Federal Reserve Bank of San Francisco

Annual Report 1974

Contents

From the Boardroom

The Federal Reserve's sixtieth year was one of the most difficult in its entire history. Like other institutions, the nation's central bank was forced to deal with an accelerating inflation in early 1974 and a decelerating level of business activity in the later months of the year, along with a continuing crisis in energy usage. The pressures on the financial community at times became intense. Despite a developing recession, commercial banks faced record money rates which were caused, at least in part, by severe inflation and heavy business-credit demands.

The banking system nonetheless performed very creditably in the face of these difficulties. For example, banks in the San Francisco (Twelfth) Federal Reserve District recorded a 10-percent increase in loans and investments in 1974, to a year-end total of $104 billion. Many major national firms turned increasingly to District banks, after encountering difficulties in the capital and commercial-paper markets, and after exhausting their lines of credit at money-center banks elsewhere. Serious problems developed at a few banks, but that cannot dim the banking system's overall accomplishment in meeting the essential credit needs of the business community.

The range of maneuver for policymakers remained quite limited throughout 1974. The Federal Reserve System attempted to fight inflation and to moderate excessive loan demand without worsening an economy that was sinking into recession. In our participation in this policymaking process, we remained keenly aware of the central bank's need to reconcile sometimes conflicting economic objectives, and of its need to act as the lender of last resort in the event of severe problems in the banking industry.

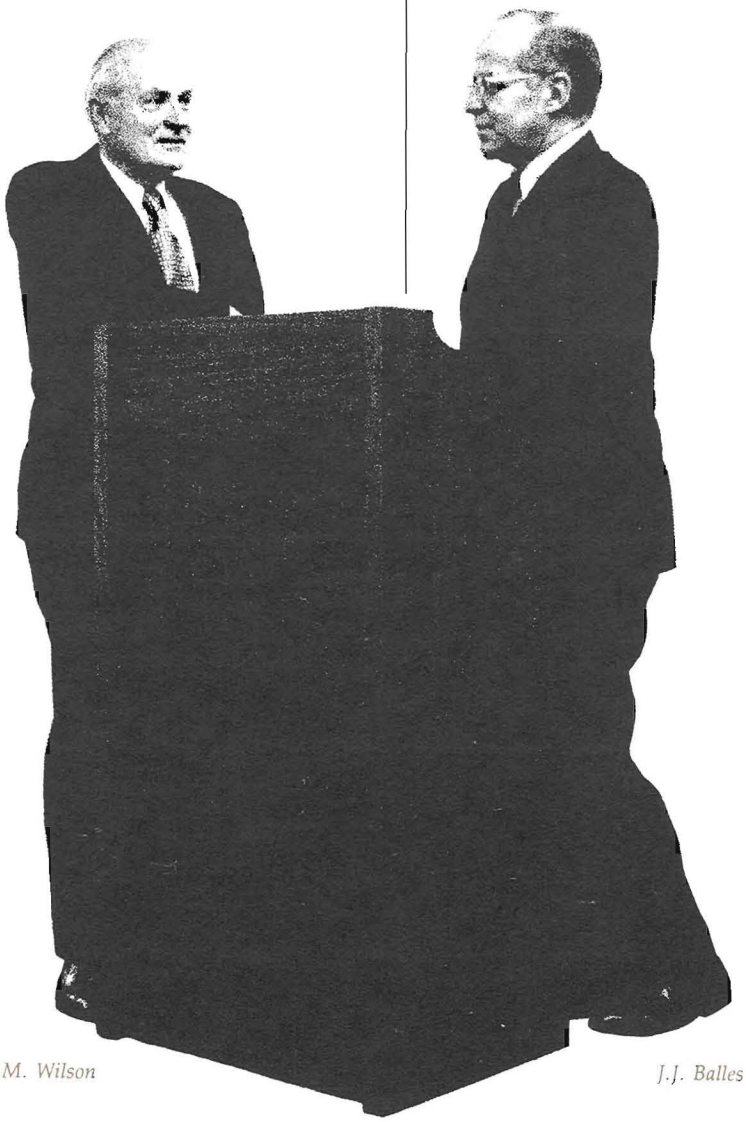
Inflation, recession and credit stringency were worldwide phenomena in 1974, strongly affecting the activities of the international-banking community. President Balles made an extended tour of Far Eastern capitals last spring, to confer with foreign monetary authorities and commercial bankers on matters of mutual interest, particularly the regulation of foreign banks in both those countries and the U.S. The information gathered on that tour helped contribute to the formulation of legislation designed to extend Federal regulation, on a nondiscriminatory basis, to all foreign banks operating inside this country.

Our Bank completed a major improvement in the money payments system last year, with the establishment of regional check-processing centers at all offices to provide overnight processing and settlement of checks in their individual service areas. But realizing that the trend of the future may lie with an electronic payments system, we encouraged the staff to follow up on such initiatives as the electronic processing of Air Force payroll checks, which became operational at our California offices last fall. We also supported the smooth daily performance of the expanding Western economy, through the continued provision of fiscal, coin, currency and other services. With the assistance of a major consulting firm, we introduced a Productivity Improvement Program — a fundamental overhaul of internal Bank operations — in an attempt to improve cost effectiveness and to develop more clearly defined jobs and improved working conditions. Through this program, we plan to handle significant increases in workload without unacceptable cost increases.

Our appreciation goes to the financial, industrial and community leaders who served as directors in 1974, helping to guide the Bank through that very difficult year. In particular, we wish to thank those who completed terms as directors during the period: Mas Oji (President, Oji Brothers Farm, Inc.) at Head Office; Leland D. Pratt (President, Kelco Company) at Los Angeles; Roderick H. Browning (President, Bank of Utah) at Salt Lake City; and Robert C. Whitwam (President, American National Bank of Edmonds) and C. Henry Bacon, Jr. (Vice Chairman, Simpson Lumber Company) at Seattle. Finally, we wish to express our appreciation to our officers and staff, whose dedication to the improved effectiveness of Bank operations has enabled us to better serve the financial community and the general public.

O. Meredith Wilson
Chairman

John J. Balles
President



O.M. Wilson *J.J. Balles*

First Year of Recession

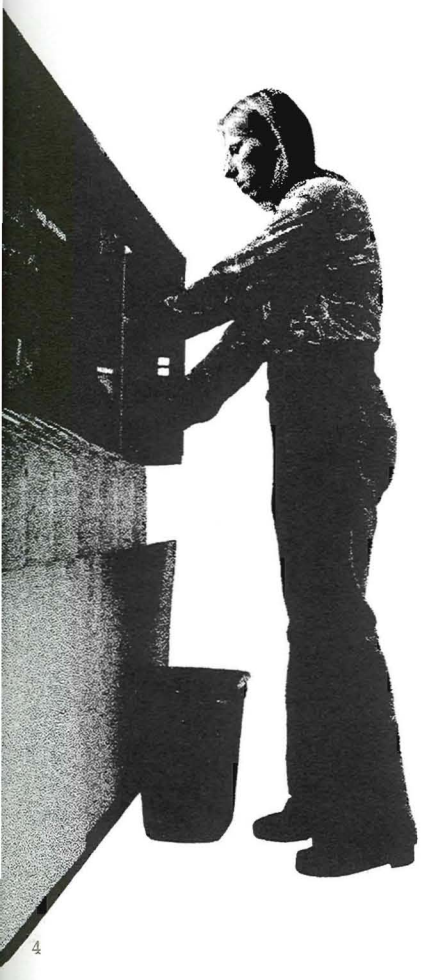
Nineteen seventy-four was a year of recession, with a 2-percent decline in real (price-adjusted) GNP, but the evidence was mixed on this score until fairly late in the year. The year began with the crunch of the oil embargo, as autos, petrochemicals and travel-related industries felt the effects of the sudden cutoff in imported crude oil. However, many observers blamed the resulting adjustment solely upon supply constraints, in a national economy that was operating right up against the limits of physical capacity. In this view, business activity would recover quickly—would snap back like a "plucked fiddle string"—once the oil spigot was turned on again.

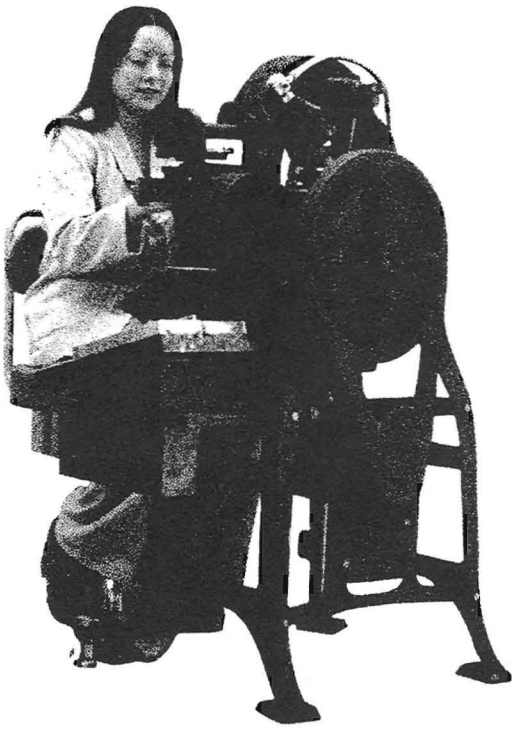
The economy appeared to follow this scenario until after midyear, except in such obvious problem areas as autos and housing. Industrial production staged a modest recovery from its winter low, unemployment remained relatively stable, and the earlier job expansion continued unabated. But then, in late summer, the classical signs of recession became quite evident, and semantic arguments about the application of the term to the 1974 economy were quickly forgotten. In the fourth quarter alone, real GNP dropped at a 9-percent annual rate, while more than 1 million jobs disappeared and the jobless rate soared from 5.8 to 7.1 percent of the civilian labor force.

To make things worse, the nation was beset during 1974 with the worst inflation of the past quarter-century, measured by a 10-percent jump in the general price level. Energy costs shot up during the embargo period, and a pervasive run-up in prices developed after the dismantling of Phase IV controls in early spring. Food prices slowed down for a while, but then began climbing again in late summer as bad weather cut into crop production. The one bright spot was in raw industrial commodities, where prices started easing as capacity utilization rates declined.

Western jobs and jobless

The same pattern of activity prevailed in the San Francisco Federal Reserve District, which encompasses the one-sixth of the national economy west of the Continental Divide. (District states include Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Utah and Washington.) The number of Western workers expanded during the year, but so did the number of jobseekers, and the





jobless lines eventually stretched as long as they did at the peak of the last recession. Total personal income increased substantially, but consumer prices rose even faster, so that family income and consumption actually declined in real terms. Factory output held up fairly well until late in the year, while farm production soared on the strength of heavy worldwide demand for Western food products.

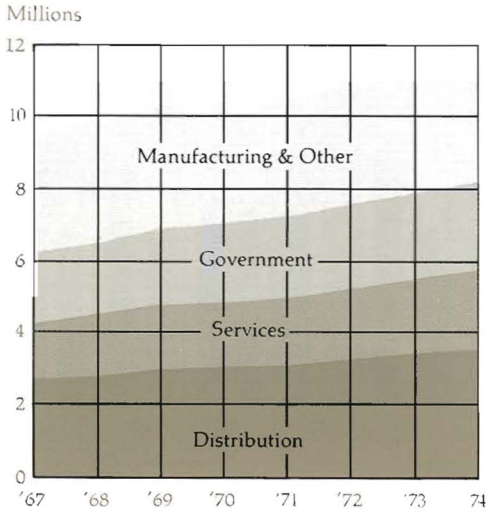
Total employment increased about 2 percent for the year, to 13.0 million, or somewhat faster than the national pace. However, employment was relatively stagnant in many major industries, and one-half of the total increase was due to only two industries, services and state-local government. Besides, these gains were not sufficient to absorb all entrants into the labor force, so that the average unemployment rate rose from 7.2 percent to 8.5 percent over the course of the year. (On the other hand, the 1974 average was in line with the 1973 figure.) At year-end, 24 of the 34 metropolitan areas in the West were classified as areas of substantial or persistent unemployment, and almost all signs pointed to a further deterioration of the job market.

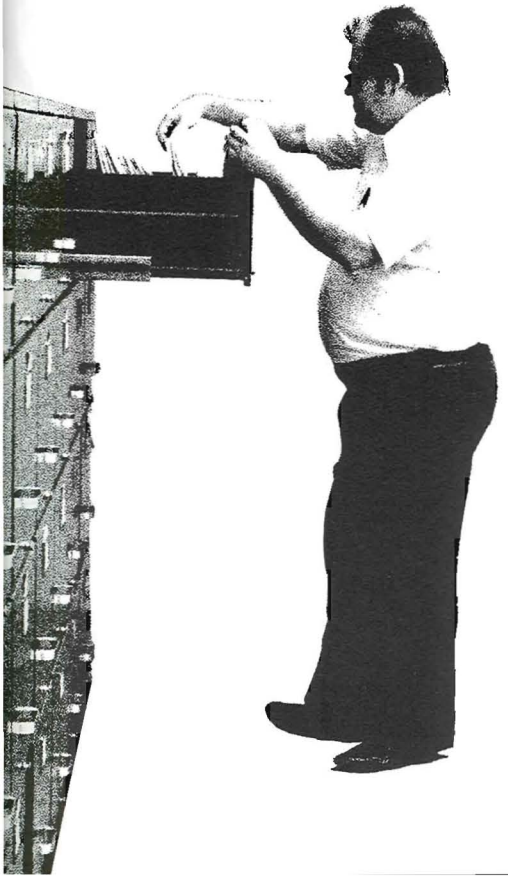
The regional unemployment rate has exceeded the national rate throughout the past decade, and the gap has actually widened to almost two full percentage points in the past several years. A number of structural factors have helped account for this problem—the relatively large number of persons who migrate westward in search of work, the relatively young age composition of the labor force, and an industrial composition based on activities that are either highly seasonal (food processing and lumber) or highly cyclical (defense-aerospace and lumber). The situation has been aggravated in the past several years by the slow recovery of the key aerospace industry from the severe slump it went through at the beginning of this decade.

Strong and weak points

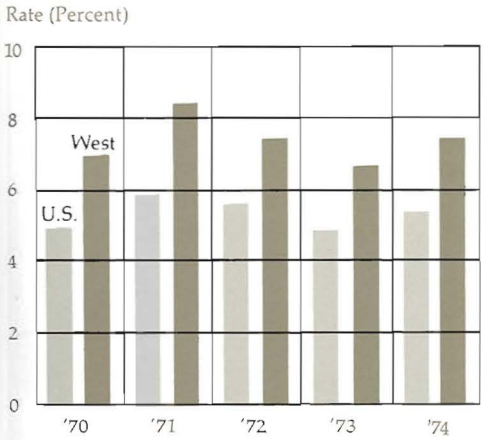
Manufacturing output in 1974 held close to the 1973 level, although the trend was decidedly downward during the final months of the year. Food processing and other nondurable-goods industries raised their output about 3 percent for the year, but durable-goods production fell about 2 percent despite isolated sources of strength such as primary metals. In most Western industries, production gains were somewhat smaller than in the previous year.

Regional employment rises modestly in '74 . . . most of gain in services and local government





Unemployment remains far worse in West than in rest of nation



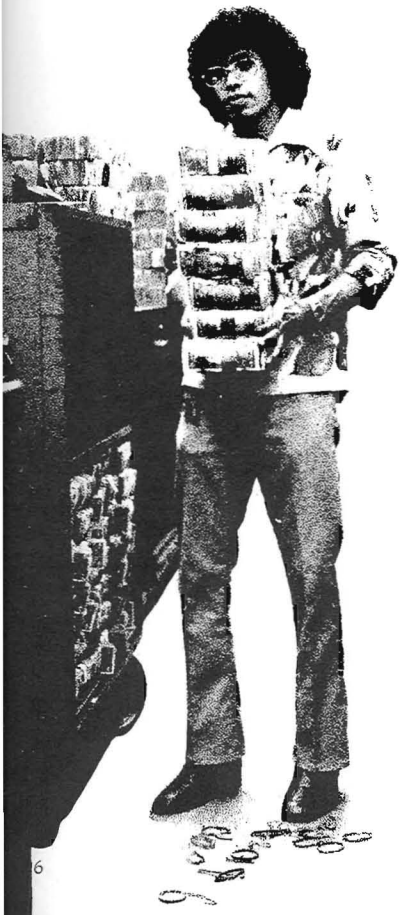
The foreign-trade sector was a very bright spot in an otherwise undistinguished business scene. Western ports boomed for the second straight year with a sharp gain in the export trade to almost $18 billion—more than double the level of two years ago—on the basis of a very strong performance by farm exports and commercial-aircraft shipments. But imports rose even more rapidly than exports to $20 billion, bolstered by the surging prices of oil and other raw materials.

Consumers and governments

Personal income expanded to about $188 billion—a rise of about 10 percent, or close to the year-earlier performance—but as in the nation generally, the gain was outpaced by an 11-percent rise in consumer prices. Consumer buying (and consumer borrowing) increased at only about half the 1973 pace. This performance reflected the severe slump in durable-goods purchases; total retail sales rose about 6½ percent, but durable sales dropped 2 percent in response to plummeting new-car sales.

Western state and local governments, like their taxpaying constituents, were forced to cut their cloak to fit the reduced amount of available cloth. Despite double-digit inflation, California's state government budgeted a 7½-percent increase in spending for fiscal 1975, and under new management, only a 6-percent increase (to $11.3 billion) for fiscal 1976. The same type of hold-down on construction programs and government services was evident in the budget planning of other jurisdictions.

Governmental planners in this region, as elsewhere in the nation, had achieved substantial surpluses in the early 1970's because of tax-rate increases, the availability of Federal revenue-sharing funds, and the easing demand for certain services, especially education. Within the past year, however, this surplus situation disappeared. The turnaround developed because of an inflationary upsurge in government costs and a recession lag in tax receipts, as well as an unexpected lag in revenue-sharing funds due to pay-out schedules which failed to take account of inflation.



In this tightening fiscal situation, governmental agencies turned increasingly to the capital market to finance their growing needs. Bond sales of Western state and local governments rose 10 percent to a record $3.5 billion during the year, despite all the problems of finding funds in 1974's crowded credit markets. But the cost of financing was not cheap; the average yield on rated general-obligation issues rose from 5.13 percent in 1973 to 5.89 percent in 1974, and the average reached 6.56 percent at the midsummer peak.

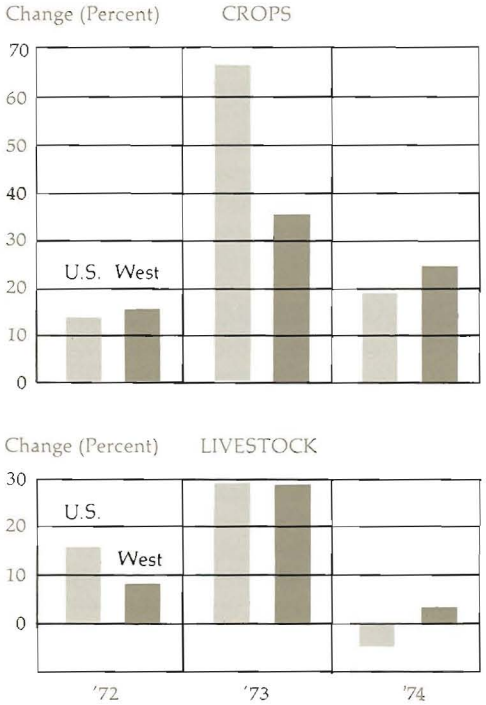
Bountiful agriculture

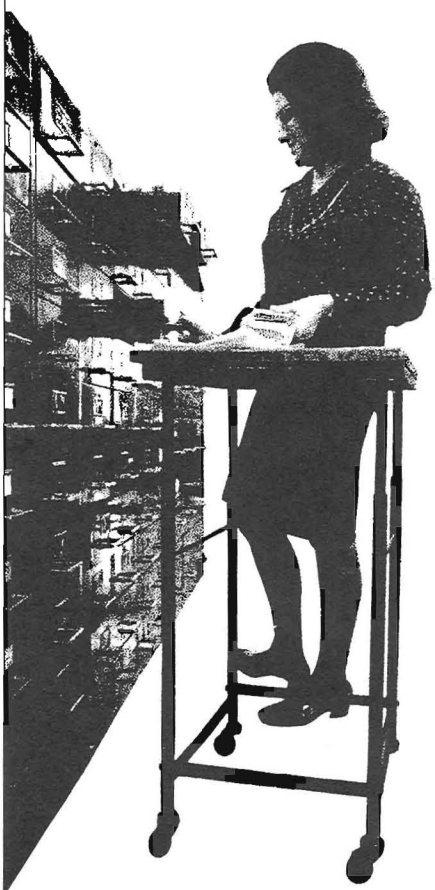
The farm year was bountiful—a year of bumper crop production and rising livestock output—but it was also a year of strain under the pressures of rising costs, supply shortages and tumbling livestock prices. Net farm income was close to the year-before level of $3.9 billion, in contrast to the sharp decline recorded nationally. Western farmers could thank the elements for much of this bounty, since they enjoyed very favorable growing weather while their counterparts elsewhere were hampered by the worst growing conditions in decades.

The farm sector generated over $14 billion in cash receipts, up 14 percent from the previous record of 1973. Most of this came from a sharp advance in crop receipts, due partly to record prices, but also to heavy output as crop records were smashed for the second straight year. Production of wheat, cotton, rice and other field crops rose very sharply, and the dollar value of exports of each of those three major commodities increased more than 70 percent in fiscal 1974. Indeed, the expansion of export sales was crucial to the regional farm prosperity; farm exports accounted for almost 18 percent of gross receipts, compared with 12 percent just two years earlier.

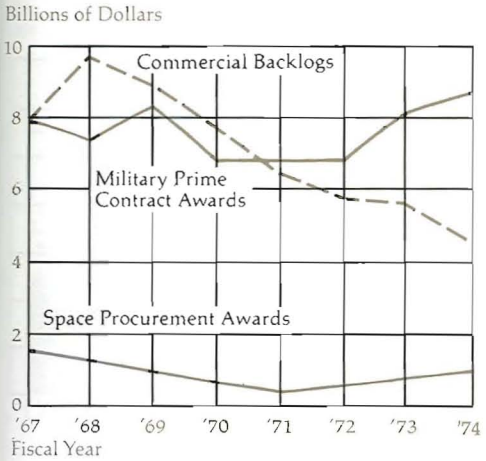
Ranchers, after a buoyant performance in 1973, posted only a modest gain in receipts in 1974. Meat production expanded rapidly, partly because of a record accumulation of animals on the farm, but also because of a fast-developing cost-price squeeze that forced ranchers to liquidate herds and reduce feeding operations. Livestock prices fell sharply after early spring, and cattle prices in particular were 22 percent below 1973 levels as the year ended. Feeding operations declined under the impact of weakening prices and soaring costs; indeed, by late fall placement of cattle and calves on feed fell one-third below year-earlier levels.

Crop receipts again advance strongly, but livestock hurt by falling prices





Aerospace sector benefits from military orders, but commercial business lags



Under the spur of the crop-production boom, Western farmland values rose 18 percent above the year-earlier level—the largest increase of the past two decades—and this gain was reflected in a 21-percent jump in real-estate loans at Federal Land Banks. The expansion of farm output, coupled with sharply higher costs of purchased inputs, meanwhile contributed to a 41-percent gain—double the national pace—in outstanding loans at Production Credit Associations.

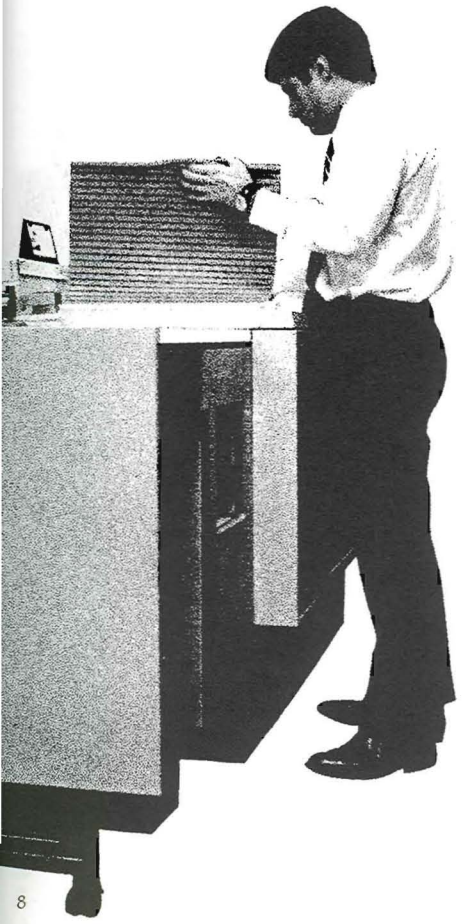
Sluggish aerospace

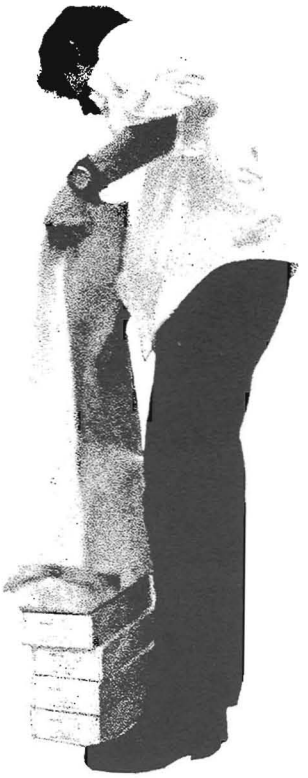
The crucial aerospace-and-electronics manufacturing industry expanded modestly during the year. (Even so, after three years of steady gains, aerospace employment remained almost 21 percent below its 1968 peak.) Military prime-contract awards rose almost 8 percent during fiscal 1974 to $8.8 billion, as the continuation of several major missile and aircraft programs again gave the regional industry a 27-percent share of the Pentagon's procurement budget. Space-agency awards to Western firms also rose significantly, primarily for the space-shuttle program, but 1974 awards (at $0.9 billion) amounted to less than one-half of the decade-ago peak.

Domestic orders for commercial aircraft declined, as rising fuel costs and falling passenger traffic caused the nation's airlines to hold down the size of their fleets of Lockheed L-1011's and Douglas DC-10's. On the other hand, some of this weakness was offset by the booming foreign market for older-generation Boeing 727's and 737's. After midyear, the recession began to cut into industrial and consumer markets for electronic equipment, while a fairly tight defense budget threatened to curtail a number of important military projects.

Falling building

The construction industry held up relatively well despite the continued slump in homebuilding, as total construction awards fell about 1 percent, to $16.4 billion, in contrast to a 6-percent decline nationally. Much of the strength came from the heavy-construction sector—water and electric-power facilities and the like—and from the construction of office buildings and other commercial facilities. In the residential sector, 1974 was a repeat of 1973. Indeed, Western housing starts dropped even faster in 1974—35 per-





cent—to 280,000 units, but still the number of houses under construction and the inventory of unsold housing remained quite high at year-end. Sales of mobile homes—the low-priced end of the market—declined 20 percent to about 70,000 units.

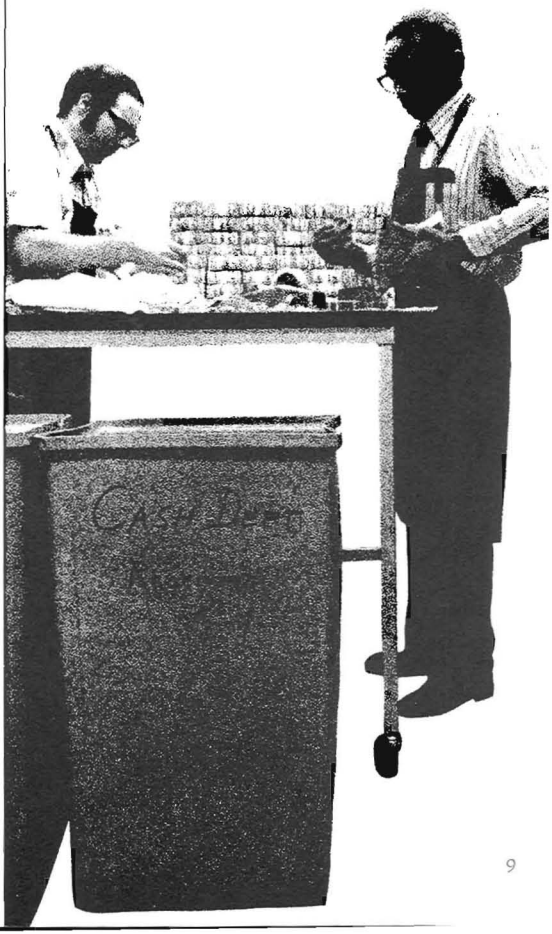
The continued uptrend in both the cost of new homes and the cost of home ownership, along with the shortage and high cost of mortgage credit, helped account for the depression in the regional housing industry. The average rate on conventional new-home loans reached a peak of 10.40 percent in early fall—up from 8.75 percent in a single year—reflecting the enormous demands placed on the credit markets as well as the reduced flow of funds into thrift institutions. Banks and savings-and-loan associations managed to increase their mortgage-loan portfolios, but at a much-reduced pace from the previous year. The lending situation improved in the late fall months as savings flows expanded and mortgage rates declined, but consumers' recession fears and the overhang of uncompleted and unsold units precluded any substantial near-term recovery in home-building.

The nationwide housing slump took a heavy toll of the Western lumber industry, forcing an 11-percent cut in production and heavy layoffs. The decline undoubtedly would have been even sharper but for the strength of the nonresidential-contruction market. This factor, along with a speculative buying flurry, helped push lumber prices to peak levels during the spring months. Total orders and prices then declined, slowly at first and later with increasing momentum, until at year-end softwood lumber prices were 19 percent below year-ago levels. The pulp-and-paper segment of the industry in contrast remained under heavy demand pressure throughout most of 1974, so that prices shot up 24 percent for the year. But as the recession deepened, paper mills as well as lumber mills were forced to curtail production and payrolls.

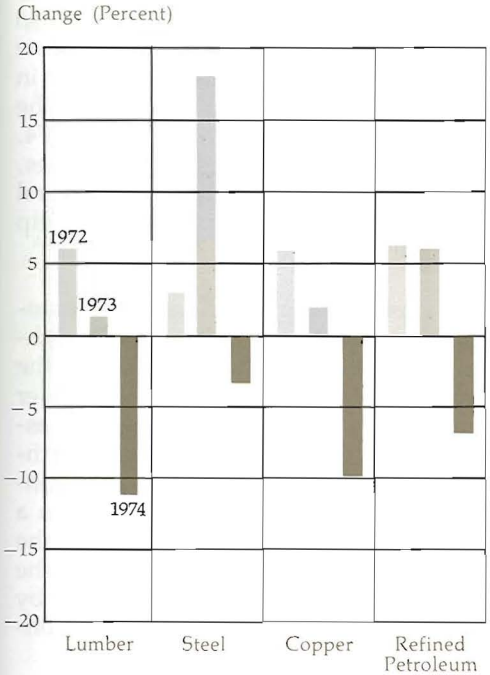
Strong metals

The regional steel industry had trouble keeping up with the inflow of orders last year, and its supply problems worsened as furnace breakdowns resulted from the all-out production pace. Output thus fell 3 percent below the 1973 pace to 7.1 million tons. To satisfy their heavy requirements, steel consumers then began to turn to foreign suppliers—increasingly so as these foreign firms began to quote lower prices in reaction to a slow-down in overseas markets. The profitability of the regional industry improved during 1974, reflecting a 25-percent rise in steel prices, and this led producers to launch several major plant-expansion programs to help meet future demand.

The Western aluminum industry maintained full-capacity operations throughout 1974, as demand strengthened in the early part of the year, and as hydropower for industry potlines again became assured after the end of the severe Northwest drought. Regional producers continued to produce heavily even when a late-year inventory buildup forced the shutdown of potlines in other areas of the country, and they were not affected by the recession until early 1975. Other non-



Lagging demand, plus supply problems, force production cuts in basic industries

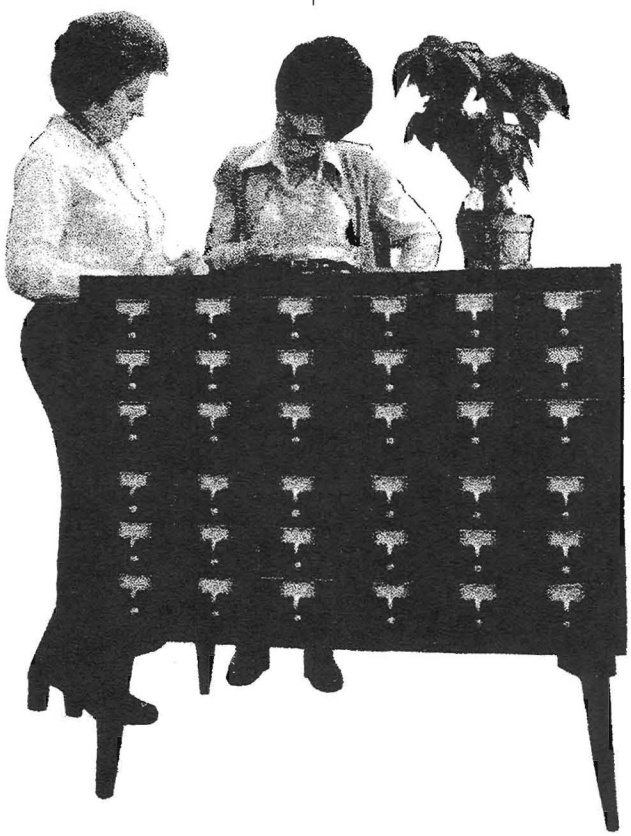


ferrous industries went through a similar (but stronger) cycle of shortages and speculative buying followed by producer inventory buildups and price declines. In copper, the early-year crunch was aggravated by fuel shortages, equipment breakdowns, strikes and other production problems. Prices of nonferrous metals soared to record levels during the spring period as the worldwide economic boom combined with widespread currency gyrations to spur industrial and speculative demand. But when the turn came, it came quickly and dramatically.

Silver, the historic Western metal, typified these up-and-down movements. Silver's price more than doubled to $6.70 an ounce in the first two months of the year, partly because of the strength of industrial demand, but mostly because of speculators' attempts to find protection against worldwide inflation and weakened currencies in the wake of the Arab oil embargo. The bubble burst after the embargo ended and the world economy turned sluggish, and prices benefitted little from the absence of silver byproduct supplies during the copper strike. By year-end the price was down to $4.27 as speculators turned away from silver in anticipation of the legalization of private gold ownership by U.S. citizens. Yet even at that reduced level, the price trend was very profitable for Western silver producers.

Reduced energy

Oil-refinery output lagged about 7 percent behind the year-ago pace, as a result of sluggish demand, a cut in foreign imports, and a continued decline in domestic crude production. Imports fell at an even faster pace than domestic output of crude, so that domestic sources increased their share of the total market to 55 percent. The import decline reflected the Arab oil embargo as well as reduced availability of Canadian and other crude, but it also reflected the cutback in regional consumption induced by soaring prices and conservation efforts. Prices of refined



products at year-end were 57 percent higher than a year ago, mostly because of the quadrupling of prices of imported crude oil.

The world oil crisis highlighted the potentialities of the Western storehouse of energy—and also highlighted the difficulties of exploiting that treasure trove. Attention centered on the 789-mile Trans-Alaska Pipeline, the principal means of reducing U.S. dependency on high-cost foreign imports in the latter part of this decade. As the Alaska pipeline boom finally got underway, six years after the discovery of the Prudhoe Bay bonanza, it touched off a frenzied pace of construction in Alaska and increased activity in supply centers such as Seattle, along with a petroleum-exploration program unrivalled in Western history. The upsurge in fuel prices also intensified interest in the exploitation of Rocky Mountain coal and shale-oil resources, but important technical and environmental issues, such as water availability and feasibility of strip-mining techniques, remain to be settled before full-scale development can begin.

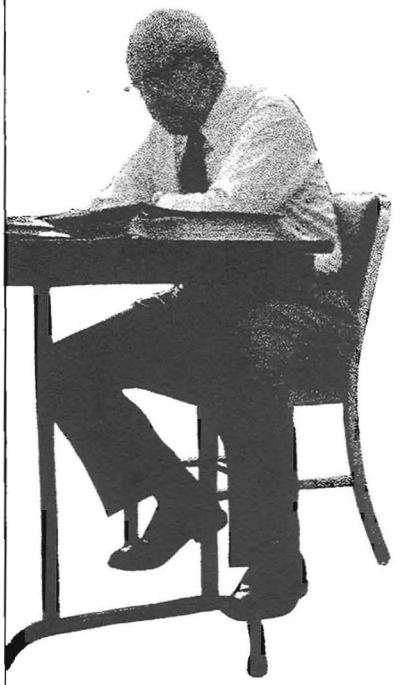
Because of the late-1974 downtrend in most regional industries, the new year opened on a gloomy recession note. Already suffering from an abortive recovery from the post-Vietnam aerospace slump, the Western economy now faces an increasingly weak demand for both its crude materials and finished products, and the results may be seen in jobless rates that are far higher than the national figure—that may reach, indeed, the highest levels in a generation. Still, the regional economy should benefit from the continued strong worldwide demand for food, and Western basic-materials producers may be the first to feel the favorable effects when housing, autos and other key national industries begin to turn around.

Another Year of Pressure

Although operating in a recession atmosphere, the nation's commercial banks in 1974 faced record money rates fanned by rampant inflation and heavy business-credit demands. The more successful banks adjusted well to this unorthodox mix, racking up record profits from a massive expansion in loans at record rates of return. Some other banks did not fare so well, however, because of sizable loan losses, large write-downs on securities, and major foreign-exchange difficulties. The strains which developed as the year progressed brought about a fundamental reassessment of bank goals, as managements shifted away from their earlier emphasis on asset growth and market expansion, and instead concentrated on the basic adequacy of bank capital structure.

After several months of relative stability in early 1974, the financial calm was shattered by sharply rising money rates which reached all-time highs in midsummer. Heavy business-credit demands converged on the nation's financial markets, and most importantly on the banks. Record demands for capital financing pushed up long-term rates to levels which diverted borrowing into interim bank loans, and severe strains in the commercial-paper market led to very high paper rates which further diverted business requests to the hard-pressed banks. Moreover, investor emphasis on the quality of securities made it difficult for many firms to raise funds through offerings of either short-term or long-term securities.

The worst strains developed around midyear, in the wake of the Con Edison, Franklin National Bank and Herstatt Bank crises. In that situation, wary investors avoided placing their funds with any but the largest and strongest banks, so that a tiered rate structure developed for the major sources of bank funds, such as large corporate deposits (CD's) and short-term interbank loans (Fed funds). Then, pressures began to ease in the fall months, as the recession deepened and as monetary policy became more accommodative. Money-market rates dropped rapidly, and this was followed by a decline in the prime business-loan rate.



Shifting policy

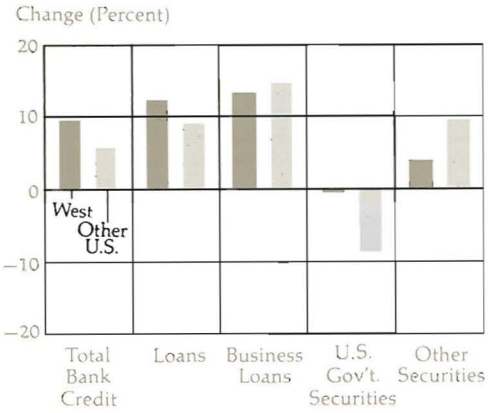
The Federal Reserve attempted to fight inflation and to moderate the excessive business-loan demand without worsening an economy that was sinking into recession. The narrowly defined money supply (M_1) grew at annual rates of 5.5 and 6.5 percent, respectively, in the first two quarters of the year, but at only a 1.6-percent rate in the July-September period, reflecting the impact of high interest rates and restrictive monetary policy earlier in the year. Then, as signs of a deepening recession became evident, Federal Reserve policy eased somewhat; at its October meeting, the Federal Open Market Committee sought "to achieve bank reserve and money-market conditions consistent with resumption of moderate growth in monetary aggregates over the months ahead," specifically with a growth rate of 4¾- to 7¼ percent in M_1. However, the money supply responded disappointingly with only a 4.3-percent rate of growth in the final quarter.

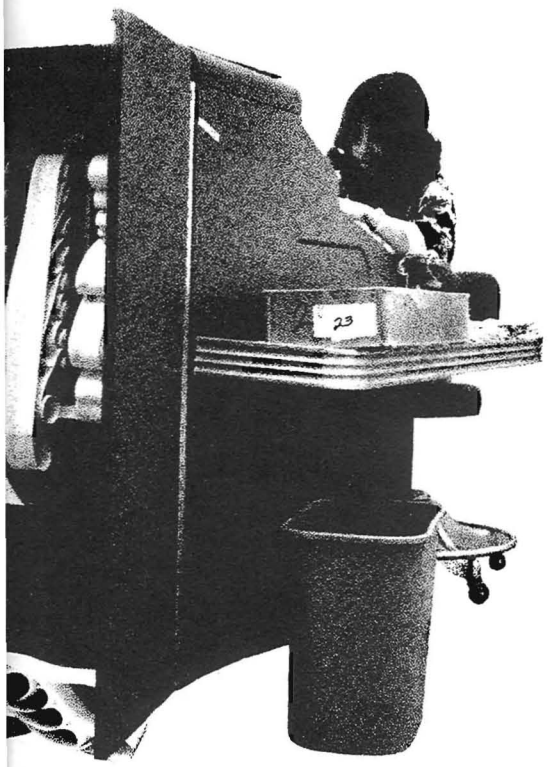
The Fed adjusted reserve requirements on time deposits in September and November, partly to lengthen the maturity structure of bank liabilities. But the November action and a later one in January included overt moves toward ease—reductions in reserve requirements on demand deposits ranging up to 1½-percentage points (to 16½ percent) on deposits of over $400 million. Also, the System reduced its discount rate on member-bank loans, in two steps, from the summer-fall peak of 8 percent to 7¼ percent just after year-end.

Despite 1974's exceedingly difficult economic environment, total bank credit nationwide increased to a record $686 billion—a $51-billion (8 percent) gain, almost all of which was recorded in the first half of the year. Loans accounted for the vast bulk of the increase; for the second year in a row, banks added only modestly to their security portfolios, largely because of a net reduction in holdings of U.S. Treasuries.

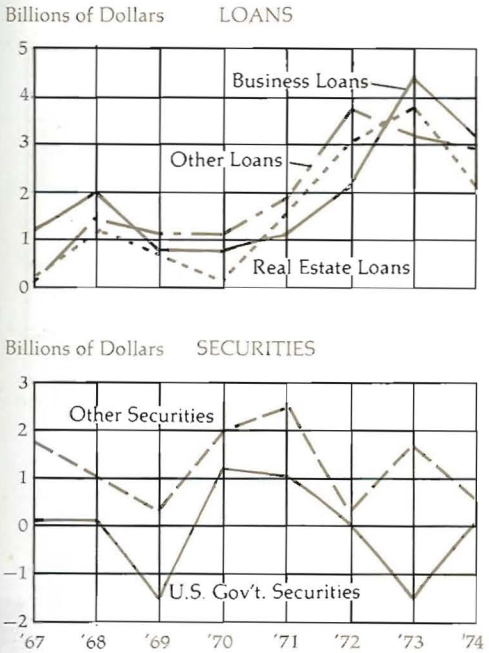
Business loans dominated the overall loan expansion with a $25-billion (16 percent) increase—almost equal to the massive 1973 expansion, despite an obviously weakening trend in the latter part of the year. This strong demand stemmed from

Bank credit expands, because of regional and national business-loan boom





Western banks put funds into business loans, at expense of other categories

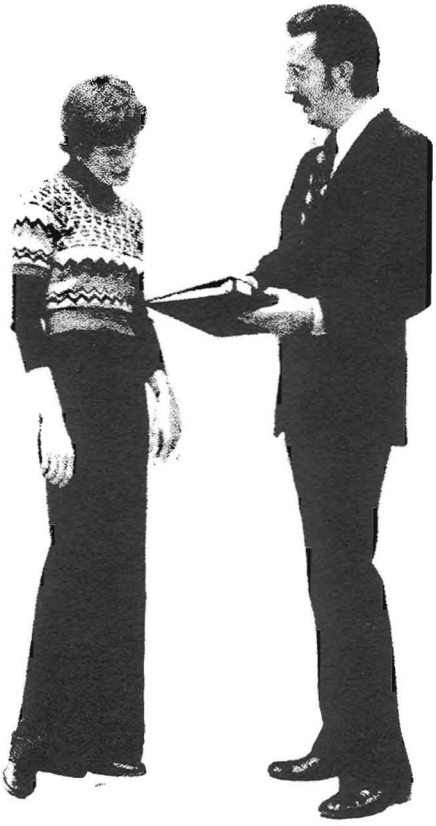


inflation-induced increases in operating costs, especially for carrying inventories and for meeting raw material shortages, and from delayed completion dates on business-investment projects. At times the pressure became severe as banks tried to accommodate the demand diverted from the capital and commercial-paper markets, but their task was eased to some degree by the sluggishness of mortgage and consumer-credit demand. The major source of funds for this nationwide loan expansion was a huge $29-billion (43 percent) increase in CD money, and temporary funds came from Federal Reserve Banks through the discount window and from other commercial banks through the Fed-funds market.

Financing the West

Western banks, amidst the turbulent business and financial scene, expanded total credit to $104 billion. This $9-billion (10 percent) gain fell short only of the record 1973 increase. Regionally as nationally, business loans dominated the statistics with a $3-billion gain, and at year-end they constituted 35 percent of total loan portfolios, close to the national ratio for the first time. Many national firms drew heavily on their loan commitments at District banks, after encountering difficulties in the capital and commercial-paper markets and/or exhausting their lines of credit at money-market banks elsewhere. Following a very sharp second-quarter rise in business loans, District banks tightened their lending practices in an effort to slow the expansion and thus reduce their loan-deposit and capital ratios. As these tightened policies took hold and as the recession deepened, the business lending pace slackened, at first modestly and then quite steeply.

With the slump in the regional housing market, the mortgage-loan gain fell more than one-third below the business-loan gain, after years of dominating regional lending activity. Suffering from a relatively small savings inflow, Western banks in midsummer raised mortgage rates to record levels and adopted other restrictive lending terms—in some cases going to a "no growth" policy on home loans. Consumer lending also weakened considerably, in part because of the squeeze on consumer real incomes,

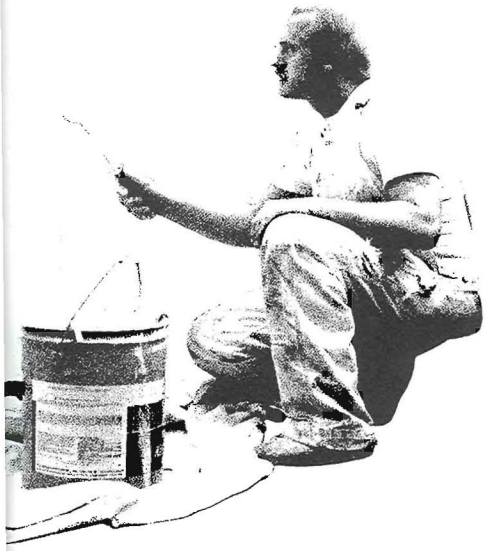


which drastically reduced sales of autos and other big-ticket items that normally account for the bulk of consumer-instalment credit.

In this as in other periods of rapidly rising interest rates, banks generally avoided selling securities as a source of funds because of the large capital losses they would have incurred. For the year as a whole, total security portfolios changed very little, despite some sales during the very tight spring and summer quarters. Altogether, banks recorded only a nominal increase in holdings of Treasuries and a reduction in municipals, but added to their holdings of Federal Agency issues. They failed to make any major shifts in the maturity composition of their holdings, except for some replenishing of Treasury bills in the final quarter.

Finding funds

Because of the need for very substantial funds to accommodate the heavy loan demand, Western banks relied more on "liability management" than on the more traditional "asset management" to obtain funds. Total deposits rose more than 10½ percent, in line with the national pace.

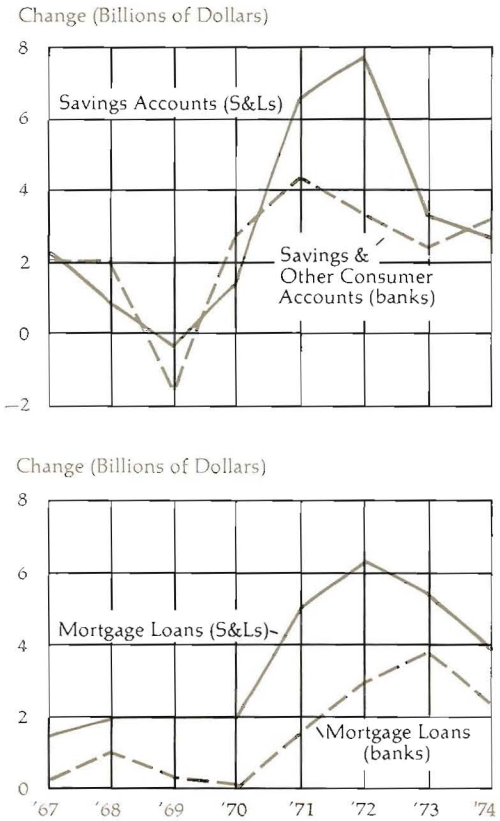


Demand deposits rose modestly, about $½ billion, but time-and-savings deposits jumped more than $9 billion.

Consumer savings deposits increased about $2½ billion, mainly in certificate accounts. But surprisingly, even passbook savings increased, despite the significant disintermediation of consumer savings into money-market instruments, brought about by banks' inability to pay more than the 5-percent Regulation Q ceiling on passbook savings—and in some cases, by their unwillingness to pay more than 4½ percent on such deposits. More than $6½ billion of the time-deposit increase came from large negotiable CD's, primarily during the massive second-quarter loan expansion. After doubling in size within two years time, CD's accounted for 20 percent of total District-bank deposits at the end of 1974.

Still, heavy reliance on these high-cost and highly volatile funds caused substantial problems, expecially during the midsummer crunch. As investors shifted their funds to the largest and strongest institutions, banks outside the top tier re-

Lenders boost mortgage loans modestly as savings inflows lag in tight-money year



portedly had trouble rolling over maturing CD's, even at premium rates. Also, banks generally ran into difficulty matching their relatively short-maturity CD's with their longer-maturity loan assets. Growing concern by the regulatory authorities and by the banks themselves led many banks to slow down their lending pace, in an effort to reduce risk exposure and stave off further weakening of their capital structure.

Paying for funds

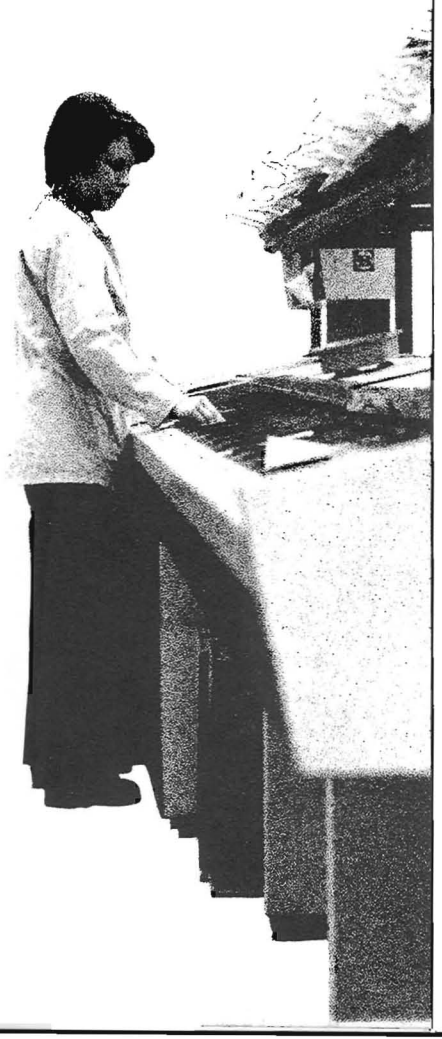
The cost of bank funds soared to all-time highs in July, then declined gradually during the remainder of the year. CD funds were very expensive; offering rates reached 12 percent in July and August, before declining to 8¾ percent by year-end. The effective rate on Fed funds ranged from a midyear peak of more than 13½ percent to a late-December low of about 8½ percent. And from April to December, member banks had to pay 8 percent for borrowing from the Federal Reserve Bank of San Francisco—a record, although far below the cost of other sources of funds.

Required reserves of District member banks increased by $300 million last year (daily average basis), mainly because of the large increase in their outstanding time deposits—and despite the several late-year reductions in reserve requirements. Member banks borrowed a record $204 million (daily average) from the Federal Reserve Bank of San Francisco, an increase of nearly $50 million over the 1973 level. Borrowing at the discount window peaked in the third quarter, when many banks came under pressure because of a restrictive monetary policy as well as their inability in a tiered Fed-funds market to borrow reserves from other member banks. Still, net Fed-funds purchases (borrowings) almost tripled during the year to $1.8 billion, and borrowings under repurchase agreements with corporations and public agencies exceeded even that high figure. District banks also obtained significantly more funds from the Eurodollar market and from holding-company sales of commercial paper, especially during the summer period.

Throughout most of the year, Western banks had trouble covering the rapidly rising cost of the funds which they needed to accommodate their strong loan demand. They had lowered the prime business-loan rate from 9¾ to 8¾ percent during the relatively calm winter months, but as money rates began to soar they raised the prime, in a series of steps, to a record 12 percent in July. They held at that level until early fall, somewhat after market rates had turned downward, and thereafter they kept the prime from falling as rapidly as the rates on the funds they borrowed. At year-end the prevailing prime of 10½ percent was more than 3 percentage points above the Fed-funds rate. This high and widening spread—a normal phenomenon for the recession phase of the business cycle—naturally helped to boost profit margins, and it also played a role in moderating loan demand and in building up bank reserves as a cushion to absorb extraordinarily large (actual and potential) loan losses.

Facing 1975

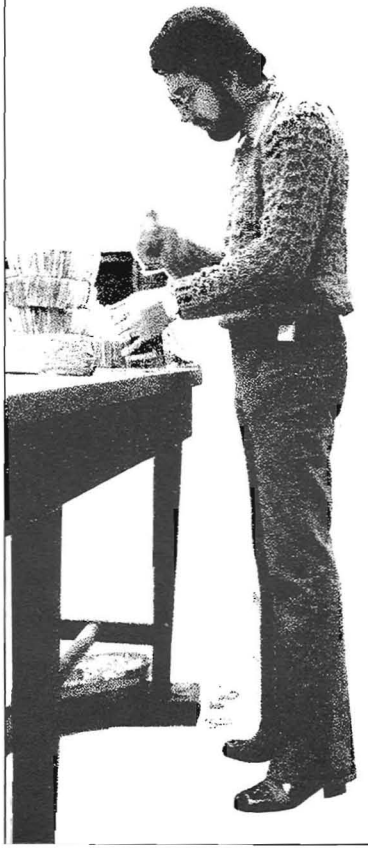
In a pressure-filled atmosphere, many banks deliberately slowed their rate of loan expansion in late 1974 to bring their assets and liabilities into better balance. Banks also reexamined the quality of their



assets, increased their loan-loss provisions for risk assets, and initiated steps to improve their capital ratios. Many of these corrective actions are still being pursued—necessarily so, because banks entered 1975 in a less liquid position and with reduced capital ratios. Moreover, banks may have trouble obtaining funds in the capital markets because of the heavy volume of corporate offerings, not to mention the huge Treasury demands caused by soaring Federal deficits.

Bank-loan demand in the West has declined more than seasonally in recent months, and it is not likely to explode again as it did in 1973 and 1974. Nonetheless, the financing of involuntary accumulations of inventories and rising receivables, at still high prices, should help sustain business-loan demand in coming months. Banks also may have to carry some borrowers who are still not able to obtain accommodation in the capital market. Meanwhile, the deteriorating economy could aggravate the problem of loan losses as increasing numbers of firms encounter liquidity problems. Rising unemployment and further declines in real income also could create repayment problems on mortgage and consumer loans.

With consumers boosting their savings, as they normally do during recession periods, and with bank deposit rates again becoming competitive, banks should benefit from an improved inflow of relatively inexpensive savings deposits this year. Moreover, with business capital expenditures probably lagging, a larger pool of corporate funds could become available for investment in CD's. In the near-term, some of the proceeds from the current heavy volume of corporate issues also may be invested in CD's, since the expenditure of such funds normally is spaced over time. The recent sharp decline in the cost of funds, along with a lagged adjustment in the prime rate, could generate wider profit margins in coming months, although some banks could find their profits limited by a slowdown in loan expansion and by actual loan losses.



Sixtieth Year of Service

The Federal Reserve Bank of San Francisco celebrated its sixtieth birthday in 1974. The Bank opened its doors on November 16, 1914 with a staff of just 21 people to provide central-banking services for the nine Western states. Today, with nearly a hundred times more employees located in five offices throughout the West — San Francisco, Los Angeles, Portland, Salt Lake City and Seattle — the Bank continues to serve the region's growing financial needs and to assist in maintaining the sound operation of the nation's banking system. Its work is constantly expanding, for commercial-bank deposits in this District have risen from less than $1½ billion in 1914 to more than $100 billion today.

In 1974, the community served by the San Francisco Reserve Bank numbered 450 banks with almost 6,200 branches. During the year, 3 national banks, 25 state banks and 1 trust company were organized in the District. The number of Federal Reserve member banks dropped slightly to 140, but member-bank offices increased moderately to 4,661. The nonmember-bank category meanwhile expanded to 307 banks and 1,504 offices.

In a related category, the Bank expanded its supervision over bank holding companies, from 65 in 1973 to 72 in 1974. Its staff investigated 128 applications to initiate or expand bank holding company activities, compared with 111 the previous year. Incidentally, holding companies were permitted to add two new nonbank activities—real property leasing and management-consultant services to non-affiliated banks—to the list of activities they already engage in.

In the international field, the Reserve Bank supervised 24 Edge Act corporations last year, up from 20 in 1973. (These corporations are bank-owned subsidiaries which engage in international-financing activities.) The Bank's staff processed 52 applications involving new or expanded overseas operations by Edge Act corporations and District member banks. To highlight the Bank's growing

international role, President Balles embarked last spring on a 25,000-mile tour of nine Far Eastern countries as a representative of the System's Steering Committee on International Banking Regulation. He made the trip to establish personal working relations with Pacific area central bankers, to gather first-hand information on the foreign operations of American banks, and to explain the System's views on foreign-bank regulation. His work contributed to the formulation of proposed legislation which would extend Federal regulation, on a nondiscriminatory basis, to all foreign banks operating inside this country.

Discount window activity

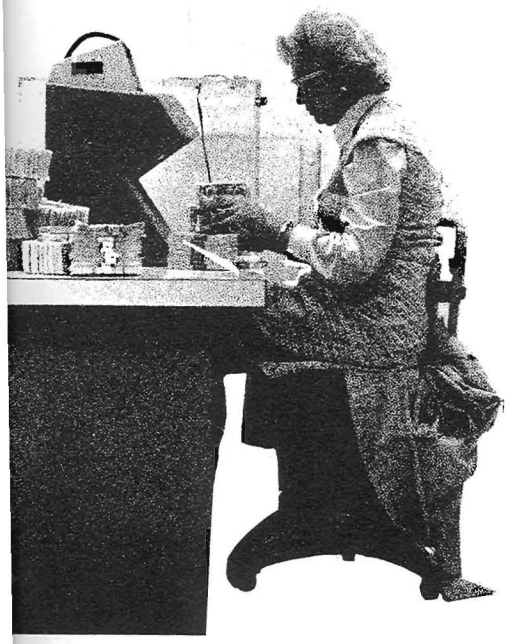
In its credit activity, the San Francisco Reserve Bank helped alleviate the strains of a very tight financial situation last year. As noted above, member-bank borrowing jumped 31 percent to $204 million (daily average), as 61 member banks—up from 54 in 1973—obtained accommodation at the discount window. To facilitate discount operations, the Federal Reserve System twice amended its credit regulations—first, in September, to allow a special discount rate for member banks requiring exceptionally large assistance over a prolonged period of time, and secondly, in October, to bring rates on advances secured by one-to-four family mortgages down to the same level as the basic discount rate.

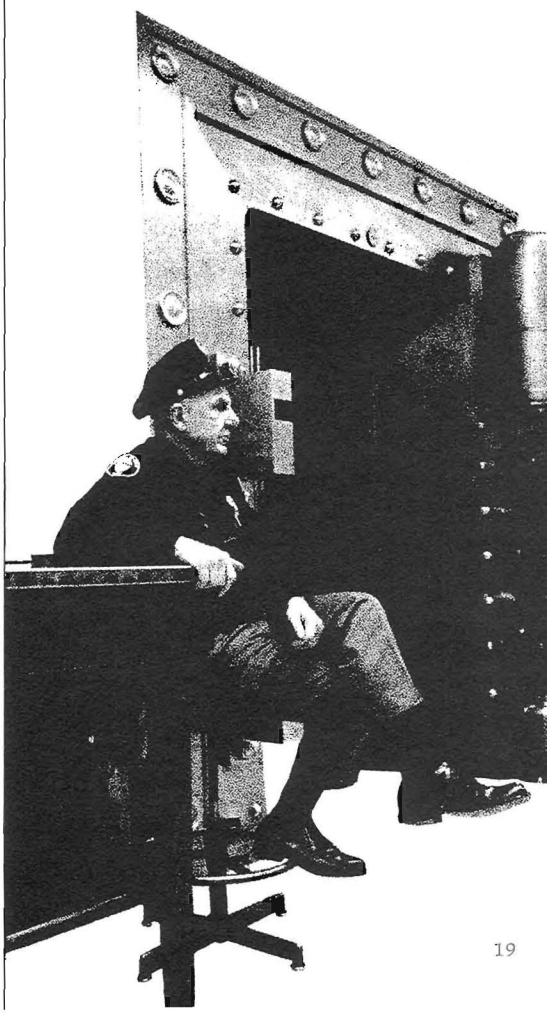
Early in the year, the Reserve Bank became involved in emergency lending to the former Beverly Hills National Bank, whose financial condition had been adversely affected by publicity concerning the difficulties of its parent company, Beverly Hills Bancorp. Working closely with the Comptroller of the Currency and the Federal Deposit Insurance Corporation, the Fed staff spent several weeks helping to devise a solution to the problem. The solution ultimately involved the sale of the bank, with substantially all of its assets and liabilities being assumed by Wells Fargo Bank.

Electronic processing

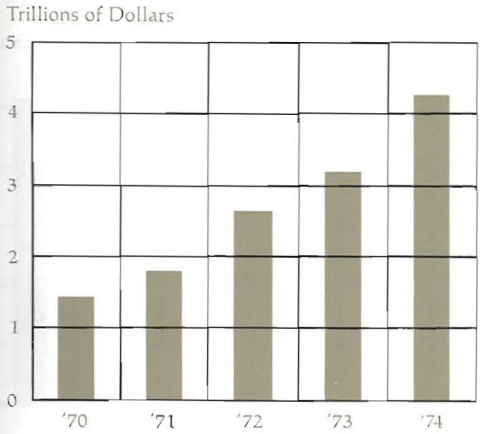
Computerized, round-the-clock check processing became a reality throughout the District as the San Francisco office opened its Regional Check Processing Center (RCPC) in April. All Reserve Bank

Paper flood of checks continues to rise at San Francisco Federal Reserve Bank





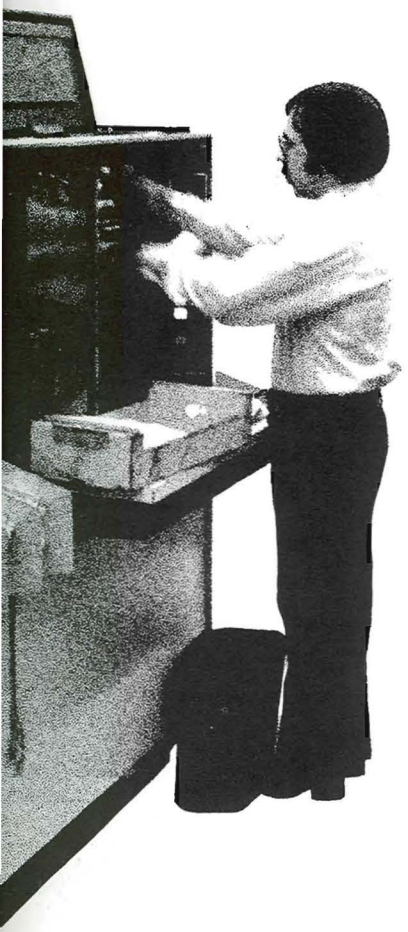
Reserve Bank's wire-transfer volume keeps growing, to more than $4 trillion

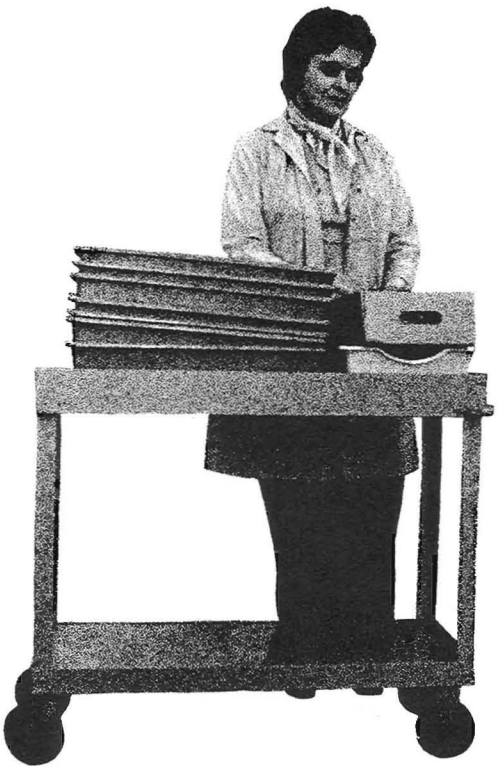


offices now house RCPC facilities. Eventually, 95 percent of all checks processed in the District should flow through the RCPC system, which generally makes possible one-day check clearing as well as lower check-handling costs for banks. The need for such a system becomes more evident as the volume of check handling continues to increase. In 1974 the San Francisco Fed processed more than 1.1 billion checks — an increase of almost 150 million, or 15 percent.

Electronic processing of payroll checks for the U.S. Air Force became operational at the San Francisco and Los Angeles offices at the end of November. This system —offered on a voluntary basis to all airmen— automatically deposits Air Force paychecks at the California Reserve Bank offices by the use of magnetic tapes. Then each payee's checking or savings account at a designated depository institution is simply increased by the amount of the paycheck. When fully implemented, nearly 300,000 personnel may be taking advantage of this electronic-payments program. Among the benefits of the system are speed, safety, and lower costs, through the elimination of check clearing and processing for individual checks.

The Reserve Bank continued to participate in a computerized communications switch, which makes it possible to transfer funds almost instantaneously from one commercial bank to another anywhere in the country. This Federal Reserve service allows member banks to earn interest on otherwise idle excess reserves, and it is especially useful to bank customers who find it necessary to transfer funds immediately. District member banks bought and sold more than $4.3 trillion using this network in 1974, an increase of more than 28 percent from the year before. Altogether, more than 1.4 million messages were involved in these funds transfers.





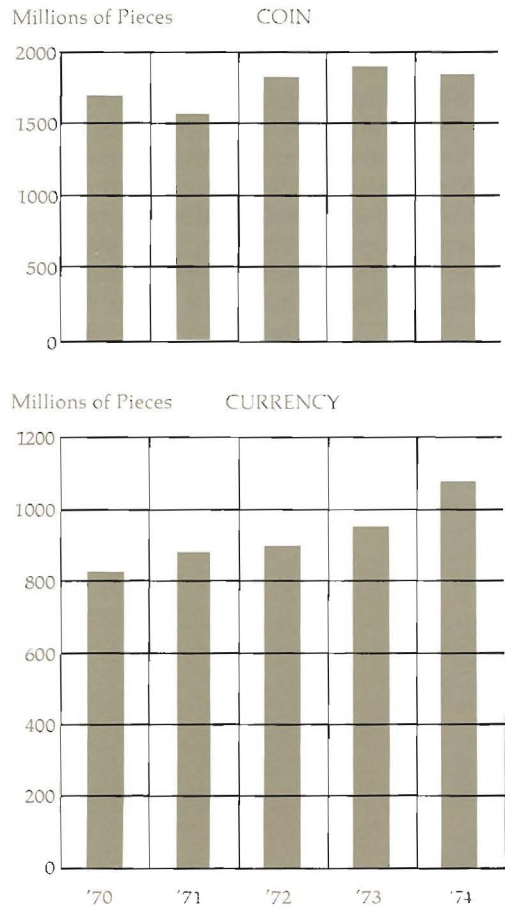
Cash and securities

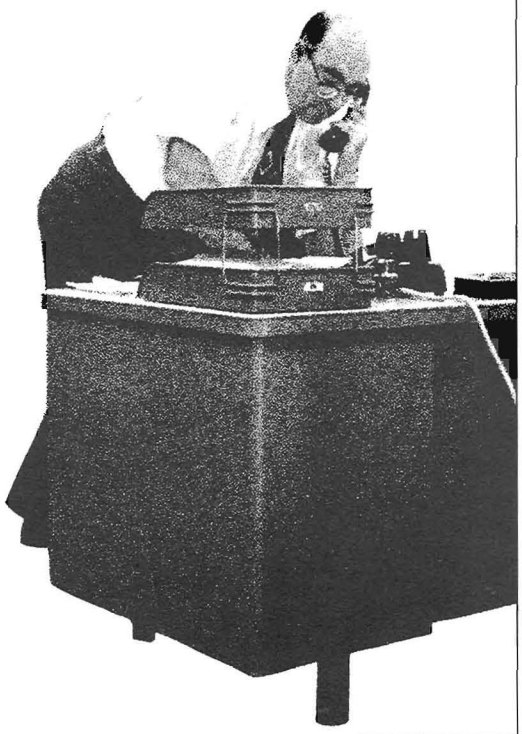
Even with the increased usage of checks and electronic transfers, coin and currency remain a large and vital responsibility of the San Francisco Reserve Bank. The amount of currency received and counted by the five Bank offices increased last year to $10.1 billion in value and almost 1.1 billion pieces—gains of 14 and 8 percent, respectively, over the year before. Coin handling declined slightly, however, with processing of 1.8 billion coins valued at $243 million—largely reflecting a severe penny shortage which developed early in the year because of hoarding brought about by soaring copper prices. The shortage later eased, however, as copper prices declined in the recession atmosphere, and as the Bank achieved success in its cooperative campaign (with banks, schools and other institutions) to recirculate coins held by the general public.

In its role as fiscal agent for the U.S. Government, the Bank was kept busy issuing and redeeming U.S. Treasury securities and savings bonds in a time of record-high interest rates. (Rates on Treasury bills reached a peak of 9.91 percent in late August.) Due to these high rates, participation by individual investors in the Treasury-bill market more than doubled in number at the San Francisco office alone, from 16,374 in 1973 to 39,347 in 1974. Marketable securities issued, exchanged and redeemed at the Bank's five offices rose in value to $297 billion — a gain of 35 percent over the year before. The heavy traffic in Treasury securities prompted the Bank to implement new streamlined methods for better service to commercial banks and the public.

The late-1973 increase in the interest rate on Series E Savings Bonds, from 5½ to 6 percent, contributed to a 3-percent increase in value of bonds sold during 1974. Redemptions once again exceeded sales, by $130 million, but this was a substantial

Currency volume again expands, but penny shortage causes reduction in coin volume





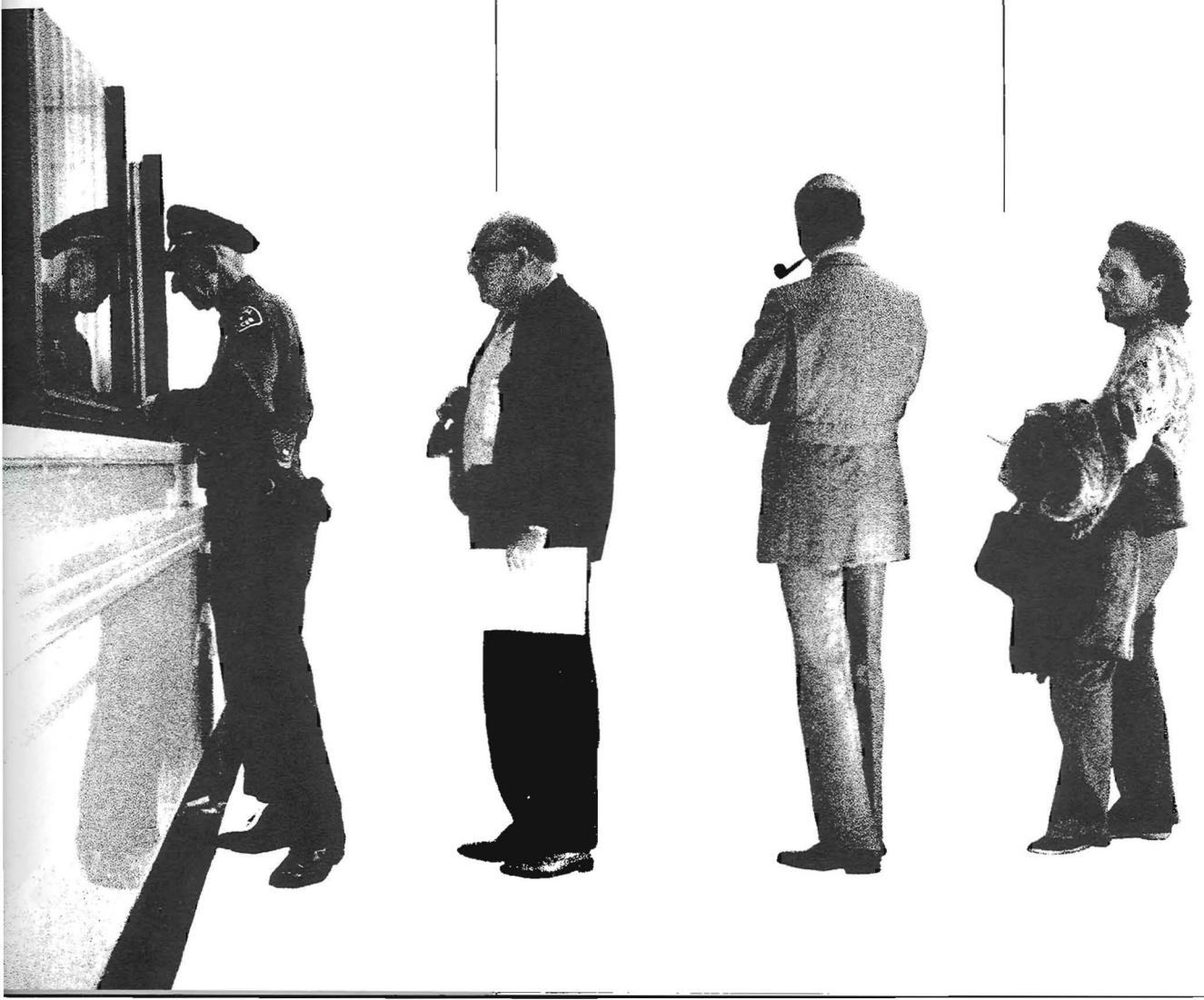
improvement over the 1973 performance. Indeed, savings-bond rates looked increasingly attractive to investors as rates on other instruments plummeted during the fall months.

The Bank recorded increases in both the number and value of food stamps handled. Some 375 million pieces were processed, a gain of 15 percent over the previous year, while dollar value rose nearly 30 percent to $806 million. This gain was partly attributable to the rising number of eligible people resulting from the increased sluggishness of the regional economy. Some reduction in processing—perhaps a one-third reduction—may occur this year because of the Agriculture Department's plan to substitute larger denominations for 50-cent and $2 coupons.

Internal operations

The past year was an important one in terms of the Bank's internal operations. Conservation and increased productivity were the by-words as the Bank responded to the pressures developing in the national economy. During the oil-embargo period, all offices of the Bank implemented energy-conservation programs affecting lighting, heating, automobiles, travel and office-equipment use. A new employee-suggestion program was put into effect as a means of encouraging employees to develop additional conservation measures.

In the fall the Bank was assisted by an outside consulting firm in conducting a diagnostic review of all internal Bank operations. The initial review identified a large number of productivity-improvement opportunities at the San Francisco office, involving virtually every department. Subsequent analyses at the branches identified additional opportunities. This study led to the initiation of a Productivity Improvement Program which will result in a fundamental overhaul of operations, in an attempt to improve cost effectiveness and to develop more clearly defined jobs and improved working conditions. For the Bank as a whole, the program should make it possible to handle expected sharp increases in work loads without unacceptable cost increases.



Federal Reserve Bank of San Francisco
Summary of Operations

	Value ($ millions)		Number (thousands)	
	1974	1973	1974	1973
Coin and Currency				
Coin received and counted	243	246	1,797,254	1,937,330
Currency received and counted	10,145	8,921	1,062,975	986,335
Collections				
Check Collections				
Commercial bank checks	248,488	192,035	967,574	833,642
Government checks*	55,317	48,095	139,486	127,736
Return items	2,286	1,883	10,055	8,422
Noncash Collections	6,352	4,476	649	727
Discounts and Advances				
Total discounts and advances	42,481	28,802	1,720‡	1,435‡
Daily average borrowings	204	158	NA	NA
Number banks accommodated	NA	NA	61‡	54‡
Fiscal Agency				
Marketable Securities				
Issuance	10,253	8,841	231	116
Exchanges and transfers	274,973	203,552	298	314
Redemptions	11,673	8,087	316	161
Savings Bonds				
Issuance	660	640	13,508	13,527
Reissues and replacements	90	82	508	461
Retirements	790	798	14,192	14,545
Other Fiscal				
Currency verified and destroyed	2,148	2,175	395,378	356,178
Federal tax deposits processed	30,932	25,481	6,754	5,935
Food stamps received and processed	806	622	375,471	326,175
Transfer of Funds				
Wire transfers	4,345,801	3,381,379	1,408	1,116

*including postal money orders
‡actual number

About the pictures

A regional Federal Reserve Bank requires the services of a number of different types of people: accountants, programmers, guards and economists; planners, clerks, typists and personnel experts; auditors, secretaries, building staff and messengers. Some of the activities of these Bank employees are pictured in these pages.

Handling money is a central activity of the Bank's staff. Shown here are people sorting and handling checks, transferring funds by wire, counting and sorting currency, handling coins in various ways (receiving, shipping, sacking and counting)–as well as people standing guard over all these activities. But many other workers are involved in policy support for the Federal Reserve System and in service activities for the Bank staff and the general public. Illustrating these activities are pictures of economic researchers, graphic artists, bank relations personnal, secretaries, painters, switchboard operators–and annual-report writers.

Directors and Officers

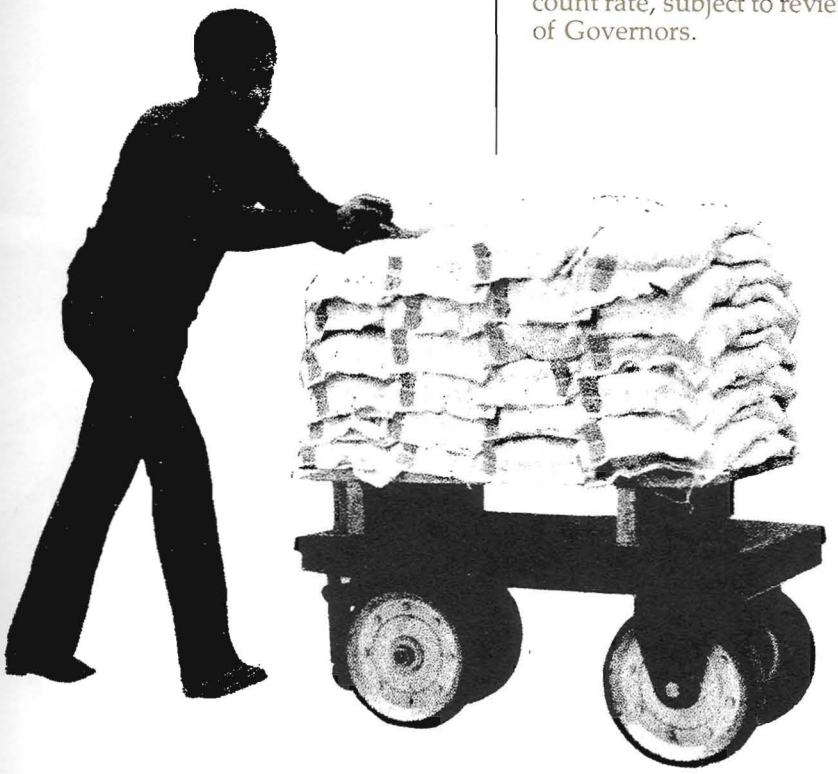
Federal Reserve functions are carried out through 12 Federal Reserve Banks and their 24 branches, coordinated by the Board of Governors in Washington, D.C.

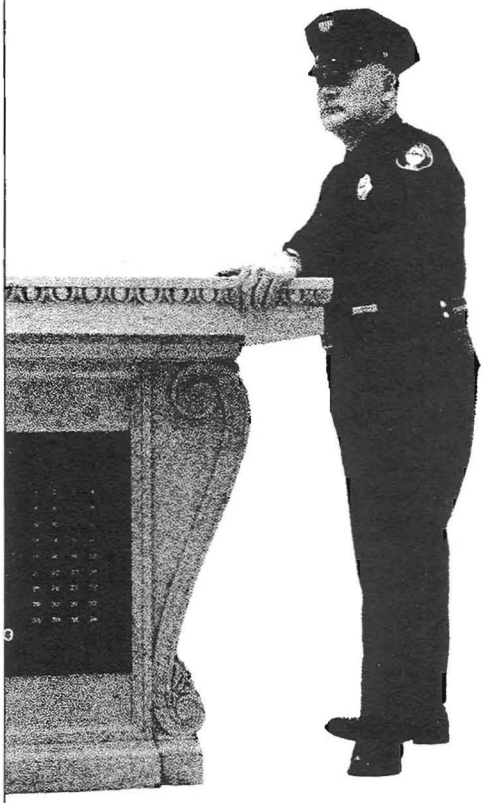
The Board of Governors consists of seven members appointed by the President of the United States and confirmed by the Senate. Board members devote their full time to the business of the Board. They are appointed for 14-year terms arranged so that one term expires every two years.

Decentralization is one of the important characteristics of the System's operation. Each of the 12 Federal Reserve Banks is a corporation organized and operated for public service, with its shareholders being its member banks.

Each Federal Reserve Bank has nine directors, divided into three classes. Class A directors are bankers and Class B directors are actively engaged in the District in commerce, agriculture, or some other industrial pursuit, but must not be officers, directors, or employees of any bank. These Class A and B directors are elected by member banks. Class C directors must meet the same qualifications as Class B directors, but they are appointed by the Board of Governors of the Federal Reserve System in Washington, D.C. The Bank's Board of Directors is charged with responsibility for overseeing and directing the management of the Reserve Bank in order to accomplish the broad public purposes of the Federal Reserve Act. One of the primary responsibilities of the Board of Directors is to establish the discount rate, subject to review by the Board of Governors.

In addition, each of the Reserve Bank's branches has a Board of Directors. In the Twelfth District, the Los Angeles Branch has a seven-member board, four appointed by the San Francisco Reserve Bank's Board of Directors and three by the Board of Governors. Each of the other Branch offices — Portland, Salt Lake City, and Seattle — has five-member boards, three appointed by the San Francisco Bank's board and two by the Board of Governors.





Changes in Boards of Directors

Because of the public nature of the directorships of the Bank and the demands upon the time of those who serve, changes occur each year in the composition of the various boards. During 1974 the following changes and reappointments were announced:

Board of Directors, Federal Reserve Bank of San Francisco

Elected by Member Banks in the Twelfth District:

Class A Director
Carl E. Schroeder
President, First National Bank of Orange County
Re-elected to a three-year term beginning January 1, 1975

Class B Director
Charles Raymond Dahl
President and Chief Executive Officer, Crown Zellerbach Corporation
Re-elected to a three-year term beginning January 1, 1975

Appointments by the Board of Governors, Federal Reserve System:

Class C Directors
O. Meredith Wilson
President and Director, Center for Advanced Study in the Behavioral Sciences, Stanford, California
Redesignated Chairman of the Board for 1975

Joseph F. Alibrandi,
President and Chief Executive Officer, Whittaker Corporation, Los Angeles
Redesignated Deputy Chairman for 1975

Boards of Directors, Branch Offices

Los Angeles Branch:

Appointment by San Francisco Reserve Bank's Board:

Robert A. Barley
President, United California Bank, Los Angeles
Newly appointed to a three-year term beginning January 1, 1974

Appointments by the Board of Governors:

Dr. Armando M. Rodriguez,
President, East Los Angeles College,
Appointed to fill a three-year term that will expire at year-end 1976.

Harvey A. Proctor,
Chairman of the Board, Southern California Gas Company, Los Angeles
Appointed to fill a three-year term that will expire at year-end 1975

Salt Lake City Branch:

Appointment by San Francisco Reserve Bank's Board:
David P. Gardner
President, University of Utah, Salt Lake City, Utah
Appointed to fill a three-year term that will expire at year-end 1976

Seattle Branch:

Appointment by the Board of Governors:
Malcolm T. Stamper
President, The Boeing Company, Seattle, Washington
Appointed to fill a three-year term that will expire at year-end 1976. (Also designated as Chairman of the Branch Board for 1975.)

Changes in Official Staff

Promotions
Kent O. Sims,
Vice President to Senior Vice President
January 1, 1974

Joseph Bisignano,
Economist to Assistant Vice President and Economist
January 1, 1975

Appointments
Richard L. Rasmussen
Planning Officer (Los Angeles)
February 1, 1974

Walter Woodbury,
Personnel Officer (Los Angeles)
May 1, 1974

James F. Leyman
Assistant General Auditor
June 1, 1974

Gordon Hammond,
Vice President, Data Processing and Management Science
July 1, 1974

Bruce Thompson,
Audit Officer (Los Angeles)
August 1, 1974

Retirements
J. Norman Aamodt
Chief Examiner
April 30, 1974

Deceased
Amadeo G. Conte,
Assistant General Auditor
April 5, 1974

Comparative Statement of Condition

(thousands of dollars)

	December 31, 1974	December 31, 1973
Assets		
Gold certificate account	$ 1,500,750	$ 1,327,367
Special Drawing Rights certificate account	49,000	49,000
Federal Reserve notes of other Federal Reserve banks	279,344	170,935
Other cash	35,556	28,039
Loans to Member Banks:		
Secured by United States Government and Agency obligations	-0-	53,000
Other eligible paper	21,950	72,500
Other paper	29,595	67,700
Federal Agency obligations	684,392	263,139
United States Government securities:		
Bills	5,351,037	5,011,138
Notes	5,823,307	5,216,920
Bonds	477,894	427,667
Total United States Government securities	$11,652,238	$10,655,725
Total loans and securities	$12,388,175	$11,112,064
Cash items in process of collection	987,173	1,212,689
Bank premises	7,540	7,685
Other assets:		
Denominated in foreign currencies	220	556
All other	232,930	155,814
Total assets	$15,480,687	$14,064,149
Liabilities		
Federal Reserve notes	$ 8,562,318	$ 7,659,768
Deposits:		
Member bank—reserve accounts	5,330,167	4,840,137
United States Treasurer—general account	357,810	349,692
Foreign	37,120	32,500
Other deposits	94,237	69,450
Total deposits	$ 5,819,334	$ 5,291,779
Deferred availability cash items	694,680	751,491
Other liabilities	180,507	144,497
Total liabilities	$15,256,839	$13,847,535
Capital Accounts		
Capital paid in	$ 111,924	$ 108,307
Surplus	111,924	108,307
Total Liabilities and Capital Accounts	15,480,687	14,064,149
Contingent liability on acceptances purchased for foreign correspondents	$ 125,798	$ 72,638

Earnings and Expenses

(thousands of dollars)

	1974	1973
Current earnings		
Discounts and advances	$ 16,107	$ 10,304
United States Government securities	837,274	666,062
Foreign currencies	873	57
All other	1	113
Total current earnings	$854,255	$676,536
Current expenses		
Total current expenses	$ 52,418	$ 46,820
Less reimbursement for certain fiscal agency and other expenses	4,788	3,210
Net expenses	$ 47,630	$ 43,610
Profit and loss		
Current net earnings	$806,625	$632,926
Additions to current net earnings:		
Profit on sales of United States Government securities (net)	0	0
Profits on foreign exchange transactions	0	0
All other	152	123
Total additions	$ 152	$ 123
Deductions from current net earnings:		
Loss on foreign exchange transactions (net)	$ 4,347	$ 5,927
Loss on sales of United States Government securities (net)	5,794	4,825
All other	574	7
Total deductions	$ 10,715	$ 10,759
Net additions (+)/deductions (−)	$–10,562	$–10,636
Net earnings before payments to United States Treasury	796,063	622,290
Dividends paid	6,645	6,221
Payments to United States Treasury (interest on Federal Reserve notes)	$785,801	$607,131
Transferred to Surplus	$ 3,616	$ 8,938
Surplus January 1	108,307	99,370
Surplus December 31	$111,924	$108,307

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January 1975

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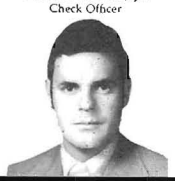

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