Message from the President and First Vice President

History may well designate both 2001 and 2002 as watershed years for the United States—years in which the country was strenuously challenged in several important areas of national life. It has become almost a cliché to say that the terrorist attacks in September 2001 have changed America forever, yet the statement is probably true. In 2002, the nation continued its recovery from the attacks, but revelations of serious deficiencies in corporate governance and accounting practices presented a significant new challenge, economic growth remained lackluster, and the stock market declined further. The threat of war in the Middle East toward the end of the year created a level of geopolitical risk that appeared to place a considerable additional drag on the economy. In this environment, the Bank, as an important component of the Federal Reserve System, gave its highest priority to reducing risk and increasing confidence and trust in the economy and financial markets.

Despite these challenges, there were some bright spots in both the national and Fifth District economies. Consumer outlays for goods and services, in particular, continued to advance, and purchases of both new and existing homes remained robust. Business investment in equipment, software, and structures, however, continued to lag, and few net new jobs were created. In the District, conditions in some high-tech industries improved, but several of the region's traditional manufacturing industries remained weak.

The recovery from the 2001 recession has featured two extraordinary developments that have strongly affected both the Fed's conduct of monetary policy and its own internal operations. For the first time in over half a century, Fed policymakers have had to take account of the risk of *de*flation as well as *in*flation in their efforts to maintain price stability. This Bank has long been in the forefront of the fight against inflation, and we are pleased, to put it mildly, that price stability has finally been achieved. If sustained, price stability will provide a firm foundation for growth in production and jobs. But when core inflation is below 2 percent, as it has been recently, policymakers obviously need to give more attention to guarding against deflation than when inflation is 4 or 5 percent or higher. Through our research and our participation in the formulation of monetary policy, the Bank worked diligently in 2002 to prevent the economy from drifting toward either deflation or a reemergence of inflation. We were strongly supported in this effort by information on business and financial conditions supplied by our boards of directors in Richmond, Baltimore, and Charlotte.

The second extraordinary development was continued robust growth in labor productivity. Productivity grew about 4 percent over the four quarters of 2002, well above even its relatively high 2½ percent average growth from 1996 to 2001. Productivity growth is a principal way the nation increases the incomes and living standards of its citizens over time. But productivity growth can also temporarily displace workers and products. The Federal Reserve is not immune to these forces of creative destruction. Our financial services businesses—check processing in particular—came under severe pressure in 2002 as a result of technological progress in the payments system.

A recent study commissioned by the Fed showed that consumers and businesses increasingly are choosing electronic forms of payment rather than checks—roughly 40 billion checks were written in the United States in 2002, down from about 50 billion in 1995. While this is a welcome—and long sought—development from the standpoint of the efficiency in the payments system, the Federal Reserve Banks face the challenge of adapting their check processing infrastructures to this fundamental change in the market environment. Late last year the Banks embarked on a major national initiative to reduce operating costs in their check services businesses while still maintaining and strengthening the Fed's presence as a nationwide provider of check services. As the year ended, the Banks decided collectively to reduce the number of check processing sites nationwide. As part of this effort, this Bank decided to discontinue its processing operations in Richmond and in Charleston, West Virginia, and Columbia, South Carolina. At the same time, we continued our preparations to standardize and modernize our check services operations in Baltimore and Charlotte as part of the Fed's nationwide check modernization program.

The Bank's banking supervision and regulation resources are also adapting to changes in market conditions. We are focused on retaining and attracting staff with a broad range of experience and skills to help supervise the complex and sophisticated activities of two of the nation's four largest banking organizations. Our District is also home to numerous community banks, several large regional banks, and several banks with particular complexities or areas of specialization. In 2002, the Bank established a new bank supervision unit that will focus specifically on these large regional and specialized institutions.

These accomplishments reflect the combined efforts of many Bank employees and our board of directors. We are fortunate indeed to have strong, knowledgeable, and independent directors whose perspective on District economic conditions as well as corporate governance issues served us exceedingly well this past year. We especially thank our retiring directors, Fred Green and Jeremiah Sheehan.

Fred shared his extensive banking experience with us, and we are pleased that he is now serving as the District's representative to the Federal Advisory Council. Jerry served as chairman of our board and provided an enormous reserve of practical business experience that helped us strengthen both our operations and policies.

The strength of corporate governance arrangements in American corporations became a subject of intense scrutiny and debate in 2002. The year opened with the unfolding accounting scandals at several large firms. These revelations ultimately led to the enactment of the Sarbanes-Oxley Act to reform corporate accounting and oversight practices. Our Annual Report essay this year addresses corporate accounting. The essay written by John Weinberg, vice president and economist, discusses this topic in terms of the fundamental challenge in corporate governance: how can a large public corporation align the incentives of professional managers with those of widely dispersed shareowners? The economic literature on corporate governance builds on an inescapable asymmetric condition—managers are much better informed than shareholders and other outside stakeholders about both a firm's actions and its performance. As last year's events demonstrated, this asymmetry can lead to abuses and even criminal activity by corporate managers that erodes the investor trust so essential to the health of the American economy. The essay recognizes that some new government regulation may be inevitable in these circumstances. It argues, however, that the most effective way to confront this problem is to reinforce and strengthen the market forces already working to align the incentives of managers and investors. Ultimately, the need to sustain investor confidence and trust is the most effective discipline on the behavior of corporate managers.

We thank all of the Bank's stakeholders for their support in 2002, and we look forward to serving them in 2003.

As this Annual Report was going to press, we were saddened to learn of the death of Irwin Zazulia, deputy chairman of our board of directors and chairman of the board's committee on financial and strategic planning for 2003. As the retired president and CEO of the Hecht's department store chain, Irwin generously shared his broad knowledge of retailing and management with the Bank. Most importantly, though, his personal warmth and strong commitment to public service lifted our spirits and made us a better Bank. We will miss him.

J. Alfred Broaddus, Jr.
President

Walter A. Varvel
First Vice President