

## Message from the President and First Vice President

**W**hile the beginning of 2003 saw a continuation of the sluggish recovery that began in late 2001, overall economic activity accelerated briskly after midyear, led by renewed growth of business investment in equipment and software. Job growth, however, continued to lag. Payroll employment was essentially unchanged over the year, a surprisingly weak labor market performance so far into a recovery. One factor limiting hiring was the ability of firms to increase worker productivity by exploiting recent technological advances. Strong productivity growth also helped restrain inflationary pressures by holding down unit labor costs. Measures of core inflation fell throughout the year to around 1 percent—the lowest level in several decades.

The Fifth District's manufacturing sector continued to feel the effects of cyclical trends and a long-term structural transformation, especially in the Carolinas. In response to the strong advances in productivity and increasing global competition, District manufacturing employment has been falling since the mid-1990s, and the 2001 recession accelerated this decline. While the end of 2003 saw a pickup in measures of District manufacturing shipments, employment in that sector continued to sag, consistent with national trends. Service sector employment fared better during 2003, however, and overall District employment was flat for the year.

The rapid technological change evident in the national and regional economies has presented challenges for the Federal Reserve Banks. Increased competition in financial services and further consolidation in the banking and financial industries—both enabled by technology—have increased pressure on the Banks to reduce operating costs in their payments services and support activities. Technology is also driving a long-anticipated transition from paper to electronic payments, and, as a result, Reserve Bank check processing volumes continued to decline in 2003. This decline in paper processing is likely to be hastened by the recent passage of the Check 21 legislation, which, when it takes effect in October 2004, will enable increased electronic clearing of checks. While the pace and nature of the transition remain uncertain, it is clear that in the future Reserve Bank check operations will involve significantly fewer people and facilities, far less paper, and far more electronic services than at present.

These trends are clearly beneficial for the nation's payment system, but they require challenging adjustments by the Reserve Banks. Early in 2003 the Banks decided collectively to reduce the number of check processing sites nationwide. Three of the five check processing operations in the Fifth District will be closed in 2004, and District check adjustments processing will be centralized in the Charlotte Office. In order to absorb check



volume diverted from the other offices, and as part of national check modernization efforts, the Baltimore and Charlotte Offices successfully adopted new check hardware and software platforms. Closure of the Richmond, Charleston, and Columbia check processing operations, to be completed in 2004, will displace approximately 250 jobs. In connection with this and other restructuring efforts, the Bank initiated a Bankwide voluntary early retirement program, which will conclude in 2004, to provide job opportunities for some displaced employees.

Technological change also creates opportunities for the Reserve Banks as a group to reduce costs by consolidating support activities. In 2003 the Bank was pleased to be chosen to provide two important national support services for all Reserve Banks. As the central site for payroll processing, we initiated operations and successfully brought three other Banks into the consolidated processing environment. Our Bank was also selected to host the national procurement function and began staffing activities late in the year.

The extensive relationships between regional Reserve Banks and the businesses and communities in their respective Districts have been a foundation of the strength of the Federal Reserve System since its founding 90 years ago. The ongoing transformation of the financial services industry has brought a renewed focus on reinforcing the Bank's regional presence. Recognizing the growing importance of Charlotte as a national banking center, and with an eye to strengthening our connections with communities in the Carolinas, the senior officer

over the District's bank supervision and regulation function was reassigned as officer in charge of the Charlotte Office in late 2003.

The banking industry continues to grow in scope and complexity, which requires all Reserve Banks to make retaining and attracting skilled and experienced staff a high priority. This need is especially pressing for our Bank given that several of the nation's largest banking companies are located in our District. During 2003, the Bank put a new supervisory program in place for several large regional banks with particular complexities or areas of specialization. This program, staffed with experienced examiners and industry specialists, provides customized, ongoing oversight for each company, similar to the national program for supervising the largest banking organizations.

The Bank's many and varied accomplishments in 2003 reflect the collective effort and energy of our employees, and we thank each member of our staff warmly for his or her contributions. We are also exceedingly fortunate to have a group of engaged and well-informed directors who provide us their perspective on District economic conditions and exercise oversight of the Bank's operations. Our directors encompass a wide range of professional backgrounds, and their participation in guiding the Bank is an extraordinarily important contribution to the Bank's strength. We especially thank our retiring directors, William "Buck" Duncan and James Haden. Buck shared his extensive knowledge as a community banker and his personal warmth in a way that engaged us all. Jim provided insightful perspective on local economic conditions

and trends in the health-care industry from the vantage point of a businessman and a keen observer of the economy. We are grateful for their service. We are also grateful to the members of our Small Business and Agricultural Advisory Council, our Community Development Advisory Council, and our Operations Advisory Committee for their outstanding support throughout the year.

As one of us nears retirement, we note that throughout the nearly 30 years that we have worked together, the Fed's predominant monetary policy challenge has been to reduce inflation. The long campaign toward this goal extended from the late 1970s through the late 1990s, and in 2003 there was widespread recognition that the Fed had achieved effective price stability. This hard-earned victory is exceptionally important because it reduces the uncertainties and risks faced by households and businesses in making financial decisions, and in that way fosters greater saving, investment, and growth in jobs and income. From now on, the focus of monetary policymakers will be *sustaining* rather than *attaining* price stability.

Academic and central bank economists have devoted considerable attention recently to determining how central banks can best sustain price stability. Our Annual Report essay this year, prepared by Al Broaddus and Marvin Goodfriend, presents an analytical framework, based on the new neo-classical synthesis, for understanding inflation and deflation, and explores the implications of this framework for some of the current challenges facing

the Fed and other central banks. One key implication of this framework is that open and effective communication is critical to a central bank's credibility. The essay explains how an inflation target would work to support the Fed's credibility and its efforts to sustain price stability.

J. Alfred Broaddus, Jr.  
*President*

Walter A. Varvel  
*First Vice President*

*This will be the last Annual Report prepared during my tenure as president. I have been honored by the privilege of serving the Bank, the Federal Reserve System, and, most importantly, all of our stakeholders in the Fifth Federal Reserve District, in this role. I am especially grateful to all of the present and past directors at all three of our offices who have helped guide the Bank — and me — over the years. I am also deeply grateful to my first vice president, Walter Varvel; his predecessor, Jimmie Monhollon; my predecessor, Bob Black; my principal policy advisor — and frequent co-author in these pages — Marvin Goodfriend; and all of the extraordinary staff teammates I've had the joy of working with over the years. I thank all of these wonderful colleagues for their support, guidance and friendship. I will miss the Bank very much, but I am confident that my successor will sustain the traditions of integrity, service, excellence, and respect for the individual that have been the Bank's foundation throughout its proud 90-year history.*

*Al Broaddus*