

HG2567
S3A1
1981



Federal Reserve Bank of San Francisco

1981
Annual Report



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Alan C. Furth
Deputy Chairman (1982)

John J. Balles
President

Caroline Leonetti Ahmanson
Chairman (1982)

Cornell C. Maier
Chairman (1981)

From the Boardroom

The nation and its central bank experienced a generally disappointing year in 1981. Despite high hopes, the national and regional economies suffered a sharp recession in the latter part of the year, concentrated in housing and other basic industries. But more favorably, the Federal Reserve's disciplined monetary policy began to pay off in terms of a significant deceleration of inflation. On the operations side, the Federal Reserve continued to implement the historic 1980 financial legislation which sharply expanded the number of depository institutions eligible to utilize the Fed's central-banking services.

The national economy produced \$2.9 trillion of goods and services in 1981, as gross national product (adjusted for inflation) increased about two percent for the year. Annual averages, however, disguised a strong downtrend in general business activity attributable to peak levels of interest rates and to the lingering effects of the 1979-80 oil-price shock. Production cutbacks and layoffs also became widespread throughout the massive nine-state district served by the Federal Reserve Bank of San Francisco, which normally accounts for one-sixth of the national output.

In contrast, the price situation improved considerably. Consumer prices, as measured in the GNP accounts, rose 8 percent over the course of the year, compared with 10-percent increases in each of the two preceding years. The Federal Reserve made headway against inflation despite a number of problems created by an unfolding era of financial deregulation and innovation, and created also by the Federal government's "crowding out" of other borrowers in financial markets. The narrow measure of the money supply—currency plus transaction (check-type) accounts—decelerated sharply in 1981, following modest declines in each of the two preceding years. The Federal Reserve's increased success in slowing money-supply growth reflected its greater experience with new operating procedures adopted in October 1979. (At that time, the Fed announced that it would no longer attempt to stabilize interest rates regardless of total demands for money and credit—and instead embarked on a multi-year program of slowing the rate of monetary growth to a non-inflationary pace.) But with borrowing demands—especially Federal deficit-financing demands—remaining relatively heavy in the face of a tightening monetary policy, interest rates remained very high by historical standards.

The Federal Reserve Bank of San Francisco operated in a new competitive environment during 1981, largely in response to the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980 (MCA). Under this legislation, Congress promoted greater equity and improved monetary control by extending reserve requirements to all depository institutions with transaction accounts or nonpersonal time deposits. In addition, Congress promoted greater efficiency in financial markets by providing access to Federal Reserve services, at explicit prices, for those institutions with reservable deposits.

In earlier years, the San Francisco Reserve Bank dealt with only 147 member banks. After MCA's passage,

however, the Reserve Bank implemented weekly-reporting requirements in November 1980 for 996 depository institutions, primarily those with \$15 million or more in total deposits, and it implemented quarterly-reporting requirements in January 1981 for 782 smaller institutions. A number of operating departments began implementing open access and pricing for financial services on a phased-in basis during 1981. Over the long run, revenues derived from providing these financial services are expected to cover all Federal Reserve costs in providing them, including an amount to reflect private-sector costs (such as taxes) not incurred by the central bank.

Management benefited greatly during 1981 from the broad-based experience and judgment of the Bank's directors at Head Office and four branches. The directors provided guidance on major management decisions and planning goals, especially in regard to the implementation of the MCA legislation. In addition, they supplied key information on economic and financial conditions as support to the Federal Reserve's formulation of monetary policy. Today, 37 public-spirited men and women serve as directors, representing a great variety of economic interests and non-profit organizations from every area of the West. And beginning in 1981, the Reserve Bank has begun to obtain useful guidance on MCA implementation from an advisory group of 12 individuals representing a broad range of regional commercial banks and thrift institutions.

We are grateful to all of these individuals, and also to those who completed terms as directors during 1981. We owe an immense debt to Cornell C. Maier (Chairman, President and CEO of Kaiser Aluminum and Chemical Corporation), who showed great gifts of leadership and motivation during his term as Chairman of our Board of Directors. Our heartfelt thanks also go to several other individuals who completed terms of service: Malcolm T. Stamper (President, The Boeing Company) at our San Francisco office; Harvey A. Proctor (Chairman of the Board, Southern California Gas Company), and Harvey J. Mitchell (President, First National Bank of San Diego County) at Los Angeles; Merle G. Bryan (President, Forest Grove National Bank), Jean Mater (Vice President, Mater Engineering Ltd.), and Robert F. Wallace (Chairman of the Board and President, First National Bank of Oregon) at Portland; David P. Gardner (President, University of Utah) at Salt Lake City; C.M. Berry (President, Seafirst Corporation), and Douglas S. Gamble (President and CEO, Pacific Gamble Robinson Company), at Seattle; and Chauncey E. Schmidt (Chairman of the Board, President, and CEO, The Bank of California), as this District's representative on the Federal Advisory Council. Finally, we wish to express our appreciation to our officers and staff, whose dedication and skill enabled us in 1981 to expand and improve our services to the financial community and to the general public.

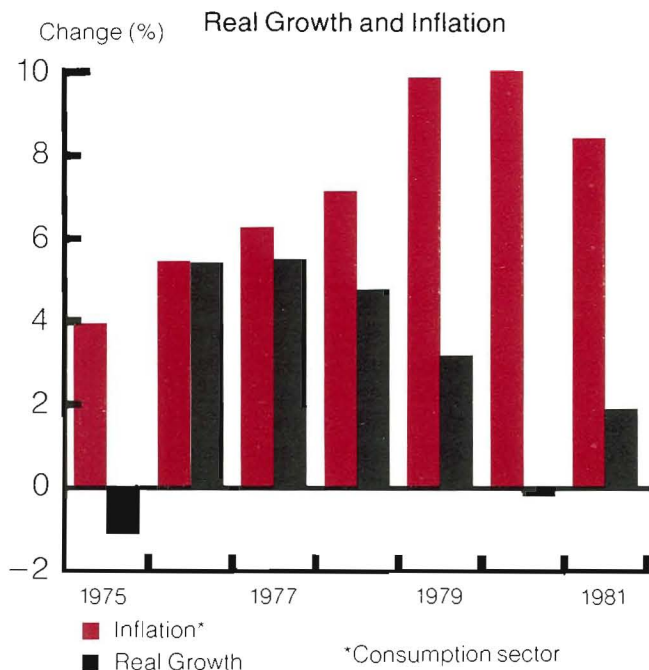
Caroline Leonetti Ahmanson
Chairman of the Board

John J. Balles
President
February 1, 1982

National Scene

The national economy produced \$2.9 trillion of goods and services in 1981, as gross national product (adjusted for inflation) increased about two percent for the year. Those annual averages, however, disguised a strong late-year downtrend in general business activity and severe weakness in several basic industries, attributable to peak levels of interest rates and to the lingering effects of the 1979-80 oil-price shock. Final sales (GNP less inventory change) rose very sharply during the winter quarter, but declined almost steadily thereafter as the economy shifted from high to low gear. On the other hand, the black cloud contained a definite silver lining in the shape of a long-awaited slowdown in inflation, caused largely by a prolonged deceleration in money-supply growth.

Business-cycle analysts dated the onset of the new recession at July 1981, hard on the heels of the January-July 1980 recession. But this type of recession dating may be out of place today. The economy has shown little, if any, growth throughout the past three years in the wake of the second oil-price shock—the 1979-80 increase of almost 150 percent in the average price of OPEC oil. Like the previous shock of the 1973-74 period, this price hike acted as a giant worldwide sales tax, raising prices and draining off purchasing power that would otherwise have been available for purchases of other goods and services. OPEC prices weakened after early 1981, but the earlier shock continued to boost costs and to disrupt energy-consuming industries, thereby contributing to the overall weak performance of the national economy.



Widespread Decline

In 1981, as in 1980, some of the nation's key industries—homebuilding, auto manufacturing, and agriculture—suffered sharp declines in output and profitability as interest and energy costs soared. More importantly, the downturn by year-end spread to many feeder industries—such as steel, machine tools, and farm equipment—and through them into the national economy as a whole. The capacity-utilization rate in manufacturing thus declined to only 73 percent in the late-fall months.

Most observers, however, expected an upturn by mid-1982—given the completion of the present inventory liquidation, the late-1981 declining trend in interest rates, and the stimulus from the 1981-82 package of individual and business tax cuts. Recent developments thus served an important purpose in setting the stage for lower inflation, lower interest rates, and a stable business environment in the years ahead.

Consumer spending, which accounts for about two-thirds of total GNP, increased about 2½ percent (in real terms) for the year as a whole, but only because of an early-1981 upsurge in purchases. Households recorded a two-percent gain in real disposable income—a relatively weak gain in historical terms. For the second straight year, consumers took on little new debt, as the ratio of consumer-installment credit to personal income fell sharply from the mid-1979 peak. Still, the decline in the ratio may represent the unwinding of inflation pressures, which had stimulated consumers to assume heavy debt burdens in earlier years. Real (inflation-adjusted) interest rates meanwhile rose to the highest levels in a generation, boosting financing costs and persuading households to postpone big-ticket purchases.

New car sales, at nine million units, fell far below the 11-million-plus pace of the boom years of the late 1970s. For domestic producers, sales for the past two years were the worst in the past two decades, reflecting a sharp upsurge in product costs. The average price of a new Detroit model—\$9,000—was 28 percent higher than two years ago, and financing and fuel costs were up considerably more. Meanwhile, spending on residential construction dropped five percent for the year, on the heels of an even sharper drop in the 1980 housing market. Housing starts averaged just 1.0 million units for the year—the lowest in the past quarter-century—and the pace slowed even more in the latter part of the year. The fortunes of the homebuilding industry were paralleled by the severe losses of the mortgage-financing industry, which became squeezed between sharp increases in their cost of funds and relatively low earnings on their portfolios of older mortgages.

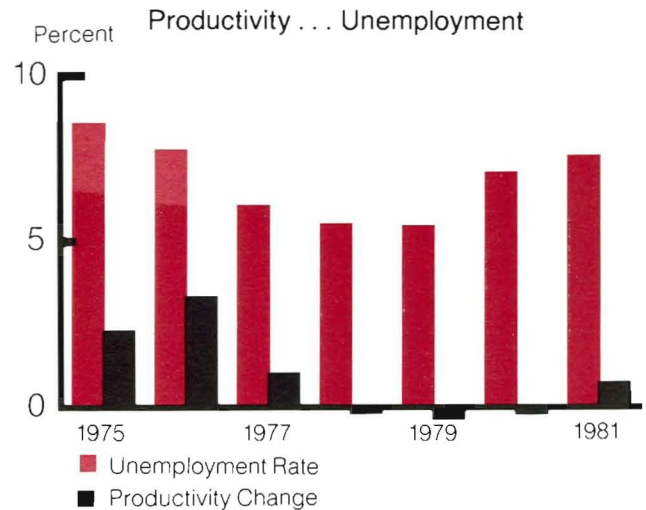
Sectoral Shifts

Much of the late-1981 recession weakness reflected business firms' efforts to clear their storerooms of goods which consumers refused to buy, and which led to a substantial buildup of inventories during the spring and summer months. Meanwhile, real corporate investment in new plant and equipment rose 2½ percent for the year—offsetting most of the 1980 decline. Corporate cash flow benefited from faster depreciation schedules voted by Congress. Still, business fixed-investment spending lagged because of an overhang of idle capacity, with factory-utilization rates at the lowest levels of the past decade.

Federal-government inflation-adjusted spending increased 3 percent—only a fraction of the previous year's increase—despite the beginning of a boom in defense spending. Real increases in defense expenditures and interest payments were largely offset by a squeeze on non-defense purchases and on grants to state and local governments. State-local spending meanwhile dropped by one percent—the first decline in the past generation. Revenues of those governments slowed because of the general economic slowdown, and the situation was aggravated by the cutbacks of Federal grants, which usually exceed one-fifth of total state-local receipts.

The foreign-trade sector, which accounted for three-fifths of the GNP increase of the 1979-80 period, turned into a definite minus in 1981. Net exports fell 13 percent, offsetting part of the large increase of the preceding year. The export sector was hurt by an appreciation in the value of the dollar and by a slump in overseas business activity. The value of exports remained flat for a year-and-a-half, as a sharp decline in industrial-goods exports offset the growth in earnings from farm exports and foreign investments. Meanwhile, spurred by cheaper costs and the more expensive dollar, foreign-merchandise imports took over a record 16½-percent share of the U.S. market. But imported oil, after the sharp 1979-80 price shock, proved to be a bright spot in the weak 1981 foreign-trade picture. With both volume and prices lower, foreign oil cost \$10 billion a year less than at the early-1980 peak.

The nation's agricultural sector remained under heavy pressure during 1981. Cash receipts, although improving, again lagged behind sharply rising production costs. Net farm income, in real terms, thus remained at only one-half of the 1979 peak for the second year in a row. And weakening income led farmers to reduce their purchases from the farm-equipment industry, whose output dropped nine percent for the year.



Job and Price Developments

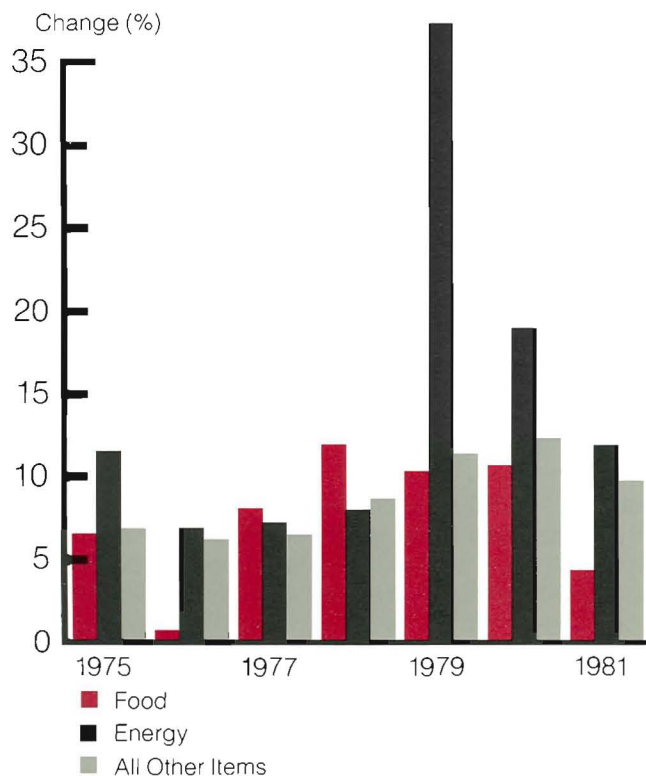
Employment in the U.S. economy increased slightly on average for the year, despite the late-year recession which involved a loss of almost two million jobs after mid-summer. With output falling at an even faster pace, the productivity of the national economy also weakened after showing early-year strength. Reflecting these developments, unemployment accounted for 7.6 percent of the civilian labor force for 1981 as a whole, but the rate jumped during the fall months to 8.9 percent in December—close to the highest point of the past generation. Still, 58 percent of the adult population held jobs in 1981, which is more than at any other time prior to the boom of the late 1970s.

In sharp contrast, the price situation improved considerably during the year. Consumer prices, as measured in the GNP accounts, increased about eight percent, as opposed to 10-percent increases in each of the two preceding years. Also, a seven-percent rise in producer prices compared strikingly with the almost 12-percent increase of 1980. And an actual decline in prices of industrial materials led to expectations of a broader deceleration of finished-goods prices in the period ahead.

Fiscal Policy Problems

Fiscal policymakers adopted a number of tax cuts in mid-summer in an attempt to reduce the excessive tax burden on productivity and economic growth. The tax program was built around a 25-percent cut in personal-income tax rates over the 1981-83 period, plus faster depreciation write-offs for business firms. Since these cuts represented primarily a belated adjustment of rates to past inflation, the income tax cut will simply offset seven years of "bracket creep" by bringing 1984 taxes back into line with what the tax system yielded in 1977 in real terms.

Consumer Price Change



measure—primarily currency plus all depository institutions' deposits (except large time certificates) and money-market fund shares—increased about 9½ percent for the second straight year. This was above the top of the Fed's target range, and reflected the booming growth of high-yielding money-market funds.

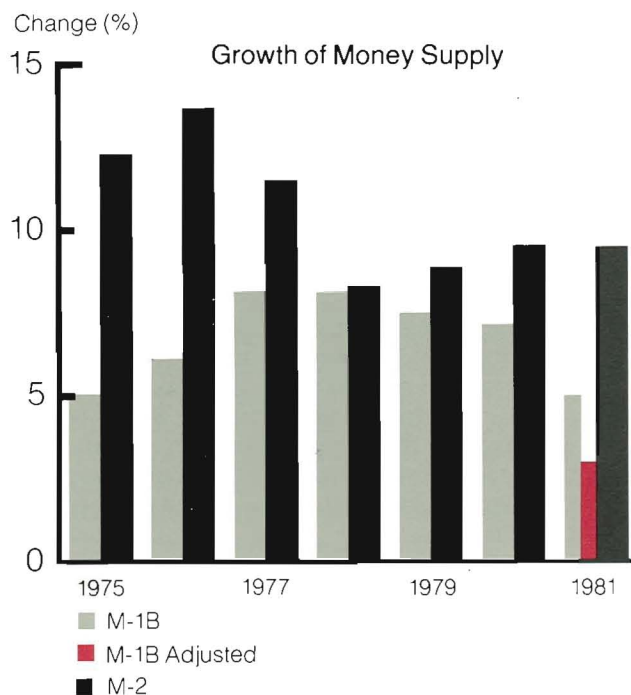
The Federal Reserve's increased success in slowing M1 money-supply growth reflected its greater experience with new operating procedures adopted in October 1979. At that time, the Fed announced that it would no longer peg the cost of bank reserves (the Federal-funds rate) and would instead target the level of reserves in the banking system—basically for the purpose of slowing the rate of monetary growth to a non-inflationary pace. Consistent with this policy, the Fed took action on several occasions during 1981 to steer money growth towards the targets announced in February. During the spring months, as money growth began to surge, the Fed sharply restricted the supply of available reserves and meanwhile raised both the discount rate (to 14 percent) and the surcharge on frequent borrowings by large banks (to four percent). Faced with the opposite problem of slow growth in the late summer and fall months, the Fed increased the supply of reserves—and in addition, it lowered the discount rate in two steps (to 12 percent), and reduced and finally eliminated the surcharge on frequent borrowings. At year-end, however, the Fed again faced the difficult problem of dealing with another upsurge in money growth.

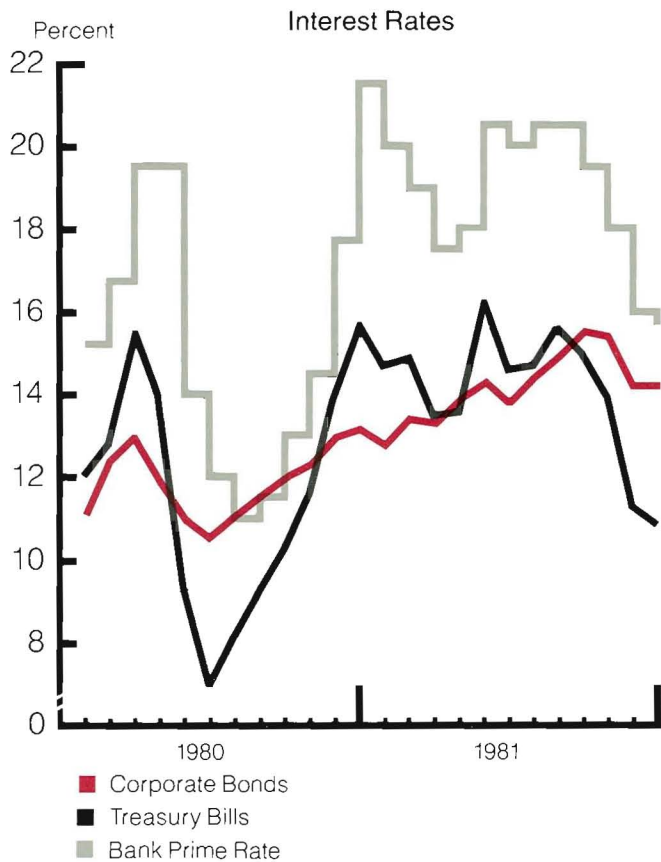
Faster business write-offs similarly will offset the mis-measurement of depreciation caused by inflation, which raised the effective corporate-tax rate very sharply in the late 1970s.

The Administration and Congress also adopted a number of major spending reductions, in tandem with the tax cuts, in an effort to stem the flow of red ink and reverse a 50-year trend in the growth of the Federal government. Nonetheless, large Federal deficits continued to undermine financial markets and the overall economy, as the deficit increased to \$58 billion for fiscal 1981 and threatened to rise to a record of perhaps \$80 billion or more in fiscal 1982.

Monetary Policy Stance

The Federal Reserve made headway against inflation during 1981 despite all the problems created by an unfolding era of financial deregulation and innovation—and also by the Federal government's "crowding out" of other borrowers in financial markets. The narrow measure of the money supply—currency plus transaction (check-type) accounts—decelerated sharply in 1981 following modest declines in each of the preceding two years. (This monetary aggregate, known as M1-B in 1981, henceforth will be known simply as M1.) The narrow money supply rose more than seven percent in 1979 and 1980, but by only five percent in 1981—and indeed, by less than three percent (below the bottom of the Fed's target range) after adjustment for shifts of savings into check-like NOW accounts. However, the broader M2 money-supply





Shifting Credit Markets

With borrowing demands relatively heavy in the face of a tightening monetary policy, interest rates remained in the stratosphere despite declines in the spring and again in the late-fall months. The yield curve traced by instruments of gradually increasing maturity remained inverted, with short-term rates holding above long-term rates for much of the year. The prime business-loan rate started the year at 21½ percent, and after retreating, climbed again to a 20½-percent secondary peak in the late summer months, before dropping to 15¾ percent in December. In contrast, corporate Aaa bond rates declined during the fall months, but at December's 14-percent average level were somewhat higher than at the beginning of the year. Real (inflation-adjusted) interest rates soared to record heights in this atmosphere, because of investors' fears of resurgent inflation and the effects of high Federal deficits.

To finance its massive revenue shortfall, the Treasury stepped up the pace of its fund-raising efforts. Federally-sponsored agencies likewise increased their borrowing activities compared with 1980. The Federal Home Loan Bank System, in particular, actively sought funds to support its lending program to a savings-and-loan industry that was battered by poor earnings and outflows of funds throughout the year. Total Federally-related financing demands thus rose from \$83 billion in 1980 to \$97 billion during 1981. State and local governments, by contrast, became moderately less active in credit markets. Many municipal borrowers could not issue new debt because prevailing high interest rates frequently exceeded statutory interest-rate ceilings on their borrowings. Also, local governments sharply curtailed their sales of mortgage-revenue bonds because of new legal restrictions on the sale of such instruments.

Corporate borrowers resorted to the credit markets more frequently in 1981 than in 1980, concentrating most of their increased borrowing in the shorter end of the market despite the persistently inverted shape of the yield curve. Firms relied heavily on commercial-bank loans and commercial-paper issues for the short-term working capital that, because of poor earnings growth, could not be generated internally at an adequate pace. Businesses generally postponed long-term bond offerings and stock sales during the year, hoping that overall credit demands would ease and bring down the level of interest rates. The new-issues pace rose significantly, however, during the several periods of declining rates in the late spring and late fall months.



Households stepped up their overall borrowing pace, at least in contrast to 1980, when the spring period's credit-control program caused a sharp reduction in consumer-credit balances. Indeed, short-term consumer debt grew an estimated 10 times faster than in the preceding year, although the overall gain was small in historical terms. In contrast, home-mortgage debt grew at a slower pace, as households reduced their purchases of new homes in response to mortgage rates which exceeded 17 percent at the summer peak.

Gain in Bank Credit

Commercial-bank credit increased by eight percent—about the same as in 1980's sluggish atmosphere—although loan portfolios increased at a somewhat more rapid pace than securities-investment portfolios. Business loans, in particular, grew at a fairly healthy (13 percent) pace during the year. But in view of the intense competition from non-bank institutions, banks apparently paid dearly in many cases for the business-loan expansion—either by cutting profit margins or by taking on somewhat riskier loans. Banks also increased their real-estate loans almost nine percent over the year, somewhat paradoxically in view of the sharp decline in homebuilding activity. But much of the real-estate lending was concentrated in commercial real-estate loans—or else in home-equity loans, which households found to be a more attractive financing source for durable-goods purchases than installment credit. Much of the real-estate lending activity thus could be classified as consumer credit, which would explain the small (three-percent) increase in consumer borrowing activity at banks during the year.

Banks faced intense competition for funds to finance 1981's credit expansion, in view of the attractiveness to depositors of money-market mutual funds and thrift-institution NOW accounts. And banks found deposit growth very costly, since most of the growth occurred in deposit categories that paid market-related rates of interest—money-market certificates, small-saver certificates, and large-denomination (over \$100,000) certificates of deposit. Over the year, higher-yielding deposit categories rose from 45 percent to more than 55 percent of small time and savings deposits, reflecting shifts of funds into these categories from core deposits (passbook savings and checking accounts). Furthermore, even transaction deposits became more expensive for banks as depositors shifted their funds from the traditional zero-interest checking accounts to NOW accounts paying 5¼-percent interest.

Mixed Bank Earnings

The banking industry turned in a mixed profits performance for the year, according to preliminary indications, with earnings just about matching the preceding year's level. The continued shift of core deposits to higher-cost categories substantially raised banks' average costs of funds. At the same time, stiff price competition on the lending side made it difficult for banks to recoup these cost increases, and thereby caused a weakening of net interest margins and profits. Earnings performance varied considerably, however, depending on the sensitivity of each bank's portfolio to increases in the cost of funds and changes in interest rates. Many wholesale (commercially-oriented) banks avoided deterioration of interest margins by keeping the maturities of both assets and liabilities short. In contrast, many retail (consumer-oriented) banks suffered because of a mismatching of maturities, with the rise in their cost of funds generally outpacing increases in their return on assets. With a heavy concentration of longer-term fixed-rate mortgage and consumer loans, retail banks failed to receive higher returns when interest rates remained high, as they did throughout most of the year. Their profits became further squeezed as their core deposits shifted to expensive money-market and small-saver certificates, thus boosting costs in line with market interest rates.

In general, high interest rates remained a problem for the banking industry as well as for its customers during 1981. Banks tried to cope with this environment by curtailing their long-term fixed-rate lending and by limiting their exposure to changes in interest rates. They made substantial progress in this regard, although the continuing shift of deposit funds to high-cost categories took its toll over the year. Nevertheless, the late-fall easing of interest rates—temporary as it may have been—brightened year-end earnings prospects for many banks and other depository institutions.



Western Business

The Western economy experienced another mediocre year in 1981, as late-year business activity weakened everywhere—from farms to factories to construction sites and government agencies. (This region, the area served by the Twelfth Federal Reserve District, includes all nine states west of the Continental Divide—see map, page 24.) Activity in this nine-state region had been spotty in the early quarters of 1981, but in the fall months, production cutbacks and layoffs became widespread throughout manufacturing, construction and other goods-producing industries. Farmers and ranchers suffered a second straight year of declining net income as a result of weakening commodity prices and rising production costs. Residential construction and home sales meanwhile remained severely depressed, despite a late-year downturn in mortgage-loan rates.

Migration into this region provided some support to the regional economy—although less than during the boom of the late 1970s—and total population increased moderately to more than 38 million. Declining job prospects and (in California) soaring home prices reduced the inflow of migrants from other states. But unsettled political and economic conditions overseas stimulated a heavy inflow of migrants from Latin America and Asia, and as a result, more new Californians apparently came from other countries than from the rest of the U.S.

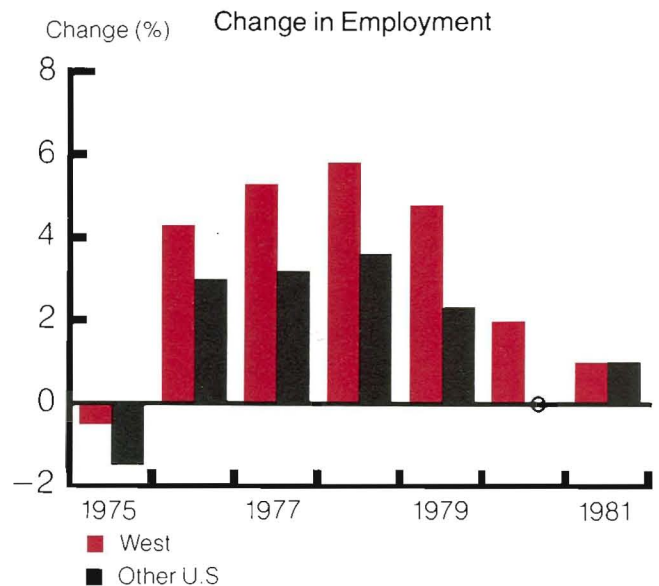
Labor-Market Weakness

As a reflection of the late-1981 slump, regional employment increased only about one percent, on an annual-average basis, to about 16.4 million for the year. The increase in jobs was only about half as great as the 1980 increase, and only a fraction of the gains recorded during the boom of the late 1970s. And for a change, employment increased no faster in the West than in the rest of the nation. The only significant gains occurred in trade and services; indeed, those two industries accounted for practically all of the region's 400,000 employment increase of the past two years. Job prospects turned bleak in a number of manufacturing industries as the year advanced, while construction employment continued to decline on the heels of the 1980 slump. With state-local government finances weakening, job levels remained practically flat in the government sector for the fourth straight year, following several decades of steady growth.

Unemployment soared throughout the West, as employment practically stagnated and as more and more job seekers poured into the regional labor force. For example, California's jobless rate practically matched the national jobless figure, which averaged 7.6 percent of the labor force for 1981 as a whole. Over the course of the year, unemployment rates rose several percentage points in most Western states. Indeed, in the Pacific Northwest, jobless rates reached double-digit levels during the fall months because of the impact of the nationwide housing slump on the region's forest-products industry.

Personal income rose about 11½ percent, to \$435 billion for the year. This was slightly better than the gain elsewhere—yet somewhat below the region's 13-percent gain in 1980. Still, real incomes increased slightly, because the consumer-price index rose about 11 percent instead of at the soaring 16-percent pace recorded the previous year. (The improvement in the inflation picture may have been overstated, because of the way the volatile housing component skewed the consumer-price index, but some improvement nonetheless was evident.) Retail sales ran almost 10 percent ahead of the previous year's pace through the early fall months, thus outrunning the 1980 increase, but still failing to keep up with the pace of inflation. Moreover, the year-to-year gain in sales then narrowed toward year-end. Most merchants experienced a disappointing holiday season—as evidenced by the number of pre-Christmas clearance sales—and a growing squeeze on retail profit margins.

Western governmental agencies also had to pull in their belts, partly because of a recession-caused slowdown in tax revenues, but for a variety of other reasons as well. Federal-government actions reduced state-local revenues through cutbacks in grants and automatic linking of Federal and state-local tax structures. In addition, these jurisdictions continued to feel the effects of the tax-and-spending limitations adopted by regional voters over the past several years. California's state government, after using its massive surpluses to ease the fiscal squeeze on other units for the past several years, now found itself with the prospect of a \$766-million revenue gap in fiscal 1982.



Governmental units in the Northwest also faced difficult conditions, strapped as they were by depressed conditions in the key forest-products industry. And one agency, the Washington Public Power Supply System, suffered catastrophic losses when it was forced to shut down two partially completed nuclear-power plants.

Industrial Performance

In the industrial sector, the key aerospace-equipment industry reduced its workforce about three percent over the course of the year because of a slowdown in orders for commercial products. Orders for commercial jet transports fell off sharply, reflecting the impact of declining passenger traffic and rising fuel costs on the earnings of the world's airlines. (As one consequence of this slowdown in orders, Lockheed announced plans to phase-out production of the wide-bodied L-1011 jet transport.) Civilian orders for electronic equipment also slowed as the national recession caused households and businesses to cut spending for such items as computers and communication equipment. Increased foreign competition added to the problems of California semiconductor firms, resulting in extended late-year plant shutdowns to work off excess inventory. In contrast, defense and space business increased sharply, as Congress substantially increased spending on such programs.

Western steel production rose about seven percent during the year, as the strong pace of nonresidential-building activity (especially an office-building boom) helped stimulate regional steel consumption. Western producers also managed to capture a larger share of the regional market, reducing the foreign-import share from 43 to 41 percent. The production gain followed on the heels of a

20-percent decline in 1980—when regional producers closed a number of high-cost facilities—so that industry output remained well below the 1979 peak. The Northwest's aluminum industry reopened some facilities shut down during a 1980 power shortage, but it eventually found itself with excess inventories because of the nationwide homebuilding slump and commercial-aircraft cut-backs. In this situation, the industry suffered a sharp profits squeeze, reflecting its inability to raise prices sufficiently to compensate for soaring energy and other costs.

The regional copper industry recovered somewhat from its 1980 strike, yet activity remained well below the 1979 peak due to weakness in demand from the auto, housing and appliance industries. With foreign and domestic demand weakening, refined metal prices moved steadily lower over the course of the year, forcing producers to close some mines and smelters for an extended period during the holiday season. The silver-mining industry also experienced a steady downtrend in prices, as decelerating inflation and high interest rates reduced speculative demand for the metal. The average producer price moved from almost \$15 per ounce early in the year to less than \$9 an ounce by year-end, far below the \$40 peak reached in early 1980. Caught between declining prices and rising costs, a major silver/lead/zinc producer thus closed its mines and smelters at Kellogg (Idaho) late in the year, idling about 2,100 workers.

Energy Developments

Regional petroleum consumption declined again during 1981, partly because of the recession, but also because of conservation measures induced by an Administration decision to accelerate decontrol of domestic crude-oil prices. Western utilities and industrial plants reduced their demand for fuel oil, taking advantage of ample supplies of clean-burning natural gas—which because of price controls were also available at lower cost. Meanwhile, on the supply side, higher prices spurred a modest increase in regional crude production, on the heels of the sharp output gains of the 1976-80 period. The import share of the regional market continued dropping to 15 percent—from 48 percent at the 1976 peak—as Western refineries substituted more and more locally-produced oil for imports.



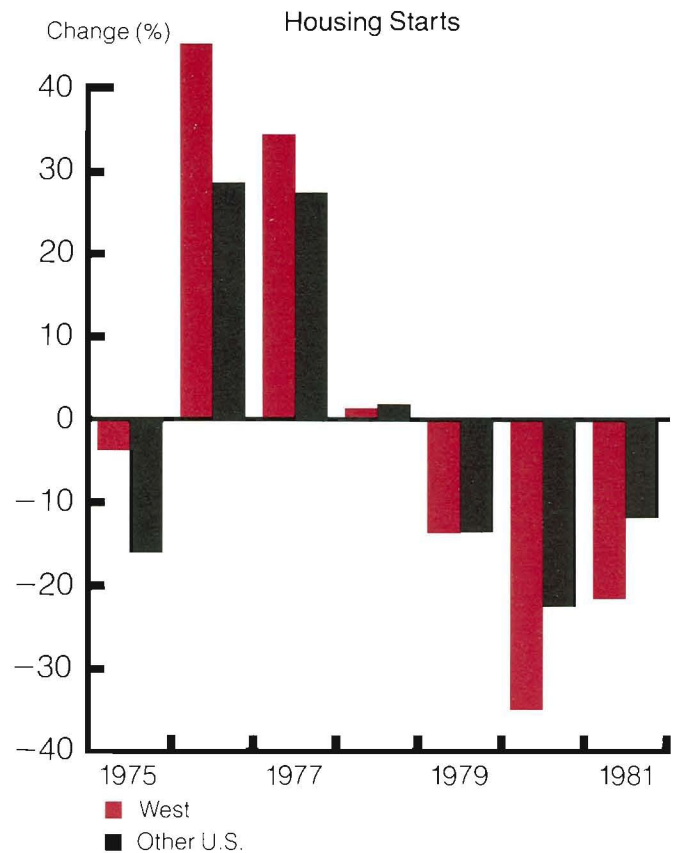
Higher wellhead prices brought about a reversal of the long-term downtrend in California production, by triggering a number of "tertiary" recovery projects to extract oil remaining in old wells. But Alaska also provided the site of several promising developments—especially the Kuparuk field, a major North Slope field adjacent to the Prudhoe Bay deposit. Initially brought on stream with an output of 80,000 barrels/day, the field is scheduled to reach a production rate of 250,000 barrels/day by the mid-1980s, with the oil being transported through the Trans-Alaska pipeline. In addition, the pipeline designed to bring Alaskan North Slope gas southeast through Canada to the "lower 48" states also moved closer to realization, when President Reagan signed legislation waiving certain U.S. regulations that had been inhibiting private financing of the project.

The emerging export market for Western coal heightened interest in the further development of the West's huge coal resources, not only in long-established Utah fields but in largely-untapped Alaska fields as well. Exports of Western coal surged over the 1979-81 period as overseas utilities and industrial firms sought lower-cost substitutes for OPEC oil. The growing overseas market for steam coal also triggered a wave of expansions of port facilities to handle huge coal-carrying ships.

Construction Scene

A continued office-building boom represented the only strong element in the 1981 construction picture, as Los Angeles, Seattle, San Francisco and other regional centers reported heavy activity in this sector. Historically low vacancy rates, increased office-building investment values, and inflation expectations all contributed to the boom, which was national and not just regional in scope. In an attempt to keep the boom going in the face of record interest rates, many institutional lenders became developers themselves by taking ownership positions in joint-venture projects. A note of caution entered the picture in late fall, however, as vacancy rates began to rise under the pressure of recession and massive additions to office space.

The three-year-old housing slump deepened further in 1981, with a 21-percent drop in building activity. Indeed, housing starts in the Western census region dropped to 243,000 units—the lowest for any year in the past generation. (At that level, starts were 56 percent below the 1978 average, compared with a 41-percent decline for the rest of the nation.) Home prices apparently fell in real terms, because of falling demand and the many "creative financing" schemes that builders and homeowners had to use to sell their properties. Most homes for sale remained out of the average family's reach, however, because of earlier price hikes and the early-1981 upsurge in mortgage interest rates, which exceeded 17 percent at the peak. During the year, the median-priced new home in California approached \$108,000—about 50 percent higher than the median price elsewhere. At mid-1981 mortgage rates, a purchaser would have needed more than a \$45,000 annual income to qualify for a mortgage loan on this average-priced California home.



The nationwide housing depression meant a deepening of the protracted slump in the Western lumber industry. With the cutback in housing-related orders, and with declines in orders from the nonresidential-construction industry and the export trade, production fell to the lowest level of the past three decades. Softwood-lumber prices on average just about matched the 1980 average figure, partly reflecting the impact of a strike at British Columbia mills in the early part of the year—but the price trend was clearly downward, with prices at year-end off about 10 percent from late-1980 levels. The pulp-paper segment of the industry recorded modest gains in sales and employment during the first half of 1981, but it too later weakened under the impact of the national recession.



Squeeze on Farm Incomes

The combination of falling commodity prices and rising production costs meant a severe squeeze on the incomes of Western farmers and ranchers. Cash farm receipts increased eight percent, to about a \$24-billion annual rate, for the first three quarters of the year. Yet bountiful supplies plus relatively weak export demand depressed prices for a wide range of products. Production costs rose sharply—especially for credit, with record interest rates being paid on growing amounts of farm debt. As a consequence, net cash income apparently weakened for the year, and this in turn meant a downtrend in sales for farm-equipment dealers and other suppliers.

Wheat prices reached the lowest levels of the past three years, on the heels of another record crop. Future prospects appeared stronger, however, because of a projected rise in foreign and domestic demand, and hence a reduction in crop carryover. Wheat exports reached record levels, reflecting heavy demand from Russian, Chinese and Indian markets. In contrast to wheat, export demands for other products suffered because of the strengthening of the U.S. dollar. This led to rising inventories and lower farm prices for cotton, nuts and other crops heavily reliant on overseas sales. A special complicating factor in the crop picture was the medfly (Mediterranean fruit fly). California's \$14-billion agricultural industry appeared threatened for a time by the medfly's infestation, but major commercial-crop growing areas remained safe from the insect's depredations. Still, the state incurred heavy expenses from the spraying of infected areas, and lost some sales in U.S. and foreign markets because of restrictions on California products.

Western cattle producers had a poor year, as their costs continued to rise while their prices declined under the impact of plentiful cattle supplies and weakening demand. Beef-cattle prices fell for the second straight year, and by late 1981 were about 14 percent below late-1979 quotations. Prices strengthened somewhat during the summer months, but then weakened again in the face of reduced consumer budgets and increased supplies of red meat and poultry. In response, cattlemen reduced their feedlot inventories in the fall months to the lowest levels of the past 15 years, and counted on slower marketings of fed cattle—and lower feed-grain prices—to restore their profit margins.

Prospects for 1982

On balance, the 1981 performance of the Western economy was better than 1980's mediocre performance in one significant respect—higher real incomes—but worse in terms of the major employment and production indexes. After an unpromising start, 1982 should turn in a more respectable record. The new year begins with continued growth in defense spending, energy exploration and commercial building. Residential builders and their supplying industries seem likely to start on the recovery path, partly because of a three-year backlog of pent-up demand, but mostly because of an expected turnaround in mortgage financing—marked by rising inflows of funds into lending institutions, lower mortgage and construction-loan rates, and hence significant declines in the monthly payments of new homebuyers. Farm and nonfarm producers also should experience a better year as inventories get pared down to more reasonable levels. And Western consumers, like their counterparts elsewhere, should benefit from growing real incomes because of the package of tax stimuli now in place and (above all) because of the nation's continued progress against inflation.



Western Finance

Western depository institutions faced a difficult year in 1981 as they tried to deal with an environment of widely fluctuating interest rates, sharp competition for funds, and softness in the regional economy. Relative performances varied widely, primarily depending on each institution's degree of retail or wholesale orientation. While most banks expanded in terms of asset size, bank earnings overall apparently fell below the 1980 record because of substantial reductions in net interest margins, especially on retail operations. The regional thrift industry meanwhile experienced the worst earnings year since World War II, with many S&Ls reporting negative spreads because of the squeeze between high-cost funds and low-yielding mortgage portfolios.

Despite the near-record cost of funds, Western banks generally outpaced their national counterparts. Outstanding bank credit—loans and security investments—exceeded \$200 billion for domestic operations, up \$18 billion for the year. The 10-percent increase in bank credit, well above 1980's seven-percent increase, reflected gains in both business and consumer lending, in contrast to a weakened real-estate category. Holdings of U.S. Treasury and state-local government securities increased by less than \$1 billion over the year.

Lending: Credit Available

Western banks expanded their commercial and industrial loans by 12 percent, to \$52 billion, during 1981. Demand increased partly because of corporate needs for working capital and inventory financing, but also because of factors such as the high cost of long-term debt financing. Commercial and industrial lending was strongest in the heavy industries—petroleum, rubber, chemicals and mining—although for widely divergent reasons. The oil industry needed funds largely for expansion purposes, whereas other industries took down bank loans to finance bloated inventories in the face of depressed markets.

Bank mortgage lending increased 13 percent, to \$67 billion, but largely because of the growth of relatively high-return, short-term home-equity loans. With the past decade's rapid escalation of Western housing prices, many homeowners took advantage of the increased equity in their homes and property to finance other purchases. Consumer loans meanwhile rose by three percent, to \$33 billion, completing the recovery from the sharp mid-1980 decline brought about by that period's credit-control program. The increase was even more significant when viewed against the backdrop of record consumer loan rates, softness in retail sales (especially autos), and the impact in several states of low usury-ceiling rates. And statistically, the increased popularity of home-equity loans for consumer purposes also tended to reduce consumer-loan figures.

Expensive Funding

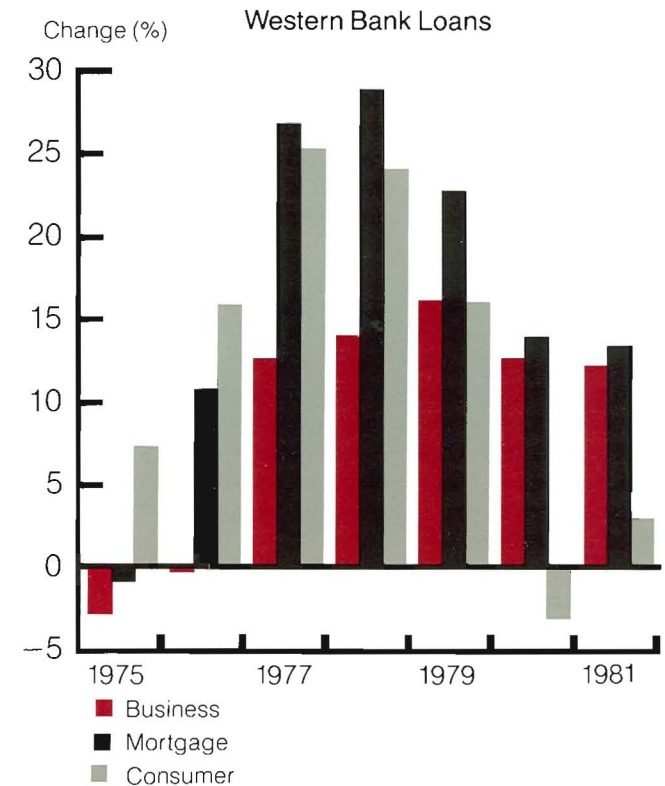
Domestic deposits of Twelfth District banks rose 10 percent to \$202 billion by year-end, and those deposits came at significantly higher costs. Higher interest rates intensified competition from other financial institutions for

banks' consumer deposits, and stimulated household and business reliance on cash-management techniques to maximize returns. Retail-oriented banks thus suffered severe pressure on margins and earnings; as their funds shifted into more expensive deposit categories, they could no longer rely as heavily as in the past on low-cost core deposits to fund fixed-rate mortgage and consumer loans.

Western banks added \$8 billion in consumer certificates with yields tied to Treasury-auction rates—six-month money-market certificates, thirty-month small savers certificates, and the new (tax-exempt) all-savers certificates. Much of this increase came at the expense of relatively inexpensive savings deposits, which declined by \$5 billion, rather than from outside the banking system. Over the year, the proportion of consumer time-and-savings deposits paying market-related interest rates rose from 50 percent to almost 60 percent.

Western banks experienced a slight decline in transaction deposits, so that they now represent less than one-quarter of banks' total deposits. This development, however, masked a major increase in banks' cost of funds and a deposit shift associated with the introduction of NOW accounts and heavy promotion of interest-bearing checking accounts. Overall, a \$7-billion gain in NOW accounts just offset an equivalent decline in bank demand balances.

Western banks thus had to rely heavily on "purchased money" for their 1981 credit expansion, with large-denomination time deposits alone accounting for nearly \$14 billion. Much of that increase did not represent new money, however, but rather a recycling of bank funds through another intermediary, money-market mutual



funds. These institutions captured a significant portion of banks' and thrifts' low-cost core deposits during the year, and relent those funds at market rates to institutions issuing large CD's.

Earnings Picture

Squeezed by high interest rates, stiff competition from thrifts and money-market funds, and increasing dependence on expensive sources of funds, Western banks generally experienced trouble boosting their earnings in 1981. For some, even a large loan expansion could not offset the narrowing of spreads caused by the sharp increase in borrowing costs. Yet for others, a fourth-quarter widening of margins on business loans made it possible to improve earnings for the year.

Operating income and interest income rose sharply in 1981 as a result of the increase in earning assets and the impact of high interest rates on income from floating-rate and short-term loans and securities. Still, operating expenses increased even more dramatically. In particular, a heavy emphasis on retail lending left many banks with a low proportion of interest-rate-sensitive assets relative to interest-sensitive liabilities. Thus, returns on fixed-rate, long-term mortgages and intermediate-term consumer loans rose much more slowly than, or even fell below, the cost of funding these assets with variable-rate consumer deposits.

The sharp climb in interest expense reflected the high cost of funds, of course. But it also reflected the massive shifts into expensive sources of funds, including 1) the movement of funds from non-interest-bearing checking accounts into 5¼-percent NOW and ATS accounts, 2) the replacement of passbook-savings deposits and maturing fixed-rate consumer certificates with more costly variable-rate certificates, and 3) the increased reliance on expensive CDs and other short-term managed liabilities. The shift was most detrimental for those banks that had benefited in earlier years from a well-developed retail deposit base of inexpensive checking and passbook-savings deposits and fixed-rate consumer certificates.

S&L Problems

Western savings-and-loan associations found even less to cheer about than banks in 1981's recession atmosphere. High home prices and persistently high interest rates sharply curtailed demand for new-home financing. According to preliminary estimates, mortgage closings totalled only \$14.8 billion—well below even 1980's modest total. Moreover, much of that lending was secured by second mortgages, generally for purposes other than home purchases.

High interest rates also affected S&L deposits, as money-market funds, in particular, attracted funds from low-yielding S&L passbook and certificate accounts. And thrifts obtained less help than anticipated from two new types of accounts—NOW's and all-savers certificates. Check-like NOW accounts, introduced regionally at the beginning of the year, grew to only \$2 billion despite very

aggressive promotion. And the much-heralded all-savers certificates, introduced in October, reached no more than \$5 to \$6 billion, with relatively little of that growth representing new (non-S&L) funds.

Nonetheless, Western S&Ls proved resourceful in finding ways to retain funds that might otherwise have left the industry. Retail repurchase agreements (repos), originally offered as part of the all-savers promotion, eventually became a significant source of funds for the industry. These instruments, although not insured, are essentially secured borrowings, and thus proved capable of attracting \$2 to \$3 billion in funds by the end of the year.

S&Ls had trouble financing their operations in view of the continued outflow of deposits from traditional passbook and certificate accounts, with their statutory interest-rate ceilings. Associations borrowed heavily from the Federal Home Loan Banks of San Francisco and Seattle at rates frequently in excess of 15-16 percent. Furthermore, S&L deposit costs became more expensive in 1981, as persistently high interest rates aggravated the continuing shift of funds from low-cost deposits to such instruments as the six-month money-market certificate and the 30-month small-savers certificate. Indeed, over the year, deposits bearing market-related interest rates rose from 64 percent to 72 percent of S&L savings capital.

Squeezed by seemingly ever-rising costs of funds and much lower-yielding mortgage portfolios, many Western S&Ls thus reported negative net interest spreads for the year. Net worth, as a result, declined from its December 1980 level, although a substantial cushion remained. The overall result was the worst earnings year for the industry since World War II.

Future Scene

Western banks and other depository institutions face continued uncertainty as they enter 1982. The present recession portends some easing in loan demand, as both businesses and consumers retrench. Falling interest rates could provide institutions with some relief from the pressure on interest margins, but the legislated phase-out of interest-rate ceilings and continued financial innovations could work in the other direction. To counter the increased interest-rate risk associated with the shift to a variable-rate consumer-deposit base, banks and thrifts may introduce and promote more variable- and floating-rate mortgage and consumer-loan products in 1982.

Banks will face continued stiff competition for consumers' savings from money funds and thrifts, and will also meet competition in the commercial-lending area from foreign lenders facing weakening overseas markets. In the consumer-lending field, competition may increase as S&Ls gain more experience and become more active in granting installment credit. Finally, depository institutions generally can count on growing inroads from a wide range of non-bank financial institutions as they begin the year.



Management Committee

(Shown from left to right, standing)

Richard T. Griffith, Executive Vice President, District Operations

Kenneth A. Grant, Senior Vice President, Computer Services

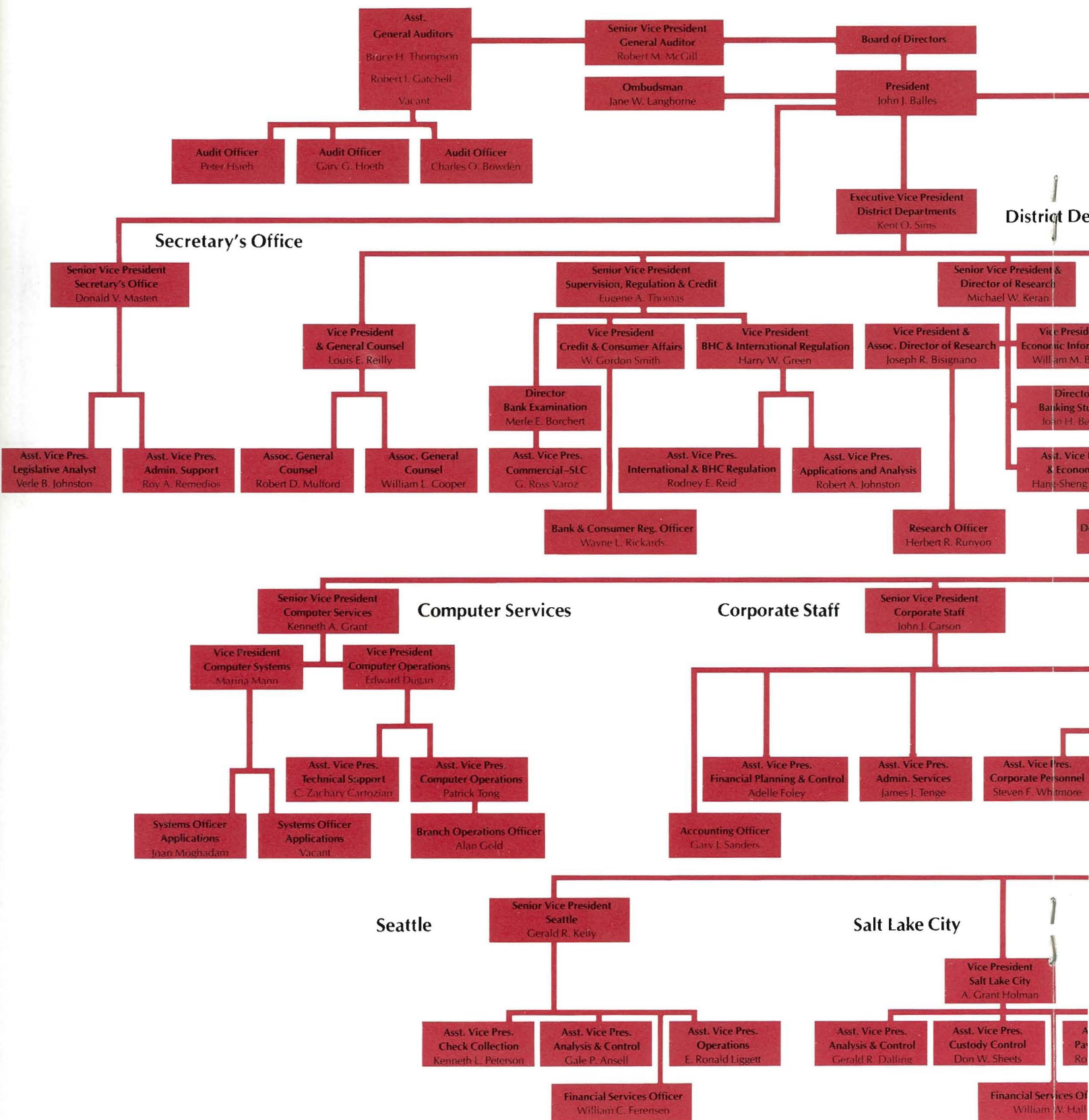
Kent O. Sims, Executive Vice President, District Departments

(seated)

John J. Carson, Senior Vice President, Corporate Staff

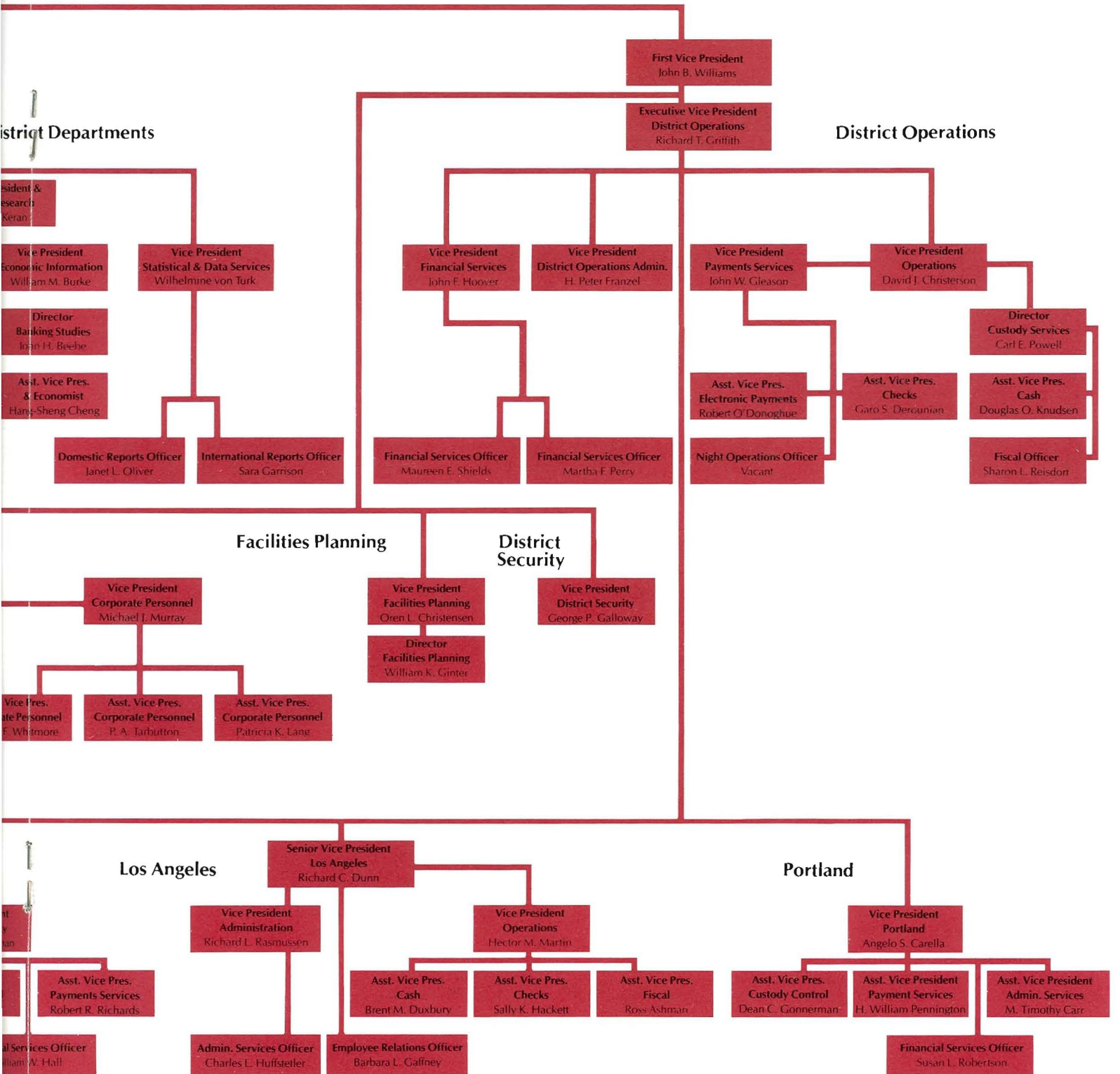
John J. Balles, President

John B. Williams, First Vice President



Federal Reserve Bank of San Francisco Organization Chart

February 1, 1982





Branch Operations

(Shown from left to right, standing)

David J. Christerson, Vice President, Operations

Richard T. Griffith, Executive Vice President, District Operations

H. Peter Franzel, Vice President, District Operations Administration
(seated)

Angelo S. Carella, Vice President, Portland

Richard C. Dunn, Senior Vice President, Los Angeles

Gerald R. Kelly, Senior Vice President, Seattle

A. Grant Holman, Vice President, Salt Lake City

Western Central Bank

The Federal Reserve Bank of San Francisco operated in a new competitive environment during 1981, largely in response to the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980 (MCA). Under this legislation, Congress promoted greater equity and improved monetary control by applying Federal Reserve reserve requirements to all depository institutions with transaction (check-type) accounts or nonpersonal time deposits. In addition, Congress promoted greater efficiency in financial markets by providing access to Federal Reserve services, at explicit prices, for those institutions now subject to reserve requirements.

During the year, the Reserve Bank provided financial services—in the area of checks, coin, currency, fiscal agency, and electronic fund transfers—for a large regional economy troubled by severe problems of recession and inflation. The Twelfth District, which is served by five Reserve Bank offices (San Francisco, Los Angeles, Portland, Salt Lake City and Seattle) is the largest Federal Reserve district in terms of population, geographic size and industrial activity. It includes the states of Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Utah and Washington, with a total population of more than 38 million people.

Implementation of MCA

As a result of the enactment of MCA, the Reserve Bank's data-collection workload expanded significantly. Previously, the Bank collected deposit data on a weekly basis from only 147 member banks, but in November 1980 it implemented weekly reporting requirements for 996 institutions (primarily those with \$15 million or more in total deposits), and in January 1981, implemented quarterly reporting requirements for 783 smaller institutions (primarily those with \$2 million to \$15 million in deposits). Of the total, about 350 institutions currently are maintaining reserve accounts directly with the Reserve Bank. Several times during the year, the Fed's Board of Governors deferred reporting and reserve-maintenance requirements for nonmember depository institutions (mostly credit unions) with under \$2 million in deposits. Congress is now giving consideration to a permanent exemption for these smaller institutions.

A number of operating departments began implementing open access and pricing for financial services on a phased-in basis during 1981. Implementation of pricing began for wire-transfer and net settlement services in January, for check and automated clearinghouse services in August, for securities handling in October, and for cash-transportation services in January 1982. Over the long run, revenues derived from providing these financial services are expected to cover all Federal Reserve costs in providing them, including an amount to reflect private-sector costs (such as taxes and capital costs) not incurred by the Federal Reserve.

In early 1980, the Reserve Bank established an MCA Policy Committee with responsibility for supervising implementation of the new legislation. The committee then

organized a Pricing and Access Project Team with the responsibility of coordinating implementation of the Act's provisions on a district-wide basis. In June 1981, the Bank organized a new Financial Services Department for offering and pricing the various financial services provided by the Reserve Bank to financial institutions. The new department is responsible for price administration, customer relations, and the planning and development of additional Fed services. In addition, the Bank in 1981 established an MCA Advisory Group, consisting of twelve senior executives from all types of depository institutions, to provide a two-way channel between the Bank and the financial community regarding implementation of MCA programs and policies. This group met six times during the year with Bank officials.

Activity at the discount window increased sharply during 1981, largely as a result of the Monetary Control Act. Under MCA, all depository institutions having reservable transaction accounts or nonpersonal time deposits are entitled to the same borrowing privileges as member banks. Nearly 250 nonmember institutions established relationships with the Twelfth District's discount window during the year, and 39 of those institutions (along with 65 member banks) exercised their borrowing privileges. While most of the borrowers used the discount window for short-term purposes, 15 member and nonmember institutions borrowed to meet their seasonal or other longer-term liquidity needs.

In September, the Reserve Bank centralized the District's discount-window administration at its San Francisco headquarters office. The Bank made the change to improve the efficiency of its credit function, and also to separate the personnel responsible for approving extensions of Federal Reserve credit from personnel responsible for the sales of priced Fed services.

Computer Developments

The Bank's Computer Services Group became closely involved in implementing MCA programs during 1981. In addition, it completed an automated securities-handling system (SHARE) and completed the second phase of a financial-statistics system (MIPE). The group also continued to work on an automated-billing system to accommodate the pricing of securities and cash transportation, and developed an automated management-reporting system to assist the Financial Services Department in analyzing prices, services, and product performance.

Culminating three years of cooperative developmental efforts, the Reserve Bank successfully implemented the SHARE securities-handling automation system at all five District offices. In addition, the Bank assisted the Kansas City, St. Louis, and Dallas Reserve Banks with their implementations of the system. The SHARE project, with San Francisco as the lead bank, represents a major cooperative effort involving software development.

In another major effort, the Bank successfully implemented the MIPE financial-statistics system, which represents a highly advanced statistical data-reporting

application. A number of current reports were converted to the MIPE system during the year.

The Federal Reserve continued work on upgrading its electronic-communications network in a project known as FRCS-80 (Federal Reserve Communications System for the '80s). The new system will be a general-purpose data-communications network, satisfying the Federal Reserve's internal-communications requirement for providing services to the financial community, the Treasury, and other government agencies. The system will improve the reliability and capacity of the Federal Reserve's communications operation, reduce the total cost of communications through a more efficient use of circuits, and increase the security of data moving within the Federal Reserve System. The computer power of FRCS-80 will be distributed among Federal Reserve offices, instead of revolving around a computerized hub as does the current Fed Wire.

Payments Services

All payments departments became actively involved in the implementation of open access and pricing during 1981. As noted above, pricing schedules were phased-in at various times during the year. The Federal Reserve now plans to review and adjust fees for those priced services on the 1982 anniversary dates of the implementation of pricing.

In pricing what were formerly "free" services, the Bank placed heavy emphasis on quality and cost control in all departments. The Check Department developed new audio-visual training programs in the critical input-processing and set-up functions. Moreover, all Bank offices established quality-assurance units to develop, implement, and monitor internal quality controls within the payments functions.

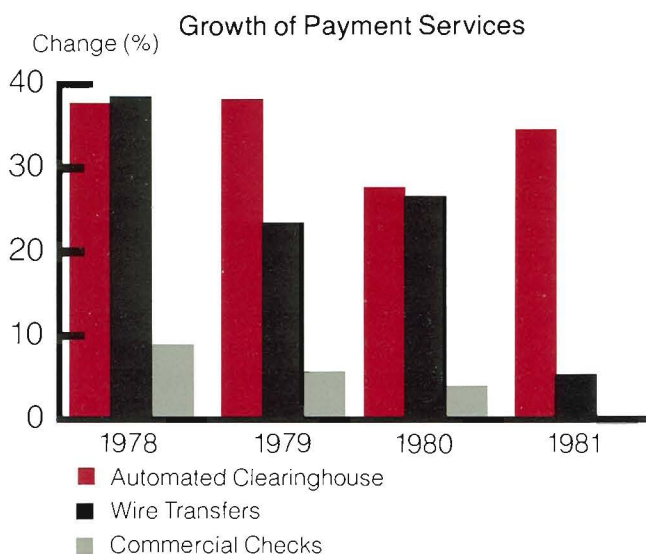
In its first several months under check pricing, the Reserve Bank experienced a six-percent decline in check-processing volume. At the same time, it witnessed a dramatic surge in the handling of "fine sort" deposits—that is, in handling pre-sorted bundles containing up to 250 checks payable at a single check-processing endpoint. Nationwide, the Federal Reserve lost an average of about eight percent of its total check volume to the private sector, which is in line with projections made before the commencement of pricing. In the preceding three years, in contrast, the Federal Reserve experienced check-processing growth of six to seven percent annually. Pricing probably was the major reason for the overall decline in volume, but other factors also contributed—such as an increase in overnight availability of check exchange among some of the nation's major commercial banks via chartered air-carrier. The Fed also provides overnight consolidated shipments among most of its 48 nationwide processing centers, but check-availability times can stretch to two days where more remote points are involved.

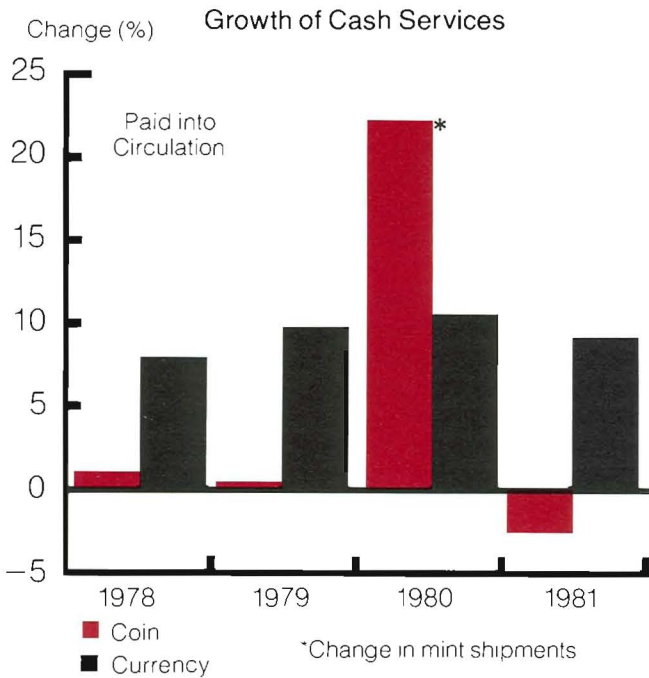
Electronic-payments activity expanded rapidly, as the Federal government and private financial institutions continued to emphasize electronic transfers for making payments. Automated clearinghouse (ACH) volume increased 35 percent over year-earlier levels. The use of electronic datalink transmissions to replace courier deliveries of tapes and reports expanded rapidly, from five sites at mid-year to 15 sites at year-end. The Reserve Bank strongly encouraged the use of electronic delivery and presentment of ACH images via datalink as a means of improving the quality of services, reducing manual operations, and encouraging greater use of ACH facilities. The Fed used long-run costs as a price basis for ACH operations. With electronic payments encouraged in this fashion, the System believes that the public will benefit in terms of efficiency and improved collection time.

Cash, Fiscal Activities

Despite all the activity in check and electronic payments, the Reserve Bank continued to handle substantial amounts of coin and currency in 1981. Altogether, it paid 4.6 billion coins and 1.7 billion pieces of currency into circulation during the year. Efficiency in the cash function improved with the installation of high-speed currency sorting machines, of which eight are now in operation at various District locations. Each machine has an optimum feed rate of 1,200 notes a minute, and is capable both of detecting counterfeits and of destroying on-line those notes which do not meet minimum fitness standards. These high-speed units also deliver a consistent quality of fit currency, which is needed to meet the requirements of the financial industry as it continues to expand its use of automated teller machines.

In its role as fiscal agent for the U.S. Government, the Reserve Bank handled substantial amounts of public-debt instruments in the form of savings bonds and marketable Treasury securities. Activity in marketable securities increased five percent in volume, reflecting continuing investor interest in the record high rates offered on such





issues. But as a result of the installation in 1980 of an automated Treasury-bill processing system, the District's Fiscal Department was able to respond effectively to the heavy workload associated with Treasury-bill purchases. The Los Angeles office, which handles all savings-bond operations for the District, installed a minicomputer-based software system to improve the efficiency as well as the quality of customer services in this area. And as noted previously, the Reserve Bank completed development of the SHARE resource-sharing project, which automates safekeeping and transfer of book-entry and definitive securities in fiscal activities.

The Bank continued efforts to curb the cost of transportation activity—which is the District's third largest expense item, after personnel costs and new-currency costs. Rising fuel prices continued to boost costs of air transportation for the inter-district check-delivery system, but costs rose at a much slower pace than heretofore. Airline-industry deregulation and the air traffic-controllers' strike led to a declining number of scheduled commercial flights, but the District's contracted commercial-freight forwarder displayed a high level of performance during the year. This permitted the Bank to reduce transportation-related float (checks credited prior to receiving payment) for those cash letters delivered to other Reserve Banks throughout the System. In early 1981, the Bank redesigned its intra-district check-delivery network into a single service contract with all offices utilizing one carrier. This streamlined system affords greater management control and cost efficiency in comparison to the previous system, which utilized a half-dozen different carriers.

Supervisory Developments

In the supervisory area, the bank examinations and bank holding-company inspections conducted during 1981 confirmed the generally healthy condition of the institutions supervised by this Reserve Bank. However, examiners found many evidences of the effects of inflation—such as reduced liquidity, marginally lower capital ratios, pressure on earnings, and (in some instances) lesser asset quality. The Bank kept examination costs in line by adopting new policies regarding frequency of examinations. One new policy permits the use of an 18-month instead of a 12-month cycle of examinations for sound and well-managed state member banks. Similarly, the Reserve Bank entered into an agreement with the California State Banking Department, whereby each agency will examine well-managed state member banks in alternating years. The Bank continued to coordinate its holding-company examinations with the examinations of subsidiary banks made by other regulatory agencies, in line with the policy developed by the Federal Financial Institutions Examination Council, the coordinating body for Federal regulatory agencies. The policy promotes efficiency by pooling the knowledge and skills of different regulators when conducting examinations of the larger bank holding-company organizations. The applications staff handled a workload which doubled in size, largely because of the desire of District financial institutions to position themselves for anticipated legislation that could reduce existing limitations on geographic operations and types of services offered. Notable among the applications processed was Midland Bank Ltd.'s request for approval to acquire a controlling interest in Crocker National Corp.—the largest and most complex application ever submitted under the Bank Holding Company Act.

In discharging its responsibilities, the Bank's staff examined more than 100 international offices—such as agencies of foreign banks, overseas offices of U.S. banking organizations, and Edge Act corporations (firms involved in international trade and finance). Edge operations continued to increase substantially during the year, in line with earlier legislation which permitted banking organizations to consolidate their Edge operations into nationwide branch networks. There are now six head offices of Edge corporations in the District with 26 branches nationwide, reflecting the conversion of individually-capitalized corporations into branches of larger entities, as well as the establishment of new branches in cities not previously served. Conversely, most of the individually-capitalized corporations previously operating here converted to branches of other out-of-district entities, while eight new Edge branches opened for business in the District. Foreign agencies, Edge corporations, and banks conducting international business meanwhile established 50 International Banking Facilities (IBFs), as a result of legislation and regulations designed to encourage offshore activities to remain within domestic jurisdictions.

The consumer-affairs staff conducted examinations at all state member banks and also at about one-fifth of their

branches, in line with a Federal Reserve program designed to achieve broad-based compliance with consumer-protection laws and regulations. The staff processed almost 1,000 individual complaints against commercial banks during 1981—about 35 percent more than in 1980—but none of the complaints required the Bank to resort to its enforcement powers to compel remedial action. In its educational role, the consumer-affairs staff published a consumer-education booklet designed to assist potential borrowers looking for a loan, as well as creditors who want to improve their customers' understanding of credit transactions. In addition, the unit co-hosted several seminars with Board of Governors staffers, to explain key material from the Truth in Lending Simplification and Reform Act both to lending-institution personnel and to examiners from other Federal agencies.

Improved Productivity

Throughout the year, the Bank's management struck an appropriate balance between cost effectiveness of operations and quality of output. The San Francisco Reserve

Bank rated second in the System in cost effectiveness, with aggregate unit costs 10 percent below the System average. Meanwhile, as a result of a quality-improvement program initiated several years ago, the Bank improved its quality of performance, as measured by reductions in errors and processing times on various operational tasks. The Federal Reserve is now actively reviewing measures of quality because of the new emphasis on market-oriented services under the Monetary Control Act.

Lastly, as a means of assuring the effectiveness of future operations, the Bank continued construction work on a 12-story, 653,000-square-foot headquarters building on San Francisco's Market Street. The present headquarters building was built in the 1920s and is small and inefficient from the standpoint of 1981-style banking operations. Indeed, with recent increases in workload, the Bank's headquarters operation now has spread over five separate buildings. The new facilities are scheduled for occupancy in late 1982, ready to assist the Bank in providing many central-banking services to a large and diverse group of Western financial institutions.

Summary of Operations

	1978	Volume (thousands)		1981
		1979	1980	
Custody Services				
Cash Services				
Currency paid into circulation	1,281,416	1,407,894	1,556,278	1,700,557
Coin paid into circulation	3,991,280	4,007,145	4,895,306 ¹	4,649,901
Fiscal Agency Services				
Savings Bonds original issues	1,547	1,563	1,327	1,136
Savings Bonds redemptions processed*	246,867	328,567	372,420	259,644
Other Treasury original issues	59	150	231	232
Food coupons processed	263,684	223,232	274,058	318,497
Payments Mechanism Services				
Check Processing Services				
Commercial checks processed	1,283,807	1,358,985	1,406,489	1,393,822
Fine sort bundles processed	N/A	N/A	804,248	1,201,909
Government checks processed	117,237	109,761	106,470	103,154
Return items processed	17,956	20,225	21,833	22,431
Electronic Funds Transfer Services				
Wire transfers processed	3,123	3,847	4,883	5,143
Automated clearinghouse transactions processed	23,512	32,448	41,298	55,483
Discounts and Advances				
Total discounts and advances*	914	1,318	1,092	1,821
Number of financial institutions accommodated*	60	59	67	106

*Number (not in thousands)

¹Unusually high volume of payout due to implementation of direct mint shipments to banks

Financial Services Group

At midyear the Bank formed a new Financial Services Department to develop and price the various operating services offered to financial institutions. This department is handling price administration, service relations, and planning and development of additional Reserve Bank services.

John F. Hoover
Vice President, Financial Services, San Francisco

Martha F. Perry
Financial Services Officer, Customer Relations
San Francisco

Maureen E. Shields
Financial Services Officer, Product Management
San Francisco

William C. Ferensen
Financial Services Officer, Seattle

William W. Hall
Financial Services Officer, Salt Lake City

Susan L. B. Robertson
Financial Services Officer, Portland

Richard L. Rasmussen
Vice President, Administration, Los Angeles



Hoover



Perry



Shields



Hall



Ferensen

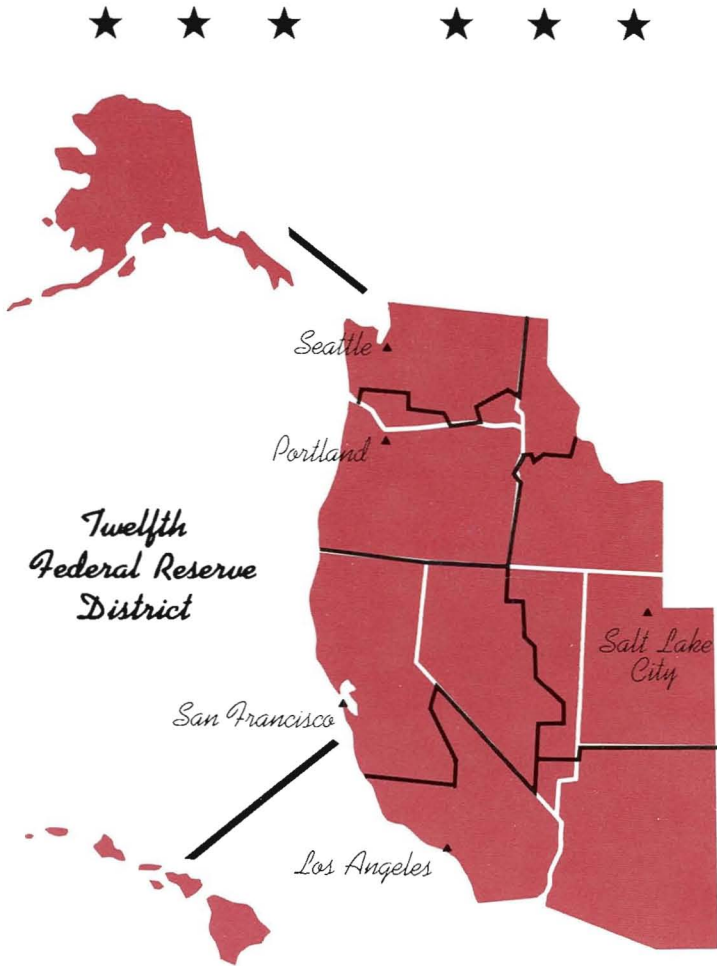


Robertson



Rasmussen

Directors



The Federal Reserve carries out its central-banking functions through a nationwide network of 12 Federal Reserve Banks and their 25 branches, under the policy guidance, coordination and general supervision of the Board of Governors in Washington, D.C. The Head Office of the Federal Reserve Bank of San Francisco has a nine-member Board of Directors. Each of the Bank's other offices at Los Angeles, Portland, Salt Lake City and Seattle has a seven-member board.

Federal Reserve directors bring management expertise to the task of overseeing Reserve Bank operations. They also provide first-hand information on key economic developments in various areas of the District, complementing the Bank's internal research efforts. In addition, Board members give advice on the general direction of monetary policy, especially with regard to the Bank's discount rate. The Head Office Board has specific responsibility for initiating changes in the discount rate, subject to review and approval by the Board of Governors.

Head Office

Chairman of the Board and Federal Reserve Agent

Caroline Leonetti Ahmanson
Chairman of the Board, Caroline Leonetti Ltd.
Hollywood, California

Deputy Chairman

Alan C. Furth
President, Southern Pacific Company
San Francisco, California

Fred W. Andrew
President and Chief Executive Officer
Superior Farming Company
Bakersfield, California

Frederick G. Larkin, Jr.
Chairman of the Executive Committee
Security Pacific National Bank
Los Angeles, California

Ole R. Mettler
President and Chairman of the Board
Farmers and Merchants Bank of Central California
Lodi, California

Clair L. Peck, Jr.
Chairman of the Board
C. L. Peck Contractor
Los Angeles, California

J. R. Vaughan
Senior Member
Richards, Watson, Dreyfuss & Gershon
Los Angeles, California

George H. Weyerhaeuser
President and Chief Executive Officer
Weyerhaeuser Company
Tacoma, Washington

Robert A. Young
Chairman of the Board and President
Northwest National Bank
Vancouver, Washington

Federal Advisory Council Member

Joseph J. Pinola
Chairman of the Board, First Interstate Bancorp
Los Angeles, California



Ahmanson



Furth



Andrew



Larkin



Mettler



Peck



Vaughan



Weyerhaeuser



Young

Federal Advisory Council Member



Pinola



Dockson



McAlpin-Grant



Tanaka



Schwaegler



Goldsmith



McMahon



Tooley

Los Angeles

Chairman of the Board

Bruce M. Schwaegler
President, Bullock's-Bullocks Wilshire
Los Angeles, California

Robert R. Dockson
Chairman and Chief Executive Officer
California Federal Savings and Loan Association
Los Angeles, California

Bram Goldsmith
Chairman of the Board, City National Bank
Beverly Hills, California

Lola McAlpin-Grant
Assistant Dean, Loyola Law School
Los Angeles, California

James D. McMahon
President, Santa Clarita National Bank
Valencia, California

Togo W. Tanaka
President, Gramercy Enterprises
Los Angeles, California

William L. Tooley
Managing Partner, Tooley & Company, Investment
Builders
Los Angeles, California

Portland

Chairman of the Board

John C. Hampton
Chairman of the Board and President
Willamina Lumber Company
Portland, Oregon

Herman C. Bradley, Jr.
President and Chief Executive Officer
Tri-County Banking Company
Junction City, Oregon

Carolyn S. Chambers
Executive Vice President/Treasurer
Liberty Communications, Inc.
Eugene, Oregon

John A. Elorriaga
Chairman and Chief Executive Officer
United States National Bank of Oregon
Portland, Oregon

Jack W. Gustavel
President and Chief Executive Officer
The First National Bank of North Idaho
Coeur d'Alene, Idaho

William S. Naito
Vice President, Norcrest China Company
Portland, Oregon

Phillip W. Schneider
Former Northwest Regional Executive
National Wildlife Federation
Portland, Oregon



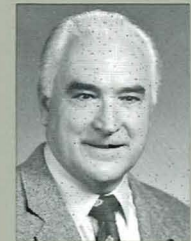
Hampton



Bradley



Chambers



Elorriaga



Gustavel



Naito



Schneider



Eccles



Erkins



Stringham



Ashton



Ence



Gianoli



Terteling

Salt Lake City

Chairman of the Board

Wendell J. Ashton
Publisher, Deseret News
Salt Lake City, Utah

Spencer F. Eccles
Chairman, President and Chief Executive Officer
First Security Corporation
Salt Lake City, Utah

Lela M. Ence
Executive Director
University of Utah Alumni Association
Salt Lake City, Utah

Robert A. Erkins
Geothermal Agri/Aquaculturist
White Arrow Ranch
Bliss, Idaho

Albert C. Gianoli
President and Chairman of the Board
First National Bank of Ely
Ely, Nevada

Fred H. Stringham
President, Valley Bank and Trust Company
South Salt Lake, Utah

J. L. Terteling
President, The Terteling Company, Inc.
Boise, Idaho

Seattle

Chairman of the Board

John W. Ellis
President and Chief Executive Officer
Puget Sound Power & Light Company
Bellevue, Washington

Merle D. Adlum
President, Maritime Trades Department,
Puget Sound District Council, AFL/CIO
Seattle, Washington

Lonnie G. Bailey
Executive Vice President and Chief Operating Officer
Farmers and Merchants Bank of Rockford
Spokane, Washington

Donald L. Mellish
Chairman of the Board, National Bank of Alaska
Anchorage, Alaska

John N. Nordstrom
Co-Chairman of the Board, Nordstrom, Inc.
Seattle, Washington

Virginia L. Parks
Vice President for Finance and Treasurer
Seattle University
Seattle, Washington

G. Robert Truex, Jr.
Chairman and Chief Executive Officer
Rainier Bancorporation and Rainier National Bank
Seattle, Washington



Ellis



Adlum



Bailey



Mellish



Nordstrom



Parks



Truex

Comparative Statement of Account

(Thousands of Dollars)

	December 31,	
	1980	1981
Assets		
Gold certificate account	\$ 1,253,000	\$ 1,083,000
Special Drawing Rights certificate account	293,000	380,000
Other cash	64,883	66,682
Loans to depository institutions	55,025	14,640
Federal Agency obligations	1,185,528	1,216,661
United States Government securities:		
Bills	5,926,467	6,580,908
Notes	7,965,458	7,996,764
Bonds	2,291,565	2,453,292
Total United States Government securities	16,183,490	17,030,964
Total loans and securities	17,426,743	18,262,265
Cash items in process of collection	827,166	515,841
Bank premises	42,508	74,622
Operating equipment	11,127	14,498
Other assets:		
Denominated in foreign currencies	794,379	808,703
All other	552,056	392,140
Total assets	21,264,862	21,597,751
Liabilities		
Federal Reserve notes	14,219,242	14,984,308
Deposits:		
Total depository institutions—reserve accounts	6,044,474	5,349,090
Foreign	56,604	51,359
Other deposits	28,683	35,476
Total deposits	6,129,761	5,435,925
Deferred availability cash items	237,572	327,588
Other liabilities	289,759	431,330
Total liabilities	20,876,334	21,179,151
Capital Accounts		
Capital paid in	194,264	209,300
Surplus	194,264	209,300
Total liabilities and capital accounts	21,264,862	21,597,751
Contingent liability: earned credits due to depository institutions		

Earnings and Expenses

(Thousands of Dollars)

	December 31,	
	1980	1981
Current Earnings		
Discounts and advances	\$ 12,977	\$ 14,797
United States Government securities	1,664,860	1,938,292
Foreign currencies	18,630	90,366
Income from services	N/A	12,848
All other	159	833
Total current earnings	1,696,626	2,057,136
Current Expenses		
Total current expenses	86,389	99,674
Less reimbursement for certain fiscal agency and other expenses	6,681	7,223
Net expenses	79,708	92,451
Profit and Loss		
Current net earnings	1,616,918	1,964,685
Additions to current earnings		
Profit on sales of United States Government securities (net)	0	0
Profits on foreign exchange transactions	15,283	0
All other	2,365	1,446
Total additions	17,648	1,446
Deductions from current net earnings		
Loss on foreign exchange transactions (net)	0	49,265
Loss on sales of United States Government securities (net)	26,590	16,667
All other	3,641	1,404
Total deductions	30,231	67,336
Net additions (+) deductions (-)	- 12,583	- 65,890
Earned credits used by depository institutions	N/A	- 51
Assessments for expenditures of Board of Governors	- 9,880	- 10,177
Net earnings before payments to United States Treasury	1,594,455	1,888,567
Dividends paid	11,192	12,018
Payments to United States Treasury (interest on Federal Reserve notes)	1,571,337	1,861,514
Transferred to surplus	11,926	15,035
Surplus January 1	182,338	194,264
Surplus December 31	194,264	209,300

San Francisco Office

P.O. Box 7702, San Francisco, California 94120

Los Angeles Branch

P.O. Box 2077, Terminal Annex, Los Angeles, California 90051

Portland Branch

P.O. Box 3436, Portland, Oregon 97208

Salt Lake City Branch

P.O. Box 30780, Salt Lake City, Utah 84130

Seattle Branch

P.O. Box 3567, Terminal Annex, Seattle, Washington 98124

About the photos:

This *Annual Report* contains photographs of directors and senior officers, plus a group of financial-service officers—the major public-contact personnel for the Bank's new Financial Services Department. In addition, interspersed throughout the text are candid photos of individuals from a number of operating and staff departments.

This report was prepared by the staff of the Federal Reserve Bank of San Francisco; produced by William Burke and Karen Rusk; graphics designed by William Rosenthal; copy written by William Burke, Barbara Bennett, Yvonne Levy and Gary Zimmerman.