1982
Annual Report

Federal Reserve Bank
San Francisco

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From the Boardroom

Caroline Leonetti Ahmanson
Chairman of the Board

John J. Balles
President

Alan C. Furth
Deputy Chairman

The year 1982 was one of mixed performance for the U.S. economy. The good news was that the inflation rate was reduced from over 10 percent in 1980 to 6 percent in 1982, and that there was a significant decline in interest rates in the second half of the year. The bad news was the unexpectedly severe recession in which real GNP fell 1.8 percent, the sharpest decline since 1947. Weak output was mirrored in a 10.8-percent unemployment rate (a postwar high) and a 68-percent utilization rate for the nation's capital stock (a postwar low).

The major factors behind the weak economy in 1982 were the high level of interest rates and a very strong dollar in foreign exchange markets that prevailed for much of the year. High interest rates were a special hindrance to the recovery in housing and business fixed investment, while a strong dollar undermined the U.S. international competitive position at home and abroad.

Prospects for recovery in 1983 have been greatly improved by a significant decline in interest rates in the second half of 1982 and by the recent declines in the international value of the dollar. The housing industry already has shown substantial recovery from its very depressed levels in the summer of 1982. Anticipated strength in consumer spending, inventory investment and Federal government purchases should be sufficient to offset the weaknesses in business fixed investment and net exports so that on balance 1983 should be a year of modest recovery.

The major policy challenge facing the Federal Reserve in 1983 is how much further it can encourage a reduction in short-term interest rates, over which it has the most influence, without re-igniting fears of renewed inflation several years down the road. Such fears of future inflation could cause long-term interest rates

to rise. This problem is compounded by the extraordinarily large government deficits (recently estimated at between $150 and $200 billion annually) expected over the next five years. If these deficits are to be financed in a non-inflationary manner, then interest rates must be high enough to attract private savers to purchase them. However, those rates may be too high to support sustained recovery in interest-sensitive industries such as housing and autos that have been most depressed by the recession. The Federal Reserve will be walking a fine line in 1983 between encouraging lower interest rates to stimulate a sustainable recovery, while assuring that rates are not so low as to result in the deficit being financed by excessive money creation and, therefore, by inflation.

With passage of the Monetary Control Act of 1980, Congress required the explicit pricing of payments services previously supplied "free," to banks holding Federal Reserve determined required reserves. Congress also specified that all costs the Federal Reserve incurs to provide these services, plus a "private sector adjustment factor," be recovered in the explicit prices charged. The adjustment factor represents tax and capital costs the Federal Reserve would incur were it a private corporation.

To ensure that its services meet the needs of a competitive marketplace, this Bank is making every effort to control costs and to improve services. By working closely with other Reserve Banks in the System, these efforts should improve the efficiency of the nation's payments mechanism significantly. During 1982, the Bank maintained the effective presence necessary for provision of key services and introduced several product enhancements that promote efficiency and improve the quality of our services.

The Reserve Bank's new San Francisco Headquarters building was nearing completion by year's end, with interior special finish work on the ground and twelfth floors remaining for completion in early 1983. One of the public features of the new building is a large walk-through educational exhibition on the ground floor. Called "The World of Economics," the exhibition is of museum quality and uses a broad range of modern museum technology to present and explain key economic principles in lively and entertaining ways. You are invited to participate in this world-class exhibition at your convenience during the coming year.

Management benefited greatly during 1982 from the broad-based experience and judgment of the Bank's directors at its Headquarters Office and at its four branches. The directors provided guidance on major management decisions and planning goals, especially with regard to implementation of the Monetary Control Act. In addition, they supplied information on economic and financial conditions to support the Federal Reserve's formulation of monetary policy. Today, 37 public-spirited men and women serve as directors, representing a great variety of economic interest and non-profit organizations from many areas of the West.

We are grateful to all of these individuals and to those who completed terms as directors during 1982. They are: Frederick G. Larkin, Jr. (Chairman of the Executive Committee, Security Pacific National Bank) and Clair L. Peck, Jnr. (Chairman of the Board, C.L. Peck, Contractor) at our San Francisco office; Phillip W. Schneider (Former Northwest Regional Executive, National Wildlife Federation) at Portland; Fred H. Stringham (President, Valley Bank and Trust Company) and Robert A. Erkins (Geothermal Agri-Aquaculturist, White Arrow Ranch) at Salt Lake City; and Donald L. Mellish (Chairman of the Board, National Bank of Alaska) and Merle Adlum (President, Puget Sound District Council, Maritime Trades Dept. AFL-CIO) at Seattle.

Finally, we wish to express our appreciation to the officers and staff whose efforts and dedication made 1982 a success. Their challenge was especially great as they moved the Reserve Bank from the five separate buildings it has occupied in recent years to its new headquarters under one roof.

Caroline Leonetti Ahmanson
Chairman of the Board

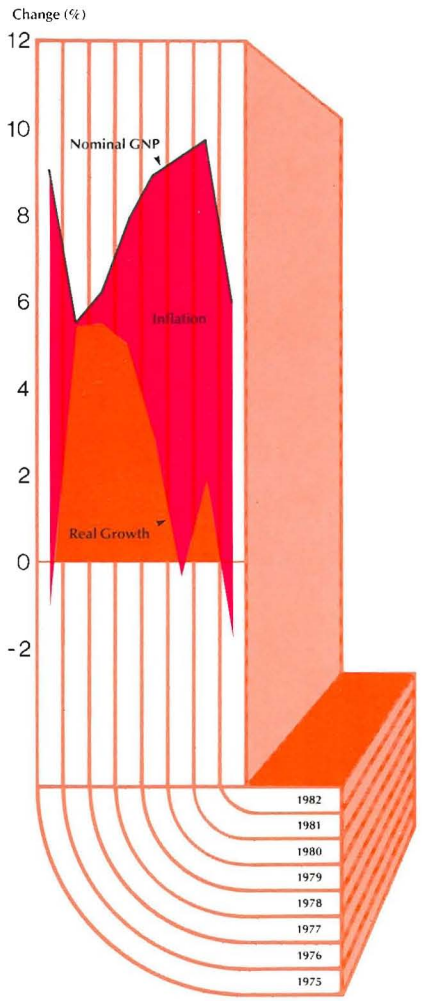
John J. Balles
President
January 26, 1983

National Scene

For the record, 1982 must go down in the books as showing the largest annual decline in the nation's output of goods and services since the 1946-47 shift from a wartime to a peacetime economy. Although the gross national product in current dollars topped $3 trillion, a gain of four percent over 1981, real GNP fell by 1.8 percent when adjustment is made for inflation. Only in 1975 did the year-to-year decrease in real GNP (1.1 percent) come close to matching last year's poor economic performance.

Although the 2.5-percent decline in GNP during this most recent recession was no larger than the average decline in the six preceding business cycles, it followed the previous downturn in 1980 much more closely than is typical. As a result of these two back-to-back recessions the unemployment rate reached 10.8 percent at year-end, the highest level since 1940, and the number of business failures rose more than 50 percent over 1981 to reach the highest level since 1932.

The decline in economic activity in 1982, however, should not divert attention from the positive developments that were taking place during the year. On the favorable side of the ledger were the decline in the annual rate of inflation (as measured by the implicit price deflator for GNP) from 9.4 percent in 1981 to only 6 percent in 1982, and the sharp fall in interest rates beginning in the second half of the year.



Real Growth and Inflation

Both the weak performance of the real economy and the magnitude of the decline in the rate of inflation came as a surprise to economists and policymakers alike. As the year opened, most forecasters were predicting that the economy soon would begin to recover from the recession and would be expanding strongly by year-end. Most expected only a modest further decline in the inflation rate from the 8.5-percent rate experienced in the last half of 1981. Reflecting the progress already made in reducing the rate of inflation, however, interest rates were expected to continue the decline begun in 1981 though some rebound in rates was anticipated in the last half of the year as the economy expanded out of the recession.

These relatively optimistic economic predictions reflected forecasters' expectations that fiscal policy would be strongly expansionary as the second-stage of the Administration's three-year tax-cut package went into effect on July 1. Progress in bringing down inflation and interest rates was expected to spark recovery in such interest-sensitive sectors of the economy as residential construction, autos and plant and equipment investment. While continuing to lean against inflation, monetary policy was expected not to hinder the downward movement in interest rates.

In fact, interest rates ceased their downward movement in January of 1982 and remained fairly stable at high levels until July. This resulted both from a slowing in monetary expansion, as the Federal Reserve sought to counter the above-target monetary growth in the fourth quarter of 1981, and from the increased realization that massive government deficits would put severe pressure on financial markets for several years into the future. Since the rate of inflation continued to decline in the first half of 1982, the failure of nominal interest rates to

decline further meant that real interest rates rose in the first quarter of 1982. For example, when consumer prices were rising at an annual rate of 7 percent, the 91-day Treasury bill rate exceeded 12 percent, giving a short-term real interest rate of about 5 percent, sharply higher than the historical average of about 1 percent. Although real rates declined by about 2½ percent in the last half of the year, they remained high by historical standards at year-end.

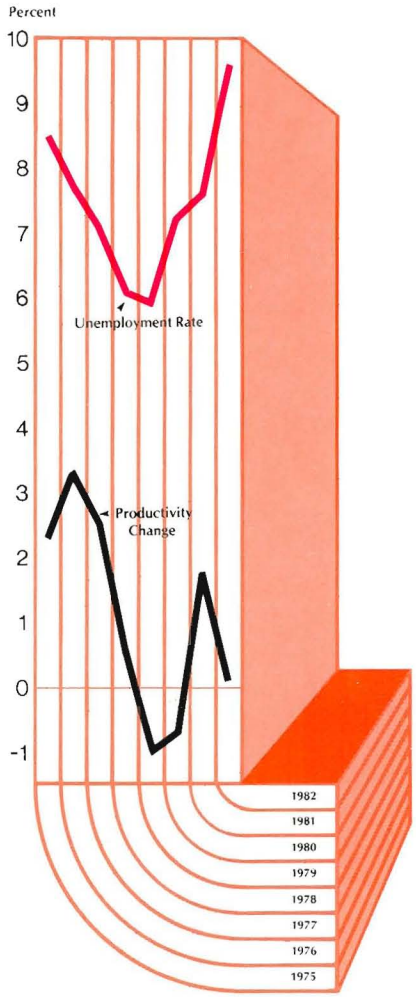
In addition, despite the cut in federal income tax rates effective in July, tax policy in 1982 was less expansionary than had been anticipated. Social Security contributions were raised, state and local taxes continued their long-run upward trend, and rising prices and hence nominal incomes continued to have the effect of raising effective tax rates by moving households into higher tax brackets. As a result, total tax collections by all levels of government represented 31.5 percent of GNP in the third quarter of 1982. This was only modestly below the 32.8 percent recorded in the first half of 1981 before the tax-cut program began.

The General Decline

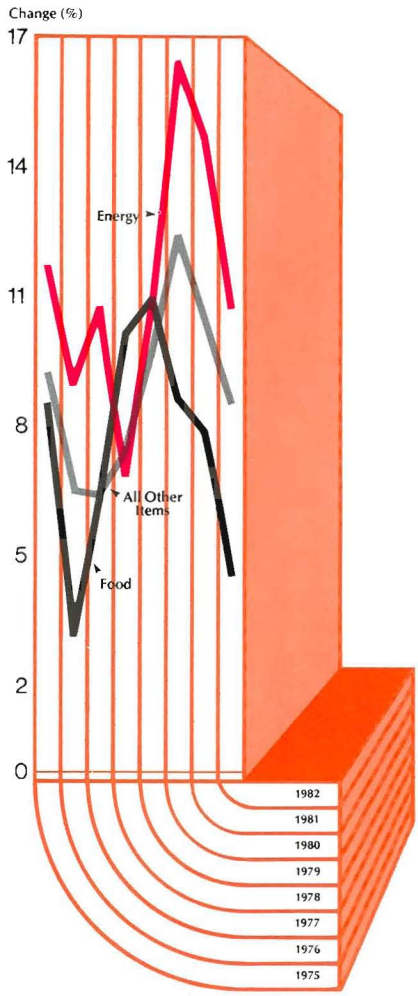
The result of these monetary and fiscal policy developments was that the economy—instead of recovering briskly in 1982—remained in recession. The decline in activity spread from housing, autos and the primary metals, which already were depressed prior to the start of the recession in July 1981, to consumption, business fixed investment and exports.

Overall consumer spending rose by one percent in real terms in 1982, about half of the increase in 1981 and well below the long-term trend of 3.8 percent average annual growth. The only other major category of expenditures showing real growth was federal government outlays for national defense, which increased 7 percent. Real expenditures for gross private domestic investment more than reversed the gain in 1981 and declined to their lowest level since 1978. The reduction in fixed investment hit both residential building and business plant and equipment expenditures. The federal government's non-defense expenditures exhibited no real growth in 1982, while state and local government outlays declined for the second year in a row. Finally, net exports of goods and services declined sharply for the second straight year. This was due to a substantial decline in net exports of U.S. goods, partially offset by a small increase in net exports of services.

The weakness in consumption spending was evident in all of the major areas of consumer purchases. Durable goods expenditures, being more sensitive to interest rates, were particularly depressed. Rising unemployment left the level of wages and salaries virtually unchanged after July, so that the chief sources of increase in personal income were gains in personal interest income and in transfer payments (including unemployment compensation). The expected increase in consumption from the combination of the personal tax cut and the cost of living increase to Social Security benefits in July, failed to materialize. Although auto sales did revive strongly in the fourth quarter, this appears to have been more the result of declining interest rates and price-reductions than the delayed influence of the mid-year tax cut. For the year as a whole, domestic auto sales amounted to 5.7 million units,



Productivity...Unemployment



Consumer Price Change

making 1982 the worst year for Detroit since 1961.

Reflecting both high mortgage rates and soft prices of existing housing, new home construction languished through most of the period. Housing starts barely exceeded one million units for the year. As in the case of autos, the fortunes of the housing industry and of mortgage lenders improved in the closing months of 1982. By the end of the year housing starts were running at a 1.25-million annual rate. Conventional mortgage rates fell about 4½ percentage points to about 13 percent by the end of the year, bringing the purchase of a new home within the reach of a greater number of households. Mortgage lenders benefited as the spread between the current market cost of funds and the yield on their mortgage portfolios narrowed.

Investment Continuing Slide

Real expenditures for business plant and equipment decreased by nearly 4 percent in 1982 and the decline accelerated as the year progressed. Recent surveys of investment intentions suggest that this weakness will carry over into 1983. In other circumstances, capital spending might be expected to respond favorably to declining interest rates, particularly when reinforced by the tax reductions and other investment incentives bestowed by the Economic Recovery and Tax Reform Act of 1981. Despite these incentives, however, businessmen, faced with a capacity utilization rate of less than 68 percent, historically high real interest rates, and a 15-percent decline in corporate profits, found little encouragement to enter the long-term commitments associated with major capital investment projects.

Inventory investment is the most volatile sector over the business cycle. As inventory stocks rise relative to sales, businessmen cut back on new production and attempt to trim the level of inventories to current and expected sales. In the first half of 1982, net inventory liquidation amounted to nearly $25 billion (at an annual rate). Inventory investment turned positive in the third quarter but this accumulation appears to have been largely involuntary and the result of sales falling below expectations. A further inventory reduction of $38 billion was made in the fourth quarter, suggesting that inventory stocks at the beginning of 1983 are closer to desired levels. Thus, inventory investment should make a substantial contribution to the early stages of the recovery.

The farm sector continued to experience hard times which can only be compared to the Great Depression of the 1930s. Net farm income declined by 60 percent between 1979 and 1980. Although 1981 saw some modest recovery the index of prices received by farmers fell by more than three percent in 1982, while prices paid by farmers rose by 3.5 percent. As a result, real incomes declined a further 25 percent to their lowest level since 1932. The depressed state of the farm economy is reflected in the fortunes of the farm equipment industry, where production fell by 26 percent during the year.

Domestic developments, such as the declines in housing and manufacturing, generally are cited as the main cause of the fall in real output in 1982. However, the foreign sector also played a key role in the overall decline. Exports of goods and services dropped by almost seven percent and imports increased slightly. As a result, our net export position deteriorated from a $24 billion surplus (in current dollars) in the fourth quarter of 1981 to a $7 billion deficit

in last year's fourth quarter. The main reasons for this decline were the strength of the American dollar, which largely resulted from the high level of domestic real interest rates relative to our trading partners, and the fact that most other industrial economies also were in recession.

Portents for the Future

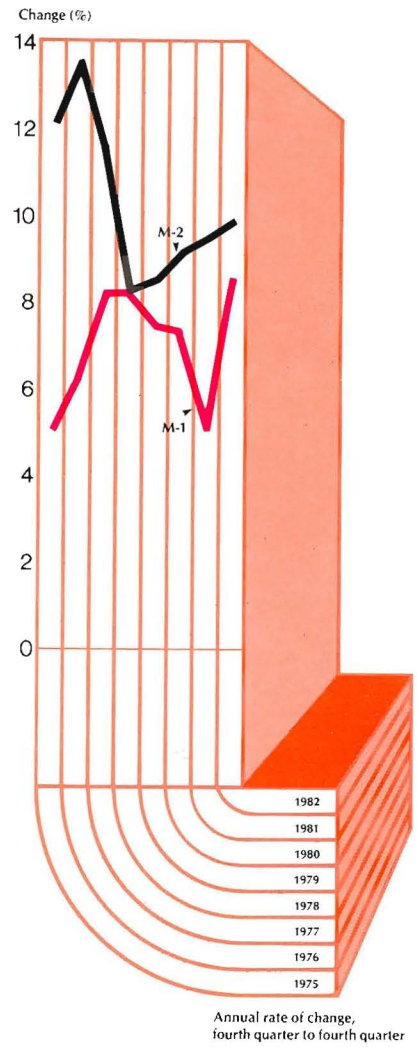
The developments of 1982 promise to have a significant influence on the economy in the months and years ahead. The decline in the rate of inflation and in interest rates is the most favorable development. Inflation is expected to stabilize at around 5 percent in 1983 which, though high by historical experience in the United States, is a far cry from the raging inflation of the winter of 1980 when it reached a peak of 12 percent. Lower interest rates should hasten the recovery of those interest-sensitive areas of the economy which have been badly battered in the past two years.

Consumption will be helped by a substantial strengthening of household balance sheets. Since 1980 there has been a modest increase in the personal saving rate, reaching 6½ percent in 1982, reflecting both high real interest rates and tax cuts. Although the higher saving rates contributed to the overall sluggishness of consumer demand, they enabled households both to add to their stocks of financial assets and to liquidate their installment obligations at a rapid rate. The ratio of repayments of installment debt to after-tax income was just under 15 percent in 1982 compared to almost 17½ percent in 1979. Consequently, when consumers feel more confident about the future, they will be better able to assume debt in order to purchase durable goods. The boom in the stock market also is a favorable sign since the individual feels more comfortable spending for goods and services when his wealth position improves. On the other hand, consumption spending no longer is being stimulated by the rising value of owner-occupied homes as it was during the 1970s.

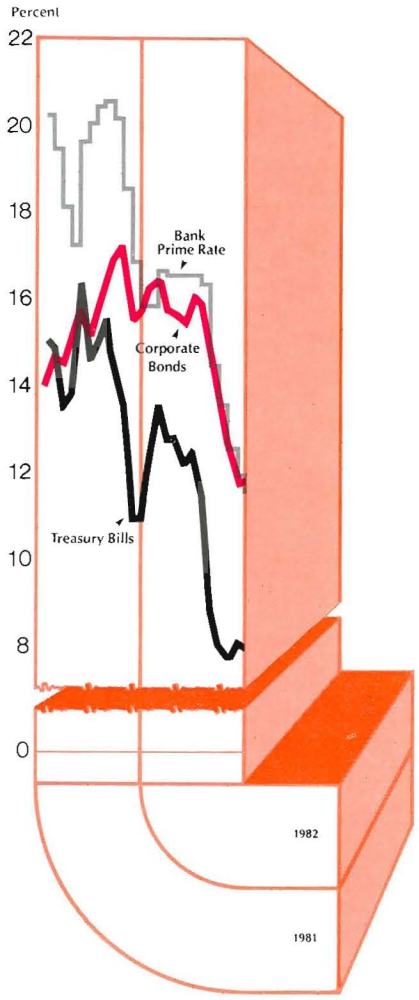
The employment outlook is less favorable. Not only is unemployment at its highest level in more than 40 years, but it is much more pervasive. While manufacturing and construction workers usually have higher cyclical unemployment rates than other employment groups, service industry, administrative and other white collar workers now are appearing in the ranks of the jobless. Professional and technical workers, and managers on the middle rung of the organizational ladder have been especially hard hit, as businesses cut costs to make their organizations more efficient and to lower the break-even point of their operations. Although these effects already have shown up in increased productivity, the unemployment rate may be slow to fall, since scaled-down firms will absorb fewer additional workers as output begins to recover. Martin Feldstein, Chairman of the Council of Economic Advisors, has expressed the opinion that even under the best of circumstances, the unemployment rate will not fall below 6 to 7 percent until 1987.

Money and the Economy

Monetary policy was conducted during 1982 in an environment of financial stress which possibly was more severe than at any time during the postwar period. Acute financial pressures were apparent in the nonfinancial corporate sector, the federal government sector and the U.S. banking community.



Growth of Money Supply



Interest Rates

The nonfinancial corporate sector faced weak final sales, record debt service burdens, high short-to-long-term debt ratios, decreasing profit margins and a very highly leveraged financial structure. These pressures were aggravated by the high level of long-term interest rates and low volume of long-term financing activity during the first half of 1982. Thus it was not possible for any significant lengthening of the average maturity of corporate debt to occur.

Financial market uncertainty was heightened during the year by unfolding news that federal government deficits would reach historic highs and remain large for several years. Compounding the uncertainty was the awareness that large quantities of debt owed to U.S. banks by several developing countries would have to be rescheduled, with some countries requiring the assistance of international agencies, such as the Bank for International Settlements and the International Monetary Fund.

While monetary policy during 1982 was conditioned by an unusual set of financial pressures on the economy, the basic thrust of policy continued to be toward promoting long-run, non-inflationary, real economic growth. When the Federal Reserve embarked on its anti-inflation policy in late 1979 it was recognized that in the short run the effect of this policy would be to raise interest rates, reduce the demand for goods and services, and to cause some contraction in output and employment. However, it was expected that this contractionary effect would be short-lived. Reduced aggregate demand would lessen the upward pressure on costs and prices. Confidence that the Federal Reserve would sustain its policy would lead households, firms and financial market participants to scale back their long-run inflation expectations. And as both actual and expected inflation declined, the inflation premium built into both short- and long-term interest rates, was expected to narrow and rates were expected to decline, leading to a revival in aggregate demand and improved growth in employment.

Events have not unfolded according to this optimistic scenario. The rate of inflation has, indeed, declined sharply. By the fourth quarter of 1982 prices were rising at a 5-percent annual rate, compared with almost 9 percent during 1981 and more than 10 percent during 1980. Most observers have concluded that progress in getting inflation down has been greater than they would have predicted in 1979. But despite this substantial reduction in the rate of inflation, nominal interest rates remained high in the first half of 1982, two and a half years after the shift to a more restrictive monetary policy. It was not until the second half of 1982 that a major decline in interest rates took place. As a result, real interest rates—which measure the true cost of borrowing after taking inflation into account—were high by historical standards and particularly by comparison with the decade of the seventies. Perhaps reflecting the high real cost of borrowing, output and employment have contracted for a longer period than in any previous recession in the postwar period.

Another way of describing the fact that both the rate of inflation and the level of output have declined more in 1982 than would have been expected on the basis of the observed behavior of the money stock, is to attribute it to the sharp drop in *velocity* since late 1981. The velocity of money represents the ratio of the nominal gross national product to the stock of money. As such, it measures the average number of spending transactions in which each dollar of money is used during a year. For example, with an M1

money stock of around $470 billion and a GNP of roughly $3 trillion, velocity was somewhat less than 7 in the fourth quarter of 1982.

Over the decade of the 1970's, M1 velocity rose at annual rates of around 3½ percent. Since late 1981, however, there has been an abrupt reversal in this long upward trend in velocity. Instead of *rising* 3½ percent, velocity *declined* by almost 5 percent between the fourth quarter of 1981 and the fourth quarter of 1982. This development was totally unexpected, as it was the first significant decline in velocity in the last thirty years. Consequently, nominal GNP increased only 4 percent in 1982. Although this produced the good news that inflation came down more rapidly than expected, it also brought the bad news of declining real output and sharply rising unemployment.

The Federal Reserve began to recognize this "velocity" problem in mid-1982. Chairman Paul Volcker expressed his concern over the behavior of velocity in his July 1982 testimony to Congress:

"M1 velocity—particularly for periods as short as three to six months—is historically volatile. A cyclical tendency to slow (relative to its upward trend) during recession is common. But an actual decline for two consecutive quarters, as happened late in 1981 and the first quarter of 1982, is rather unusual. The magnitude of the decline during the first quarter was larger than in any quarter of the entire postwar period."

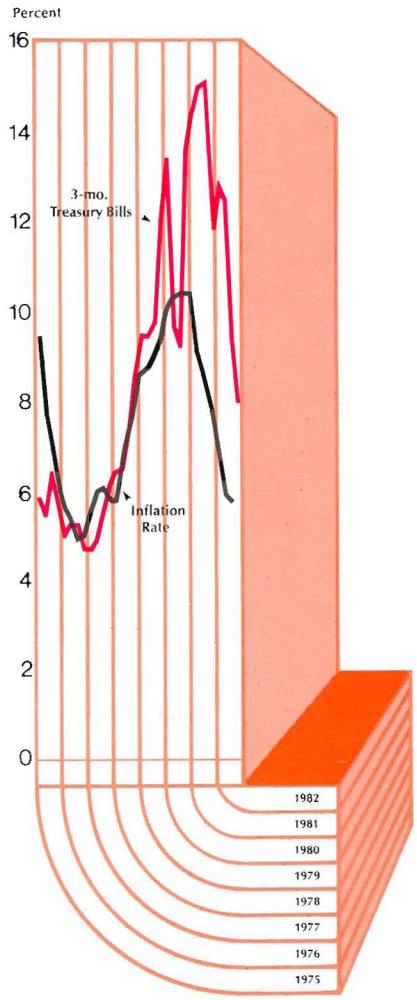
The continued weakness of the economy and the atypical behavior of velocity were factors which contributed to the decision of the Federal Reserve to lower the discount rate seven times from July to the end of the year. The discount rate, which is the rate paid by depository institutions for very short-term borrowed funds from the Federal Reserve, remained unchanged at 12 percent during the first half of 1982. Between July 21 and August 27 the discount rate was lowered four times in increments of one-half percentage point each to 10 percent. The rate was reduced three times further between October and December, ending the year at 8½ percent.

Largely in response to the interest rate decline in the last half of 1982 monetary growth accelerated. M1 (currency plus checkable deposits) grew at an annual rate of 12 percent in the second half of 1982, compared with growth of 4.8 percent in the first six months. While part of the growth in M1 during the final quarter of the year was due to the temporary placement of funds from maturing All-Savers Certificates into transactions accounts, it was clear that greater monetary stimulus had been provided owing to the continued weak economy and the unexpected decline of velocity.

Monetary Control Problems

At the same time as the Federal Reserve was responding to the unexpected weakness of the real economy, short-run monetary control was made temporarily more difficult by a series of institutional changes. In the fourth quarter of the year a large block of All-Savers Certificates matured and were not renewed by their holders. It was expected that some of these funds would be held temporarily in transactions balances and thus would contribute to a temporary bulge in M1.

More importantly, two new types of deposit accounts were introduced, one becoming available on December 14, 1982, the other on January 5, 1983. The first of these—known as the Money Market Deposit Account—enabled banks and thrift institutions to compete with money market funds by offering an insured account



Inflation and the Short-Term Interest Rate

bearing an unregulated yield and offering the right to a limited number of third-party transfers per month (maximum of six). This was expected to draw funds out of transactions accounts and thus lead to a decline in M1. Early indications are that these accounts have been enthusiastically received by investors. However, most of the funds going into the new Money Market Deposit Accounts appear to be coming from short-term savings-type accounts. The second new account—the super-NOW account—enables institutions to pay market rates of return on insured checking accounts with a $2500 minimum. This is attracting funds back into M1.

Because the effects of these various innovations on the public's demand to hold M1 were so uncertain, the Federal Open Market Committee (FOMC) decided in October temporarily to suspend M1 targeting and to rely instead on M2 and M3, which include savings-type and investment-type instruments of consumers and businesses, in addition to transactions balances. It seems probable that the focus away from M1 will be maintained through the early part of 1983, as information is gathered on how the public is responding to these innovations. When the major shift of funds between accounts has been completed, it may be possible to return to targeting M1. However, since a substantial part of M1 is likely to consist of accounts which yield an unregulated interest rate, the selection of an appropriate growth target will be inherently more difficult. This is a challenge which policymakers must face in 1983.

Credit Markets

Credit markets in 1982 were influenced both by general economic conditions—especially the sharp reduction in the rate of inflation and the dramatic weakening of the real economy—and by the policy actions of the fiscal and monetary authorities.

In the early part of the year, monetary policy remained tight as the Federal Reserve sought to bring the monetary aggregates back to their long-run targets. As a result, both long- and short-term interest rates remained high. This was despite a substantial decline in the rate of inflation. In retrospect, it appears that the System's tight monetary policy may have offset the tendency for reduced inflation to bring interest rates down. As a result, when policy was relaxed somewhat at mid-year in response to the unusually weak economy, interest rates declined dramatically. Between the end of June and the end of December the interest rate on Federal funds declined almost 600 basis points to below 9 percent. The prime lending rate fell from 16½ percent to 11½ percent. Similar declines occurred in the long-term financial markets. The yield on Aaa corporate bonds, for example, declined from nearly 16 percent in July to less than 12 percent by year-end.

Despite such declines, interest rates remain high by historical standards, reflecting both investors' nervousness that inflation might erupt again in the future and the pressure on financial markets of unprecedentedly large Federal borrowing. In the fiscal year ending in September 1982, the U.S. Treasury ran an overall deficit amounting to $110.7 billion. It is estimated that during calendar 1982 the Treasury absorbed more than half of all net funds raised in the nation's credit markets. The federal deficit is expected to be even higher in 1983 and without action by

the fiscal authorities either to raise taxes or to curtail expenditures, the deficit will remain in the $100–200 billion range for several years.

Although economic recovery will increase the pool of saving available to finance these deficits, it also will increase private credit demands. Thus most commentators suggest that a major decline in Federal deficits is required for there to be any significant easing in financial markets.

International Financial Strains
Considerable strains developed in international financial markets during the year over the risks of international lending to the developing nations. It is estimated that the aggregate debt of non-OPEC developing countries doubled from $350 billion in 1978 to $700 billion in 1982. About one-half of this debt was owed to private banks.
The bulk of it was concentrated in about a dozen countries, many of which had to put off repaying the principal; a few could not even pay the interest.

A number of developments led to this situation. First, in 1979-82 the world economy slid into a prolonged recession, resulting in a sharp fall in the world demand for the developing countries' exports and in precipitous declines in the prices of primary products. Unwilling to cut back their economic growth, a number of these countries resorted to large foreign borrowings. Second, interest rates climbed to historical highs in international financial markets. These high interest rates not only increased the burden of interest payments for the borrowing countries but also caused them to shift to short-term credits, resulting in bunching-up of maturing debts and liquidity crunches for some of the borrowers. Third, several developing nations had followed inappropriate exchange-rate policies, keeping their exchange rates fixed in the face of rapid domestic inflation. The result was rising trade deficits and large capital outflows. Fourth, a decline in world demand for oil during 1982 reduced the petroleum exports of several developing countries; Mexico was particularly hard-hit by this development. Finally, confronted with the deteriorating world payments condition, some banks abruptly reduced new credits to the developing nations during 1982.

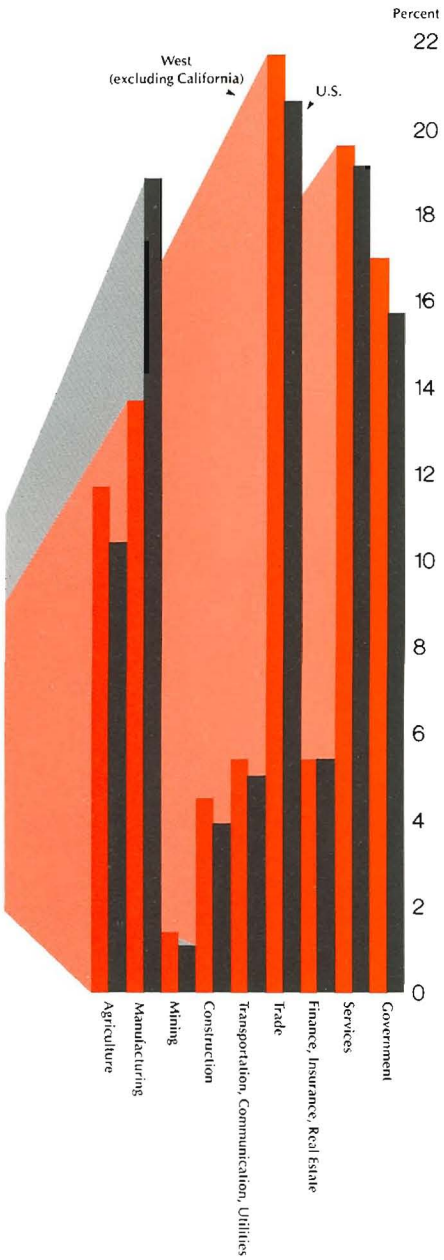
In this situation the governments of the United States and of other major industrial countries attempted to aid the debtor nations by providing emergency credits to tide them over the short run. In December, the International Monetary Fund agreed to extend $4 billion medium-term credit to Mexico in support of an austerity program for reducing its balance of payments deficit. This move set the pattern for a strategy worked out by the major industrial nations to extend aid to the hard-pressed debtor nations, conditioned upon the borrowing nations' agreement to adopt appropriate policies for adjusting their balance of payments. Given the large amount of funds that are being put together for shoring up the international agencies' lending resources, the sharp decline in interest rates since last July, and the expected recovery, however modest, of the world economy, the prospect for the international financial markets should improve in 1983.

Western Business

Historically, business conditions in the Twelfth Federal Reserve District have been better than those in the nation taken as a whole. However, current economic conditions in the nine states of the District seem inconsistent with the popular view that the Western economy is relatively recession-proof. The West traditionally has been a leader in the development of new industry and it enjoys a large supply of skilled labor and entrepreneurs. Yet the Western region's economy has reacted relatively adversely to the 1982 national recessionary conditions.

The economies of Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Utah and Washington were depressed in 1982. For the District as a whole, unemployment was higher than the 10.8-percent national rate in November. The slowing of job growth in the early part of the year turned into actual net job losses in many areas. The depressed level of economic activity reflected in large part the nationwide recession, but special conditions in some of the Western states exaggerated the effect of the national downturn.

Employment Share By Sector



Two Western Problems

Two main problems appeared to underlie the exaggerated Western response to the national recession. First, some of the states' economies are unusually dependent on a few resource extraction or industrial sectors. This limited diversification lessens the West's protection from (and indeed exaggerates) cyclical downturns.

The second problem is a paradox. The relative attractiveness of future prospects in the West has induced continued in-migration which can raise unemployment rates by swelling the labor force. Employment creation is hard-pressed to match the population growth rate during prosperous times; in recessionary conditions the task is that much more difficult. With the exception of Oregon all of the Western states presently are net recipients of new migrants. Nevada's population grew the fastest in the West, increasing 63.5 percent in the decade ended in 1980.

One Diversified State

California is the only state in the District that is fully "diversified" industrially. Its economy is composed of a broad mix of agricultural, manufacturing, service and resource-based industries (such as lumber production and petroleum extraction).

In this sense, the industrial pattern of California's economy is very much like that of the nation as a whole. Indeed, California's automobile manufacturing and other heavy industries have been as hard-hit as those elsewhere. Jobs in this sector have declined by almost one-third since 1979. High interest rates also have weakened formerly strong housing demand, led to weak construction activity, and depressed the allied lumber industry in the state. The aerospace and electronics industries—although potentially more recession-proof in California because of their defense orientation—suffer from the same sluggish demand and weak foreign markets that plague these industries nationwide. California agriculture, while producing record harvests in many crops, also is struggling because of continued high operating costs, low prices and weakened foreign demand as a result of the strong dollar.

Although all of these developments are true of analogous activities nationwide, California had an unemployment rate of 11.2 percent in late 1982, somewhat higher than the national rate. The major explanation for the state's relatively poor employment performance would appear to be the continued strong influx of workers—including illegal immigrants—who continue to be attracted by California's long-term prospects. The legal civilian labor force alone grew nearly three percent this year in California, while the national increase averaged only 1.6 percent.

Less Diversified Economies

In contrast to California, many states in the District depend on a few major industries or resources, and their economic problems clearly are linked to this fact. For example, the economies of the Pacific Northwest states—although more diversified now than in the past—remain heavily dependent on the lumber and wood products industry.

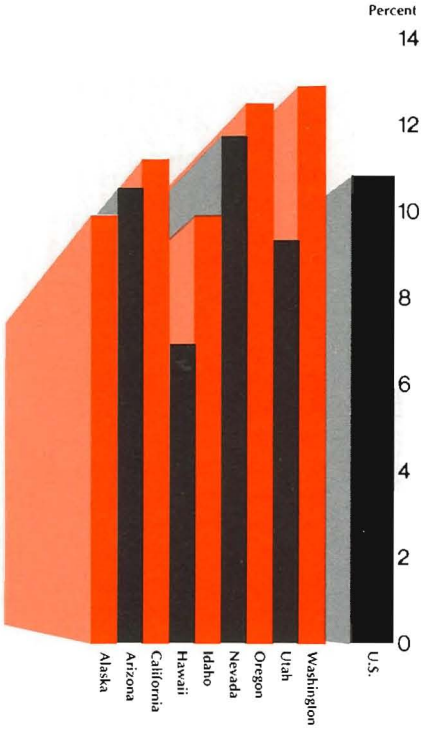
As high interest rates and a weak export market plague this credit-sensitive industry, softwood lumber production in the Northwest has dropped nearly 35 percent from its peak level in 1978. In Oregon, this sector represents nearly one-third of the state's manufacturing employment. Thus, it was inevitable that Oregon would suffer an exaggerated downturn. Its overall unemployment rate was 12.5 percent in November of 1982, well above the national average. Some local unemployment rates in Oregon exceed 30 percent.

Similarly, the state of Washington, with 15 percent of its workers employed by the lumber and wood products industry, has felt the effect of the economic slump both locally and statewide. The unemployment rate has soared above 20 percent in some counties and the rate for the state as a whole was 12.9 percent in November. Washington has suffered additionally because the major weakness in the airline industry has hurt its important airframe manufacturing business.

The intermountain states and Alaska, traditionally known for their orientation toward the mineral industry, have suffered serious declines in mining activity. Arizona, for example, is the nation's largest copper producer, providing two-thirds of the nation's copper output. But weak worldwide demand for copper has depressed its price and forced the shutdown of several large mines. Employment in copper mining in Arizona has fallen 45 percent in the last year, leaving 10,000 of the state's copper mining employees out of work. Low prices for gold, silver, and molybdenum have curtailed mining activity in Nevada as well, causing a loss of 11 percent of mining jobs between August 1981 and August 1982.

A similar story can be told about Idaho's silver mining industry. Idaho's Silver Valley produced 40 percent of the nation's silver in 1981, but depressed silver prices have forced three primary mines to close this year, leaving 2,800 workers jobless. This is a 50-percent drop in mining employment that has devastated several counties' economies. Local unemployment rates run as high as 33 percent.

Unemployment Rates



Fortunately, despite the severity of these declines in mining activity, the effect on these states' general economies has not been as severe as that of the decline of the lumber industry in the Northwest. The relatively smaller proportion of total employment engaged in these resource industries has meant smaller economic repercussions. Thus, the November unemployment rates for Idaho and Arizona were 9.9 and 10.5 percent respectively—when the national average was 10.8 percent.

The Luckier Ones

Some Western states are relatively prosperous, despite their seemingly less-diversified economies. Weakened energy demand, for example, has stifled growth in Utah's vast energy-related industries—including coal, oil and gas. But the growth of defense manufacturing and information processing industries in the state is helping to offset the losses experienced in the raw materials industries.

The state of Utah also has benefitted from special demographic circumstances. Unlike California, the previously rapid rate of labor force in-migration has slowed and the state's homogeneous, high quality labor force and cohesive social community have buffered the impact of the national recession. Utah thus enjoyed the second lowest unemployment rate in the West in November at 9.3 percent.

Alaska, dependent upon petroleum extraction, continues to enjoy the benefits of this massive source of revenue despite the weakness in world demand for crude oil that has lowered oil prices. It has maintained better than average economic conditions, with a November unemployment rate of 9.9 percent. And new jobs continue to be generated.

Hawaii, although dependent on only three major activities—tourism, agriculture and the military—has not suffered as much as might be expected from its lack of diversification. Indeed, the state enjoys the lowest unemployment rate in the West—6.9 percent in November—and employment this year has been buoyed by an unusually strong tourist season. The number of visitors to Hawaii is expected to pass the record mark of four million—an increase of nearly eight percent over the level a year ago. This growth, combined with the growth in military activity, has counteracted the effects of a world oversupply of sugar and pineapples that has lowered their prices and caused cutbacks and job losses in the agricultural sector.

Special Problems

In addition to the general problems created by the national recession and by lack of diversification in certain regional economies, some Western states have suffered from unusual structural or policy problems. Certain industries in Washington and Oregon, for example, had to cope with a 58-percent increase in the price of electric power in October owing to a realignment of Bonneville Power Administration rates. The rate increase affects most the heavy users of direct service electrical power, such as aluminum processors who already face a glutted product market.

Fiscal austerity has jeopardized government jobs throughout the District, but especially those in California where a legacy of budget control referenda has created strong pressure for reductions in the size of the state's bureaucracy. This year, nearly 24,000 state and local government employees lost their jobs and California's recently passed budget actually was below that of a year ago.

The national recession has reduced the growth in Nevada's gambling revenues as consumers tighten their belts, but the problem has been compounded by the loss of the state's monopoly on gambling. The industry now is legal in Atlantic City, New Jersey. As a result, Nevada's unemployment rate grew to 11.7 percent this November, from 7.0 percent one year ago, and gaming revenue growth in 1981 fell sharply.

California's diversified agricultural sector was battered by natural as well as economic storms. Early rains destroyed 20 percent of the tomato crop in September and damaged valuable grape crops. In addition, an unusually strong dollar and competition from subsidized imports threaten the viability of the state's raisin crop.

Future Prospects

Despite the comparatively poor unemployment statistics for the West, the economic outlook for the Twelfth District states may not be as bad as it appears. It is clear from the in-migration trends that workers continue to have confidence in the future vitality of the region. The West's civilian labor force grew nearly three percent in 1982—almost twice as fast as the national rate of 1.6 percent.

Indeed, there is considerable basis for this enthusiasm. The West harbors a disproportionate share of the nation's agricultural capacity, much of its high-technology industry, and substantial natural and human resource bases. In addition, the industries of many of these states are oriented toward defense products and are, therefore, expected to benefit from the projected annual increases in the Reagan Administration's defense budget.

These characteristics, combined with a modern transportation and communications infrastructure, should permit the West to rebound solidly. Therefore, the West should recover more rapidly than the nation as a whole as the economy turns up.

Western Finance

The challenges posed by another year of high interest rates, accelerating deposit deregulation, and a slowdown in the Western economy, tested Twelfth District depository institutions' ability to maintain asset quality and earnings. Although District banks posted earnings of nearly $1.7 billion in 1982 almost all measures of profitability suffered, especially during the first half of the year. Earnings rebounded in the second half as interest rates fell and margins widened, but not by enough to post an increase over 1981 earnings. Still, Western banks fared better than many of their business and household customers, whose financial conditions continued to deteriorate under the pressure of heavy borrowing costs and across-the-board weakness in product and labor markets.

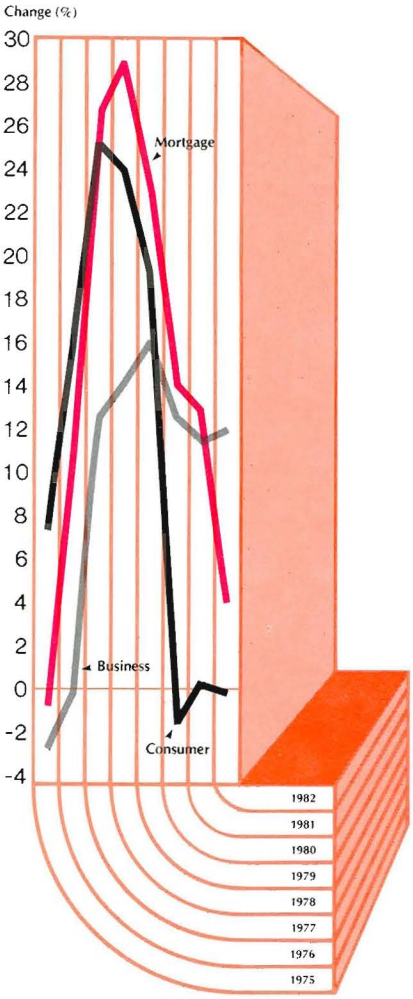
For the first time in many years, Western banks slipped behind their national counterparts in both asset expansion and earnings performance. Indeed, Western banks' consumer banking operations, long a source of strength, hampered many banks in the region as household loan demand remained slow and the cost of consumer deposits soared. Despite the weak showing in the aggregate, however, many individual Western banks were able to record sizeable earnings gains.

Recession Hurts Credit Demand

The recession that plagued the Western region's businesses and households also curtailed their demands for credit through most of 1982. With weak loan growth and little change in banks' securities holdings, total bank credit growth was anemic; only commercial and industrial lending continued to show moderate strength. However, much of that was tied to poor business conditions and the unwillingness to use alternative sources of financing rather than to a resurgence in economic activity.

Commercial and industrial loans accounted for half of the $13 billion (6 percent growth) in total loans. Through much of the year businesses were under severe pressure to meet their borrowing needs in the short end of the market. Increased borrowing from banks filled the funding gaps arising from firms' temporary working capital needs. Western banks were a source of interim credit when funds in the commercial paper or long-term bond markets either dried up or became prohibitively expensive. While this boosted banks' business loan growth throughout much of 1982, it reflected the fundamental weakness of the economy and disruptions in the normal lines of long-term financing.

By year-end, however, much of the pressure on business loan demand had subsided. Interest rates had fallen significantly, and the financial markets had begun to function in a more normal manner. Borrowers began taking advantage of the declines in long-term interest rates to raise funds in the equity and bond markets; simultaneously borrowers began to paydown their short-term bank loans.



Western Bank Loans

Faced much of the year with high mortgage and consumer credit interest rates, as well as the specter of rising unemployment, Western households severely curtailed bank borrowing. Real estate loans did increase by $3 billion (a four-percent increase) but most of the strength came from commercial real estate activity. Residential mortgage growth fell well below the rapid pace of recent years. Both supply and demand considerations accounted for the weakness. High rates had an obvious effect on the demand for both housing and mortgages. Moreover, many Western financial institutions—with sizeable portfolios of low-yielding long-term fixed rate mortgages—also have taken actions to limit their exposure to interest rate risk by limiting new extensions of fixed-rate mortgages or by selling rather than holding new mortgages.

Consumer loans for durables such as automobiles, appliances, furniture, etc., exhibited continued weakness in 1982. In fact, consumer loans—primarily installment credit—at Western banks, have stagnated since 1979. While in 1982 the decline in consumer loans was very small, it signaled the inability and unwillingness of many consumers to increase their debt burden amid continued concern over the course of the economy. Increased competition for consumer loan and credit card business from both out-of-district institutions and thrifts with newly authorized consumer lending authority, may have eroded Western banks' share of this market.

Funding Costs Up

Competition from money market funds and thrifts for both business and consumer balances, as well as the acceleration in deposit interest rate ceiling deregulation, also kept the cost of funds up. Almost the entire 1982 increase in domestic deposits ($16 billion) came in instruments paying market returns, placing continued upward pressure on costs. In addition, a $3-billion increase in non-deposit sources, primarily Federal funds and repurchase agreements, also provided banks with ample funds to expand asset growth during the year.

Western banks recorded a $2-billion increase in NOW account balances, but small-denomination time deposits (under $100,000) provided the bulk of new deposits. Of course, the strength in small time deposits reflected the enormous popularity of market-return deposit instruments and the wide variety of newly authorized instruments that became available in 1982, which induced a continued flow of below-market-return checking and savings balances into these accounts. Large time deposits ($100,000 and over), which represent nearly one-third of domestic deposits at District banks, also continued to be a major source of funding, especially earlier in the year.

The surge in small denomination time deposit growth in 1982 was even more dramatic when one notes that Western banks reported a $1-billion decline in holdings of six-month money market certificates ($28 billion as of December). Indeed, other factors such as the sharp decline in short-term interest rates boosted growth in the 2½-year small-savers certificate (SSC's). SSC's jumped by over $3 billion to the $9-billion level. All-Savers Certificates began maturing in October, and quickly declined in importance; by year-end they were surpassed by ceiling-free IRA balances which had grown to $1.5 billion. The 7- to 31-day money market account authorized in September also was a big hit with depositors, although, at year-end many of these deposits were transfered into the newly authorized ceiling-free insured money market deposit account (MMDA). Authorization of the MMDA's for offering in mid-December resulted in a dramatic shift in the composition of banks' consumer deposit base, as over $15 billion rapidly moved out of checking, NOW's, savings and other types of short-term consumer instruments and into the new account. The authorization of the Super NOW account in January is likely to continue this trend.

Earnings Slump

Aggregate earnings of Western banks deteriorated in 1982, falling about ten percent from 1981, as many institutions suffered from narrowed interest margins, weak asset growth and rising loan losses. Continued upward pressure on overhead expenses, especially personnel costs and occupancy expenses, also were felt by many institutions. While District banks generally posted much stronger second half results because lower interest rates lessened pressures on margins, most banks' second half earnings also suffered because of the necessity of adding to their loan loss cushions.

Net interest income at Western banks rose slightly in 1982 as earnings from the $13 billion increase in loan volume more than offset reduced earnings from narrowed margins on the remainder of the portfolio. Despite the overall reduction in interest margins, caused primarily by the soaring cost of consumer deposits, there were some bright spots on the funding side as well. Falling interest rates and weak loan demand combined to help Western banks to record sizeable reductions in expenses for offshore borrowing, as well as for managed liabilities and other purchased funds.

Unlike interest income, operating earnings failed to keep pace with operating expenses. Thus, the small increase in net interest income easily was overshadowed by continued sharp increases in overhead expenses and a tremendous jump in banks' provision for loan losses. The fifty percent increase (nearly $.5 billion) in loan loss provisions at Western banks was the most significant factor in lowering District banks' aggregate earnings in 1982. Like their counterparts elsewhere in the nation, District banks suffered across-the-board deterioration in asset quality in most loan categories. This erosion of asset quality was a reflection of the troubled nature of many national and international credits held by large institutions, as well as problem loans arising from the depressed local markets facing some smaller banks. And while earnings have suffered, most banks have taken significant steps to provide an adequate cushion against future losses arising from the weakened state of the economy.

Twelfth District Thrifts

The housing slump as well as increased competition among various types of financial institutions as a result of deregulation, have made 1982 another difficult year for Western savings and loan associations. Apart from the accelerated pace of deposit rate deregulation, the year represented a continuation of trends that have emerged over the last several years. Like banks, S&Ls continued to witness a change in the composition of their portfolio of liabilities to one which is both higher cost and more interest-rate sensitive. On the asset side, mortgage lending activity continued at a very slow pace as high interest rates and flat or declining housing prices provided little incentive for consumers to buy housing. However, during the last half of 1982, mortgage interest rates headed downward. This trend, if it continues, may provide the stimulus to mortgage demand that the S&L industry has been looking for.

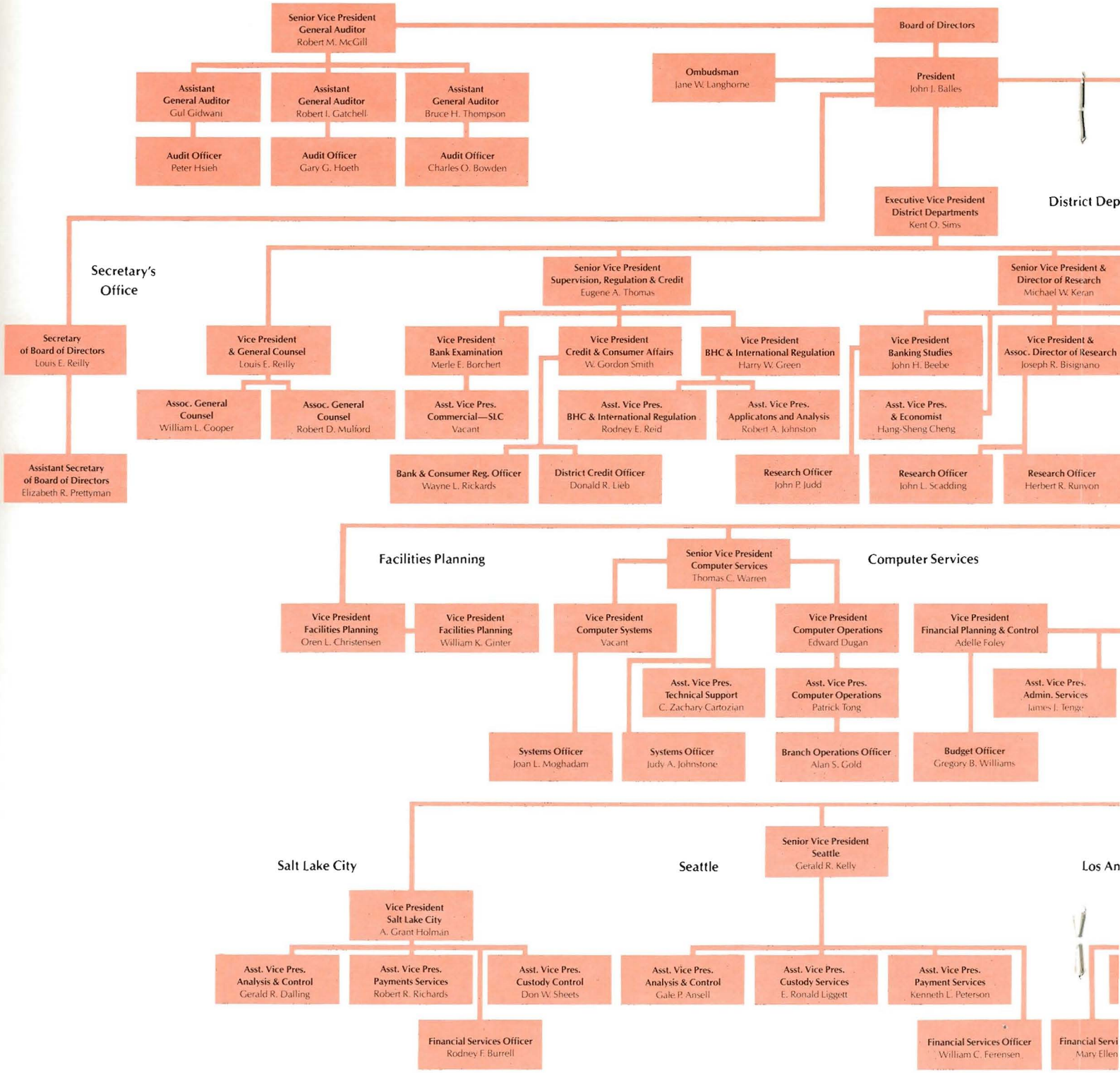
Thrifts were more successful in retaining funds this year than last. Whereas in previous years money flowed out of S&Ls into high-yield money market fund accounts, in 1982 thrifts were authorized to offer several new deposit instruments that enabled them to compete more effectively for funds. Preliminary estimates show an $8 billion deposit inflow for Twelfth District S&Ls in 1982, about two-thirds of which was in large certificates of deposit ($100,000 and more). Passbook savings and NOW accounts captured some transitory funds in the latter part of the year, while total market-return small-denomination time deposits were up by about $2 billion even after the All-Savers runoff. Along with the new MMDA these instruments helped to retain consumer funds that might otherwise have been lost to money market funds.

Many S&Ls still found themselves facing continued operating losses in 1982 as the cost of funds crept up and yields on mortgage portfolios remained low. While at some institutions operating losses continued to reduce net worth, in the face of lower interest rates and a modest recovery in housing, the industry outlook at year-end 1982 had brightened considerably.

1983 Prospects

The rapid increase in the pace of deposit deregulation taken by the Depository Institutions Deregulation Committee in late 1982 will set the tempo for heightened competition in 1983. Not only will banks and thrifts finally have short-term ceiling-free deposit accounts to compete with money market mutual funds, but it is likely that these instruments will be a precursor to additional "market-determined" instruments. Thus, competition should intensify for both corporate and consumer savings. Additional emphasis will be placed on the ability of institutions to design instruments and services, and to price those services in such a manner that the package is not only attractive to consumers but profitable to the institutions.

Competition for savings will have an effect on lending operations. With business loan demand likely to remain weak, at least through the early stages of the recovery, institutions will have to search for profitable lending opportunities. Certainly, consumer installment and mortgage lending could be poised for a recovery if the general level of interest rates continues its gradual decline. However, more interest-sensitive consumer deposits also are likely to affect the form as well as the cost of mortgage and installment contracts, as institutions take steps to promote more adjustable rate loan products and to implement more cost effective service fee schedules.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Analysis & Control
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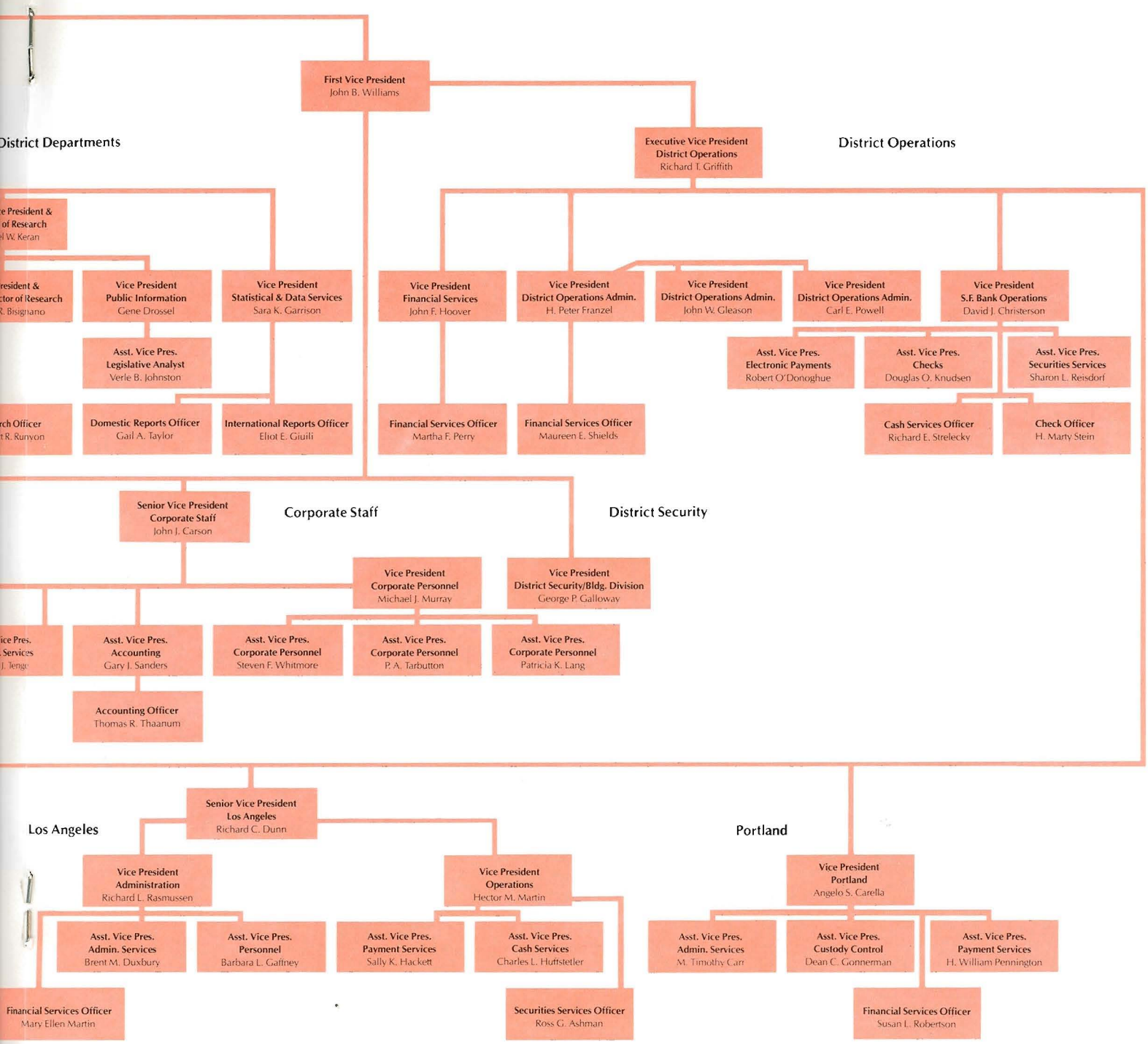
Asst. Vice Pres.
Custody Services
E. Ronald Liggett
Asst. Vice Pres.
Payment Services
Kenneth L. Peterson
Financial Services Officer
Rodney F. Burrell
Financial Services Officer
William C. Ferensen
Financial Servi
Mary Ellen

Organization Chart

February 1, 1983



Management Committee
(Shown from left to right, standing)
Kent O. Sims, Executive Vice President, District Departments
Richard T. Griffith, Executive Vice President, District Operations
John J. Carson, Senior Vice President, Corporate Staff
(seated)
John B. Williams, First Vice President
John J. Balles, President
Thomas C. Warren, Senior Vice President, Computer Services

Western Central Bank

During 1982 the operations of the Federal Reserve Bank of San Francisco continued in an atmosphere of rapid financial innovation. This environment has been influenced heavily by passage of the Depository Institutions Deregulation and Monetary Control Act of 1980 (MCA). However, another historic piece of legislation was signed into law as the year drew to a close: the Garn-St. Germain Depository Institutions Act of 1982 is expected to foster still more competitive innovation.

Under the MCA of 1980, Congress required depository institutions to be subject to reserve requirements established by the Federal Reserve System. The MCA was intended to promote improved monetary control and greater competitive equity among institutions with similar powers. In addition, the Act provided access to Federal Reserve services, at explicit prices, for all institutions subject to reserve requirements set by the Federal Reserve.

The Twelfth Federal Reserve District, which is served by five Reserve Bank offices (San Francisco, Los Angeles, Portland, Salt Lake City and Seattle) is the largest in the Federal Reserve System in terms of population, geographic size and industrial activity. It includes the states of Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Utah and Washington, and serves a total population of more than 38 million people. The Reserve Bank provides financial services—in the areas of checks, coin, currency, U.S. fiscal agency services, and electronic fund transfers—to this large regional economy.

Complex Environment

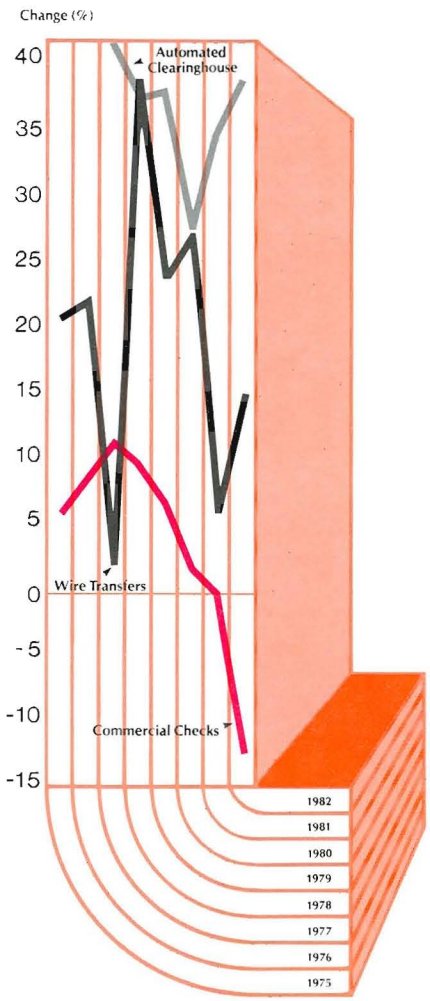
While the San Francisco Federal Reserve Bank shares the same responsibilities and functions as other Reserve Banks in their role as central bankers, certain aspects of the District are unique. Almost 30 percent of the population of the Twelfth District resides in the four-county Los Angeles metropolitan area. In addition, the District serves a potential market of 4,000 financial institutions spread over five time zones. Geographic disparity also is an important characteristic. The vastness of the region served, and the complexity and variety of the population in the District, mean that Reserve Bank services must be tailored to regional needs.

New Services

The Bank formed a Financial Services department in 1981 to market its priced services to financial institutions as provided by the MCA. Each of the Bank's five offices serves institutions located in its respective zone, but District-wide responsibility for the planning and direction of the priced services resides in the Operations Division of the District's Head Office.

One of the early service innovations by the Bank was a new on-line communications service, called FedLine, that was introduced in April 1982. FedLine originally was offered on a test basis to six pilot institutions. The reception has been so enthusiastic that FedLine computers were installed in over one hundred financial institutions in 1982 and over four hundred more are scheduled for installation in the coming year.

Initially, subscribers to the service will use FedLine's microcomputers to transfer funds directly through the Federal Reserve's communications system (FEDWIRE). In 1983, however, FedLine will enable users to perform a variety of transactions directly through the Federal Reserve's communication sytem.



Growth of Payments Services

Automation

Implementation of computer system enhancements to support MCA programs continued to flow from the Bank's Computer Services Group throughout the year. Check float monitoring and reporting was improved, and a new system to monitor the Fed's transportation network and to track the flow and timely receipt of cash letters throughout the Federal Reserve was developed. Together, these innovations provide the means to evaluate the potential for further reductions in float and the granting of credit to financial institutions based on actual availability of funds.

The SHARE system for automated securities handling, which was developed by the San Francisco Reserve Bank in cooperation with the St. Louis and Kansas City Reserve Banks, was in full production at these three Reserve Banks during 1982. The Dallas Reserve Bank also installed the system in 1982. In addition, planning commenced for installation of SHARE at the Chicago and New York Reserve Banks in 1983. The Cleveland and Boston Reserve Banks also will begin the SHARE installation process in 1983. Thus, the San Francisco Reserve Bank has assumed a leading role within the Federal Reserve System in implementing resource-shared software.

The new Federal Reserve national communications network, called FRCS-80, was installed in San Francisco during 1982. This new communications system permits improved reliability and increased capacity to serve the Federal Reserve and depository institutions more effectively. Improved security for transmitting information and increased efficiency of communications circuit usage at lower total costs also result from the implementation of this state-of-the-art network.

The Reserve Bank also designed and gained approval for a new intradistrict communications network to link the five offices of the San Francisco Reserve Bank. This network, called SPINE, is compatible with, and complementary to FRCS-80 and should generate the same type of benefits within the Twelfth District that FRCS-80 is providing nationwide. SPINE will be installed at the Los Angeles Branch during 1983 and at the Reserve Bank's other three branches by late 1984.

Among the many 1983 automation projects that target internal operating efficiency improvements, there are two that are particularly worthy of mention. One is a new online entry system for accounting applications; another is the development of a chargeback system to monitor the costs and usage of automated services to user functions. Both are targeted for installation early in 1983.

Many of these innovations in automation were facilitated by the move of the San Francisco Reserve Bank's data center in September to its new headquarters. The upgrading of computer capacity, the installation of an improved network control center, and planned future computer upgrades in the Bank's branch offices, have positioned the Twelfth District to meet the major challenges forecast for the 1980s. With these major enhancements the Reserve Bank should be able successfully to handle the increased processing needs of the Federal Reserve System, the Twelfth District, and the financial institutions it serves.

Payments Services

In planning the future of payments services in a priced environment the Reserve Bank has put heavy emphasis on quality and cost control. The Bank handles approximately seven million checks daily from throughout the District. Since a critical element in managing all check products, new or existing, is the quality of the services, a special customer information book was prepared to provide financial institutions with a clear understanding of the Bank's processing procedures and to help reduce errors caused by improper input.

Funds transfer (FEDWIRE) has been the fastest growing bank service in the past two years. On-line funds transfers now constitute 99 percent of total FEDWIRE activity in the Twelfth District. Implementation of the new FedLine service mentioned earlier, is expected to encourage most of the remaining one percent of volume to move from off-line to the much more efficient on-line during 1983. More importantly, FedLine provides the same type of computerized access to small- and medium-sized financial institutions that, up to now, has only been available to large financial institutions.

The Automated Clearing House (ACH) was another fast-growing service offered by the Bank during 1982. The major products offered by ACH are debit and credit originations which consist mainly of government disbursements, corporate payrolls, cash concentration, and insurance drafts. The Twelfth District accounts for 20 percent of total System volume in these combined areas.

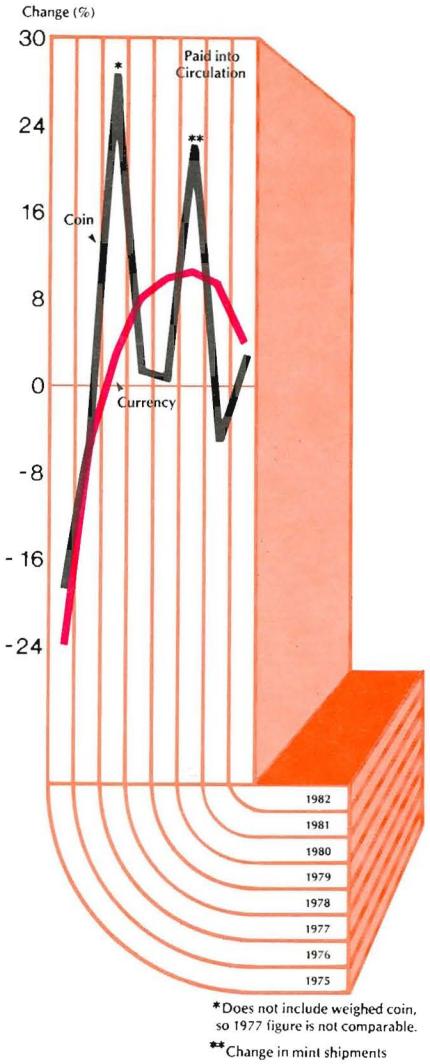
Cash, Securities Services

The Reserve Bank continued to meet the growing cash and Treasury securities needs of the institutions and public doing business in the Twelfth District. Notwithstanding the growing popularity of electronic funds transfer and the continuing use of paper checks, substantial amounts of coin and currency continue to be needed by the Western economy. In 1982, the Reserve Bank put into circulation 4.8 billion coins and 1.8 billion pieces of paper currency. High speed currency sorting machines handle 1,200 pieces of currency a minute, automatically detecting counterfeits and destroying currency not fit for further use. Output of this equipment steadily is improving the quality of currency in circulation.

The Reserve Bank is the fiscal agent for the U.S. Government and in this role it handled substantial amounts of bills, notes, bonds and other Treasury securities. An automated Treasury-bill processing system enables the Bank to handle a high volume of bids in T-bill auctions such as those generally associated with very high interest rates. For reasons of efficiency, the Reserve Bank has consolidated a significant portion of its savings bond operations for the entire District in its Los Angeles office.

Improved Efficiency

Bank management was continually challenged throughout the year to strike the appropriate balance between cost efficiency through increased productivity and quality of output. In priced services, the goal was to compete in the marketplace on the basis of quality and price while recovering all Federal Reserve costs plus a fixed mark-up to reflect private sector costs such as taxes and capital costs not incurred by the Federal Reserve. The goal was to provide an appropriate level of quality at the lowest practical cost.



Growth of Cash Services

Management and staff also faced the challenge in 1982 of consolidating the Reserve Bank's headquarters operations from five separate buildings into a single new facility on San Francisco's historic Market Street. The move took place over several months to minimize the inevitable disruptions to communications and the continuity of operations. The Bank's new headquarters provide substantially improved facilities for serving the large and diverse Western economy as well as providing a more efficient work place for its officers and staff.

Supervisory Developments

Examinations of state member banks in 1982 disclosed continuing pressures on bank earnings, liquidity and asset quality. Although the condition of most banks supervised by this Reserve Bank remained generally sound, many institutions experienced declining profits and an increasing volume of troubled loans. Both of these conditions generally reflected the effects of the economy on the banks' customers. Of 48 banks examined in 1982, the deteriorating condition of seven was severe enough to warrant formal corrective agreements. The Reserve Bank also examined 65 bank holding companies in 1982, and made formal agreements with five on procedures, controls and policies to ensure improved future prospects.

Early in the year two System-wide programs were implemented to achieve greater efficiency in supervisory operations. Arrangements were made with the state banking departments in California and Nevada to implement an Alternating Examination Program in which the annual examination of certain sound and well managed banks will alternate between the Reserve Bank and the appropriate state banking department. In a separate agreement with the California Banking Department, it was determined that the examinations of two multibillion dollar banks will be made jointly by the Reserve Bank and the State Banking Department on an extended examination cycle.

A new Commercial Bank Report of Examination, adopted by the Board of Governors of the Federal Reserve System in mid-October, was used for three of the last examinations conducted by the Reserve Bank in 1982, and will be used for all examinations conducted in 1983. To facilitate an orderly implementation of the new report, the Reserve Bank completed an extensive revision of the financial ratios used for pre-examination analysis in order to make these data compatible with the new report and the Uniform Bank Performance Report used by all three of the Federal bank regulatory agencies.

The industry-wide trend toward formation of bank holding companies continued, as evidenced by receipt of 98 applications to form bank holding companies in 1982—an increase of 66 percent over 1981. This trend was part of an increase in overall applications volume, since existing bank holding companies also are expanding through bank and nonbank acquisitions and the establishment of **de novo** organizations and offices. The overall volume of all types of bank holding company applications was 306 in 1982, which is an increase of 38 percent over 1981. The Reserve Bank also received thirteen applications for membership in the Federal Reserve System, and four merger applications in which the surviving institution was a state member bank.

Despite the increased demand upon its resources, the applications processing activity achieved an excellent record for timeliness in 1982. All applications delegated to the Reserve Bank were processed within the mandated processing period, and the Reserve Bank's average processing time per application compared favorably with all other Reserve Banks.

The expansion of international banking facilities continued its rapid pace in 1982, as 83 such new facilities were authorized in the District. Banking organizations also continued to consolidate their Edge Corporation operations into extended branch networks. Seven additional branch offices of Edge Corporations opened within the District during the year, and an additional headquarters office of one Edge Corporation was established to administer the branch network formed by consolidating individually capitalized corporations. Examinations of such corporations are coordinated and directed by this Bank in concert with seven other Federal Reserve Banks.

The Consumer Affairs staff processed approximately 200 consumer complaints against state member banks in 1982, roughly the same number as in 1981. Another 200 complaints were received against institutions supervised by other regulatory agencies, and were referred to those agencies. The number of referrals dropped significantly in 1982, suggesting that consumers are becoming more knowledgeable about where complaints should be directed.

Of the complaints against state member banks, roughly one-third involved legitimate bank errors, which the banks voluntarily corrected once the matter was brought to their attention. Approximately half the complaints processed during the year involved matters covered under consumer laws or regulations; the other half concerned unregulated matters such as complaints about the time period required to clear checks. In addition to complaints, the Consumer Affairs staff responded to an estimated 1,100 regulatory inquiries during the year, many of which were technical in nature requiring research and formal response.

The Educational and Advisory Service continued to be offered to state member banks to assist them in understanding and complying with consumer laws and regulations. Depending on compliance conditions in the bank, limited or more extensive advisories were routinely conducted in connection with most compliance examinations, particularly when examinations revealed the need for special supervisory action.

A 40-page consumer education booklet, completed by the Consumer Affairs staff as a Bank objective in 1980 and published in mid-1981, met with continued success. Unexpected popularity led to printings totaling 35,000 by early 1982, and the advertisement of the booklet in a popular periodical in 1982 necessitated a third printing to handle some 10,000 additional requests.

Credit Activity

The Bank continued to assist depository institutions in meeting their liquidity needs by providing funds through the discount window. In 1982, 105 Twelfth District institutions, including five thrift institutions, had occasion to borrow from the Federal Reserve. While most of these institutions borrowed

for short-term adjustment purposes, several borrowed under seasonal lines of credit or to meet longer term liquidity needs.

Each of the five offices of the District experienced a large increase in the amount of collateral pledged by institutions to secure potential borrowings at the discount window. At year-end the Reserve Bank held $18.5 billion in collateral accounts, an increase of $7.3 billion (65 percent) from the $11.2 billion level at year-end 1981.

Emergency loans were made in 1982 to seven institutions having serious financial difficulties. Working closely with other federal and state supervisory agencies, the District Credit Unit administered loans to enable these institutions to stay afloat pending mergers with stronger institutions or to regain financial health. By year-end, three of the institutions had merged with other institutions.

A major accomplishment of the Credit Unit during the year was the implementation of the Qualified Loan Review (QLR) program. The QLR program provides that qualifying institutions may pledge certain types of customer paper as collateral for advances at the discount window and for Treasury Tax and Loan deposits without the Reserve Banks' prior analysis and approval of the financial condition and creditworthiness of the pledging institution's customers. To quality for participation in the QLR program an institution must, in the judgment of its supervising agency and the Reserve Bank, be in sound financial condition and have a satisfactory internal loan review and examination program.

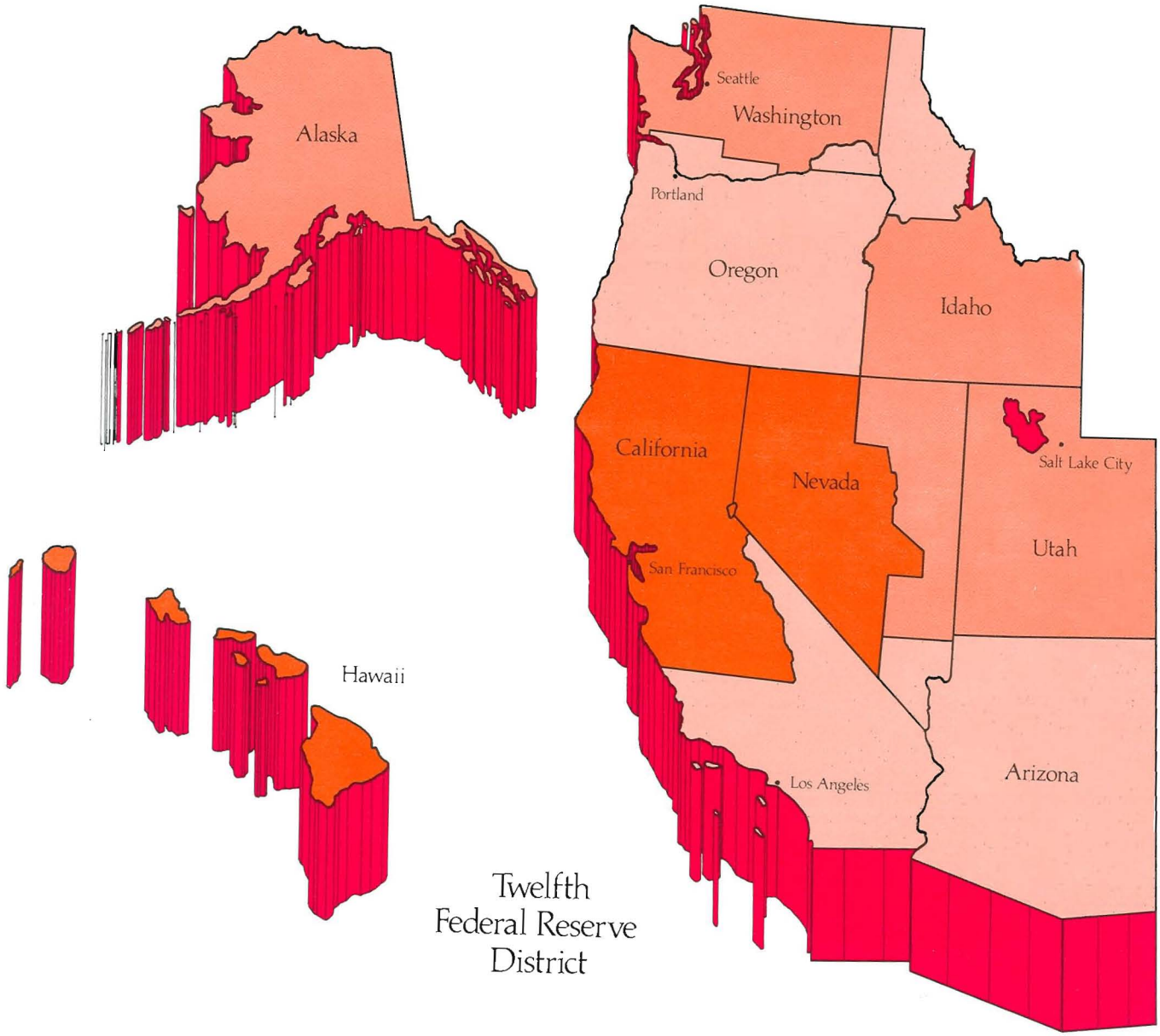
Summary of Operations

	Volume (thousands)			
	1979	1980	1981	1982
Custody Services				
Cash Services				
Currency paid into circulation	1,407,894	1,556,278	1,700,557	1,767,236
Coin paid into circulation	4,007,145	4,895,306[1]	4,649,901	4,779,409
Securities Services				
Savings Bonds original issues	1,563	1,327	1,136	995
Savings Bonds redemptions processed*	328,567	372,420	402,885	339,820
Other Treasury original issues	150	231	232	182
Food coupons processed	223,232	274,058	318,497	313,761
Payments Mechanism Services				
Check Processing Services				
Commercial checks processed	1,358,985	1,406,489	1,393,822	1,210,143
Fine sort bundles processed	N/A	804,248	1,201,909	2,619,403
Government checks processed	109,761	106,470	103,154	101,310
Return items processed	20,225	21,833	22,431	23,952
Electronic Funds Transfer Services				
Wire transfers processed	3,847	4,883	5,143	5,882
Automated clearinghouse transactions processed	32,448	41,298	55,483	76,944
Discounts and Advances				
Total discounts and advances*	1,318	1,092	1,821	1,281
Number of financial institutions accommodated*	59	67	106	105

*Number (not in thousands)

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

Branch Operations
(Shown from left to right, standing)
Richard C. Dunn, Senior Vice President
Richard T. Griffith, Executive Vice President, District Operations
Angelo S. Carella, Vice President, Portland
H. Peter Franzel, Vice President, District Operations Administration
(seated)
A. Grant Holman, Vice President, Salt Lake City
David J. Christerson, Vice President, Operations
Gerald R. Kelly, Senior Vice President, Seattle



Twelfth
Federal Reserve
District

Directors

The central-bank functions of the Federal Reserve are handled 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


Ahmanson

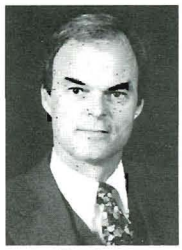
Deputy Chairman
Alan C. Furth
President
Southern Pacific Company
San Francisco, California


Furth

Fred W. Andrew
Chairman of the Board,
President and Chief
Executive Officer
Superior Farming Company
Bakersfield, California


Andrew

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


Eccles

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


Mettler

Togo W. Tanaka
Chairman
Gramercy Enterprises
Los Angeles, California


Tanaka

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


Vaughan

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


Weyerhaeuser

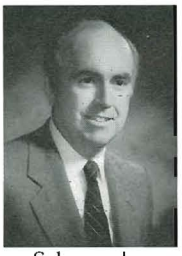
Robert A. Young
Chairman of the Board and President
Northwest National Bank
Vancouver, Washington


Young

Federal Advisory Council Member
Joseph J. Pinola
Chairman of the Board
First Interstate Bancorp
Los Angeles, California

Federal Advisory Council Member


Pinola


Schwaegler


Brown


Dockson


Goldsmith


McAlpin-Grant


McMahon


Tooley

Los Angeles

Chairman of the Board
Bruce M. Schwaegler
President
Bullock's-Bullocks Wilshire
Los Angeles, California

Thomas R. Brown, Jr.
Chairman and Chief
Executive Officer
Burr-Brown Research Corporation
Tucson, Arizona

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 for Special Projects
Loyola Law School
Los Angeles, California

James D. McMahon
President and Chief
Executive Officer
Western United National Bank
(in organization)
Encino, California

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

Portland

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


Hampton

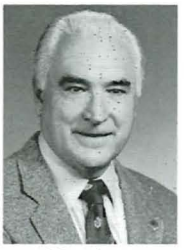
Herman C. Bradley, Jr.
President and Chief
Executive Officer
Tri-County Banking Company
Junction City, Oregon


Bradley

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


Chambers

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


Elorriaga

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


Gustavel

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


Naito

G. "Johnny" Parks
Northwest Regional Director
International Longshoremen's &
Warehousemen's Union
Portland, Oregon


Parks


Bailey


Nordstrom


Philip


Ellis


Mallott


Parks


Truex

Seattle

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

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

Byron I. Mallott
Chairman of the Board and
Chief Executive Officer
Sealaska Corporation
Juneau, 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

W. W. Philip
Chairman, President and
Chief Executive Officer
Puget Sound Bancorp
Tacoma, Washington

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

Salt Lake City

Chairman of the Board
Wendell J. Ashton
Publisher
Deseret News
Salt Lake City, Utah


Ashton

John A. Dahlstrom
Chairman of the Board
Tracy-Collins Bank and
Trust Company
Salt Lake City, Utah


Dahlstrom

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


Ence

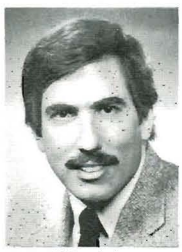
Albert C. Gianoli
President and Chairman of
the Board
First National Bank of Ely
Ely, Nevada


Gianoli

Fred C. Humphreys
President and Chief
Executive Officer
The Idaho First National Bank
Boise, Idaho


Humphreys

David Nimkin
Executive Director
Salt Lake Neighborhood Housing
Services, Inc.
Salt Lake City, Utah


Nimkin

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


Terteling

Comparative Statement of Account

(Thousands of Dollars)

	December 31, 1981	December 31, 1982
Assets		
Gold certificate account	$ 1,083,000	$ 1,233,000
Special Drawing Rights certificate account	380,000	518,000
Other cash	66,682	78,347
Loans to depository institutions	14,640	2,800
Federal Agency obligations	1,216,661	1,129,600
United States Government securities:		
Bills	6,580,908	6,879,306
Notes	7,996,764	7,915,801
Bonds	2,453,292	2,345,411
Total United States Government securities	17,030,964	17,140,518
Total loans and securities	18,262,265	18,272,918
Cash items in process of collection	515,841	1,080,878
Bank premises	74,622	103,914
Operating equipment	14,498	22,848
Other assets:		
Denominated in foreign currencies	808,703	945,296
All other	392,140	418,700
Total assets	21,597,751	22,673,901
Liabilities		
Federal Reserve notes	14,984,308	15,730,215
Deposits:		
Total depository institutions—reserve accounts	5,349,090	4,717,959
Foreign	51,359	34,440
Other deposits	35,476	81,716
Total deposits	5,435,925	4,834,115
Deferred availability cash items	327,588	1,396,541
Other liabilities	431,330	265,766
Total liabilities	21,179,151	22,226,637
Capital Accounts		
Capital paid in	209,300	223,632
Surplus	209,300	223,632
Total liabilities and capital accounts	21,597,751	22,673,901

Earnings and Expenses

(Thousands of Dollars)

	December 31, 1981	December 31, 1982
Current Earnings		
Discounts and advances	$ 14,797	$ 8,691
United States Government securities	1,938,292	1,978,747
Foreign currencies	90,366	70,551
Income from services	12,848	38,341
All other	833	918
Total current earnings	2,057,136	2,097,248
Current Expenses		
Total current expenses	99,674	116,726
Less reimbursement for certain fiscal agency and other expenses	7,223	7,741
Net expenses	92,451	108,985
Profit and Loss		
Current net earnings	1,964,685	1,988,263
Additions to current earnings		
Profit on sales of United States Government securities (net)	0	10,677
All other	1,446	0
Total additions	1,446	10,677
Deductions from current net earnings		
Loss on foreign exchange transactions (net)	49,265	24,536
Loss on sales of United States Government securities (net)	16,667	0
All other	1,404	2,459
Total deductions	67,336	26,995
Net additions (+) deductions (−)	− 65,890	− 16,318
Earned credits used by depository institutions	− 51	− 1,294
Assessments for expenditures of Board of Governors	− 10,177	− 10,147
Net earnings before payments to United States Treasury	1,888,567	1,960,504
Dividends paid	12,018	13,053
Payments to United States Treasury (interest on Federal Reserve notes)	1,861,514	1,933,119
Transferred to surplus	15,035	14,332
Surplus January 1	194,264	209,300
Surplus December 31	209,300	223,632

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 84125

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

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San Francisco, California 94120

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