History should show the fall in the dollar as the single most important factor in the recovery of the District economy.

Inside

Message *from the Chairman and the President*

As we look back on 1987, we are encouraged by the modest gains experienced by the economy of the Eleventh District. In spite of these gains, the economy of the Southwest remains lackluster at best, especially when compared with the rest of the country. Indeed, many of the most significant challenges of 1986 have persisted throughout 1987. Energy-related activity has not yet demonstrated a vigorous rebound, and the positive effects of the dollar's decline on domestic growth have continued to be measured only in small and gradual improvements. The real estate and construction sectors remain the most obvious drags on the regional economy, and their difficulties have spilled over onto the District's financial institutions.

As a result, the earnings picture for the District's financial institutions was dismal in 1987, and the prospects for a turnaround in the near future are dim. Financial institutions in our District failed at a pace that eclipsed even the record-setting failure rate in 1986, primarily because of problems with real estate loans. But while many of the problems of 1986 have persisted into 1987, some positive differences have emerged between this year and last.

For example, our research now suggests that a basic turnaround in the Southwestern economy is indeed taking place, so we look for 1988 to be a better year. At the same time though, the momentum of our regional economy will continue to be sustained by the health and vitality of the national economy. Though few of us are confident enough to predict the future, the uncertainty over the relationship between the stock market crash during October 1987 and overall economic activity in 1988 clouds the picture even further. Also, it is clear that our region's economy is directly affected by international developments and by the value of the dollar abroad. To give a deeper understanding of these relationships, the first accompanying article profiles the practical findings of our staff's research in this area.

On the banking structure front, 1987 brought changes that should impact the District's financial system for many years. Specifically, it saw the beginnings of interstate banking and branch banking in Texas, both of which are already changing the shape of the banking industry in the state. Change also occurred in Louisiana, where interstate banking and expanded branching legislation had been enacted in 1986, and to a lesser extent in New Mexico, where 1986 had seen minor changes in the branching and interstate banking statutes intended to facilitate the acquisition of failed banks.

A number of efforts to strengthen the Texas banking industry also were begun or completed in 1987, including mergers between in-state bank holding companies, out-of-state acquisitions of Texas institutions, and FDIC open-bank assistance to troubled institutions. In the aggregate, we expect these developments to contribute to improved competitiveness and performance by Eleventh District financial institutions over the long term. Meanwhile, we are continuing to allocate resources to the supervision and regulation function, a move which reflects our concerns in this area.

As the financial service industry changes, so also must the Federal Reserve change. We are proud that many of the Dallas Fed's highest priority initiatives in 1987 were designed to help District institutions cope with change. The creation and refinement of efficient electronic services continue to be emphasized at the Dallas Fed as they do throughout the entire Federal Reserve System. The second accompanying article describes some of the legislation leading to the expansion of electronic and other financial services offered by the Federal Reserve.

During 1987, the Dallas Fed introduced service improvements and innovations in each of our product lines, including electronic and conventionally paper-based services. At the same time that our customer support has set a new standard for professionalism and responsiveness, the fees charged for our services have remained remarkably constant and, in some cases, have even been lowered. In this era of trade-offs, we believe the commitment of our staff has been responsible for producing such positive results on all fronts.

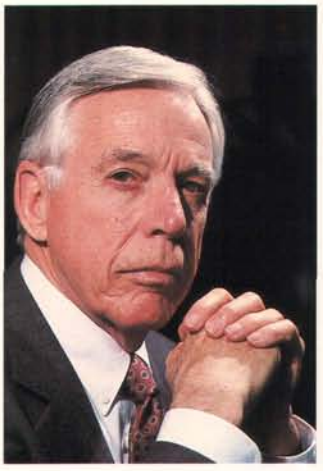
Changes abound in the financial world, and the Dallas Fed promises to be a major force in the formulation of solutions for today and tomorrow. To meet these challenges, the Dallas Fed has crafted a strategic plan, "An Agenda for the 90's," that spotlights the Bank's highest organizational priorities.

We believe we possess extraordinary research and analysis capabilities, and we intend to apply them in collaborative support of regional economic development. It is clear that we have the capacity to foster the success of the District's financial institutions by designing and supporting products that are error-free, technologically advanced, cost effective, and, at the same time, physically and informationally secure. Moreover, the Dallas Bank and its branches in Houston, San Antonio, and El Paso are all eager to contribute toward improving life for the nation, the region, the community, and the neighborhood. We will continue to place an emphasis on our community affairs involvements, both as an enlightened public service institution and as concerned and caring private citizens.

The Dallas Fed's ability to deal with the rapidly changing economic, legislative, regulatory, and technological environments will be challenged over the next few years. But rather than just reacting to change, we intend to anticipate it through improvements in our management system that place added emphasis on planning, accountability, integrity, and teamwork.

Needless to say, communications will play a vital role in our future. Whether you are in business, banking, education, or government or are a member of the general public, the Federal Reserve Bank of Dallas will continue to provide informative and educational publications to help you better understand the Federal Reserve System and its role in maintaining the economic vitality of our country and our region. As we face the future together, we will need a rare combination of knowledge and inspiration. We are confident that our troubled region enjoys through all of us the strength, perseverance, and promise to create greater prosperity for all in the years ahead.

Bobby R. Inman
Chairman



Robert H. Boykin
President

Effects of the Lower Dollar

on the economies of the Eleventh District states

Texas, Louisiana, and New Mexico face a serious challenge—to make the transition from an economy built largely on mineral resource extraction to one that emphasizes its human resources. In meeting this challenge, the decline in the foreign exchange value of the dollar that began early in 1985 will have a special significance for the District. Recent movements in the dollar will prove important in determining which U.S. industries prosper over the coming decade. And many of these same industries—especially those that use an educated work force—are likely to emerge as leaders in the long-run transformation of the District economy.

By making U.S. goods less expensive relative to foreign goods, a lower dollar provides a general stimulus to U.S. economic activity. But the benefits are not likely to be shared equally by individual industries and states. Because the dollar has depreciated at different rates against the various currencies and since various industries differ in their exposure to trade with a particular country, declines in the dollar have been more favorable for some industries than for others. Substantial differences also exist across industries in the sensitivity of production to exchange rate movements. And in view of the geographic concentration of U.S. industrial production, the lower dollar likely will trigger important regional imbalances.

Industries Likely to Benefit from the Lower Dollar

The response of production in a given industry to an exchange depreciation depends on the size of the depreciation for that industry. Therefore, industry-specific measures of dollar depreciation were developed by weighting the inflation-adjusted movements in the exchange rates of U.S. trading partners by their shares of U.S. trade in the particular industry product.

The results show that the changes in the dollar since early 1985 have had an uneven impact on the competitive positions of U.S. industries. The automobile industry, for example, has been extremely favored by recent movements in the dollar. A large share of U.S. trade in automobiles is with Japan and Europe, against whose currencies the dollar has fallen by more than 50 percent. On the other hand, little improvement has occurred in the terms under which U.S. apparel manufacturers compete internationally. Trade in apparel is dominated by the Pacific Newly Industrialized Countries (PACNIC), against whose currencies scarcely any real depreciation has developed.

To evaluate an industry's production response to dollar declines, it is necessary to know not only the amount of depreciation that has occurred for that industry, but also how sensitive its production is to changes in exchange rates. Measuring this responsiveness to movements in exchange rates requires using information on industry exposure to international

German Mark DM20

trade as well as on the potential for substitution between foreign and domestic products within the same industry group. The more exposed a domestic industry is to trade, and the more substitutable its product for foreign products, the more sensitive its production will be to changes in exchange rates. The results here reveal significant differences across industries in their exchange rate sensitivity. Domestic production of electric and electronic equipment, for example, has proved to be three times as sensitive as domestic textile production to dollar movements.

With these two elements—effective dollar depreciation and exchange rate sensitivity—it is possible to identify the U.S. industries whose production is likely to respond most significantly to the fall in the dollar. The analysis was carried out for manufacturing, mining, and agriculture—the three sectors of the economy that are most open to international competition. Figures 1 through 3 detail the results (also see the accompanying box). The maroon bars show the size of dollar depreciation that has occurred for each industry over the period March 1985-August 1987. The grey bars measure how sensitively production reacts to these movements in the dollar. The turquoise bars then combine the two factors to provide an estimate of how production will respond to the lower dollar in the long run.

Recent movements in the dollar will prove important in determining which U.S. industries prosper over the coming decade.

Manufacturing. The measurements indicate a substantial variation in the expected production response of U.S. manufacturing industries to the dollar's depreciation. For example, transportation equipment is expected to show the largest production response—more than double the average for manufacturing. Petroleum and coal products, on the other hand, are expected to show the smallest production response—only about one-fifth the average.

In general, durable goods manufacturers are projected to benefit more from the lower dollar than are nondurable goods manufacturers. The most significant gains are expected in transportation equipment, miscellaneous manufacturing (including toys and sporting equipment), and scientific instruments. These industries have enjoyed a real exchange rate depreciation of 20 percent or more, and production in each industry is highly sensitive to exchange rate movements. Industries whose production is expected to respond least significantly include apparel, textiles, lumber and wood products, and petroleum products. For these industries, either the recent movements in the dollar have been only moderately favorable or their production tends to be unresponsive to changes in exchange rates.

Mining. Another major sector to benefit from the lower dollar is mining. For bituminous coal and oil and gas extraction, the gains should be particularly significant since the dollar has fallen by 20 percent or more. The boost to domestic oil and gas production will be especially helpful to the District states, although these gains will fall well short of offsetting the losses stemming from the earlier plunge in oil prices.

Canadian Dollar C$100

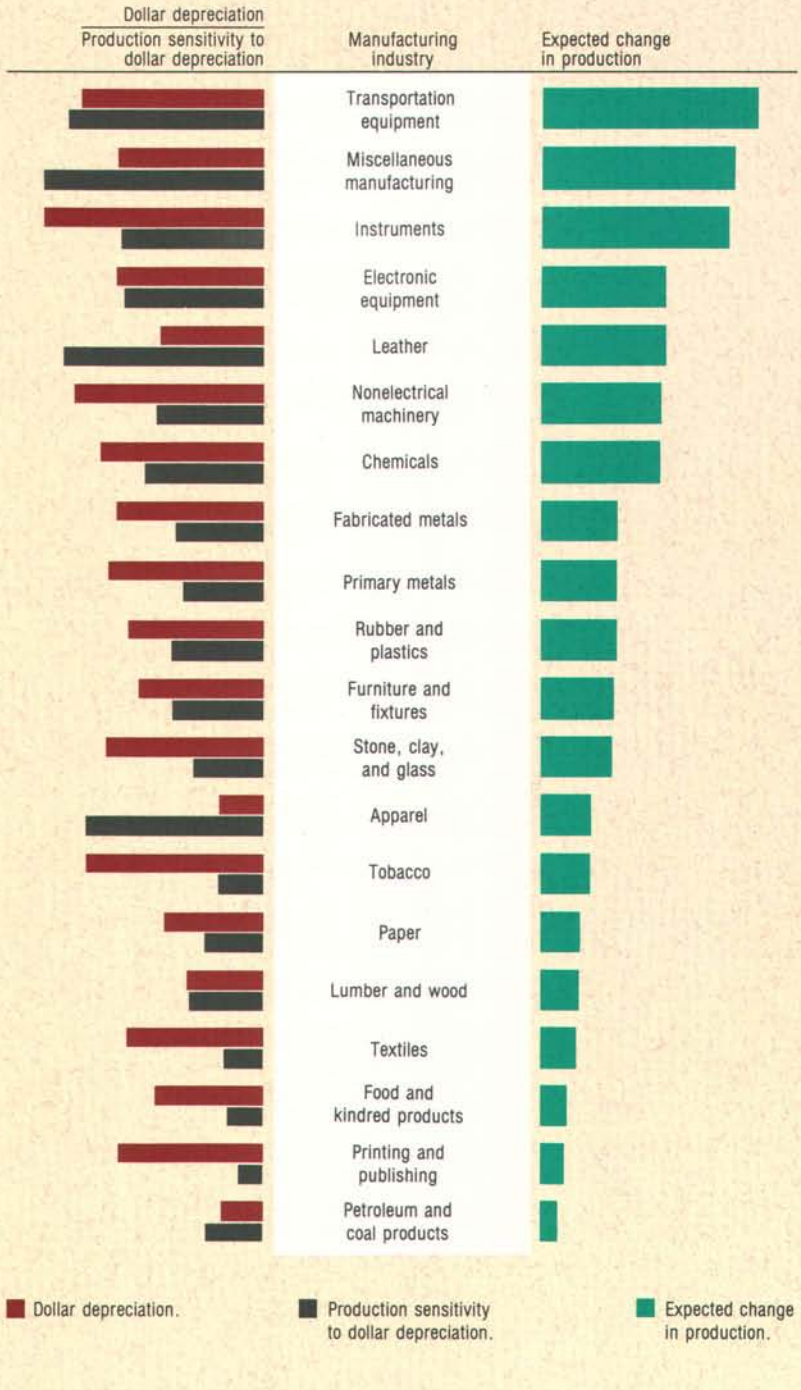
How To Interpret Figures 1-3

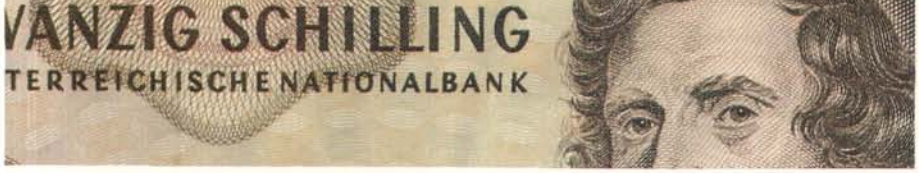
Figures 1-3 detail the effects of recent movements in the dollar on U.S. production by manufacturing, mining, and agricultural industries. On the left-hand side of the figures, the maroon bars show the amount of dollar depreciation that occurred for each industry over the period March 1985 through August 1987, while the grey bars show how sensitive production in each industry would be to any given decline in the value of the dollar. These two sets of information have then been used in developing the turquoise bars on the right-hand side to show how much of an increase in production would be expected from each industry in response to the lower dollar. The data represented by the various sets of bars are not comparable from one set to another. That is, the lengths within each bar set have been scaled so that only the bars of the same color can be compared with each other. Therefore, the maroon bars are not comparable to the grey bars, the maroon bars are not comparable to the turquoise bars, and the grey bars are not comparable to the turquoise bars. But all bars within the same color set are comparable with each other, with the varying lengths showing the relative response of each industry within the group. For example, the turquoise bar for transportation equipment is 1.8 times as long as the turquoise bar for nonelectrical machinery. This comparative figure thus indicates that the amount of production gain expected for transportation equipment in response to the lower dollar is 80 percent more than that expected for nonelectrical machinery.

How much a particular state or region is helped by the lower dollar is determined largely by the mix of industries in its economy.

Figure 1

Expected Changes in U.S. Manufacturing Production in Response to Changes in the Dollar





Austrian Schilling ASCH20

While the expected response of U.S. mining production is significant, it is only 80 percent of the overall response projected for U.S. manufacturing. The amount of dollar depreciation is comparable between the two sectors, but the expected production responses differ because mining production is somewhat less sensitive to changes in exchange rates. Mining is an increasing-cost industry. That is, additional production comes at an increasingly greater expense. As a result, mining production tends to be less responsive than manufacturing production to a given improvement in market conditions.

Agriculture. As a whole, U.S. agriculture also stands to benefit from the fall in the dollar. But the overall response for these products is projected to be only 60 percent of the manufacturing production response. For one thing, less dollar depreciation has accrued to agriculture. The dollar measures for fisheries and livestock, for example, show an effective depreciation of only 10 percent. In addition, agricultural production, like mining, is less sensitive than manufacturing production to exchange rate movements. Many agricultural products, including livestock and many perishable crops, are not widely exported outside the United States. Production in these categories thus does not vary significantly with movements in the exchange value of the dollar.

Figure 2
Expected Changes in U.S. Mining Production in Response to Changes in the Dollar

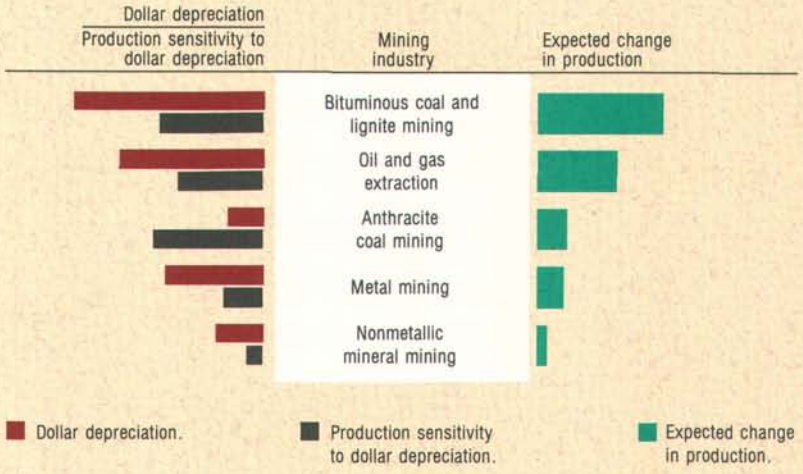
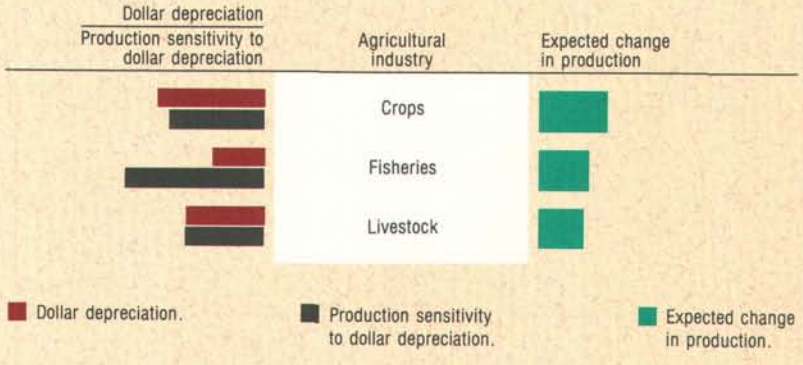


Figure 3
Expected Changes in U.S. Agricultural Production in Response to Changes in the Dollar

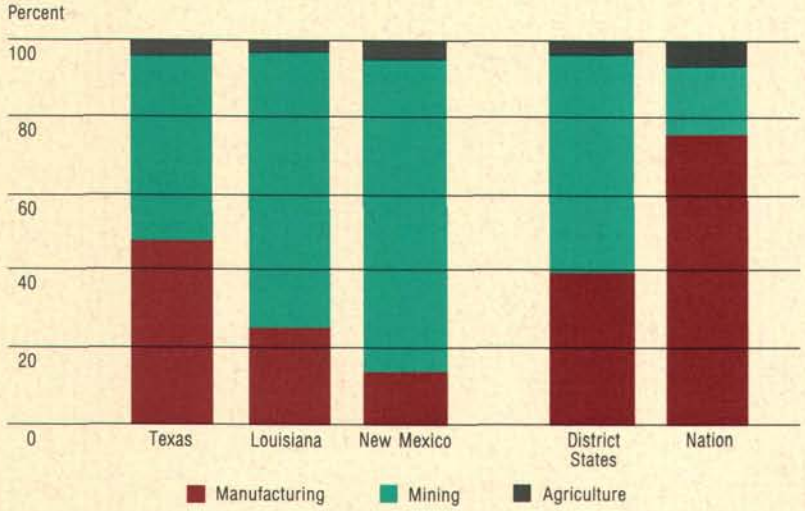


State and Regional Comparisons

How much a particular state or region is helped by the lower dollar is determined largely by the mix of industries in its economy. Areas gaining the most are those with a large contingent of industries whose production is most favored by the fall in the dollar. Thus, the upper Midwest stands to benefit greatly because of the importance of automobile production to its economy. Conversely, those areas of

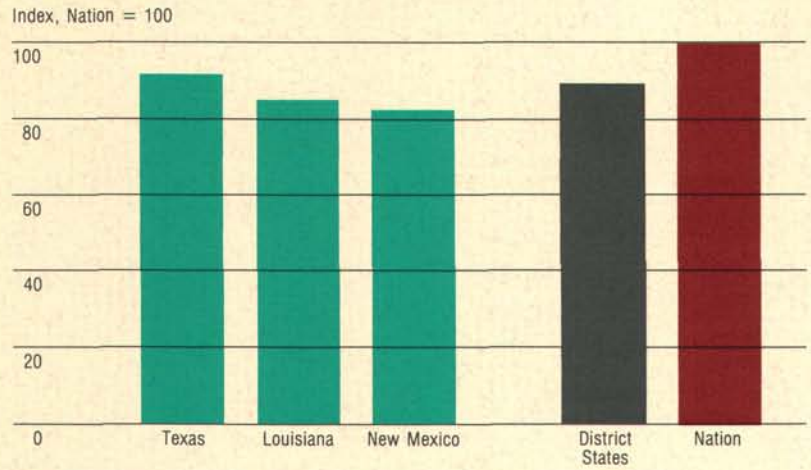
the nation with a heavy representation of industries least favored by recent movements in the dollar probably will not receive much of a boost to their economies. Although the Southern Atlantic states, for example, are well endowed with tobacco, textile, and apparel manufacturing, this region likely will not prosper as much because these industries are not particularly sensitive to dollar declines.

Figure 4
Composition of Trade-Sensitive Production[1] in the Eleventh District States and the Nation



1. Trade-sensitive production in this figure is the sum of manufacturing, mining, and agricultural production.

Figure 5
Expected Response of Total Trade-Sensitive Production[1] in the Eleventh District States and the Nation to Changes in the Dollar



1. Trade-sensitive production in this figure is the sum of manufacturing, mining, and agricultural production.

A breakdown of trade-sensitive production in both the District states and the nation is provided in Figure 4. What stands out, of course, is the importance of mining and the relative unimportance of manufacturing to the District states. In the District, mining accounts for 57 percent of the total value of trade-sensitive production, and manufacturing accounts for 40 percent. On the other hand, for the nation, manufacturing is predominant, with a 76-percent share of trade-sensitive production, while mining's share is only 17 percent. In a look within the District, New Mexico emerges as the state most dependent on mining and the least endowed with manufacturing. Texas has the greatest representation of manufacturing and is the least reliant on mining.

What do the recent movements in the dollar mean for the District overall? To project the effects of the lower dollar on the general level of production in the District states, the individual industry responses were averaged, using weights that reflect the importance of the various industries to total trade-sensitive production in the District. The results, indexed relative to the national average, are shown in Figure 5.

The overall gains projected in District production show up as close to, but somewhat less than, those for the nation. That these gains are smaller is not surprising, given the importance of mining to the District and that mining

Italian
Lira
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production is expected to respond less significantly to the fall in the dollar than is manufacturing production.

Of the three District states, Texas stands to benefit the most, with an overall gain in production that is 91 percent of the nationwide average. This reflects the relative importance of manufacturing to the Texas economy. Because of the predominance of mining in its economy, New Mexico is projected to benefit least from the fall in the dollar, with production gains that are only 83 percent of the national average.

The overall gains projected in District production show up as close to, but somewhat less than, those for the nation.

Conclusion

The District states will benefit substantially from recent declines in the dollar. By increasing the demand for oil outside the United States, a lower exchange value of the dollar will serve to raise the dollar price of oil. While insufficient to restore conditions to pre-1985 levels, this factor will cushion the decline in domestic oil production.

More importantly, the lower dollar will create new employment opportunities in many of the District's manufacturing industries. This will make it easier for the economy to absorb workers displaced from mining and construction. Indeed, history should show the fall in the dollar that began in early 1985 as the single most important factor in the recovery of the District economy.

And what of the future? In the economies of the District states, manufacturing and its related activities are likely to occupy a more prominent position. The particular manufacturing industries to rise in importance are those that rely heavily on a skilled work force, either in product assembly or product design, and these are the industries that have been favored by recent declines in the dollar. Both the national and the regional economies are steadily developing those industries that utilize people skills and that make greater use of this country's most valuable resource—its brainpower.

Changing Times

The effects of the Monetary Control Act and the Competitive Equality Banking Act on the direction of financial services

Innovation and change are key words in describing the course of the financial industry over the past decade. Major pieces of banking legislation have provided the impetus for change, and the financial industry and the Federal Reserve System have reacted in innovative ways.

Banking and the role of the Federal Reserve changed significantly in 1980 with the passage of the Monetary Control Act. The provisions of this act will continue to have far-reaching effects on financial institutions' products as well as on Federal Reserve operations.

Change is constant in the world and in the banking industry. In 1987, the Competitive Equality Banking Act was passed. It requires a concerted effort by financial institutions and the Federal Reserve to respond innovatively. To meet the requirements of the new legislation, new methods must be developed to process and return checks and check-related information. The Federal Reserve and national banking groups have already begun to address the issues involved. With input from the financial community, the direction of the check payments system will be decided.

Here is a brief look at how these two pieces of legislation—the Monetary Control Act of 1980 and the Competitive Equality Banking Act of 1987—have provided a framework for the direction of financial services.

Monetary Control Act of 1980

On March 31, 1980, the Depository Institutions Deregulation and Monetary Control Act became effective. It may well be remembered as the most important event to affect the banking community since the 1930s. Some of the principles that had been ingrained in banking and finance since the Depression and before were substantially changed by the act. The Monetary Control Act, as it has come to be called, created a new regulatory environment that had an impact on all financial institutions and paved the way for a possible restructuring of the financial industry.

Inflation, consumerism, and the promotion of competition were the driving forces behind the passage of the MCA. The inflation that persisted during the 1970s caused many consumers to take their deposits out of commercial banks and savings and loans and invest them in such alternatives as money market funds, where they were able to receive higher interest rates. In an attempt to provide equity in the competition for deposits, the MCA provided for the phaseout of Regulation Q interest rate ceilings, which limited the amount of interest institutions could pay for certain types of deposits. These institutions also were given the opportunity to offer interest-bearing Negotiable Order of Withdrawal (NOW) accounts to their customers.

Inflation also had caused the Federal Reserve System to lose some of its state member banks, as these institutions found it increasingly less desirable to hold noninterest-bearing reserves at Federal Reserve Banks.

The MCA strengthened the Federal Reserve's base of monetary policy operations, however, as it required uniform reserve requirements from all institutions with transaction-type deposits. At the same time, the Federal Reserve was required to make its services available to all depository institutions on a fee basis.

The promotion of greater competition among various types of financial institutions and the attempt to open up additional alternatives to consumers accounted for other provisions of the Monetary Control Act. Thrifts were given increased powers, including new investment opportunities, and along with the introduction of NOW accounts and the phase-out of Regulation Q, the different types of financial institutions—commercial banks, savings and loan associations, and credit unions—were made more equal and potentially more competitive than ever before.

One of the first effects of this new law was overall increased competition within the industry.

Many predicted that the MCA would have as profound an effect on the structure of the financial industry as any one piece of legislation enacted since the Depression era. One of the first effects of this new law was overall increased competition within the industry. As various types of financial institutions were given more nearly equal powers, the competition among them for certain types of deposits and for consumers of certain types of services increased. Many institutions found themselves less isolated from the other types of institutions than they were before. Competition also developed between public and private enterprise for handling services provided by the Federal Reserve, and the possibility existed that the private sector would take over some of these.

Perhaps the most important consequence of the increased availability of NOW accounts was that low-cost deposits became less common. In the past, commercial banks had been able to acquire a substantial amount of funds through noninterest-paying demand deposits, but NOW accounts increased the cost of funds for financial institutions. The Federal Reserve's pricing of its services further increased the cost of check processing, and financial institutions had to consider passing these costs on to the consumer. Therefore, the days of "free" services that were only implicitly priced to consumers were coming to an end.

Effects on the Federal Reserve and the Banking System

The MCA changed the customers the Federal Reserve served, the services provided, and how the Federal Reserve behaved as an organization. It fundamentally restructured the U.S. banking system. The deregulation of deposit interest rate ceilings combined with the pricing of Federal Reserve Bank services to pave the way for a new era in banking.

For the Federal Reserve System, the MCA had three major effects. First, it required the Federal Reserve to establish universal reserve requirements for all types of depository institutions, thereby expanding the Federal Reserve's account relationship from somewhat over 5,000 accounts

Systemwide to a potential of over 40,000. Second, the MCA lowered the percentages of deposits required to be held as reserves with the Federal Reserve. And third, the Federal Reserve was required to offer financial services for a fee to all depository institutions rather than solely to those who were members of the Federal Reserve System—primarily national banks.

These three things combined—universal reserve requirements, lowering the percentage required to be reserved, and charging for financial services—brought the Federal Reserve into the competitive market for financial services as never before.

The Federal Reserve was required to set prices for its financial services, including check processing, transfers of funds, automated clearinghouse, securities, noncash collection, and currency and coin transportation services. To meet the requirements of the MCA, the Federal Reserve basically did three things:

- Phased in a pricing policy, charging explicit fees designed to cover costs.
- Phased down reserve requirements from a 7-18 percent range to a 3-12 percent range.
- Opened new accounts for nonmember banks, savings and loans, and credit unions. The number of active reserve accounts handled at the Dallas Fed more than doubled—from 718 in 1980 to 1,557 in 1987.

For financial institutions, the changes required by the MCA were significant. Several major developments occurred directly or indirectly as the result of the MCA. For the banking industry, the act basically did the following:

- It started a movement away from providing consumers with "free" retail payment services toward charging direct fees for services used.
- Approximately $6 billion per day in Federal Reserve float benefits was lost to check writers.
- An increased incentive was provided to financial institutions to use more efficient electronic payments delivery systems.
- New payments instruments were introduced, such as NOW accounts, share drafts, and money market funds.
- Institutions began to pay interest on deposits at close to market rates (with the exception of demand deposits). To cover the operating costs of servicing these deposits, institutions set higher maximum balance requirements and imposed direct fees for servicing these accounts.

These developments are far-reaching in their impact, both in terms of redistributing the benefits and costs of payments system use and in influencing the future direction of payments innovation.

The passage of the Monetary Control Act brought significant changes to our relationship with the banking community. A broader range of prod-

Major Banking Legislation Since 1900

Federal Reserve Act (1913)
Established the Federal Reserve System

McFadden Act (1927)
Prohibited branching across state lines

Banking Act of 1933 (Glass-Steagall Act)
Prohibited paying interest on demand deposits, and established the FDIC

Bank Holding Company Act (1956)
Regulated formation and expansion of new bank holding companies

Bank Merger Act (1966)
Established merger guidelines

Amendments to Bank Holding Company Act (1970)
Regulated one-bank holding companies

Depository Institutions Deregulation and Monetary Control Act (1980)
Established uniform reserves and initiated deregulation

Garn-St Germain Depository Institution Act (1982)
Permitted banks and thrifts to offer a money market deposit account, continued deregulation, and addressed emergency acquisition provisions

Competitive Equality Banking Act (1987)
Recapitalized the FSLIC, closed nonbank bank loophole, and required the Federal Reserve to improve the nation's check payments system

ucts, new fees, new operating procedures, and more electronic services have resulted. The effects of deregulation continue to be felt.

Competitive Equality Banking Act of 1987

Now there is a new challenge to add to the evolution of the payments system. In 1987, legislation was passed that also will impact significantly the Federal Reserve and its operations as well as the relationship that financial institutions have with their customers. The Competitive Equality Banking Act of 1987 has many sections that cover a wide variety of banking topics—most notably the recapitalization of the Federal Savings and Loan Insurance Corporation (FSLIC) and the closing of the nonbank bank loophole.

The act most impacts Federal Reserve operations in the area of expedited funds collection, by specifying maximum time limits within which funds are to be made available to customers.

At the same time, the act gives very broad regulatory powers to the Federal Reserve to regulate the payments system and expedite the collection of checks. Because of reductions in the amount of time a depositor's bank will have before giving customers credit for their deposited checks, increased emphasis will be placed on the transmission of information to a depositor's bank regarding whether the deposited check will be paid.

The Board of Governors of the Federal Reserve System is directed to write regulations that will require the speedy return of a dishonored item to the depositor's bank, that all returned checks be eligible for return through the Federal Reserve banks, that institutions be permitted to return dishonored checks directly to the institution in which the check was first deposited, that endorsements be placed in specified positions, and that the requirements be expanded to notify a depositor's bank that a check will not be paid.

Simply putting a return item in the mail by midnight of the business day following receipt may no longer be an acceptable method of return. To meet the new requirements, new technology will be employed, new endorsement standards will be enforced, and the industry's very thinking on the check collection process will be altered. The Federal Reserve will have to put processes in place to help make this happen. The banking industry will have to do the same. A lot of work will have to be done in a relatively short time period—within the next three years.

The Dallas Fed is fortunate in this regard because we have already been thinking about return items. In 1983, a return item pilot program began at the Dallas Fed that was designed to begin returning checks directly to the institution of first deposit. This process avoids unneeded steps of sending a dishonored check back through all intermediary stops in processing—thus saving both time and effort. This program continues today as the Dallas Fed prepares to help lead the way in increasing the efficiency and decreasing the time required to process return checks.

Simply putting a return item in the mail by midnight of the business day following receipt may no longer be an acceptable method of return.

The Year in Review

A look back at 1987 and a look forward

During 1987, the Dallas Fed continued to deal with the provisions of the MCA while preparing for the changes to come as a result of the Competitive Equality Banking Act. We continued to broaden our service offerings, create new electronic access methods, and enhance our traditional products. While traditional services such as processing checks and distributing currency and coin remain the backbone of our business, we have found that by enhancing these services, we can address the specific needs of the various financial institutions we serve.

Check Services

Each day four to five million checks are processed by the Dallas Fed and its branch offices. Our major goal in this area is to provide efficient check services while offering financial institutions a flexible deposit schedule. To meet this goal, the Dallas Fed has introduced new deposit deadlines for certain types of checks and expanded some services. In San Antonio and Houston, deadlines were extended to increase the amount of time available to regional depositors for processing and transportation.

The newest service announcement for the checks area concerns payor bank services. These include capturing and transmitting check information electronically to payor institutions—making the information available sooner, as well as improving the efficiency and lowering the expense.

We are proud of the fact that the Dallas Fed has been a leader in the area of returned checks. Our pilot program to send return items directly to the institution of first deposit, and thereby avoid unnecessary trips to intermediary institutions, will be implemented nationwide in 1988. With the changes that will be necessary as a result of the Competitive Equality Banking Act, this program will take on even more significance in meeting the challenges of improving the nation's payments system.

Securities Services

For the Securities Department, 1987 saw a consolidation of operations and an expansion of electronic services. In mid-1987, the definitive safekeeping and noncash collection operations at the El Paso Branch were consolidated with those at the Dallas Office.

Full implementation of the Treasury Direct program was accomplished nationwide. The program is a joint Treasury/Federal Reserve System effort to provide unique book-entry accounts for safekeeping Treasury securities owned by individuals or businesses.

During 1987, the Dallas Fed participated in another Treasury/Federal Reserve System joint effort. This involved the consolidation of all bearer security transactions at the Federal Reserve Bank of New York. This effort was part of the Treasury's ongoing program to discontinue providing physical securities and move toward electronic book-entry ownership—a more efficient method of record keeping for Treasury securities.

Electronic Services

Perhaps the most dramatic changes either have already occurred or are going to occur in the area of electronic services. The Federal Reserve System has been involved with electronic services since funds were sent by wire in the early 1900s, but only since 1976 has the option been offered to send payments through the automated clearinghouse.

Electronic payments no longer are just the wave of the future—they are the wave of the present.

Electronic payments no longer are just the wave of the future—they are the wave of the present. In the past few years, the Dallas Fed has seen increased interest in conversion and an increase in actual conversion to making payments electronically. Nevertheless, electronic payments are not likely to replace cash and checks, and the much discussed cashless or checkless society probably will not emerge in the near future.

For the Dallas Fed and its branches, 1987 was a year in which more options were offered to make more payments electronically. Our goal is to make available at least one form of electronic payment for every type and size of financial institution.

In 1982, the Dallas Fed introduced financial institutions in the Eleventh Federal Reserve District to the RESPONSE network—the electronic communications link to the Federal Reserve. Almost 900 institutions are now connected to this network. Over the past five years, the Dallas Fed has offered access to traditional services such as funds and securities transfers, and currency and coin ordering. During 1987, we expanded the services available over the network by offering automated clearinghouse origination, receipt, and return items through a new software called ADVANCE. In addition, we offered payor bank services and an online directory of routing numbers of financial institutions. The services offered by the Dallas Fed through the RESPONSE network are the Fed's main electronic connection to financial institutions in the Eleventh District.

In 1987, we introduced CATIE—the Customer Assistance Touch-Tone Information Express. CATIE allows the use of a Touch-Tone telephone to handle ACH return items as well as access to reserve and clearing account information. By using the information available over CATIE, institutions have another electronic option by which to return ACH items. At the end of 1987, some 450 District financial institutions had requested codes to access the services offered through CATIE.

Toward the end of 1987, those institutions and data processors that were members of the PULSE ATM network were given the option of

receiving ACH files over their electronic connections. This service, introduced by the PULSE system in September, represents a reduction in the handling involved in receiving the ACH items on magnetic tapes.

Payments Risk

With increased interest in electronic payments, interest also rose in the area of payments risk. Risks exist in any payments system—from fraud, operational breakdowns, accounting mistakes, and the unexpected failure of a participant to settle funds transferred that day. Perhaps the greatest risk to the payments system arises from large-dollar transfers.

To alleviate this risk, monitoring has been established on daylight overdrafts—when funds sent so exceed funds received that the sender's reserve account has a negative balance during the day. The Dallas Fed also has improved the reserve requirement calculation function and instituted net debit caps for senders.

Customer Assistance

To support the financial services offered by the Dallas Fed and to improve the overall service level, a Customer Assistance group was created in 1986. The group, the first formal Customer Assistance group in the Federal Reserve System, takes care of the human side of the Fed's increasingly complicated business.

The Customer Assistance area has responsibility for overseeing the relationships with our customers as well as working with participants on the RESPONSE network. During 1987, representatives handled over 100,000 calls and 130,000 letters from District institutions. This group enables the Dallas Fed to increase the quality of its financial services by improving the ability to handle questions and resolve problems for Eleventh District financial institutions.

Supervision and Regulation

The year 1987 was one of continued frustration for a large number of District financial institutions. Problems growing out of real estate, energy, and, to a lesser extent, agriculture continued to affect financial institutions in all three District states, but primarily in Texas and Louisiana. In Texas, 64 banks failed (counting 12 banks that received open-bank assistance from the Federal Deposit Insurance Corporation [FDIC] and two unincorporated, uninsured banks). There were 15 bank failures in Louisiana (five in the Eleventh District portion of the state) but none in New Mexico.

Supervision of financial institutions in the Eleventh District required an increasing commitment of personnel at both Dallas and Houston, where a

new examination office had been opened in 1986. At year-end, the Supervision and Regulation Department had expanded to 149 authorized employees, counting both Dallas and Houston, an increase of 14 percent from year-end 1986.

The 1986 legislation that permitted countywide branch banking and interstate banking in Texas had its first major impact during 1987. The branching option was particularly useful in reopening failed banks under new ownership and in countywide consolidations of holding company banks under one bank charter. As this new power began to be used, the number of banks in the state declined, but the number of banking offices remained roughly the same. For the District as a whole, more than 170 banks became branches during 1987, a trend that is expected to continue.

At year-end, the Comptroller of the Currency, relying on recent federal court decisions from outside the District, had approved applications by two national banks in Texas to branch outside their county. The Texas Attorney General has brought suit to overturn these approvals. If his suit is not successful, statewide branching would appear to be the logical result, suggesting that additional major changes in the Texas banking structure may be in the offing.

Texas and Louisiana also have recently enacted interstate banking legislation, with the first interstate acquisitions in the Eleventh Federal Reserve District taking place in 1987. As of year-end, five out-of-state bank holding companies had acquired, or been approved to acquire, banks in Texas. In another noteworthy transaction, two of the largest bank holding companies in Texas were permitted to merge during the year to form the largest banking organization in the state.

The role of the Federal Reserve is to stimulate new services and help make those services a viable option for financial institutions.

The Future

During 1987, the effects of the Monetary Control Act were still present in the financial community. An increase in the use of electronic services has given the nation a more efficient payments system. The role of the Federal Reserve is to stimulate new services and help make those services a viable option for financial institutions. Over the coming years, that area will present one of the best opportunities for innovation.

As 1988 begins, the challenges of the Competitive Equality Banking Act are before the financial industry. This act will significantly affect all financial institutions as they prepare, along with the Federal Reserve, to improve the collection and return of checks.

For the Dallas Fed and the Federal Reserve System, our future will be characterized by trying to relate to an industry that is in a rapidly changing environment. While that environment is determined primarily by legislative actions, the Federal Reserve will attempt to be in a position to relate effectively to the industry no matter how its course develops.

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Financial Summary

Volume of Operations

HEAD OFFICE AND BRANCHES COMBINED

	Number of Pieces Handled		Dollar Amount (Thousands)	
	1987	1986	1987	1986
Currency received and counted	883,620,250	812,550,906	11,533,427	10,495,540
Coin received and counted	1,975,981,000	1,792,379,500	309,804	292,259
Food stamps redeemed	206,636,225	183,828,486	1,028,646	889,048
Transfers of funds	6,287,618	6,316,858	9,018,968,357	8,344,572,013
CHECKS HANDLED				
U.S. government checks	34,940,896	35,752,474	47,492,216	47,690,697
Fine sort	260,093,356	213,957,099	72,845,488	66,209,777
All other[1]	1,011,009,063	1,095,756,723	548,771,257	561,096,515
ACH ITEMS HANDLED[2]				
Commercial	47,860,311	38,387,075	326,210,299	300,960,553
Government	27,018,829	24,477,526	16,778,829	14,183,997
COLLECTION ITEMS HANDLED				
U.S. government coupons paid	28,086	42,398	27,422	31,954
All other	227,245	234,657	679,324	717,527
ISSUES, REDEMPTIONS, EXCHANGES OF U.S. GOVERNMENT SECURITIES				
Definitive and book-entry	9,340,164	9,163,129	994,215,840	1,040,471,524
LOANS				
Advances made	2,761	1,960	59,760,201	43,098,145

[1]Exclusive of checks drawn on the Federal Reserve Banks.
[2]The 1986 ACH volumes and dollar values have been revised.

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Effective January 1, 1988

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