserve System by increasing the independence of the Federal Reserve Board.

² See attached chronology relating to Federal Reserve legislative developments.

³ S. Rep. No. 77, 73rd Cong., 1st Sess., p. 14, May 17, 1933.
H. Rep. No. 150, 73rd Cong., 1st Sess., p. 2, May 19, 1933.

o The Banking Act of 1935

The Banking Act of 1935 further strengthened the powers of the Board of Governors by removing the Secretary of the Treasury and the Comptroller of the Currency from the Board. A former Treasury Secretary, Senator Carter Glass, sponsored this amendment. He argued that the Secretary of the Treasury didn't belong on the Federal Reserve Board because of the chance that the Secretary would exercise undue influence on the Board, "treating the board as a mere bureau of the Treasury Department."⁵ Glass said that Senator McAdoo, who had also been a Treasury Secretary, agreed with him. They believed that influence of this sort was not proper, and it was never contemplated that the Federal Reserve would function as an adjunct to the Treasury.

Although the American banking community lobbied for more control of the banking system when the Banking Bill of 1935 was being considered, they also expressed strong concern that the central bank not come directly under the influence of the Executive Branch. Political pressures would always be for inflation, they claimed, never for curbing the false prosperity of booms.

World War II and the Federal Reserve/Treasury Relationship

The Federal Reserve Board was given greater powers to control money and credit during World War II, but the Treasury's financing requirements necessarily dominated war time Federal Reserve policy. In an address in May 1948, Marriner Eccles said:

The record of the financing of the war shows that as much as \$8 billion a month was being spent, the public debt grew from around \$40 billion to \$280 billion in the short space of four or five years. The public debt was 60 percent of all debt. It would be perfectly obvious that in order to do that at a fixed interest basis, which was maintained throughout the war, we had to have a central open market operation. We were able to say to Treasury: 'We will finance whatever is necessary at the rates of interest now prevailing.' That was just before the war and we did.⁶

⁵ 79 Cong., Rec. 11,766-77 (1935).

⁶ Address of Marriner S. Eccles, Chairman, Board of Governors of the Federal Reserve System to the Chairmen's Conference, White Sulphur Springs, West Virginia, May 29, 1948.

While this cooperative policy of war financing was obviously in the national interest, postwar support for government bond prices had long-term inflationary consequences, and the Board believed that supporting government bonds at a fixed rate was feeding inflation. In 1951 the Federal Reserve reached the historic "Accord" with the Treasury, which asserted the Fed's independence and relieved it of the responsibility of fixing the interest rate on Treasury debt issues.

Congressional Proposals

Putting the Federal Reserve System financing under the congressional appropriations process is not a new idea. Several proposals have been considered, but each time the Congress has decided to maintain the current system. The Congress has thereby succeeded in avoiding the problems that could arise if the nation's monetary policy were influenced by considerations of short-term expediency.

In 1964 the Congress held hearings entitled, "The Federal Reserve System After Fifty Years," in which a proposal calling for an audit by the GAO (H.R. 9631) was submitted, as was a bill (H.R. 9685) addressing the issue of putting the Fed under appropriations. Testifying on behalf of the Treasury before the House Committee on Banking and Currency, Secretary C. Douglas Dillon advised against taking such action:

This committee is dealing with a living institution--an institution that has demonstrated its capacity to innovate, to experiment, and to adapt itself to a very wide range of circumstances. But in this process of change, it has never lost certain characteristics--an established tradition of independent judgment: a mixture of regional participation in policymaking with ultimate central control that is unique in our Government; an ability to attract highly qualified officials and staff; and a reputation for operating efficiently and impartially.

Change without clear purpose can be dangerous too. If there are persuasive reasons for particular proposals--if it can be shown that ownership of Federal Reserve Bank stock by member banks has biased Federal Reserve policy decisions or if budgetary or auditing practices have been loose, to take two examples--by all means, this committee should act. But I doubt the advisability of taking action simply for the sake of achieving symmetry with other Government agencies particularly if there was danger that such action might impair a long tradition of regional participation and efficient service of which I believe the country can be proud.

The legislation was not adopted.

In 1968, the House Banking and Currency Committee again held hearings on proposed structural changes to the Federal Reserve. The hearings on H.R. 11, chaired by Congressman Wright Patman, also addressed the issue of having the Congress appropriate operating funds for the Fed. In testimony the Treasury Department stated that subjecting the Fed to the appropriations process was unnecessary and "might widely be regarded as increasing the possibilities for reducing the independence of the System within the Government and as possibly leading to undesirable interferences with policies."

In 1975 the Senate Banking, Housing and Urban Affairs Committee considered a proposal to submit the Federal Reserve's budget to appropriations. Again, the argument was that such involvement by the Congress would largely dissolve the shield of relative independence from political influence that was built into the Federal Reserve Act. This principle was reiterated in a 1975 letter to Senator Proxmire from Joseph W. Barr, former Secretary of the Treasury, along with five other past secretaries, stressing how important they felt it was for the Federal Reserve to retain its status as a nonappropriated agency.

⁷ "The Federal Reserve System After Fifty Years," Hearings before the Subcommittee on Domestic Finance of the House Committee on Banking and Currency, 88th Cong. (Jan.-April, 1964.)

In 1978 with passage of the Federal Banking Agency Audit Act the Congress included an exemption from GAO audit for Federal Reserve transactions with foreign central banks and foreign governments, monetary policy matters, and any documents dealing with these topics. In passing this exemption, the Congress relied in large measure upon fears that information collected during the GAO audits (or GAO comments or criticisms) might be used to influence the System's policies for short-term political reasons. The key provision is the setting of limitations on the auditing process; one limitation is the absolute prohibition against auditing monetary policy matters.

Other Reviews of the Federal Reserve's Budgetary Status

In October 1967, the President's Commission on Budget Concepts presented its report, which led to the present federal unified budget concept. While the Commission found that the budget as a general rule should comprise the full range of federal activities, it did not recommend including the Federal Reserve in the budgetary process. The report observed that to do so might jeopardize the flexibility and independence of the central bank's monetary policy function.⁸

The Report of the President's Commission on Financial Structure and Regulation, also known as the Hunt Commission Report, stated in 1971 that "it is wise to keep the central bank and its decision making responsibility in a basically insulated position within the Federal Government." The Hunt Commission concluded that:

The present position of the Federal Reserve provides for enough communication of ideas and coordination of action with the Executive Branch to serve the purposes of effective government. It also permits thorough and frequent review of central bank performance by the Congress to assure accountability to the public will. These vital safeguards are currently fully respected. The Commission strongly urges that the Federal Reserve System retain its present independence of decision-making to protect monetary policy from partisan political influences (Recommendation 13).⁹

⁸ Report of the President's Commission on Budget Concepts. (GPO, 1967) p. 28.

⁹ The Report of the President's Commission on Financial Structure and Regulation, (GPO, 1971) p. 94.

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More recently, in September 1976, in its report on the "Off-Budget Activities of the federal government," the House Committee on the Budget reviewed the budgetary status of a number of agencies exempt from inclusion in the budget. That report notes that the Board of Governors' budget (but not that of the Federal Reserve Banks) is included in the Appendix to the federal government's budget. Although the Committee recommended that a number of entities' budgets no longer be "off-budget," it chose not to review the expenses and budget status of the Federal Reserve.

Conclusion

The Federal Reserve's independence from the budget process has not isolated the Fed from the Congress. In 1978 the Congress passed the Full Employment and Balanced Growth Act, also known as the Humphrey Hawkins Act. It requires that the Board report twice a year to Congress on its monetary policy objectives and plans as they relate to the most recent Economic Report of the President. Rather than becoming involved in Federal Reserve System operations, the Congress has opted over the years to strengthen the System's reporting procedures and requirements. In the years since 1978, members of the Board or its staff have frequently testified before the Congress on many matters, including the Federal Reserve's budget.

The Federal Reserve System was created by the Congress in legislation carefully crafted to insulate the central bank from influences of private bankers, the Executive Branch and short-term political pressures in the Congress. This system has been examined and reexamined by committees of the Congress and independent commissions examining the banking and budget systems. All have concluded that the Congress acted wisely in establishing and maintaining the budgetary independence of the Federal Reserve System.

CHRONOLOGY OF MAJOR CONGRESSIONAL CONSIDERATION OF
FEDERAL RESERVE STRUCTURE AND FINANCING

- 1913 Federal Reserve Act of 1913; Pub. L. 63-43: Determined structure of the Federal Reserve; designed as a regional system with a governing Board. Provided the Federal Reserve with unique status as an "independent" central bank within government, and organized its operation with the intent of insulating it from political pressures. The Act stipulated that the System's operating expenses were to be funded by assessments on earnings of the Reserve Banks. Ten percent of the Reserve Banks' net earnings was in a special surplus account maintained by the Treasury, and the remainder (90 percent) was paid to the U.S. government as a franchise tax.
- 1927 McFadden Act, also known as the Banking Act of 1927; Pub. L. 69-639: Extended the charters on the Reserve Banks for an indeterminate period (initially the Federal Reserve Act provided for renewable 20-year charters.) Certain restraints put on branch banking by state member banks in the FRS. American Bankers Association president testified that member banks want optional, rather than obligatory, contribution to capital of FRS and want "a voice in placing . . . reserve funds with approved Reserve agents as now, instead of all being impounded by law, and from the earnings of which the government abstracts a part." Because reserve funds are the property of the member banks, the member banks believed they should have a voice in how the funds are used. This view was not reflected in the act that passed. (House Banking and Currency Committee, Hearings on H.R. 6855, 68 Cong. 1 Sess. (GPO, 1924.))
- 1931-1932 Hearings on the Reconstruction Finance Corporation. The bill "requires the FR Banks to transact the business of this corporation, to receive deposits from it," but the Fed is not provided compensation for it, Glass said. During the hearings Glass contended that the Government owns not a dollar of interest in the Federal Reserve System. Undersecretary of the Treasury Ogden Mills says that the government has interest in the Federal Reserve System through the franchise tax. Glass questioned the arrangement saying the FR Banks were not government institutions. He said that the franchise tax (which has since been repealed) should not be collected any longer. He and Mills agreed that the FR Banks "do for government in its fiscal operations a tremendous amount of business without any compensation at all," and should be compensated. (H.R. 5060 and H.R. 5116, 72 Cong. 1 Sess., (GPO, 1932.))

- 1932-33 Hearings on Operation of the National and Federal Reserve Banking System in the U.S. Senate (later became the Banking Act of 1933). In discussion before the Senate Banking Committee, Eugene Meyer, Chairman of the Board, and Senator Glass discussed government financing of emergency recovery programs and institutions. Meyer said that the government had not contributed any money to the maintenance of the Federal Reserve System, and Glass said that it never should. Glass reiterated: "The government does not own one dollar of proprietary interest in the Federal Reserve System, and I for one have been intent on keeping it that way. I don't think the government should have anything to do with it except by way of supervisory control." (S. Res. 71, 71 Cong. 3 Sess. (GPO, 1932.))
- 1933 Banking Act of (June 16) 1933, Pub. L. 73-66: In addition to important changes in operating procedures and structure of FOMC, the Act stated that funds of the Federal Reserve System, the FDIC and the Comptroller of the Currency were not public moneys. Subsequently the Federal Reserve was not subject to GAO audit, or the appropriations process. Federal Reserve surplus account funds used to capitalize the FDIC. Franchise tax requirement was eliminated to enable the Reserve Banks to restore their surplus accounts. To strengthen the Board's political independence, terms of governors were extended from 10 to 12 years. (S. Rep. 77, 73 Cong. 1 Sess., (GPO, 1933.))
- 1934 Hearings of the House Appropriations Committee on H.R. 9410; Permanent Appropriations Repeal Act, 1934. All government agencies were required to address Congress on their budgetary status. Testimony given regarding the Federal Reserve's special status. These hearings constituted the only written explanation (as far as can be determined) of the amendment. Testimony explicitly addressed the language in the 1933 Banking Act formally granting the Federal Reserve its financial independence. Testifying on behalf of the Board was Chester Morrill, Secretary of the Board and chief administrative officer. He was, in part, responsible, along with Senator Carter Glass, for the provision in the 1933 Banking Act that the Federal Reserve's funds were "not to be construed as government funds or appropriated moneys." Morrill said that the Federal Reserve had never considered the funds to be anything else.
- "We do not agree that they were ever public moneys or appropriated moneys." Nothing was ever done about it until ... the Banking Act of 1933 when Senator Glass "who took very great exception" to that idea, "objected to any such idea being permitted to exist, and incorporated into the Banking Act an amendment to the Federal Reserve Act to that effect." (H.R. 9410, 73 Cong. 2 Sess., (GPO, 1934.))

- 1935 Banking Act of 1935; Pub. L. 74-305: The FOMC was created in its present form; salaries of Board members were improved to help attract qualified individuals and to restore to the Board the stature to which it was legislatively entitled. Independence was further defined and promoted by extending terms of governors from 12 to 14 years and removing the Secretary of the Treasury and Comptroller of the Currency from the Board.¹
- 1938 Hearings on "Government Ownership of the Twelve Federal Reserve Banks," H.R. 7230, sponsored by Wright Patman, before the House Banking and Currency Committee, chaired by Congressman Steagall. Instead of concentrating on whether the Federal Reserve Banks "shall be the property of the United States;" the hearings were used by the Housing Banking Committee to question Federal Reserve officials, such as Chairman Marriner Eccles, on monetary policy and System operations. (H.R. 7230, 75 Cong. 3 Sess. (GPO, 1938.))
- The bill also recommended expanding the Federal Reserve Board to 15 members, including the Treasury Secretary, the Comptroller of the Currency, and Chairman of the FDIC. The bill was not seriously considered.
- 1945 Senate hearings on the "Government Corporation Control Act" on providing for financial control of Government Corporations. The General Accounting Office expressed the view that the Reserve Banks should be excluded from the Act because they were examined frequently and thoroughly by examiners under the direction of the Board of Governors. (Expenditures in the Executive Department's Committee Hearings on H.R. 2177, 79 Cong. 1 Sess., (GPO, 1945.))
- 1949- Douglas Committee. Report of the Joint Economic Committee
1950 issued. Key recommendations stated that credit policies must be flexible and the Federal Reserve System must remain independent of executive domination. Hearings before the subcommittee on monetary, credit and fiscal policies (81 Cong. 1 Sess., pursuant to Sec. 5A of Pub. No. 304 (GPO, 1949.))

¹ Before enactment of the 1935 Banking Act, the title "governor" referred to the chief executive officer of the Board, and there were eight Board "members" on the Board. With passage of that Act their titles were changed to governor. As a result, the Board had seven governors and a chairman.

1952 Patman hearings on General Credit Control and Debt Management before the Joint Economic Committee. Overwhelming weight of testimony favored independence of the Federal Reserve from political pressures and agreed on the inherent inflationary risks in using the Federal Reserve to supply the Treasury with cheap credit. Congressman Patman indicated that his interest in government audit of the Federal Reserve was not only for information, he wanted Congress to exercise control over income and expenditures by the Board and the Reserve Banks so that it could influence the policies of the System. "I do not mean inconvenience just to inconvenience you (the Fed) but I mean quickly to pass upon policies."

No mandate issued from Congress but the Federal Reserve furnished its own audit reports to appropriate congressional committees for inspection. (Subcommittee on General Credit Control and Debt Management, 82 Cong. 1 Sess., (GPO, 1951-1952.))

1964 Hearings on "The Federal Reserve System After Fifty Years": Proposals made for improvement of Federal Reserve and introduction of H.R. 9631 calling for audit by the GAO; and H.R. 9685 addressing the issue of the Federal Reserve being put under appropriations by Congress. After the conclusion of these exhaustive hearings, Congressman Hayes summed up the committee's overall evaluation: "If there were any evidence of corruption or bad management, inefficiency, I think there would be a prima facie case for making some change. But it seems to me that the reputation of the Federal Reserve System for integrity and honesty in the way they handle their affairs is unrivaled." (Proposals for the Improvement of the Federal Reserve, and Staff Report, Subcommittee on Domestic Finance of the House Committee on Banking and Currency, 88 Cong. 2 Sess. (GPO, Aug. 1964.))

1968 The House Banking and Currency Committee Report on H.R. 11, proposed by Congressman Wright Patman. Proposed structural changes to the Federal Reserve System, among them: an annual audit of the Board and Reserve Banks and Branches by the Comptroller General of the U.S. and operating funds for the Federal Reserve System to be appropriated by Congress. The Treasury Department stated that the measures (either government auditing or subjecting the Fed to appropriations process) were unnecessary and "might widely be regarded as increasing the possibilities for reducing the independence of the System within the Government and as possibly leading to undesirable interferences with policies." The hearings did not result in legislation.

The Treasury further noted that Congress has also exempted other major bank supervisory authorities--the FDIC and the Comptroller of the Currency--from the regular appropriations process. (Compendium on Monetary Policy Guidelines and Federal Reserve Structure pursuant to H.R. 11, 90 Cong. 2 Sess. (GPO, December 1968.))

- 1975 The Senate Banking, Housing, and Urban Affairs Committee hearings on S. 2285 and S. 2509 chaired by Senator William Proxmire. Consideration was given to a proposal to limit expenditures by the Board of Governors and the Federal Reserve Banks to amounts approved in appropriations acts. (Hearings before the Senate Banking, Housing and Urban Affairs Committee on S. 2285 and S. 2509, 94 Cong. 1 Sess. (GPO, 1976.)) Similar hearings held 1977-1980 by Senate banking Committee covered substantive issues as well as budgetary issues.
- 1977 Federal Reserve Reform Act of 1978, Pub. L. 95-188: Amendments passed that provided for Senate confirmation of Board's Chairman and Vice Chairman and for the extension of conflict of interest provisions to Federal Reserve Bank directors, officers and employees. This action was seen by Congress as a way of making Federal Reserve management more accountable to Congress.
- 1978 Federal Banking Agency Audit Act of 1978; Pub. L. 95-320: Congress authorized the GAO to perform audits of banking agencies but included an exemption from GAO audit for Federal Reserve transactions with foreign central banks and foreign governments for monetary policy matters and for any documents dealing with these topics. In passing this exemption, Congress relied in large measure upon concerns that information collected during the GAO audits (or GAO comments or criticisms) might be used to influence the System's policies for short-term political reasons. Full Employment and Balanced Growth Act; also known as the Humphrey-Hawkins Act; Pub. L. 95-523: Requires that the Board report twice a year to the House and Senate Banking Committees on its monetary policy objectives and plans as they relate to the most recent Economic Report of the President. (Hearings before the Senate Governmental Affairs Committee on H.R. 2176, 95 Cong. 1 Sess. (GPO, 1978.))
- 1980 Monetary Control Act of 1980; Pub. L. 96-221: Required that all depository institutions be subject to reserve requirements set by the Board. Also required the Federal Reserve Banks to charge depository institutions for services.
- The GAO report entitled "Response to Questions Bearing on the Feasibility of Closing the Federal Reserve Banks" concluded that there were no overbearing reasons for closing the Federal Reserve Banks. The study also stated that "no alternative to the banks presently exists." House Banking, Finance and Urban Affairs Committee, Hearings on H.R. 7; 96 Cong. 1 Sess. (GPO, 1979.))
- 1985 The Congressional Budget Office Report on "The Budgetary Status of the Federal Reserve System:" CBO addressed three budgetary options for Congressional treatment of the Federal Reserve. In testifying before the JEC on the results of the study, the director of the Congressional Budget Office noted that the risks of reducing the Federal Reserve's independence on policy matters is greatest if Federal Reserve expenses are appropriated and if the Reserve System is required to project its financial operations. The risk is smaller (but still exists) if the budgetary coverage is primarily informational and limited to operating expenses.

FINANCIAL INDEPENDENCE OF CENTRAL BANKS OF THE G-10 COUNTRIES¹

While detailed arrangements differ from country to country, in general the central banks in the G-10 countries have a high degree of budgetary autonomy, even in countries where the central bank has less autonomy than the Federal Reserve in determining monetary policy. Budgets are developed and implemented by the central banks themselves. The degree of subsequent central government review varies from modest to none (except in Japan where a more extensive review takes place). In no case is the central bank's budget submitted to the legislature or parliament for formal review or included in the central government's budget.

The degree of independence of G-10 central banks is summarized in Table A. Following is a more detailed description of each of the G-10 central banks with regard to budget processes and earnings distributions.

BELGIUM

1. Budget process. The National Bank of Belgium drafts its own budget. A government official then reviews the budget to see if it is in accordance with the general thrust of government budgetary policy. The Bank, as a rule, tries to stay within the overall guidelines of the government, but it is not legally obligated to do so and the process of reconciling views of the Bank and the government on budgetary matters is informal.

2. Earnings distributions. The amount of profits that the Bank returns to the government is determined in part by formulas described by law and in part reflects discussions between the Bank and the Ministry of Finance. In recent years only about 7 percent of net profits have been added to reserves with the remainder going to the government.

¹ The G-10 countries now include Switzerland.

CANADA

1. Budget process. The Bank of Canada's yearly budget is drawn up by the Bank's staff under the direction of the Governor of the Bank and submitted for approval to the Bank's Board of Directors. (The Board consists of five directors, including the Deputy Minister of Finance serving ex officio.) The Bank's functions as the government's fiscal agent (primarily involving debt management and foreign exchange transactions) are audited by the Auditor General. The Bank's own affairs are audited by two external auditors appointed by the cabinet on the recommendation of the Minister of Finance.

2. Earnings distribution. The central government has received all profits of the central bank in recent years. At times in the past, the Bank of Canada used a portion of its profits to build up an internal contingency fund. However, the relatively low statutory ceiling on the size of this fund was reached a number of years ago, and since then all profits have gone to the government.

FRANCE

1. Budget process. The Bank of France has the authority to set its own budget. Normally, however, the Bank voluntarily follows any government policies setting limits on overall spending increases in government agencies. The Bank pays for its budgetary expenses out of income earned from its operations.

2. Earnings distribution. All profits are turned over to the Treasury.

GERMANY

1. Budget process. The Bundesbank's budget is set by the Central Bank Council. This procedure is not a part of the overall government budget process. In accordance with German corporate law, the Bank publishes an annual income statement.

2. Earnings distribution. Almost all Bundesbank profits have recently been distributed to the central government. In the past, significant additions to reserves have also been made. The law governing the Bundesbank provides that up to 20 percent of annual profits should be added to a reserve pool, so long as cumulative contributions do not exceed an upper limit of 5 percent of the notes and coins in circulation. A further 10 percent of annual profits can be added to reserves within certain restrictions. Recently, only small additions to reserves have been made, with nearly all profits (98 percent in 1984, the most recent year for which data are available) distributed to the central government.

ITALY

1. Budget process. The Bank of Italy is autonomous in regard to budget and salary matters. The Bank submits its budget once a year for ratification by the Treasury, which is generally pro forma.

2. Earnings distribution. Over half of the Bank's profits are turned over to the Treasury, with the remainder going into a reserve account.

JAPAN

1. Budget process. The budget of the Bank of Japan is not included in the central government's annual budget. However, the Bank's budget must be submitted to, and approved by, the Ministry of Finance, which has occasionally required the Bank to alter proposed budgets. The Bank's budget and expenditure practices are also subject to examination by the Board of Audit, a separate government agency roughly akin to the U.S. General Accounting Office.

JAPAN, cont.

2. Earnings distribution. All profits are turned over to the government.

THE NETHERLANDS

1. Budget process. The Netherlands National Bank sets its own budget and is not subject to budgetary control by the central government.
2. Earnings distribution. Earnings from the Bank's operations over and above its expenses are generally turned over to the Treasury.

SWEDEN

1. Budget process. The areas in which the Swedish Riksbank may make expenditures are limited by law, but the government does not set the Riksbank's budget. Indeed the Riksbank does not appear to have a formal budget, although it does maintain personnel, administrative, and some other budgets as forms of internal control.
2. Earnings distribution. The Riksbank determines the amount of profits to be returned to the Treasury. A large proportion of earnings is simply put into reserves.

SWITZERLAND

1. Budget process. The Swiss National Bank is essentially autonomous in its budget-making authority. The budget for the Bank's operation does not need the approval of government ministers or the Federal Council. The Bank's Annual Report, which details its expenditures, earnings and reserve accumulations, is submitted to the Federal Council.

SWITZERLAND, cont.

2. Earnings distribution. In Switzerland, the central bank is a private corporation. As part of its expenses the central bank pays a (small) fixed dividend to shareholders, makes a stipulated (small) addition to reserves, pays federal income tax to the central government, and makes a fixed per capita distribution to the local cantons. The law provides for distribution, two-thirds to the cantons and one-third to the federal government, of any net profits resulting from earnings above expenses and after additions to reserves. In practice, the Bank has chosen to exercise its rights as a private corporation and has added to its reserves each year in amounts large enough to leave no net profits after additions to reserves. As a consequence, the federal government has received almost none of the Bank's earnings.

UNITED KINGDOM

1. Budget process. The Bank of England has a high degree of autonomy in determining its own budget. The Bank draws up its own annual operating budget which must be approved by its Court of Directors. While the government never directly reviews the Bank's budget, it can have an indirect influence on the Bank's expenditures. About half the Bank's income is from fees the government pays for services the Bank performs, mainly marketing government debt and acting as the government's fiscal agent. The fees which the Bank charges the government for these services are reviewed annually, giving the government an opportunity to raise questions about the costs of the Bank's operations on its behalf.

2. Earnings distribution. The profits of the Bank of England are derived from the Issue Department (concerned with the provision of currency) and the Banking Department (dealing with all other central bank matters). All profits of the Issue Department are turned over to the Treasury. Profits of the Banking Department are divided into three different parts. One part, consisting of a payment in lieu of dividends as spelled out in the Bank of England Act, goes to the Treasury. Another part goes to the government in the form of corporate taxes. The remainder is transferred to reserves. Since profits of the Issue Department have been much larger than profits of the Banking Department, only a small portion (about 2 percent in recent years) of total profits have been added to reserves, with the rest (about 98 percent) distributed to the Treasury.

Conclusion

In all of the G-10 countries, budgets of the central banks are handled outside of the normal governmental appropriations process. Each of the central banks finances its expenditures out of its own income (mainly interest earnings on their portfolio holdings). Profits in excess of expenses are then turned over to the government or added to reserves in varying degree. In no case is a budget statement for the central bank listing the bank's expenses and receipts included in the central government's budget document. In all cases except Switzerland (where no central bank profits have been turned over to the central government in recent years), the central government's budget does contain a line for profits received from the central bank.

Table A

The Budgetary Independence of Central Banks of G-10 Countries²

	Is the central bank subject to the normal governmental appropriations process? _____	What is the degree of the government's review of the central bank's own budget proposals? _____	What percentage of the central bank's profits after expenses has been turned over to the government in recent years? _____
Belgium	No	Low	95%
Canada	No	Low	100%
France	No	Low	100%
Germany	No	None	95%
Italy	No	Low	50%
Japan	No	Moderate	100%
The Netherlands	No	None	100%
Sweden	No	None	60%
Switzerland	No	None	0%
United Kingdom	No	Low	95%

² The G-10 countries now include Switzerland.

PLANNING, BUDGET AND CONTROL PROCESSES OF THE FEDERAL RESERVE SYSTEM

Both the Reserve Banks and the Board of Governors use an annual, calendar year planning, budget and control process. Each process has been developed to ensure that objectives and goals are met in an efficient and effective manner. Following is a detailed description.

RESERVE BANKS

The planning process for the Federal Reserve Banks includes strategic planning and short-term tactical planning at the System and Reserve Bank levels. Major goals, objectives and strategies are identified during the planning process. The budget process includes the identification, review and approval of resources needed to achieve goals and objectives. The control process includes the comparison of actual results against planned goals and objectives, and the comparison of actual financial performance against the approved budget.

The Planning and Control System (PACS)

In 1977, the Federal Reserve Banks implemented a new accounting and budgeting system, PACS, which allows for a more effective review of expenses, an expense audit trail and an expense accountability structure. PACS is a uniform expense accounting, cost accounting and reporting system that enables the Board to compare Reserve Banks' financial performance and facilitates uniform expense aggregation among Reserve Banks and Branches. The PACS system also serves the control function by allowing for comparisons of actual performance against budget at a detailed object and activity level.

A uniform chart of accounts and functional grouping of expenses are identified in PACS. Costs are identified at a detailed expense level--such as officer salaries--and are separated into three groups: direct, support and overhead. All costs are accumulated by major function, the largest aggregation being the four primary missions of the Federal Reserve System: (1) Monetary and Economic Policy; (2) Services to the U.S. Treasury and Other Government Agencies; (3) Supervision and Regulation of Financial Institutions; and (4) Services to Financial Institutions and the Public. All support and overhead costs are fully redistributed or allocated to these four major service lines.

PACS provides productivity statistics (primarily unit cost and items per manhour), environmental statistics (to clarify the differences between Banks' operating environments) and quality statistics. PACS also allows for separate accounting and reporting of project costs that are not involved in routine production of activities and services.

The PACS system was designed prior to passage of the Monetary Control Act which required pricing of the Federal Reserve's payment services. Since then, PACS has been modified to reflect the need for different and changed information regarding priced services. It continues to serve as the fundamental accounting system for all services the Federal Reserve Banks provide, priced and nonpriced.

Over time, the PACS process has been studied by government agencies, private organizations, the General Accounting Office and outside public accounting firms. The PACS system has been judged to be very effective and several agencies have studied its design for their own use.

The Board periodically audits Reserve Bank compliance with the PACS instructions through on-site operations reviews. These audits have affirmed Reserve Bank compliance with the PACS instruction. Similarly, independent examinations have determined that PACS is an appropriate and effective accounting mechanism for the Federal Reserve.¹

Impact of Pricing on Process

The Monetary Control Act of 1980 (MCA) had a much larger impact on the System's planning, budgeting and control process than just its impact on the PACS system. Before pricing, the sole objective of the budget process was to control resources and minimize the growth of expense. Reserve Banks were encouraged to compete against each other to realize the lowest expense and greatest productivity increases.

With the MCA, the process had to be adjusted to include other objectives such as the legislated mandate of full cost recovery for priced services. Beginning in 1983, the planning, budget and control process was divided into two primary areas for compilation, reporting and analysis purposes--Central Bank and Treasury Services and Priced Financial Services.

Essentially, the more traditional approach used in Federal Reserve budgeting continues to be applied to services in the Central Bank and Treasury Services sector; the emphasis remains on holding down expense growth and cost minimization. District trends are carefully compared to System trends. For priced services, an approach more akin to that employed by private business is utilized--with emphasis on recovery of costs and achievement of business

¹ Comptroller General of the United States, Report to the Chairman, Committee on Banking, Housing and Urban Affairs, United States Senate, "An Examination of Concerns Expressed about the Federal Reserve's Pricing of Check Clearing Activities." January 14, 1985.

Arthur Andersen & Co., "Federal Reserve System: Report on Priced Services Activities." Forthcoming, 1985.

objectives. The planning process now includes business planning for priced services, and necessarily, the control process includes monitoring Reserve Banks' cost recovery performance for priced services.

In addition, the MCA has resulted in changes to the System's management process. Reserve Banks are now required to have their financial plans and prices for their priced services reviewed by Product Directors and a Pricing Policy Committee as well as the Board of Governors.

The Budget Schedule

At the beginning of each calendar year, the budget planning process begins with the development and approval of budget guidelines based on an assessment of workload and productivity changes forecasted for the budget year. The annual budget objective includes these guidelines and is used by the Reserve banks in the development of plans and budgets. In addition, a strategic directional statement covering three years is developed to guide the Reserve Banks in the development of priced service business and financial plans. In the spring, the Reserve Banks develop their own goals, objectives and strategies and begin their budget process. During the summer the budgets are reviewed at the Reserve Banks, and in the fall the Board of Governors reviews and approves the Reserve Bank budgets.

The Reserve Banks' Planning Process

System Level

Senior management officials of the Reserve Banks and Board staff discuss significant issues in the course of meetings throughout the year. These discussions focus management attention on key issues and the need to make effective use of resources to meet agreed upon objectives. The annual Reserve Banks' Budget Objective and the strategic guidelines for priced services are additional elements for planning at the System level.

Reserve Bank Level

Planning occurs at each Reserve Bank as well as at the System level. Although the services provided by each Reserve Bank are similar, the conditions confronting the Reserve Banks differ markedly. Some are located in areas in which unit banking predominates; others serve large branch banking organizations. Rates of regional economic growth differ markedly among the Reserve Banks, as do wage levels, labor skills and prices of other inputs. The importance of these differences in environmental conditions has increased with the advent of pricing. Effective resource control thus makes it essential for individual Reserve Banks to engage in detailed planning.

The Budget Process

For nonpriced services, the Board of Governors each year formally approves a budget expense limit in the form of a percentage increase over the expense level in the current year. The process begins early in the calendar year when an advisory group is formed under the Conference of First Vice Presidents to make recommendations to the Conference (and ultimately to the Board of Governors) on basic budget assumptions for the upcoming year. The Budget Objective Advisory Group makes economic assumptions for the budget year, and assesses major legislation and other factors influencing the System's responsibilities. An aggregate expense guideline is established for the total of all Central Bank and Treasury (nonpriced) Services; and the cost recovery objective for priced services is reaffirmed. The Advisory Group's recommendation is forwarded to the Conference of Presidents and the Conference of First Vice Presidents prior to submission to the Board.

At the Board, a thorough review is conducted of the assumptions made and a budget objective is approved by the Board of Governors in an open Board meeting. The budget objective is then sent to the Reserve Banks and serves as

the overall top management guide for formulating Reserve Bank budgets. The budget objective serves as a challenging goal for the Reserve Banks and helps ensure that financial planning among the Reserve Banks is consistent. During the Board's subsequent review and approval of Reserve Banks' budgets, compliance with the Budget Objective is carefully considered.

An example of the process used by a Reserve Bank follows:

At the onset of the budget cycle, a Reserve Bank initiates planning efforts to direct upcoming events. Senior management (President, First Vice President, and other senior level officers) identifies and/or modifies the broad strategic direction for the next few years. Senior management also establishes for Bank operations a District Budget Objective for central bank and Treasury services (nonpriced areas) that reflects the System Objective as well as any other factors unique to the Reserve Banks. For priced services, the primary objective is to match costs with revenues. The strategic direction, coupled with the Bank's own Budget Objective, sets the stage for the budget process.

Based on the strategic direction, middle management develops more detailed plans for each of its functions. The budget numbers are then based on these detailed plans.

For expense budgets, management of each department is asked to budget for nearly all expenses. Wherever possible, departments are expected to zero-base the estimates, especially for expenditures such as travel, training and education, etc. In those instances where technical expertise is required the budget estimates are developed centrally for the entire Bank. For example, the budget estimates for automation expense are developed by staff experts familiar with the Bank's systems and with anticipated changes in the industry. The total estimate is then apportioned to departments based on anticipated usage. In some cases, departments use a uniform budget assumption

provided by a central area to ensure bank-wide consistency, e.g., a department applies a factor for an expected office supply cost increase (developed by the purchasing function) to its usage-based estimate.

Because salary and benefit expense accounts for a large part of a Bank's expense budget (about 60 percent), Bank management closely scrutinizes the salary plans. Each Division's management estimates its staffing needs for the remainder of the current year and for the upcoming calendar year. Senior management reviews proposed staffing changes, which are sometimes reduced as a result. To achieve consistency, the personnel function develops the Bank's estimates related to administration of the salary program for merit and other salary increases. The Fed does not have any automatic cost of living increases. The analysis includes a projection of the effect of turnover rates and lags in filling open positions. Much attention is also devoted to evaluating the predicted salary movements in other local corporations as well as the salary conditions and guidelines set forth in the System Budget Objective. The overall Bank projection is closely reviewed by the First Vice President and, upon approval, applied to each department's budget.

Department management is responsible for reviewing its budget increase against the Bank's objective and for justifying any exceptions to the guideline. Finally, a central budget analysis function compiles all the budget data, makes comparisons with historical trends and notes any questionable areas requiring senior management's attention. The budget staff often presents budget alternatives for senior management's review. A summary of all budget data by major responsibility is then presented to the First Vice President for review. Each division head and branch manager must present his/her budget, staff projections, and supporting rationale to the First Vice President. As a result of this close scrutiny, adjustments to the budget data are sometimes required.

Once the necessary adjustments are completed, an executive summary of the overall budget is prepared and forwarded to the Bank's President and First Vice President. Following their approval, the budget package is sent to an Executive Committee of the Board of Directors. After the Committee's review, the budget is presented for approval to the Board of Directors with the Executive Committee's recommendation for action. The final step is to secure approval from the Board of Governors.

During the budget year, senior management closely reviews actual performance against the budget on a monthly basis. Depending on the results of these monitoring efforts, it is sometimes necessary to adjust spending plans for the rest of the year.

System Projects

Certain Reserve Bank expenditures are associated with major research and development projects undertaken for the benefit of the entire System; therefore, all Districts must bear a share of the costs incurred. Budgets must be prepared and approved for these shared costs so that each Reserve Bank can include its portion of the shared cost in its annual budget.

Budgets for such projects are reviewed by the sponsoring Conference of First Vice Presidents' Subcommittee/Committee, Board staff and other responsible System groups. After these reviews are completed, the budgets are approved by the Conference of First Vice Presidents and the allocated costs forwarded to the individual Reserve Banks for inclusion in their respective budgets. This process occurs between March and July of each year and affords an extra level of scrutiny on significant projects underway in the System.

Capital Budget Process

The Reserve Banks' planning, budgeting and control process includes the preparation, review and approval of capital outlay schedules. Reserve Banks annually evaluate needs for building, furniture, furnishing and fixtures, land and automation equipment. In accordance with generally accepted accounting principles (GAAP), depreciation of capital assets is included in Reserve Banks' expenses. All large capital expenditures undergo a thorough review separate from the actual planning, budgeting and control process. Acquisitions of mainframe computers and peripheral equipment, at certain dollar levels, must be approved by the Board of Governors on a case by case basis.

The Board has established detailed, comprehensive guidelines for preparation of Reserve Banks' proposals for the purchase of capital assets. In a new building program, these guidelines are exhaustive and compose more than 70 pages in a Facilities Planning Manual. The Board must approve the project at various stages of construction. The Automation Procurement Guidelines cover the procedures for justifying acquisitions in this category.

Expert technical staff at the Board review all proposals and make recommendations to the Director of the Division of Federal Reserve Bank Operations or to the Board of Governors, depending on the approval level. The Board considers these procedures extremely effective in controlling Reserve Banks' expenses.

Federal Reserve Banks' Budget Review at the Board of Governors

Reserve Bank budgets are forwarded to the Board in the fall. Budget analysts at the Board review the budgets and note significant Systemwide issues which need to be addressed during the budget review. Reserve Bank budget data are received at the Board via automated transmission and are thus

easily aggregated and subjected to analysis. The narrative justifications of the budget data, particularly the executive summaries and the statements of objectives, are analyzed in terms of the Bank's own trend in past years, the level of increase in specific areas compared to that of other Districts, and in terms of compliance with the System Budget Objective and cost recovery objectives for priced services.

Budget data consist of the major expense objects which comprise the total budget such as salaries, equipment, supplies, etc., the major service lines and services, as well as revenue and volume estimates. From each Reserve District information on about 19 expense objects and 49 services are received and reviewed at the Board. Employment data for the 49 services are also received and analyzed as are data on the following:

- a) system projects
- b) salary expense components
- c) benefits
- d) selected volume and unit cost estimates
- e) capital outlays (by eight classes)
- f) costs and revenues by priced services
- g) priced volume projections

In conjunction with the budget analysts, personnel in the Division of Federal Reserve Bank Operations who are expert in particular services performed at Reserve Banks review each Reserve Bank's budget as it relates to their area of expertise. These persons identify questions regarding budget objectives and initiatives and evaluate the resource requirements budgeted in light of their special knowledge of services and problem situations at particular Banks.

In addition, staff of the Board's Personnel Division carefully review sections of the budget related to salaries and benefits. This staff is also responsible for the review of salary and benefit administration at the Reserve

Banks throughout the year and are knowledgeable about local business environments. Budget proposals are reviewed relative to local labor market data, known problem areas and specific administration considerations.

Also, the Product Directors, the Pricing Policy Committee and the Board review Reserve Bank priced service budgets and process proposed for the budget year. This combined review successfully accomplishes the integration of price and budget review into one overall review of Bank objectives. The various reviews yield issues and questions to be explored at the budget meetings held in the fall with the Reserve Bank Presidents and the Committee on Federal Reserve Bank Activities (consisting of three Governors).

The budget analyst assigned to the particular Reserve Bank assembles all issues and questions raised during the review phase. These questions, which may be as high as 50 in number, are wired to the Reserve Banks and written explanations are received and analyzed to determine if further review is necessary.

The most important issues become the agenda for the Reserve Bank's budget meeting, which is scheduled with each Reserve Bank President and the Committee on Federal Reserve Bank Activities whose function it is to critique the Reserve Bank budget being proposed. The staff briefs Committee members on the important issues and problems to be discussed with the Reserve Bank President. Board staff will often make recommendations to the Committee regarding actions the Reserve Bank President should be asked to take before final budget approval by the Board of Governors.

At the budget meeting, the First Vice President and the Reserve Bank's Senior Financial Officer usually assist the Reserve Bank President. Although there is no set format for each meeting, each party usually has time to make a summary statement before specific issues, problems, and questions are addressed. Fundamentally, the budget meeting serves as the occasion when the

top management of the Reserve Banks and the Board of Governors reach consensus on that particular Reserve Bank's plans and budget for the coming year. After the 12 District budget meetings, the Reserve Banks make whatever changes the Committee requires and a new iteration or final District budget is determined. Board staff receives the final budget and reviews it for compliance with the agreements reached during the budget meeting.

Budget Approval

When the Committee on Federal Reserve Bank Activities is satisfied with each Reserve Bank's budget, these budgets are sent to the Board of Governors for approval. Budgets are reviewed and approved at an open meeting of the Board of Governors. Subsequently, a letter is sent to each Reserve Bank President stating the budget level approved by the Board and any budget conditions placed on this budget level.

The Monitoring and Control Process

District expenses are monitored and controlled at both the Reserve Banks and the Board of Governors. The Reserve Banks are permitted flexibility to move approved levels of spending within expense and services structure; however, the Board guidelines require notification on significant reallocations of approved budget levels. Careful monitoring minimizes overruns and increases flexibility by permitting transfers.

Nonpriced Services

Because the Reserve Banks budget and report expense in the same cost components (PACS), a comparison of budget to actual spending is possible at the lowest level of budget detail. Expenses are reported on a quarterly basis to the Board, and, as soon as possible following receipt of actual data, a comparison of actual expense to budgeted expense is made.

Priced Services

The establishment of prices for Federal Reserve services mandated by the MCA has resulted in additional review of Reserve Bank expenses. Detailed product level information is needed as well as timely monitoring of performance. A cost/revenue/volume reporting process collects and records financial data relative to priced services. The establishment and approval of prices and the effective monitoring of priced services performance are key elements in the overall management of Reserve Bank resources. However, market discipline is the focal point when costs of Federal Reserve priced services are considered. Full costs must be recovered in the marketplace or the service must be eliminated. This discipline helps guarantee that costs in the priced services areas are no greater than necessary.

Board staff also prepares an annual report to the Board of Governors on Reserve Bank budget, employment, unit cost and volume performance. As needed, a detailed mid-year review is sometimes conducted to ensure that budget levels are being achieved.

II. BOARD OF GOVERNORS

The Board has an annual planning, budget and control process that involves all Divisions at the Board and all management levels. The Chairman has appointed the Administrative Governor to assume oversight responsibility of Board administrative and management matters. The Administrative Governor has a key role in the entire Board process in ensuring that all elements of the process are coordinated, that responsibility for all objectives is complete, that resources are adequately provided, and that duplication of effort is avoided.

In addition, activities of each Division and Office are divided into groups called Programs. These Programs are the level at which resource planning is conducted, plans are approved and budgets are prepared.

The Board's Program Structure

The Board of Governors has adopted a Program Structure which reflects Board resources by categories along functional lines consistent with System responsibilities. Both expenses and employment are organized into four major areas: (1) Formulation of Monetary Policy; (2) Supervision and Regulation of Financial Institutions; (3) Financial Services to the System, the Government, and the Public; and (4) System Policy Direction and Board Support. Data processing costs are distributed to the four major areas based on usage. Other support and overhead responsibilities are included in category four.

The Budget Schedule

The Board of Governors budgets on an annual calendar year basis. At the beginning of the year, the staff seek guidance from the System's strategic planning sessions and from legislative and economic developments and use this information to develop budget guidelines. In the spring, a budget target is established to guide budget development. The Divisions prepare their budget, including program objectives and expense and employment requests, during the summer. In the fall, the Division budgets are submitted to the Office of the Controller, which along with the Staff Director for Management, reviews each budget. In addition, the Board Oversight Committees review their respective Division budgets. And finally, the Administrative Governor reviews the budget and forwards it to the Board of Governors for approval in December prior to the beginning of the calendar year.

The Budget Process

The budget process at the Board of Governors begins with the establishment of a budget expense limit in the form of a percentage increase over the current year's estimated expenditure.

In early spring each Division is requested to review current and future resource needs. Each Division's management prepares a statement of major events that could be expected to materially affect the Division's budget and provides initial estimates of budget increases or decreases associated with those events.

In addition, the Office of the Controller prepares a "current level of operation" budget target. This target takes into account known or anticipated factors such as the planned federal government general pay increase, retirement costs, hospital and medical costs, inflation, etc., and results in a projected increase in expenses over the current year estimate. Along with the Division's input, this current level forms the basis for further review and setting of the final guideline used for developing the budget. The Chairman of the Board approves the final guideline, which is then sent out to the Divisions for use in developing their budgets. The major responsibility for formulating budget requirements rests with the Program Managers. Program Managers undertake a comprehensive process starting with identifying new initiatives as well as reevaluating ongoing activities. The budget includes a description of the program's objectives and projects undertaken to accomplish objectives, the resources needed to accomplish objectives and projects, and an indication of the priority of each project.

The Program Managers forward their budget, in the form of decision packages, to Division management for evaluation and coordination. The administrative assistant in each Division reviews the submission for completeness and conformity to the Board's budget guidelines which allow Division management to focus attention on the substance of the requests.

Upon completion of the review session with all the Program Managers and agreement at the Division level on the level of activity and funding necessary for activities, the Division Director submits, in September, the Division's proposed budget to the Controller's office.

Capital Budget Process

Historically, the Board of Governors has followed the same accounting practices as the federal government; that is, it expenses rather than depreciates capital assets. However, it is now making the transition to GAAP (generally accepted accounting principles). This approach more closely resembles those of private sector concerns, rather than that of the federal government. The Reserve Banks currently follow GAAP.

An important part of the Board's planning and budget process is the planning and budgeting for major capital acquisitions. In the case of major building or renovation programs, such as the construction of the Martin Building in the early 1970s, a multi-year plan and budget were prepared and approved by the Board of Governors. Similarly, major purchases of large mainframe computers have occurred only after detailed cost/benefit analyses and lease/purchase analyses are prepared and reviewed.

The Board must approve all major capital acquisitions. In the case of smaller capital items, such as furniture and equipment, the various Divisions include in their budget their resource requests and these are reviewed during the normal budget process.

Centrally Provided Services

Because of the size of the Division of Data Processing's expenditures and the support characteristics of this Division's work, special processes have been established to plan, review and control data processing expenses. Each Division or Office at the Board that uses data processing resources must provide, as part of its budget submission, its expected use of data processing.

In addition to requests for anticipated data processing resource utilization, Divisions are requested to provide expected usage data to those Divisions with responsibility to provide specific services. (For example, all books are budgeted in the libraries of the Research and Statistics and Legal

Divisions.) These data allow the Division providing the services to prepare its own budget. The purpose of these requests is to ensure that centrally provided services are budgeted in accordance with the expected pattern of use.

Board Review Process

Division budgets are reviewed at various management levels. The Controller's Office analyzes each Division's submission to determine that the cost justification is adequate, that objectives are consistent with the Division mission and goals, and that the proposed resource levels are appropriate for effective and efficient accomplishment of objectives. Technical questions and initial revisions for change are handled between the Controller's Office and the Division. Key issues are identified for further discussion. The Controller's Office and the Staff Director for Management hold budget meetings with each Division Director to communicate their analysis, request further information, if necessary, and receive answers to questions raised. These meetings usually result in reductions to Division budget. Each Division budget, as adjusted, is then reviewed with the Administrative Governor or the appropriate Board Oversight Committee.

Board Approval

A consolidated budget document is prepared and submitted to the Chairman via the Administrative Governor prior to the Board's full consideration. This review often results in further reductions to Division budgets. In early December, the Controller's Office prepares the Board budget for review and approval by the Board of Governors at a public Board meeting. An official record of the Board's budget (the Official Budget Book) is prepared summarizing Division objectives, initial budget submissions, changes made during budget reviews, and the approved budget.

The Monitoring and Control Process

Board expenses are monitored and reviewed throughout the budget year by all levels of Board management. To facilitate this monitoring, each Division at the beginning of the year allocates its approved budget into quarterly plans, which show by quarter, the funding for each object and sub-object class of expenditure in each program. The Office of the Controller produces reports throughout the budget year to the lowest level of accounting detail. The Office of the Controller uses these reports to monitor actual performance against budgeted targets and alert management on a timely basis of any problems.

Formal performance reports are submitted to the Board on a quarterly basis. Each July Division budgets as of June 30 are formally reviewed in meetings with the Controller and the Staff Director for Management. Prior to the meetings, projections for the remainder of the year are made by the Office of the Controller and discussed with administrative personnel from the Divisions. Significant changes to the original budget must be approved by the Board or by management (below the Board level) under delegated authority. Early in the following year, a comprehensive report discussing the previous year's performance employment and expense trends, and attainment of objectives, is presented to the Board for review.

Requests for changes to budget are very carefully evaluated by the Controller's Office, and in most cases, by the Staff Director for Management. The review process is similar to the budget review process. Of course only very significant and important resource problems are dealt with by changing approved budgets. In most cases, Divisions must find offsetting decreases to fund unanticipated needs.

Appendix D: FEDERAL RESERVE SYSTEM EXPENDITURES, EMPLOYMENT AND PRODUCTIVITY

Table of Contents

	<u>Page</u>
Overview	1
I. Total System Expenses and Employment by Program	6
A. Monetary and Economic Policy	6
B. Services to the Treasury and Government Agencies	8
C. Services to Financial Institutions and the Public	9
D. Supervision and Regulation	12
II. Reserve Bank Expenses and Employment	14
Reserve Bank Expenses and Employment by Service Line	17
A. Service Line I: Monetary & Economic Policy	19
B. Service Line II: Services to the Treasury and Government Agencies	23
C. Service Line III: Services to Financial Institutions and the Public	27
D. Service Line IV: Supervision and Regulation	31
III. Board of Governors' Expenses and Employment	33
Board Expenses and Employment by Program Structure	35
IV. PACS Performance Measures	37
Productivity	39
V. 1985 Federal Reserve Budgets	41

FEDERAL RESERVE EXPENDITURES, EMPLOYMENT AND PRODUCTIVITY

Overview

Over the 1974-1984 period as a whole Federal Reserve System expenditures grew at an average annual rate of 0.7 percent in real terms¹ and employment declined by 3671, or 13 percent. Table 1 indicates important variations in the rate of spending growth over time. For example, the 1974 to 1979 period was characterized by improved productivity in many of the operating functions at the Reserve Banks and by a multi-year cost control program at the Board and the Reserve Banks. In real terms, costs actually declined from 1977 through 1979. However, the implementation of the Monetary Control Act in 1980 resulted in significant transitional costs in the monetary and economic policy area and increased expenditures in Supervision and Regulation. The Act also had a profound impact on the Federal Reserve's role as a service provider, since it required the System to explicitly price the services it provides to depository institutions rather than to supply them without explicit charge, and also permitted nonmember institutions access to Federal Reserve services.

At the beginning of 1984, the System adopted contemporaneous reserve requirements, further increasing expenses in data reporting--which comprises 40 percent of all expenditures in Monetary and Economic Policy.

Note: Throughout this document, real dollars are on the basis of GNP implicit price deflator (1972 = 100).

¹ Reserve Bank and Board expenses exclude the cost of currency because the Fed reimburses the Bureau of Printing and Engraving for their total costs of producing Federal Reserve notes. See Table 1.

Table 1
Total System Expenses in Actual and Constant Dollars¹
(dollars in millions)

Year	Reserve Banks ²		Board ³		Banks + Board		Percentage Change Real \$	FR Currency		Total System		Percentage Change Real \$
	Expenses	Real \$	Expenses	Real \$	Expenses	Real \$		Expenses	Real \$	Expenses	Real \$	
1974	519.0	450.9	31.6	27.4	550.6	478.4		30.2	26.2	580.8	504.6	
1975	562.1	447.2	36.0	28.6	598.1	475.8	-0.5	37.2	29.6	635.2	505.3	0.1
1976	609.6	460.8	40.4	30.5	650.0	491.3	3.3	48.8	36.9	698.8	528.2	4.5
1977	626.9	447.8	45.6	32.6	672.5	480.4	-2.2	55.0	39.3	727.5	519.6	-1.6
1978	654.6	435.2	49.5	32.9	704.1	468.1	-2.5	60.1	39.9	763.2	507.4	-2.3
1979	693.9	424.7	53.9	32.9	747.8	457.6	-2.2	68.4	41.9	816.2	499.5	-1.6
1980	792.8	444.4	60.4	33.9	853.2	478.2	4.5	73.1	41.0	926.3	519.2	3.9
1981	886.1	453.0	62.4	31.9	948.5	484.9	1.4	82.9	42.4	1031.4	527.3	1.5
1982	973.6	469.4	67.9	32.7	1041.5	502.2	3.5	98.4	47.4	1139.9	549.6	4.2
1983	1028.5	477.7	72.2	33.5	1100.7	511.2	1.8	152.1 ⁴	70.6 ⁴	1252.8 ⁴	581.9 ⁴	5.9 ⁴
1984	1067.8	478.0	77.9	34.9	1145.7	512.8	0.3	162.6	72.8	1308.3	585.6	0.6
Avg. Annual Growth	7.5%	.6%	9.4%	2.4%	7.6%	.7%		18.3%	10.7%	8.5%	1.5%	

1/ Data for Reserve Banks and the Board of Governors are not collected through the same accounting system. Total System expenses are defined as Reserve Bank expenses, including depreciation, Board of Governors' operating expenses and estimated depreciation, and FR currency expenses. Constant dollar data is deflated by GNP Implicit Price Deflator 1972=100.

2/ Any differences between total expenses as reported in the Board's Annual Report and total expenses as shown on this table are due to the exclusion of cost of earnings credits in PACS reports and other minor timing adjustments.

3/ Any differences between expenses as reported in the Board's Annual Report and expenses shown on this table are due to netting of minor receipts against expenses for performance reporting compared to the Annual Report which reveals gross receipts and expenditures. Also, the Board's current budgeting and accounting procedures do not recognize a capital items category. All items purchased are expensed in the year they are received. Since this can distort the trend in operating expenses when large capital items (buildings and computers) are involved, the Board's operating budget shows these items separate from operating expenses. In the treatment here, an estimated depreciation schedule was developed covering the Board's large capital items over the previous decade. The large items depreciated in the estimate include costs for the Martin Building, for renovating the Eccles Building, and purchases of computer systems and upgrades.

4/ As a result of an accounting change in 1983, \$30,442,000 of prior year currency expenses were recognized in 1983. Also, 1983 F.R. currency costs include the full cost of \$30 million of equipment purchased by the Bureau of Engraving and Printing in 1983. This equipment is expected to benefit the Federal Reserve over future periods. Excluding the full one-time impact of the accounting change and apportioning the cost of currency printing equipments over the future years of benefit would reduce 1983 currency costs to \$94,693,000 and total System expenses to \$1.195 billion, respectively.

The System employment trend mainly reflects developments at the Reserve Banks since Bank employment makes up 94 percent of System employment. As shown in Table 2, employment declined for five years after 1974, when a total of 3,377 employees or 12.1 percent of total employment were cut from the payroll. In 1980 and 1981, employment increased 2.6 percent and 1.1 percent, respectively, largely as a result of the Monetary Control Act, but in 1982 and 1983 employment again declined, reflecting cutbacks in response to significant volume losses, largely in check processing.

Table 2
Total System Employment

<u>Year</u>	<u>Reserve Bank¹</u>	<u>Board of Governors²</u>	<u>Total System</u>	<u>Percent Change</u>
1974	26,567	1,361	27,928	6.6
1975	26,341	1,443	27,784	-0.5
1976	25,186	1,446	26,632	-4.2
1977	24,300	1,473	25,773	-3.2
1978	23,479	1,469	24,948	-3.2
1979	23,104	1,447	24,551	-1.6
1980	23,682	1,516	25,198	2.6
1981	23,989	1,491	25,480	1.1
1982	23,230	1,525	24,755	-2.9
1983	22,883	1,583	24,466	-1.2
1984	22,669	1,588	24,257	-0.9
Avg. Annual Growth Rate	-1.5%	1.6%	-1.4%	

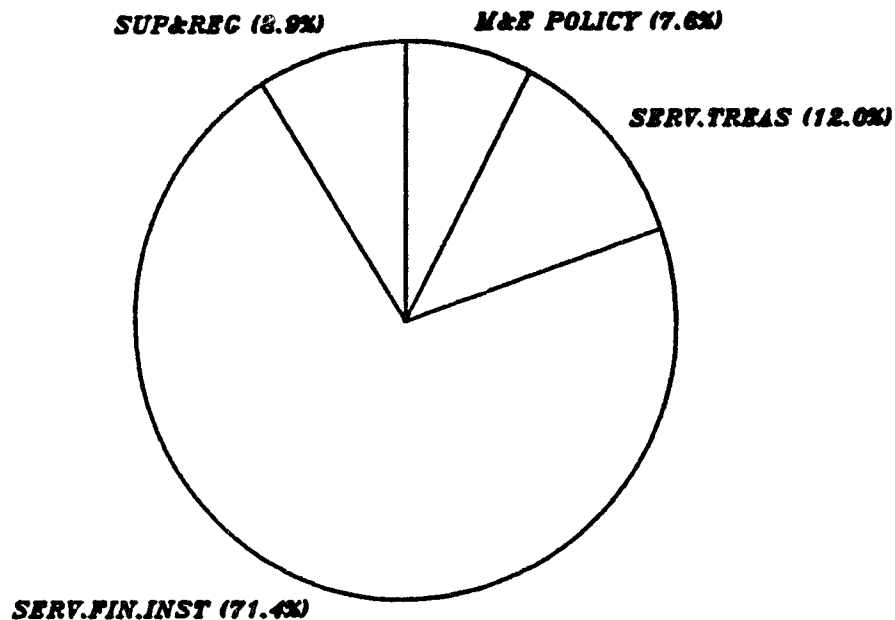
¹ Average number employees and officers as reported in the Functional Expense Accounting System from 1973-1976, and in the PACS system from 1977-1983.

² Employees at year-end.

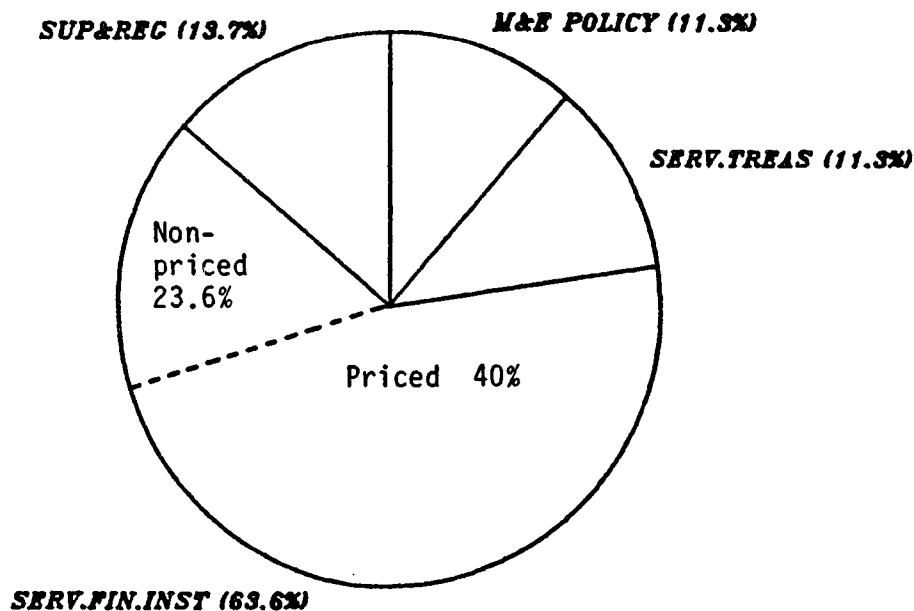
Total Federal Reserve spending comprises three broad categories: expenditures by the Board of Governors, expenditures by the Reserve Banks, and the purchase of Federal Reserve currency. Reserve Banks account for about 84 percent of total spending outlays, Board expenses for about 7 percent and Federal Reserve currency for 9 percent on average for the 1974 to 1984 period. For analytical purposes, the Federal Reserve usually evaluates Reserve Bank expenditures minus currency costs, since the Reserve Banks reimburse the Bureau of Engraving and Printing for its total production costs.

Figure 1 shows the distribution of Federal Reserve expenditures by major service line in 1977 compared to 1984. The year 1977 is used as the base period since it is the first year for which PACS data on expenditures by service line are available. The most notable change is the decline in the share of expenses for services to financial institutions and the public, from approximately 70 percent of the total in 1977 to about 60 percent in 1984. Following the MCA, the priced services component of Federal Reserve activities declined from an estimated one-half of total Federal Reserve spending to approximately 40 percent. This decline in the share of services to financial institutions and the public was offset by increases in the shares of Monetary and Economic Policy and Supervision and Regulation.

Figure 1
SYSTEM EXPENSES BY MAJOR PROGRAM
1977



1984



Note: System policy and Board support, which accounts for approximately 2.3% of total expenses, has been allocated by expense. PACS data are not available for the Board of Governors so its cost distribution has been estimated.

. Total System Expenses and Employment by Program

The data given in this section for System Functions include both expenses incurred at the Reserve Banks and at the Board of Governors. The data are derived from two separate accounting systems. The Reserve Bank portion of the combined System data includes all direct costs as well as fully allocated support and overhead costs. The Board of Governors portion of the System cost includes direct plus data processing costs. Expenses for "System Policy Direction and Board Support," and estimated capital depreciation have been distributed into the four major service lines used by the Reserve Banks.

A. Monetary and Economic Policy

Expenditures in monetary and economic policy had the second fastest rate of increase over the last seven years, growing at an average annual rate of 6.6 percent in real terms. As Figure 2 indicates, the bulk of this increase occurred from 1981 to 1983. Approximately 40 percent of direct activity costs in this area are for data collection and preparation. In large part the growth in monetary and economic policy spending was a result of an increase in the number of institutions reporting deposit data and reserve requirements from about 5,500 before passage of the MCA to more than 17,000 afterwards. This increase improved the System's ability to measure changes in the monetary aggregates. Expenditures on Monetary and Economic Policy began to moderate in 1982. More than half of the relatively small increase for 1983 was attributable to the cost of implementing contemporaneous reserve requirements, a change made to improve monetary control. In 1984 expenditures declined slightly.

Figure 2

MONETARY & ECONOMIC POLICY

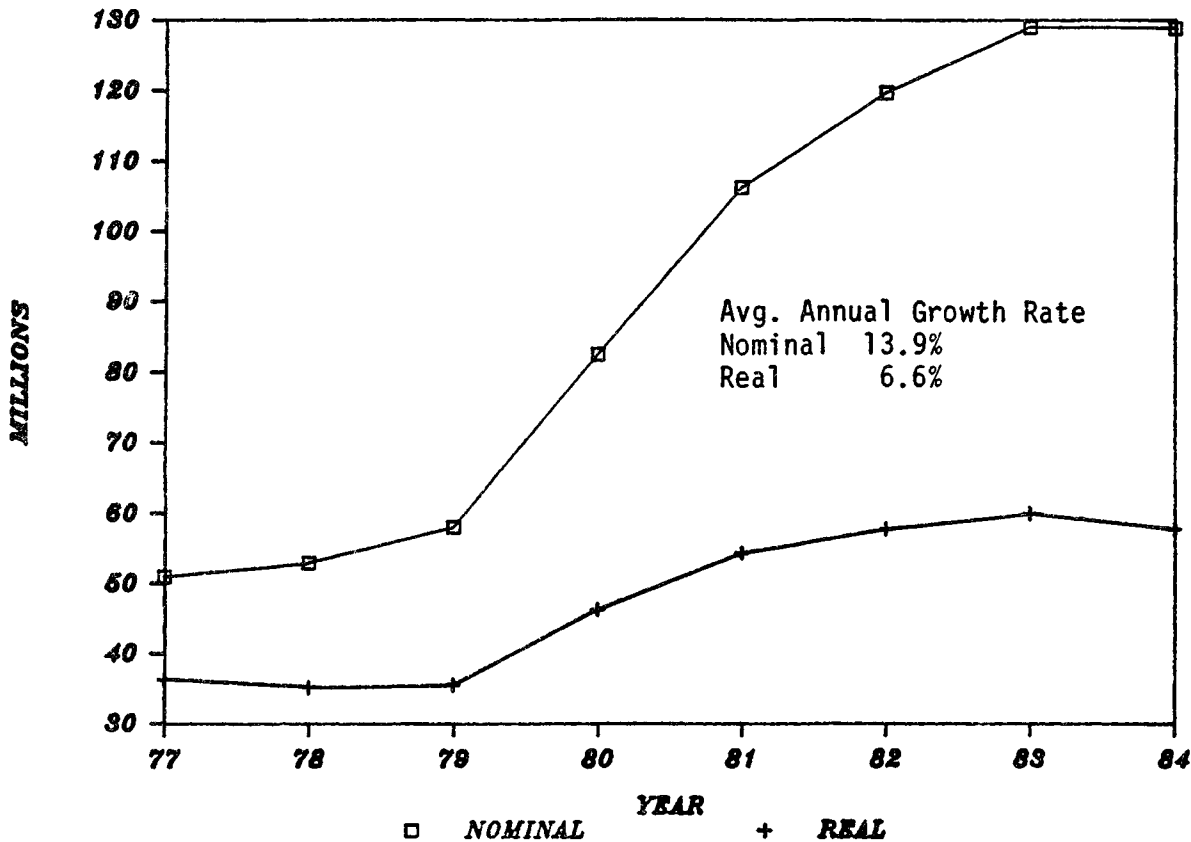


Table 3
Monetary and Economic Policy
System Expenses and Employment 1977-1984
(dollars in millions)

Year	Total Expense	Percent Change	Expenses Constant Dollars	Percent Change Constant Dollars	Total Employees	Percent Change
1977	\$52.30		\$37.36		1,220	
1978	54.50	4.2	36.14	-3.3	1,184	-3.0
1979	59.70	9.5	36.54	1.1	1,180	-0.3
1980	84.20	41.0	47.20	29.2	1,247	5.7
1981	108.10	28.4	55.27	17.1	1,335	7.1
1982	121.50	12.4	58.58	6.0	1,360	1.9
1983	130.90	7.7	60.80	3.8	1,414	4.0
1984	130.20	-0.5	58.28	-4.1	1,417	0.2
Avg. Annual Growth Rate		13.9		6.6		2.2

B. Services to the Treasury and Government Agencies

One of the responsibilities Congress gave the Federal Reserve was to act as fiscal agent for the U.S. Government. In this role the Federal Reserve provides a number of services to the Treasury and other government agencies. For example, the Federal Reserve issues and redeems Treasury and some other government agency securities. Through their electronic book entry system, the Reserve Banks also maintain bookkeeping records for government securities. In addition, a number of other services are provided, such as redeeming and destroying food stamps for the Department of Agriculture. As Figure 3 indicates, over the last seven years significant year-to-year changes took place in expenditures; to some extent this is a result of fluctuations in the purchases of Treasury securities by the public, and procedural changes requested by the Treasury. Over the period as a whole, expenditures in real dollars were flat. Employment fell by 206 or 10.3 percent between 1977 and 1984.

Figure 3

SERV. US TREASURY & AGENCIES

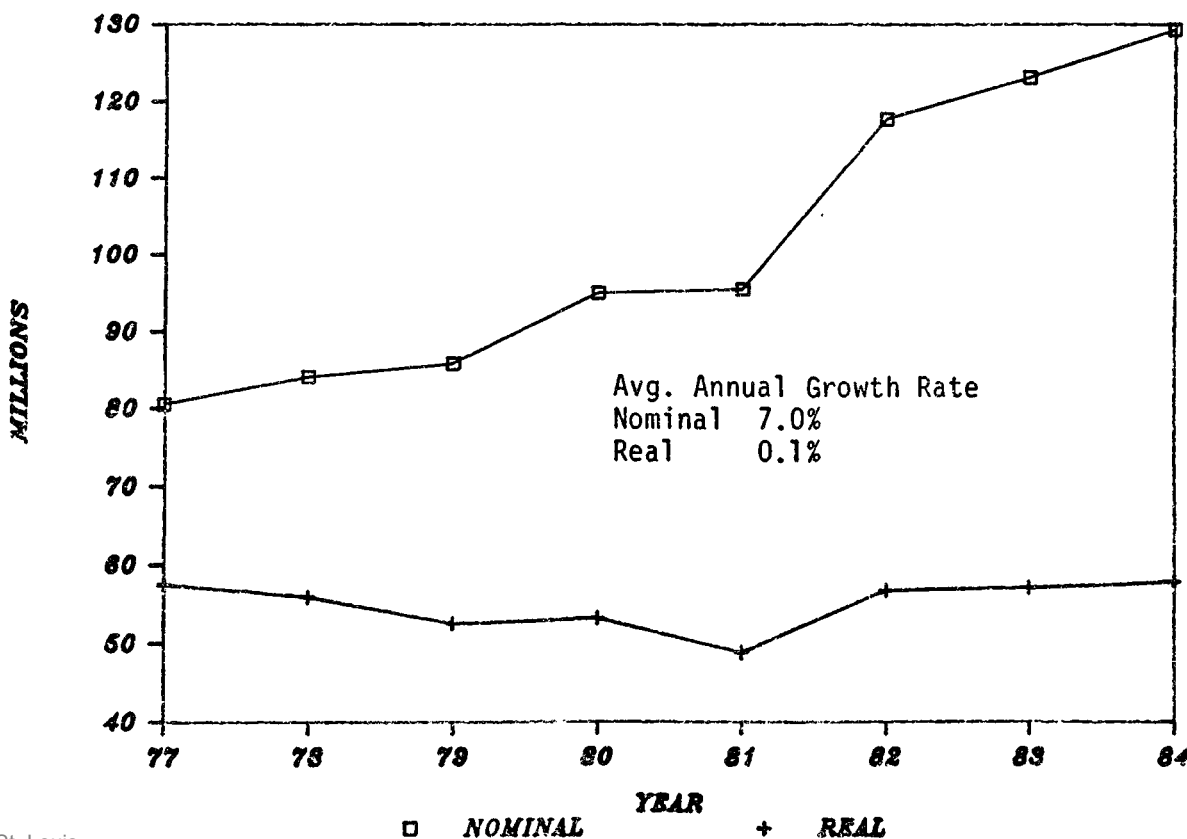


Table 4
 Services to U.S. Treasury and Government Agencies
 System Expenses and Employment
 1977-1984
 (dollars in millions)

Year	Total Expense	Percent Change	Expenses Constant Dollars	Percent Change Constant Dollars	Total Employees	Percent Change
1977	\$80.6		\$57.6		2,004	
1978	84.2	4.5	55.8	-3.0	1,919	-4.2
1979	85.9	2.0	52.6	-5.9	1,883	-1.9
1980	95.1	10.7	53.3	1.4	1,946	3.3
1981	95.6	0.5	48.9	8.3	1,881	-3.3
1982	117.9	24.0	56.9	16.3	1,851	-1.6
1983	123.2	4.5	57.2	0.7	1,839	-0.6
1984	129.4	5.4	57.9	1.2	1,798	-2.2
Avg. Annual Growth Rate		7.0		0.1		-1.5

C. Services to Financial Institutions and the Public

Prior to passage of the MCA about 5,000 banks, mostly larger institutions, were eligible for Federal Reserve services. More than 7,700 depository institutions now use Federal Reserve services. The objectives of the pricing provisions of the Monetary Control Act were to improve efficiency in the payments system through enhanced competition, while assuring that an adequate level of payment services was available nationwide. The Act also required that over the long run, fees for priced services be established on the basis of all direct and indirect costs actually incurred in providing the services, including the cost of float and an allocation of imputed costs (taxes and the cost of capital) that would have been incurred had the services been furnished by a private business firm. The latter comprises what is known as the Private Sector Adjustment Factor, or the PSAF.²

² Board of Governors of the Federal Reserve System, The Federal Reserve System - Purposes and Functions, Washington, D.C. 1984, p. 104.

Beginning in 1981 and throughout 1982 the Reserve Banks experienced a significant decline in the demand for some of their services, and for commercial check processing in particular. The initial result was that Federal Reserve expenditures on priced services were greater than the income generated by fees.

The Reserve Banks began to make resource adjustments to reduce costs almost immediately. For example, total employment in this service line declined 1.4 percent in 1981 and 9.5 percent in 1982. In commercial checks alone, employment declined by 833. "Fixed cost" adjustments took longer to make but by 1983 they were well underway. Prices were also changed to increase revenues. Beginning in 1983 an imputed cost for Federal Reserve float³ was also included as a component of total costs. By 1984 the market test of pricing required by the Monetary Control Act was being met, and all costs including float and the PSAF were fully recovered. As Figure 4 indicates, total expenditures in this area, including priced and nonpriced services, decreased in real terms at an annual average rate of 0.7 percent between 1977 and 1984.

³ Float, which occurs primarily in the process of collecting commercial checks, is created when the Federal Reserve credits a payee institution for its collections before it debits the account of the payor institution. In effect, float is an interest-free loan from the Federal Reserve. Prior to 1983 float was not priced but was instead reduced through operational improvements. Starting in 1983 the cost of float calculated on the basis of the federal funds rate has been included in Federal Reserve prices.

Figure 4

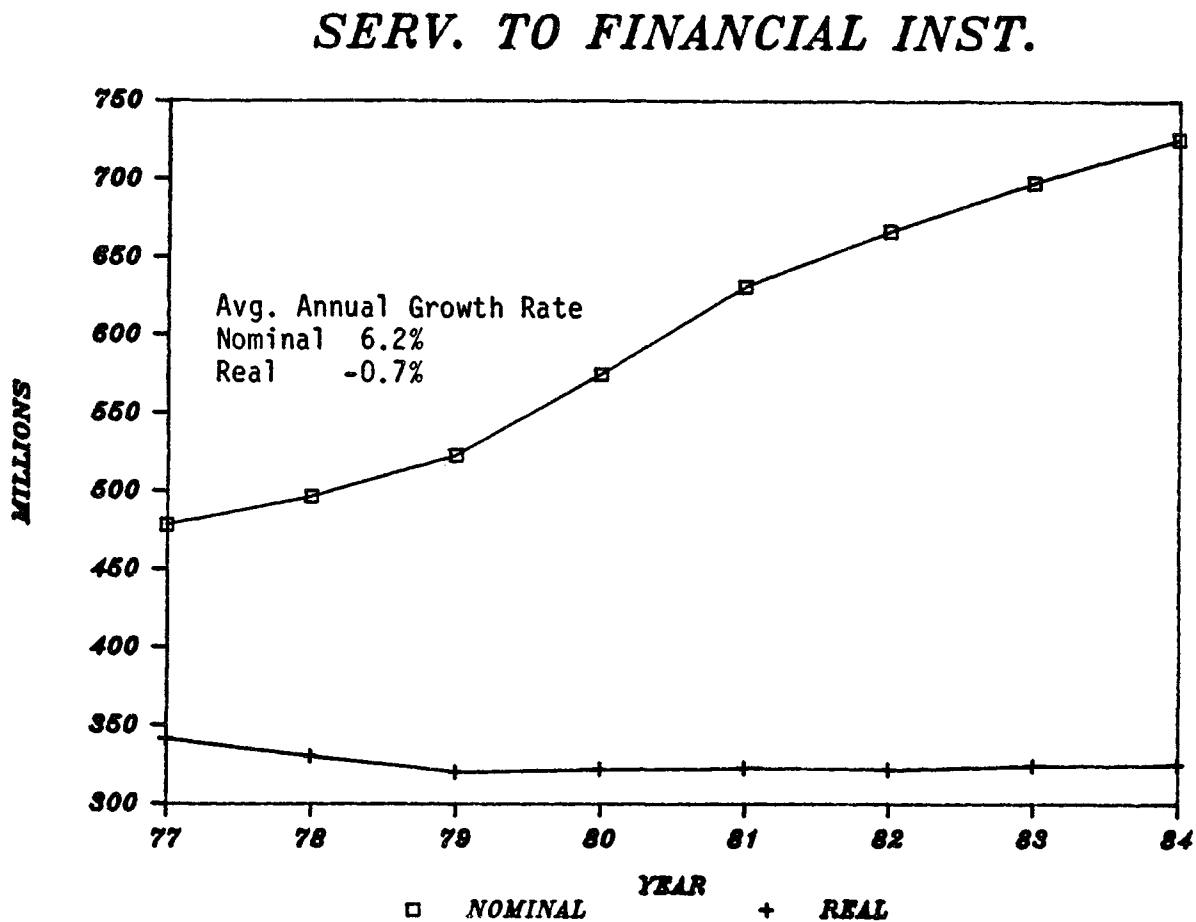


Table 5
Services to Financial Institutions and the Public
System Expenses and Employment
1977-1984
(dollars in millions)

Year	Total Expense	Percent Change	Expenses Constant Dollars	Percent Change Constant Dollars	Total Employees	Percent Change
1977	\$479.20		\$342.29		10,355	
1978	497.40	3.8	329.84	-3.6	9,958	-3.8
1979	523.90	5.3	320.62	-2.8	9,894	-0.6
1980	575.50	9.9	322.59	0.6	9,731	-1.7
1981	632.30	9.9	323.26	0.2	9,591	-1.4
1982	668.30	5.7	322.23	-0.3	8,682	-9.5
1983	699.30	4.6	324.80	0.8	8,559	-1.4
1984	728.20	4.1	325.96	0.4	8,535	-0.3

Avg. Annual
Growth Rate

6.2

-0.7

-2.7

D. Supervision and Regulation

Supervision and regulation was the fastest growing area of Federal Reserve expenditures over the last seven years, increasing by an average annual rate of 7.4 percent in real terms. (See Figure 5.) Much of this rise was accounted for by an increased workload. For example, the number of bank holding company inspections rose at an average annual rate of 17.4 percent over the period. Similarly, the number of bank holding company applications per year more than doubled, as did the number of financial institutions monitored. The number of cease and desist orders issued per year tripled.

To some extent this increase in workload reflects the increase in bank holding company formations, the accelerating pace of change in the financial sector following elimination of interest rate ceilings on deposits, and deregulation in general. The MCA also contributed to the increase in spending on Supervision and Regulation through an increase in monitoring Reserve accounts. Additionally, legislation such as the International Banking Act, the Community Reinvestment Act, and the Financial Institutions Regulatory and Interest Rate Control Act also increased the Federal Reserve's responsibilities.

Figure 5

SUPERVISION & REGULATION

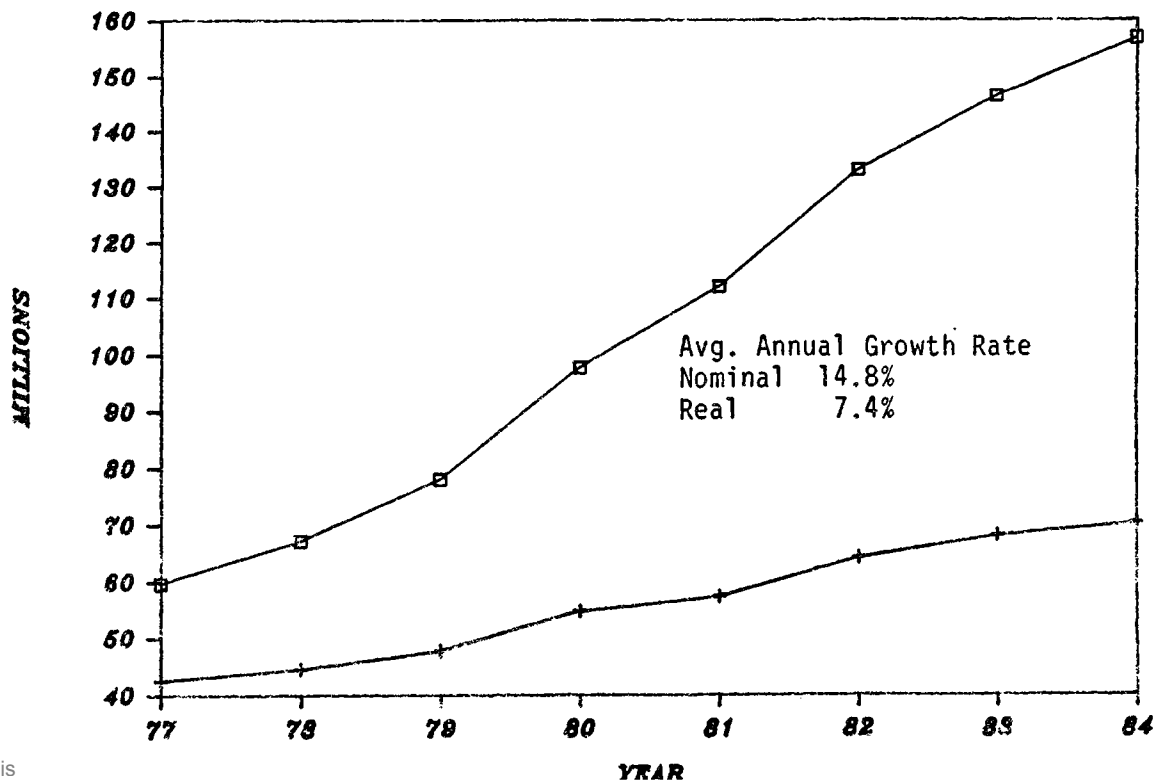


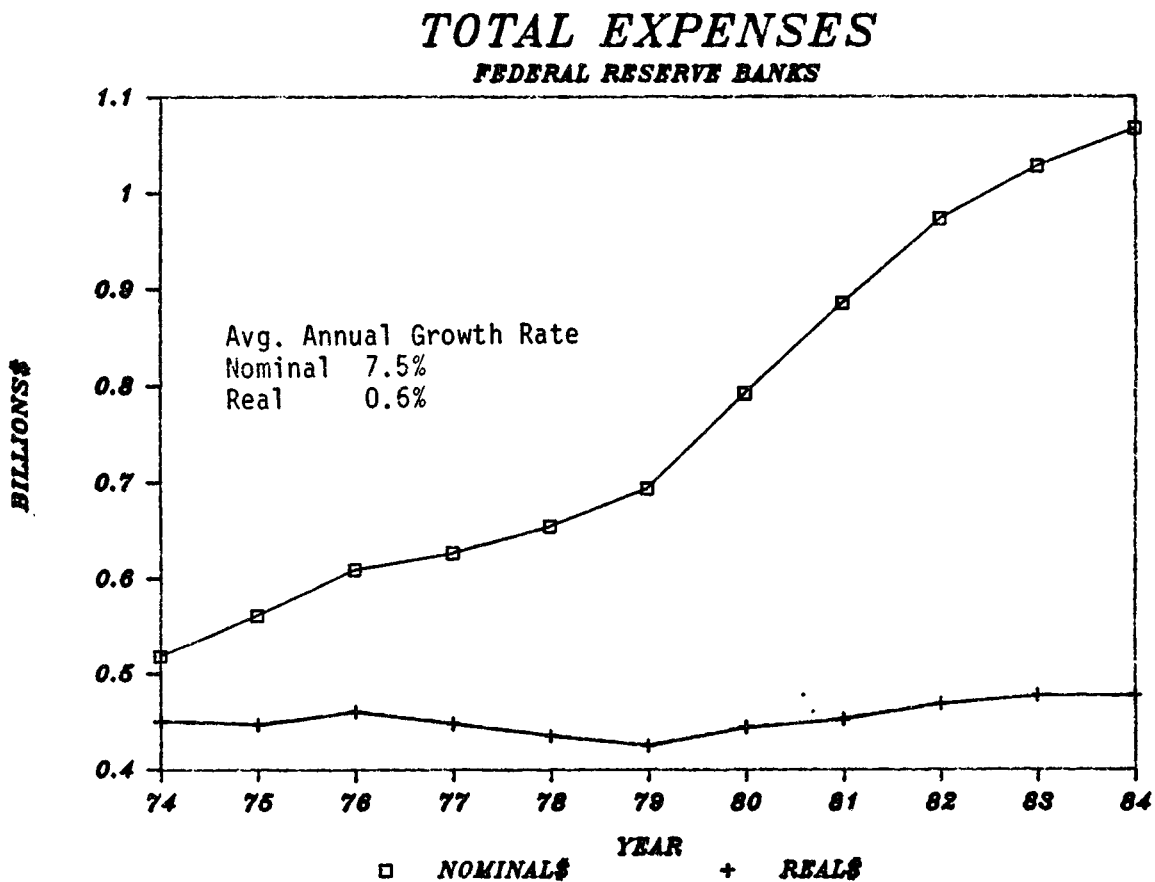
Table 6
Supervision and Regulation
System Expenses and Employment
1977-1984
(dollars in millions)

<u>Year</u>	<u>Total Expense</u>	<u>Percent Change</u>	<u>Expenses Constant Dollars</u>	<u>Percent Change Constant Dollars</u>	<u>Total Employees</u>	<u>Percent Change</u>
1977	\$60.20		\$43.00		1,501	
1978	67.70	12.5	44.89	4.4	1,579	5.2
1979	78.60	16.1	48.10	7.2	1,668	5.6
1980	98.30	25.1	55.10	14.6	1,856	11.3
1981	112.70	14.7	57.62	4.6	2,001	7.8
1982	133.70	18.6	64.46	11.9	2,069	3.4
1983	147.20	10.1	68.32	6.0	2,152	4.0
1984	158.10	7.4	70.77	3.6	2,186	1.6
Avg. Annual Growth Rate		14.8		7.4		5.5

II. Reserve Bank Expenses and Employment

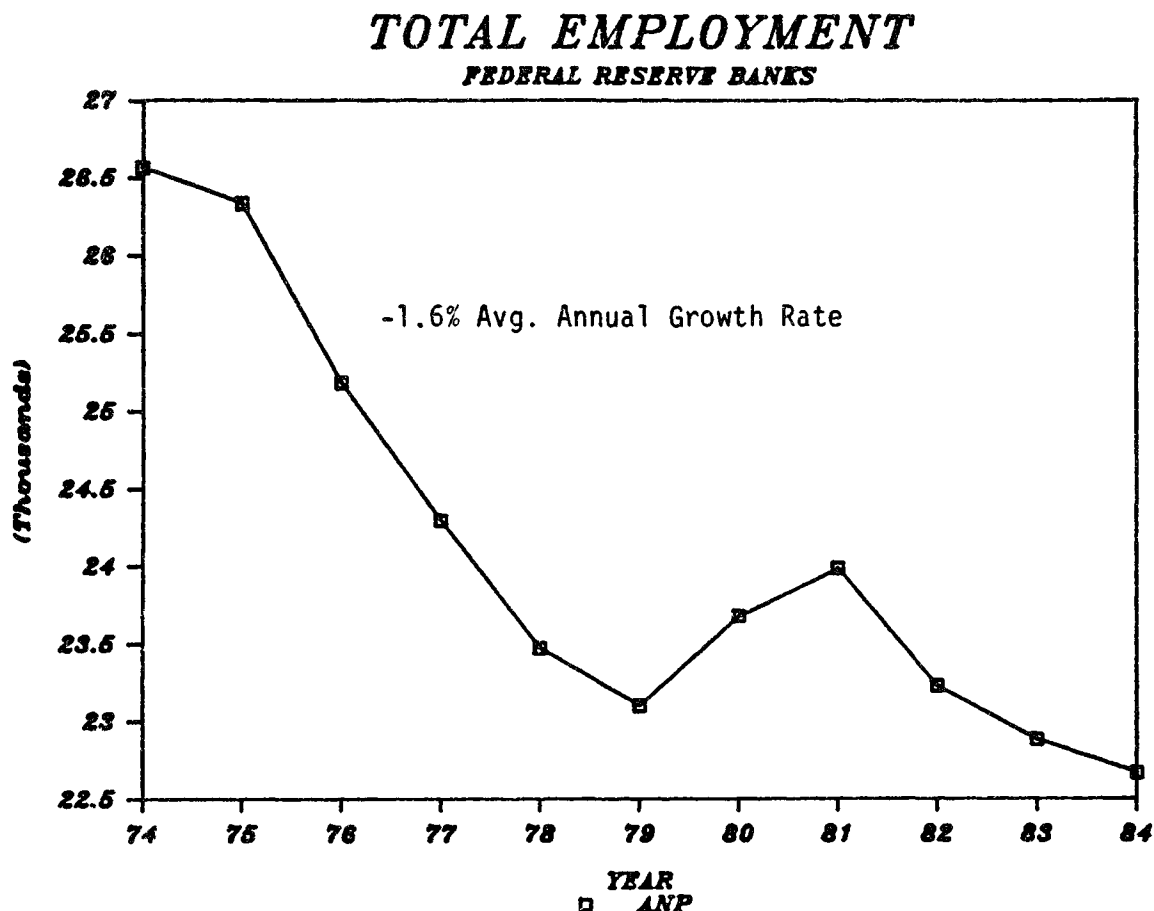
Reserve Bank expenses (excluding currency) show an average annual growth of 7.5 percent (0.6 percent in constant dollars), while employment decreased at an average annual rate of 1.6 percent. However, as indicated by Figures 6 and 7, significant changes in expenses and employment took place at the same time.

Figure 6



Note: These data are derived from PACS' highly detailed accounting and management information system. It is important to point out that the PACS reports themselves are much more disaggregated. Data on spending are published quarterly at each Reserve Bank office, by a number of subservice lines and by object of expenditure. These data are available to the public.

Figure 7



In the early seventies, the Reserve Banks carried out a systemwide program to improve the nation's payment mechanism system by establishing Regional Check Processing Centers (RCPCs) to achieve more timely check clearing. While most RCPCs were in house, a major shift from daytime operations to nighttime operations took place. In addition, 11 offsite RCPCs were organized and staffed. The improved timeliness and service the RCPCs offered brought in additional volume. With their establishment, there was a determined effort to make efficiency and productivity gains by using improved automated equipment and emphasizing cost restraint. Employment at Reserve Banks was reduced

by 3,463 or 13.0 percent (from 26,567 in 1974 to 23,104 in 1979) and expenses, in constant dollars, decreased over the period from \$451 million in 1974 to \$425 million in 1979, an average annual decline of 1.2 percent. These reductions were made in spite of continued expansion in volumes processed. (Volume growth in check processing, the largest operating area, averaged 6.8 percent per year over this same period.) When the Monetary Control Act (MCA) was passed in 1980, virtually no resources at the Banks could be redirected to accomplish the new requirements placed on the System by the Act. Resources had to be expanded, which reversed the trend in expenses and employment in place since 1974.

Adjusting to the requirements of the MCA is clearly the most important factor affecting Reserve Bank operations. Previously, reserve requirements had been imposed only on member banks. The new legislation, however, resulted in a great increase in the number of depository institutions reporting deposit data and maintaining reserve accounts at the Reserve Banks.

Another feature of the MCA which had a major impact on Reserve Bank resources, was the requirement that the Federal Reserve price explicitly certain services provided to depository institutions. Heretofore, these services were provided to member banks at no explicit cost. Thus, the Reserve Banks had to establish new operations for pricing, billing, and customer servicing in response to passage of the MCA.

MCA requirements led to an increase of 578 staff members in 1980, reversing a five-year period of decline. In the following year an additional 307 staff were added bringing Reserve Bank employment to 23,989. This level was still 2,578 or 9.7 percent below the 1974 staff level of 26,567. However, as pricing resulted in volume loss, the Reserve banks adjusted rapidly. Staff was reduced throughout 1982 (by 759) and during 1983 (by 347). The 1984 Reserve Bank staff level of 22,669 was the lowest in the decade.

The trend in expenses also shows the impact of the MCA. Expenses increased 14.3 percent in 1980, the largest annual increase since 1974. (Adjusted for inflation the increase was 4.5 percent, also the highest since 1974.) Year-over-year increases have been lower since 1980; 11.8 percent for 1981 over 1980 (2.3 percent adjusted for inflation); 9.9 percent for 1982 (3.6 percent adjusted for inflation); and 5.6 percent for 1983 (1.3 percent adjusted for inflation), and 3.8 percent for 1984 (0.1 percent adjusted for inflation).

Reserve Bank Expenses and Employment by Service Line

Tables 7 and 8 show Reserve Bank expenses and employment by PACS service lines from 1977 through 1984. Although numerous accounting changes took place over this six-year period, the general trends are captured in the statistics. For example, Reserve Bank expenses and employment have grown more rapidly in monetary and economic policy (16.4 percent and 3.7 percent average annual growth rate (AAGR), respectively) and supervision and regulation (15.1 percent and 5.8 percent AAGR, respectively) than in other areas during this period.

Table 7
Federal Reserve Bank Expenses by PACS Service Line
1977-1984
(dollars in thousands)

Year	Monetary and Economic Policy	Services to the U.S. Treasury & Gov't. Agencies	Svcs. to ¹ Financial Institutions & the Public	Supervision and Regulation of Banks	Total
1977	\$34,247	\$78,569	\$461,366	\$52,698	\$626,881
1978	34,876	82,072	479,353	58,291	654,592
1979	38,244	83,536	504,371	67,754	693,904
1980	59,567	92,486	554,686	86,068	792,804
1981	81,163	93,401	611,698	99,863	886,125
1982	93,010	115,126	646,151	119,316	973,603
1983	100,443	120,256	675,918	131,848	1,028,465
1984	99,351	126,307	701,453	140,690	1,067,802
Avg. Annual Growth Rate	16.4%	7.0%	6.2%	15.1%	7.9%
Constant Dollars ²	8.9%	0.1%	-0.7%	7.6%	0.9%

¹ Excludes FR currency costs. See page 1.

² GNP Deflator 1972=100.

Table 8
Federal Reserve Bank Employment by PACS Service Line
1977-1984

Year	Monetary and Economic Policy	Services to the U.S. Treasury & Gov't. Agencies	Services to Financial Institutions & the Public	Supervision and Regulation	Support	Overhead
1977	641	2,004	10,246	1,273	4,292	5,858
1978	610	1,919	9,850	1,337	4,146	5,616
1979	597	1,883	9,790	1,411	4,055	5,367
1980	618	1,946	9,614	1,589	4,238	5,680
1981	717	1,881	9,480	1,733	4,434	5,745
1982	743	1,851	8,566	1,796	4,599	5,676
1983	804	1,838	8,424	1,862	4,367	5,589
1984	826	1,798	8,395	1,885	4,340	5,424
Actual	185	-206	-1,851	612	48	-434
% Change	29%	-10.3%	-18.1%	48%	1.1%	-7.4%
Avg. Annual Growth Rate	3.7%	-1.5%	-2.8%	5.8%	.2%	-1.1%

A. Service Line I - Monetary and Economic Policy. The PACS accounting system captures in service line I all costs associated with determining and achieving the monetary policy of the System. Table 9 depicts expenses and employment from 1977 to 1984. Expenses are broken out by cost of activities (all direct costs including data processing and occupancy costs), System projects (major systemwide development efforts), and overhead cost allocations, such as administration, personnel, accounting, etc. Employment data are for direct activities only since support and overhead employment are not allocated to output areas.

Table 9
Monetary and Economic Policy (Service Line I)
Expenses and Employment All Reserve Banks
(dollars in thousands)

Year	Expenses					Employment	
	Cost of Activities	System Projects	Overhead	Total	% Change	Employees	% Change
1977	\$23,662	\$ 67	\$10,518	\$34,247		641	
1978	24,894	32	9,950	34,876	1.8%	610	-4.8%
1979	26,380	112	11,752	38,244	9.7	598	-2.0
1980	29,214	16,580	13,768	59,567	55.7	618	3.4
1981	36,093	29,108	15,962	81,163	36.3	717	16.2
1982	45,492	20,851	26,677	93,010	14.6	743	3.6
1983	51,185	21,194	28,064	100,443	8.0	804	8.2
1984	55,055	13,975	30,320	99,351	-1.1	826	2.7
Avg. Ann. Growth Rate	12.8%	114.5%	16.3%	16.4%		3.7%	
Constant Dollars	5.6%	100.7%	8.9%	8.9%			

Note: Support and overhead costs have been allocated into the four output service lines.

From 1977 to 1984, expenses in monetary and economic policy increased 16.4 percent on an average annual basis, (8.9 percent in constant dollars) and employment increased by 3.7 percent. In 1978, total employment declined by 31 or 4.8 percent, and in 1979, total employment declined by 13 or 2.1 percent.

Beginning in 1980 and continuing throughout 1983, however, expenses and employment grew substantially in monetary and economic policy for numerous reasons. Large expense increases occurred in System project and overhead areas, and in the data reporting area.

System Projects

A System project cost increase of \$21.1 million from 1977 to 1983 occurred between 1979 and 1983. This increase results directly from the passage of the Monetary Control Act of 1980 (MCA). All costs of meeting MCA requirements were accumulated in a System project and allocated to this service line. Following are the actual costs of implementing the MCA:

Table 10
MCA System Project
1980-1983

<u>Year</u>	<u>Amount</u>
1980	\$16,459,690
1981	28,122,193
1982	14,562,922
1983	<u>5,646,490</u>
TOTAL	\$64,791,295

Other System projects related to the System's long-range automation program were allocated to this service line during this period. Also, since 1982 the cost of moving toward contemporaneous reserve requirements (CRR) was allocated entirely to this service line. Following are the costs of implementing CRR:

Table 11
CRR System Project
1982-1984

<u>Year</u>	<u>Amount</u>
1982	\$ 89,613
1983	6,499,389
1984	5,708,901

Overhead

A sharp increase in overhead allocations occurred in 1982 when costs increased \$10.7 million or 67.1 percent. This increase resulted primarily from a thorough review of the PACS accounting system methods for allocating overhead. The review was conducted in order to achieve overhead allocations which would associate costs more closely with benefits. For example, beginning in 1982, cost of the Research Library at Reserve Banks was allocated entirely to service line I - monetary and economic policy, whereas before 1982, these costs were spread to all services on a ratio basis.

Data Reporting

As discussed previously, expenses of statistical reporting to the Board grew at an average annual rate of 18.1 percent from 1977 to 1984.

The cost of data reporting increased sharply in 1980, and is attributed to several pieces of legislation which affected the volume and complexity of data reports.

- o The Depository Institutions Deregulation and Monetary Control Act of 1980 (MCA), which applied Federal Reserve requirements to all U.S. depository institutions with certain types of accounts, greatly increased the number of depository institutions reporting monetary aggregates data to and maintaining reserve accounts with the Federal Reserve.

- o The International Banking Act of 1978 (IBA) created an increased need for supervisory, regulatory, and financial information and resulted in large increases in the number of respondent institutions reporting deposits and financial data. In 1980, previous reporting instruments were replaced with the far more detailed quarterly Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks, and the quarterly Report of Condition for Edge Act Corporations.
- o In 1981, the Board of Governors' authorization of International Banking Facilities (IBFs) resulted in the implementation of a number of new statistical reports on IBF activities designed to monitor IBFs and to interpret changes in the monetary aggregates. In addition, IBFs reporting on the Treasury International Capital series, which the Federal Reserve handles on behalf of the U.S. Treasury, have increased greatly.
- o Passage of the Garn-St Germain Act of 1982, and related actions by the Depository Institutions Deregulation Committee (DIDC), led to the deregulation of deposit accounts, reporting changes and significant workload increases associated with the monetary aggregates data flows.
- o And finally, the change from lagged to Contemporaneous Reserve Requirements (CRR), which was implemented on February 2, 1984, resulted in significant preparatory system development costs in 1983, and on a continuing basis has resulted in an increased workload associated with the required additional monitoring of reserve calculations and reserve position performance, the processing of reserve statements, as well as the added complexity of the monetary aggregates data flows. These amounts are direct results of volume increases pursuant to mandate and changes in reserve administration.

In interpreting these increases, it must be recognized that the workload associated with the volume increases is not strictly additive. The need to assure data quality, which includes comparisons between multiple report series filed by the same institutions, requires that each additional piece of information be run against other data reported by the institution. Therefore, overall workload and costs are expanded to a greater degree than would have been the case for simple collection of the additional data.

B. Service Line II - Services to the U.S. Treasury and Government Agencies.

Service line II in the PACS system includes Reserve Bank costs for acting as fiscal agent for the U.S. government as well as performing other operations for governmental agencies. Examples include issuing, servicing and redeeming savings bonds and other instruments of public debt; processing government agency coupons; processing food coupons; performing Treasury tax and loan accounting; and maintaining the Treasury's general account. Workloads are largely determined by policies of the governmental agencies involved.

As shown on Table 12, from 1977 to 1984, expenses in services to the Treasury and government agencies grew at an average annual rate of 7.0 percent and 0.1 percent in constant dollars. Employment declined by 206 or -10.3 percent. On an average annual basis, employment declined by 1.5 percent.

Table 12
Services to the U.S. Treasury and Government Agencies (Service Line II)
Expenses and Employment All Reserve Banks
(dollars in thousands)

<u>Year</u>	<u>Expenses</u>				<u>Employment</u>	
	<u>Cost of Activities</u>	<u>System Projects</u>	<u>Overhead</u>	<u>Total</u>	<u>Percent Change</u>	<u>Employees</u>
1977	\$51,751	\$ 555	\$26,263	\$78,569		2,004
1978	55,197	355	26,520	82,072	4.5%	1,919
1979	54,644	925	27,966	83,536	1.8	1,883
1980	58,933	2,133	31,420	92,486	10.7	1,946
1981	60,472	2,092	30,837	93,401	1.0	1,881
1982	66,898	6,152	42,076	115,126	23.3	1,851
1983	71,083	6,908	42,265	120,256	4.5	1,839
1984	76,083	7,014	43,210	126,307	5.0	1,798
Avg.						
Annual Growth Rate	5.7%	43.7%	7.4%	7.0%		-1.5%
Constant Dollars	-1.1%	34.4%	.5%	.1%		

In the late 1970s the volume increase was due primarily to high interest rates. The rapid increase in workloads in the fiscal agency forced many Reserve Banks to increase staff in the short term and undertake automation efforts for the long term. A long-term automation development effort to standardize the securities transfer and safekeeping systems (SHARE) among the Reserve Banks also began in 1980. Table 13 below shows the costs of this program from 1980 to 1984. This development effort has been primarily included in service line II.

Table 13
SHARE Costs
1980-1984 (in thousands)

<u>Year</u>	<u>Amount</u>
1980	\$2,381
1981	1,448
1982	626
1983	1,670
1984	3,881

Treasury changes in the savings bond program also increased workload levels and complexity in 1980. These changes involved the introduction of a new series of savings bonds and the accelerated remittance of savings bond sales. The Reserve Banks, as fiscal agents, were required to increase the level of accounting detail, process more frequent remittances from issuing agents and operate under additional, more complex savings bond issuing procedures. The changes also required the recall, reconciliation, and exchange of unissued series of savings bond stock from over 40,000 issuing agents. As a result, the Reserve Banks found it necessary to increase staff in this area in 1980 and undertake automation efforts.

In 1981 a general decline in Treasury volume of 11.4 percent resulted in Reserve Banks reducing employment by 3.3 percent in this area and holding expenses flat (1.0 percent increase). The dramatic drop in volume caused unit costs to increase by 12.2 percent even though expenses increased only 1.0 percent. The decline in volume occurred mainly in the marketable security area where volume dropped by 34.9 percent. Volume also declined in the savings bond area by 5.9 percent.

In 1982, expenses increased by 23.3 percent, employment and volume continued to decline (1.6 percent and 6.2 percent, respectively), and unit costs increased by 32.5 percent.

Of the 23.3 percent or \$21.7 million increase, direct and support costs rose only 10.6 percent; however, System project and overhead costs increased 46.5 percent. A fundamental reevaluation of several System project and overhead allocations in 1981 associated overhead costs more closely to benefiting activities and resulted in significant changes effective January 1982. These changes increased overhead allocations to service line II substantially. (For example, protection costs were directed toward service

line II because of the valuables handled in the fiscal services.) The unit cost increase of 32.5 percent is a direct result of the continuing volume declines and the increased overhead allocations.

In addition, in 1982 the Federal Reserve Banks were called upon to provide fiscal services to additional government agencies as well as increased services to existing customers. The Treasury also requested procedural changes in the savings bond program, federal tax deposit (FTDs) accounting, and some automation changes. The savings bond stock monitoring program, initiated as a result of GAO recommendations, required more frequent reconcilements, at a greater level of detail, of unissued stock held by issuing agents; many Reserve Banks automated their stock monitoring systems. FTD reporting and reconciliation procedures were also changed as were the Fedwire/TFCS programming edits, both requiring additional resources at Reserve Banks.

In 1983, expenses increased by 4.5 percent and employment declined by 0.7 percent. Overall, volume continued to decline by 3.3 percent resulting in a 7.3 percent rise in unit costs. However, Reserve Bank efforts to improve automated systems continued to be a major factor. During 1983, the Treasury began working with the Reserve Banks to develop a Treasury marketable securities book-entry system for individual investor accounts. The Reserve Banks were also in the process of completing automation efforts in the savings bond program as well as servicing the growing needs of government agencies.

In general, from 1979 to 1984, the Reserve Banks steadily reduced staff levels in fiscal services, maintained small to moderate cost growth, automated several fiscal agency functions and successfully responded to rapidly changing workloads and major Treasury program changes.

Fiscal Agent Reimbursement

The Federal Reserve Banks perform fiscal agency services for the U.S. Treasury, government, quasi-government and international agencies. As fiscal agents, the Reserve Banks perform services as directed under specific statutory authorization. Although the Reserve Banks perform a variety of fiscal agent functions, program responsibility and authority remain with the principal.

Reimbursement for fiscal agent services is obtained through statutory requirements or negotiation with the principal. However, principals are responsible for securing adequate funds to fulfill their statutory program responsibilities.

C. Service Line III - Services to Financial Institutions and the Public.

Service line III in the PACS system includes Reserve Bank costs for providing services to depository institutions and the public. In 1984, this service line amounted to 65.7 percent of total Reserve Bank expenses.

Commercial check operations is the largest service in this service line (and in the Reserve Banks). In 1984, check costs represented about 48 percent of total service line costs (and about 31 percent of total 1984 expenses).

Currency operations are the second largest group of activities and comprised about 18 percent of the costs of service line III in 1984. Other services and their percentage of service line costs in 1984 are: coin (5 percent), electronic funds transfer (13 percent), government checks and postal money orders (2 percent), securities (4 percent), loans to depository institutions (1 percent), non-cash collection (2 percent), public programs (5 percent), and other activities (3 percent).

In 1984, about 65 percent of service line III expenses were devoted to providing priced services (some began in 1981 and 1982). Virtually all operations in commercial checks, securities, and non-cash collection are priced. Selected operations are priced in the currency, coin, and electronic funds transfer areas. Overall, from 1977 to 1984, expenses increased at an average annual rate of 6.2 percent while employment declined by 1,851 or 18.1 percent.

Table 14
Services to Financial Institutions and the Public (Service Line III)
Expenses and Employment (All Reserve Banks)
(dollars in thousands)

Year	Expenses				Percent Change	Employment	
	Cost of Activities	System Projects	Overhead	Total		Employees	Percent Change
1977	\$316,326	\$ 2,564	\$142,477	\$461,367		10,246	
1978	327,419	4,513	147,422	479,354	3.9%	9,840	-3.9%
1979	355,428	4,773	144,171	504,371	5.2	9,790	1.1
1980	386,511	9,271	158,903	554,686	10.0	9,614	-1.8
1981	429,757	15,673	166,268	611,698	10.3	9,480	-1.4
1982	448,073	13,850	184,228	646,151	5.6	8,566	-9.6
1983	468,134	20,390	187,394	675,918	4.6	8,424	-1.7
1984	483,768	23,873	193,813	701,453	3.8	8,395	-0.3
Avg. Annual							
Growth Rate	6.3%	37.6%	4.5%	6.2%		-2.8%	
Constant Dollars	-.6%	28.7%	-2.2%	-.7%			

From 1979 to 1980, volume in all areas grew substantially, employment declined slightly and unit costs increased in most areas. Beginning in 1981 and throughout 1982, the effect of pricing was evident. A 15.1 percent decline in check volume in 1982, in addition to the 5.1 percent decline in 1981, resulted in an increase in unit costs. The Reserve Banks reduced variable

resources in response to the decline in volume. Total employment declined 1.4 percent and 9.6 percent in 1981 and in 1982, respectively and in commercial checks alone, employment declined by 833 employees. However, the adjustment to fixed costs took longer. In 1983, expenses increased only 4.6 percent, employment continued to decline (1.7 percent), volume had stabilized and unit costs were again within acceptable levels. In 1984, expenses increased only 3.8 percent and employment continued to decline.

The MCA has added greater discipline to the Federal Reserve's budget process by requiring matching of costs with revenues for priced services. Reserve Banks cannot budget cost increases unless sufficient revenue can be generated to cover those incremental costs. Also, Reserve Banks must reduce costs if volume declines. This provision adds a market discipline test on existing programs as well as on potential new programs. Also, under its earlier mandate to provide services to member banks, the Federal Reserve was mainly dealing with wholesale financial institutions since member banks tended to be larger banks. Now, however, the number of institutions with access to Federal Reserve services has increased from 5,000 to 40,000, thus increasing the costs of operation considerably. In addition, the System has had to eliminate or price for float. This requirement has led to the implementation of many operations to reduce float levels thereby increasing unit costs. Moreover, the MCA has led the System to a reevaluation of services provided: 1) certain districts have dropped the cash transportation service because the private sector can provide it more efficiently; 2) some districts are developing plans to phase out the definitive securities business because it is not cost justified; and 3) in many instances the Banks have enhanced a number of service offerings which have been favorably received by customers.

Under the joint discipline of MCA requirements and the market for banking services, the Reserve Banks have made substantial improvements to the efficiency of the payments mechanism process (despite significant declines in average personnel):

- o Acceleration of check collection has shifted check volume of about \$2 billion daily from two-day collection to one-day collection.
- o Daily average check float has been reduced by \$3.3 billion or 73 percent between 1980 and fourth quarter 1983, and has continued to decline in 1984.
- o The Fed has expanded on-line electronic access to approximately 4,600 depository institutions.
- o A high dollar group sort program has been designed to reduce incentives for remote disbursement by banks.
- o Non-cash availability has improved.
- o New net settlement arrangements have been developed.

It is apparent that the Federal Reserve's current production and development expenses are well within the market range. By 1984 the market test of pricing required by the Monetary Control Act was being met, and all costs including float and the PSAF were fully recovered. Total expenditures in this area, including priced and nonpriced services, decreased in real terms at an annual rate of 0.7 percent between 1977 and 1984.

In order to retain its position as a viable provider of priced services as the MCA requires, the Federal Reserve must continue to adhere to the market discipline which it has followed for the last several years. By being a market participant, the Reserve Banks must exercise cost restraint in service line III and make staff reductions when required. The Reserve Banks have demonstrated their ability in cost containment as indeed they must in order to continue to act as a provider of payments mechanism services.

D. Service Line IV - Supervision and Regulation.

Service Line IV in the PACS system includes Reserve Bank costs related to the supervision and regulation of depository institutions. Operations are classified into three services: 1) supervision of district financial institutions - includes costs for all on-site examinations and inspections of commercial banks, international banking organizations, bank holding companies, etc.; 2) administration of laws and regulations related to banking contains costs for processing banking organization and holding company applications, processing condition and other statistical reports, and monitoring reserve accounts; and 3) banking and financial market structure studies capture costs associated with research and analysis of the structure of banking markets. Legislative actions and the rapidly changing environment in the financial industry have had a substantial impact on this service line.

As shown in Table 15, total expenses increased \$87.9 million or 15.1 percent on an average annual basis from 1977 to 1984. Employment grew by 612 employees. On an average annual basis, employment increased 5.7 percent per year.

Table 15
Supervision and Regulation (Service Line IV)
Expenses and Employment (All Reserve Banks)
(dollars in thousands)

Year	Expenses				Percent Change	Employment	
	Cost of Activities	System Projects	Overhead	Total		Employees	Percent Change
1977	\$36,849	\$ 101	\$15,748	\$52,698		1,273	
1978	40,688	107	17,496	58,291	10.6%	1,337	5.0%
1979	45,393	313	22,048	67,754	16.2	1,411	5.5
1980	55,057	3,437	27,574	86,068	27.0	1,589	12.6
1981	66,210	2,009	31,644	99,863	16.0	1,733	9.1
1982	77,091	6,981	35,244	119,316	19.5	1,796	3.6
1983	87,824	7,820	36,204	131,848	10.5	1,862	3.7
1984	95,554	6,653	38,481	140,690	6.7	1,885	1.2
Average Annual Growth Rate	14.6%	81.9%	13.6%	15.1%		5.7%	
Constant Dollars	7.2%	70.2%	6.3%	7.7%			

System project costs rose significantly from 1977 to 1983. In 1980 the credit control program accounted for an increase of \$2.7 million, while the 1982 increase reflects a change in cost allocations. In 1980 total expenses rose by \$3.9 million and 96 employees were added to monitor the new reserve accounts.

Throughout this period, various legislative actions and regulatory changes had substantial impact on this service line. The Depository Institutions Deregulation and Monetary Control Act of 1980 meant universal reserve requirements, the phasing out of interest rate regulations and increased access to the discount window. As a result, oversight, monitoring, rule-making and enforcement responsibilities grew. The Garn-St Germain Act resulted in an increased number of mergers involving extraordinarily complex legal, financial and competitive issues. The International Banking Act broadened examination responsibilities for supervising U.S. branches and agencies of foreign banks. Ongoing supervision of domestic banks in recent years has involved substantial monitoring and surveillance of credits associated with distressed industries and foreign borrowers. The Community Reinvestment Act meant new responsibility for evaluating lending records of and working with state member banks to ensure that they are meeting the credit needs of their communities. Several other consumer protection laws were enacted, each mandating specific examination procedures.

Also, the workload in the monitoring of reserve accounts has expanded significantly over the last several years due to: (1) the implementation of the Monetary Control Act of 1980, causing a net increase in the number of reserve accounts to be monitored; (2) substantially more institutions requiring closer monitoring and counseling; (3) the increase in the number of problem banks requiring closer monitoring; and (4) the implementation of a new reserve reporting system.

III. Board of Governors' Expenses and Employment

During the 10-year period 1974 to 1984, operating expenses for the Board increased at an average annual rate of 9.4 percent (2.4 percent in constant dollars). Employment increased by 227 employees or 1.6 percent on an average annual basis. However, as indicated by the following figures, the composition of expenses and employment during the last decade changed significantly.

During the period 1974 to 1977, employment at the Board of Governors increased by 112 employees or 8.2 percent and expenses grew by \$13.4 million or 44.7 percent. This growth period was a direct result of several legislative initiatives in the area of consumer regulation. For example, the Board established a new division during this period -- the Division of Consumer and Community Affairs -- to respond to legislatively mandated responsibilities. Legislation included the Home Mortgage Disclosure Act, the Equal Credit Opportunity Act and the Fair Credit Billing Act.

From 1977 to 1979 Board employment fell by 26 or 1.8 percent and expenses increased \$3 million or 18 percent. No significant legislative requirements were being placed on the Board and, therefore, through productivity improvements, employment actually declined.

From 1979 to 1980, 69 employees were added, an increase of 4.8 percent. This growth can be directly attributed to the impact of the Financial Institutions Regulatory and Interest Rate Control Act which greatly increased the Board's supervision and regulation responsibilities, primarily in the area of bank holding companies.

From 1980 to 1981, the Board undertook a position control program similar to the program in place throughout the federal government, leading to a reduction of 25 employees. However, with the passage of the Monetary Control Act of 1980, the smaller staff gave the Board inadequate resources to carry out its responsibilities under the Act. Therefore, employment increases were necessary both in 1982 and 1983. Employment increased by only 5 from 1983 to 1984.

Figure 8

TOTAL EXPENSES

FEDERAL RESERVE BOARD

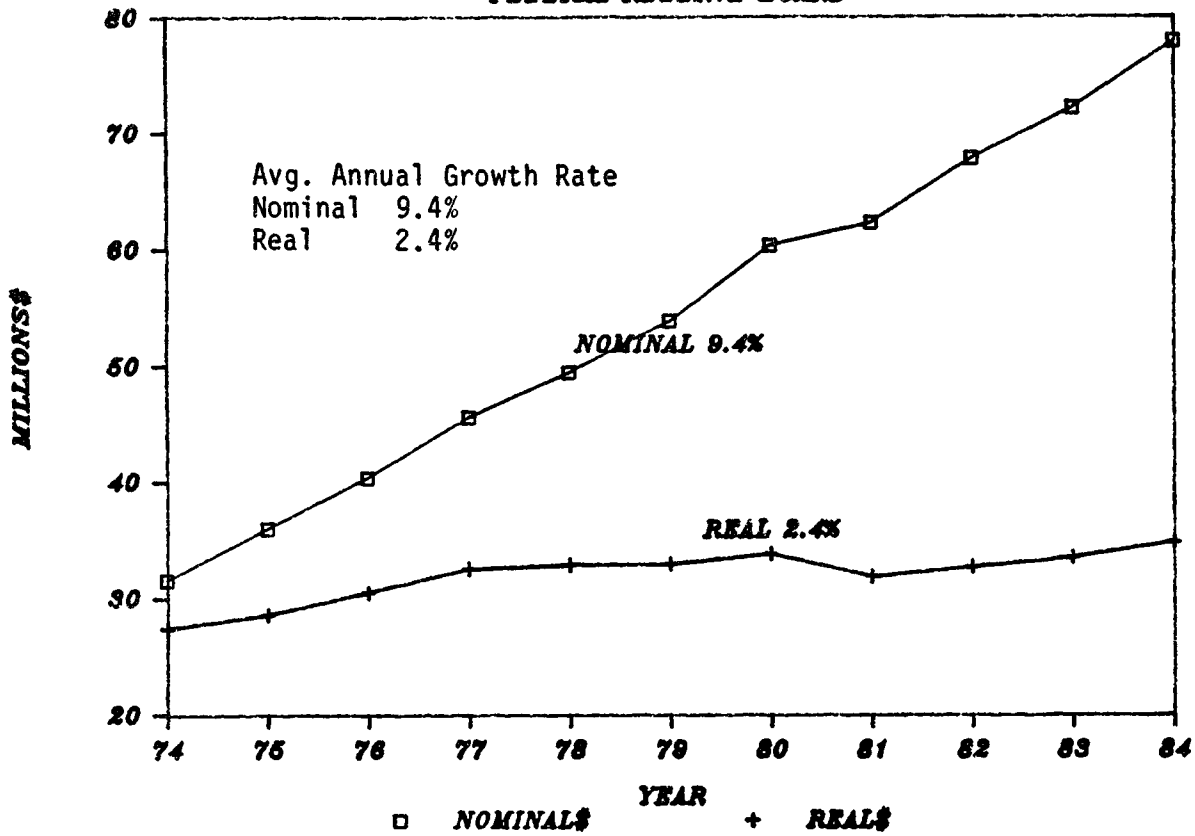
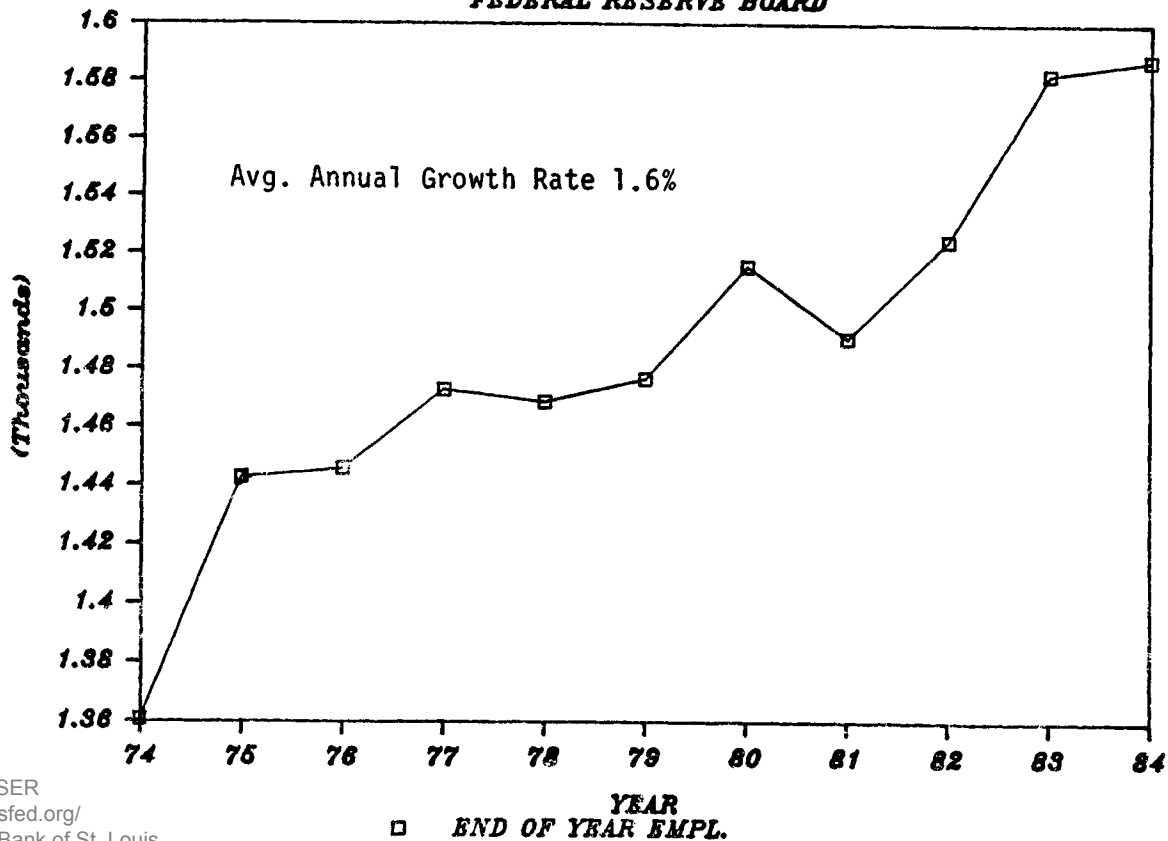


Figure 9

TOTAL EMPLOYMENT

FEDERAL RESERVE BOARD



Expenses increased at a greater rate than employment in the last two years due to purchase and lease of automation equipment designed to enhance productivity. In addition, the System's long-range automation program and the MCA required the Board's computers to be upgraded and more staff were added to the Division of Data Processing to support the long-range automation program.

Board Expenses and Employment by Program Structure

Expenses and employment from 1977 to 1984 by the major functional categories of the Board program structure are discussed below. Expenses in the largest category, System Policy Direction and Board Support were \$18.5 million and employment totaled 543 in 1977. From 1977 to 1984, expenses grew by a moderate 6.9 percent, or -0.1 percent in constant dollars, while employment grew by 13 or 0.3 percent per year. Expenses in this category fluctuated greatly during the period primarily because of wide swings in the cost of living adjustment for retirees.

Cost containment measures for utilities, mail and facilities support held the increase in controllable expenses to minimal levels during the period and employment actually was lower in 1982 than in 1977. Expenses and employment grew at a faster rate in the last three years of the period because of the data processing costs resulting from the administration information retrieval system, a program designed to integrate administrative data bases, reduce duplication of effort, and lower costs.

The Formulation of Monetary Policy Category is the second largest at the Board. In 1977, expenses totaled \$16.3 million with 579 employees. From 1977 to 1984, expenses increased 7.9 percent--or 0.9 percent in constant dollars--on an average annual basis and employment increased 0.3 percent. The

expenses and employment levels for this category increased at a very low rate from 1977 through 1979 (8.4 percent and 0.3 percent, respectively). The Credit Restraint Program and Monetary Control Act of 1980 resulted in significant increases from 1979 to 1981. Expenses and employment increased on an average annual basis by 11.4 percent and 3.0 percent, respectively. The increases were primarily associated with new data processing reporting series. Employment actually declined from 1981 to 1984 (-27 or 4 percent) and the rate of increase in expenses declined to 5.3 percent, primarily reflecting the completion of developmental work for data processing projects to support MCA.

The Supervision and Regulation Function has been the fastest growing area at the Board since 1977. Expenses have increased at an average annual rate of 12.3 percent per year from 1977 to 1984, or 5.1 percent in constant dollars, and employment rose by 73 or 4.1 percent on an average annual basis. Consumer legislation in the early years of the period and, more importantly, the Financial Institutions Regulatory and Interest Rate Control Act in 1978 resulted in steady increases in expenses and employment from 1977 through 1980. Problems of financial institutions, and research to keep ahead of changes in the banking industry also led to sharper increases in employment and expenses from 1980 through 1984 than the rest of the Board experienced.

Expenses and employment in the Financial Services to the System, Government and Public Function grew at moderate pace from 1977 through 1982. Expenses increased on an average annual basis by 2.8 percent and employment increased by 7 or 1.3 percent per year. In 1983 and 1984, expenses increased by 20 and 17 percent respectively, in response to requirements to oversee System efforts in pricing. These are expected to moderate considerably. In the 1977-1984 period expenses grew at an average annual rate of 7.0 percent or 0.1 percent in constant dollars.

Table 16
Board Expenses and Employment by Major Function
(dollars in millions)

	<u>Monetary Policy</u>		<u>Supervision & Regulation</u>		<u>Financial Services</u>		<u>System Policy</u>	
	<u>Exp.</u>	<u>Emp.</u>	<u>Exp.</u>	<u>Emp.</u>	<u>Exp.</u>	<u>Emp.</u>	<u>Exp.</u>	<u>Emp.</u>
1977	\$16.3	579	\$5.8	228	\$5.0	109	\$18.5	543
1978	17.9	574	7.5	242	4.4	108	19.7	545
1979	19.1	583	8.4	258	4.9	103	21.5	497
1980	21.7	629	9.5	268	5.1	117	23.8	502
1981	23.7	618	10.1	268	5.7	111	23.0	494
1982	25.0	617	11.1	273	5.8	116	26.0	524
1983	26.8	610	11.8	290	6.9	134	26.7	549
1984	27.6	591	13.0	301	8.1	140	29.3	556
Avg. Annual Growth 1977-1978	7.9%	.3%	12.3%	4.1%	7.0%	3.6%	6.9%	.3%
Constant Dollars	0.9%		5.1%		0.1%		-0.1%	

Note: Service lines have been adjusted to include the same services for comparability over time and include estimated capital depreciation.

IV. Description of PACS Performance Measures

Starting in 1978, the Federal Reserve implemented an approach for summarizing its costs per unit of output in individual activities to provide a bottom line for operations. Summary measures are produced both of change in cost of the System and individual districts, and of comparative levels of cost among Districts.

Two main benefits are provided by these summary measures. First, senior management can use them to track and communicate the total results of operations. Second, the summary measures put in perspective cost levels achieved in each individual activity, with small activities receiving relatively little weight and larger activities receiving proportionately greater weight.

General Description

Two types of cost measures are provided--a time-series scale measure and a cross-sectional or inter-District measure. The time series measure compares the expense of producing this year's volume of products with last year's cost levels, and is expressed as a percent change in cost. The cross-sectional measure compares each District's expense with that of producing the District's volume at System-average cost levels.

Relation to PACS

The summary cost measures are constructed from the Federal Reserve's cost accounting system--PACS. They summarize, in dollar and percentage terms, each District's performance. The measures may be used alone, or in conjunction with the detailed cost accounting information which they summarize. Analytical tables are produced which tie the summary measures back into each individual activity and type of expense.

The summary measures include total costs. PACS also provides narrower unit cost concepts such as production costs and productivity measures such as output-per-manhour. These additional measures of cost and productivity may be summarized into aggregate measures.

Productivity

An aggregate unit cost index, composed of more than 20 activities with measurable volume outputs, may be the best overall measure of operating efficiency. This statistic is a weighted index and accordingly is more heavily impacted by developments in the larger operating units, especially commercial check operations, the largest single operation of the Reserve Banks. Due to changes in accounting methods, and in operations themselves, a time span limited to five years is utilized for the time series. Expenses for monetary & economic policy and supervision and regulation are not included in the index because there is no suitable measure of volume output.

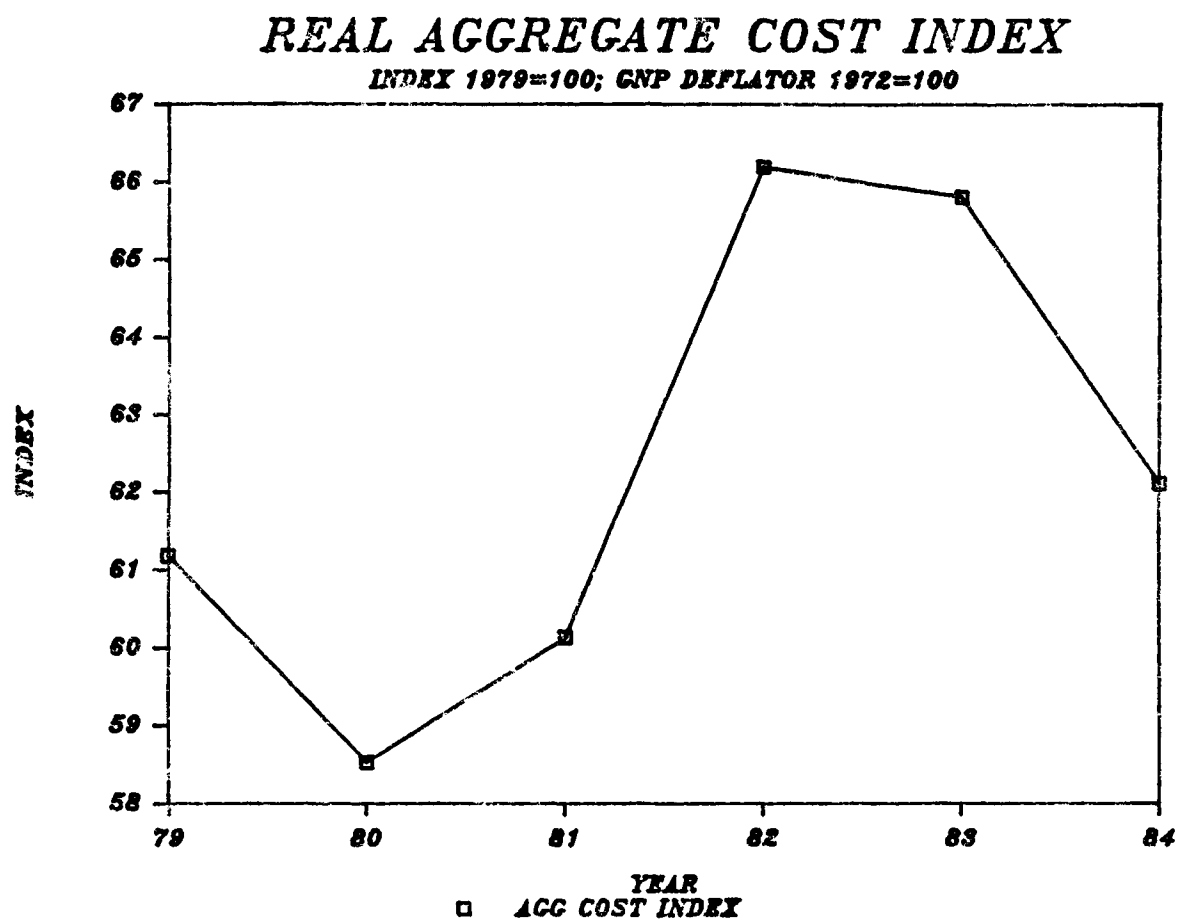
Table 17 shows the pattern of year-to-year changes in the aggregate volume of Reserve Bank operations, as well as aggregate unit costs adjusted for inflation. As Table 17 and Figure 10 indicate, following passage of the MCA and the imposition of pricing, aggregate volumes in the services to financial institutions area declined in 1981 and 1982. While resource adjustments were made, unit costs increased somewhat in 1981 and markedly so in 1982, largely because of the difficulty of reducing fixed costs in the short run. However, over the last two years--partially as a result of increased volumes as well as resource adjustments--unit costs have declined significantly, a pattern that is expected to continue in 1985.

Table 17

Aggregate Unit Cost and Aggregate Volume 1979-1983
(Time Series 1979=100)

Year	Aggregate Volume		Real Aggregate Unit Cost	
	Index	Percent Change	Index	Percent Change
1979	100.00		61.19	
1980	108.41	8.4%	58.53	-4.3%
1981	104.92	-3.2	60.14	2.8
1982	98.07	-6.5	66.91	11.3
1983	102.02	4.0	65.80	-1.7
1984	108.78	6.6	62.12	-5.6

Figure 10



IV. The Federal Reserve System's 1985 Budget

In late 1984 the Board of Governors approved 1985 budgets for the Reserve Banks and the Board with total spending of about \$1.2 billion. Actual spending in 1984 totaled \$1.14 billion. Thus the 1985 budget provides for a maximum increase of about 5 percent (See Table 18). Given expected increases in workload, this 5.1 percent budget increase will require significant cuts in some areas. The budget increase is for all Federal Reserve services, priced and nonpriced, including Reserve Banks and the Board of Governors. After fees for services to depository institutions, expenditures are expected to grow by about 3.6 percent.

System employment is projected to increase by 82, or 0.3 percent in 1985.

Table 18
Federal Reserve System Expenses
1984 Actual - 1985 Budget

	<u>1984</u>	<u>1985</u>	<u>% Change</u>
Monetary & Economic Policy	130.2	131.7	1.1
Services to Treasury & Government Agencies	129.4	140.6	8.6
Services to Financial Institutions	728.2	757.9	4.1
Supervision and Regulation	<u>158.1</u>	<u>174.4</u>	<u>10.3</u>
TOTAL	1145.7	1204.4	5.1

NOTE: These data are for Reserve Banks and Board of Governors expenses excluding currency costs. As discussed previously the data are derived from two separate accounting systems. For comparability over the time periods estimates were made to allocate expenses into major programs and for the Board of Governors which accounts for only 7 percent of the total expenditures.

Table 19
Federal Reserve System Employment
1984 Actual - 1985 Budget

	<u>1984</u>	<u>1985</u>	<u>% Change</u>
Reserve Bank ¹	22,669	22,809	0.6
Board of Governors ²	<u>1,588</u>	<u>1,530</u>	<u>-3.7</u>
TOTAL	24,257	24,339	0.3

¹ Average number of personnel.

² End of year employment.

This overall increase provides significant variation in budgeted expenditures among functions. For example, spending on monetary and economic policy is expected to increase by about 1.0 percent in 1985. This continues the pattern of reduced spending in this function that started in 1984 after the cost bulges resulting from the Monetary Control Act and contemporaneous reserve requirements had been absorbed. As explained earlier the largest single component of costs in this area is for data collection and preparation.

Expenditures in services to financial institutions and the public are expected to grow by about 4.1 percent. Approximately two-thirds of expenditures in this area are for priced services and are budgeted to rise by 4.4 percent. Just as in 1984, all costs associated with priced services including the cost of float and the PSAF are expected to be recovered.

Expenditures in the nonpriced component of services to financial institutions and the public are budgeted to increase by about 3.4 percent. The principal reasons for this growth in spending are increases in the volume of currency and coin handled by the Reserve Banks and the rise in postal costs.

Spending on services for the U.S. Treasury and other government agencies is budgeted to grow by 8.6 percent. More than two-thirds of this anticipated increase is the result of a new system which will provide computer automated recordkeeping for Treasury notes and bonds held by individuals. This "book entry" approach is already used for Treasury securities held by institutions and for Treasury bills held by individuals. Its extension to Treasury notes and bonds held by individuals is expected to yield substantial savings to the Treasury. This new approach will also provide improved service to individuals buying Treasury notes and bonds and eliminate the need for safekeeping actual paper instruments.

Reserve Banks

The 1985 Reserve Banks' budget allows for an overall increase of \$54.5 million, or 5.1 percent, and an employment increase of 141 or 6.2 percent.

Table 20
Reserve Bank Expenses by Service Line¹
1984 Actual - 1985 Budget

	<u>1984</u>	<u>1985</u>	<u>% Change</u>
Monetary & Economic Policy	99.4	98.4	-1.0
Services to Treasury & Government Agencies	126.3	137.0	8.5
Services to Financial Institutions	701.5	730.3	4.1
Supervision and Regulation	<u>140.7</u>	<u>156.7</u>	<u>11.4</u>
TOTAL	1067.8	1122.3	5.1

¹ Includes support and overhead allocation.

Table 21
Reserve Bank Employment by Service Line¹
1984 Actual - 1985 Budget

	<u>1984</u>	<u>1985</u>	<u>% Change</u>
Monetary & Economic Policy	826	833	.8
Services to Treasury & Government Agencies	1,798	1,825	1.5
Services to Financial Institutions	8,395	8,441	.5
Supervision and Regulation	1,885	1,903	1.0
Support	4,340	4,390	1.2
Overhead	<u>5,424</u>	<u>5,417</u>	<u>-0.1</u>
TOTAL	22,668	22,809	0.6

Expenses in the Monetary and Economic Policy service line are budgeted to decline by approximately \$1 million or 1.0 percent, and staff is expected to increase by 7 or 0.8% above the 1984 level. The expense decrease is a result of declines in overhead and System project costs, primarily due to completion of the Contemporaneous Reserve Requirement (CRR) System Project. The direct and support expense increases reflect expanded office automation projects in most districts and increased automation efforts for economic modeling and forecasting.

Expenses in Services to the U.S. Treasury and Government Agencies are budgeted to increase by \$10.7 million or 8.5 percent over the 1984 level. Staff is expected to increase by 27 or 1.5 percent. Of the expense and employment increases, \$5.3 million and approximately 33 personnel are associated with the Treasury Securities Access Book Entry System (T-DAB).

Expenses in Services to Financial Institutions and the Public, both priced and nonpriced, are budgeted to increase \$28.8 million or 4.1 percent, and employment is expected to increase by 46, or 0.5 percent. Nonpriced services' expense and employment increases are primarily due to volume increases in both currency and coin, and the impact of open access policy. Priced services expense increases are primarily in commercial check, transfer of account balances, and automated clearing house operations.

Expenses in Supervision and Regulation in 1985 are budgeted to increase \$16 million or 11.4 percent over the 1984 level. Employment is expected to increase by 8, or 1.0 percent. The rise in expense will result from an increase in the allocation to Supervision and Regulation of the Integrated Accounting System projects; however, this increase is offset by several Districts' plans to reduce staff.

Board of Governors

Total expenses for the Board of Governors are projected at \$3.9 million, or 5 percent increase, over the 1984 level. These figures include a \$4.75 million depreciation expense. Employment is expected to decrease by 58, or 3.7 percent.

Table 22
Board of Governors Expenses¹
1984 Actual - 1985 Budget

	<u>1984</u>	<u>1985</u>	<u>% Change</u>
Monetary & Economic Policy	27.6	29.9	8.3%
Supervision and Regulation	13.0	13.3	2.2%
Financial Services	8.1	8.8	9.3%
System Policy and Board Support	<u>29.3</u>	<u>29.9</u>	<u>1.9%</u>
TOTAL	78.0	81.9	5.0%

¹ Includes depreciation expense. Figures may not add due to rounding.

Table 23
Board of Governors Total Employment
1984 Actual - 1985 Budget

<u>1984</u>	<u>1985</u>	<u>% Change</u>
1,568	1,530	-3.7

Expenses in the Monetary and Economic Policy category at the Board will rise \$2.3 million, or 8.3 percent. The largest elements of this increase are associated with the development costs of the resource shared application project (STAT) and the allocation of costs, including depreciation, for the contingency processing center.

Expenses in the Supervision and Regulation category are budgeted to increase by \$300,000 or 2.2 percent. Increases in this area are being offset by reductions in the volume of work of the Division of Consumer and Community Affairs and a decrease in the use of data processing resources.

The financial services categories are budgeted to increase by \$700,000 or 9.3 percent. The major cause of the increase is the improvement to the planning and control system (PACS), which will facilitate comparison of revenue and expense projections with actual data as they become available.

System Policy and Board Support costs are budgeted to rise by \$600,000, or 1.9 percent. The relatively modest size of the increase is associated with reduced nonpersonal costs in 1985 for publications and repairs and alterations for the Board's facilities.