

## A LETTER FROM THE ACTING PRESIDENT

The Federal Reserve Bank of Dallas opened for business 90 years ago in rented quarters downtown, a milestone we celebrated in November. Our location has changed three times since then, as we've grown and evolved with the dynamic region we serve. But our fundamental mission—to promote economic prosperity, financial stability and an effective payments system—has not changed. In 2004, we performed essential activities in support of that mission and saw continuation of the evolutionary forces that marked our first 90 years.

The Dallas Fed's evolution will continue in 2005 as it moves forward under new leadership. After nearly 14 years as president and 36 years of service to the Federal Reserve System, Bob McTeer resigned last year to become chancellor of the Texas A&M University System. Richard W. Fisher, vice chairman of Kissinger McLarty Associates, was named the Dallas Fed's 12th president. As the first new president in the 21st century, he'll set the Bank's direction for the coming decades. We're pleased to have Richard join the Bank and look forward to working with him.



### ECONOMIC OVERVIEW



The Eleventh District economy continued to expand in 2004, but at a much slower pace than it has enjoyed in the past. After outperforming the nation since the mid-1970s, Texas—by far the District's largest component—has been slow to recover from the most recent recession. Coming out of the downturn in the second half of 2003—more than 18 months after the nation—Texas posted steady job growth of 1.3 percent in 2004, half what it has averaged since 1974.

Several factors account for changes in the Texas economy's performance. The state was hard-hit when the high-tech bubble burst. The sector's slow recovery and the resulting structural change in the economy are among the principal reasons for the state's sluggish growth.

The energy industry did well throughout the District, thanks to soaring oil and natural gas prices, but rising energy prices haven't propelled the Texas economy ahead of the nation's the way they did in the 1970s and '80s. Research conducted here at the Dallas Fed indicates that climbing energy prices still benefit the Texas economy, but only by about a sixth as much as they did in the early 1980s. Since then, the Texas energy industry has shrunk, while the rest of the state's economy has grown.

In the early 1980s, the oil and gas industry accounted for more than 20 percent of Texas output. Today, it accounts for only about 5 percent. At the same time, the energy industry has become less sensitive to price fluctuations. As a result, rising energy prices haven't helped Texas' economic growth the way they once did.

The Texas economy is in transition. However, the good business climate, strong sense of entrepreneurship and optimism, and reliance on free market principles that underpin the state's economy will help it remain dynamic and prosperous.

## FINANCIAL SERVICES



An efficient, stable and secure payments system is essential to the U.S. economy. The Federal Reserve and the Dallas Fed continued to have an integral role in the payments system by providing financial institutions with high-quality services and products, evolving with the latest in technology. As consumers and businesses increasingly adopt electronic forms of payment, we have both modified our service offerings and revamped our processing infrastructure for payments.

The Check Clearing for the 21st Century Act, which took effect in October, clears the way for banks to process checks electronically by making substitute checks—created from digital images—the legal equivalent of the original paper checks. Check 21 allows paper checks to be converted to digital images upon initial presentment and exchanged in electronic format through final payment or converted to substitute paper checks, if necessary. The payments system will benefit from the more rapid and less costly electronic collection of checks.

The Fed is supporting Check 21 with new products that facilitate the move to electronic processing. One of our initial services allows financial institutions to present paper checks that the Fed converts to digital images. Another service allows the Fed to receive and process digital images in lieu of paper checks. We will launch additional products and services in 2005.

Major transition in the use of paper checks is prompting changes at the Dallas Fed and across the Federal Reserve System. In 2004, we consolidated check operations at our El Paso and San Antonio branches into the Dallas office as part of the national restructuring of the Fed payments infrastructure. Both consolidations went well, notwithstanding the operational and administrative complexities. Check operations from our Houston Branch and the Oklahoma City Branch of the Kansas City Federal Reserve Bank will move to Dallas in 2005. Meanwhile, the Eleventh District's check-adjustments functions were consolidated at the Houston Branch.

As consumers and businesses continue to write fewer checks and use debit and credit cards and the automated clearinghouse more often, the move from paper will likely accelerate, transforming the nation's payments system.

While the move from checks to electronic payments continued, cash remained generally steady. In 2004, we processed near-record levels of currency and made record improvements in cost efficiency and productivity. We were particularly glad to see the long-awaited Texas quarter hit the streets in June. Demand across the Lone Star State was high, as expected.

## BANKING SUPERVISION

Economic growth depends on a sound, competitive banking system. Through its supervisory activities, the Dallas Fed promotes the safe and sound operation of banking institutions based in the Eleventh District. Our supervisory role with District organizations also extends to fostering



compliance with consumer credit laws and encouraging institutions to meet the credit needs of their communities.

In addition to our formal supervisory role, we serve the industry through informal means. Banking supervision staff frequently participate on panels to discuss regulatory changes and other issues. In 2004, we conducted seminars to help bank directors understand their special fiduciary responsibilities, a particularly relevant topic given the focus on corporate governance. We continued to promote electronic filing of required financial reports and distributed tips and clarifications to help filers understand their responsibilities.

The Dallas Fed's consumer affairs staff continued to conduct advisory visits to provide state member banks with guidance on implementing their consumer compliance programs. The staff also serves the public by responding to inquiries about consumer laws and regulations and investigating complaints about specific practices. In 2004, we responded to more than 200 inquiries and complaints.

## RESEARCH AND PUBLIC AFFAIRS



In keeping with the tenet that educated citizens are the foundation of a healthy economy, the Bank is dedicated to providing the public with information and insight into economic concepts and ideas. This is accomplished through a full array of public programs and outreach efforts, including conferences, publications and a web site. Our staff is active throughout the District, speaking to groups and providing perspective on issues affecting business and industry.

Sometimes, they go farther afield. Two Dallas Fed economists served on the President's Council of Economic Advisers in 2004. We are also proud of our affiliation with Finn Kydland, a Dallas Fed research associate who in December became a Nobel laureate in economics for his work on business cycles and macroeconomic policy.

Research conferences in 2004 focused on a variety of issues affecting the national and state economies. At one conference, a group of distinguished speakers examined globalization's impact on jobs, the environment, intellectual property rights, child labor and capital flows. Another conference, cosponsored by the National Association for Business Economics, addressed technology's potential impact on economic growth and productivity. We partnered with the University of Texas at Austin, in conjunction with the Delegation of the European Commission, on an international conference that discussed the euro's successes and the obstacles it still faces.

Also on the international front, economists at our San Antonio and El Paso branches convened a panel of experts to discuss the economy along the Texas-Mexico border, where security concerns and global competition are challenging the strong growth the area has enjoyed in recent years. Our Community Affairs office brought together bankers and others to discuss the latest research on immigrants' role in our economy, explore ways to provide them with banking and community development services, and identify business opportunities this growing market presents.

We also reached out to the public through our publications. *Building Wealth*, the Bank's personal finance education guide, was the most downloaded resource from our web site. *E-Perspectives* and *Banking and Community Perspectives* provided readers with information about home-ownership preservation, community development financing, Texas' changing demographics, and ways financial institutions can provide products and services to immigrants and low- to moderate-income populations. One of our most widely read publications

is *Southwest Economy*, which carried articles on the Texas economy, Social Security, immigration, energy prices and service-sector productivity.

Regional and national economic updates were posted on our web site as events unfolded. The Bank's web site attracts readers from around the world; the Spanish-language section has become particularly popular.

Our children are growing up in an increasingly global economy, and the Dallas Fed offers economic education resources for both students and teachers to help young people understand economic issues. Several hundred teachers attended our "Evening at the Fed" program on energy issues, a personal finance education workshop about the cost of credit, and a conference on the past, present and future of the U.S. economy. We saw an increase in the number of students entering our annual economic essay contest and the number of teachers participating in coaching sessions for Fed Challenge, in which high school students simulate the monetary policy decision-making process.

### LIFELONG LEARNING



The topic of this year's annual report essay is the importance of lifetime learning in our rapidly changing, knowledge-based economy. As the essay says, learning doesn't stop once we have a diploma in hand. Continually expanding knowledge and updating skills are important to individual workers as well as the economy.

Serving as the Bank's interim president has been a learning experience for me, causing me to study more deeply the Federal Reserve's monetary policy functions. When I joined the Dallas Fed 31 years ago, I never expected to one day participate in Federal Open Market Committee discussions, where monetary policy is made. While we temporarily handed off our vote to my colleague at the Atlanta Fed, as protocol prescribes, I've been proud to deliver the Bank's economic perspective to the FOMC.

The learning never stops for organizations, either—including the Federal Reserve. And as the economy continues to evolve and the needs of our customers change, we'll keep on adjusting, improving and progressing.

### IN APPRECIATION

I'd like to acknowledge the tremendous service of our boards of directors and advisory council members last year. All are private citizens who give their time and expertise to help us better understand the dynamics of the economy. Particular appreciation goes to departing board members Ron R. Harris, Marvin L. Ragsdale and R. Tom Roddy at the San Antonio Branch and Richard W. Weekley at the Houston Branch.



I would also like to thank the Bank staff for their accomplishments in 2004. Bank employees do a marvelous job of meeting our mandate, by studying the economy, supervising banks and offering high-quality financial services. Not only do they provide public service to our region and nation, but they also make the Dallas Fed a rewarding place to be. Their spirit of teamwork and dedication to excellence will help ensure the Bank's continued success through the next 90 years.

*Helen C. Holcomb*