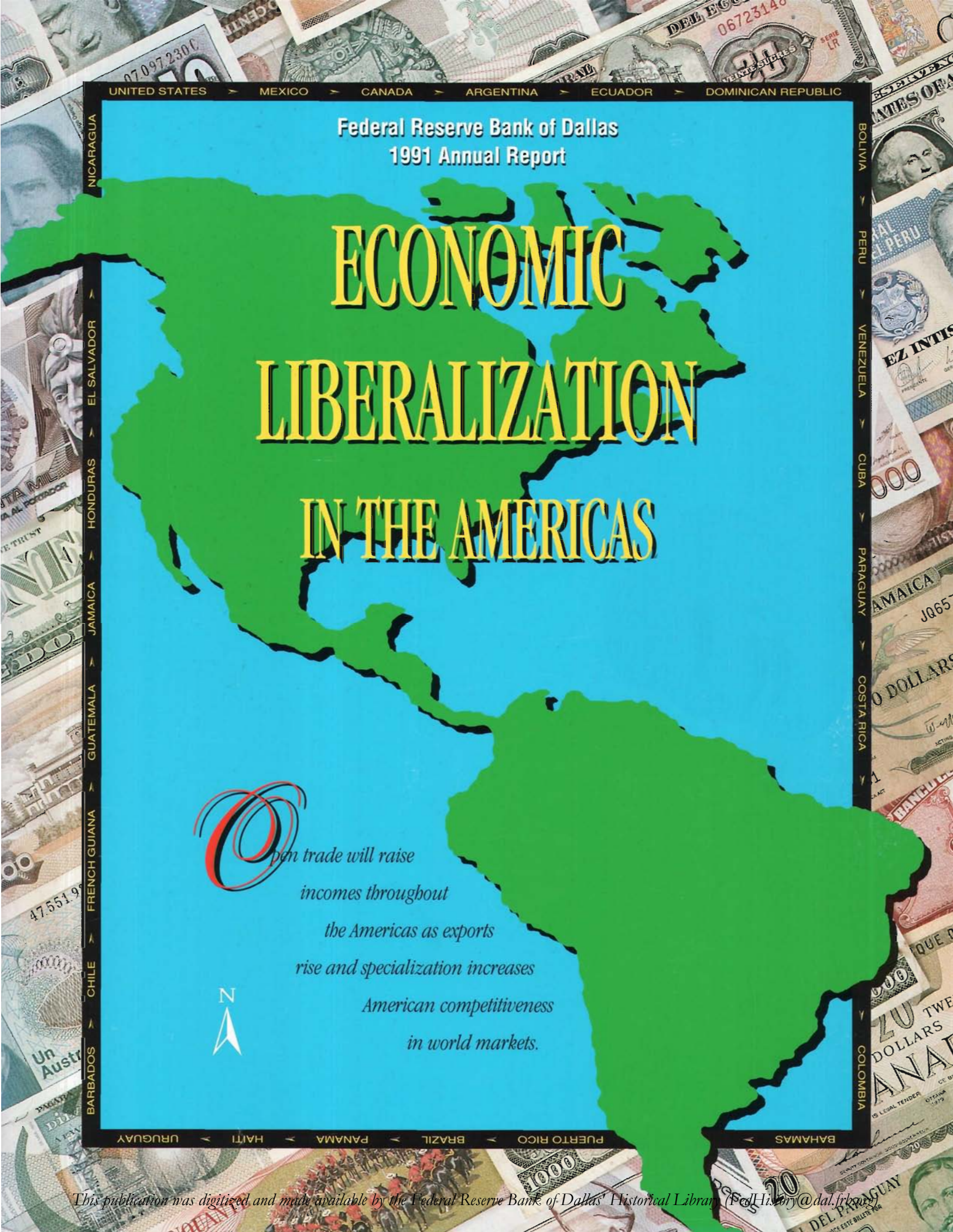

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10
CRUZEIROS
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REPUBLICA ORIENTAL DEL URUGUAY

Contents

President's Message

During the past year of economic weakness in the United States, the Eleventh Federal Reserve District fared better than the nation as a whole. Having worked through the difficulties of an earlier recession, this District was better prepared to deal with the challenges brought on by the national economic decline and, despite some hardship, managed to sustain moderate economic growth during 1991.

Factors contributing to this growth included improved manufacturing output, growing transportation employment, stabilized real estate values, increased construction activity, and a strengthened banking industry. In addition, strong export growth helped cushion the decline in the energy and defense industries, illustrating the increasingly important role of exports in our District's economy.

The role of exports in our District is significant, in that our region tends to be more sensitive to international trade than is the United States as a whole. In difficult times, therefore, exports can make the difference between a growing District economy and a declining one. This potential for economic growth from international trade offers a unique opportunity for the District.

To help the District take advantage of this opportunity, we are building a base of knowledge and expertise, through our Research Department, to contribute to the expansion of free trade by fostering a better understanding of the benefits of trade with Canada, Mexico and Latin America. This effort has gained attention within the Western Hemisphere, and already in 1992, we have met with officials in Mexico City and elsewhere to improve our understanding of the challenges before us. We believe these efforts will improve trade relations, increase exports, provide an improved basis for economic and financial stability among Western Hemisphere nations, and strengthen the economies of both the District and the United States. In this regard, we have devoted this year's Annual Report essay to promoting a better understanding of free trade and economic integration within the Western Hemisphere.

The Federal Reserve Bank of Dallas also uses its voice to convey conditions within the Eleventh District in the formulation of national economic policy. My presence on the Federal Open Market Committee provides representation for the District in monetary policy deliberations. To assist me in developing monetary policy recommendations, economists from the Dallas Fed continually conduct research on the District economy and maintain direct contact with District business and financial leaders. This contact between the people of the District and policymakers contributes to a more effective policy and a stronger economy.

Another Federal Reserve contribution to a strong economy is its role in maintaining financial safety and soundness through the supervision and regulation of financial

institutions. During the past year, we've seen considerable progress in the health of the District's financial institutions. During 1991, the return on District banking assets improved and was just above the national average. This rise represents an improvement over the industry's performance in recent years. Bank failures in the District declined from 105 in 1990 to 33 in 1991. In addition, the number of discount window loans declined from 1,750 in 1990 to 421 in 1991. These changes are signs of a more stable and healthier financial environment.

In 1991, Congress passed legislation that altered the process of bank supervision and discount window lending and recapitalized the deposit insurance fund. The recapitalization was needed to allow bank regulatory authorities to deal more effectively with the banking difficulties that have emerged elsewhere in the nation. The financial recovery in our District underscores the need for such efforts to resolve troubled financial institutions in order to set the stage for growth and prosperity.

In the area of financial services, the Federal Reserve System has continued measures to improve efficiency through the widening use of electronic automated clearinghouse technology and has initiated the nationwide consolidation of some of our operations. During 1991, the Federal Reserve Bank of Dallas was chosen as one of three consolidation sites for the System's data processing operations. This action was taken to reduce costs and to provide better services for financial institutions. We are proud to have been chosen.

In the coming year, we will contribute to our District through the representation of its unique concerns and interests in the formulation of monetary policy; the supervision of state member banks, bank holding companies, and foreign banking entities; the provision of quality financial services; and research into important economic issues. Beyond these primary contributions, I am focusing the resources of the Dallas Fed on activities that promote understanding of free enterprise. I want the Federal Reserve Bank of Dallas to be known as the "Free Enterprise Fed," and I want us to make significant contributions to economic education on that subject.

As command and control economies in Russia and Eastern Europe have fallen, too many of our citizens don't understand and appreciate the nature of the system that won that ideological war. Too many don't really understand how capitalism works and how capitalism and freedom are so intimately tied together. I want the Dallas Fed to be a beacon of light on that general subject.

In support of this, I am setting forth three broad goals for the Federal Reserve Bank of Dallas. First, I intend that the Dallas Fed become the Federal Reserve System's window to Mexico and Latin America as expanding trade and economic integration throughout the Western Hemisphere increase the importance of the U.S. dollar. The issue of free trade, in my view, represents a special case of free enterprise. Next, to promote a smoothly functioning and stable financial system, the Dallas Fed will become more active in all aspects of Federal Reserve System policy formulation. Maintaining stability and functionality within the financial system is essential to sustaining free enterprise. Finally, the Dallas Fed will explore critical central banking issues and bolster its efforts to provide information and insight that will enhance the understanding of the Federal Reserve and its importance in a free enterprise system.

We believe this combination of tending to daily business while providing leadership in areas that support free enterprise lends itself to a prosperous future for the Eleventh District and the nation.

Robert D. McTeer, Jr.

President and Chief Executive Officer

Economic Liberalization in the Americas

Economic liberalization offers enormous potential for growth but only in an atmosphere of monetary and price stability. Economic liberalization has taken hold in the Americas. Since beginning major trade reforms in 1984, Mexico has regained its position as the United States' third largest trading partner. Argentina, Bolivia, Brazil, Chile and Peru—like Mexico—are dismantling trade barriers, deregulating the private sector, and privatizing state-owned corporations.

Trade liberalization drives economic liberalization. Open trade will raise incomes throughout the Americas as exports rise and specialization increases American competitiveness in world markets. Free trade in goods and services requires consistent policies in other areas. Barriers to trade include state ownership of corporations, export subsidies, lack of clearly defined property rights, and unstable prices and currencies. Hence, liberalization in the Americas naturally involves privatizing state firms, dismantling subsidies, protecting property rights, and ensuring the stability of prices and exchange rates.

To complement economic liberalization, some Latin American nations are taking a step not normally associated with economic openness. Instead of allowing their currencies to fluctuate freely, Mexico and Argentina have taken measures to peg their exchange rates to the U.S. dollar. *(See "A Glossary of Exchange Rate Regimes" for an explanation of exchange rate pegging and related policies.)*

These new currency pegs result from attempts not only to establish a stable, anti-inflationary monetary policy but also to make the policy credible. Credibility is crucial because Latin American governments had difficulty adhering to any one policy during the instability of the 1980s. Unless potential investors expect financial and monetary stability to continue, Latin American nations will not attract investment. Even with freer trade, development of the region's economic base and financial markets will be limited if governments fail to convince the domestic and international business communities that monetary stability will be sustained.

Currency pegs help a government signal its commitment to stable monetary policy because deviations from the policy are highly visible. If a country pegging its currency to the dollar does not keep inflation in line with U.S. inflation, the action becomes readily apparent through pressure on foreign exchange reserves held by the country's central bank and, ultimately, through pressure on its exchange rates. To the extent that U.S. monetary policy ensures U.S. price stability, pegging to the dollar allows a country to import U.S. price stability.

Price stability facilitates trade and stimulates investment by improving firms' ability to predict selling prices and the costs of doing business. Exchange rate pegs can enhance price stability because Latin American countries that fix the prices of their currencies in terms of the dollar, in effect, are importing U.S. price stability. If Latin American countries were to inflate their currencies but hold their exchange rates fixed, Latin American prices would rise relative to foreign prices. With these higher prices, producers in Latin America would not be able to compete with foreign producers. Imports would rush in. Exports would stagnate. Consequently, as long as they peg their exchange rates to the dollar, Latin American countries must follow monetary policies consistent with those of the United States. Thus, these currency ties challenge all central banks of the Western Hemisphere to adhere to stable monetary policy in pursuit of price stability.

In the long term, market-based exchange rates may be more advantageous for the Americas than pegged rates. Although pegged rates may help promote credible policies that will lead to stable prices, not every price movement is caused by monetary expansion. When an event such as a sudden jump in oil prices moves foreign prices out of line with domestic prices, a market-based exchange rate can shift to bring external and internal prices into balance. After convincing world financial markets and the public that they will persistently and successfully fight inflation, Latin American governments may no longer need the external discipline of pegged exchange rates to prove the point.

Monetary stability will enhance the positive effects on economic growth of the freer trade already emerging in Latin America. As countries liberalize trade under a stable monetary policy, they will increasingly focus on production of goods and services they can produce efficiently, instead of producing what is profitable when high trade barriers protect certain markets from competition. What a country cannot produce efficiently, or produces relatively less efficiently, it will import. The result is more trade, more efficiency, lower prices and higher real incomes among all trading nations.

Because Latin American countries' monetary and exchange rate policies have often been responses to their trade experiences and policies, an analysis of trade, growth and exchange rate policies helps to explain recent developments in the region.

A Glossary of Exchange Rate Regimes

Exchange rates can be determined by several methods. At one extreme is a *pegged*, or *fixed, exchange rate* policy, in which the central bank fixes the price of its currency at a constant value and exchanges a foreign currency, such as the U.S. dollar, for the local currency at the constant value. The central bank becomes the main or residual supplier of foreign exchange to the market. The central bank's ability to support its own currency's exchange value depends on the size of central bank dollar holdings.

At the other extreme is a *floating*, or *market-based, exchange rate* policy, in which exchange rates are determined completely in the market, with little or no intervention by the central bank. If the market for foreign exchange is not well-developed, small movements in the demand for and supply of dollars may cause large exchange rate movements.

Numerous exchange rate arrangements fall between the extremes of fixed rates and market-based rates. The most common type in Latin America is a *crawling peg*. In a crawling peg regime, the central bank increases the price of the dollar over time to maintain the competitiveness of domestic goods in international markets. In this sense, crawling pegs resemble market-based exchange rate regimes. On the other hand, the central bank buys and sells dollars at an announced exchange rate and continues to be the main source of foreign exchange, making the crawling peg more like the fixed rate regime.

Trade Policy and Growth in Retrospect

Although recent exchange rate pegging represents a new turn in Latin American currency policy, the idea has been pursued in the past with somewhat different goals. Many Latin American countries in the 1950s and 1960s pegged their currencies to the dollar to promote price stability *and* to complement the growth strategy that most of them followed, known as *import substitution*.

Import substitution was based on the fear that the prices of raw materials, which Latin American countries exported, would fall relative to the prices of manufactured goods, which these countries imported. But instead of initially focusing on manufacturing for export, the import substitution thesis counseled continued exports of raw materials and the substitution of locally manufactured products for imports. Under import substitution, Latin American countries aimed to protect their manufacturers by means of high tariffs and other trade barriers, so that local producers could begin business without serious price competition.

As part of their import substitution programs, Latin American governments maintained an exchange rate policy designed to keep the price of imported capital goods low. In practice, this exchange rate policy involved pegging the domestic currency to the U.S. dollar at a rate below what a free market would produce. In other words, they pegged their currencies at an "overvalued" level. Latin American importers would be able to give relatively little of their currency for relatively many dollars, so that the Latin American price of U.S. capital goods would be low. Meanwhile, the Latin Americans used high tariffs to price U.S. noncapital goods out of their markets, so that Latin producers could have those markets for themselves.

Aided by their protected manufacturing sectors, Argentina, Brazil and Mexico grew rapidly during the 1940s, 1950s and 1960s. However, import substitution changed the mix of imports but failed to reduce them. Import substitution helped some industries develop but not their suppliers. For example, the limited scope of internal demand denied large capital-intensive industries the economies of scale common in large developed countries. As imports of finished goods fell, imports of inputs rose. Also, by overvaluing their pegged currencies, Latin American governments effectively subsidized imports, aggravating the problem.

The exchange rate policy these countries followed in pursuing import substitution—keeping the dollar artificially cheap in terms of their own currencies—caused problems in their traditional export sectors as well. An exchange policy that keeps the prices of imported capital goods low will automatically make a country's export prices to foreigners artificially high. The traditional export sectors of the Latin American countries, including agriculture, had difficulty competing in world markets. Because agriculture was an important export industry for many Latin American countries while manufacturing was a net importer, the import substitution strategy led to the very balance of payments problems it had been designed to check. Investment and economic growth fell. By the 1960s, some Latin American countries began to seek different growth strategies that involved altering their foreign exchange policies.

Brazil, for example, began to focus on manufacturing for export but did so during a period of domestic inflation. If Brazil had pegged its currency to the dollar, its products would have been priced out of world markets, while its import volume would have soared. To cope with inflation at home while maintaining low prices for its exports, Brazil adopted a crawling peg. When domestic prices rose, Brazil's policymakers would adjust the exchange rate. However, most other Latin American countries, such as Mexico, maintained their import substitution strategies and fixed exchange rates. *("A Chronology of Economic Events in Latin America" briefly highlights the recent economic experience of Brazil and other countries in the region.)*

The earlier ties of Latin American currencies to the dollar had imposed external monetary discipline to hold down inflation. As other Latin American countries joined Brazil in severing their currency links to the dollar in the late 1970s and 1980s, this source of discipline disappeared.

A Chronology of Economic Events in Latin America

1945–59

Concerned about their dependence on foreign manufactured products, Latin American countries begin development programs based on the philosophy of import substitution.

Many countries raise trade barriers to protect local manufacturers from foreign competition in consumer goods.

To cheapen imports of production machinery used to make consumer goods, Latin American countries peg their exchange rates to the U.S. dollar at artificially inexpensive rates. These exchange rates aid local consumer goods manufacturers but hurt exports.

Latin America begins a protracted period of growth, with the aid of its protected manufacturing sector.

1960–69

Import substitution hits a snag. Increased imports of not only machinery but also components outstrip the reductions in consumer goods imports. Industrial suppliers fail to develop as hoped.

Brazil begins to target export markets. To lower its prices to foreign buyers, Brazil uncouples its currency from the dollar and imposes a crawling peg. This event occurs years before the breakup of the Bretton Woods system, which had fixed exchange rates between most world currencies.

1970–79

Oil prices more than double in the early 1970s and redouble by the end of the decade.

Latin American debt rises quickly. Mexico and Venezuela borrow to increase oil production, and Brazil borrows to forestall economic decline.

Latin American exchange rate policies vary as some countries float. Despite the breakup of the Bretton Woods system, most Latin American countries continue to peg to the dollar but undergo at least one major devaluation during the decade.

(Continued on page 9)

The Debt Crisis of the 1980s and Its Legacy

In the 1960s, financial markets became increasingly international, and the types of financial instruments available proliferated. These changes set the stage for what was to come in the 1970s, when a dramatic rise in oil prices created a balance of payments deficit and thereby restrained the growth of most Latin American countries.

The 1973 oil-price shock triggered recessions in the United States and Europe and led international financial institutions to look elsewhere for lending opportunities. Brazil chose to avoid recession by launching a public spending program for nuclear and hydroelectric power generation and for alternative fuels production, making the country an attractive candidate for loans. Mexico and Venezuela borrowed to develop their oil reserves, while private Argentine borrowers sought funding for diverse projects *(Figure 1)*.

By the early 1980s, falling prices for oil, metals and other raw materials led to rapid declines in Latin American export income *(Figure 2)*. Mexico and Venezuela could not sell oil at the high prices they had anticipated. Brazil's export prices fell relative to its import prices. Given the large debts these countries had incurred and the dramatic increase in world interest rates in the early 1980s, the declines in income precipitated an international crisis. Latin American countries could not fully meet their debt payments, but unlike the situation in the 1970s, new loans did not flow in to ease the problem.

To earn enough foreign currency to pay interest on their debts, many Latin American countries increased competitiveness by lowering their export prices and raising import prices to encourage local production. They accomplished both by devaluing their currencies and uncoupling them from the dollar. They subsidized domestic export producers to increase exports further. To discourage imports still further, they raised tariffs and other import barriers. For the same reason, many countries also curtailed domestic demand by imposing restrictive fiscal and monetary policies, at least for a while.

But as Latin America's financial problems worsened, its governments began to reassess the austere monetary policies they had followed in the early stages of the crisis. Domestic recessions were reducing tax revenues in the face of mounting foreign and domestic debt obligations. The most expedient funding option many Latin American governments could devise was to print money.

Figure 1
Latin American Foreign Debt Escalates

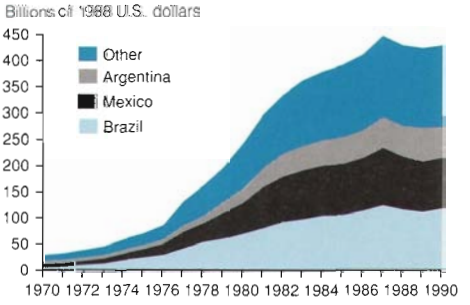

Figure 2
Prices of Latin American Exports Collapse

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Figure 3
Inflation Rates Soar in Latin America

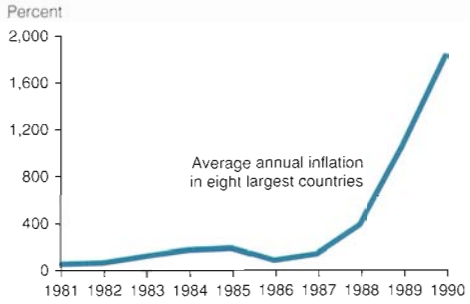
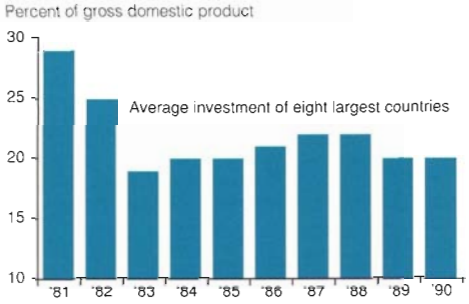


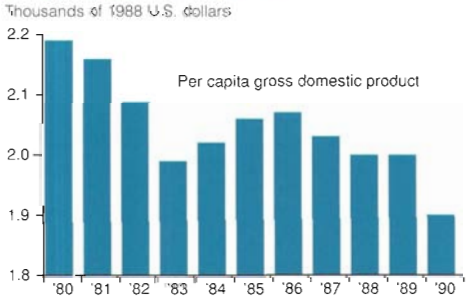
Figure 4
Investment Rates in Latin America Fall



Excessive money creation resulted in high inflation rates *(Figure 3)*, creating private-sector uncertainty and suppressing investment. These direct effects of inflation on investment, while already severe, were compounded by the consequent exchange rate instability, with disquieting effects on the plans of both exporters and importers. This additional uncertainty only accelerated the decline in investment that Latin American governments had already helped precipitate *(Figure 4)*. Their previous moves toward monetary and fiscal austerity had lowered expected returns on investment, while new import restrictions had raised the cost of the foreign-made equipment in which expanding or retooling businesses might have planned to invest.

The investment collapse in the 1980s caused Latin American incomes to fall even further *(Figure 5)*. Latin American production facilities became increasingly antiquated. Because many of the countries had closed their markets and subsidized domestic exporters, Latin American exporters faced retaliation in foreign markets. The United States and Europe raised import tariffs and pursued antidumping procedures. Without assured access to markets in the United States and Europe, Latin American producers faced growing difficulties competing in the international marketplace. For Latin America, the 1980s came to be known as the *Lost Decade*.

Figure 5
Latin American Incomes Decline



1980–89

Worldwide recession occurs. The prices of oil and other commodities decline.

As exports of most commodities drop, Latin American nations fall behind on their debt obligations.

To adjust their balances of payments, Latin American countries allow their exchange rates to slide against the dollar. Even countries that have long tried to fix their exchange rates, such as Mexico, devalue. Brazilian, Chilean and Argentine currencies depreciate against the dollar at an accelerated pace.

Latin American countries try to protect their home producers with higher trade barriers. The United States retaliates with its own protectionism.

Investment crashes in many countries. Plants and mines close, and unemployment increases.

Latin American countries print money to pay their debts.

Even in countries with traditionally low rates of inflation, such as Mexico and Colombia, inflation accelerates to triple-digit levels. Countries with chronic high inflation, such as Argentina, Bolivia, Brazil and Peru, move toward hyperinflation.

Latin American countries cannot pay their U.S. bank debts if they do not export, so the United States airs plans to barter debt relief and access to U.S. markets for Latin American trade liberalization. The first proposal, called the Baker Plan and based mainly on debt relief, falls short of helping stabilization and recovery in Latin America. The subsequent Brady Plan, based on debt reduction, is more successful.

To stabilize their economies, some Latin American countries, such as Mexico, Bolivia and Chile, import conservative U.S. monetary policy by pegging their exchange rates to the dollar.

1990–present

Trade liberalization broadens and deepens. Canada, Mexico and the United States move toward a North American free trade agreement, while U.S. President George Bush announces plans for a hemisphere-wide free trade area. Other liberalization schemes materialize in Latin America and the Caribbean.

Argentina joins other Latin American countries in pegging its currency to the dollar.

Monetary Policy and Trade Reform in the 1990s

In the aftermath of the debt crisis, many Latin American countries are altering their stances on both trade and exchange rates. The protectionism of the early 1980s has given way to an opening of markets throughout Latin America to restore economic growth. The opening of markets will be effective and sustainable only when free trade is coupled with price and monetary stability. To stabilize their prices, Mexico, Bolivia and Chile began pegging their currencies to the U.S. dollar in the late 1980s, and Argentina began in 1991. Other Latin American countries are expected to follow. *(The progress Mexico, Brazil and Argentina are making in trade reform is described in "The New Liberalism: Three Examples.")*

The uncoupling of Latin American currencies from the dollar in the early 1980s provided some relief from balance of payments problems. But without a rigid external constraint on money creation, many Latin American governments could not resist the temptation to cover their debts by printing money. When these governments returned to policies of monetary restraint, the private sector treated the new policies as only temporary. Instead of a return to price stability and investment growth, investment remained low, and producers continued to push up their prices.

The Importance of Credibility

Although Latin American governments can only regain full credibility by maintaining stable monetary and financial policies over a protracted period, there are ways to strengthen credibility in the interim. A government can couple its stable monetary policy with rules that would make a policy reversal easy for the public to detect and

costly to the government. Pegging the exchange rate to a commodity, such as gold, or a more stable currency is one such rule. If Latin American countries inflated their currencies but held their exchange rates fixed, prices of domestic goods would rise faster than those of foreign goods. As a result, exports from these countries would be priced out of foreign markets, while low-priced imports would flood the markets at home. Economic activity would decline.

Meanwhile, to maintain its fixed exchange rate, a government would have to spend its foreign currency reserves to purchase its own currency in international markets. The loss of foreign currency reserves would be easily noticeable, and with reserves diminished or depleted, the government would no longer be able to support the price of its own currency. Not only would an overt devaluation occur, but the devaluation would aggravate inflation by sharply increasing the price of imports. A new round of inflation, bad in and of itself, would trigger a new round of economic decline.

Thus, a country with a fixed exchange rate has an added incentive to limit inflation, and the private sector knows it. Moreover, any attempt by the government to short-circuit this discipline by reimposing trade and exchange controls signals that the government is not really committed to maintaining low inflation.

Eventually, when the public takes for granted the government's commitment to hold down inflation, the country might safely uncouple its currency. With a credible, demonstrated commitment to keep inflation low, a government can pursue a stable monetary policy, yet allow its exchange rate to adjust to external market forces and, thus, to accommodate price movements that are not tied to excessive internal monetary expansion. But first the credibility of monetary policy must be established. An exchange rate peg can help establish this credibility, but pegging is not an easy or a foolproof approach to price stability.

The New Liberalism: Three Examples

The pragmatic nature of the Western Hemisphere's new liberalism greatly enhances the prospects for successful reform. Liberalization promises debt reduction, market access and vast opportunity for growth.

In June 1990, President Bush announced his Enterprise for the Americas initiative, a plan to create a free trade area encompassing the Western Hemisphere. The measure complements efforts to create fully integrated regional trade areas, which include the proposed North American Free Trade Area (Canada, Chile, Mexico, United States), the Caribbean Community (Barbados, Guyana, Jamaica, Trinidad and Tobago), the Southern Cone Common Market (Argentina, Brazil, Paraguay, Uruguay), the Andean Group (Bolivia, Colombia, Ecuador, Peru, Venezuela), and the Central American Common Market (Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua).

Over the past decade, liberalization took place by fits and starts and in varying degrees throughout Latin America. The following examples highlight the experiences of Mexico, Brazil and Argentina.

Mexico

To some extent, Mexico's movement to liberalize reflects debt fatigue and uncertainty over U.S. policy toward Mexican exports to the United States. A milestone in Mexico's liberalization effort came in 1986 with the negotiated entrance into the General Agreement on Tariffs and Trade (GATT). The country's liberalization was dramatic, with Mexico lowering its highest tariff barrier from 100 percent to 20 percent *ad valorem* and eliminating most nontariff barriers, such as import licenses on most products, export subsidies and official import prices. Further, the privatization of government-owned enterprises, the relaxation of restrictions on direct foreign investment, and the amendment of Mexican patent law reflect the strong

(Continued on page 13)

The Importance of Consistency

Exchange rate pegging cannot be applied successfully unless the government combines an open trade stance with other consistent and credible policies. In the late 1970s and early 1980s, for example, the Southern Cone countries of Argentina, Chile and Uruguay followed exchange rate policies similar to Mexico's policies of the 1990s. Argentina and Uruguay, however, did not support their exchange policies with fiscal measures that would permit the monetary stability implied by linking. As their fiscal deficits mounted, these countries severed their currencies' ties to the dollar.

Chile's policies, on the other hand, led to a fiscal surplus. But the country's loose financial regulatory environment and unstable capital flows, along with strict labor regulation and schemes that protected wages from inflation, resulted in balance of payments difficulties. Chile could not maintain a stable exchange rate policy, particularly after the country's export prices fell relative to import prices in the early 1980s.

In contrast, Mexico appears to be achieving success with an exchange rate policy that is part of a broad reform program. Mexico has taken measures to achieve fiscal responsibility, preserve the stability of financial markets, and support its central bank in responsible monetary policies. Most observers believe that the comprehensiveness of Mexico's policies enhances their credibility, giving them greater prospects for success. Mexico has turned its high government deficits of the late 1970s and early 1980s into surpluses in the 1990s. Having regained a more solid financial footing, Mexico's government should be more successful in carrying out its announced intention of modernizing the agricultural sector and improving social services, education and infrastructure. Also, Mexican policymakers have deregulated financial and capital markets substantially and have begun privatizing government-owned commercial banks to enhance competition. Moreover, Mexico has broadened its range of export industries, making the country less susceptible to serious fluctuations in the price of oil.

The same principles at work in Mexico may be helping Argentina overcome a 20-year cycle of hyperinflation and devaluation. In the throes of hyperinflation in July 1989, Argentine prices tripled in one month! In 1991, however, Argentina combined pegging the austral to the dollar with strong fiscal reform and a monetary rule that ensures full convertibility of the Argentine currency with the dollar. By early 1992, Argentina had a substantially deregulated economy with low inflation.

The Road Ahead

Unlike the exchange rate pegs of the import substitution era, the new currency linking has been approached against the backdrop of a liberalized economy. Freer trade should help keep Latin American domestic product prices in line with international prices. The possibility of balance of payments crises should help keep the central banks of the region from printing too much money. Any attempt to subvert this discipline by reintroducing trade barriers would call into question the credibility of government policy and resurrect the specter of the high inflation and low growth of the 1980s.

Stability of the exchange rate in the context of consistent policies to fight inflation, however, should create an atmosphere conducive to the expansion of trade and the development of financial

markets, including foreign exchange markets in the Americas. Underdeveloped financial markets can handle only a small volume of foreign exchange transactions. Accordingly, when exchange rates are allowed to float, policymakers may fear that even a small change in the supply of or the demand for dollars would cause large and unstable movements in exchange rates. Indeed, this concern was the underlying motivation for strong central bank intervention in the past.

For now, Latin American central banks are the primary agents in their foreign exchange markets. Generally, exporters are required to surrender foreign exchange to the central bank, and importers buy most of their foreign exchange from it. Growth in Latin America's financial markets would give the private sector sufficient depth to allow the central banks of the region to dismantle their controls on foreign exchange.

As trade and financial integration expand, markets for Latin American currencies can develop to facilitate the growing volume of goods and asset transactions. As private foreign exchange markets develop, central banks will probably play a declining role in determining exchange rates. At some point in the future, Latin American countries may find that market-based exchange rate regimes have become the arrangement most beneficial to their economies.

The difficulties Latin American central banks encountered in maintaining fixed exchange rates in the 1970s and 1980s suggest that, in the long run, a market-based rate will be conducive to low inflation only if the region's central banks consistently keep money growth low and maintain credibility with respect to their inflation goals. An important step in achieving low money growth is to safeguard the independence of the central bank. Maintaining an independent central bank separates the power to print money from the power to spend money (as detailed in the *1990 Annual Report* of the Federal Reserve Bank of Dallas). But independence of the central bank, in and of itself, may not be sufficient to restore credibility to monetary policy. If central banks can sustain low money growth and high credibility, fixed exchange rates may become unnecessary shackles. Until that time, however, Latin American governments may temper the power to print money with a strong constraint, such as some form of exchange rate regime whereby their currencies are linked to a low-inflation currency, like the U.S. dollar.

(Continued from page 11)

commitment to liberalization of the Mexican economy started in the de la Madrid administration and intensified in the Salinas administration.

Consequently, Mexican trade with the United States has grown substantially. Mexico has once again become the United States' third largest trading partner. More important from the U.S. standpoint is the fact that U.S. exports to Mexico have nearly doubled as a result of Mexico's unilateral liberalization effort. The final step in this process is the North American Free Trade Agreement now being negotiated by Mexico, Canada and the United States.

Brazil

Some observers may think Brazil is lagging in liberalization, but this is a misconception. Brazil's protection level was never as high as that of other Latin American countries at their worst.

Brazil began liberalizing in 1990. The country has abandoned its so-called law of similars, which protected industries producing goods that competed with imports, and by 1994, Brazil plans to have reduced average tariffs from 34 percent to 14 percent. With credible and enduring liberalization now, Brazil should be successful both in maintaining its international competitiveness in such sectors as light and medium manufacturing and in strengthening other sectors.

An event that could galvanize Brazil's future liberalization came in early 1991 with the signing of the Southern Cone Free Trade Agreement (Mercosur Agreement) by Argentina, Brazil, Paraguay and Uruguay. Under the agreement, trade barriers among the four nations are to be completely eliminated by 1995. Sectoral integration in capital goods has been under way since the signing of agreements in 1986. The effectiveness of the present program, as always, depends on Brazil's efforts at macroeconomic stabilization, an area of limited success in the past decade.

(Continued on page 15)

Conclusion

More and more countries throughout the world have concluded that price stability and economic openness are the underpinnings of economic growth. In attempting to put two decades of volatility behind them, many Latin American governments not only are pursuing monetary stability but are implementing policies to convince their business communities that stability will continue long enough to justify investment.

The long-term credibility of central bank policies is essential to successful reform. Already, some Latin American governments have provided models for others seeking the benefits of free trade. They have complemented trade liberalization with monetary and exchange rate polices that are consistent with free trade. Some countries may follow the example of Chile and Argentina by passing laws to create central banks with sufficient independence to withstand political pressure to cover their governments' debts by issuing more money. Credibility, however, increases with both the number of steps taken and the visibility of steps governments must take to undo new policies. The more steps and the greater their visibility, the more difficult is their reversal. The highly visible policy of linkage of a nation's currency to a stable anchor, coupled with other clearly defined monetary rules, would increase credibility still further. Eventually, such arrangements can give way to policies that rely only on internal discipline, thus eliminating the need for fixed exchange rates.

The Federal Reserve Bank of Dallas believes that open markets and stable prices and currencies are in the best interests of all countries of the Western Hemisphere. Open markets and stable prices and currencies can help speed the recovery of U.S. exports to Latin America, as demonstrated by the recent growth of U.S. exports to Mexico. For the United States, exchange rate stability facilitates hemispheric trade flows in a period of intensifying competition with other countries. Economic liberalization and price

stability throughout the hemisphere enhance the growth prospects for the United States and its trading partners in the 1990s.

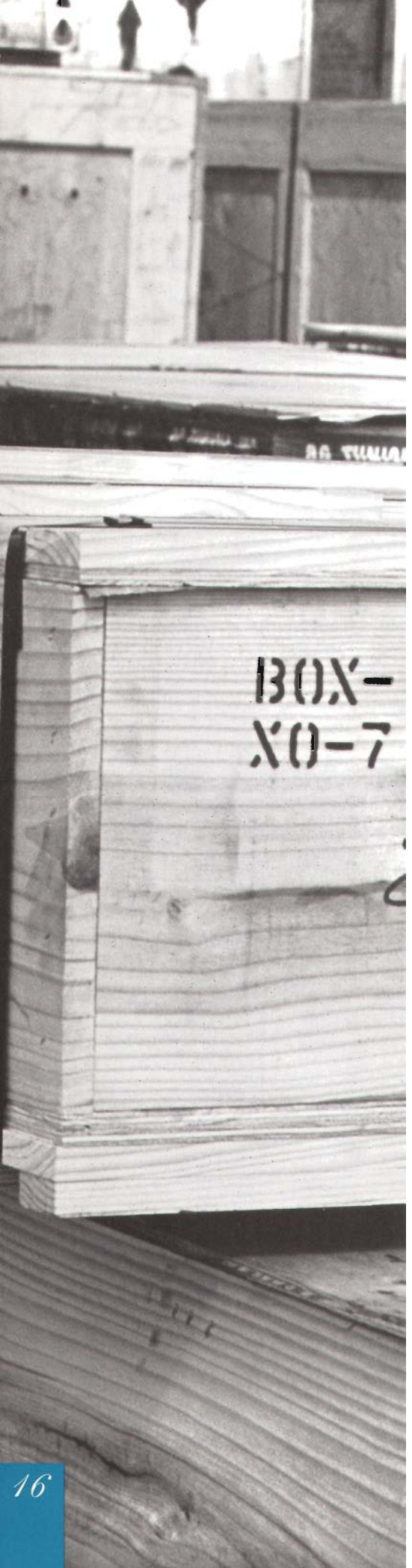
Trade and financial integration will continue in the Western Hemisphere, and some Latin American countries will likely wish to strengthen their monetary ties to the United States. The United States should not shy away from such an opportunity but, rather, should strive to set a standard of economic openness and price stability for others to emulate. Economic liberalization in the Americas depends on it. Liberalization in the Americas, however, increases the burden on the Federal Reserve System. Now more than ever, stable U.S. monetary policy pursued by an independent central bank is critically important for the economic health and growth of our country and our hemisphere.

(Continued from page 13)

Argentina

In early 1991, Argentina attempted to break its devaluation–hyperinflation cycle with a broad-based fiscal adjustment plan, but inflation did not fall. Later in 1991, Argentina adopted an exchange rate program to help ensure the credibility of monetary policy. The legislation requires the central bank to maintain 100-percent backing of the monetary base (currency in circulation plus commercial bank reserves on deposit with the central bank), with foreign reserves at an exchange rate no greater than 10,000 australes per dollar. Moreover, after years of restrictions on foreign currency buying from the central bank, the austral became fully convertible with the dollar. These policies generated dramatic reductions in inflation, large capital inflows from abroad, and a stock market boom during the remainder of 1991.

Encouraged by the success of the relinking policy, Argentina liberalized even further by eliminating nontariff barriers, drastically reducing tariff rates, and reducing export taxes and quotas. Then, in late 1991, President Carlos Menem introduced legislation to deregulate the economy even more. By early 1992, Argentina had become an open economy, with low inflation and a fixed exchange rate. The long-term success of the program depends on whether Argentina continues to improve the competitiveness of its economy.



Acknowledgment

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Data Sources for Figures

Figure 1:
The World Bank

Figure 2:
Inter-American Development Bank

Figure 3:
Inter-American Development Bank
(Average annual inflation rates weighted by gross domestic product for Argentina, Bolivia, Brazil, Chile, Colombia, Mexico, Peru and Venezuela)

Figure 4:
Inter-American Development Bank
(Average annual investment as a percentage of gross domestic product for Argentina, Bolivia, Brazil, Chile, Colombia, Mexico, Peru and Venezuela)

Figure 5:
Inter-American Development Bank
(Gross domestic product per capita for Argentina, Bahamas, Barbados, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Suriname, Trinidad and Tobago, Uruguay and Venezuela)

The Year in Review

Supervision and Regulation and Loan

Eleventh District banking conditions continued to improve in 1991. The profitability of District banks increased from 1990 and surpassed the profitability of U.S. banks overall. The return on District banking assets rose to 0.7 percent in 1991 from 0.4 percent in 1990. Widening net interest margins, gradual improvement in local real estate markets, and continued government resolution efforts all contributed to the gain in profitability.

District bank failures declined from 105 in 1990 to 33 in 1991. Also reflecting improved financial conditions, the number of loans extended by the Federal Reserve Bank of Dallas' discount window declined from 1,750 in 1990 to 421 in 1991, and total credit extended by the Dallas Fed's discount window fell from $4.6 billion to $1 billion.

As the supervisor of state member banks and bank holding companies in the Eleventh District, the Dallas Fed performs examinations for safety and soundness and for compliance with both the Community Reinvestment Act and consumer protection laws. In 1991, the Dallas Fed's examiners conducted 556 examinations related to the supervision of District financial institutions, including 14 examinations of U.S. agencies of foreign banks and 45 consumer affairs examinations. In addition, the Dallas Fed processed 114 applications for mergers and acquisitions, changes in control and management, and other actions requiring regulatory approval.

Legislation passed by Congress in 1991 will alter the process of bank supervision and lending. The new law places limits on discount window loans to undercapitalized institutions. It also prescribes a range of supervisory actions to be taken if a bank's capital position deteriorates below a specified limit. Additionally, the law mandates annual on-site bank examinations, requires outside audits for banks above a specified asset size, and increases the authority of the Federal Reserve in supervising U.S. offices of foreign banks.

The changing financial and regulatory environment of the 1990s brings new opportunities and challenges for Eleventh District financial institutions. The Dallas Fed remains dedicated to promoting the safety and soundness of the financial industry during this period of ongoing change.

Financial Services

Financial services remained one of the primary areas of emphasis for the Federal Reserve Bank of Dallas in 1991.

The Dallas Fed was selected as one of three consolidation sites to support data services and automation efforts for the Federal Reserve System. After an extensive analysis of 39 possible locations, the selection committee chose Dallas, along with Richmond, Va., and East Rutherford, N.J. Site selection was based on each location's environment, labor and space availability, and economy and culture. A transition plan for consolidating operations over the next several years is being developed. Under the consolidation concept, each of the three centers will back up the other two, providing dual backup for each location. As a result, the reliability

and availability of Federal Reserve services will improve. Currently, the System's one contingency center in Culpeper, Va., supports 10 of the 12 Districts. The Culpeper center, now capable of supporting one District at a time, is being upgraded to support two simultaneously.

The Federal Reserve System initiated a program to move all commercial automated clearinghouse (ACH) transactions that financial institutions originate or receive through the Federal Reserve Banks to electronic access no later than June 30, 1993. The Dallas Fed is working closely with its customers to complete this transition by January 1993. An all-electronic ACH improves the efficiency of the ACH mechanism by promoting timely posting of ACH payments to customer accounts and enhances the attractiveness of the ACH system by allowing greater processing flexibility. Electronic access also enhances the integrity of the ACH mechanism by reducing credit and fraud risk, providing a higher level of security, and improving contingency and disaster recovery capabilities. At year-end, about 33 percent of the Dallas Fed's receiving points for ACH items were connected to its electronic RESPONSE network. The network facilitates both ACH transmissions and access to all other online services.

By the end of 1991, the Dallas Fed had completed customer conversion to Fedline, the new personal computer software for the RESPONSE network. Fedline will enhance the efficiency of access to the Dallas Fed's financial services. Conversion of the Dallas Fed's RESPONSE users involved extensive internal resources and cooperation on the part of network participants. Also introduced in 1991 was FLASH-Light, a receive-only electronic access method designed for institutions that receive a minimum number of ACH items per day.

In currency and coin operations, 50 percent of the $1 notes issued by the Dallas Fed now come from the new Bureau of Engraving and Printing Western Currency Facility in Fort Worth. The Fort Worth facility, the first U.S. currency production plant outside Washington, D.C., began operation in April 1991. By 1994, the plant is expected to be producing 4.5 billion notes per year, or 40 percent of the Federal Reserve System's requirements. The plant is expected to lessen the workload of the Bureau of Engraving and Printing in Washington, D.C., which reached its printing capacity several years ago.

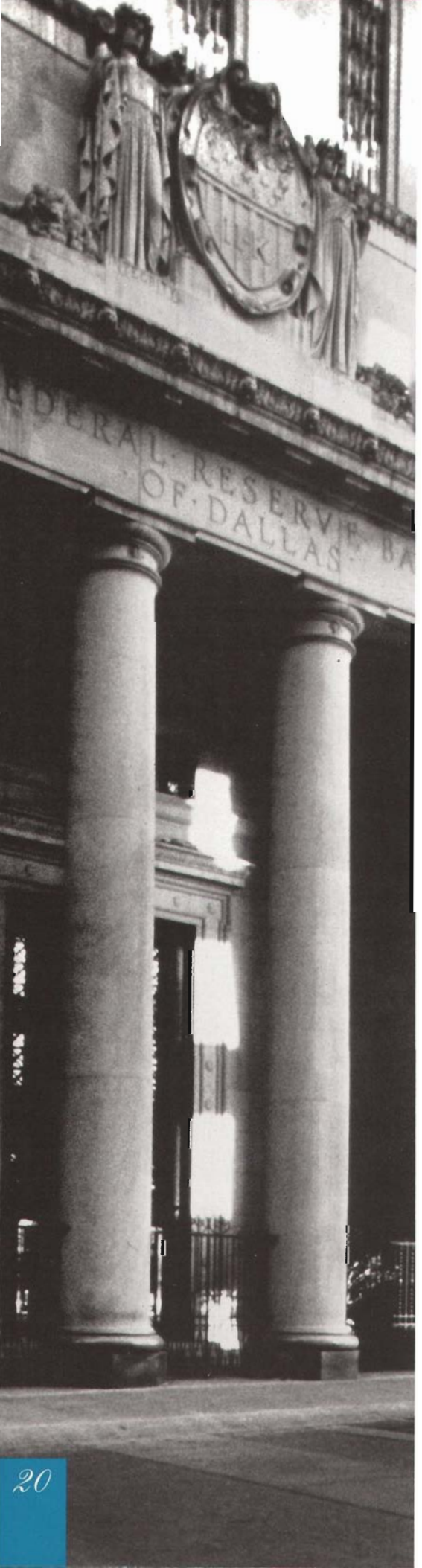
In September 1991, the Federal Reserve began issuing Series 1990 $100 notes, the first currency with two new security enhancements. They augment existing counterfeiting deterrents and will help deter the use of high-technology systems, such as color copiers and laser scanners, for counterfeiting. The enhancements are a security thread and microprinting, neither of which can be reproduced easily by a photocopier. The Bureau of Engraving and Printing plans to print other denominations with these security features.

Training for and implementation of the Regional Delivery System (RDS) were completed in the Houston and San Antonio territories in 1991. RDS, the new method of purchasing U.S. savings bonds, was introduced by the Treasury Department as a cost-effective and efficient means of inscribing and delivering savings bonds sold to the public over the counter. Financial institutions will accept, process and forward customer orders to the Federal Reserve for bond issuance and mailing. The entire process will take a maximum of 15 days. Implementation for the Dallas and El Paso territories is scheduled for 1992.

In check processing, the conversion to Check Processing Control System (CPCS) software was completed at the three Dallas Fed Branches. The CPCS software allows the Branches to process checks through the Dallas Office computers more quickly and with greater reliability. In addition, as a leader in the improvement of return item processing, the Dallas Fed helped successfully introduce a return item intermingling program (currently in the pilot stage) that allows qualified return items and forward collection items to be combined in a single cash letter. The benefits of intermingling include smoother processing, easier reconcilement, less paperwork, less time to prepare cash letters, and a significant savings on service fees.

Finally, the Federal Reserve announced continued support and enhancement of its cost accounting program for financial institutions, Functional Cost Analysis. The Dallas Fed will continue to receive and process data from institutions on income, expenses and item-count information for various functions. The reports that the Dallas Fed compiles from these data will help institutions compare and price products, control costs and evaluate operations.

The Federal Reserve Bank of Dallas will continue to strive to meet the financial services needs of depository institutions through an emphasis on electronic technology and the efficiency, cost-effectiveness and reliability it provides the banking industry.



Tribute to a Building

For more than 70 years, the imposing granite and limestone building at 400 S. Akard Street in downtown Dallas has been the home of the Federal Reserve Bank of Dallas.

Designed by a prominent Chicago architectural firm and first occupied in early 1921, the Dallas Fed building reflected the same revival-style architecture as other Federal Reserve Banks built during the 1920s. The liberal use of arches, stonework and ironwork in the design helped create a symbol of the stability of the Federal Reserve System and of its vital role as the country's central bank and fiscal agent.

The Dallas Federal Reserve building was constructed with 1,300 tons of steel, 1 million bricks and 20,000 square feet of limestone and granite. The cornerstone was laid on April 2, 1920, and 11 months later, the building's doors opened for business.

Although the distinctive edifice attracted tourists from across the state, visitors seemed more impressed that the Dallas Fed headquarters was the first commercial building west of the Mississippi River to be equipped with air conditioning—a miracle to most Dallas residents at the time.

A stately structure with elaborately sculpted cornices and a front entrance flanked with massive columns, the building represents an important architectural milestone in the historical development of the area. In tribute to the enduring significance of its design, the Dallas Fed building was designated a historic landmark in May 1979.

Remarkably, the building stands today as a monument to the vision of the first Federal Reserve leaders, who understood the need to create a structure strong enough to transcend the years and, more important, the need to create a work environment that would be flexible and useful in eras its planners could not even imagine.

As men and women of the early 1990s work behind the same walls that welcomed the first Federal Reserve staff in 1921, the building verifies that the high standards that were its foundation stand firm at the Federal Reserve Bank of Dallas almost three-quarters of a century later.

In 1992, the Federal Reserve Bank of Dallas will experience yet another milestone as it prepares to move from its landmark home on Akard Street to a new building at 2200 Pearl Street. We can only hope that the years ahead will be as memorable as the past 71 have been at 400 S. Akard.

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Effective December 31, 1991

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Assistant Vice President

John A. Bullock
Assistant Vice President

Richard A. Gutierrez
Assistant Vice President

Effective January 1, 1992

STATEMENT OF CONDITION

	December 31, 1991 (Thousands)	*December 31, 1990 (Thousands)*
ASSETS		
Gold certificate account[1]	$ 515,000	$ 585,000
Special drawing rights certificate account[2]	463,000	463,000
Coin	42,850	44,137
Loans to depository institutions	2,500	22,900
Securities:		
Federal agency obligations	237,160	226,345
U.S. government securities	10,455,745	8,390,883
Total securities	$10,692,905	$ 8,617,228
Items in process of collection	772,558	977,079
Bank premises (net)	140,461	71,551
Other assets	2,296,846	2,704,393
Interdistrict settlement account	1,599,508	986,328
TOTAL ASSETS	$16,525,628	$14,471,616
LIABILITIES		
Federal Reserve notes	$13,530,418	$11,481,291
Deposits:		
Depository institutions	1,645,660	1,756,755
Foreign	11,430	11,400
Other	96,637	7,046
Total deposits	$ 1,753,727	$ 1,775,201
Deferred credit items	722,424	745,829
Other liabilities	96,179	99,821
TOTAL LIABILITIES	$16,102,748	$14,102,142
CAPITAL ACCOUNTS		
Capital paid in	$ 211,440	$ 184,737
Surplus	211,440	184,737
TOTAL CAPITAL ACCOUNTS	$ 422,880	$ 369,474
TOTAL LIABILITIES AND CAPITAL ACCOUNTS	$16,525,628	$14,471,616

[1] This Bank's share of gold certificates deposited by the U.S. Treasury with the Federal Reserve System.

[2] This Bank's share of special drawing rights certificates deposited by the U.S. Treasury with the Federal Reserve Bank of New York.

STATEMENT OF OPERATIONS

	For the year ended December 31	
	1991	*1990*
	(Thousands)	*(Thousands)*
CURRENT INCOME		
Interest on loans	$ 292	$ 32,125
Interest on government securities	729,590	744,950
Income on foreign currency	190,408	197,734
Income from priced services	49,082	49,787
Other income	663	728
Total current income	$ 970,035	$1,025,324
CURRENT EXPENSES		
Current operating expenses	$ 98,422	$ 92,358
Less expenses reimbursed	7,342	6,336
Current net operating expenses	$ 91,080	$ 86,022
Cost of earnings credits	6,049	6,848
Current net expenses	$ 97,129	$ 92,870
CURRENT NET INCOME	$ 872,906	$ 932,454
PROFIT AND LOSS		
Additions to current net income:		
Profit on sales of government securities (net)	$ 4,908	$ 2,240
Profit on foreign exchange transactions (net)	27,748	162,594
Other additions	6	41
Total additions	$ 32,662	$ 164,875
Deductions from current net income:		
Loss on sales of government securities (net)	$ 0	$ 0
Loss on foreign exchange transactions (net)	0	0
Other deductions	28	2
Total deductions	$ 28	$ 2
Net additions (deductions)	$ 32,634	$ 164,873
Cost of unreimbursable Treasury services	$ 4,272	$ 4,278
Assessment by Board of Governors:		
Expenditures	$ 8,034	$ 7,937
Federal Reserve currency costs	11,210	8,915
NET INCOME AVAILABLE FOR DISTRIBUTION	$ 882,024	$1,076,197

STATEMENT OF SURPLUS

	For the year ended December 31	
	1991	*1990*
	(Thousands)	*(Thousands)*
Surplus, January 1	$ 184,737	$ 170,565
Net income available for distribution	882,024	1,076,197
LESS:		
Dividends paid	11,468	11,027
Payments to the U.S. Treasury	843,853	1,050,998
Net amount transferred to (from) surplus	$ 26,703	$ 14,172
Surplus, December 31	$ 211,440	$ 184,737

VOLUME OF OPERATIONS

District Summary

	Number of Pieces Handled		Dollar Amount (Thousands)	
	1991	1990	1991	1990
Currency received and counted	1,018,631,771	959,597,700	14,065,791	13,559,912
Coin received and counted	474,163,877	727,955,791	68,592	111,793
Food stamps redeemed	392,604,472	319,719,912	1,960,574	1,672,384
Transfers of funds	6,007,500	6,747,065	8,170,674,245	10,368,347,128
CHECKS HANDLED				
Commercial—processed	1,091,740,644	1,129,534,456	521,793,307	570,465,998
Commercial—fine sorted	427,791,335	383,290,202	104,621,557	96,459,566
U.S. government checks	31,245,000	34,397,594	37,790,042	49,144,367
ACH ITEMS HANDLED				
Commercial	108,278,400	91,458,412	435,011,018	378,729,990
U.S. government	42,578,234	41,739,399	49,189,268	39,044,581
COLLECTION ITEMS HANDLED				
U.S. government coupons paid	12,546	17,827	23,138	22,736
Municipal coupons and bonds	219,855	277,864	679,211	770,545
ISSUES, REDEMPTIONS, EXCHANGES OF U.S. GOVERNMENT SECURITIES				
Definitive and book-entry	4,358,666	6,350,898	1,358,640,070	765,177,143
LOANS				
Advances made	421	1,750	1,021,049	4,591,018

The Federal Reserve Bank of Dallas is one of 12 regional Federal Reserve Banks in the United States. Together with the Board of Governors in Washington, D.C., these organizations form the Federal Reserve System and function as the nation's central bank. The System's basic purpose is to provide a flow of money and credit that will foster orderly economic growth and a stable dollar. In addition, Federal Reserve Banks supervise banks and bank holding companies and provide certain financial services to the banking industry, the federal government and the public.

Since 1914, the Federal Reserve Bank of Dallas has served the financial institutions in the Eleventh District. The Eleventh District encompasses approximately 360,000 square miles and comprises the state of Texas, northern Louisiana and southern New Mexico. The three branch offices of the Federal Reserve Bank of Dallas are in El Paso, Houston and San Antonio.


10
CRUZEIROS
BRASIL
ESTADOS UNIDOS
LIBERTY

Federal Reserve Bank of Dallas
400 South Akard Street
Dallas, Texas 75202
(214) 651-6111

After June 1992:
2200 North Pearl Street
Dallas, Texas 75201
(214) 922-6000

El Paso Branch
301 East Main Street
El Paso, Texas 79901
(915) 544-4730

Houston Branch
1701 San Jacinto Street
Houston, Texas 77002
(713) 659-4433

San Antonio Branch
126 East Nueva Street
San Antonio, Texas 78204
(512) 978-1200