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*89th Annual  
Report  
2002*

*Board of Governors of the Federal Reserve System*

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*Report*  
2002



*Board of Governors of the Federal Reserve System*

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*Letter of Transmittal*

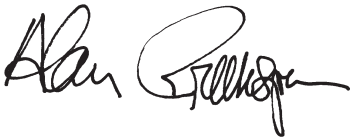
BOARD OF GOVERNORS OF THE  
FEDERAL RESERVE SYSTEM  
Washington, D.C., April 2003

THE SPEAKER OF  
THE HOUSE OF REPRESENTATIVES

Pursuant to the requirements of section 10 of the Federal Reserve Act, I am pleased to submit the eighty-ninth annual report of the Board of Governors of the Federal Reserve System.

This report covers operations of the Board during calendar year 2002.

Sincerely,

A handwritten signature in black ink, appearing to read "Alan Greenspan". The signature is fluid and cursive, with the first name "Alan" written in a larger, more prominent script than the last name "Greenspan".

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*Monetary Policy and  
Economic Developments*

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## *Monetary Policy and the Economic Outlook*

The economy of the United States has suffered a series of blows in the past few years, including the fall in equity market values that began in 2000, cutbacks in capital spending in 2001, the horrific terrorist attacks of September 11, the emergence of disturbing evidence of corporate malfeasance, and an escalation of geopolitical risks. Despite these adversities, the nation's economy emerged from its downturn in 2001 to post moderate economic growth last year. The recovery was supported by accommodative monetary and fiscal policies and undergirded by unusually rapid productivity growth that boosted household incomes and held down business costs. The productivity performance was also associated with a rapid expansion of the economy's potential, and economic slack increased over the year despite the growth in aggregate demand.

After turning up in late 2001, activity began to strengthen more noticeably early last year. Sharp inventory cutbacks in 2001 had brought stocks into better alignment with gradually rising final sales, and firms began to increase production in the first quarter of 2002 to curtail further inventory runoffs. Moreover, businesses slowed their contraction of investment spending and began to increase outlays for some types of capital equipment. Household spending on both personal consumption items and

housing remained solid and was supported by another installment of tax reductions, widespread price discounting, and low mortgage interest rates. By midyear, the cutbacks in employment came to an end, and private payrolls started to edge higher.

Although economic performance appeared to be gradually improving, the tentative nature of this improvement warranted the continuation of a highly accommodative stance of monetary policy. Accordingly, the Federal Open Market Committee (FOMC) held the federal funds rate at 1 $\frac{3}{4}$  percent through the first part of the year. In March, however, the FOMC shifted from an assessment that the risks over the foreseeable future to its goals of maximum sustainable growth and price stability were tilted toward economic weakness to an assessment that the risks were balanced.

Around midyear, the economy began to struggle again. Concerns about corporate governance came to weigh heavily on investors' confidence, and geopolitical tensions, especially the situation in Iraq, elevated uncertainties about the future economic climate. Equity prices fell during the summer, liquidity eroded in corporate debt markets, and risk spreads widened. Businesses once again became hesitant to spend and to hire, and both manufacturing output and private payrolls began to decline. State and local governments struggled to cope with deteriorating fiscal positions, and the economies of some of our major trading partners remained weak. Although the already accommodative stance of monetary policy and strong upward trend of productivity were providing important support

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NOTE. The discussion here and in the next section ("Economic and Financial Developments in 2002 and Early 2003") consists of the text, tables, and selected charts from the Monetary Policy Report submitted to the Congress on February 11, 2003, pursuant to section 2B of the Federal Reserve Act.

to spending, the Committee perceived a risk that the near-term weakening could become entrenched. In August, the FOMC adjusted its weighting of risks toward economic weakness, and in November, it reduced the targeted federal funds rate 50 basis points, to 1¼ percent. The policy easing allowed the Committee to return to an assessment that the risks to its goals were balanced. With inflation expectations well contained, this additional monetary stimulus seemed to offer worthwhile insurance against the threat of persistent economic weakness and substantial declines in inflation from already low levels.

On net, the economy remained sluggish at the end of 2002 and early this year. The household sector continued to be a solid source of demand. Motor vehicle sales surged at year-end on the tide of another round of aggressive discounting by the manufacturers, other consumer outlays trended higher, and activity in housing markets remained exceptionally strong. Concerns about corporate governance appeared to recede somewhat late last year, in part because no new revelations of major wrongdoing had emerged. However, the ongoing situation in Iraq, civil strife in Venezuela that has curtailed oil production, and tensions on the Korean peninsula have sustained investors' uncertainty about economic prospects and have pushed prices higher on world oil markets. Faced with this uncertainty, businesses have been cautious in spending and changed payrolls little, on net, over December and January.

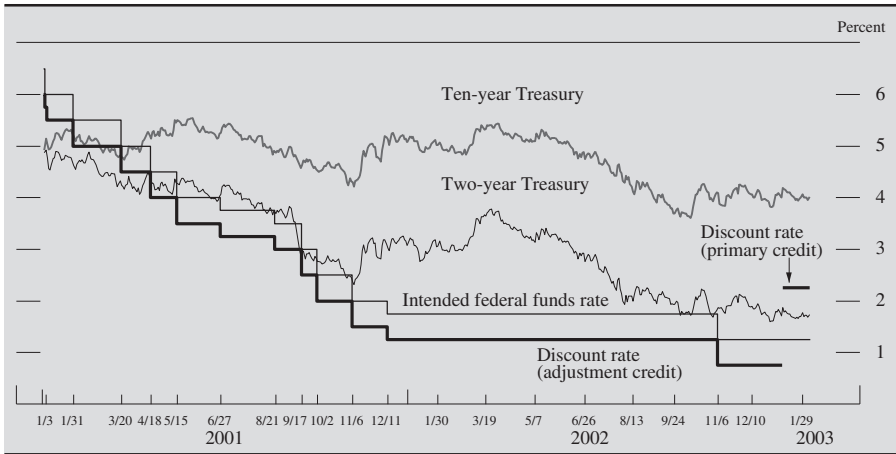
Mindful of the especially high degree of uncertainty attending the economic outlook in the current geopolitical environment, the members of the FOMC believe the most likely outcome to be that fundamentals will support a strengthening of economic growth.

Business caution is anticipated to give way over the course of the year to clearer signs of improving sales. Inventories are lean relative to sales at present, and restocking is likely to provide an additional impetus to production in the period ahead. The rapid expansion of productivity, the waning effects of earlier declines in household wealth, and the highly accommodative stance of monetary policy should also continue to boost activity. Although state and local governments face budgetary problems, their restraint is likely to offset only a part of the stimulus from past and prospective fiscal policy actions at the federal level. In addition, the strengthening economies of our major trading partners along with the improving competitiveness of U.S. products ought to support demand for our exports. Taken together, these factors are expected to lead to a faster pace of economic expansion, while inflation pressures are anticipated to remain well contained.

### **Monetary Policy, Financial Markets, and the Economy over 2002 and Early 2003**

As economic growth picked up during the early months of 2002, the FOMC maintained its target for the federal funds rate at 1¼ percent. A sharply reduced pace of inventory liquidation accounted for a significant portion of the step-up in real GDP growth, but other indicators also suggested that the economy was gaining momentum. Reductions in business outlays on equipment and software had moderated significantly after dropping precipitously in 2001, and consumer spending was well maintained by sizable gains in real disposable personal income. Residential construction activity was spurred by low home mortgage interest rates. The improvement in economic conditions

Selected Interest Rates



NOTE. The data are daily and extend through February 5, 2003. The dates on the horizontal axis are those of scheduled FOMC meetings and of any intermeeting policy actions. On January 9, 2003, the

Federal Reserve changed the main credit program offered at the discount window by terminating the adjustment credit program and beginning the primary credit program.

sparked a rally in equity markets late in the first quarter and pushed up yields on longer-term Treasury instruments and investment-grade corporate bonds; yields on speculative-grade bonds declined in reaction to brighter economic prospects and the perceived reduction in credit risk. Meanwhile, surging energy prices exerted upward pressure on overall inflation, but still-appreciable slack in resource utilization and a strong upward trend in private-sector productivity were holding down core price inflation.

At both its March and May meetings, the FOMC noted that the apparent vigor of the economy was importantly attributable to a slowdown in the pace of inventory liquidation and that considerable uncertainty surrounded the outlook for final sales over the next several quarters. The Committee was especially concerned about prospects for a rebound in business fixed investment, which it viewed as key to ensuring sustainable economic expansion.

Although the decline in investment spending during the first quarter of 2002 was the smallest in a year, gloomy business sentiment and large margins of excess capacity in numerous industries were likely to hamper capital expenditures. According to anecdotal reports, many firms were unwilling to expand capacity until they saw more conclusive evidence of growing sales and profits. At the same time, however, the FOMC noted that, with the federal funds rate unusually low on an inflation-adjusted basis and considerable fiscal stimulus in train, macroeconomic policies would provide strong support to further economic expansion. Against this backdrop, the Committee at the March 19 meeting judged the accommodative stance of monetary policy to be appropriate and announced that it considered the risks to achieving its long-run objectives as being balanced over the foreseeable future, judgments it retained at its meeting in early May.

The information reviewed at the June 25–26 FOMC meeting confirmed that the economy was expanding but at a slower pace than earlier in the year. As expected, the degree of impetus to economic activity from decelerating inventory liquidation had moderated. Residential investment and consumer spending also had slowed appreciably after surging earlier in the year. The most recent data on orders and shipments suggested a small upturn in business spending on equipment and software, but the improvement in capital spending appeared to be limited, unevenly distributed across industries, and not yet firmly indicative of sustained advance. Industrial production continued to increase, and the unemployment rate declined somewhat.

In financial markets, investors and lenders had apparently become more risk averse in reaction to the mixed tone of economic data releases, growing geopolitical tensions, further warnings about terrorist attacks, and additional revelations of dubious corporate accounting practices. In concert, these developments pushed down yields on longer-term Treasury securities, while interest rates on lower-quality corporate bonds rose notably, and equity prices dropped sharply. Although the economy continued to expand and the prospects for accelerating aggregate demand remained favorable, downbeat business sentiment and skittish financial markets rendered the timing and extent of the expected strengthening of the expansion subject to considerable uncertainty. In these circumstances, the FOMC left the federal funds rate unchanged to keep monetary policy very accommodative and once again assessed the risks to the outlook as being balanced.

By the time of the August 13 FOMC meeting, it had become apparent that economic activity had lost some of its

earlier momentum. Turbulence in financial markets appeared to be holding back the pace of the economic expansion. Market participants focused their attention on the lack of convincing evidence that the recovery was gaining traction and the possibility that more news of corporate misdeeds would surface in the run-up to the Securities and Exchange Commission's August 14 deadline for the certification of financial statements by corporate executives. Although the cumulative losses in financial wealth since 2000 were restraining expenditures by households, very low mortgage interest rates were helping to sustain robust demand for housing. Moreover, the financial resources made available by a rapid pace of mortgage refinancing activity, in combination with attractive incentives offered by auto manufacturers, supported other consumer spending. The Committee continued to judge the prevailing degree of monetary accommodation as appropriate to foster a solid expansion that would bring the economy to fuller resource utilization. At the same time, the Committee recognized the considerable risks to that outlook and the potential adverse consequences for economic prospects from possible additional deterioration of financial conditions. The members noted, however, that a further easing of monetary policy, if it came to be viewed as appropriate, could be accomplished in a timely manner. In light of these considerations, the FOMC opted to retain a target rate of 1¾ percent for the federal funds rate, but it viewed the risks to the economy as having shifted from balanced to being tilted toward economic weakness.

When the FOMC met on September 24, data indicated that economic growth had picked up in the third quarter, on average, buoyed in part by a surge in motor vehicle production. The uneventful passing of the mid-August

deadline for recertification of corporate financial statements briefly alleviated investors' skittishness in debt and equity markets. However, the most timely information suggested that some softening in economic activity had occurred late in the summer. Those economic reports, along with a darker outlook for corporate profits and escalating fears of a possible war against Iraq, led market participants to revise down their expectations for the economy. Equity prices and yields on both longer-term Treasury and private securities moved sharply lower in early autumn. In the Committee's view, heightened geopolitical tensions constituted a significant additional source of uncertainty clouding the economic outlook. Still, fundamentals suggested reasonable prospects for continued expansion. Accordingly, the FOMC left the federal funds rate unchanged at the close of the September meeting but also reiterated its view that the risks to the outlook were weighted toward economic weakness.

The information reviewed at the November 6 meeting indicated a more persistent spell of below-par economic performance than the FOMC had anticipated earlier. With home mortgage rates at very low levels, residential construction activity remained high. But consumer spending had decelerated noticeably since midsummer under the combined weight of stagnant employment and declining household wealth resulting from further decreases in equity prices. Worries about the potential for war against Iraq, as well as persistent concerns about the course of economic activity and corporate earnings, were apparently engendering a high degree of risk aversion among business executives that was constraining capital spending and hiring. Despite a weakening in the exchange value of the dollar, sluggish economic growth among

major trading partners spelled difficulties for U.S. exports, and a rebound in foreign output seemed more likely to follow than to lead a rebound at home. Moreover, economic slack that was larger and more persistent than previously anticipated ran the risk of reducing core inflation appreciably further from already low levels. Given these considerations, the Committee lowered its target for the federal funds rate  $\frac{1}{2}$  percentage point, to  $1\frac{1}{4}$  percent. The relatively aggressive adjustment in the stance of monetary policy was deemed to offset the potential for greater economic weakness, and the Committee accordingly announced that it judged risks to the outlook as balanced with respect to its long-run goals of price stability and sustainable economic growth.

When the FOMC met on December 10, overall conditions in financial markets had calmed considerably. Indicators of production and spending, however, remained mixed. The manufacturing sector registered large job losses in the autumn, and industrial production continued its slide, which had begun around midyear. A more vigorous rebound in business fixed investment was not evident, and indeed the recent data on orders and shipments and anecdotal reports from business contacts generally signaled continued softness in capital spending. Very low home mortgage interest rates were supporting residential construction activity, but consumption expenditures were sluggish. On balance, the Committee's view was that in the absence of major shocks to consumer and business confidence, a gradual strengthening of the economic expansion was likely over the coming quarters, especially given the very accommodative stance of monetary policy and probable further fiscal stimulus. The FOMC left the federal funds rate

unchanged and indicated that it continued to view the risks to the outlook as balanced over the foreseeable future.

By the time of the FOMC meeting on January 28–29, 2003, it had become apparent that the economy had grown only slowly in the fourth quarter of last year, but little evidence of cumulating weakness appeared in the most recent data, and final demand had held up reasonably well. The escalation of global tensions weighed heavily on business and investor sentiment. Firms apparently were remaining very cautious in their hiring and capital spending, and equity prices had declined on balance since the December meeting. But yield spreads on corporate debt—especially for riskier credits—narrowed further, and longer-term Treasury yields declined slightly. Although the fundamentals still pointed to favorable prospects for economic growth beyond the near term, geopolitical developments were making it especially difficult to gauge the underlying strength of the economy, and uncertainties about the economic outlook remained substantial. Against this background, the Committee decided to leave the federal funds rate unchanged and stated that it continued to judge the risks to the outlook as balanced.

### **Economic Projections for 2003**

An unusual degree of uncertainty attends the economic outlook at present, in large measure, but not exclusively, because of potential geopolitical developments. But Federal Reserve policymakers believe the most probable outcome for this year to be a pickup in the pace of economic expansion. The central tendency of the real GDP forecasts made by the members of the Board of Governors and the Federal Reserve Bank presidents is  $3\frac{1}{4}$  percent to

$3\frac{1}{2}$  percent, measured as the change between the final quarter of 2002 and the final quarter of this year. The full range of these forecasts is 3 percent to  $3\frac{3}{4}$  percent. Of course, neither the central tendency nor the range is intended to convey the uncertainties surrounding the individual forecasts of the members. The civilian unemployment rate is expected to end the year in the  $5\frac{3}{4}$  percent to 6 percent range.

Apart from the geopolitical and other uncertainties, the forces affecting demand this year appear, on balance, conducive to a strengthening of the economic expansion. Monetary policy remains highly accommodative, and federal fiscal policy is and likely will be stimulative. However, spending by many state and local governments will continue to be restrained by considerable budget difficulties. Activity abroad is expected to improve this year, even if at a less robust pace than in the United States; such growth together with the improving competitiveness of U.S. products should generate stronger demand for our exports. Furthermore, robust gains in productivity, though unlikely to be as large as in 2002, ought to continue to promote both household and business spending. Household purchasing power should be supported as well by a retreat in the price of imported energy products that is suggested by the oil futures market. And the adverse effects on household spending from past declines in equity wealth probably will begin to wane.

A reduction of businesses' hesitancy to expand investment and hiring is critical to the durability of the expansion, and such a reduction should occur gradually if geopolitical risks ease and profitability improves. Inventories are relatively lean, and some restocking ought to help boost production this year, albeit to a much smaller extent than did

Economic Projections for 2003

Percent

Indicator	MEMO: 2002 actual	Federal Reserve Governors and Reserve Bank presidents	
		Range	Central tendency
<i>Change, fourth quarter to fourth quarter<sup>1</sup></i>			
Nominal GDP .....	4.1	4½–5½	4¾–5
Real GDP .....	2.8	3–3¾	3¼–3½
PCE chain-type price index .....	1.9	1¼–1¾	1¼–1½
<i>Average level, fourth quarter</i>			
Civilian unemployment rate .....	5.9	5¾–6	5¾–6

1. Change from average for fourth quarter of previous year to average for fourth quarter of year indicated.

last year’s cessation of sharp inventory liquidations. In addition, the continued growth of final sales, the tax law provision for partial expensing of equipment purchases, replacement demand, and a more hospitable financial environment should induce many firms to increase their capital spending. The growth of investment likely will be tempered, however, by the persistence of excess capital in some areas, notably the telecommunications sector, and reductions in business spending on many types of new structures may continue this year.

Federal Reserve policymakers believe that consumer prices will increase less this year than in 2002, especially if energy prices partly reverse last year’s sharp rise. In addition, resource utilization likely will remain sufficiently slack to exert further downward pressure on underlying inflation. The central tendency of FOMC members’ projections for increases in the chain-type price index for personal consumption expenditures (PCE) is 1¼ percent to 1½ percent this year, lower than the actual increase of about 2 percent in 2002. ■



## *Economic and Financial Developments in 2002 and Early 2003*

In 2002, the United States economy extended the upturn in activity that began in late 2001. Real GDP increased 2¾ percent over the four quarters of last year, according to the advance estimate from the Commerce Department. However, the pace of activity was uneven over the course of the year, as concerns about emerging economic and political developments at times weighed heavily on an economy already adjusting to a succession of shocks from previous years.

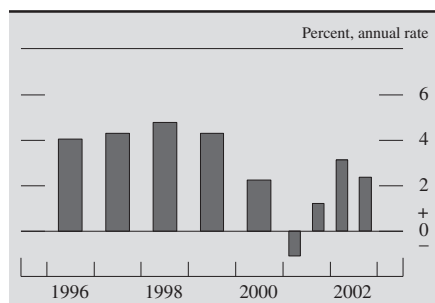
Economic conditions improved through the first part of the year. Household spending on both personal consumption items and housing remained solid, businesses curtailed their inventory liquidation and began to increase their outlays for some types of capital equipment, and private employment started to edge higher. But the forward momentum diminished noticeably later in the year when concerns about corporate governance put a damper on finan-

cial markets and geopolitical developments boosted oil prices and added to the uncertainty already faced by businesses about the economic outlook. In the summer, equity prices fell, risk spreads widened, and liquidity eroded in corporate debt markets. Businesses' caution was reflected in their reluctance to substantially boost investment, restock inventories, or add to payrolls. Responding to these developments, as well as some weakening in demand from abroad, manufacturers trimmed production during the fall. Employment at private businesses declined again, and the unemployment rate rose to 6 percent in December. However, despite the modest pace of last year's overall recovery, output per hour in the nonfarm business sector grew 3¾ percent over the year—an extraordinary increase even by the standards of the past half decade or so.

Signals on the trajectory of the economy as we enter 2003 remain mixed. Some of the factors that had noticeably restrained the growth of real GDP in the fourth quarter of last year—most especially a sharp decline in motor vehicle production—are not on track to be repeated. Moreover, employment leveled off on average in December and January, and readings on industrial production have had a somewhat firmer tone of late. Nevertheless, the few data in hand suggest that the economy has not yet broken out of the pattern of subpar performance experienced over the past year.

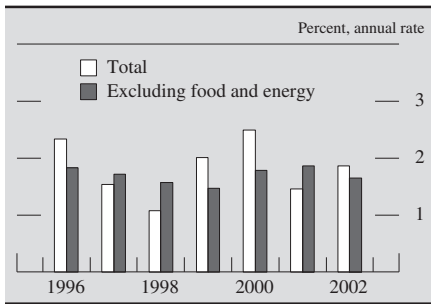
Consumer price inflation moved up a bit last year, reflecting sharply higher

Change in Real GDP



NOTE. Here and in subsequent charts, except as noted, annual changes are measured from Q4 to Q4, and change for a half-year is measured between its final quarter and the final quarter of the preceding period.

Change in PCE Chain-Type Price Index



NOTE: The data are for personal consumption expenditures (PCE).

energy prices. Excluding the prices of food and energy items, the price index for personal consumption expenditures increased 1¾ percent, about ¼ percentage point less than in 2001; this deceleration most likely resulted from continued slack in labor and product markets, robust gains in productivity, and somewhat lower expectations of future inflation.

**The Household Sector**

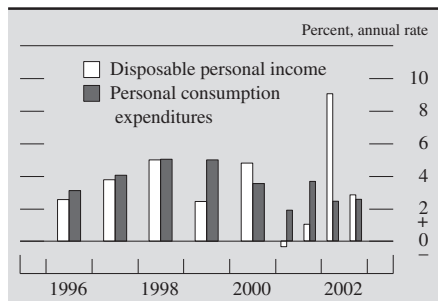
**Consumer Spending**

Consumer spending grew at a moderate pace last year and, on the whole, continued to be an important source of support for overall demand. Personal consumption expenditures rose 2½ percent in real terms, near the 2¾ percent increase in 2001 and down from the more than 4 percent average growth over the preceding several years. Sales of new motor vehicles fell only a little from the extremely high levels of late 2001; outlays were especially strong during the summer and late in the year, when manufacturers were offering aggressive price and financing incentives. Growth of spending on other durable goods was well maintained last year as well, although the gains were smaller than is

often seen early in an economic recovery; in contrast to the situation in many previous cycles, spending on durable goods did not decline sharply during the recession and so had less cause to rebound as the recovery got under way. Apart from outlays on durable goods, spending for most categories of consumer goods and services increased at a moderate rate last year.

That moderate rate of aggregate consumption growth was the product of various crosscurrents. On the positive side, real disposable personal income rose nearly 6 percent last year, the fastest increase in many years. Strong productivity growth partially offset the effects of stagnant employment in restricting the growth of household income, and the phase-in of additional tax reductions from the Economic Growth and Tax Relief Reconciliation Act of 2001 boosted household purchasing power appreciably. In addition, high levels of mortgage refinancing allowed homeowners to reduce their monthly payments, pay down more costly consumer credit, and, in many cases, extract equity that could be used to support other spending. On the negative side, household wealth again moved lower last year, as continued reductions in equity values outweighed further appreciation of house prices. By the end of

Change in Real Income and Consumption



the third quarter, according to the Federal Reserve's flow-of-funds accounts, the ratio of household net worth to disposable income had reversed nearly all of its run-up since the mid-1990s.

Consumer confidence, which had declined during most of 2001 and especially after the September 11 attacks, picked up in the first half of last year, according to both the Michigan Survey Research Center (SRC) and Conference Board surveys. However, confidence retreated over the summer along with the drop in equity prices, and by early this year, consumer confidence again stood close to the levels of late 2001. These levels of consumer confidence, though at the bottom of readings of the past several years, are nevertheless above levels normally associated with recession.

The personal saving rate, which has trended notably lower since the early 1980s, moved above 4 percent by late last year after having averaged 2¼ percent in 2001. The saving rate has been buffeted during the past two years by surges in income induced by tax cuts and by spikes in spending associated with variations in motor vehicle incentives. But, on balance, the extent of the increase in the saving rate has been roughly consistent with a gradual response of consumption to the reduction in the ratio of household wealth to disposable income.

### Residential Investment

Real expenditures on residential investment increased 6 percent in 2002—the largest gain in several years. Demand for housing was influenced by the same factors affecting household spending more generally, but it was especially supported by low interest rates on mortgages. Rates on thirty-year fixed-rate mortgages, which stood at around 7 per-

cent in the first months of the year, fell to around 6 percent by the autumn and dipped below that level early this year—the lowest in thirty-five years. Not surprisingly, attitudes toward homebuying, as measured by the Michigan SRC, remained quite favorable.

Starts of new single-family homes were at 1.36 million units last year, 7 percent above the already solid pace for 2001. Sales of both new and existing homes were brisk as well. Home prices continued to rise but at a slower rate than in 2001, at least according to some measures. The repeat-sales price index for existing homes rose 5½ percent over the four quarters ended in 2002:Q3, a slowing from the 8¾ percent increase over the comparable year-earlier period. The constant-quality price index for new homes rose 4½ percent last year, but this increase was close to the average pace over the past few years. At the same time, measures of house prices that do not control for the mix of homes sold rose considerably more last year than in 2001, a difference indicating that a larger share of transactions were in relatively expensive homes.

In the multifamily sector, starts averaged a solid 345,000 units last year, an amount in line with that of the preceding several years. However, the pace of building slowed a little in the fall. Apartment vacancy rates moved notably higher last year and rent and property values declined; these changes suggest that the strong demand for single-family homes may be eroding demand for apartment space.

### Household Finance

Households continued to borrow at a rapid pace last year; the 9¼ percent increase in their debt outstanding was the largest since 1989. Low mortgage interest rates helped spur both very

strong home purchases and refinancing of existing loans, which together increased home mortgage debt 11½ percent. Refinancing activity was especially elevated in the fourth quarter, when fixed mortgage interest rates dipped to around 6 percent. Torrid refinancing activity helps explain last year's slowdown of consumer credit, which is household borrowing not secured by real estate: A significant number of households reportedly extracted some of the equity from their homes at the time of refinancing and used the proceeds to repay other debt as well as to finance home improvements and other expenditures. According to banks that participated in the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices in October, the frequency and size of cash-out refinancings were substantially greater than had been reported in the January 2002 survey. Although automakers' financing incentives and attractive cash rebates stimulated a substantial amount of consumer borrowing, the growth rate of consumer credit in 2002, at 4¼ percent, was more than 2½ percentage points below the pace in 2001.

Even though households took on a large amount of mortgage debt last year, extraordinarily low mortgage rates kept the servicing requirement for that debt (measured as a share of homeowners' disposable income) well below its previous peak levels. Moreover, reflecting large gains in residential real estate values, equity in homes has continued to increase despite sizable debt-financed extractions. The combined influence of low interest rates and the sizable gain in disposable personal income also kept the total servicing costs faced by households—which in addition to home mortgage payments include costs of other financial obligations such as rental payments of tenants, consumer install-

ment credit, and auto leases—relative to their incomes below previous peaks. Against this backdrop, broad measures of household credit quality deteriorated very little last year, and signs of financial stress were confined mainly to the subprime segment of the market. Delinquency rates on home mortgages inched up, while those on auto loans at finance companies were flat. Delinquency rates on credit cards bundled into securitized asset pools remained close to those of recent experience.

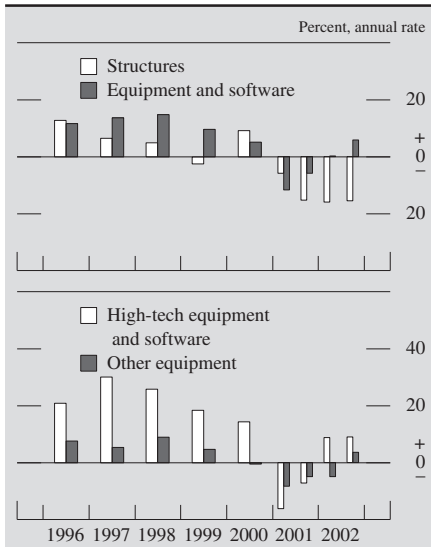
## **The Business Sector**

Overall business fixed investment moved lower last year, although the decline was not nearly so precipitous as in 2001. Outlays for equipment and software edged up, but spending on structures fell sharply. Financing conditions worsened over the summer, with equity prices declining, initial public offerings (IPOs) drying up, credit market spreads widening, and banks tightening up somewhat on credit standards in the wake of increased reports of corporate malfeasance. In addition, geopolitical concerns increased firms' already heightened uncertainty about the economic outlook. These factors contributed to an apparent deterioration in business confidence, and businesses still have not felt any great urgency to boost investment appreciably. For similar reasons, although firms slowed their rate of inventory liquidation last year, they have yet to undertake a sustained restocking.

## **Fixed Investment**

After dropping sharply in 2001, real spending on equipment and software rose 3 percent last year. Spending on high-technology equipment, one of the hardest-hit sectors in 2001, showed signs of uneven improvement. The

## Change in Real Business Fixed Investment



NOTE. High-tech equipment consists of computers and peripheral equipment and communications equipment.

clearest rebound was in computing equipment, for which spending rose 25 percent in real terms; this gain fell short of the increases posted in the late 1990s but far more than reversed the previous year's decline. Software investment also turned positive, rising 6 percent after declining about 3 percent in 2001. By contrast, real outlays for communications equipment were reported to be up only slightly in 2002 after plummeting 30 percent in 2001.

Business spending on aircraft fell sharply last year. Airlines were hit especially hard by the economic downturn and by the reduction in air travel after the September 11 attacks; although expenditures for new aircraft held up through the end of 2001 because of the very long lags involved in producing planes, shipments of planes slowed greatly thereafter. Meanwhile, business outlays on motor vehicles edged up last year. Demand for autos and light trucks

by rental companies weakened sharply along with the drop in air traffic that occurred after September 11 but recovered gradually over the course of last year. Purchases of medium and heavy trucks fell off overall, despite the fact that demand for heavy (class 8) trucks was boosted by spending in advance of the implementation of more-stringent environmental regulations.

Investment in equipment other than high-tech and transportation goods moved modestly higher through most of last year, as real outlays for industrial machinery and a wide range of other equipment gradually strengthened through the summer. Although spending edged lower again in the fourth quarter, investment in non-high-tech, nontransportation equipment increased 3½ percent for the year as a whole.

Spending on equipment and software was supported last year by low interest rates, which helped hold down the cost of capital, as did the tax provision enacted in March 2002 that allows partial expensing of new equipment and software purchased before September 11, 2004. Moreover, modest increases in final sales together with replacement demand no doubt spurred many firms to make new capital outlays. Nevertheless, some sectors, most notably telecommunications, probably still had excess holdings of some forms of capital. Concerns about corporate malfeasance, which had become more intense over the spring and summer, weighed heavily on financial markets and raised the cost of capital through reduced share prices and higher yields on the bonds of lower-rated firms. In addition, uncertainty about the geopolitical situation, including the possible consequences for oil prices of an outbreak of war with Iraq, likely made many firms reluctant to commit themselves to new expenditures. In all, busi-

nesses have been, and appear to remain, quite cautious about undertaking new capital spending projects.

Real business spending for nonresidential structures declined sharply for a second year in 2002. Outlays for the construction of office buildings and industrial buildings were especially weak. Vacancy rates for such buildings increased throughout the year, and property values and rents moved lower. Construction of new hotels and motels also fell considerably, reflecting the weakness in the travel industry. By contrast, spending on other commercial buildings, such as those for retail, wholesale, and warehouse space, moved only a little lower last year.

A number of factors likely account for investment in structures having been much weaker than investment in equipment. Structures depreciate very slowly, so businesses can defer new outlays without incurring much additional deterioration of their capital stock. And unlike investment in equipment, spending on structures is not eligible for partial expensing. According to some analysts, concerns about additional acts of terrorism (and, until late in the year, the lack of insurance to cover such events) may also have had a damping effect on some types of construction, particularly large “trophy” projects.

### Inventory Investment

The sharp inventory runoffs that characterized the economic downturn, together with gradually rising final sales, implied that, by early last year, stocks were in much better alignment with sales than had been the case during 2001. Accordingly, businesses lessened the pace of inventory liquidation early in the year and by summer had turned to some modest restocking. However, firms appeared to have exerted tight control

over production and inventories; with prospects for the strength of the recovery having diminished in the second half of the year, businesses quickly cut production, and inventories only edged up in the fourth quarter, according to incomplete and preliminary data. In all, total inventories were about unchanged last year compared with a liquidation of more than \$60 billion in 2001, and this turnaround contributed 1 percentage point to the growth of real GDP over the year. At year-end, inventory-to-sales ratios in most sectors stood near the low end of their recent ranges.

In the motor vehicle industry, last year’s very strong sales were matched by high levels of production, and the stock of inventories, especially for light trucks, appeared at times to be higher than the industry’s desired levels. Nevertheless, the surge in sales late in the year helped to pare stocks, and dealers ended the year with inventories of light vehicles at a comfortable level.

### Corporate Profits and Business Finance

The profitability of the U.S. nonfinancial corporate sector improved from its lows of 2001 but relative to sector output remained at the low end of the range experienced over the past thirty years. Economic profits of nonfinancial corporations—that is, book profits adjusted for inventory valuations and capital consumption allowances—rebounded in late 2001 and were little changed through the third quarter of last year. The sluggish expansion of aggregate demand and the lack of pricing power associated with intense competitive pressures were the main factors that held down profits in 2002. Also playing a role, especially in the manufacturing sector, were costs arising from underfunded defined-benefit pension plans.

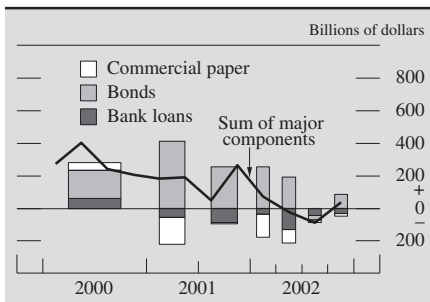
Reflecting the pause in economic growth, earnings reports for the fourth quarter indicate that profits may have dropped some late in the year.

A dearth of expenditures on fixed capital and moribund merger and acquisition activity were the chief culprits behind the sluggish pace of nonfinancial corporate borrowing last year. Also important was the propensity of some firms to draw on liquid assets—which began the year at high levels—rather than to seek external financing. Consequently, debt of the nonfinancial corporate sector expanded only 1½ percent, a rate slower than the already subdued pace in 2001. The composition of business borrowing was dominated last year, as it was in 2001, by longer-term sources of funds. Robust demand for higher-quality corporate debt on the part of investors, combined with the desire of firms to lock in low interest rates, prompted investment-grade corporations to issue a large volume of bonds during the first half of 2002. With funding needs limited, investment-grade issuers continued to use the proceeds to strengthen their balance sheets by refinancing higher-coupon bonds and by paying down short-term obligations

such as bank loans and commercial paper. Buoyed by declining yields, gross issuance of below-investment-grade bonds for the most part also held up well during the first half, although this segment of the market was hit hard after revelations of corporate malfeasance, as investors shunned some of the riskiest issues; issuance was especially weak in the beleaguered telecom and energy sectors, which continue to be saddled with overcapacity and excessive leverage. Despite falling share prices, seasoned equity offerings were also well maintained over the first half of the year, in part because of the decision of some firms—especially in the telecom and energy sectors—to reduce leverage. IPOs, by contrast, were sparse. The evaporation of cash-financed mergers and acquisitions and desire by firms to conserve cash kept equity retirements at their slowest pace since 1994.

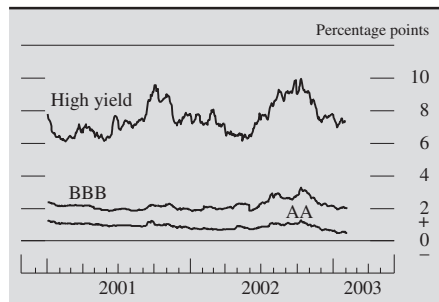
Over the summer, investors grew more reluctant to buy corporate bonds because of concerns about the reliability of financial statements, deteriorating credit quality, and historically low recovery rates on defaulted speculative-grade debt. Macroeconomic data suggesting that the economic recovery was

Major Components of Net Business Financing



NOTE. Seasonally adjusted annual rate for nonfarm nonfinancial corporate business. The data for the sum of major components are quarterly. The data for 2002:Q4 are estimated.

Spreads of Corporate Bond Yields over the Ten-Year Treasury Yield



NOTE. The data are daily and extend through February 5, 2003. The spreads compare the yields on the Merrill Lynch AA, BBB, and 175 indexes with the yield on the ten-year off-the-run Treasury note.

losing momentum and widespread company warnings about near-term profits pushed yields on speculative-grade debt sharply higher. Risk spreads on investment-grade bonds also widened appreciably in the third quarter, as yields in that segment of the corporate bond market declined less than those on Treasury securities of comparable maturity. Investors' aversion to risk was also heightened by mounting tensions with Iraq; by early autumn, risk spreads on junk-rated bonds reached their highest levels in more than a decade. Gross bond issuance both by investment-grade and below-investment-grade firms fell off markedly, and the amount of redemptions was large. By the third quarter, net issuance of bonds by non-financial corporations had turned negative for the first time since the early 1950s. Trading conditions in the corporate bond market deteriorated during this period, as bid-asked spreads reportedly widened in all sectors. With share prices dropping and stock market volatility increasing, issuance of seasoned equity nearly stalled in the summer and early autumn. IPOs were virtually nonexistent amid widely publicized investigations into the IPO allocation process at large investment banks.

A smattering of more upbeat news about the economy in mid-autumn and the absence of major revelations of corporate wrongdoing sparked a rally in equity prices and rekindled investors' appetite for corporate debt. Over the remainder of the year and during early 2003, risk spreads narrowed considerably on investment-grade corporate bonds—especially for the lowest rated of these issues—and even more on speculative-grade bonds, although they remained high by historical standards. In the meantime, liquidity in the corporate bond market generally improved. A brightening of investor sentiment

caused a rebound in gross bond issuance, with firms continuing to use bond proceeds to refinance long-term debt and to pay down short-term debt. Rising stock prices and reduced volatility also allowed seasoned equity issuance to regain some ground in the fourth quarter. The improved tone in corporate debt markets carried over into early 2003. Gross corporate bond issuance continued at a moderate pace, and despite the drop in stock prices in the latter half of January, seasoned equity issuance has been reasonably well maintained. IPO activity and venture capital financing, however, remained depressed.

The heavy pace of bond issuance, sagging capital expenditures, and diminished merger and acquisition activity allowed firms to pay down large amounts of both business loans at banks and commercial paper last year. The runoff in business loans that started in early 2001 intensified in the first half of 2002. At the same time, commercial paper issuers that were perceived as having questionable accounting practices encountered significant investor resistance, and most of these issuers discontinued their programs. Bond rating agencies stepped up the pressure on firms to substitute longer-term debt for shorter-term debt and thereby reduce rollover risk. In addition, banks raised the total cost of issuing commercial paper by tightening underwriting standards and boosting fees and spreads on the associated backup lines of credit—especially for lower-rated issuers. In doing so, respondents to the April Senior Loan Officer Opinion Survey on Bank Lending Practices cited heightened concerns about the deterioration of issuers' credit quality and a higher probability of lines being drawn. Many commercial paper issuers either turned to longer-term financing or dropped out of the credit markets altogether, and the volume



of nonfinancial commercial paper outstanding shrank about one-fourth during the first six months of the year after having dropped one-third in 2001.

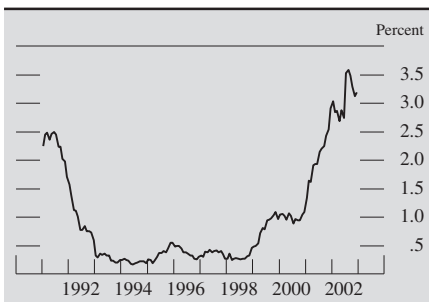
The volatility that gripped equity and bond markets around midyear, however, did not spill over to the commercial paper market. Quality spreads in the commercial paper market were largely unaffected, in part because many of the riskiest issuers had already exited the market, while others had strengthened their cash positions and significantly reduced rollover risk earlier in the year. Indeed, because of difficulties in the corporate bond market, some nonfinancial firms turned temporarily to the commercial paper market to obtain financing, and the volume of outstanding paper rose in July after a lengthy period of declines. Over the remainder of the year, business loans at banks and commercial paper outstanding contracted rapidly, as inventory investment remained negligible, and firms continued to take advantage of relatively low longer-term interest rates by issuing bonds.

A decline in market interest rates and improved profitability helped reduce the ratio of net interest payments to cash

flow in the nonfinancial corporate sector last year. Even so, many firms struggled to service their debt, and corporate credit quality deteriorated markedly. The trailing average default rate on corporate bonds, looking back over the preceding twelve months, was already elevated and climbing when WorldCom's \$26 billion default in July propelled the average rate to a record level. The amount of nonfinancial corporate debt downgraded by Moody's Investors Service last year was more than fourteen times the amount upgraded. At less than 25 percent, the average recovery rate in 2002 on all defaulted bonds—as measured by the price of bonds at default—was at the low end of recovery rates over the past decade. Delinquency rates on business loans at commercial banks rose noticeably before stabilizing in the second half of the year, and charge-off rates remained quite high throughout 2002.

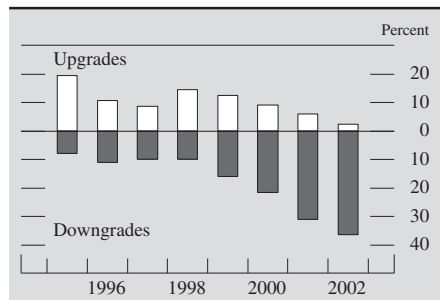
After expanding rapidly in 2001, commercial mortgage debt grew much more slowly during the first quarter of last year, as business spending on non-residential structures fell. Despite the continued contraction in outlays on non-residential structures, commercial mort-

Default Rate on Outstanding Bonds



NOTE. The default rate is monthly and extends through December 2002. The rate for a given month is the face value of bonds that defaulted in the twelve months ending in that month divided by the face value of all bonds outstanding at the end of the calendar quarter immediately preceding the twelve-month period.

Ratings Changes of Nonfinancial Corporations



NOTE. Data are at an annual rate. Debt upgrades (downgrades) are expressed as a percentage of par value of all bonds outstanding.

SOURCE. Moody's Investors Service.

gage debt accelerated over the remainder of the year, apparently because of refinancing to extract a significant portion of equity from existing properties. The issuance of commercial-mortgage-backed securities (CMBS), a key source of commercial real estate financing in recent years, was well maintained in 2002. Even as office vacancy rates rose, the quality of commercial real estate credit remained stable last year. Commercial banks firmed standards on commercial real estate loans in 2002, on net, and delinquency rates on commercial real estate loans at banks stayed at historically low levels. Delinquency rates on CMBS leveled off after increasing appreciably in late 2001, and forward-looking indicators also do not suggest elevated concerns about prospective defaults: Yield spreads on CMBS over swap rates remained in the fairly narrow range that has prevailed over the past several years.

## **The Government Sector**

### **Federal Government**

Despite modest economic growth, the federal budget position deteriorated sharply in 2002. After running a unified budget surplus of \$127 billion in fiscal 2001, the federal government posted a deficit of \$158 billion in fiscal 2002—and that deficit would have been \$23 billion larger if not for the shifting of some corporate tax payments from fiscal 2001 to fiscal 2002. After adjustment for that tax shifting, receipts declined 9 percent in fiscal 2002: A \$50 billion drop in corporate payments stemmed largely from tax provisions enacted in the 2002 stimulus bill (especially the partial-expensing provision on investment), and a decline in individual tax payments of \$136 billion was largely attributable to a drop in capital gains

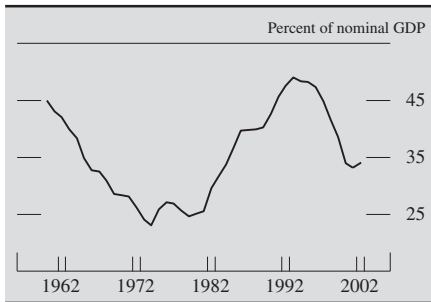
realizations and to lower tax rates that were enacted in the 2001 tax bill.

Meanwhile, federal outlays increased nearly 8 percent in fiscal 2002 and 11 percent excluding a decline in net interest expenses. Spending increased notably in many categories, including defense, homeland security, Medicaid, and income security (which includes the temporary extended unemployment compensation program). Federal government consumption and investment—the part of spending that is counted in GDP—rose more than 7 percent in real terms in 2002. (Government spending on items such as interest payments and transfers are not counted in GDP because they do not constitute a direct purchase of final production.)

The turn to deficit in the unified budget means that the federal government, which had been contributing to national saving since 1997, began to reduce national saving last year. The reversal more than offset an increase in saving by households and businesses, and gross national saving declined to 15 percent of GDP by the third quarter of last year—the lowest national saving rate since the 1940s.

After it reentered the credit markets as a significant borrower of net new funds in the second half of 2001, the Treasury continued to tap markets in volume last year. Federal net borrowing was especially brisk over the first half of the year. With federal debt rapidly approaching its statutory borrowing limit, the Secretary of the Treasury declared a debt ceiling emergency on May 16 and identified about \$80 billion worth of accounting measures that could be used to create financing room within the existing \$5.95 trillion limit. The Secretary's announcement and subsequent employment of one of these devices—in which Treasury securities held in government trust funds were temporarily

### Federal Government Debt Held by the Public



NOTE. Through 2001, the data for debt are year-end figures and the corresponding value for GDP is for Q4 at an annual rate; the final observation is for 2002:Q3. Excludes securities held as investments of federal government accounts.

replaced by Treasury IOUs not subject to the debt ceiling—had little effect on Treasury yields, as market participants were apparently confident that the ceiling would be raised in time to avoid default. And indeed, the Congress approved legislation raising the statutory borrowing limit to \$6.4 trillion on June 27. With its credit needs remaining substantial, the Treasury continued to borrow heavily over the second half of 2002. The increase in the Treasury's net borrowing last year caused the ratio of publicly held debt to nominal GDP to rise for the first time since 1993.

### State and Local Governments

State and local governments have continued to struggle in response to sluggish growth of receipts. In the current fiscal year (which ends June 30 for most states), most state governments are reported to be facing significant shortfalls. Although a variety of strategies may be available for the purpose of technically complying with balanced-budget requirements, including tapping nearly \$20 billion in combined rainy-day and general fund balances and turn-

ing to the capital markets, many states will be forced to boost revenues and hold the line on spending.

Real expenditures for consumption and gross investment by state and local governments rose less than 2 percent in 2002—the smallest increase in ten years. The slowdown in spending growth was widespread across expenditure categories and included notably smaller increases in outlays for construction. Employment in the state and local sector continued to rise in 2002, but at a slower rate than in recent years.

Debt of the state and local government sector expanded last year at the fastest pace since 1987. Governments used the proceeds to finance capital spending and to refund existing debt in advance. Net issuance of short-term municipal bonds was also well maintained, as California and some other states facing fiscal difficulties turned to shorter-term borrowing while fashioning more permanent solutions to their budget problems. Worsening budget situations contributed to some deterioration in municipal credit quality last year. Credit-rating downgrades outpaced upgrades by a significant margin, and the yield spread of BBB-rated over insured AAA-rated municipal bonds rose significantly over the second half of 2002.

### The External Sector

The U.S. current account deficit widened again in 2002 after a brief respite during the cyclical slowdown in 2001. Two-thirds of the expansion of the deficit last year was attributable to a decline in the balance on goods and services, although net investment income also fell sharply as receipts from abroad declined more than payments to foreign investors in the United States. The broad exchange value of the dollar peaked

around February 2002 after appreciating about 13 percent in real terms from January 2000; in early February 2003 it was down about 5 percent from the February 2002 level.

### Trade and the Current Account

Both exports and imports rebounded in 2002 as the cyclical downturn of the previous year was reversed and spending on travel recovered from the post-September 11 slump. As is often the case, the amplitude of the recent cycle in trade has been greater than that of real GDP. In 2001, stagnant real GDP in the United States and abroad was coupled with declines of 11½ percent in real exports and 8 percent in real imports. Last year, moderate growth of both foreign and domestic real GDP was exceeded by gains of 5 percent and 9 percent, respectively, in our real exports and imports. The faster growth of imports relative to exports over the past two years was consistent with the historical pattern in which the responsiveness of imports to income is greater in the United States than in the rest of the world. Although the dollar depreciated on balance last year, the lagged effects of its prior appreciation over the two previous years contributed to the faster growth in imports relative to exports in 2002.

Real exports of goods posted a strong gain in the second quarter of 2002 after six consecutive quarters of decline. However, as output growth slowed abroad, exports decelerated in the third quarter and then fell in the fourth quarter. On balance, exports of goods rose about 2 percent over the course of the year, reversing only a small portion of the previous year's decline. Not surprisingly, the increase in goods exports in 2002 was concentrated in the destinations where GDP growth was

strongest—Canada, Mexico, and several developing Asian economies. A gain of 12 percent in real exports of services in 2002 more than reversed the previous year's decline and reflected both a pickup in tourism and an increase in other private services. Export prices turned up in the second quarter after a year of decline and continued to rise at a moderate pace in the second half.

The very rapid growth of real imports of goods in the first half of last year was a reaction to the revival of U.S. activity, and they gained about 9 percent over the year. The particularly large gains in imports of consumer goods and automotive products reflected the buoyancy of U.S. consumption expenditures. Imports of most major categories of capital goods also increased on balance over the year. However, as with exports, import growth was considerably stronger in the first half of the year than in the second. This pattern likely reflected the deceleration in U.S. GDP, along with the effects of some depreciation of the dollar. In addition, there may have been some shifting of import demand from later in the year to the earlier months as it began to appear more likely that labor contract negotiations at West Coast ports would not go smoothly.<sup>1</sup> Imports of services more than reversed their 2001 decline over the course of the year, and gains were recorded for both travel and other private services. Prices of non-oil imports turned up in the second quarter after declining over the preceding four quar-

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1. The dispute between the Pacific Maritime Association and the International Longshore and Warehouse Union eventually led to an eleven-day port closure in late September and early October that ended when President Bush invoked the Taft-Hartley Act. Although the monthly pattern of trade was influenced by the closure, the overall level of imports for the year does not appear to have been much affected.

ters, as a result of the weaker exchange rate and a turnaround in prices of internationally traded commodities.

The spot price of West Texas intermediate crude oil climbed above \$35 per barrel in early 2003, its highest level since the beginning of 2000. Oil prices had fallen to around \$20 per barrel during 2001 amid general economic weakness, but they began rising in February and March of last year in response to both improving global economic activity as well as a production-limiting agreement between OPEC and several major non-OPEC producers. Even though production in a number of OPEC and non-OPEC countries in fact exceeded the agreed limits last year, heightened tensions in the Middle East along with severe political turmoil in Venezuela continued to put upward pressure on prices. The pressure intensified late in the year as a strike in Venezuela that began on December 2 virtually shut down that country's oil industry, and Venezuelan oil production was still well below pre-strike levels in early 2003. Concern over a possible war with Iraq, along with a very low level of crude oil inventories in the United States, has helped to keep spot prices high. Also in response to the heightened tensions, the price of gold shot up about 30 percent over the past year.

### The Financial Account

The increase in the current account deficit in 2002 was about equal on balance to the stepped-up foreign official purchases of U.S. assets, as changes in the components of private capital flows were offsetting. Private foreign purchases of U.S. securities were about \$360 billion at an annual rate through November, a volume similar to last year's total. However, there was some shift in the composition of flows away

from equities and toward Treasury securities. This shift may have reflected the damping of equity demand caused by slower economic growth and continued concern about corporate governance and accounting. Over the same period, purchases by private U.S. investors of foreign securities declined nearly \$100 billion. Accordingly, the net balance of private securities trading recorded a sharp increase in net inflows.

In contrast, net foreign direct investment inflows fell about \$70 billion between 2001 and 2002. Foreign investment in the United States and investment abroad by U.S. residents both declined, but the decline in flows into the United States was considerably larger, as merger activity slowed and corporate profits showed little vigor. U.S. direct investment abroad held up fairly well in 2002, a result largely reflecting retained earnings.

## The Labor Market

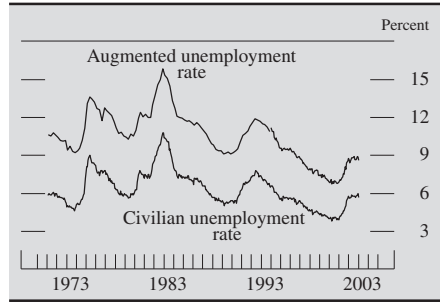
### Employment and Unemployment

Labor markets appeared to stabilize last spring after the sharp deterioration of 2001 and early 2002. Employment on private payrolls, which had declined an average of 160,000 per month in 2001, leveled off in the spring and moved slightly higher over the summer. But labor demand weakened again as the economy softened later in the summer, and private employment declined about 80,000 per month on average in the last four months of the year. Private payrolls rebounded nearly 150,000 in January, though the magnitude of both the especially sharp decline in December and the rebound in January likely was exaggerated by difficulties in adjusting for the normal seasonal movements in employment during these months.

The manufacturing sector continued to be the weakest segment of the labor market; even during the spring and early summer, when the overall labor market seemed to be improving, factory payrolls contracted on average. Declines in factory employment were more pronounced—at about 50,000 per month—toward the end of the year. Employment at help-supply firms and in wholesale trade—two sectors in which activity closely tracks that of manufacturing proper—rose over the summer but also turned down again later in the year. And employment in retail trade, though quite erratic, leveled off over the summer before declining further in the fall. However, employment in services other than help supply grew reasonably steadily throughout the year and rose nearly 50,000 per month after March; health services and education services contributed more than half of those job gains. The finance and real estate sectors also added jobs last year, probably because of the surge in mortgage refinancings and high levels of activity in housing markets. Last year’s job losses in the private sector were partially offset by an increase in government employment that averaged about 20,000 per month; the increase resulted mostly from hiring by states and municipalities, but it also reflected hiring in the fall by the Transportation Security Administration.

Overall employment moved lower, on net, and the unemployment rate increased a little less than ½ percentage point over the year, to 6 percent, before dropping back to 5.7 percent in January 2003. The unemployment rate probably has been boosted slightly by the federal temporary extended unemployment compensation program. By extending benefits for an additional three months, the program allows unemployed individuals whose regular bene-

Measures of Labor Utilization



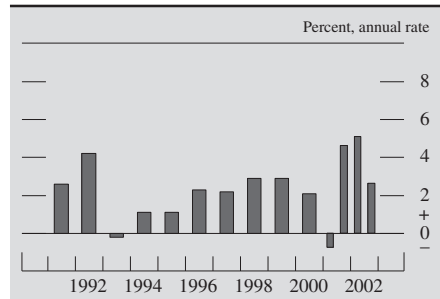
NOTE. The data extend through January 2003. The civilian rate is the number of civilian unemployed divided by the civilian labor force. The augmented rate adds to the numerator and the denominator of the civilian rate the number of those who are not in the labor force but want a job. The small break in the augmented rate in January 1994 arises from the introduction of a redesigned survey. For the civilian rate, the data are monthly; for the augmented rate, the data are quarterly through December 1993 and monthly thereafter.

fits have expired to be more selective in accepting job offers and provides them with an incentive not to withdraw from the labor force. In addition, as would be expected in a still-weak labor market, the labor force participation rate moved lower last year.

Productivity and Labor Costs

Labor productivity rose impressively in 2002. Output per hour in the nonfarm business sector increased an estimated

Change in Output Per Hour



NOTE. Nonfarm business sector.

3¾ percent from the fourth quarter of 2001 to the fourth quarter of 2002. Labor productivity typically suffers in an economic downturn as businesses reduce hours worked by proportionally less than the decline in output; conversely, productivity typically rebounds early in an expansion as labor is brought back toward fuller utilization. During the most recent downturn, however, productivity held up comparatively well, a performance that makes last year's surge all the more impressive. Indeed, productivity rose at an average annual rate of nearly 3 percent over the past two years, faster than the average pace of increase during the late 1990s.

Very likely, the rapid pace of last year's productivity growth was due in part to the special circumstances that developed after the September 11 attacks. Businesses cut labor substantially in late 2001 and early 2002 amid widespread fear of a sharp decline in demand; when demand held up better than expected, businesses proved able to operate satisfactorily with their existing workforces. Moreover, the fact that this step-up in productivity was not reversed later in the year suggests that at least a portion of it is sustainable. The recent rapid growth in productivity may derive in part from ongoing improvements in the use of the vast amount of capital installed in earlier years, and it may also stem from organizational innovations induced by the weak profit environment.

Indicators of hourly compensation sent mixed signals last year. The rise in the employment cost index (ECI) for hourly compensation in private nonfarm businesses, 3¼ percent, was 1 percentage point lower than the increase in 2001. Compensation increases likely were damped last year by the soft labor market and expectations of lower consumer price inflation. The wages and salaries component and the benefits

component of the ECI both posted smaller increases last year. The deceleration was less pronounced for the benefits component, however, which was boosted by further large increases in employers' health insurance costs. According to the ECI, health insurance costs, which constitute about 6 percent of overall compensation, rose 10 percent last year after having risen about 9 percent in each of the preceding two years.

An alternative measure of compensation costs is compensation per hour in the nonfarm business sector, which is derived from information in the national income and product accounts. According to this measure, hourly compensation rose 4¼ percent last year—a little more than the increase in the ECI and up from a much smaller increase in 2001. One important difference between these two measures of compensation is that the ECI omits stock options, while nonfarm compensation per hour captures the value of these options upon exercise. The very small increase in the latter measure in 2001 likely reflects, in part, a drop in option exercises in that year, and the larger increase in 2002 may point to a firming, or at least to a smaller rate of decline, of these exercises.

## **Prices**

The chain-type price index for personal consumption expenditures (PCE) rose about 2 percent last year, compared with an increase of 1½ percent in 2001. This step-up in consumer price inflation resulted from a jump in energy prices. Outside of the energy sector, consumer price inflation was pushed lower last year by continued slack in labor and product markets as well as by expectations of future inflation that appeared to be lower in 2002 than in most of 2001. The increase in PCE prices excluding food and energy, which was just 1¾ per-

## Alternative Measures of Price Change

Percent

Price measure	2001	2002
<i>Chain-type</i>		
Gross domestic product .....	2.0	1.3
Gross domestic purchases .....	1.3	1.6
Personal consumption expenditures .....	1.5	1.9
Excluding food and energy ...	1.9	1.7
Chained CPI .....	1.2	1.9
Excluding food and energy ...	1.8	1.6
<i>Fixed-weight</i>		
Consumer price index .....	1.9	2.3
Excluding food and energy ...	2.7	2.1

NOTE. Changes are based on quarterly averages and are measured to the fourth quarter of the year indicated from the fourth quarter of the preceding year.

cent, was about  $\frac{1}{4}$  percentage point less than in 2001. The price index for GDP was less affected by last year's rise in energy prices than was the PCE measure; much of the energy price increase was attributable to higher prices of imported oil, which are not included in GDP because they are not part of domestic production. On net, GDP prices rose only  $\frac{1}{4}$  percent last year, a deceleration of  $\frac{3}{4}$  percentage point that reflected not just the deceleration in core consumer prices but also considerably smaller increases for prices of construction.

The upturn in consumer energy prices in 2002 was driven by a jump in crude oil prices. Gasoline prices increased some 25 percent from December 2001 to December 2002; prices of fuel oil increased considerably as well. By contrast, consumer prices of natural gas posted only a modest rise after declining sharply in 2001, and electricity prices moved lower. More recently, the rise in crude oil prices since mid-December, together with cold weather, has increased the demand for natural gas and has led to higher spot gas prices; the higher spot prices for both oil and gas are likely to be boosting consumer energy prices early this year.

The PCE price index for food and beverages increased only  $\frac{1}{2}$  percent last year; the increase followed a 3 percent rise in 2001 that reflected supply-related price increases for many livestock products including beef, poultry, and dairy products. But livestock supplies had recovered by early last year, and a drought-induced selloff of cattle herds last summer pushed prices still lower.

The prices of goods other than food and energy items decelerated sharply last year. Prices for apparel, new and used motor vehicles, and a wide range of other durable goods all declined noticeably and, on average, at a faster pace than in 2001. Price increases for services were much larger than for goods and slowed less from the previous year. Both tenants' rent and the imputed rent of owner-occupied housing—categories that account for a sizable share of services—rose significantly less last year than they did in 2001. But many other services prices posted increases in 2002 that were about the same as in 2001. Information on medical prices was mixed. According to the CPI, the price of medical services continued to accelerate, rising  $5\frac{1}{2}$  percent last year. But the increase in the PCE measure of medical services prices was less than 3 percent, a smaller increase than in 2001. One reason for this difference is that the prices of services paid for by Medicare and Medicaid are included in the PCE index but not in the CPI (because services provided by Medicare and Medicaid do not represent out-of-pocket costs to consumers and so are outside of the CPI's scope), and Medicare reimbursement rates for physicians were reduced last year.

Despite the acceleration in medical prices in the CPI but not in the PCE price index, the CPI excluding food and



energy decelerated notably more than did the core PCE price index between 2001 and 2002. The two price measures differ in a number of respects, but much of last year's greater deceleration in the CPI can be traced to the fact that the CPI suffers from a form of "substitution bias" that is not present in the PCE index. The CPI, being a fixed-weight price index, overstates increases in the cost of living because it does not adequately take into account the fact that consumers tend to substitute away from goods that are rising in relative price; by contrast, the PCE price index does a better job of taking this substitution into account. Last year, the Bureau of Labor Statistics began to publish a new index called the chained CPI; like the PCE price index, the chained CPI does a more complete job of taking consumer substitution into account, but it is otherwise identical to the official CPI. In 2001, an unusually large gap between increases in the official CPI and the chained CPI arose, pointing to very large substitution bias in the official CPI in that year. This gap narrowed in 2002, indicating that substitution bias declined between the two years. (Final estimates of the chained CPI are not yet available; the currently available data for both 2001 and 2002 are preliminary and subject to revision.)

Survey measures of expected inflation generally ran a little lower in 2002 than in 2001. According to the Michigan SRC, median one-year inflation expectations plummeted after the September 11 attacks, but by early 2002, expectations returned to the 2<sup>3</sup>/<sub>4</sub> percent range that had prevailed during the previous summer. These expectations gradually moved lower over the course of last year and now stand around 2<sup>1</sup>/<sub>2</sub> percent. Meanwhile, the Michigan SRC's measure of five- to ten-year inflation expectations remained steady at about

2<sup>3</sup>/<sub>4</sub> percent during 2002, a rate a little lower than the 3 percent inflation expectations that had prevailed through most of 2001.

## **U.S. Financial Markets**

Developments in financial markets last year were shaped importantly by sharp declines, on net, in equity prices and most long-term interest rates and by periods of heightened market volatility. In contrast to 2001, when the Federal Reserve eased the stance of monetary policy eleven times, last year saw one reduction in the intended federal funds rate—in early November—and interest rates on short-term Treasury securities had moved little until then. Longer-term interest rates, by contrast, were more volatile. Investors' optimism about future economic prospects pressured longer-term Treasury bond yields higher early in 2002. But as the year progressed, that optimism faded when the economy failed to gather much momentum, and longer-term Treasury yields ended the year appreciably lower. Softer-than-expected readings of the economic expansion, a marked deterioration in corporate credit quality, concerns about corporate governance, and heightened geopolitical tensions made investors especially wary about risk. Lower-rated firms found credit substantially more expensive, as risk spreads on speculative-grade debt soared for most of the year before narrowing somewhat over the last few months. Even for higher-quality firms, risk spreads widened temporarily during the tumultuous conditions that prevailed in financial markets over the summer. In addition, commercial banks tightened standards and terms for business borrowers, on net, in 2002, and risk spreads on business loans remained in an elevated range throughout the year. Increased caution

on the part of investors was particularly acute in the commercial paper market, where the riskiest issuers discontinued their programs.

Federal borrowing surged last year, while private borrowing was held down by the significantly reduced credit needs of business borrowers. Declines in longer-term interest rates during the first half of the year created incentives for both businesses and households to lock in lower debt-service obligations by heavily tapping corporate bond and home mortgage markets, respectively. While mortgage borrowing remained strong, businesses sharply curtailed their issuance of longer-term debt during the second half of 2002 amid the nervousness then prevailing in the financial markets.

### Interest Rates

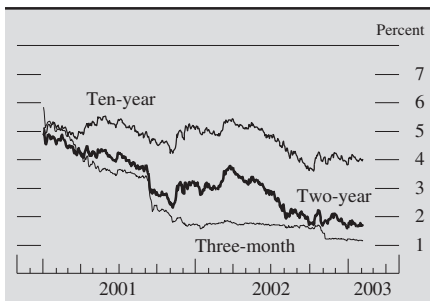
Reflecting an unchanged stance of monetary policy over most of last year, short-term market interest rates moved little until early November, when the FOMC lowered the target federal funds rate ½ percentage point, and other short-term interest rates followed suit. Yields on intermediate- and long-term Treasury securities, by contrast, declined

as much as 1½ percentage points, on net, in 2002. Longer-term interest rates began last year under upward pressure, as signs that the economy had bottomed out started to nudge rates higher in the final weeks of 2001. Positive economic news pushed interest rates up appreciably further during the first quarter of 2002. The increase in longer-term interest rates was consistent with the sharp upward tilt of money market futures rates, which suggested that market participants expected that the FOMC would almost double the intended level of the funds rate by year's end. However, as readings on the strength of the economic expansion came in on the soft side, investors substantially trimmed their expectations for policy tightening, and yields on longer-term Treasury securities turned down in the spring.

The slide in longer-term Treasury yields intensified over the summer amid weaker-than-expected economic data, heightened geopolitical tensions, fresh revelations of corporate malfeasance, and disappointing news about near-term corporate profits. In concert, these developments prompted investors to mark down their expectations for economic growth and, consequently, their anticipated path for monetary policy. A widespread retrenchment in risk-taking sent yields on speculative-grade corporate bonds sharply higher and kept those on the lower rungs of investment grade from declining, even as longer-term nominal Treasury yields fell to very low levels by the end of July.

The uneventful passing of the Securities and Exchange Commission's August 14 deadline for officers of large companies to certify corporate financial statements somewhat assuaged investors' anxieties about corporate governance problems. But subsequent news suggesting that the economy was losing momentum and a flare-up in ten-

Interest Rates on Selected Treasury Securities



NOTE. The data are daily and extend through February 5, 2003.

sions with Iraq further boosted demand for Treasury securities. The FOMC's decision at the August meeting—to leave the intended federal funds rate unchanged but to judge the balance of risks to the outlook as weighted toward economic weakness—pulled the expected path of the funds rate lower, and longer-term Treasury yields sank to forty-year lows in early autumn. A high degree of investor uncertainty about the future path of monetary policy was evidenced by implied volatilities of short-term interest rates derived from option prices, which soared to record levels in early autumn. The size of the FOMC's November cut in the target federal funds rate and the shift to balance in its assessment of risks surprised market participants, but the policy easing appeared to lead investors to raise the odds that the economy would pick up from its sluggish pace. Generally positive economic news and rising equity prices over the remainder of the year also bolstered confidence and prompted market participants to mark up the expected path for monetary policy and push up longer-term Treasury yields.

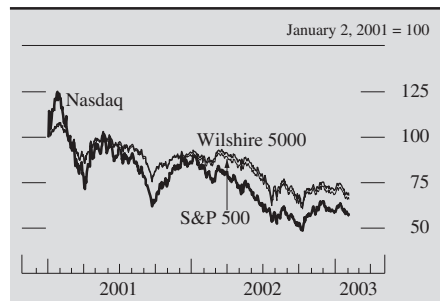
Yields on higher-quality investment-grade corporate bonds generally tracked those on Treasuries of comparable maturity last year, although risk spreads on these instruments widened moderately over the summer and early autumn before narrowing over the remainder of the year. Interest rates on below-investment-grade corporate debt, by contrast, increased for much of last year, as spreads over Treasuries ballooned in response to mounting concerns about corporate credit quality, historically low recovery rates on defaulted bonds, and revelations of improper corporate governance; credit risk spreads widened in all speculative sectors but especially in telecom and energy. By the summer, investors' retreat from risk-taking had wid-

ened bid-asked spreads in the corporate bond market enough to impair trading. Risk spreads on speculative-grade bonds narrowed considerably over the year's final quarter and in early 2003, though they remain elevated by historical standards; risk spreads for the weaker speculative-grade credits remain exceptionally wide, as investors evidently anticipate a continued high level of defaults and low recovery rates.

### Equity Markets

Equity prices were buffeted last year by considerable fluctuations in investors' assessments of the outlook for the economy and corporate earnings and by doubts about the quality and transparency of corporate balance sheets. Net declines in stock prices in 2002 exceeded those posted during either of the preceding two years. Worries about the pervasiveness of questionable corporate governance and a deterioration in the earnings outlook—especially in the technology sector—depressed equity prices in early 2002. The positive tenor of economic data, however, managed to outweigh those concerns, and stock prices staged a rally halfway through the first quarter, with the gains tilted toward “old economy” firms. But the rebound

### Major Stock Price Indexes



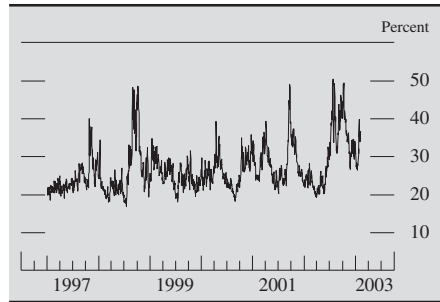
NOTE: The data are daily and extend through February 5, 2003.

was short lived. Share prices started to tumble in early spring across all sectors as weaker-than-expected economic data eroded investors' confidence in the strength of the economic expansion. These developments were reinforced by first-quarter corporate earnings reports that, though mostly matching or exceeding investors' expectations, painted a bleak picture of prospective sales and profits.

Over the spring and summer, accounting scandals, widespread warnings about near-term corporate profitability, and heightened geopolitical tensions intensified the slide in stock prices. Particularly large declines in share prices were posted for technology firms, whose prospects for sales and earnings were especially gloomy. Equity prices were boosted briefly by the uneventful passing of the August 14 deadline to certify financial statements, but they quickly reversed course on continued concerns about the pace of economic growth and corporate earnings and the escalating possibility of military action against Iraq. By early October, equity indexes sank to their lowest levels since the spring of 1997, and implied stock price volatility on the S&P 100 surged to its highest reading since the stock market crash of 1987. The drop in stock prices widened the gap between the expected year-ahead earnings-price ratio for the S&P 500 and the real ten-year Treasury yield—one simple measure of the equity premium—to levels not seen since the mid-1990s.

Share prices turned around in late October, as the third-quarter corporate earnings reports were not as weak as investors had originally feared. Equity prices were also given a boost in early November by the larger-than-expected monetary policy easing, and the rally was sustained over the remainder of the year by the generally encouraging tone

### Implied S&P 100 Volatility



NOTE. The data are daily and extend through February 5, 2003. The series shown is the implied volatility of the S&P 100 stock price index as calculated from the prices of options that expire over the next several months.

SOURCE. Chicago Board Options Exchange.

of economic data. Greater confidence among investors in the economic outlook also helped bring down the implied volatility on the S&P 100 significantly by year-end, although it remains at an elevated level by historical standards. Despite the fourth-quarter rebound, broad equity indexes were down, on net, about 20 percent in 2002, while the tech-heavy Nasdaq lost more than 30 percent.

The decline in equity prices during the first three quarters of 2002 is estimated to have erased more than \$3½ trillion in household wealth, a loss of nearly 9 percent of total household net worth, although the fourth-quarter rise in stock prices restored about \$600 billion. Still, the level of household net worth at the end of last year was more than 40 percent higher than it was at the start of the bull market in 1995. Equity prices maintained their upward momentum during the first half of January 2003 but then fell sharply amid the looming prospects of military action against Iraq and a still-gloomy outlook for corporate earnings. Broad stock price indexes have lost almost 5 percent this year; however, solid fourth-quarter earnings from many

prominent technology companies helped brighten investors' sentiment regarding that sector, and the Nasdaq is down about 3 percent this year.

### Debt and Financial Intermediation

A deceleration of business borrowing slowed growth of the debt of nonfederal sectors about 1 percentage point in 2002, to 6½ percent. By contrast, the decline in interest rates last year kept borrowing by households and state and local governments brisk. At the federal level, weak tax receipts and an acceleration in spending pushed debt growth to 7½ percent last year after a slight contraction in 2001.

For the year as a whole, corporate borrowing was quite weak, mainly because of sagging capital expenditures, a drying up of merger and acquisition activity, and a reliance on liquid assets. Although businesses tapped bond markets in volume over the first half of the year, subsequent concerns about the reliability of financial statements and the quality of corporate governance and deteriorating creditworthiness ruined investors' appetite for corporate debt in the summer and early autumn. Households, by contrast, flocked to the mortgage markets to take advantage of low mortgage rates throughout the year, and strong motor vehicle sales supported the expansion of consumer credit. For depository institutions, the net effect of these developments was an acceleration of credit to 6½ percent last year, 2 percentage points above the pace of 2001. The growth of credit at thrift institutions moderated, though the slowdown can be attributed for the most part to a large thrift institution's conversion to a bank charter. The growth of credit at commercial banks accelerated to 6¾ percent—a significant increase from the anemic pace in 2001; the

pickup was driven by large acquisitions of securities, especially mortgage-backed securities, as well as a surge in home equity and residential real estate lending.

By contrast, business lending at commercial banks dropped 7 percent last year after falling almost 4 percent in 2001; last year's decline kept overall loan growth for 2002 to about 5 percent. In the October Senior Loan Officer Opinion Survey on Bank Lending Practices, respondents noted that the decline in commercial and industrial (C&I) lending since the beginning of the year reflected not only the limited funding needs of creditworthy borrowers that found bond financing or a runoff of liquid assets more attractive, but also a reduction in the pool of creditworthy borrowers. Over the course of last year, banks reported some additional net tightening of standards and terms on C&I loans, mainly in response to greater uncertainty about the economic outlook and rising corporate bond defaults, although the proportions of banks that reported doing so declined noticeably. Direct measures of loan pricing conditions from the Federal Reserve's quarterly Survey of Terms of Business Lending also indicated that banks were cautious lenders last year, as the average spread of C&I loan rates over market interest rates on instruments of comparable maturity remained wide, and spreads on new higher-risk loans declined only slightly from the lofty levels that prevailed over the first half of the year. Although bank lenders were wary about business borrowers, especially toward lower-rated credits, they did not significantly constrict the supply of loans: Most small firms surveyed by the National Federation of Independent Businesses in 2002 reported that they experienced little or no difficulty satisfying their borrowing needs.

Loan quality at commercial banks improved overall last year. Loan delinquency rates edged down through the third quarter of 2002—the latest period for which Call Report data are available—in response to better performance of residential real estate and consumer loans and a stable delinquency rate on C&I loans. Despite the improvement in consumer loan quality, domestic banks imposed somewhat more stringent credit conditions when lending to households, according to the survey on bank lending practices. Moderate net proportions of surveyed institutions tightened credit standards and terms for credit card and other consumer loans throughout last year. The net fraction of banks that tightened standards on residential mortgage loans rose late in the year to the highest share in the past decade, but nonetheless remained quite low. Commercial banks generally registered strong profit gains last year, although steep losses on loans to energy and telecommunications firms significantly depressed profits at several large bank holding companies. Despite the increased rate of provisioning for loan losses, the banking sector's profitability stayed in the elevated range recorded for the past several years, as a result of the robust fee income from mortgage and credit card lending, effective cost controls, and the relatively inexpensive funding offered by inflows of core deposits. As of the third quarter of last year, virtually all assets in the banking sector were at well-capitalized institutions, and the substitution of securities for loans on banks' balance sheets helped edge up risk-based capital ratios.

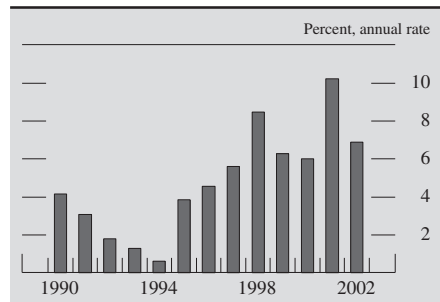
The financial condition of insurance companies, by contrast, worsened notably last year. Both property and casualty insurers and life and health insurers sustained significant investment losses from the decline in equity prices and the

deterioration in corporate credit quality. However, these negative pressures were offset somewhat by the continued strong growth of insurance premiums, and both sectors of the insurance industry stayed fairly well capitalized in 2002.

## Monetary Aggregates

The broad monetary aggregates decelerated noticeably last year after surging in 2001. Short-term market interest rates, which had declined swiftly during 2001, were stable over the first half of the year; deposit rates, in a typical pattern of lagged adjustment, continued to fall. Consequently, the opportunity cost of holding M2 assets increased, especially for its liquid deposit (checking and savings accounts) and retail money fund components, thereby restraining the demand for such assets. After decelerating in the first half of the year, M2 rebounded significantly in the second half, because of a surge in liquid deposits and retail money market mutual funds. The strength in both components partly reflected elevated volatility in equity markets against the backdrop of a still-low opportunity cost of holding such deposits. In addition, another wave

### M2 Growth Rate



NOTE. M2 consists of currency, travelers checks, demand deposits, other checkable deposits, savings deposits (including money market deposit accounts), small-denomination time deposits, and balances in retail money market funds.

of mortgage refinancing boosted M2 growth during this period. (Refinancings cause prepayments to accumulate temporarily in deposit accounts before being distributed to investors in mortgage-backed securities.) All told, over the four quarters of the year, M2 increased 7 percent, a pace that exceeded the expansion of nominal income. As a result, M2 velocity—the ratio of nominal GDP to M2—declined for the fifth year in a row, roughly in line with the drop in the opportunity cost of M2 over this period.

Reflecting in part the slowing of its M2 component, M3—the broadest money aggregate—expanded 6½ percent in 2002, a pace well below the 12¾ percent advance posted in 2001. Growth in M3 was also held down by a sharp deceleration of institutional money funds, as their yields dropped to close alignment with short-term market interest rates. This effect was only partly offset by the pickup in needs to fund bank credit, which resulted in an acceleration in the issuance of managed liabilities, including large time deposits. M3 velocity continued to decline in 2002.

### New Discount Window Programs

On October 31, 2002, following a three-month public comment period, the Board of Governors approved changes to its Regulation A that established two new types of loans to depository institutions—primary and secondary credit—and discontinued the adjustment and extended credit programs. The new programs were implemented on January 9, 2003. The seasonal credit program was not altered.

The primary reason for adopting the new programs was to eliminate the subsidy to borrowing institutions that was implicit in the basic discount rate, which

since the late 1960s had usually been set below market interest rates. The subsidy required Federal Reserve Banks to administer credit extensions heavily in order to ensure that borrowing institutions used credit only in appropriate circumstances—specifically, when they had exhausted other reasonably available funding sources. That administration was necessarily somewhat subjective and consequently difficult to apply consistently across Reserve Banks. In addition, the heavy administration was one factor that caused depository institutions to become reluctant to use the window even in appropriate conditions. Also, depository institutions were concerned at times about being marked with a “stigma” if market analysts and counterparties inferred that the institution was borrowing from the window and suspected that the borrowing signaled that the institution was having financial difficulties. The resulting reluctance to use the window reduced its usefulness in buffering shocks to the reserve market and in serving as a backup source of liquidity to depository institutions, and thus undermined its performance as a monetary policy tool.

To address these issues, the Board of Governors specified that primary credit may be made available at an above-market interest rate to depository institutions in generally sound financial condition. The above-market interest rate eliminates the implicit subsidy. Also, restricting eligibility for the program to generally sound institutions should reduce institutions’ concerns that their borrowing could signal financial weakness.

The Federal Reserve set the initial primary credit rate at 2.25 percent, 100 basis points above the FOMC’s target federal funds rate as of January 9, 2003. The target federal funds rate remained unchanged, and thus the adop-

tion of the new programs did not represent a change in the stance of monetary policy. In the future, the primary credit rate will be adjusted from time to time as appropriate, using the same discretionary procedure that was used in the past to set the adjustment credit rate. The Federal Reserve also established procedures to reduce the primary credit rate to the target federal funds rate in a national emergency, even if key policymakers are unavailable.

Institutions that do not qualify for primary credit may obtain secondary credit when the borrowing is consistent with a prompt return to market sources of funds or is necessary to resolve severe financial difficulties. The interest rate on secondary credit is set by formula 50 basis points above the primary credit rate. The rate was set initially at 2.75 percent. Because secondary credit borrowers are not in sound financial condition, extensions of secondary credit usually involve some administration.

## **International Developments**

The international economy rebounded in 2002 after a stagnant performance in 2001, but recovery was uneven in both timing and geographical distribution. Growth abroad picked up sharply in the first half of last year, as a strong rally in the high-tech exporting economies in developing Asia was joined by robust growth in Canada and, to a lesser extent, Mexico. Japan also posted respectable growth in the first half, largely as a result of a surge of exports. However, performance in the euro area remained sluggish, and several South American economies experienced difficulties, with full-fledged crises in Argentina and Venezuela and mounting concerns about prospects for Brazil. As the U.S. economy decelerated in the second half, the

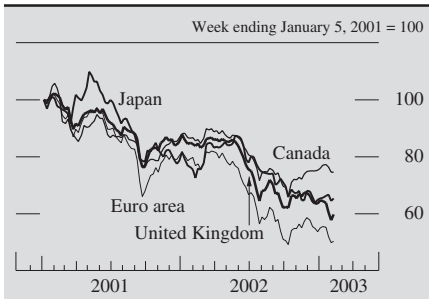
rapid pace of recovery slowed in developing Asia and in Canada, while performance remained lackluster in much of the rest of the world.

Monetary policy actions abroad also diverged across countries in 2002 as authorities reacted to differing economic conditions. In Canada, official interest rates were raised in three steps by July amid concerns that buoyant domestic demand and sharply rising employment would ignite inflationary pressures. Monetary authorities in Australia and Sweden also increased policy rates in the first half of the year. However, as economic conditions weakened around the world in the second half, official interest rates were held constant in Canada and Australia and were lowered in Sweden. Monetary policy was held steady throughout 2002 in the United Kingdom, where growth was moderate and inflation subdued, but official interest rates were lowered 25 basis points, to 3.75 percent, in early February 2003 in response to concerns about the prospects for global and domestic demand. The European Central Bank (ECB) held rates constant through most of the year, as inflation remained above the ECB's 2 percent target ceiling, but rates were lowered 50 basis points in December as the euro area's already weak recovery appeared to be stalling. Japanese short-term interest rates remained near zero, while authorities took some limited further steps to stimulate demand through nontraditional channels. Monetary policy was tightened in both Mexico and Brazil in response to concerns about the inflationary effects of past currency depreciation.

Yield curves in the major foreign industrial countries steepened and shifted up in the first quarter of 2002 in response to generally favorable economic news, but later they flattened out and moved back down as the outlook



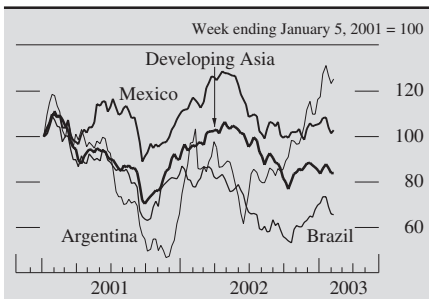
### Equity Indexes in Selected Foreign Industrial Countries



NOTE. The data are weekly. The last observations are the average of trading days through February 5, 2003.

deteriorated. Similarly, equity prices in the major foreign industrial economies held up well early in the year but then declined along with the U.S. stock market and ended the year down sharply from the previous year. The performance of the stock markets in the emerging-market economies was mixed. Share prices in Brazil and Mexico fell sharply in the second and third quarters but then showed some improvement toward the end of the year. In the Asian emerging-market economies, equity prices rose in the first half of 2002 on a general wave of optimism, especially in the high-technology producing econo-

### Equity Indexes in Selected Emerging Markets



NOTE. The data are weekly. The last observations are the average of trading days through February 5, 2003.

mies; equity prices began to decline around midyear as global demand softened but posted modest rebounds late in the year.

The foreign exchange value of the dollar continued its mild upward trend into the early part of 2002, as it appeared that the United States was poised to lead a global economic recovery. However, the dollar weakened sharply in the late spring and early summer amid deepening concerns about U.S. corporate governance and profitability. Around that time market analysts also appeared to become more worried about the growing U.S. current account deficit and its potential negative influence on the future value of the dollar. The dollar rebounded somewhat around midyear as growth prospects for other major economies, particularly in the euro area, appeared to dim; the dollar dropped back again late in the year, as geopolitical tensions intensified, and continued to depreciate in early 2003. In nominal terms the dollar has declined about 5 percent on balance over the past year, with depreciations against the currencies of the major industrial countries and several of the developing Asian economies partly offset by appreciation against the currencies of several Latin American countries.

### Industrial Economies

The Canadian economy recorded the strongest performance among the major foreign industrial countries last year despite some slowing in the second half. The strength, which was largely home-grown, reflected robust growth of consumption and residential construction as well as an end to inventory runoffs early in the year. The expansion was accompanied by very rapid increases in employment and utilization of capacity, and the core inflation rate breached the

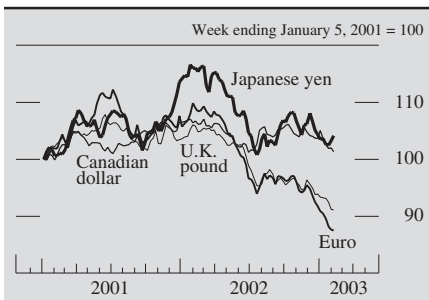
upper end of the government's 1 percent to 3 percent target range near the end of the year. The Canadian dollar appreciated against the U.S. dollar in the first half of the year, but it dropped back somewhat in the second half as the economy slowed; by the end of the year it was up only slightly on balance. The Canadian dollar has moved up somewhat more so far this year.

The Japanese economy recorded positive growth during 2002, although it was not enough to fully reverse the decline in output that occurred in 2001. Despite about 10 percent appreciation of the yen against the dollar in 2002, Japanese growth was driven largely by exports, with smaller contributions from both increased consumption and a slower pace of inventory reduction. In contrast, private investment continued to decline, although not as sharply as in 2001. Labor market conditions remained quite depressed, and consumer prices continued to fall. Little progress was made on the serious structural problems that have plagued the Japanese economy, including the massive and growing amount of bad loans on the books of Japanese banks. A new set of official measures that aims at halving the value of bad loans within two and a half years was

announced in the fall, but the details of this plan are still not fully specified. In September, the Bank of Japan announced a plan to buy shares from banks with excessive holdings of equity, which would help to reduce bank exposure to stock market fluctuations. Because the transactions are to occur at market prices, there would be no net financial transfer to the banks. Near the end of last year the Bank of Japan (BOJ) raised its target range for bank reserves at the BOJ from ¥10–15 trillion to ¥15–20 trillion, increased the monthly amount of its outright purchases of long-term government bonds, and broadened the range of collateral that can be used for market operations. In December the monetary base was up about 20 percent from a year earlier, a rise partially reflecting the increased level of bank reserves at the BOJ. However, the twelve-month rate of base money growth was considerably below the 36 percent pace registered in April. Broad money growth remains subdued.

Economic performance in the euro area was quite sluggish last year. Although exports were up sharply, growth in consumption was modest, and private investment declined. The area's lackluster economic performance pushed the unemployment rate up by several tenths of a percentage point by the end of the year. Economic weakness was particularly pronounced in some of the larger countries—Germany, Italy, the Netherlands, and, to a lesser extent, France. In contrast, growth in Spain and some of the smaller euro-area countries—Ireland, Portugal, Finland, and Greece—was much more robust. Headline inflation jumped to a bit above 2½ percent early in the year, owing to higher food and energy prices and in small part to the introduction of euro notes and coins. Increased slack in the economy, however, together with the

U.S. Dollar Exchange Rate against Selected Major Currencies



NOTE. The data are weekly. Exchange rates are in foreign currency units per dollar. Last observations are the average of trading days through February 5, 2003.

15 percent appreciation of the euro by the end of the year, helped to mitigate inflation concerns, and the ECB lowered its policy interest rate in December. The euro continued to appreciate in early 2003.

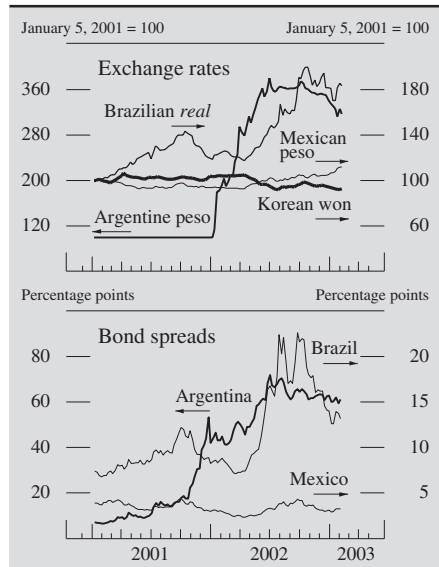
Economic growth in the United Kingdom held up better than in the other major European countries last year, and sterling strengthened about 10 percent versus the dollar. However, the expansion remained uneven, with the services sector continuing to grow more rapidly than the smaller manufacturing sector. Despite tight labor markets, inflation remained a bit below the Bank of England's target of 2½ percent for most of the past year. A sharp rise in housing prices has, however, raised some concern about the possibility of a real estate price bubble. The British government announced its intention to complete a rigorous assessment of its criteria for joining the European Monetary Union (EMU) by the middle of this year and, if they are met, to hold a referendum on entry.

### Emerging-Market Economies

The Brazilian economy posted a surprisingly strong rebound in 2002 despite a major political transition and accompanying turbulence in financial markets. The Brazilian *real* depreciated sharply between May and October, and sovereign bond spreads climbed to 2,400 basis points as it became increasingly likely that Luiz Inácio Lula da Silva (Lula), the Workers' Party candidate, would win the presidential election. Given some of the past stances of the party, this possibility fueled concerns among foreign investors about a potential erosion of fiscal and monetary discipline. In response to the sharp deterioration in financial conditions facing Brazil, a \$30 billion IMF program was

approved in September 2002, \$6 billion of which was disbursed by the end of the year. However, financial conditions improved markedly after Lula won the election in late October and appointed a cabinet perceived to be supportive of orthodox fiscal and monetary policies, including greater central bank independence. By January 2003 the *real* had reversed about one-fourth of its previous decline against the dollar, and bond spreads had fallen sharply. However, the new administration still faces some major challenges. In particular, serious concerns remain over the very large quantity and relatively short maturity of the outstanding government debt. In addition, last year's currency depreciation fueled a rise in inflation that has

U.S. Dollar Exchange Rates and Bond Spreads for Selected Emerging Markets



NOTE. The data are weekly averages that are indexed to the week ending January 5, 2001. Exchange rates (top panel) are in foreign currency units per dollar. Bond spreads (bottom panel) are the J.P. Morgan Emerging Market Bond Index (EMBI+) spreads over U.S. Treasuries. Last observations are the average of trading days through February 5, 2003.

prompted several increases in the monetary policy interest rate. In January the government raised the upper bound of its inflation target range for this year to 8.5 percent from 6.5 percent, although the target for next year was lowered at the same time to 5.5 percent from 6.25 percent.

Argentine GDP contracted further in 2002 after declining 10 percent in 2001. The currency board arrangement that had pegged the peso at a one-to-one rate with the dollar collapsed early last year; the peso lost nearly three-fourths of its value by late June, and sovereign bond spreads spiked to more than 7,000 basis points. By early 2002, the banking system had become effectively insolvent as a result of the plunging peso, the weak economy, and the government's default on debt that the banks held mostly involuntarily. Confronted with this situation, the government forced the conversion of the banks' dollar-denominated assets and liabilities to pesos and also mandated the rescheduling of a large share of deposits. As a result of these and other measures, confidence in the banking system, already shaken, was further impaired. Financial and economic conditions eventually stabilized in the second half of the year, but there are no signs yet of a sustained recovery. The government also defaulted on obligations to multilateral creditors in late 2002 and early 2003. In January, Argentina and the International Monetary Fund reached agreement on a \$6.6 billion short-term program that will go to meeting Argentina's payments to the IMF at least through the elections expected in the spring and also to clearing its overdue obligations to the multilateral development banks.

Venezuela experienced extreme economic and political turmoil over the past year. In February 2002 the central bank abandoned the bolivar's crawling peg to

the dollar, and the bolivar depreciated sharply. Opponents of President Hugo Chavez mounted a short-lived coup in April and declared a national strike in early December. The strike brought the already-weak economy to a standstill, and output in the key oil industry plummeted. The strike abated in early February in all sectors but oil. In response to the strike, Chavez increased his control of the state-owned oil company and oil production began rising in early 2003, but it was still well below pre-strike levels. With the exchange rate plunging in late January, the government suspended currency trading for two weeks before establishing a fixed exchange rate regime and some restrictions on foreign currency transactions.

One of the few bright spots in Latin America last year was the Mexican economy. Boosted by the U.S. recovery, growth was moderate for the year as a whole despite some late slowing. However, financial conditions deteriorated somewhat after midyear as market participants reevaluated the strength of the North American recovery. Mexican stock prices slid about 25 percent between April and September, and sovereign bond spreads widened nearly 200 basis points to around 430 basis points over the same period. Nevertheless, the Mexican economy did not appear to be much affected by spillovers from the problems elsewhere in Latin America; bond spreads dropped sharply between October and the end of the year to around 300 basis points, a level considerably lower than elsewhere in the region. The peso depreciated about 12 percent against the dollar over the course of last year. The decline fueled an increase in twelve-month inflation to more than 5½ percent by year-end. The acceleration put inflation above the government target rate of 4½ percent and well above the ambitious 3 percent tar-

get set for 2003. In response to increasing inflation, the Bank of Mexico has tightened monetary policy four times since September 2002. The peso has continued to depreciate in early 2003, and bond spreads have moved back up a bit.

The Asian emerging-market economies generally performed well in 2002, although there were significant differences within the region. Outside of China, the strongest growth was recorded in South Korea, which benefited in the first half of the year from both an upturn in global demand for high-tech products and a surge in domestic demand, particularly consumption. However, consumer confidence deteriorated at the end of the year as tensions over North Korea intensified; the uneasy situation, as well as the substantial existing consumer debt burden, pose significant risks to growth in consumption this year. The Korean won appreciated sharply against the dollar between April and midyear in response to improving economic conditions; it then dropped back in late summer and early fall as perceptions about the strength of the global recovery were adjusted downward. However, the won turned back up against the dollar late last year.

The performance of the ASEAN-5 economies—Indonesia, Malaysia, the Philippines, Singapore, and Thailand—also was generally robust in 2002, although the overall softening in global demand in the second half of the year was evident there as well. The second-half slowing in production was particularly pronounced in Singapore, which is heavily dependent on exports of high-technology products. Taiwan, another high-technology producer, also showed a significant deceleration in output between the first and second halves of the year. Both of these economies experienced some mild deflation in 2002, although prices turned up toward the end of the year.

Although the Hong Kong economy did not show as much improvement as most other emerging Asian economies in the first half of last year, it recorded very strong growth in the third quarter. Nevertheless, prices continued to fall for the fourth consecutive year. The mainland Chinese economy, which again outperformed the rest of the region in 2002, enjoyed surging investment by the government and by foreign investors as well as robust export growth. The Chinese economy continued to experience mild deflation last year. ■

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## *Monetary Policy Report of July 2002*

### **Monetary Policy and the Economic Outlook**

The pace of economic activity in the United States picked up noticeably in the first half of 2002 as some of the powerful forces that had been restraining spending for the preceding year and a half abated. With inventories in many industries having been brought into more comfortable alignment with sales, firms began boosting production around the turn of the year to stem further run-offs of their stocks. And while capital spending by businesses has yet to show any real vigor, the steep contraction of the past year or so appears to have come to an end. Household spending, as it has throughout this cyclical episode, continued to trend up in the first half. With employment stabilizing, the increases in real wages made possible by gains in labor productivity and the effects of a variety of fiscal actions have provided noticeable support to disposable incomes. At the same time, low interest rates have buoyed the purchase of durable goods and the demand for housing. Growth was not strong enough to forestall a rise in the unemployment rate, and slack in product and labor markets, along with declining unit costs as productivity has soared, has helped to keep core inflation low. The exceptionally strong performance of productivity over the past year provides further evidence of the U.S. economy's expanded capac-

ity to provide growth over the longer haul.

The Federal Reserve had moved aggressively in 2001 to counter the weakness that had emerged in aggregate demand; by the end of the year, it had lowered the federal funds rate to 1¾ percent, the lowest level in forty years. With only tentative signs that activity was picking up, the Federal Open Market Committee (FOMC) decided to retain that unusual degree of monetary accommodation by leaving the federal funds rate unchanged at its January meeting. Confirmation of an improvement in activity was evident by the time of the March meeting, and the FOMC moved toward an assessment that the risks to the outlook were balanced between its long-run goals of price stability and maximum sustainable economic growth, a view maintained through its June meeting. The durability and strength of the expansion were recognized to depend on the trajectory of final sales. The extent of a prospective strengthening of final sales was—and still is—uncertain, however, and with inflation likely to remain contained, the Committee has chosen to maintain an accommodative stance of policy, leaving the federal funds rate at its level at the end of last year.

The economy expanded especially rapidly early in the year. As had been anticipated, much of the first quarter's strength in production resulted from the efforts of firms to limit a further draw-down of inventories after the enormous liquidation in the fourth quarter of 2001. With respect to first-quarter sales, purchases of light motor vehicles dropped back from their extraordinary fourth-

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NOTE. The discussion in this section consists of the text and tables from the Monetary Policy Report submitted to the Congress on July 16, 2002; the charts from this report (as well as earlier reports) are available on the Board's web site, at [www.federalreserve.gov/boarddocs/hh](http://www.federalreserve.gov/boarddocs/hh).

quarter level, but other consumer spending increased substantially. Housing starts, too, jumped early in the year—albeit with the help of weather conditions favorable for building in many parts of the country—and spending on national defense moved sharply higher. All told, real GDP is now estimated to have increased at an annual rate in excess of 6 percent in the first quarter.

Economic activity appears to have moved up further in recent months but at a slower pace than earlier in the year. Industrial production has continued to post moderate gains, and nonfarm payrolls edged up in the second quarter after a year of nearly steady declines. However, several factors that had contributed importantly to the outsized gain of real output in the first quarter appear to have made more modest contributions to growth in the second quarter. Available data suggest that the swing in inventory investment was considerably smaller in the second quarter than in the first. Consumer spending has advanced more slowly of late, and while the construction of new homes has expanded further, its contribution to the growth of real output has not matched that of earlier in the year.

Notable crosscurrents remain at work in the outlook for economic activity. Although some of the most recent indicators have been encouraging, businesses still appear to be reluctant to add appreciably to workforces or to boost capital spending, presumably until they see clearer signs of improving prospects for sales and profits. These concerns, as well as ongoing disclosures of corporate accounting irregularities and lapses in corporate governance, have pulled down equity prices appreciably on balance this year. The accompanying decline in net worth is likely to continue to restrain household spending in the period ahead, and less favorable finan-

cial market conditions could reinforce business caution.

Nevertheless, a number of factors are likely to boost activity as the economy moves into the second half of 2002. With the inflation-adjusted federal funds rate barely positive, monetary policy should continue to provide substantial support to the growth of interest-sensitive spending. Low interest rates also have allowed businesses and households to strengthen balance sheets by refinancing debt on more favorable terms. Fiscal policy actions in the form of lower taxes, investment incentives, and higher spending are providing considerable stimulus to aggregate demand this year. Foreign economic growth has strengthened and, together with a decline in the foreign exchange value of the dollar, should bolster U.S. exports. Finally, the exceptional performance of productivity has supported household and business incomes while relieving pressures on price inflation, a combination that augurs well for the future.

### Monetary Policy, Financial Markets, and the Economy over the First Half of 2002

The information reviewed by the FOMC at its meeting of January 29 and 30 seemed on the whole to indicate that economic activity was bottoming out and that a recovery might already be under way. Consumer spending had held up remarkably well, and the rates of decline in manufacturing production and business purchases of durable equipment and software had apparently moderated toward the end of 2001. In addition, the expectation that the pace of inventory runoff would slow after several quarters of substantial and growing liquidation constituted another reason for anticipating that economic activity would improve in the period imme-

diately ahead. Nonetheless, looking beyond the near term, the FOMC faced considerable uncertainty about the strength of final demand. Because household spending had not softened to the usual extent during the recession, it appeared likely to have only limited room to pick up over coming quarters. Intense competitive pressures were thought to be constraining the growth of profits, which could damp investment and equity prices. At the same time, the outlook for continued subdued inflation remained favorable given the reduced utilization of resources and the further pass-through of earlier declines in energy prices. Taken together, these conditions led the FOMC to leave the stance of monetary policy unchanged, keeping its target for the federal funds rate at  $1\frac{3}{4}$  percent. In light of the tentative nature of the evidence suggesting that the upturn in final demand would be sustained, the FOMC decided to retain its assessment that the more important risk to achieving its long-run objectives remained economic weakness—the possibility that growth would fall short of the rate of increase in the economy's potential and that resource utilization would fall further.

When the FOMC met on March 19, economic indicators had turned even more positive, providing encouraging evidence that the economy was recovering from last year's recession. Consumer spending had remained brisk in the early part of the year, the decline in business expenditures on equipment and software appeared to have about run its course, and housing starts had turned back up. Industrial production, which had been falling for nearly a year and a half, increased in January and February as businesses began to meet more of the rise in sales from current production and less from drawing down inventories. Indications that an expansion had taken

hold led to noticeable increases in broad stock indexes and in long-term interest rates. But the strength of the recovery remained unclear. The outlook for business fixed investment—which would be one key to the strength of economic activity once the thrust from inventory restocking came to an end—was especially uncertain, with anecdotal reports indicating that businesses remained hesitant to enter into major long-term commitments. While the FOMC believed that the fiscal and monetary policies already in place would continue to stimulate economic activity, it considered the questions surrounding the outlook for final demand over the quarters ahead still substantial enough to justify the retention of the current accommodative stance of monetary policy, particularly in light of the relatively high unemployment rate and the prospect that the lack of price pressures would persist. Given the positive tone of the available economic indicators, the FOMC announced that it considered the risks to achieving its long-run objectives as now being balanced over the foreseeable future.

By the time of the May 7 FOMC meeting, it had become evident that economic activity had expanded rapidly early in 2002. But the latest statistical data and anecdotal reports suggested that the expansion was moderating considerably in the second quarter and that the extent to which final demand would strengthen was still unresolved. Business sentiment remained gloomy as many firms had significantly marked down their own forecasts of growth in sales and profits over coming quarters. These revised projections, along with the uncertainty surrounding the robustness of the overall economic recovery, had contributed to sizable declines in market interest rates and weighed heavily on equity prices, which had



dropped substantially between the March and May meetings. The outlook for inflation had remained benign despite some firming in energy prices, as excess capacity in labor and product markets held the pricing power of many firms in check, and the apparent strong uptrend in productivity reduced cost pressures. In these circumstances, the FOMC decided to keep the federal funds rate at its accommodative level of 1¾ percent and maintained its view that, against the background of its long-run goals of price stability and sustainable economic growth, the risks to the outlook remained balanced.

Over the next seven weeks, news on the economy did little to clarify questions regarding the vigor of the ongoing recovery. The information received in advance of the June 25–26 meeting of the FOMC continued to suggest that economic activity had expanded in the second quarter, but both the upward impetus from the swing in inventory investment and the growth in final demand appeared to have diminished. In financial markets, heightened concerns about accounting irregularities at prominent corporations and about the outlook for profits had contributed to a substantial decline in equity prices and correspondingly to a further erosion in household wealth. But some cushion to the effects on aggregate demand of the decline in share prices had been provided by the fall in the foreign exchange value of the dollar and the drop in long-term interest rates. Although the FOMC believed that robust underlying growth in productivity, as well as accommodative fiscal and monetary policies, would continue to support a pickup in the rate of increase of final demand over coming quarters, the likely degree of the strengthening remained uncertain. The FOMC decided to keep unchanged its monetary policy stance and its view

that the risks to the economic outlook remained balanced.

### Economic Projections for 2002 and 2003

The members of the Board of Governors and the Federal Reserve Bank presidents, all of whom participate in the deliberations of the FOMC, expect the economy to expand rapidly enough over the next six quarters to erode current margins of underutilized capital and labor resources. The central tendency of the forecasts for the increase in real GDP over the four quarters of 2002 is

#### Economic Projections for 2002 and 2003

Percent

Indicator	Federal Reserve Governors and Reserve Bank presidents	
	Range	Central tendency
	2002	
<i>Change, fourth quarter to fourth quarter<sup>1</sup></i>		
Nominal GDP .....	4½–5½	4¾–5¼
Real GDP .....	3–4	3½–3¾
PCE chain-type price index .....	1¼–2	1½–1¾
<i>Average level, fourth quarter</i>		
Civilian unemployment rate .....	5½–6¼	5¾–6
	2003	
<i>Change, fourth quarter to fourth quarter<sup>1</sup></i>		
Nominal GDP .....	4½–6	5–5¾
Real GDP .....	3¾–4¼	3½–4
PCE chain-type price index .....	1–2¼	1½–1¾
<i>Average level, fourth quarter</i>		
Civilian unemployment rate .....	5–6	5¼–5½

1. Change from average for fourth quarter of previous year to average for fourth quarter of year indicated.

3½ percent to 3¾ percent, and the central tendency for real GDP growth in 2003 is 3½ percent to 4 percent. The central tendency of the projections of the civilian unemployment rate, which averaged just under 6 percent in the second quarter of 2002, is that it stays close to this figure for the remainder of the year and then moves down to between 5¼ percent and 5½ percent by the end of 2003.

Support from monetary and fiscal policies, as well as other factors, should lead to a strengthening in final demand over coming quarters. Business spending on equipment and software will likely be boosted by rising sales, improving profitability, tax incentives, and by the desire to acquire new capital embodying ongoing technological advances. Improving labor market conditions and a robust underlying trend in productivity growth should further bolster household income and contribute to an uptrend in spending. In addition, the liquidation of last year's inventory overhangs has left businesses in a position to begin rebuilding stocks as they become more persuaded that the recovery in final sales will be sustained.

Most FOMC participants expect underlying inflation to remain close to recent levels through the end of 2003. Core inflation should be held in check by productivity gains that hold down cost increases, a lack of pressure on resources, and well-anchored inflation expectations. Overall inflation, which was depressed last year by a notable decline in energy prices, is likely to run slightly higher this year. In particular, the central tendency of the projections of the increase in the chain-type index for personal consumption expenditures over the four quarters of both 2002 and 2003 is 1½ percent to 1¾ percent, compared with last year's pace of 1¼ percent.

## **Economic and Financial Developments in 2002**

The pace of economic activity picked up considerably in the first half of 2002 after being about unchanged, on balance, in the second half of 2001. Final sales advanced modestly as substantial gains in household and government spending were partly off-set by weak business fixed investment and a widening gap between imports and exports. In addition, inventory liquidation slowed sharply as businesses stepped up production to bring it more closely in line with the pace of final sales. The increase in real GDP was particularly rapid early in the year, with the first-quarter gain elevated by a steep reduction in the pace of the inventory run-off, a surge in defense spending, and a weather-induced spurt in construction. Real GDP is currently estimated to have risen at an annual rate of just over 6 percent in the first quarter and appears to have posted a more moderate gain in the second quarter.

Private payroll employment declined through April, and at midyear the unemployment rate stood somewhat above its average in the fourth quarter of 2001. Core inflation—which excludes the direct influences of the food and energy sectors—remained subdued through May, held down by slack in resource utilization and continued sizable advances in labor productivity. Overall inflation was boosted by a surge in energy prices in March and April, but energy prices have since retreated a bit. Inflation expectations remained in check in the first half of this year.

As judged by declines in most interest rates over the first half of the year, financial market participants have marked down their expectation of the vigor of the economic expansion. Interest rates, along with most equity indexes, rose

noticeably toward the end of the first quarter in reaction to generally stronger-than-expected economic data. But Treasury yields and equity prices more than rolled back those increases on renewed questions about the strength of the rebound in the economy, including growing uncertainty regarding prospective corporate profits and concerns about escalating geopolitical tensions and about the governance and transparency of U.S. corporations. Private demands on credit markets moderated in the first half of the year, as businesses substantially curbed their net borrowing. For the most part, this reduction reflected further declines in business investment, a pickup in operating profits, and a return to net equity issuance. But, in addition, lenders became more cautious and selective, especially for borrowers of marginal credit quality.

Market perceptions that the recovery in the United States might turn out to be less robust than anticipated also put downward pressure on the foreign exchange value of the dollar as measured against the currencies of our major trading partners, especially during the second quarter of 2002. Central banks in some foreign countries, including Canada, tightened policy as growth firmed. The euro-area economy recovered modestly during the first half, and some brighter signs were evident in Japan. In contrast, the dollar strengthened on balance against the currencies of our other important trading partners; in particular, the Mexican peso lost ground, and financial markets reacted to political and economic problems in several South American countries.

### The Household Sector

Household spending began the year on a strong note and continued to rise in the second quarter. Further gains in dis-

posable income have supported a solid underlying pace of spending. The decline in stock prices in the first half of 2002 reduced household wealth, and the debt-service burden remained high, but financial stress among households to date has been limited.

### *Consumer Spending*

Real consumer expenditures increased at an annual rate of 3¼ percent in the first quarter. Demand for motor vehicles dropped from an extraordinary fourth-quarter pace, but purchases remained supported in part by continued large incentive packages. Outlays for other goods and services advanced smartly in the first quarter. In the second quarter, the rate of increase in consumer spending looks to have eased somewhat. Motor vehicle purchases were little changed, and most other major categories of consumer spending likely posted smaller gains than earlier in the year.

Real disposable personal income moved sharply higher in the first quarter and appears to have risen a little further in the second quarter. Wages and salaries have increased only moderately this year. But tax payments have fallen markedly; last year's legislation lowered withheld tax payments again this year, and final payments this spring on tax obligations for 2001 were substantially below last year's level (likely related at least in part to a decline in capital gains realized last year). All told, real disposable income increased at an annual rate of 8 percent between the fourth quarter of last year and May. However, household net worth has likely fallen further because the negative effect of the decline in stock prices has been only partly offset by an apparent continued appreciation in the value of residential real estate. According to the flow of funds accounts, by the end

of the first quarter, the ratio of household net worth to disposable income had reversed close to two-thirds of its run-up in the second half of the 1990s; this ratio has undoubtedly registered additional declines since the end of March. Consumer sentiment improved over the first several months of the year, with indexes from both the Conference Board and the Michigan Survey Research Center reversing last fall's sharp deterioration. However, both indexes have given up some of those gains more recently.

The personal saving rate increased in the first half of this year, as the decline in wealth over the past two years likely held down consumer spending relative to disposable personal income. In May, the saving rate stood at 3 percent of disposable income, up from an average of 1½ percent over 2001. Movements in the saving rate have been very erratic over the past year, reflecting cyclical factors, the timing of tax cuts, and adjustments in incentives to purchase motor vehicles.

### *Residential Investment*

Real residential investment increased at an annual rate of about 15 percent in the first quarter, and the level of activity appears to have remained robust in the second quarter. The first-quarter surge was spurred partly by unseasonably warm and dry winter weather, which apparently encouraged builders to move forward some of their planned construction. At the same time, underlying housing activity has been supported by the gains in income and confidence noted above, and, importantly, by low interest rates on mortgages. In the single-family sector, starts averaged an annual rate of 1.35 million units over the first five months of the year—up 6½ percent from the already buoyant pace registered in 2001. Sales of exist-

ing homes jumped in early 2002 after moving sideways during the preceding three years; sales of new homes have also been running quite high in recent months.

Home prices have continued to move up strongly. For example, over the year ending in the first quarter, the constant-quality price index for new homes rose 5¼ percent, and the repeat-sales price index for existing homes was up 6¼ percent. Despite these increases, low mortgage rates have kept housing affordable. Rates on thirty-year conventional fixed-rate loans averaged less than 7 percent in the first half of this year, and rates on adjustable-rate loans continued the downtrend that began in early 2001. The share of median household income required to finance the purchase of a median-price house is close to its average for the past ten years and well below the levels that prevailed in the 1970s and 1980s.

In the multifamily sector, housing starts averaged 340,000 units at an annual rate over the first five months of the year, a pace close to the average of the previous five years. However, conditions in this market have deteriorated somewhat during the past year. In the first quarter, the vacancy rate for apartments spiked to the highest level since the late 1980s, and rents and property values were below year-earlier readings.

### *Household Finance*

As it did last year, household debt appears to have expanded at more than an 8 percent annual rate during the first half of 2002. Although consumer credit (debt not secured by real estate) has increased, the bulk of the expansion in household debt has come from a sizable buildup of home mortgage debt. Refinancing activity has fallen below last year's record pace, but it has remained

strong as households have continued to extract a portion of the accumulated equity in their homes.

The aggregate household debt-service burden—the ratio of estimated minimum scheduled payments on mortgage and consumer debt to disposable personal income—although still elevated, has moved little this year. The effect of the fast pace of household borrowing on the debt burden has been offset by lower interest rates and the brisk growth in disposable income. On balance, indicators of credit quality do not suggest much further deterioration in the financial condition of households. While delinquency rates for subprime borrowers have risen further for auto loan pools and have stayed high for mortgages, mortgage delinquencies for all borrowers have changed little, and delinquencies on credit card accounts at banks have not risen significantly since the mid-1990s. The number of personal bankruptcy filings also has essentially moved sideways this year, albeit at a historically high rate. Lenders have apparently reacted to these indicators of household credit quality by tightening standards for consumer loans, as reported on the Federal Reserve's Senior Loan Officer Opinion Surveys. Standards for mortgage loans, however, have changed little, and, on the whole, credit appears to have remained readily available to the household sector.

### The Business Sector

Spending in the business sector appears to have bottomed out recently, but a strong recovery has not yet taken hold. Real business fixed investment, which declined sharply last year, fell again in the first quarter, but seems to have firmed in the second quarter. Excess capacity in some sectors and uncertainty about the pace of the economic expan-

sion are likely still restraining equipment demand, but rising output, improving corporate profits, and continuing technological advances appear to be working in the opposite direction. Many businesses have worked off their excess stocks, and the substantial inventory runoff that began in the first quarter of last year seems to be drawing to a close. The combination of higher profits and weak investment spending has led to a drop in borrowing by the nonfinancial business sector thus far this year.

### *Fixed Investment*

Real business spending on equipment and software (E&S) was little changed in the first quarter after having dropped sharply last year. In the high-tech category, real expenditures moved up in the first quarter after a double-digit decline in 2001. Outlays for computers posted large gains in inflation-adjusted terms in both the fourth and first quarters; many businesses apparently postponed computer replacement over much of last year but now seem to be taking advantage of ongoing technological progress and the associated large declines in prices. In contrast, real expenditures for communications equipment were little changed in the first quarter after having plunged by one-third during 2001. Excess capacity in the provision of telecom services is continuing to weigh heavily on the demand for communications equipment. Business outlays for software edged down in real terms in the first quarter.

Real spending on transportation equipment dropped in the first quarter. Outlays for aircraft shrank dramatically as the reduction in orders after last year's terrorist attacks began to show through to spending. Outlays for motor vehicles fell sharply early in the year owing to weakness in the market for

heavy trucks and a reported reduction in fleet sales to rental companies related to the downturn in air travel. Real E&S spending outside of the high-tech and transportation categories moved up in the first quarter after sizable declines in the three preceding quarters. This pattern probably reflects the deceleration and subsequent acceleration in business output, which is an important determinant of spending in this category.

In the second quarter, real E&S spending likely rose, borne along by increases in sales and a rebound in profits. Incoming data on orders and shipments suggest that real outlays for high-tech equipment advanced and that expenditures for other nontransportation equipment also rose. Spending on aircraft probably contracted further, but orders for heavy trucks surged this spring, as some companies reportedly shifted purchases forward in anticipation of stricter emissions requirements that are scheduled to take effect in the fall. Because of lags in the ordering and building of new equipment, the provision for partial expensing in the Job Creation and Worker Assistance Act passed by the Congress in early March will likely bolster investment spending gradually.

Real outlays for nonresidential structures registered a very large decline in the first quarter after having slipped appreciably in 2001. Outlays for office and industrial structures, lodging facilities, and public utilities dropped substantially. Vacancy rates for offices jumped in the first quarter to their highest level since the mid-1990s; in addition, rents and property values were noticeably below their levels one year earlier. Vacancy rates have risen dramatically in the industrial sector as well. Construction of drilling structures also contracted sharply in the first quarter, thereby continuing the downtrend that

began in the middle of last year in the wake of the decline in the prices of oil and natural gas from their peaks a few quarters earlier. Incoming data point to further declines in spending for nonresidential structures in the second quarter.

### *Inventory Investment*

Businesses ran off inventories at an annual rate of nearly \$30 billion in the first quarter. This drawdown followed a much larger liquidation—at an annual rate of roughly \$120 billion—in the fourth quarter, and the associated step-up in production contributed almost 3½ percentage points to the first-quarter increase in real GDP. Book-value data on inventories outside of the motor vehicle sector point to a further slackening of the drawdown more recently. Since last fall, inventory–sales ratios have more than reversed the run-up that occurred as the economy softened. Currently, inventories do not appear to be excessive for the economy as a whole, although industry reports suggest that overhangs persist in a few areas. In contrast to inventories in other sectors, motor vehicle stocks increased in the first half of this year, as automakers boosted production in order to rebuild stocks that had been depleted by the robust pace of sales in late 2001. Motor vehicle inventories were no longer lean as of the middle of this year.

### *Corporate Profits and Business Finance*

The economic profits of the U.S. nonfinancial corporate sector grew 5 percent at a quarterly rate in the first quarter of this year after a surge of 13¾ percent in the fourth quarter of 2001. The corresponding ratio of profits to sector GDP has edged up to 8¾ percent, reversing a portion of the steep decline registered

over the preceding few years but remaining well below its peak in the mid-1990s. Early indicators point to further profit gains in the second quarter.

The rise in profits since late 2001, combined with weak capital expenditures and low share repurchase and cash-financed merger activities, have helped keep nonfinancial corporations' need for external funds (the financing gap) below the average of last year. In addition, corporations have turned to the equity markets to raise a portion of their needed external funds: Corporations have sold more new equity than they have retired this year—the first period of net equity issuance in nearly a decade. They have used much of these funds to repay debt. As a result, the growth of nonfinancial business debt appears to have slowed considerably in the first half of 2002 after rapid gains in preceding years.

Much of the growth in nonfinancial business debt this year has been concentrated in the corporate bond market (though issuance has not been quite so strong as in 2001), as firms have taken advantage of historically attractive yields. Many corporations have used the proceeds of their bond offerings to pay down commercial and industrial (C&I) loans at banks and commercial paper. In recent months, however, net corporate bond issuance has slowed, and the contraction in short-term funding appears to have moderated.

About one fifth of total bond offerings over the first half of 2002 have been in the speculative-grade market. This fraction is about unchanged from last year but still well below the proportions seen in the latter half of the 1990s, and speculative-grade bond offerings have been concentrated in the higher quality end of that market. Troubles in the two largest sectors of the market—telecommunications and energy—have

continued to weigh on issuance this year.

Although many businesses have apparently substituted bond debt for shorter-term financing by choice, others, especially investment-grade firms in the telecommunications sector, have done so by necessity: They were pushed out of the commercial paper market or otherwise encouraged by investors and credit-rating agencies to curb their reliance on short-term sources of financing to limit the associated rollover risk. Indeed, commercial paper outstanding ran off sharply in February and early March, when several companies that were perceived as having questionable accounting practices were forced to tap bank lines to pay off maturing commercial paper. With lower-quality borrowers leaving the market in the face of elevated risk spreads, commercial paper outstanding shrank nearly 30 percent in the first half of the year after a sizable decline in 2001.

Some firms that exited the commercial paper market turned, at least temporarily, to banks as an alternative. Nonetheless, on net, commercial and industrial loans at banks have declined this year, reflecting borrowers' preference for lengthening the maturity of their liabilities and the overall reduction in the demand for external financing, noted earlier. To a more limited extent, a somewhat less receptive lending environment probably also weighed on business borrowing at banks. In particular, banks continued to tighten terms and standards on C&I loans on net over the first half of this year, although the fraction of banks that reported having done so fell noticeably in the Federal Reserve's Senior Loan Officer Opinion Survey in April. Banks have also imposed stricter underwriting standards and higher fees and spreads on backup lines of credit for commercial paper over

most of 2001 and early 2002; banks cited increased concerns about the credit-worthiness of issuers and a higher likelihood of lines being drawn down.

Indicators of credit quality still point to some trouble spots in the nonfinancial business sector. The ratio of net interest payments to cash flow has trended up since the mid-1990s for the nonfinancial corporate sector as a whole, with increases most pronounced for weaker speculative-grade firms. The default rate on outstanding corporate bonds has remained quite elevated by historical standards. By contrast, although the delinquency rate on C&I loans at banks has risen a bit further this year, it has stayed well below rates observed in the early 1990s. In part, however, this performance may be attributable to more aggressive loan sales and charge-offs than in the past. It may be that problems have risen more for large firms than for smaller ones, as the increase in C&I loan delinquencies over recent quarters was limited to large banks, where loans to larger firms are more likely to be held. Credit rating downgrades continued to outpace upgrades by a substantial margin, as was the case in the last quarter of 2001. Spreads of corporate bond yields over those on comparable Treasuries have remained high by historical standards and have risen considerably across the credit-quality spectrum for telecom firms. Corporate bond spreads also widened, though to a much smaller extent, for a few highly rated firms in other industries owing to concerns about their accounting practices.

After having surged late last year, growth in commercial mortgage debt dropped back in the first half of this year amid a sharp decline in construction activity. Issuance of commercial mortgage backed securities (CMBS), a major component of commercial mortgage finance, has been especially weak.

Nonetheless, investor appetite for CMBS has apparently been strong, as yield spreads have narrowed this year. Delinquency rates on CMBS pools, which had been rising during the early part of the year, seem to have stabilized in recent months, and delinquency rates on commercial mortgages held by banks and insurance companies have remained near their historical lows.

The low level of risk spreads for CMBS suggests that concerns about terrorism insurance have not been widespread in the market for commercial mortgages, and responses to the Federal Reserve's Senior Loan Officer Opinion Survey in April indicate that most domestic banks required insurance on less than 10 percent of the loans being used to finance high-profile or heavy-traffic properties. Nonetheless, that fraction was much higher at a few banks, and some credit-rating agencies have placed certain CMBS issues—mainly those backed by high-profile properties—on watch for possible downgrade because of insufficient terrorism insurance.

### The Government Sector

The federal unified budget moved into deficit in fiscal 2002 after having posted a substantial surplus in fiscal 2001. The deterioration reflects a sharp drop in tax collections (resulting in part from the effects of the economic downturn, the decline in stock prices, and legislated tax cuts) and unusually large supplemental spending measures. As a consequence, federal debt held by the public increased in the first half of the year after rapid declines during the previous several years. The budgets of states and localities have also been strained by economic events, and many state and local governments have taken steps to relieve these pressures.



*Federal Government*

Over the first eight months of fiscal year 2002 (October through May) the unified budget recorded a deficit of \$147 billion, compared with a surplus of \$137 billion over the same period of fiscal year 2001. Nominal receipts were 12 percent lower than during the same period of fiscal 2001, and daily Treasury data since May suggest that receipts have remained subdued. Individual tax payments are running well below last year's pace; this weakness reflects general macroeconomic conditions, the legislated changes in tax policy, and the decline in stock prices and consequent reduction in capital gains realizations in 2001. The extent of the weakness was not widely anticipated—this spring's nonwithheld tax payments, which largely pertain to last year's liabilities, generated the first substantial negative April surprise in revenue collections in a number of years. Corporate tax payments have also dropped from last year's level because of weak profits and the business tax provisions included in the Job Creation and Worker Assistance Act of 2002.

Nominal federal outlays during the first eight months of fiscal 2002 were 10 percent higher than during the same period last year; excluding a drop in net interest payments owing to the current low level of interest rates, outlays were up 14 percent. The rate of increase was especially large for expenditures on income security, health, and national and homeland defense. Real federal expenditures for consumption and gross investment, the part of government spending that is a component of real GDP, rose at an annual rate of roughly 11½ percent in the first calendar quarter of 2002 as defense spending surged. The available data suggest that real federal expenditures for consumption and gross invest

ment increased further in the second quarter.

Federal saving, which equals the unified budget surplus adjusted to conform to the accounting practices followed in the national income and product accounts, has fallen considerably since the middle of last year. Net federal saving, which accounts for the depreciation of government capital, turned negative in the first quarter of this year. At the same time, the net saving of households, businesses, and state and local governments has moved up from its trough of last year. On balance, net national saving as a share of GDP has held roughly steady in the past several quarters after having moved down sharply since 1999.

Federal debt held by the public, which had been declining rapidly over the past few years, grew at a 3¼ percent annual rate in the first quarter of 2002 and is estimated to have increased considerably more in the second quarter. The ratio of federal government debt held by the public to nominal GDP fell only slightly in the first quarter following several years of steep declines. In response to the changing budget outlook, the Treasury suspended its buy-back operations through mid-August and increased the number of auctions of new five-year notes and ten-year indexed securities.

During the second quarter, the Treasury took unusual steps to avoid breaching its statutory borrowing limit of \$5.95 trillion. In early April, it temporarily suspended investments in the Government Securities Investment Fund—the so-called G-fund of the Federal Employees' Retirement System. Incoming individual nonwithheld tax receipts later that month allowed the Treasury to reinvest the G-fund assets with an adjustment for interest. Late in May, the Treasury declared a debt ceiling emergency, which allowed it to

disinvest a portion of the Civil Service Retirement and Disability Fund, in addition to the G-fund, to keep its debt from breaching the statutory limit. At the time of the declaration, the Treasury indicated that disinvestments from these two funds, combined with other stopgap measures, would be sufficient to keep it from breaching the debt ceiling only through late June. The Congress approved legislation raising the statutory borrowing limit to \$6.4 trillion on June 27.

### *State and Local Governments*

Slow growth of revenue resulting from the economic downturn has also generated a notable deterioration in the fiscal position of many state and local governments over the past year. In response, many states and localities have been trimming spending plans and, in some cases, raising taxes and fees. In addition, many states have been dipping into rainy-day and other reserve funds. Together, these actions are helping to move operating budgets toward balance.

Real consumption and investment spending by state and local governments rose at an annual rate of 4¼ percent in the first quarter, but available data suggest that outlays were little changed in the second quarter. Outlays for consumption items seem to have held to only moderate increases in the first half of this year, a step-down from last year's more robust gains. Investment spending rose briskly in the first quarter and retreated in the second quarter; this pattern largely reflects the contour of construction expenditures, which were boosted early in the year by unseasonably warm and dry weather.

Debt growth in the state and local government sector has slowed so far in 2002 from last year's very rapid pace. States and localities have continued

to borrow heavily in bond markets to finance capital expenditures and to refund existing obligations, including short-term debt issued last year. The overall credit quality of the sector has remained high despite the fiscal stresses associated with the recent economic slowdown, and yield ratios relative to Treasuries have changed little this year, on net.

### *The External Sector*

Stronger growth in the United States contributed to a widening of U.S. external deficits in the first quarter of this year. The United States has continued to receive large net private financial inflows in 2002, but both inflows and outflows have been at lower levels than in recent years.

### *Trade and the Current Account*

The U.S. deficit on trade in goods and services widened about \$27 billion in the first quarter, to nearly \$380 billion at an annual rate, as a surge in imports overwhelmed a slower expansion of exports. U.S. net investment income decreased \$33 billion to a slight deficit position after recording modest surpluses in all four quarters last year. The U.S. deficit on other income and transfers widened about \$9 billion, to nearly \$70 billion at an annual rate. The U.S. current account, which is the sum of the above, recorded a deficit in the first quarter of \$450 billion at an annual rate, 4.3 percent of GDP and nearly \$70 billion larger than the deficit in the fourth quarter of 2001.

Real exports of goods and services increased 3 percent at an annual rate in the first quarter, after five quarters of decline. This improvement resulted from a very large step-up in service receipts, as payments by foreign travelers moved

back up to near pre-September 11 levels and other private service receipts increased as well. The real value of exported goods contracted in the first quarter, but at only a 3½ percent annual rate. Goods exports had declined much more steeply in the previous three quarters under the effects of slower output growth abroad, continued appreciation of the dollar, and plunging global demand for high-tech products. The better performance in the first quarter of 2002 included a markedly slower rate of decline of machinery exports and a small increase in exported aircraft. While exports of computers continued to fall, exports of semiconductors rose for the first time in nearly two years. Export prices continued to edge down in the first quarter.

U.S. real imports of goods and services expanded in the first quarter at an 8 percent annual rate. As was the case with exports, a substantial part of the increase came from larger service payments related to increased travel abroad by U.S. residents. Reflecting the rebound in U.S. economic activity, imports of real goods rose at about a 4 percent pace in the first quarter of 2002, the first increase in four quarters, as a decline in oil imports was more than offset by a substantial increase in imports of other goods. Growth of non-oil imports was led by increased imports of computers, autos, and consumer goods. The price of imported non-oil goods declined at about a 2¼ percent annual rate, in line with its trend in 2001; prices fell for a wide range of capital goods and industrial supplies.

Declining demand during the second half of last year put the price of West Texas intermediate (WTI) crude oil in December 2001 at around \$19 per barrel, its lowest level since mid-1999. Unusually warm winter weather in the United States—along with low prices—

helped keep the value of oil imports at a very low level in the first quarter. But oil prices began to rise in February and March as global economic activity picked up and as OPEC reduced its production targets in an agreement with five major non-OPEC producers (Angola, Mexico, Norway, Oman, and Russia). Oil prices remained firm in the second quarter around \$26 per barrel amid turmoil in the Middle East, a one-month suspension of oil exports by Iraq, disruption of supply from Venezuela, and increasing global demand. The price of gold also has reacted to heightened geopolitical tensions and moved up more than 13 percent over the first half of 2002.

### *The Financial Account*

The shift in the pattern of U.S. international financial flows observed in the second half of 2001 continued into the first quarter of this year. Influenced by increased economic uncertainty, questions about corporate governance and accounting, and sagging share prices, foreign demand for U.S. equities remained weak. Foreign net purchases of U.S. bonds slowed; although purchases of corporate bonds continued to be robust, demand for agency and Treasury bonds slackened. Nonetheless, because U.S. net purchases of foreign securities also fell off, the contribution of net inflows through private securities transactions to financing the U.S. current account deficit remained at a high level. Preliminary and incomplete data for the second quarter of 2002 suggest a continuation of this pattern.

Slower economic activity, both in the United States and abroad, and reduced merger activity caused direct investment inflows and outflows to drop sharply late last year. Direct investment inflows, which were strong through the first half

of 2001, plummeted in the second half. U.S. direct investment abroad stayed at a high level through the third quarter but then fell sharply. Both inflows and outflows remained weak in the first quarter of 2002. Available data point to a pickup of capital inflows from official sources during the first half of 2002, as the recent weakening of the foreign exchange value of the dollar prompted some official purchases.

### The Labor Market

Labor markets weakened further in the first few months of the year; they now appear to have stabilized but have yet to show signs of a sustained and substantial pickup. Growth of nominal compensation slowed further in the first part of the year after having decelerated in 2001. With productivity soaring in recent quarters, unit labor costs have fallen sharply.

#### *Employment and Unemployment*

After having fallen an average of nearly 160,000 per month in 2001, private payroll employment declined at an average monthly rate of 88,000 in the first quarter and was about unchanged in the second quarter. Employment losses in the manufacturing sector have moderated in recent months, and employment in the help supply services industry—which provides many of its workers to the manufacturing sector—has increased. These two categories, which were a major locus of weakness last year, gained an average of 11,000 jobs per month over the past three months, compared with an average loss of 76,000 jobs per month in the first quarter of the year and 163,000 jobs per month over 2001.

Apart from manufacturing and help supply, private payrolls fell 12,000 per

month in the first quarter and declined 8,000 per month in the second quarter. In the second quarter, hiring in construction fell by the same amount as in the first quarter. Retail employment declined somewhat after rising a bit in the first quarter, and the employment gain in services other than help supply was slightly smaller than in the first quarter. However, employment losses in several other categories abated in the second quarter.

The unemployment rate in the second quarter averaged 5.9 percent, up from a reading of 5.6 percent in both the fourth quarter of last year and the first quarter of this year. The higher unemployment rate in recent months is consistent with weak employment gains, and it probably was boosted a bit by the federal temporary extended unemployment compensation program. Because this program provides additional benefits to individuals who have exhausted their regular state benefits, it encourages unemployed individuals to be more selective about taking a job offer and likely draws some people into the labor force to become eligible for these benefits.

#### *Productivity and Labor Costs*

Labor productivity has increased rapidly in recent quarters. After rising at an average annual rate of around 1 percent in the first three quarters of last year, output per hour in the nonfarm business sector jumped at an annual rate of 5½ percent in the fourth quarter of last year and 8½ percent in the first quarter of this year. Productivity likely continued to rise in the second quarter, albeit at a slower pace. Labor productivity often rises briskly in the early stages of economic recoveries, but what makes the recent surge unusual is that it followed a period of modest increases, rather than declines. In earlier postwar

recessions, productivity deteriorated as firms retained more workers than may have been required to meet reduced production needs. The strength in productivity growth around the beginning of this year suggests that employers may have doubted the durability of the pickup in sales and, therefore, deferred new hiring until they became more convinced of the vigor of the expansion. Smoothing through the recent cyclical fluctuations, productivity advanced at an average annual rate of close to 3½ percent between the fourth quarter of 2000 and the first quarter of this year. Although this pace is unlikely to be sustained, it further bolsters the view that the underlying trend in productivity has moved up since the first half of the 1990s.

The employment cost index (ECI) for private nonfarm businesses increased just under 4 percent during the twelve months ended in March of this year, after rising about 4¼ percent in the preceding twelve-month period. The recent small step-down likely reflects the lagged effects of the greater slack in labor markets and lower consumer price inflation. The wages and salaries component and the benefits component of the ECI both decelerated by ¼ percentage point relative to the preceding year. The slowing in benefits costs occurred despite a 2½ percentage point pickup in health insurance cost inflation, to a 10½ percent rate of increase.

Nominal compensation per hour in the nonfarm business sector—an alternative measure of compensation based on the national income and product accounts—rose 3½ percent during the year ending in the first quarter. This rate represented a sharp slowing from the 7¼ percent pace recorded four quarters earlier, which likely had been boosted significantly by stock options; stock options are included in this measure at

their value when exercised. The deceleration in this measure of compensation is much more dramatic than in the ECI because the ECI does not include stock options. The moderate increase in nominal compensation combined with the spike in productivity growth led unit labor costs to drop at an annual rate in excess of 5 percent in the first quarter, after a decline of 3 percent in the fourth quarter.

Information about the behavior of compensation in more recent months is limited. Readings on average hourly earnings of production or nonsupervisory workers suggest a further deceleration in wages: The twelve-month change in this series was ¾ percent in June, ¾ percentage point below the change for the preceding twelve months.

## Prices

A jump in energy prices in the spring pushed up overall inflation in the first part of 2002, but core inflation remained subdued. The chain-type price index for personal consumption expenditures (PCE) increased at an annual rate of 2¼ percent over the first five months of the year, compared with a rise of just over 1 percent for the twelve months of 2001. Core PCE prices rose at an annual rate of just over 1½ percent during the first five months of this year, which was the pace recorded for 2001.

Energy prices rose sharply in March and April but have turned down more recently. Gasoline prices spiked in those two months, as crude oil costs moved higher and retail gasoline margins surged. Since April, gasoline prices have, on balance, reversed a small part of this rise. Natural gas prices stayed low in early 2002 against a backdrop of very high inventories; however, these prices have, on average, moved higher in more recent months. Electricity prices

have dropped this year, a move reflecting deregulation of residential prices in Texas as well as lower prices for coal and natural gas, which are used as inputs in electricity generation. All told, energy prices increased at an annual rate of 20 percent over the first five months of the year, reversing a little more than half of last year's decline.

Consumer food prices increased at an annual rate of 1½ percent between December and May. A poor winter crop of vegetables pushed up prices early this year, but supplies subsequently increased and prices came down. In addition, consumer prices for meats and poultry, which began to weaken late last year, remained subdued this spring.

Core inflation was held down over the first five months of the year by continued softness in goods prices, including a significant decline in motor vehicle prices. Non-energy services prices continued to move up at a faster pace than core goods prices, although the very sizable increases in residential rent and the imputed rent of owner-occupied housing have eased off in recent months. The rate of increase in core consumer prices has been damped by several forces. One is the lower level of resource utilization that has prevailed over the past year. Core price increases were also held down by declines in non-oil import prices and the lagged effects of last year's decline in energy prices on firms' costs. In addition, inflation expectations have stayed in check: The Michigan Survey Research Center index of median expected inflation over the subsequent year has rebounded from last fall's highly unusual tumble, but its average in recent months of 2¾ percent is below the average reading of 3 percent in 2000.

Like core PCE inflation, inflation measured by the core consumer price index (CPI) has remained subdued.

However, the levels of inflation corresponding to these two alternative measures of consumer prices are markedly different: Core PCE inflation was about 1½ percent over the twelve months ended in May, while core CPI inflation was about 2½ percent. This gap is more than ½ percentage point larger than the average difference between these inflation measures during the 1990s (based on the current methods used to construct the CPI instead of the official published CPI). The larger differential arises from several factors. First, the PCE price index (unlike the CPI) includes several components for which market-based prices are not available, such as checking services provided by banks without explicit charges; the imputed prices for these components have increased considerably less rapidly in the past couple of years than previously. Second, the substantial acceleration in shelter costs since the late 1990s has provided a larger boost to the CPI than to the PCE price index because housing services have a much larger weight in the CPI. Third, PCE medical services prices—which are largely based on producer price indexes rather than information from the CPI—have increased more

Alternative Measures of Price Change  
Percent

Price measure	2000 to 2001	2001 to 2002
<i>Chain-type</i>		
Gross domestic product .....	2.3	1.4
Gross domestic purchases .....	2.2	.7
Personal consumption expenditures .....	2.4	.7
Excluding food and energy ...	1.9	1.3
<i>Fixed-weight</i>		
Consumer price index .....	3.4	1.2
Excluding food and energy ...	2.7	2.5

NOTE. Changes are based on quarterly averages and are measured from Q1 to Q1.

slowly than CPI medical services prices over the past couple of years.

The chain-type price index for gross domestic purchases—which captures prices paid for consumption, investment, and government purchases—rose at an annual rate of roughly 1 percent in the first quarter of 2002, putting the four-quarter change at  $\frac{3}{4}$  percent. This pace represents a marked slowing relative to the  $\frac{2}{4}$  percent rise in the year-earlier period, owing to both a drop in energy prices (as the decline in the second half of 2001 was only partly offset by the increase this spring) and more rapid declines in the prices of investment goods such as computers. The GDP price index rose at an annual rate of  $\frac{1}{4}$  percent in the first quarter and was up almost  $\frac{1}{2}$  percent relative to the first quarter of last year. The GDP price index decelerated somewhat less than the index for gross domestic purchases, in part because declining oil prices receive a smaller weight in U.S. production than in U.S. purchases.

### U.S. Financial Markets

Market interest rates have moved lower, on net, since the end of 2001, as market participants apparently viewed the ongoing recovery as likely to be less robust than they had been expecting late last year. Such a reassessment of the strength of economic activity and associated business earnings, along with worries about the accuracy of published corporate financial statements, weighed heavily on major equity indexes, which dropped 12 to 31 percent. The debt of the nonfinancial sectors expanded at a moderate pace, but lenders have imposed somewhat firmer financing terms, especially on marginal borrowers.

Households' preferences for safer assets, which had intensified following last year's terrorist attacks, diminished

early in 2002, as evidenced by strong flows into both equity and bond mutual funds. Equity fund inflows lessened in May and turned into outflows in June, however, as concerns about the strength and accuracy of corporate earnings reports mounted. But the net shift toward longer-term assets this year appears to have contributed to a significant deceleration in M2, which has also been slowed by reduced mortgage refinancing activity and a leveling out of the opportunity cost of holding M2 assets.

### *Interest Rates*

Uncertain about the robustness of the economic recovery, the FOMC opted to retain its accommodative policy stance over the first half of 2002, leaving its target for the federal funds rate at  $\frac{1}{4}$  percent. Market participants, too, have apparently been unsure about the strength of the recovery, and shifts in their views of the economic outlook have played a significant role in movements in market interest rates so far this year. During the first quarter of the year, news on aggregate spending and output came in well above expectations, and Treasury coupon yields rose between 35 and 65 basis points. The second quarter, however, brought renewed concerns about the economic outlook, compounded by sharp declines in equity prices. In recent months, Treasury coupon yields have more than reversed their earlier increases and are now 40 to 50 basis points below their levels at the end of 2001.

Survey measures of long-term inflation expectations have been quite stable this year, implying that real rates changed about as much as nominal rates. The spread between nominal and inflation-indexed Treasury yields, another gauge of investors' expectations about inflation, has moved over a rela-

tively wide range since the end of 2001, but, on net, it has edged up only slightly. Even the small widening of this spread likely overstates a shift in sentiment regarding future price pressures in the economy. In mid-February, the Treasury reassured investors that it would continue to issue indexed debt, an announcement that was reinforced in May when the Treasury made public its decision to add one more auction of ten-year indexed notes to its annual schedule of offerings. This reaffirmation of the Treasury's commitment to issue indexed securities may have pulled indexed yields down by bolstering the actual and expected liquidity of the market.

Yields on longer-maturity bonds issued by investment-grade corporations have stayed close to their lows of the past ten years, but speculative-grade yields remained near the high end of their range since the mid-1990s. Spreads relative to Treasury yields have widened most recently for both investment- and speculative-grade bonds as concerns about corporate earnings reporting intensified. Such concerns have also played a prominent role in the commercial paper market, especially early this year, when investors, who had become increasingly worried about accounting scandals, imposed high premiums on lower-quality borrowers. Subsequently, however, many such borrowers either left the commercial paper market or reduced their reliance on commercial paper financing, and the average yield spread on second-tier commercial paper over top-tier paper has narrowed considerably.

Interest rates on car loans have changed little, on net, this year, and mortgage rates have moved lower. However, according to the Federal Reserve's Survey of Terms of Business Lending, interest rates on C&I loans at domestic

banks have moved a bit higher this year, as banks have raised the spread of the average interest rate on business loans over the target federal funds rate. The wider spread reflects higher risk premiums on C&I loans to lower-quality borrowers; spreads for higher-quality borrowers have changed little on net.

### *Equity Markets*

After falling in January in reaction to pessimistic assessments of expected business conditions over the coming year—especially in the tech sector—stock prices rebounded smartly toward the end of the first quarter on stronger-than-expected macroeconomic data. Most first-quarter corporate earnings releases met or even exceeded market participants' expectations, but many firms included sobering guidance on sales and earnings prospects in those announcements. These warnings, combined with mounting questions about corporate accounting practices, worries about threats of domestic terrorism, and escalating geopolitical tensions, have taken a considerable toll on equity prices since the end of March. On net, all major equity indexes are down substantially so far this year. Share prices in the telecom and technology sectors have performed particularly poorly, and, on July 10, the Nasdaq was 31 percent lower than at the end of 2001. The Wilshire 5000, a broad measure of equity prices, fell 18½ percent over the same period, returning to a level 40 percent below its historical peak reached in March 2000.

Declining share prices pulled down the price-earnings ratio for the S&P 500 index (calculated using operating profits expected over the coming year). Nonetheless, the ratio remained elevated relative to its typical values before the mid-1990s, suggesting that investors



continued to anticipate rapid long-term growth in corporate profits.

### *Monetary Policy Instruments*

At its March 19 meeting, the FOMC assessed the priorities, given limited resources, it should attach to further studies of the feasibility of outright purchases for the System Open Market Account (SOMA) of mortgage-backed securities guaranteed by the Government National Mortgage Association (GNMA-MBS) and the addition of foreign sovereign debt securities to the list of collateral eligible for U.S. dollar repurchase agreements by the System. As noted in the February and July 2001 Monetary Policy Reports to the Congress, such alternatives could prove useful if outstanding Treasury debt obligations were to become increasingly scarce relative to the necessary growth in the System's portfolio, and the FOMC had requested that the staff explore these options. Noting that many of the staff engaged in these studies were also involved in contingency planning, which had been intensified after the September 11 attacks, the FOMC decided to give the highest priority to such planning. Federal budgetary developments over the past year meant that constraints on Treasury debt supply would not become as pressing an issue as soon as the FOMC had previously thought. Still, given the inherent uncertainty of budget forecasts, the likely significant needs for large SOMA operations in coming years, and the lead times required to implement new procedures, the FOMC decided that the exploratory work on the possible addition of outright purchases of GNMA-MBS should go forward once it was possible to do so without impeding contingency planning efforts.

The Federal Reserve also addressed possible changes to the structure of its discount window facility. On May 17, 2002, the Federal Reserve Board released for public comment a proposed amendment to the Board's Regulation A that would substantially revise its discount window lending procedures. Regulation A currently authorizes the Federal Reserve Banks to operate three main discount window programs: adjustment credit, extended credit, and seasonal credit. The proposed amendment would establish two new discount window programs called primary credit and secondary credit as replacements for adjustment and extended credit. The Board also requested comment on the continued need for the seasonal program but did not propose any substantive changes to the program.

The proposal envisions that primary credit would be available for very short terms, ordinarily overnight, to depository institutions that are in generally sound financial condition at an interest rate that would usually be above short-term market interest rates, including the federal funds rate; currently, the discount rate is typically below money market interest rates. The requirement that only financially sound institutions should have access to primary credit should help reduce the stigma currently associated with discount window borrowings. In addition, because the proposed discount rate structure will eliminate the incentive that currently exists for depository institutions to borrow to exploit a positive spread between short-term money market rates and the discount rate, the Federal Reserve will be able to reduce the administrative burden on borrowing banks. As a result, depository institutions should be more likely to turn to the discount window when money markets tighten significantly, enhancing the window's ability to serve

as a marginal source of reserves for the overall banking system and as a backup source of liquidity for individual depository institutions. Secondary credit would be available, subject to Reserve Bank approval and monitoring, for depository institutions that do not qualify for primary credit.

The proposed amendment is intended to improve the functioning of the discount window and the money market more generally. Adoption of the proposal would *not* entail a change in the stance of monetary policy. It would not require a change in the FOMC's target for the federal funds rate and would not affect the overall level of market interest rates. The comment period on the proposal ends August 22, 2002. If the Board then votes to revise its lending programs, the changes likely would take place several months later.

#### *Debt and Financial Intermediation*

Growth of the debt of domestic nonfinancial sectors other than the federal government is estimated to have slowed during the first half of 2002, as businesses' needs for external funds declined further owing to weak capital spending, continuing inventory liquidation, and rising profits. In addition, growth in consumer credit moderated following a surge in auto financing late last year. On balance, nonfederal debt expanded at a 5½ percent annual rate in the first quarter of the year after growing 7½ percent in 2001. In contrast, the stock of federal debt held by the public, which had contracted slightly in 2001, grew 3¼ percent at an annual rate in the first quarter and expanded further in the second quarter, as federal tax revenues fell short of expectations and government spending increased substantially. The sharp rise in federal debt outstanding followed a few years of declines.

The proportion of total credit supplied by depository institutions over the first half of the year is estimated to have been near its lowest value since 1993. Although banks have continued to acquire securities at about the same rapid pace observed in 2001, the shift in household and business preferences toward longer-term sources of credit greatly reduced the demand for bank loans. As noted, banks' loans to businesses ran off considerably, as corporate borrowers turned to the bond market in volume to take advantage of favorable long-term interest rates. Growth of real estate loans slowed markedly this year, partly as outlays for nonresidential structures declined, but growth of consumer loans was fairly well maintained. With some measures of credit quality in the business and household sectors still pointing to pockets of potential strain, loan-loss provisions remained high at banks and weighed on profits. Nonetheless, bank profits in the first quarter stayed in the elevated range observed over the past several years, and virtually all banks—98 percent by assets—remained well capitalized.

Among nondepository financial intermediaries, government-sponsored enterprises (GSEs) curtailed their net lending (net acquisition of credit market instruments) during the first quarter of the year, but available data suggest that insurance companies more than made up for the shortfall. The GSEs appeared to continue to restrain their net lending in the second quarter, in part as yields on mortgage-backed securities, which are a major component of their holdings of financial assets, compared less favorably to yields on the debt they issue. Net lending by insurance providers in the first quarter was especially strong among life insurance companies, which experienced a surge in sales late last year in the aftermath of the Septem-

ber 11 terrorist attacks. Net lending by the GSEs amounted to 14 percent of the net funds raised by both the financial and nonfinancial sectors in the credit markets in the first quarter of 2002, and the figure for insurance companies was 10 percent; depository credit accounted for 13 percent of all net borrowing over the same period.

### *Monetary Aggregates*

The broad monetary aggregates decelerated considerably during the first half of this year. M2 rose 4½ percent at an annual rate after having grown 10¼ percent in 2001. Several factors contributed to the slowing in M2. Mortgage refinancing activity, which results in prepayments that temporarily accumulate in deposit accounts before being distributed to investors in mortgage-backed securities, moderated over the first half of this year. In addition, the opportunity cost of holding M2 assets has leveled out in recent months, so the increase in this aggregate has been more in line with income. Because the rates of return provided by many components of M2 move sluggishly, the rapid declines in short-term market interest rates last year temporarily boosted the attractiveness of M2 assets. In recent months, however, yields on M2 components have fallen to more typical levels relative to short-term market interest rates. Lastly, precautionary demand for M2, which was high in the aftermath of last year's terrorist attacks, seems to have unwound in 2002, with investors shifting their portfolios back toward longer-term assets such as equity and bond mutual funds. With growth in nominal GDP picking up significantly this year, M2 velocity—the ratio of nominal GDP to M2—rose about 1½ percent at an annual rate in the first quarter of 2002, in sharp contrast to the

large declines registered throughout 2001.

M3—the broadest monetary aggregate—grew 3½ percent at an annual rate through the first six months of the year after rising 12¾ percent in 2001. Most of this deceleration, apart from that accounted for by M2, resulted from the weakness of institutional money market funds, which declined slightly, after having surged about 50 percent last year. Yields on these funds tend to lag market yields somewhat, and so the returns on the funds, like those on many M2 assets, became less attractive as their yields caught up with market rates.

### *International Developments*

Signs that economic activity abroad had reached a turning point became clearer during the first half of 2002, but recovery has been uneven and somewhat tepid on average in the major foreign industrial countries. Improving conditions in the high-tech sector have given a boost to some emerging-market economies, especially in Asia, but several Latin American economies have been troubled by a variety of adverse domestic developments. Foreign financial markets became increasingly skittish during the first half of the year amid worries about global political and economic developments, including concerns about corporate governance and accounting triggered by U.S. events. Oil prices reversed a large part of their 2001 decline.

During the first half, monetary authorities in some foreign countries where signs of recovery were most evident and possible future inflation pressures were becoming a concern—Canada, Australia, New Zealand, and Sweden, among others—began to roll back a portion of last year's easing, raising expectations that policy tightening

might become more widespread. However, policy was held steady at the European Central Bank (ECB) and the Bank of England. The Bank of Japan (BOJ) maintained short-term interest rates near zero and kept balances of bank deposits at the BOJ at elevated levels. Yield curves in most foreign industrial countries became a bit steeper during the first quarter as long-term rates rose in reaction to news suggesting stronger U.S. growth and improving prospects for global recovery. Since then, long-term rates have edged lower, on balance, in part as investors shifted out of equity investments. Foreign equities performed well in most countries early in the year, but share prices in many countries have fallen since early in the second quarter—in some cases more steeply than in the United States. The broad stock indexes for the major industrial countries are down since the beginning of the year, except in Japan, where stock prices, on balance, are about unchanged. High-tech stocks have been hit especially hard.

During the first quarter of 2002, the foreign exchange value of the dollar (measured by a trade-weighted index against the currencies of major industrial countries) appeared to react primarily to shifting market views about the relative strength of the U.S. recovery and its implications for the timing and extent of future monetary tightening. Despite some fluctuations in this period, the dollar stayed fairly close to the more than sixteen-year high reached in January. In the second quarter, however, the dollar trended downward as earlier market enthusiasm about U.S. recovery dimmed. Concerns about profitability, corporate governance, and disclosure at U.S. corporations appeared to dampen the attraction of U.S. securities to investors, as did worries that the United States was particularly vulnerable to

the consequences of global geopolitical developments. With U.S. investments perceived as becoming less attractive, the financing requirements of a large and growing U.S. current account deficit also seemed to emerge as a more prominent negative factor. The dollar has lost more than 9 percent against the major currencies since the end of March and is down, on balance, more than 8 percent so far in 2002. In contrast, the dollar has gained about 2 percent this year, on a weighted-average basis, against the currencies of our other important trading partners.

The dollar's exchange rate against the Japanese yen was quite volatile in the first half and, on balance, the dollar has fallen more than 10 percent since the beginning of the year. Although Japan's domestic economy continued to struggle with deflation and severe structural problems, including mounting bad loans in the financial sector and growing bankruptcies, some indicators (including strong reported first-quarter GDP, a firming of industrial production, and a somewhat better reading on business sentiment in the BOJ's second-quarter Tankan survey) suggested that a cyclical recovery has begun. The yen's rise occurred despite downgradings of Japan's government debt by leading rating services in April and May and several episodes of intervention sales of yen in foreign exchange markets by Japanese authorities in May and June. Japanese stock prices, which had fallen to eighteen-year lows in early February, turned up later as economic prospects became less gloomy. At midyear, the TOPIX index was about where it was at the start of the calendar year.

After declining in the final quarter of 2001, euro-area GDP appears to have increased in the first half, though at only a modest rate. Exports firmed and inventory de-stocking appeared to be winding

down, but consumption remained weak. The pace of activity varied across countries, with growth in Germany—the euro area’s largest economy—lagging behind. Despite lackluster area-wide growth, concerns about inflation became increasingly prominent. For most of the first half, euro-area headline inflation persisted at or above the ECB’s 2 percent target limit, partly on higher energy and food price inflation; even excluding the effects of those two components, inflation picked up somewhat during the period. Inflation concerns also were fanned by difficult labor market negotiations this spring, but the strength of the euro may blunt inflationary pressures to some extent. The new euro notes and coins were introduced with no noticeable difficulties at the beginning of the year, but the euro drifted down against the dollar for several weeks thereafter. Since then, however, the euro has reversed direction and moved steadily higher. On balance, the dollar has lost nearly 11 percent against the euro so far in 2002.

The United Kingdom seemed to weather last year’s slump better than most industrial countries, as strength in consumption counteracted weakness in investment and net exports, though growth did weaken in the last quarter of 2001 and into the first quarter of 2002. Notable increases in industrial production and continued strength in the service sector indicate that growth picked up in the second quarter. Household borrowing has increased briskly, supported by rapid increases in housing prices, and unemployment rates remain near record lows. At the same time, retail price inflation has remained below the Bank of England’s 2½ percent target. Sterling has fallen nearly 5 percent against the euro since the beginning of the year, while it has gained more than 6 percent against the dollar. Elsewhere in Europe,

the exchange value of the Swiss franc has been driven up by flows into Swiss assets prompted in part by uncertainties about global political developments. The Swiss National Bank eased its official rates in May to counteract this pressure and provide support for the Swiss economy.

Economic recovery appears to be well under way in Canada. Real GDP increased 6 percent at an annual rate in the first quarter, and other indicators point to continued strong performance in the second quarter. Canadian exports—particularly automotive exports—benefited early in the year from the firming of U.S. demand, but the expansion has become more widespread, and employment growth has been strong. Although headline consumer price inflation has remained in the bottom half of the Bank of Canada’s target range of 1 percent to 3 percent, core inflation has crept up this year. In April, the Bank of Canada increased its overnight rate 25 basis points, citing stronger-than-expected growth in both the United States and Canada, and it increased that rate again by the same amount in June. The Canadian dollar, which had been at a historically low level against the U.S. dollar in January, moved up quite steeply in the second quarter and has gained about 5 percent for the year so far.

The Mexican economy was hit hard by the global slump in 2001 and especially by the weaker performance of the U.S. economy. Mexican exports stabilized early this year as U.S. activity picked up, and other indicators also now suggest that the Mexican economy is beginning to recover. In February, despite the weak level of activity at the time, the Bank of Mexico tightened monetary policy to keep inflation on track to meet its 4½ percent target for 2002, and the Mexican peso moved up a

bit against the dollar during February and March. In April, with inflation apparently under control, the central bank eased policy, and since then the peso has moved down substantially. Against the dollar, the decline since the beginning of the year has amounted to almost 7 percent. After rising through April, Mexican share prices also fell sharply, leaving them at midyear about unchanged from their end-2001 levels.

Financial and economic conditions deteriorated significantly in Argentina this year. The Argentine peso was devalued in January and then allowed to float in early February; since then, it has lost more than 70 percent of its value versus the dollar. The peso's fall severely strained balance sheets of Argentine issuers of dollar-based obligations. Various stop-gap measures intended to restrict withdrawals from bank accounts and to force conversion of dollar-denominated loans and deposits into peso-denominated form put banks and depositors under further stress. Meanwhile, economic activity has continued to plummet, and the government has struggled to gain support for reforms that would address chronic fiscal imbalances. Since late 2001, the government has been servicing its obligations only to its multilateral creditors, and spreads on Argentina's international debt have soared to more than 65 percentage points.

In recent months financial markets elsewhere in the region have become

more volatile. Brazilian markets have been roiled by political uncertainties related to national elections coming in the fall. Attention has focused on vulnerabilities associated with Brazil's large outstanding stock of debt, much of which is short-term. Since April, the value of the *real* against the dollar has fallen nearly 20 percent, and Brazilian spreads have widened substantially. Several other South American countries, including Uruguay and Venezuela, also have been beset by growing financial and economic problems.

Asian economies that rely importantly on exports of computers and semiconductors (Korea, Singapore, Malaysia, and Taiwan) have grown quite vigorously so far this year, a buoyancy reflecting in part the recent turnaround of conditions in the technology sector and stronger U.S. growth. The currencies of several countries of this group have moved up against the dollar. In Korea, the expansion has been more broad-based, as domestic demand was fairly resilient during the recent global downturn and has remained firm. China, which is less dependent on technology exports, has continued to record strong growth as well. Other countries in the region also have started to recover from steep slowdowns or contractions in 2001, although Hong Kong has continued to be troubled by the collapse of property prices. Most stock markets in the region have recorded gains so far this year. ■

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*Federal Reserve Operations*

## *Consumer and Community Affairs*

Among the Federal Reserve's responsibilities in the areas of consumer and community affairs are

- Supervising banks to ensure their compliance with the regulations
- Writing and interpreting regulations to implement federal laws intended to protect and inform consumers
- Investigating complaints from the public about bank compliance with the regulations
- Promoting community development in historically underserved markets.
- Analyzes applications for mergers and acquisitions by state member banks and bank holding companies in relation to CRA performance
- Disseminates information on community development techniques to bankers and the public through Community Affairs Offices at the Reserve Banks.

### *Examination for Compliance with the CRA*

The Federal Reserve assesses the CRA performance of state member banks during examinations for compliance with consumer protection regulations. By statute, banks with assets of less than \$250 million that were rated "satisfactory" for CRA performance in their most recent examination are examined not more than once every forty-eight months, and those that were rated "outstanding" for CRA purposes in their most recent examination are examined not more than once every sixty months. Banks with assets of \$250 million or more that were rated "satisfactory" or "outstanding" in their most recent examination are examined not more than once every twenty-four months. During the 2002 reporting period, the Federal Reserve conducted 312 CRA examinations. Of the banks examined, 40 were rated "outstanding" in meeting community credit needs, 270 were rated "satisfactory," 1 was rated "needs to improve," and 1 was rated as being in "substantial noncompliance."<sup>1</sup>

These responsibilities are carried out by members of the Board of Governors, the Board's Division of Consumer and Community Affairs, and the consumer and community affairs staffs at the Federal Reserve Banks.

### **Supervision for Compliance with Consumer Protection and Community Reinvestment Laws**

#### Activities Related to the Community Reinvestment Act

The Community Reinvestment Act (CRA) requires that the Board and other banking agencies encourage financial institutions to help meet the credit needs of the local communities in which they do business, consistent with safe and sound business practices. To carry out this mandate, the Federal Reserve

- Examines state member banks to assess compliance with the CRA

1. The 2002 reporting period was from July 1, 2001, through June 30, 2002.



*Analysis of Applications for  
Mergers and Acquisitions in  
Relation to the CRA*

During 2002, the Board of Governors considered applications for several significant banking mergers:

- In June, the Board approved an application by Royal Bank of Canada (Montreal, Canada) and RBC Centura Bank, Inc. (Rocky Mount, North Carolina), to acquire Eagle Bancshares, Inc., and its subsidiary, Tucker Federal Bank (both in Tucker, Georgia).
- In October, the Board approved an application by Citigroup, Inc. (New York, New York), to acquire Golden State Bancorp, Inc. (San Francisco, California).
- In December, the Board approved an application by Cooperatieve Centrale Raiffeisen-Boerenleenbank B.A. (Rabobank Nederland Utrecht, The Netherlands) to acquire VIB Corp. and its subsidiary, Valley Independent Bank (both in El Centro, California).

Comments were received from the public on each of these applications. Many commenters expressed concern that the proposed merger or acquisition could lead to decreased lending levels in low-income communities, including mortgage, small-business, and community development lending; abusive lending practices; the provision of costly and inadequate banking services to low-income consumers; and the closure of branch offices in low-income communities.

In the case of the Royal Bank of Canada application, the bank subsidiary of Eagle Bancshares, Tucker Federal

Bank, had received a CRA rating in 2001 of “needs to improve” from its primary supervisor, the Office of Thrift Supervision. The Board considered information indicating that Tucker Federal Bank’s CRA performance had improved since then and noted that Tucker would be merged into RBC Centura Bank (which had a CRA rating of “satisfactory”) upon consummation of the merger of the holding company.

In the Citigroup case, many of the public commenters’ concerns related to the activities of Citigroup’s subprime lending subsidiaries. A special examination of those activities, by the Federal Reserve Bank of New York, was still under way at the time. In acting on the application, the Board noted that a careful review of the record indicated that Citigroup, on balance, had a satisfactory record of compliance and concluded that the ongoing examination of the subprime subsidiaries did not warrant delay or denial. The Board indicated that many of the issues raised by commenters could be more adequately addressed through the special examination. The Board noted, moreover, that if violations or other concerns were identified during the special examination, the Board has broad authority to enforce compliance with fair lending and other applicable laws through the supervisory process.

In the third application, the Board found that the CRA record of the depository institution was consistent with approval.

The Board acted on other bank and bank holding company applications that involved protests by members of the public concerning CRA performance; one also involved a bank having a CRA rating lower than “satisfactory.” Another thirty-three applications raised other issues related to CRA, fair lend-

ing, or compliance with consumer credit protection laws and regulations.<sup>2</sup>

### Other Consumer Compliance Activities

The Division of Consumer and Community Affairs' Compliance Oversight Section supports and oversees the supervisory efforts of the Federal Reserve Banks to ensure that consumer protection laws and regulations are fully and fairly enforced. Section staff provide guidance and expertise to the Reserve Banks on consumer protection regulations, enforcement techniques, examiner training, and emerging issues. They develop, update, and revise examination policies, procedures, and guidelines and review Reserve Bank supervisory reports and work products. Section staff also participate in interagency activities designed to promote uniformity in examination principles and standards.

Examinations are the Federal Reserve's primary means of enforcing bank compliance with consumer protection laws. During the reporting period, the Reserve Banks conducted 387 consumer compliance examinations—316 of state member banks and 71 of foreign banking organizations.<sup>3</sup> To assess the effectiveness of

the Reserve Banks' consumer compliance supervision program, Division staff visited each Reserve Bank during the year to review documents developed by Reserve Bank consumer compliance examiners during bank examinations and other supervisory activities.

Also during 2002, the Board issued guidance for Reserve Bank examiners on consumer protection laws and regulations. For example, the Board clarified the signature provisions of Regulation B, which implements the Equal Credit Opportunity Act, and provided supplemental guidance to assist examiners in writing CRA performance evaluations for large banks.

### *Fair Lending*

Under the Equal Credit Opportunity Act, the Board refers any violation that it has reason to believe constitutes a "pattern or practice" of discrimination to the Department of Justice. During 2002 the Board made six such referrals. Two involved violations of the prohibition against requiring an applicant's spouse to sign a credit obligation (unless the spouse is a co-applicant or the spouse's signature is necessary under state law to permit the creditor to take possession of the property in case of default). Two other referrals involved discrimination on the basis of marital status by lenders that combined the income of married joint applicants but not the income of unmarried joint applicants. One of the two lenders was also found to have priced loans on the basis of marital status. A fifth referral resulted from a lender's practice of failing to consider child support a source of income and imposing a minimum income requirement, which had a disparate impact on the basis of sex. The sixth referral involved a lender that

2. In addition, nine applications involving other CRA issues, fair lending issues, or compliance with consumer credit protection laws and regulations were withdrawn in 2002. Other applications were handled by the Reserve Banks under authority delegated to them by the Board.

3. The foreign banking organizations examined by the Federal Reserve are organizations operating under section 25 or 25(a) of the Federal Reserve Act (Edge Act and agreement corporations) and state-chartered commercial lending companies owned or controlled by foreign banks. These institutions are not subject to the Community Reinvestment Act and typically engage in relatively few activities that are covered by consumer protection laws.

engaged in a pattern or practice of redlining (discouraging loan applications from consumers living in minority neighborhoods) in a major city.

In 2001 the Board supplemented interagency procedures for fair lending examinations with alternative procedures for banks having low-discrimination-risk profiles. Typically, such banks are stable community banks, commonly specializing in commercial or agricultural lending, that are located in suburban or rural markets having a low percentage of minority residents. The alternative procedures facilitate the allocation of resources for more-intensive analysis of institutions that have higher-risk profiles. During 2002, roughly 25 percent of all fair lending examinations were conducted using the alternative procedures.

### *Flood Insurance*

The National Flood Insurance Reform Act of 1994 substantially amended the National Flood Insurance Act of 1968, which created the National Flood Insurance Program (NFIP). The amendments sought to increase compliance with federal flood insurance requirements, increase participation in the NFIP, increase income to the National Flood Insurance Fund, and decrease the financial burden on the federal government, taxpayers, and victims resulting from floods. Under the amendments, the Federal Reserve Board and the other federal financial institution supervisory agencies are required to impose civil money penalties when they find a pattern or practice of violations of the NFIP. Any such civil money penalties are remitted to the Federal Emergency Management Agency for deposit in the National Flood Mitigation Fund.

During the 2002 reporting period, the Board imposed civil money penalties on

two state member banks for violations of the Board's Regulation H, which implements the National Flood Insurance Act: In October 2001, a consent order assessing penalties of \$10,500 was issued against McIlroy Bank and Trust (Fayetteville, Arkansas), and in April 2002, a consent order assessing penalties of \$10,000 was issued against Community Bank of Granbury (Granbury, Texas).

### *Coordination with Other Federal Banking Agencies*

Member agencies of the Federal Financial Institutions Examination Council (FFIEC) develop uniform examination principles, standards, procedures, and report formats.<sup>4</sup> In 2002, the FFIEC issued examiner guidance under the Real Estate Settlement Procedures Act regarding settlement service mark-ups and unearned fees. The FFIEC is in the process of revising examination procedures related to the Truth in Lending Act, the Home Ownership and Equity Protection Act, the Home Ownership Counseling Act, and the Homeowners Protection Act.

In 2001, the Federal Reserve joined with the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) to publish an advance notice of proposed rulemaking, seeking public comment on a wide range of questions related to revising the Community Reinvestment Act. In 2002, the agencies reviewed the comments and weighed various possible amendments to the

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4. The FFIEC member agencies are the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration.

regulations. At year-end 2002, they were reaching a final decision about whether to issue a proposed rule and, if so, what changes to propose. They were weighing whether any change with the potential for substantial benefits would be justified in light of the burdens of implementation.

Also in 2002, the Board, the OCC, and the FDIC conducted the annual update for the host-state loan-to-deposit ratios used to determine compliance with section 109 of the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994.

### Consumer and CRA Training for Bank Examiners

Ensuring that financial institutions comply with laws and regulations that protect consumers and encourage community reinvestment is an important part of the bank examination and supervision process. As the number and complexity of consumer financial transactions grow, training for examiners of the state member banks under the Federal Reserve's supervisory responsibility becomes even more important.

Federal Reserve bank examiners are employees of the Federal Reserve Banks, which carry out compliance supervision under authority delegated by the Board. Their training, however, is a shared responsibility of the Board and the Reserve Banks. Individuals seeking to become commissioned examiners for the Federal Reserve must complete a formal course of training. Assistant examiners complete three levels of course work, with attention to internal controls, information technology, risk management, risk-focused examination techniques, and integrated supervision concepts. In addition to passing two proficiency examinations, examiners must exhibit strong analytical, critical-

thinking, and decisionmaking skills. Commissioned examiners serve as "examiners in charge" of bank examinations.

To help ensure that supervision staff have the knowledge and skills needed to be successful in an evolving financial industry, the System must continually identify, develop, coordinate, and review training and development opportunities. At least every three years, Board and Reserve Bank staff review the core consumer affairs curriculum, updating subject matter and adding new elements as appropriate. Each course is updated periodically to take account of major technical changes as well as changes in instructional delivery techniques. The staff also look for opportunities to deliver courses via alternative channels such as the Internet or other distance-learning technologies.

The core consumer affairs curriculum comprises five courses focused on various consumer laws, regulations, and examining concepts. In 2002, these courses were offered in twelve sessions to more than 200 consumer compliance examiners:

- *Consumer Compliance Examinations I.* Emphasizes examination procedures and the practical application of banking regulations; focuses on the consumer laws and regulations that govern financial institution operational procedures and non-real-estate lending. The course is geared toward assistant examiners with three to six months of examination experience.
- *Consumer Compliance Examinations II.* Equips assistant examiners with the fundamental skills needed to determine compliance with the basic elements of consumer laws and regulations governing real estate transactions; also covers System policies

on all major aspects of the consumer compliance risk-focused examination process. Assistant examiners have six to twelve months of examination experience when they complete the course.

- *Fair Lending Examination Techniques*. Provides assistant examiners with the skills and knowledge needed to plan and conduct a risk-focused fair lending examination. Assistant examiners generally have eighteen months of examination experience when they complete the course.
- *Community Reinvestment Act Examination Techniques*. Prepares assistant examiners to write performance evaluations for the CRA portion of consumer compliance examinations. Students must be familiar with the CRA regulation and CRA examination procedures.
- *Commercial Lending Essentials for Consumer Affairs*. Optional training opportunity. Familiarizes assistant examiners with basic techniques for underwriting and pricing commercial loans, including identifying the bank's credit culture and risk profile.

In addition to providing core training, the training program emphasizes the importance of continuing professional development. Opportunities for continuing development might include special projects and assignments, self-study programs, rotational assignments, instructing at System schools, or mentoring.

## Reporting on Home Mortgage Disclosure Act Data

The Home Mortgage Disclosure Act (HMDA) requires that mortgage lenders covered by the act collect and make

public certain data about their home purchase, home improvement, and refinancing loan transactions. Depository institutions generally are covered if (1) they are located in metropolitan areas, (2) they met the asset threshold at the end of the preceding calendar year (for 2001, assets of more than \$31 million; for 2002, more than \$32 million), and (3) they originated at least one home purchase loan (or refinancing) in the preceding calendar year. For-profit mortgage companies are covered if (1) they are located in metropolitan areas, (2) they had assets of more than \$10 million (when combined with the assets of any parent company) at the end of the preceding calendar year or originated 100 or more home purchase loans and refinancings in the preceding calendar year, and (3) their home purchase loan originations and refinancings accounted for 10 percent or more of their total loans by dollar volume in the preceding calendar year.

In 2002, a total of 6,659 depository institutions and affiliated mortgage companies and 972 independent mortgage companies reported HMDA data for calendar year 2001. Lenders submitted information about the disposition of loan applications, the geographic location of the properties related to loan applications and loans, and, in most cases, the race or national origin, income, and sex of applicants and borrowers. The FFIEC processed the data and produced disclosure statements on behalf of the FFIEC member agencies and the Department of Housing and Urban Development (HUD).

The FFIEC prepared individual disclosure statements for each lender that reported data—one statement for each metropolitan area in which the lender had offices and reported loan activity. In 2002, the FFIEC prepared more than 53,000 disclosure statements, reporting

data for calendar year 2001.<sup>5</sup> Each institution made its disclosure statement public in July, and reports containing aggregate data for all mortgage and home improvement loans in each of 330 metropolitan areas were made available at central depositories.<sup>6</sup> FFIEC member agencies, the reporting institutions, HUD, the Department of Justice (DOJ), and members of the public use these data. The data also assist HUD, the DOJ, and state and local agencies in responding to allegations of lending discrimination and in targeting lenders for further inquiry.

The HMDA data reported for 2001 covered 27.6 million loans and applications, about 44 percent more than in 2000. The greater volume was due primarily to an increase of about 120 percent in refinancing activity. The number of home purchase loans covered by HMDA and extended in 2001, compared with 2000, increased 8 percent for Hispanics, 4 percent for Asians, and 1 percent for whites but fell 7 percent for blacks. The precise change for Native Americans could not be determined because of reporting errors in the 2000 data. Over the period 1993 through 2001, the number of home purchase loans extended increased 158 percent for Hispanics, 92 percent for Asians, 76 percent for blacks, 28 percent for Native Americans, and 26 percent for whites.

For each income category, the number of home purchase loans reported

was higher in 2001 than in 2000; the increase was 2 percent for lower-income and higher-income applicants and 4 percent for middle-income applicants. From 1993 through 2001, the number of home purchase loans to lower-, middle-, and upper-income applicants increased 82 percent, 50 percent, and 60 percent respectively.

In 2001, 32 percent of Hispanic applicants and 29 percent of black applicants for home purchase loans reported under HMDA sought government-backed mortgages; the comparable figures were 16 percent for white and for Native American applicants and 8 percent for Asian applicants. Twenty-seven percent of lower-income applicants for home purchase loans, compared with 9 percent of higher-income applicants, applied for government-backed mortgages in 2001.

Overall, the denial rate for conventional home purchase loans (that is, loans that are not government-backed) was 21 percent in 2001. The rate rose steadily from 1993 through 1998 but has fallen since then. In 2001, denial rates for conventional home purchase loans reported under HMDA were 36 percent for black applicants, 35 percent for Native American applicants, 23 percent for Hispanic applicants, 16 percent for white applicants, and 11 percent for Asian applicants. Each of these rates was lower than the comparable rate for 2000.

### Agency Reports on Compliance with Consumer Protection Laws and Regulations

The Board is required to report annually on compliance with consumer protection laws by entities supervised by the various federal agencies. This section summarizes data collected from the twelve Federal Reserve Banks, the

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5. The FFIEC also compiles information on applications for private mortgage insurance (PMI) similar to the information on home mortgage lending collected under HMDA. Lenders typically require PMI for conventional mortgages that involve small down payments.

6. Central depository sites include libraries, universities, and city planning offices. A list of the sites can be found at [www.ffiec.gov/hmdacf/centdep/default2.cfm](http://www.ffiec.gov/hmdacf/centdep/default2.cfm).

FFIEC member agencies, and other federal enforcement agencies.<sup>7</sup>

*Regulation B  
(Equal Credit Opportunity)*

The FFIEC agencies reported that 83 percent of the institutions examined during the 2002 reporting period were in compliance with Regulation B, the same percentage as for the 2001 reporting period. Of the institutions not in full compliance, 81 percent had five or fewer violations. The most frequent violations involved failure to take one or more of the following actions:

- Provide a written notice of credit denial or other adverse action containing a statement of the action taken, the name and address of the creditor, a notice of rights, and the name and address of the federal agency that enforces compliance
- Provide a statement of reasons for credit denial or other adverse action that is specific and indicates the principal reasons for the adverse action
- Collect information for monitoring purposes about the race or national origin and sex of the applicants seeking credit primarily for the purchase or refinancing of a principal residence
- Notify the credit applicant of the action taken within the time frames specified in the regulation.

Three formal enforcement actions containing provisions relating to Regulation B were issued during the 2002

reporting period—two by the OTS and one by the OCC. The Federal Trade Commission settled one action and continued its litigation against a mortgage lender for alleged violations of the Equal Credit Opportunity Act (ECOA) and Regulation B. The alleged violations include failing to take written applications for mortgage loans, failing to provide rejected applicants with written notice of adverse action, failing to collect required information about the race or national origin and sex of applicants for mortgage loans; and, when providing notice of adverse action, failing to give the name and address of the federal agency that administers compliance with the ECOA.

The other agencies that enforce the ECOA—the Farm Credit Administration (FCA), the Department of Transportation, the Securities and Exchange Commission, the Small Business Administration, and the Grain Inspection, Packers and Stockyards Administration of the Department of Agriculture—reported substantial compliance among the entities they supervise. The FCA’s examination and enforcement activities revealed violations of the ECOA mostly related to creditors’ failure to collect information in mortgage applications for monitoring purposes and failure to comply with rules regarding adverse action notices. No formal enforcement actions relating to Regulation B were initiated by these agencies.

*Regulation E  
(Electronic Fund Transfers)*

The FFIEC agencies reported that approximately 92 percent of the institutions examined during the 2002 reporting period were in compliance with Regulation E, compared with 95 percent for the 2001 reporting period.

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7. Because the agencies use different methods to compile the data, the information presented here supports only general conclusions. The 2002 reporting period was from July 1, 2001, through June 30, 2002.

The most frequent violations involved failure to comply with the following requirements:

- Determine whether an error occurred, and transmit the results of the investigation to the consumer within ten business days
- Credit the customer's account in the amount of the alleged error within ten business days of receiving the error notice, if more time is needed to conduct the investigation
- Report the results of the investigation to the consumer within three business days after its completion.

The agencies did not issue any formal enforcement actions relating to Regulation E during the reporting period.

#### *Regulation M (Consumer Leasing)*

The FFIEC agencies reported that more than 99 percent of the institutions examined during the 2002 reporting period were in compliance with Regulation M, which is comparable to the level of compliance for the 2001 reporting period. The few violations noted involved failure to adhere to specific disclosure requirements. The agencies did not issue any formal enforcement actions relating to Regulation M during the reporting period.

#### *Regulation P (Privacy of Consumer Financial Information)*

July 2001 through June 2002 marked the first full year of implementation of Regulation P. Examinations found few violations, and no formal enforcement actions were issued.

#### *Regulation Z (Truth in Lending)*

The FFIEC agencies reported that 77 percent of the institutions examined during the 2002 reporting period were in compliance with Regulation Z, compared with 79 percent for the 2001 reporting period. Of the institutions not in full compliance, 73 percent had five or fewer violations, compared with 75 percent for the 2001 reporting period. The most frequent violations involved failure to take one or more of the following actions:

- Accurately disclose the finance charge, taking any prepaid finance charges into account
- Accurately disclose the number, amounts, and timing of payments scheduled to repay the obligation
- Ensure that if the disclosed finance charge (which affects other disclosures) is understated, the amount disclosed is understated by no more than \$100
- Ensure that disclosures reflect the terms of the legal obligation between the parties
- Provide the index value for the periodic adjustments to variable-rate loans.

Three formal enforcement actions containing provisions relating to Regulation Z were issued during the 2002 reporting period—two by the OTS and one by the OCC. In addition, 174 institutions supervised by the Federal Reserve, the FDIC, or the OTS were required, under the Interagency Enforcement Policy on Regulation Z, to refund a total of approximately \$1.2 million



to consumers for the 2002 reporting period. During the reporting period, the FTC continued its efforts to curb abusive practices by some subprime mortgage lenders, entering into three settlements, initiating three legal actions, and pursuing litigation against one creditor for alleged violations of the Truth and Lending Act (TILA) and the Home Ownership and Equity Protection Act.

The Department of Transportation (DOT) concluded its investigation of five cases involving air carriers for possible violations of the TILA. All five cases involved the timeliness of processing requests for credit card refunds. Four of the cases were closed with warning letters; in the fifth case, DOT entered into a consent order that directed the carrier to cease and desist from further violations of the refund provisions of the TILA and assessed a civil penalty of \$25,000. In addition, the DOT continued to prosecute a cease-and-desist consent order issued in 1993 against a travel agency and a charter operator. The complaint alleged that the two organizations had violated Regulation Z by routinely failing to send credit statements for refund requests to credit card issuers within seven days of receiving fully documented credit refund requests from customers. The case remained pending because the principal of the company was serving a prison sentence for an unrelated airline bankruptcy fraud conviction.

*Regulation AA  
(Unfair or Deceptive Acts  
or Practices)*

The three banking regulators with responsibility for enforcing Regulation AA's Credit Practices Rule—the Federal Reserve, the OCC, and the FDIC—reported that 99 percent of insti-

tutions examined during the 2002 reporting period were in compliance, the same proportion as for the 2001 reporting period. Among the institutions not in full compliance, the most frequently cited violations involved

- Failing to provide a clear, conspicuous disclosure regarding a cosigner's liability for a debt
- Entering into a consumer credit contract containing a nonpossessory security interest in household goods, a practice barred by Regulation AA.

No formal enforcement actions relating to Regulation AA were issued during the reporting period.

*Regulation CC  
(Availability of Funds and  
Collection of Checks)*

The FFIEC agencies reported that 90 percent of institutions examined during the 2002 reporting period were in compliance with Regulation CC, compared with 91 percent for the 2001 reporting period. Among the institutions not in full compliance, the most frequently cited violations involved the failure to take one or more of the following actions:

- Make funds from certain checks, both local and nonlocal, available for withdrawal within the times prescribed by the regulation
- Provide a written notice explaining why an exception to the institution's availability policy was invoked
- Provide a written notice when the depository bank extended the time for making funds available for withdrawal

- Follow special procedures when invoking the exception for large-dollar deposits.

No formal enforcement actions relating to Regulation CC were issued during the reporting period.

### *Regulation DD (Truth in Savings)*

The FFIEC agencies reported that 87 percent of institutions examined during the 2002 reporting period were in compliance with Regulation DD, compared with 88 percent for the 2001 reporting period. Among the institutions not in full compliance, the most frequently cited violations involved

- Advertisements that were inaccurate or misleading (or both)
- Use of the phrase “annual percentage yield” in an advertisement without disclosing additional terms and conditions of customer accounts
- Failure to provide notice before maturity for automatically renewing time accounts having a term of more than one month.

No formal enforcement actions relating to Regulation DD were issued during the reporting period.

## **Implementation of Statutes Designed to Inform and Protect Consumers**

### **Changes in the Collection of Data on Home Mortgage Loans**

The past decade has witnessed important developments in mortgage markets, spurred in part by improvements in

technology and information-processing capabilities. Prominent among these developments have been the movement to risk-based pricing of mortgage credit and the growth of new channels for loan applications, funding, and origination. In 2002, the Board took note of these changes in carrying out a review of Regulation C, which implements the Home Mortgage Disclosure Act (HMDA).

The express purposes of HMDA are to

- Provide the public and government officials with data that will help show whether lenders are serving the home-lending needs of the neighborhoods and communities in which they are located
- Help government officials target public investment to promote private investment where it is needed
- Provide data that assist in identifying possible discriminatory lending patterns and enforcing antidiscrimination statutes.

Regulation C requires lenders to report data about each mortgage loan application or origination (including loan amount, type, and purpose), each applicant or borrower (including race or ethnicity, sex, and income), and each property (including location and occupancy status). These data are made available to the public after identifying information is removed to protect consumers’ privacy.

In 2002, the Board concluded that significant changes to Regulation C were needed to keep pace with developments in the mortgage-lending market. One change was to broaden the types of data collected to include data on loan pricing. This change will aid both in

detering discrimination and in helping data users better understand the mortgage market, particularly the subprime market. Over the years, the focus of concerns about discrimination has shifted from lenders' decisions to approve or deny applications to lenders' loan-pricing practices. The widespread adoption of risk-based pricing has focused attention on the fairness of lenders' pricing decisions. Obtaining information about loan pricing is critical to ensuring the continued utility of the HMDA data.

Beginning January 1, 2004, lenders will report rate spreads for loans that exceed a certain price threshold (for first lien loans, prices must be reported if the difference between the loan's annual percentage rate and the yield on Treasury securities with comparable maturities is 3 percentage points or more; for subordinate lien loans, if the difference is 5 percentage points or more). Lenders will also report whether a loan meets the price-based triggers of the Home Ownership and Equity Protection Act, which requires that borrowers of high-priced loans be given special disclosures and other protections.

The Board also revised Regulation C to reflect another major change in the mortgage market—the increasing availability of preapproval programs. Preapproval programs offer the possibility of conditional approval of a mortgage loan before a borrower has chosen a property, enabling the borrower to demonstrate to potential home sellers that the borrower will likely be able to obtain a loan. Regulation C will require lenders to report preapproval requests that are evaluated under programs in which the lender gives approved applicants a written commitment letter, good for a set period and for up to a fixed dollar amount. Beginning January 1, 2004, lenders will identify preapproval

requests that are approved and result in loan originations as well as requests that are denied. Lenders may, but will not be required to, report preapproval requests that are approved but not accepted by the applicant.

In addition, the Board revised the categories for identifying the race and national origin of applicants and borrowers to conform to categories used by the Bureau of the Census and other federal agencies. Following guidance provided by the Office of Management and Budget, the Board will permit an applicant to select more than one race and will distinguish between race and Hispanic ethnicity; these changes take effect January 1, 2004.

In response to the growing number of telephone applications and the increasing proportion of loan applications for which information on applicant race, ethnicity, or sex is missing, the Board mandated collection of such data on telephone applications; this rule, which parallels the rule for mail and Internet applications, took effect January 1, 2003.

Finally, the Board made several changes to improve the consistency and utility of the HMDA data. These changes include simplifying the definitions of loan types and distinguishing loans for manufactured homes from loans for site-built homes.

### Revisions to Truth in Lending Regulations

In April 2002, the Board revised the official staff commentary to Regulation Z (Truth in Lending) to clarify how creditors that place Truth in Lending Act disclosures in the same document as the credit contract can satisfy the requirement to provide the disclosures before consummation and in a form the consumer can keep. The revi-

sions also provide guidance on disclosing costs for certain credit insurance policies.

The Board also took the following regulatory actions during the year:

- Raised from \$480 to \$488 the total dollar amount of points and fees that triggers additional requirements for certain mortgage loans under the Home Ownership and Equity Protection Act, effective in January 2003, to reflect changes in the consumer price index, as prescribed by the statute.
- Maintained at \$32 million the exemption threshold for depository institutions required to collect data in 2003 under the Home Mortgage Disclosure Act, in keeping with the consumer price index for urban wage earners and clerical workers (CPI-W), as prescribed by the statute.

### Economic Effects of the Electronic Fund Transfer Act

As required by the Electronic Fund Transfer Act (EFTA), the Board monitors the effects of the act on institutions' compliance costs and the benefits of the act to consumers.

Approximately 85 percent of U.S. households have or use one or more electronic fund transfer (EFT) service—for example, an ATM card, a debit card, or direct deposit. The proportion of households using EFT services has grown over the past ten years at an annual rate of 2 percent to 3 percent, according to data from the Board's Survey of Consumer Finances (the most recent data available were from 1998; data from the 2001 survey are to be released in 2003).

Automated teller machines remain the most widely used EFT service. About two-thirds of U.S. households have an

ATM card. In 2002, the number of ATM transactions per month averaged almost 1.2 billion, an increase of nearly 3 percent from 2001. The number of installed ATMs rose nearly 9 percent, to about 352,000.

Direct deposit is also widely used. About 60 percent of U.S. households have funds deposited directly into their checking or savings accounts. Use of the service is particularly common in the public sector: Approximately 72 percent of all government payments in fiscal year 2002 were made using electronic funds transfer, including 79 percent of social security payments, 98 percent of federal salary and retirement payments, and 39 percent of federal income tax refunds.

Direct bill payment is a less widely used EFT payment mechanism. About 36 percent of U.S. households have payments automatically deducted from their accounts.

About one-third of U.S. households use debit cards, which consumers use at merchant terminals to debit their checking or savings accounts. These point-of-sale (POS) systems account for a fairly small share of electronic transactions, but their use has continued to grow rapidly. The average number of POS transactions per month rose almost 39 percent, from 304.0 million in 2001 (revised from previously reported data) to 421.7 million in 2002, though the number of POS terminals fell, to 3.5 million.

Electronic check conversion is a variation of electronic funds transfer whereby a check is used as the source of information for a one-time electronic payment from the consumer's checking account via EFT. During 2002, Board staff helped develop and distribute consumer information to explain the process ([www.federalreserve.gov/pubs/checkconv/default.htm](http://www.federalreserve.gov/pubs/checkconv/default.htm)).

The incremental costs associated with the Electronic Fund Transfer Act are difficult to quantify because no one knows how industry practices would have evolved in the absence of statutory requirements. The benefits of the EFTA are also difficult to measure because they cannot be isolated from consumer protections that would have been provided in the absence of regulation. The available evidence suggests no serious consumer problems with the EFTA (see the section “Agency Reports on Compliance with Consumer Protection Laws and Regulations”).

### **Consumer Complaints**

The Federal Reserve investigates complaints against state member banks and forwards to the appropriate enforcement agency complaints that involve other creditors and businesses. Each Reserve Bank investigates complaints against state member banks in its District.

The Board provides guidance to the Reserve Banks on complaint program policies and procedures through advisory letters and periodic updates to the Consumer Complaint Manual. In 2002, the Board issued guidance and new codes for identifying complaints and inquiries about electronic check conversion transactions and the sale of insurance by state member banks. The Board also clarified procedures for investigating complaints alleging unlawful credit discrimination. In addition, the Board established supplemental procedures to help the Reserve Banks focus and expedite investigations.

In 2002 the Board initiated a workflow study of the Federal Reserve’s complaint-handling process to identify ways to maximize efficiency and effectiveness. The study is expected to be completed by early spring 2003.

The Board also established an advisory group to assess the Federal Reserve’s complaints and inquiry database—Complaints Analysis Evaluation System and Reports (CAESAR). The advisory group is organized into two subcommittees: one to develop and implement improvements to data entry and reporting processes, and the other to analyze the adequacy of the complaint and inquiry code structure. Enhancements to CAESAR will be implemented in the first quarter of 2003.

### **Complaints against State Member Banks**

In 2002 the Federal Reserve received just over 5,700 complaints from consumers. The majority (63 percent) related to practices that are not subject to federal regulation (see next section, “Unregulated Practices”). About 48 percent of the complaints received were against state member banks (see tables). Of the complaints against state member banks, 66 percent involved loan functions: 3 percent alleged discrimination on a basis prohibited by law (race, color, religion, national origin, sex, marital status, age, the fact that the applicant’s income comes from a public assistance program, or the fact that the applicant has exercised a right under the Consumer Credit Protection Act), and 63 percent concerned other credit-related practices, such as the imposition of annual membership fees, or credit denial on a basis not prohibited by law (for example, credit history or length of residence). Twenty-four percent of the complaints against state member banks involved disputes about interest on deposits and general deposit account practices, and the remaining 10 percent concerned disputes about electronic fund transfers, trust services, or other

## Consumer Complaints against State Member Banks and Other Institutions Received by the Federal Reserve System, 2002

Subject	State member banks	Other institutions <sup>1</sup>	Total
Regulation B (Equal Credit Opportunity) .....	66	36	102
Regulation C (Home Mortgage Disclosure Act) .....	0	1	1
Regulation E (Electronic Fund Transfers) .....	64	76	140
Regulation H (Bank Sales of Insurance) .....	0	0	0
Regulation M (Consumer Leasing) .....	0	0	0
Regulation P (Privacy of Consumer Financial Information) .....	12	4	16
Regulation Q (Payment of Interest) .....	0	0	0
Regulation Z (Truth in Lending) .....	617	374	991
Regulation BB (Community Reinvestment) .....	2	1	3
Regulation CC (Expedited Funds Availability) .....	29	25	54
Regulation DD (Truth in Savings) .....	72	48	120
Fair Credit Reporting Act .....	375	201	576
Fair Debt Collection Practices Act .....	64	17	81
Fair Housing Act .....	1	5	6
Flood insurance rules .....	3	10	13
Regulations T, U, and X .....	0	0	0
Real Estate Settlement Procedures Act .....	20	14	34
Unregulated practices .....	1,440	2,128	3,568
<b>Total</b> .....	<b>2,765</b>	<b>2,940</b>	<b>5,705</b>

1. Complaints against these institutions were referred to the appropriate regulatory agencies.

practices. Information on the outcomes of the investigations of these complaints is provided in the table.

During 2002, the Federal Reserve completed the investigation of 86 complaints against state member banks that were pending at year-end 2001 and found four violations of regulations. In the vast majority of cases, the bank had correctly handled the customer's account; notwithstanding, the bank in many cases chose to reimburse or otherwise accommodate the consumer.

Also during the year, the Federal Reserve handled more than 2,000 inquiries about consumer credit and banking policies and practices. In responding to these inquiries, the Board and Reserve Banks gave specific explanations of laws, regulations, and banking practices and provided relevant printed materials on consumer issues.

## Unregulated Practices

As required by section 18(f) of the Federal Trade Commission Act, the Board monitors complaints about banking practices that are not subject to existing regulations, focusing on those that concern possible unfair or deceptive practices. In 2002 the Board received more than 1,400 complaints that involved unregulated practices. The categories that received the most complaints involved checking and credit card accounts: Consumers alleged that unauthorized withdrawals were made from their checking accounts (101), disputed amounts withdrawn (155), and complained about insufficient-funds charges and procedures (141); they also complained about fees associated with credit card accounts (149) and about debt-collection tactics (109). The remainder

Consumer Complaints Received by the Federal Reserve System,  
by Subject of Complaint, 2002

Subject of complaint	Complaints against state member banks					
	Total		Not investigated		Investigated	
	Number	Percent	Unable to obtain sufficient information from consumer	Explanation of law provided to consumer	Bank legally correct	
					No reimbursement or other accommodation	Goodwill reimbursement or other accommodation
Loans						
Discrimination alleged						
Real estate loans .....	19	1	2	1	6	0
Credit cards .....	20	1	8	1	8	2
Other loans .....	27	1	0	2	12	0
Other type of complaint						
Real estate loans .....	508	18	16	37	211	92
Credit cards .....	1,007	37	7	7	340	429
Other loans .....	227	8	10	22	91	29
Deposits .....	658	24	21	83	272	112
Electronic fund transfers .....	64	2	3	5	20	15
Trust services .....	30	1	1	4	11	1
Other .....	205	7	7	21	84	22
<b>Total .....</b>	<b>2,765</b>	<b>100</b>	<b>75</b>	<b>183</b>	<b>1,055</b>	<b>702</b>

of the complaints concerned unregulated practices in other areas: Consumers complained about credit denials attributed to credit history, failure to remove the lien on property for which the mortgage had been paid off, and poor customer service.

Complaint Referrals to HUD

In accordance with a memorandum of understanding between HUD and the federal bank regulatory agencies, in 2002 the Federal Reserve referred to HUD ten complaints alleging state member bank violations of the Fair Housing Act. In two of the ten cases the Federal Reserve’s investigations revealed no evidence of illegal discrimination. In a third case the bank had made an error regarding the consumer’s

adverse action notice, which the bank subsequently corrected. The remaining seven cases are pending.

**Advice from the Consumer Advisory Council**

The Board’s Consumer Advisory Council—whose members are drawn from consumer and community organizations, the financial services industry, academic institutions, and state agencies—advises the Board on matters concerning laws administered by the Board and other issues related to consumer financial services. Council meetings are open to the public.

In 2002, the Council met in March, June, and October. The rules implementing the Community Reinvestment Act (CRA) were a major topic at the March

## Consumer Complaints Received—Continued

Complaints against state member banks						Referred to other agencies	Total complaints
Investigated					Pending, December 31		
Customer error	Bank error	Factual or contractual dispute—resolvable only by the courts	Possible bank violation—bank took corrective action	Matter in litigation			
0	0	0	2	0	8	19	38
0	1	0	0	0	0	7	27
0	1	2	1	0	9	10	37
0	75	13	10	11	43	498	1,006
1	79	16	8	1	119	795	1,802
1	42	4	1	4	23	521	748
2	74	27	10	14	43	475	1,133
0	6	0	9	1	5	76	140
0	2	4	0	3	4	21	51
2	14	9	0	2	44	518	723
<b>6</b>	<b>294</b>	<b>75</b>	<b>41</b>	<b>36</b>	<b>298</b>	<b>2,940</b>	<b>5,705</b>

and June meetings. In March, Council members commented on the investment test, data collection, and the small-bank test. Some members considered the existing investment test to be sufficient, while others preferred that a separate community development test replace the investment test. Regarding data collection for small-business and small-farm lending, some members emphasized that gathering quality data is a substantial burden for small banks and questioned the overall benefits of collecting detailed data. Members also commented on the appropriate size-definition of “small bank.” In June, Council members considered the effectiveness of the evaluation criteria for community development performance in terms of changing community dynamics. Members also noted the importance of con-

text in evaluating a bank’s CRA performance and emphasized that bankers should review the performance context with regulators at the beginning of examinations.

In March, Council members discussed Regulation C, which implements the Home Mortgage Disclosure Act. They provided views on issues still under review after the Board’s January 2002 revisions to the regulation, including the appropriate threshold for collecting price data on higher cost loans; a proposal to require lenders to ask telephone applicants their race, ethnicity, and sex; and a proposal to report lien status for applications and originated loans. A discussion of Regulation B, which implements the Equal Credit Opportunity Act, focused on proposed changes to the definition of “creditor”



and the prohibition against data notation for non-mortgage credit. Members provided both supporting and opposing views on removing the prohibition against data notation.

In June, Council members discussed the rules implementing the privacy provisions of the Gramm–Leach–Bliley Act. Members commented on the effectiveness of the required privacy notices in light of the notices’ length and complexity. Other comments concerned the low rates of response to the notices. Also in June, Council members discussed financial literacy and noted the challenges of designing and delivering financial literacy training in an environment of technological advances and expanding financial products. They emphasized that no single solution or design works for all consumers and that a broad approach to training and delivery systems is necessary to reach those in need of training.

At the October meeting, the amendments proposed by the Department of Housing and Urban Development to its Regulation X, which implements the Real Estate Settlement Procedures Act (RESPA), were a topic of discussion. Council members focused on whether the proposed “guaranteed mortgage package agreement” and the proposed revisions to the good-faith estimate would benefit financial institutions and consumers during the mortgage selection process. Members also addressed inconsistencies between the Board’s Truth in Lending Act disclosure rules and HUD’s proposed RESPA rules.

The Council also discussed identity theft and access to credit cards during the October meeting. Regarding identity theft, members considered the adequacy of current laws and whether potential legislative, regulatory, or industry solutions would be effective in combating identify theft. Many members agreed

that limiting the use and display of personal identifiers (such as social security numbers) and providing additional tools to identity-theft victims to clear their credit records would be beneficial. The discussion of access to credit cards focused on consumers who may not have the ability to repay their debt, particularly students.

### **Promotion of Community Development in Historically Underserved Markets**

In 2002, the community affairs function within the Federal Reserve System expanded its activities to promote economic growth and financial literacy in historically underserved markets. The structure and mission of the community affairs program was conceived to help financial institutions meet their responsibilities under the Community Reinvestment Act, and Community Affairs Offices around the System continued during the year to hold CRA roundtables with bankers and community development organizations to increase understanding of CRA-related policy issues and investment tools. However, community affairs programs have broadened to respond to the evolving financial and regulatory needs of diverse groups and communities. Reserve Bank Community Affairs Offices focus on providing information and investment opportunities to low- and moderate-income communities within their Districts, while the Board’s Community Affairs Office brings a national perspective, engaging in projects that have significant implications for public policy. In 2002, System community affairs programs also addressed financial education, financial services for Native Americans, banking for immigrant communities, emerging issues and opportu-

nities in community development, and community development finance.

### Promotion of Financial Education

Consumers who are well informed on financial matters are generally able to make better decisions for their families, increasing their economic security and well-being. In turn, secure families are better able to contribute to vital, thriving communities, further fostering community economic development. As a consequence, financial education has risen on the agendas of educators, community groups, businesses, government agencies, and policymakers.

The Board supported a wide range of activities promoting financial education in 2002, including conducting research, sponsoring meetings, providing training, and preparing educational materials. Staff in the Board's Division of Consumer and Community Affairs prepared articles for the *Journal of Family and Consumer Sciences* and the *Federal Reserve Bulletin* ("Financial Literacy: An Overview of Practice, Research, and Policy," [www.federalreserve.gov/pubs/bulletin/2002/1102lead.pdf](http://www.federalreserve.gov/pubs/bulletin/2002/1102lead.pdf)) summarizing efforts in research, fieldwork, and public policy that further the goal of creating financially literate consumers.

Research initiated by Board staff investigated consumers' financial management practices and their engagement in the financial services marketplace, consumers' choices of financial institutions for home-secured loans, consumers' efforts at comparison shopping, and consumers' complaint actions with respect to problems with credit cards.

During the year, partnerships with other agencies and organizations were formed to undertake a variety of financial education initiatives. Board staff collaborated with the National Endow-

ment for Financial Education in a national symposium on financial literacy and provided training on consumer credit management for Air Force Command financial specialists. Consumer education materials on financial privacy, developed in collaboration with other government agencies, were launched during National Consumer Protection Week 2002 ([www.federalreserve.gov/pubs/privacy/default.htm](http://www.federalreserve.gov/pubs/privacy/default.htm)).

Across the Federal Reserve System, Community Affairs Offices organized programs to heighten employee awareness of fundamental financial management concepts. At the Board, community affairs staff organized lunch-and-learn sessions on savings and budgeting and joined with staff of the Management Division to identify best practices in employee financial education. The Federal Reserve Bank of St. Louis held information sessions focused on employee housing and credit resources, and several Reserve Banks hosted Consumer Protection Week activities for their employees.

Reserve Banks in Atlanta, Boston, Chicago, Cleveland, Philadelphia, and San Francisco supported financial education initiatives in their Districts. For example, the San Francisco Reserve Bank published a compendium of financial literacy resources for bankers interested in offering financial education programs that serve their local markets ([www.frbsf.org/community/webresources/bankersguide.pdf](http://www.frbsf.org/community/webresources/bankersguide.pdf)). The Chicago Reserve Bank coordinated asset-building workshops in Illinois and southeastern Wisconsin to provide information on investment approaches for low- and moderate-income persons. And the Boston, Atlanta, and Chicago Reserve Banks hosted workshops in their communities on the benefits of the federal Earned Income Tax Credit and Assets for Independence programs as

## Lending in Indian Country

*Overcoming challenges to development requires leadership, commitment, creativity, and flexibility. . . . [T]he vision of tribal leaders and the involvement of partners have helped to bring the new ideas, as well as the capital and technical assistance, necessary to create viable economies in Indian Country.*

Mark W. Olson, *Member*, Board of Governors  
November 18, 2002

Extension of economic development into underserved communities often rests on gaining an understanding of local culture and history. With such an understanding, lenders, developers, and local leaders can bridge the information and credit gaps to facilitate the flow of capital and other resources that support growth and development.

Understanding local culture and history is especially critical to overcoming the challenges of lending on Indian reservations and tribal lands, collectively known as Indian Country. In many Native American communities, misunderstanding, mistrust, and discrimination have historically hindered the development of the infrastructures—governmental, physical, educational, and financial—needed to support market-based economies. Further, many tribal communities are underserved by financial institutions, a situation that limits their access to the credit and capital vital to their growth and development. As a result, many tribal communities struggle with significant social and economic challenges, as seen in high rates of unemployment, inadequate housing, and low educational attainment.

Sovereignty is a central issue in economic development in Indian Country. As

sovereign nations, Native American communities have the right to self-govern and to adjudicate contractual disputes in their own tribal courts. While the exercise of sovereignty preserves the right of tribal self-governance, it also creates a complex legal environment that results in uncertainty for lenders and investors, who seek consistency in their evaluation of risk and the likely return on investment. At the same time, some tribal members are unfamiliar with the requirements and expectations of lenders and other private-sector investors. These competing forces—the business need for certainty and predictability on one hand and unfamiliarity with lender and investor needs on the other—can disrupt the flow of information between Native American communities and the banking industry, impairing the operation of an efficient market.

### The Role of the Federal Reserve

Staff of the Community Affairs Offices (CAOs) at the Board of Governors and several Federal Reserve Banks have worked with tribal leaders and bankers for nearly a decade to address the factors that hinder lending and discourage financial investments in Indian Country. CAO staff

wealth-creation vehicles for low-income families.

### Programs in Cooperation with Native Americans

In 2002, the community affairs function addressed credit and lending barriers

faced by Native American populations through sponsorship of the Federal Reserve System's first national conference on banking opportunities on Indian reservations and tribal lands (see box "Lending in Indian Country"). System staff continued to facilitate meetings and workshops and to convene task forces to

have sought to increase communication and highlight opportunities for profitable relationships and development in Indian Country by creating mutually beneficial partnerships. They have fostered the exchange of information through workshops on sovereign lending, articles in Reserve Bank newsletters, assistance in designing a financial training curriculum for Native American students, and support for the development of regulations and procedures that govern secured credit transactions. At the national level, CAO staff at the Board have served on federal task forces that helped develop policy to improve funding opportunities in Indian Country.

Through ongoing relationships with tribal leaders and bankers, the Federal Reserve has gained valuable insight into the cultural and legal issues and the concerns of all parties. This insight led to recognition by the Federal Reserve and its Native American partners of a need for a national dialogue on lending in Indian Country.

### **Pathway to a National Conference**

To promote a national dialogue, the Federal Reserve and its tribal partners began planning a conference that could serve as a catalyst, stimulating new partnerships and creative initiatives in Native American communities across the country. An advisory committee made up of tribal leaders, lenders, community development practitioners, attorneys, and academics knowledgeable about Indian Country issues was formed by the Community Affairs Officers

of the Board and participating Reserve Banks (the Reserve Banks of Chicago, Kansas City, Minneapolis, and San Francisco). The committee helped ensure that agenda topics were culturally sensitive and accurately portrayed the credit needs and concerns of Native American communities and at the same time emphasized the critical role of banks in creating economic opportunity in Indian Country. To promote the partnerships between lenders and communities that are essential to the growth and stabilization of local economies, the conference agenda was developed to highlight ways in which creative economic development efforts—financed by leveraging funds from government loan and guarantee programs with bank credit—can result in safe, sound lending transactions.

The conference, held on November 18–20, 2002, in Scottsdale, Arizona, drew more than 400 participants. It provided a forum for financiers, tribal leaders, and economic developers to discuss innovative development opportunities in Indian Country. The conference format employed “talking circles,” a discussion method unique to the Native American culture that invites tribal members to enter into dialogue following each plenary session. Breakout sessions addressed related issues integral to development in Indian Country, including commercial codes, bank formation, regulatory matters, and wealth-building strategies. The breakout sessions afforded an opportunity to explore more fully the topics addressed in panel discussions, enabling the building of partnerships to effect sustainable economic revitalization in Indian Country.

discuss financing of housing and small businesses on tribal lands and financial literacy within tribal communities. Through a national interagency Native American task force, Board staff began planning for a policy development forum on financial literacy in Indian Country scheduled for May 2003.

### **Banking for Immigrant Communities**

Major demographic changes and population shifts have been the impetus for several Federal Reserve initiatives involving immigrant banking markets. Seven Reserve Banks—Atlanta, Boston,

Chicago, Dallas, Kansas City, New York, and Richmond—sponsored programs and outreach meetings during 2002 to heighten financial institutions' awareness of the credit and financial service needs of Hispanic communities. English and Spanish versions of materials on Electronic Transfer Accounts (an account designed by the U.S. Treasury for recipients of federal benefits), the *matricula consular* card for Mexican nationals seeking banking services, and financial literacy ("Building Wealth: A Beginner's Guide to Securing Your Financial Future") are available on the Dallas Reserve Bank's web site (at [www.dallasfed.org/htm/ca/pubs.html](http://www.dallasfed.org/htm/ca/pubs.html)). Through other activities, the Chicago Reserve Bank addressed the needs of the Asian-American community, and the Minneapolis Reserve Bank, the needs of Islamic and Hmong immigrant communities.

### Emerging Issues and Opportunities

The Federal Reserve in 2002 conducted programs and held conferences on emerging issues in community development to encourage research and discussion among academics and practitioners. Among the topics discussed were

- Community development and smart growth (affordable housing, brown-fields redevelopment, transit systems, and urban revitalization)
- Microenterprise development in small cities and towns
- Entry-level employment opportunities in technology for low- and moderate-income persons
- Financial innovation in community development

- Loss mitigation and foreclosure prevention
- Sustaining and revitalizing communities affected by economic downturns.

### Community Development

Federal Reserve outreach activities and programs in rural markets continued in 2002. Initiatives included conferences on community development challenges and opportunities for rural residents and business owners, rural policy, and opportunities for public-private partnerships to further economic development in rural communities. Board staff continued to work with the Rural Home Loan Partnership, an interagency group committed to increasing affordable housing in rural communities.

Small-business development is an important component of efforts to rebuild and strengthen communities. Several Reserve Banks held workshops to provide information on opportunities for business development and partnerships with local community development organizations. Reserve Banks also provided technical assistance and information on the mechanics of accessing tax credits for small businesses and for commercial development. Board staff participated on a task force sponsored by the Department of Commerce to explore development and capital formation for minority microentrepreneurs.

The community affairs function continued to expand its presence in the international arena. Board staff participated with the Organisation for Economic Co-operation and Development (OECD), a body of international groups working to build partnerships and identify collaborative approaches to development, and delivered remarks at an OECD conference in England on the use of private finance for community build-

ing. Board staff also held meetings with officials from Indonesia, Japan, Yugoslavia, New Zealand, and Russia to discuss community development policies and strategies.

The preservation of affordable housing remains a central issue for the Federal Reserve. During 2002, Board staff served in various capacities to support the housing activities of the Federal Reserve's external partners. For exam-

ple, Board staff served as the Federal Reserve liaison to the Local Initiatives Support Corporation advisory board's Center for Home Ownership. Board staff also provided support to Governor Edward Gramlich in his role as chairman of the board of directors for the Neighborhood Reinvestment Corporation, a national nonprofit organization charged by Congress with revitalizing older, distressed communities. ■

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## *Banking Supervision and Regulation*

The U.S. banking system exhibited considerable strength in 2002, producing record earnings while absorbing significant deterioration in asset quality, lackluster revenues from financial-market activities, and the effects of economic weakness more generally. This remarkable performance is attributable in part to historically low interest rates; it also reflects the benefits of fundamentally strong balance sheets and prudent capitalization as well as the industry's continuing enhancements to risk-management processes and capabilities.

Industry earnings rose 20 percent for the year, supported by robust growth in low-cost core deposits, continued profitability from consumer lending and mortgage banking operations, and improved operating efficiency. Elevated credit costs and reversals in market-sensitive lines of business offset some of this improvement.

Nonperforming assets rose over the year, particularly at large, complex institutions. The rise was fueled by a series of high-profile bankruptcies and continuing weak economic growth. The effect on banks of these bankruptcies was somewhat muted, however, as bondholders rather than banks absorbed much of the credit costs associated with these high-profile borrowers. Credit-protection instruments also played a role in reducing bank credit losses. Banks thus appear to have benefited significantly from their ability to disperse risk through credit derivatives, the syndicated loan market, loan sales, and securitization activities, combined with better risk-management and risk-measurement systems.

Net interest margins widened moderately for the year, a result of low interest rates and growth in low-cost core deposits. Demand for business loans was weak, leading to a \$70 billion (or 7 percent) decline in aggregate commercial and industrial loans outstanding. With supply boosted by historically low mortgage rates, banks added significantly to their holdings of one- to four-family mortgage loans and pass-through securities. Loans outstanding under home equity lines of credit grew nearly 40 percent, the third consecutive year that these balances have risen by more than 20 percent. Commercial real estate lending, especially lending to finance non-farm nonresidential properties, multifamily housing, and new construction, also grew rapidly.

The economic environment also affected the way in which banks funded their operations. During this period of low interest rates and soft equity prices, many households shifted funds into interest-bearing bank transaction accounts at the same time many banks undertook significant initiatives to bolster core deposit growth. By the end of 2002, money market deposit accounts and savings deposits accounted for nearly 30 percent of the industry's funding. Capital remains a key strength of the industry, as the total risk-based capital ratio remained at about 12.7 percent.

Non-interest revenues from the origination of mortgages for sale to others were a major positive for the industry, as were service charges on rapidly growing deposit accounts. Market-sensitive revenues were again weak, consistent with the overall softness in equity markets. Most banks supported their earn-

ings by taking significant securities gains, in some cases associated with adjustments to the institution's interest rate risk profile.

Banks also reported significant gains in operating efficiency, attributable in part to a change in accounting practice that reduced expenditures to amortize goodwill. Special charges offset some of these gains at a small number of large institutions related to restructuring and potential litigation-related expenses.

Work continued toward finalizing a new international capital standard, with approval of the new framework expected in 2003 and implementation of the new rules in 2007. This year's efforts included an unprecedented coordinated effort among supervisors and bankers in the G-10 countries to assemble detailed information on the risk profiles of individual banks and the measured risks associated with these positions.

Bankers and supervisors enter 2003 in a strong position but with a cautious outlook. Both the positive and negative influences seen in 2002 appear likely to subside. By year-end 2002, asset quality was showing signs of some improvement at most banks and possible signs of economic improvement and some recovery in equity markets were emerging. Charge-offs on consumer loans remained generally stable, as available evidence continued to suggest that household debt burdens were manageable. Bankers expect credit quality to stabilize and ultimately to improve in the coming year, although an uncertain economy and geopolitical concerns may continue to affect the activities and outlook of both households and businesses. Despite these uncertainties, the fundamental strengths of the industry leave it well positioned to support, and benefit from, an economic recovery.

## **Scope of Responsibilities for Supervision and Regulation**

The Federal Reserve is the federal supervisor and regulator of all U.S. bank holding companies (including financial holding companies formed under the authority of the Gramm-Leach-Bliley Act) and of state-chartered commercial banks that are members of the Federal Reserve System. In overseeing these organizations, the Federal Reserve seeks primarily to promote their safe and sound operation and their compliance with laws and regulations, including the Bank Secrecy Act and consumer protection and civil rights laws.<sup>1</sup>

The Federal Reserve also has responsibility for the supervision of all Edge Act and agreement corporations; the international operations of state member banks and U.S. bank holding companies; and the operations of foreign banking companies in the United States.

The Federal Reserve exercises important regulatory influence over entry into the U.S. banking system and the structure of the system through its administration of the Bank Holding Company Act, the Bank Merger Act (with regard to state member banks), the Change in Bank Control Act (with regard to bank holding companies and state member banks), and the International Banking

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1. The Board's Division of Consumer and Community Affairs is responsible for coordinating the Federal Reserve's supervisory activities with regard to the compliance of banking organizations with consumer protection and civil rights laws. To carry out this responsibility, the Federal Reserve trains a number of its bank examiners in the evaluation of institutions with regard to such compliance. The chapter of this volume covering consumer and community affairs describes these regulatory responsibilities. Compliance with other banking statutes and regulations, which is treated in this chapter, is the responsibility of the Board's Division of Banking Supervision and Regulation and the Federal Reserve Banks, whose examiners also check for safety and soundness.



Act. The Federal Reserve is also responsible for imposing margin requirements on securities transactions. In carrying out these responsibilities, the Federal Reserve coordinates its supervisory activities with other federal banking agencies, state agencies, functional regulators, and the bank regulatory agencies of other nations.

### **Supervision for Safety and Soundness**

To ensure the safety and soundness of banking organizations, the Federal Reserve conducts on-site examinations and inspections and off-site surveillance and monitoring. It also undertakes enforcement and other supervisory actions.

#### **Examinations and Inspections**

The Federal Reserve conducts examinations of state member banks, the U.S. branches and agencies of foreign banks, and Edge Act and agreement corporations. In a process distinct from examinations, it conducts inspections of holding companies and their nonbank subsidiaries. Pre-examination planning and on-site review of operations are integral parts of the overall effort to ensure the safety and soundness of financial institutions. Whether it is an examination or an inspection, the review entails (1) an assessment of the quality of the processes in place to identify, measure, monitor, and control risks, (2) an appraisal of the quality of the institution's assets, (3) an evaluation of management, including an assessment of internal policies, procedures, controls, and operations, (4) an assessment of the key financial factors of capital, earnings, liquidity, and sensitivity to market risk, and (5) a review for compliance with applicable laws and regula-

tions. The table provides information on the examinations and inspections conducted by the Federal Reserve during the past five years.

#### *State Member Banks*

At the end of 2002, 949 state-chartered banks (excluding nondepository trust companies and private banks) were members of the Federal Reserve System. These banks represented approximately 12 percent of all insured U.S. commercial banks and held approximately 27 percent of all insured commercial bank assets in the United States. The guidelines for Federal Reserve examinations of state member banks are fully consistent with section 10 of the Federal Deposit Insurance Act, as amended by section 111 of the Federal Deposit Insurance Corporation Improvement Act of 1991 and by the Riegle Community Development and Regulatory Improvement Act of 1994. A full-scope, on-site examination of these banks is required at least once a year; exceptions are certain well-capitalized, well-managed institutions having assets of less than \$250 million, which may be examined once every eighteen months.

#### *Bank Holding Companies*

At year-end 2002, a total of 5,963 U.S. bank holding companies were in operation, of which 5,135 were top-tier bank holding companies. These organizations controlled 6,278 insured commercial banks and held approximately 94 percent of all insured commercial bank assets in the United States.

Federal Reserve guidelines call for annual inspections of large bank holding companies as well as smaller companies that have significant nonbank assets. In judging the financial condition of the subsidiary banks owned by holding

State Member Banks and Holding Companies, 1998–2002

Entity/Item	2002	2001	2000	1999	1998
<i>State member banks</i>					
Total number	949	970	991	1,010	994
Total assets (billions of dollars)	1,863	1,823	1,645	1,423	1,312
Number of examinations	814	816	899	858	820
By Federal Reserve System	550	561	610	551	511
By state banking agency	264	255	289	307	309
<i>Top-tier bank holding companies</i>					
Large (assets of more than \$1 billion)					
Total number	329	312	309	283	273
Total assets (billions of dollars)	7,483	6,905	6,213	5,625	5,136
Number of inspections	439	413	352	332	290
By Federal Reserve System <sup>1</sup>	431	409	346	329	281
On site	385	372	309	298	262
Off site	46	37	37	31	19
By state banking agency	8	4	6	3	9
Small (assets of \$1 billion or less)					
Total number	4,806	4,816	4,800	4,831	4,880
Total assets (billions of dollars)	821	768	716	679	647
Number of inspections	3,726	3,486	3,347	3,064	3,257
By Federal Reserve System	3,625	3,396	3,264	2,973	3,178
On site <sup>2</sup>	264	730	835	684	723
Off site	3,361	2,666	2,429	2,289	2,455
By state banking agency	101	90	83	91	79
<i>Financial holding companies</i>					
Domestic	602	567	462	...	...
Foreign	30	23	21	...	...

NOTE. Data for prior periods have been updated.

1. For large bank holding companies subject to continuous, risk-focused supervision, includes multiple targeted reviews.

2. In 2002, the supervisory program for small bank holding companies was revised, resulting in more

inspections being performed off site versus on site. See text section “Bank Holding Companies” for more information.

... Not applicable.

companies, Federal Reserve examiners consult examination reports prepared by the federal and state banking authorities that have primary responsibility for the supervision of those banks, thereby minimizing duplication of effort and reducing the burden on banking organizations.

Small, noncomplex bank holding companies—those that have consolidated assets of \$1 billion or less—are subject to a special supervisory program that was implemented in 1997 and modified in 2002.<sup>2</sup> The program permits a more flexible approach to supervision

of such companies. If all of a company’s subsidiary depository institutions have composite and management ratings of “satisfactory” or better, and if no material outstanding issues at the holding company or consolidated level are otherwise indicated, only a composite rating and a management rating based on the ratings of the lead subsidiary depository institution are assigned to the company. In 2002, the Federal Reserve conducted 3,361 reviews of such bank holding companies. If a company’s subsidiary depository institutions have ratings lower than “satisfactory” or other significant supervisory issues, a more thorough off-site review of the organization is conducted using surveillance results and other information. If the informa-

2. Refer to SR letter 02–01 for a discussion of the factors considered in determining whether a bank holding company is complex or noncomplex.

tion obtained off site from these sources is not sufficient to determine the overall financial condition of the holding company and to assign the composite and management ratings, the holding company is subject to increased supervisory review that may include an on-site review and off-site monitoring.

While the 2002 modifications to the special supervisory program principally affect the supervision of small holding companies, they also promote more-effective use of targeted on-site reviews to fulfill the requirements for, when necessary, the full-scope inspection of larger holding companies—those with consolidated assets of \$1 billion to \$5 billion. In general, the modifications direct Reserve Banks to use surveillance results and other information to focus attention and resources on holding companies that warrant increased scrutiny.

#### *Financial Holding Companies*

Under the Gramm–Leach–Bliley Act, the Federal Reserve has supervisory oversight authority and responsibility for bank holding companies, including those that operate as financial holding companies. The statute streamlines the Federal Reserve’s supervision of all bank holding companies and sets forth parameters for the relationship between the Federal Reserve and other regulators. The statute differentiates between the Federal Reserve’s relations with regulators of depository institutions and its relations with functional regulators (that is, regulators for insurance, securities, and commodities).

As of year-end 2002, 602 domestic bank holding companies and 30 foreign banking organizations had financial holding company status. Of the domestic institutions, 37 financial holding companies had consolidated assets of \$15 billion or more; 90, between \$1 bil-

lion and \$15 billion; 85, between \$500 million and \$1 billion; and 390, less than \$500 million.

#### *Specialized Examinations*

The Federal Reserve conducts specialized examinations of banking organizations in the areas of information technology, fiduciary activities, transfer agent activities, and government and municipal securities dealing and brokering. The Federal Reserve also conducts specialized examinations of certain entities, other than banks, brokers, or dealers, that extend credit subject to the Board’s margin regulations.

With passage of the Gramm–Leach–Bliley Act in 1999, the Federal Reserve ceased conducting routine annual examinations of securities underwriting and dealing activities through so-called section 20 subsidiaries of bank holding companies. Under the act, the Federal Reserve is generally required to rely on the supervisory activities of the functional regulator for broker–dealer subsidiaries unless the Board has cause to believe that a broker–dealer poses a material risk to an insured depository affiliate. No such examinations for cause were conducted during 2002.

#### *Information Technology Activities*

In recognition of the importance of information technology to safe and sound operations in the financial industry, the Federal Reserve reviews the information technology activities of supervised financial institutions as well as certain independent data centers that provide information technology services to these institutions. Several years ago, the information technology reviews of banking institutions were integrated into the overall supervisory process, and thus all safety and soundness examinations

## Adoption of Rules Governing Transactions with Affiliates

In 2002, the Federal Reserve Board issued a new regulation that addresses transactions between insured depository institutions and their affiliates. The new regulation—Regulation W (Transactions between Member Banks and Their Affiliates)—implements sections 23A and 23B of the Federal Reserve Act. It takes effect April 1, 2003.

### Background

Sections 23A and 23B of the Federal Reserve Act are designed to protect depository institutions from losses in transactions with their affiliates. They also limit a depository institution's ability to transfer to its affiliates the subsidy arising from the institution's access to the federal safety net. Section 23A subjects covered transactions between depository institutions and their affiliates (for example, loans from a depository institution to or for the benefit of an affiliate, and purchases of assets by a depository institution from an affiliate) to quantitative limits and collateral requirements. Section 23B requires that depository institutions conduct most transactions with affiliates on terms and under circumstances that are substantially the same as those granted to nonaffiliates—that is, a depository institution may not grant its affiliate more favorable terms and conditions than it would grant a similarly situated nonaffiliate in a comparable transaction. This provision is commonly referred to as the “market terms requirement.”

Before adoption of Regulation W, the statutory provisions of sections 23A and 23B of the Federal Reserve Act had been implemented by means of Board interpretations and informal staff guidance. Having a comprehensive and consistent application of the statutory provisions became especially important with passage in 1999 of the Gramm–Leach–Bliley Act (GLBA). GLBA not only provided for broader affiliations among financial services providers

but emphasized, in the statutory and regulatory frameworks it established, the importance of limitations on affiliate transactions as a means of protecting depository institutions from losses in their transactions with affiliates.

### Key Provisions of Regulation W

Key provisions of Regulation W, and some of the important exemptions from the rule, are described below.

#### Derivatives Transactions and Intraday Credit

Derivatives transactions between a depository institution and its affiliates are not subject to the quantitative limitations and collateral requirements of section 23A. They are, however, subject to the market terms requirement of section 23B. In addition, depository institutions are required to adopt policies and procedures under section 23A to manage the credit exposure arising from their derivatives transactions with affiliates.

Intraday extensions of credit by depository institutions to affiliates also are subject to the market terms requirement of section 23B. However, such extensions of credit are exempt from the quantitative limits and collateral requirements of section 23A if the depository institution adopts policies and procedures to manage its credit exposure to affiliates in such transactions and has no reason to believe that the affiliate receiving intraday credit would have difficulty repaying the loan.

#### Scope of Application— Foreign Banking Organizations

To help ensure a competitive playing field for U.S. depository institutions vis-à-vis foreign banking organizations operating in the United States, Regulation W applies to transactions between the U.S. branches and

agencies of a foreign bank and the foreign bank's affiliates engaged in the United States in securities underwriting and dealing, insurance underwriting, merchant banking, and insurance company investment. The issue of competitive equity arises most strongly in connection with these activities—activities that a U.S. bank cannot engage in directly or through an operating subsidiary.

#### Scope of Application— Financial Subsidiaries

Congress amended section 23A in 1982 to provide that under the statute, subsidiaries of a depository institution generally are not affiliates of the institution. This provision was based on the premise that subsidiaries of a depository institution generally are consolidated with the depository institution and are engaged only in activities that the depository institution may conduct directly.

In 1999, GLBA authorized depository institutions to own financial subsidiaries that engage in activities that the parent institution may not conduct directly. GLBA also amended section 23A to define a financial subsidiary of a bank as an affiliate of the bank—and thus subjected transactions between the bank and its financial subsidiaries to the limitations of sections 23A and 23B. Section 23A, as amended by GLBA, defines a financial subsidiary as a subsidiary of any state or national bank that is engaged in an activity that is not permissible for national banks (other than a subsidiary that federal law specifically authorizes national banks to control). A subsidiary of a financial subsidiary is also a financial subsidiary.

Exceptions to the definition of a financial subsidiary are included in Regulation W for (1) insurance agency subsidiaries of banks, (2) subsidiaries of state-chartered banks that engage in activities that the parent state bank may engage in directly under federal and state law, and (3) subsidiaries of state-chartered banks that engage in activities that the subsidiary

was legally conducting before Regulation W was issued.

#### Loan Purchases

For some years, the Board has allowed a depository institution to purchase a loan from an affiliate if the institution makes an independent evaluation of the borrower's creditworthiness before the affiliate extends the loan and if the institution commits to purchasing the loan before the affiliate extends the loan. In 1995, Board staff expressly limited the availability of this exemption to institutions whose loan purchases from any one affiliate represented no more than 50 percent of the dollar amount of the loans made by that affiliate. This condition was designed to prevent bank holding companies from using the exemption extensively to fund their non-bank lending affiliates.

Regulation W retains this 50 percent limitation but allows the institution's primary federal regulator, on a case-by-case basis, to restrict loan purchases even more if appropriate to protect the safety and soundness of the institution.

At the time Regulation W was adopted, the Board sought comment on a proposed rule that would prevent a depository institution from using this exemption if its purchases of loans from an affiliate under the exemption exceeded 100 percent of the institution's capital stock and surplus.

#### Conclusion

A key premise of the Gramm–Leach–Bliley Act is that sections 23A and 23B of the Federal Reserve Act limit the risk to depository institutions of the broader affiliations permitted by GLBA and make extensive prior-transaction review by the bank regulatory agencies unnecessary. In light of the greater role of these statutory provisions in risk management, Federal Reserve examiners and other supervisory staff have been directed to review inter-company transactions for compliance with the statute and Regulation W frequently and rigorously.

are now expected to include a review of information technology risks and activities. During 2002, the Federal Reserve was the lead agency in two examinations of large, multiregional data processing servicers examined in cooperation with the other federal banking agencies.

#### *Fiduciary Activities*

The Federal Reserve has supervisory responsibility for institutions that together hold more than \$15 trillion of assets in various fiduciary capacities. During on-site examinations of fiduciary activities, the institution's compliance with laws, regulations, and general fiduciary principles and potential conflicts of interest are reviewed; its management and operations, including its asset- and account-management, risk-management, and audit and control procedures, are also evaluated. In 2002, Federal Reserve examiners conducted 194 on-site fiduciary examinations.

#### *Transfer Agents and Securities Clearing Agencies*

As directed by the Securities Exchange Act of 1934, the Federal Reserve conducts specialized examinations of those state member banks and bank holding companies that are registered with the Board as transfer agents. Among other things, transfer agents countersign and monitor the issuance of securities, register the transfer of securities, and exchange or convert securities. On-site examinations focus on the effectiveness of the institution's operations and its compliance with relevant securities regulations. During 2002, the Federal Reserve conducted on-site examinations at 30 of the 98 state member banks and bank holding companies that were registered as transfer agents. Also during

the year the Federal Reserve examined 1 state member limited-purpose trust company acting as a national securities depository.

#### *Government and Municipal Securities Dealers and Brokers*

The Federal Reserve is responsible for examining state member banks and foreign banks for compliance with the Government Securities Act of 1986 and with Department of the Treasury regulations governing dealing and brokering in government securities. Thirty-five state member banks and 10 state branches of foreign banks have notified the Board that they are government securities dealers or brokers not exempt from Treasury's regulations. During 2002 the Federal Reserve conducted 9 examinations of broker-dealer activities in government securities at these institutions. These examinations are generally conducted concurrently with the Federal Reserve's examination of the state member bank or branch.

The Federal Reserve is also responsible for ensuring compliance with the Securities Act Amendments of 1975 by state member banks and bank holding companies that act as municipal securities dealers, which are examined pursuant to the Municipal Securities Rule-making Board's rule G-16 at least once each two calendar years. Of the 27 entities that dealt in municipal securities during 2002, 8 were examined during the year.

#### *Securities Credit Lenders*

Under the Securities Exchange Act of 1934, the Federal Reserve Board is responsible for regulating credit in certain transactions involving the purchase or carrying of securities. In addition to examining banks under its jurisdiction

for compliance with the Board's margin regulations as part of its general examination program, the Federal Reserve maintains a registry of persons other than banks, brokers, and dealers who extend credit subject to those regulations. The Federal Reserve may conduct specialized examinations of these lenders if they are not already subject to supervision by the Farm Credit Administration, the National Credit Union Administration, or the Office of Thrift Supervision.

At the end of 2002, 795 lenders other than banks, brokers, or dealers were registered with the Federal Reserve. Other federal regulators supervised 166 of these lenders, and the remaining 629 were subject to limited Federal Reserve supervision. On the basis of regulatory requirements and annual reports, the Federal Reserve exempted 281 lenders from its on-site inspection program. The securities credit activities of the remaining 348 lenders were subject to either biennial or triennial inspection. One hundred twenty-seven inspections were conducted during the year, compared with 65 in 2001.

### Enforcement Actions and Civil Money Penalties

In 2002 the Federal Reserve completed 18 enforcement cases involving 32 separate actions, such as cease-and-desist orders, written agreements, removal and prohibition orders, and civil money penalties. The Board of Governors collected \$60,829 in civil money penalties. All funds collected were remitted to the Department of the Treasury.

All final enforcement orders issued by the Board and all written agreements executed by the Reserve Banks in 2002 are available to the public and are posted on the Board's web site [www.federalreserve.gov/boarddocs/](http://www.federalreserve.gov/boarddocs/)

enforcement). In addition to formal enforcement actions, the Reserve Banks in 2002 completed 116 informal enforcement actions, such as resolutions with boards of directors and memorandums of understanding.

### Risk-Focused Supervision

In recent years the Federal Reserve has created several programs aimed at enhancing the effectiveness of the supervisory process. The main objective of these initiatives has been to sharpen the focus on (1) those business activities posing the greatest risk to banking organizations and (2) the organizations' management processes for identifying, measuring, monitoring, and controlling risk.

#### *Regional Banking Organizations*

The risk-focused supervision program for regional banking organizations applies to institutions having a management structure organized by function or business line, a broad array of products, and operations that span multiple supervisory jurisdictions. For smaller regional banking organizations, the supervisory program may be implemented with a point-in-time inspection. For larger institutions, it may take the form of a series of targeted reviews. For the largest, most complex institutions, the process is continuous, as described in the next section. To minimize burden on the institution, work is performed off site to the greatest extent possible. Additionally, to minimize the number of requests for information from the institution, examiners make use of public and regulatory financial reports, market data, information from automated surveillance screening systems (see section "Surveillance and Risk Assessment"), and internal management reports.

### *Large, Complex Banking Organizations*

The Federal Reserve applies a risk-focused supervision program to large, complex banking organizations (LCBOs).<sup>3</sup> The key features of the LCBO supervision program are (1) identifying those LCBOs that are judged, on the basis of their shared risk characteristics, to present the highest level of supervisory risk to the Federal Reserve System, (2) maintaining continual supervision of these institutions to keep current the Federal Reserve's assessment of each organization's condition, (3) assigning to each LCBO a supervisory team composed of Reserve Bank staff members who have skills appropriate for the organization's risk profile (the team leader is the central point of contact, has responsibility for only one LCBO, and is supported by specialists skilled in evaluating the risks of LCBO business activities and functions), and (4) promoting Systemwide and inter-agency information-sharing through an automated system.

Supporting the supervision process is an automated application and database—the Banking Organization National Desktop (BOND)—that was developed to facilitate real-time, secure information-sharing and collaboration across the Federal Reserve System and with certain other federal and state regulators. During 2002, BOND was enhanced to include the capability of searching and accessing supervisory documents using web-based technology. BOND performance and functionality were also improved to promote analysis across institutions.

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3. For an overview of the Federal Reserve's LCBO program, see Lisa M. DeFerrari and David E. Palmer, "Supervision of Large Complex Banking Organizations," *Federal Reserve Bulletin*, vol. 87 (February 2001), pp. 47–57.

During the year, the Federal Reserve, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission formed an inter-agency working group to assess whether, in light of the post-September 11 risk environment, additional guidance on business resumption is needed. The agencies held a series of meetings with financial institutions and core clearing and settlement organizations to discuss lessons learned and the need for improving the resilience of the financial system after a wide-scale disruption. In September 2002, the working group published for comment a Draft Interagency White Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System.<sup>4</sup> The agencies are continuing to work with representatives of the industry to identify sound practices and plan to issue a final paper in 2003.

### *Community Banks*

The risk-focused supervision program for community banks emphasizes the review of activities having the highest level of risk to an institution and provides a tiered approach to the examination of these activities. Examination procedures are tailored to the characteristics of the bank, keeping in mind its size, complexity, and risk profile. The examination procedures entail both off-site and on-site work, including planning, completion of a pre-examination visit, preparation of a detailed scope-of-examination memorandum, thorough documentation of the work done, and preparation of an examination report tailored to the scope and findings of the examination. The framework for risk-focused super-

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4. *Federal Register*, vol. 67, no. 172 (Sept. 5, 2002), pp. 56835–56842.



vision of community banks was developed jointly with the Federal Deposit Insurance Corporation and has been adopted by the Conference of State Bank Supervisors.

### Surveillance and Risk Assessment

The Federal Reserve uses automated screening systems to monitor the financial condition and performance of state member banks and bank holding companies between on-site examinations. The screening systems analyze supervisory data and regulatory financial reports to identify companies that appear to be weak or deteriorating. This analysis helps to direct examination resources to institutions that exhibit higher risk profiles. Screening systems also assist in the planning of examinations by identifying companies that are engaging in new or complex activities.

In addition to using automated screening systems, the Federal Reserve prepares quarterly Bank Holding Company Performance Reports for use in monitoring and inspecting supervised banking organizations. The reports contain, for individual bank holding companies, financial statistics and comparisons with peer companies. They are compiled from data provided by large bank holding companies in quarterly regulatory reports (FR Y-9C and FR Y-9LP). During 2002, information on securitization and asset sales activities was added to the report to help examiners and analysts evaluate the potential risks of these activities. Among the new information collected is detail on the volume and composition of securitization activities, the volume and composition of retained credit exposures, and delinquencies of and net losses on securitized assets. Also during the year the Federal Reserve substantially expanded the information on

insurance activities collected via the report.

Historically, paper copies of the Bank Holding Company Performance Reports have been provided to individual bank holding companies and to state banking agencies. Effective with the March 2002 report, paper distribution was replaced by electronic distribution of non-confidential information via the Board's National Information Center web site. The change was made to improve the efficiency and timeliness of distribution of the reports and to provide broader access to the reports by public users.

The Federal Reserve works through the Federal Financial Institutions Examination Council (FFIEC) Task Force on Surveillance Systems to coordinate surveillance activities with the other federal banking agencies.<sup>5</sup> During the year, the task force added to the Uniform Bank Performance Report several items on securitization activities substantially similar to the items added to the Bank Holding Company Performance Report. Also during the year, the task force adopted a web-based distribution system for the Uniform Bank Performance Report.

### International Activities

The Federal Reserve supervises the foreign branches of and overseas investments by member banks, Edge Act and agreement corporations, and bank holding companies; and investments by bank holding companies in export trading companies. It also supervises the activities that foreign banking organizations

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5. The member agencies of the FFIEC are the Board of Governors, the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).

conduct through entities in the United States, including branches, agencies, representative offices, and subsidiaries.

#### *Foreign Operations of U.S. Banking Organizations*

The Federal Reserve examines the international operations of state member banks, Edge Act corporations, and bank holding companies principally at the U.S. head offices of these organizations, where the ultimate responsibility for their foreign offices lies. In 2002 the Federal Reserve examined 1 foreign branch of a state member bank and 4 foreign subsidiaries of Edge Act corporations and bank holding companies. The examinations abroad were conducted with the cooperation of the supervisory authorities of the countries in which they took place; when appropriate, the examinations were coordinated with the Office of the Comptroller of the Currency. Examiners also make visits to the overseas offices of U.S. banks to obtain financial and operating information and, in some instances, to evaluate their efforts to implement corrective measures or to test their adherence to safe and sound banking practices.

At the end of 2002, 61 member banks were operating 855 branches in foreign countries and overseas areas of the United States; 31 national banks were operating 652 of these branches, and 30 state member banks were operating the remaining 203. In addition, 16 nonmember banks were operating 17 branches in foreign countries and overseas areas of the United States.

#### *Edge Act and Agreement Corporations*

Edge Act corporations are international banking organizations chartered by the Board to provide all segments of the

U.S. economy with a means of financing international business, especially exports. Agreement corporations are similar organizations, state chartered or federally chartered, that enter into an agreement with the Board to refrain from exercising any power that is not permissible for an Edge Act corporation.

Under sections 25 and 25A of the Federal Reserve Act, Edge Act and agreement corporations may engage in international banking and foreign financial transactions. These corporations, most of which are subsidiaries of member banks, may (1) conduct a deposit and loan business in states other than that of the parent, provided that the business is strictly related to international transactions, and (2) make foreign investments that are broader than those made by member banks because they may invest in foreign financial organizations, such as finance companies and leasing companies, as well as in foreign banks.

Edge Act and agreement corporations numbered 80 and were operating 12 branches at year-end 2002. These corporations are examined annually.

#### *U.S. Activities of Foreign Banks*

The Federal Reserve has broad authority to supervise and regulate the U.S. activities of foreign banks that engage in banking and related activities in the United States through branches, agencies, representative offices, commercial lending companies, Edge Act corporations, commercial banks, and certain nonbank companies. Foreign banks continue to be significant participants in the U.S. banking system.

As of year-end 2002, 193 foreign banks from 55 countries were operating 253 state-licensed branches and agencies (of which 10 were insured by the

Federal Deposit Insurance Corporation) as well as 52 branches licensed by the Office of the Comptroller of the Currency (of which 6 had FDIC insurance). These foreign banks also directly owned 16 Edge Act and agreement corporations and 3 commercial lending companies; in addition, they held an equity interest of at least 25 percent in 86 U.S. commercial banks.

Altogether, the U.S. offices of these foreign banks at the end of 2002 controlled approximately 18 percent of U.S. commercial banking assets. These foreign banks also operated 92 representative offices; an additional 57 foreign banks operated in the United States solely through a representative office.

State-licensed and federally licensed branches and agencies of foreign banks are examined on site at least once every eighteen months, either by the Federal Reserve or by a state or other federal regulator; in most cases, on-site examinations are conducted at least once every twelve months, but the period may be extended to eighteen months if the branch or agency meets certain criteria.

The Federal Reserve conducts a joint program for supervising the U.S. operations of foreign banking organizations in cooperation with the other federal banking agencies and state banking agencies. The program has two main parts. One part focuses on the examination process for those foreign banking organizations that have multiple U.S. operations and is intended to improve coordination among the various U.S. supervisory agencies. The other part is a review of the financial and operational profile of each organization to assess its general ability to support its U.S. operations and to determine what risks, if any, the organization poses through its U.S. operations. Together,

these two processes provide critical information to U.S. supervisors in a logical, uniform, and timely manner. The Federal Reserve conducted or participated with state and federal regulatory authorities in 307 examinations during 2002.

### Technical Assistance

In 2002 the Federal Reserve System continued to provide technical assistance on bank supervisory matters to foreign central banks and supervisory authorities. Technical assistance involves visits by System staff members to foreign authorities as well as consultations with foreign supervisors who visit the Board or the Reserve Banks. Technical assistance in 2002 was concentrated in Latin America, Asia, and former Soviet bloc countries.

During the year, the Federal Reserve offered supervision training courses in Washington, D.C., and in a number of foreign jurisdictions exclusively for foreign supervisory authorities. System staff also took part in technical assistance and training missions led by the International Monetary Fund, the World Bank, the Inter-American Development Bank, the Asian Development Bank, the Basel Committee on Banking Supervision, and the Financial Stability Institute.

### Supervisory Policy

Within the supervisory policy function, the Federal Reserve develops guidance for examiners and financial institutions as well as regulations for financial institutions under the supervision of the Federal Reserve. Staff members also participate in international supervisory forums and provide support for the work of the Federal Financial Institutions Examination Council.

## Capital Adequacy Standards

During 2002, the Federal Reserve, together with the other federal banking agencies, issued two final rules amending the agencies' regulatory capital guidelines and issued guidance on a number of policy topics. One final rule established the regulatory capital treatment of equity investments in nonfinancial companies held by banking organizations. The other final rule reduced from 100 percent to 20 percent the risk weight applied, under the agencies' risk-based capital guidelines, to certain claims on qualifying securities firms. The Federal Reserve, together with the other federal banking agencies, also issued policy guidance on management of country risk and asset securitization and draft guidance on credit card lending. The Federal Reserve also clarified that preferred stock covered by certain hedging arrangements is not includable in regulatory capital. In addition, the Federal Reserve issued guidance introducing a new statistical loan-sampling methodology for community banks.

### *Capital for Nonfinancial Equity Investments*

In January, the Federal Reserve, together with the OCC and the FDIC, adopted a final rule governing the regulatory capital treatment of equity investments in nonfinancial companies held by banks, bank holding companies, and financial holding companies. The final rule subjects covered equity investments to a capital charge that increases in steps as the banking organization's level of concentration in equity investments increases. Agency monitoring also increases as the level of concentration in equity investments increases. A summary of the key provisions of

the new capital rule was published in SR letter 02-4 on March 4, 2002.

### *Claims on Securities Firms*

In April, the federal banking agencies issued final rules amending the risk-based capital standards for banks, bank holding companies, and savings associations by reducing from 100 percent to 20 percent the risk weight accorded to certain claims on, and claims guaranteed by, qualifying securities firms having high investment-grade ratings in countries that are members of the Organisation for Economic Co-operation and Development. The change brings the risk weight in line with a 1998 revision to the Basel Capital Accord. Qualifying U.S. securities firms are broker-dealers registered with the Securities and Exchange Commission (SEC) that are in compliance with the SEC's net capital rule. The Board's final rule also applies a 20 percent risk weight to certain collateralized claims on qualifying securities firms.

### *Management of Country Risk*

In February, the Federal Reserve and the other federal banking agencies published guidance for banking organizations concerning the elements of an effective country risk management process. The interagency guidance builds on the findings of a 1998 study by the Interagency Country Exposure Review Committee on the country risk management practices of U.S. banks, supplementing and strengthening previous guidance and ensuring that banking organizations' management of risks arising from their international activities are appropriately and adequately addressed during the examination process. The guidance was contained in SR letter 02-5, issued March 8, 2002.

### *Credit Card Lending*

In July, under the auspices of the Federal Financial Institutions Examination Council, the federal banking agencies issued draft guidance on account management and loss allowance for credit card lending. The draft guidance describes the agencies' expectations regarding prudent risk-management practices for credit card activities, particularly with regard to credit-line management, over-limit accounts, and workouts. It also addresses income recognition and loss-allowance practices in connection with credit card lending.

### *Hedging of Preferred Stock Issued through Special-Purpose Entities*

In March, the Federal Reserve issued guidance clarifying that preferred stock issued through special entities owned by bank holding companies is not includable in tier 1 capital if it is covered by certain hedging derivatives contracts. To be included in tier 1 capital, the Federal Reserve requires that the provisions of such preferred stock permit a banking organization to defer dividends for up to five years, a feature that allows bank holding companies to conserve cash in times of financial and liquidity pressure. Some hedging derivatives contracts contravene this policy by requiring a bank holding company to make contract payments on the derivative to its counterparty during periods of deferral on the preferred stock while providing for the deferral of payments to the bank holding company by the counterparty.

### *Statistical Loan Sampling at Community Banks*

In October, the Federal Reserve issued guidance introducing a statistical sampling method to increase the compre-

hensiveness and effectiveness of credit review in examinations of certain community banks. In addition, the guidance clarified that loan reviews conducted as part of full-scope Federal Reserve examinations are expected to comply with existing Federal Reserve guidance or with the new loan-sampling guidance.

### *Securitization Guidance*

In May 2002, the federal banking agencies released several policy statements on securitization-related issues. The guidance builds on the agencies' final rules for "Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations," which were issued in November 2001. The agencies also issued a question-and-answer document responding to some questions that have arisen regarding their rules.

- One policy statement clarified the risk-based capital treatment of accrued interest receivables for banking organizations that securitize credit card receivables through trusts and record as an on-balance-sheet asset the interest and fee income due on the securitized receivables. Because such amounts of interest and fee income generally must be paid to the trust for payment to holders of senior positions in a securitization before any amount is returned to the banking organization, the banking organization must treat the accrued interest receivable as a residual for purposes of risk-based capital. This treatment results in the banking organization's being required, under the recourse provisions of the agencies' capital rules, to hold "dollar-for-dollar" capital against the receivable amount.

- In another policy statement, the agencies advised examiners and banking organizations that the use by banking organizations of adverse supervisory actions or negative changes in supervisory thresholds as triggers for the early amortization or transfer of servicing in securitizations constitutes an unsafe and unsound banking practice. Examples of such supervisory triggers include a downgrade in a banking organization's CAMELS rating, an enforcement action, or a downgrade in a bank's "prompt corrective action" capital category. The supervisory concern arises because a banking organization that triggers such a provision is likely to already be subject to financial and liquidity pressure. Triggering an early amortization or transfer of servicing in a securitization can create or exacerbate liquidity and earnings problems that may lead to further deterioration in the banking organization's financial condition.
- A third policy statement was intended to aid examiners and banking organizations in identifying instances of "implicit recourse," a term that generally refers to a banking organization's providing greater credit support to a securitization than is required contractually. Because banking organizations' risk-based capital requirements generally are based on their maximum credit exposure under contract, such capital requirements do not capture the additional credit risk being undertaken by the organization through its implicit recourse actions. This guidance identifies several types of implicit recourse and supervisory actions that the agencies may take to address banking organizations' provision of implicit recourse.

### Interagency Advisory on Accounting for Accrued Interest Receivable Related to Credit Card Securitizations

In December 2002, the Federal Reserve and the other federal banking agencies issued guidance regarding the appropriate accounting treatment for financial institutions that record an asset commonly referred to as accrued interest receivable (AIR) in connection with the securitization of credit card receivables. Consistent with generally accepted accounting principles, the guidance clarifies that when the terms of the securitization legally isolate the institution's (seller's) right to the AIR, the seller generally should report the AIR as a subordinated retained interest when accounting for the sale of credit card receivables. This means that the value of the AIR, at the date the receivables are transferred to the trust, must be adjusted on the basis of its relative fair (market) value.

### Business Continuity

In 2002, in response to the events of September 11, 2001, the Federal Reserve developed a business-continuity risk profile that provides a consistent framework for benchmarking business-continuity programs and serves as a tool in conducting targeted examinations of business-continuity planning. Federal Reserve examiners plan to pilot test the business-continuity risk profile in 2003, with the goal of identifying areas for improvement at individual institutions and developing a profile of business-continuity programs at large, complex banking organizations supervised by the Federal Reserve.

## International Guidance on Supervisory Policies

As a member of the Basel Committee on Banking Supervision (Basel Committee), the Federal Reserve in 2002 participated in efforts to revise the international capital regime and to develop international supervisory guidance. The Federal Reserve's goals in these activities are to advance sound supervisory policies for internationally active banking institutions and to improve the stability of the international banking system. The efforts are described in the following sections.

### *Capital Adequacy*

The Federal Reserve continued to participate in a number of technical working groups of the Basel Committee in efforts to develop a new capital accord. These groups worked to develop a revised consultative paper based on further deliberations of the committee and on comments received by the committee on its January 2001 consultative paper and on technical papers subsequently issued by the working groups. The committee and working groups also continued formal and informal communication with the banking industry and other interested parties, including the launching of a third quantitative impact study, referred to as QIS 3. QIS 3 was undertaken with the goal of ensuring the efficacy of the Basel Committee's proposals and gathering information helpful in assessing whether further modifications are necessary before the committee's planned release of a revised consultative paper in spring 2003.

In addition, in October 2002, a committee working group issued a second working paper on asset securitization,

following issuance of a first paper in October 2001. The purpose of the second paper was to discuss and seek feedback on some revisions to the securitization framework discussed in the two consultative papers. In December 2002, a committee working group issued a paper on pillar III—market discipline—in order to seek feedback on the latest proposals on disclosure.

### *Risk Management*

The Federal Reserve contributed to several supervisory policy papers, reports, and recommendations issued by the Basel Committee during 2002. These documents were generally aimed at improving the supervision of banking organizations' risk-management practices. The paper "Management and Supervision of Cross-Border Electronic Banking Activities" (issued in October) was prepared for the purposes of identifying banks' risk-management responsibilities with respect to cross-border banking and focusing attention on the need for effective home country supervision of, and continued international cooperation regarding, electronic banking. The paper "Sound Practices for the Management and Supervision of Operational Risk" (issued in July) outlines a set of principles that provide a framework for the effective management and supervision of operational risk. The framework is intended for use by banks and supervisory authorities when evaluating policies and practices related to the management of operational risk. The report "Supervisory Guidance in Dealing with Weak Banks" (issued in March) provides practical guidance for banking supervisors in their work with weak banks. The guidance includes discussions of problem identification, cor-

rective action, resolution techniques, and exit strategies.

#### *Internal Control, Accounting, and Disclosure*

The Federal Reserve participates in the Basel Committee's Task Force on Accounting Issues and the Transparency Group and represents the Basel Committee at international meetings on the issues addressed by these groups. In particular, the Federal Reserve in 2002 represented the Basel Committee at meetings of the committee of the International Accounting Standards Board (IASB) that works to improve guidance on accounting for financial instruments. In addition, a representative of the Federal Reserve participates in the IASB's Standards Advisory Council.

During 2002 the Federal Reserve also contributed to several reports, papers, and comment letters on internal control, accounting, and disclosure that were issued by the Basel Committee, including a proposed amendment to the International Accounting Standard on financial instruments, the International Accounting Standard on disclosures for financial statements of financial institutions, guidance on international loan-loss reserving, and a survey of bank disclosure practices.

#### *Joint Forum*

In its work with the Basel Committee, the Federal Reserve also continued its participation in the Joint Forum—a group made up of representatives of the committee, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors. The Joint Forum works to increase mutual understanding of issues related to the supervision of firms operating in each of the financial sectors.

#### **Gramm–Leach–Bliley Act**

The Gramm–Leach–Bliley Act (GLBA) repealed those provisions of the Glass–Steagall Act and the Bank Holding Company Act that restricted the ability of bank holding companies to affiliate with securities firms and insurance companies. The provisions of GLBA, together with the Federal Reserve's implementing regulations, establish conditions that a bank holding company or a foreign bank must meet to be deemed a financial holding company and to engage in expanded activities.

In addition to controlling depository institutions, a financial holding company may engage in securities underwriting and dealing, serve as an insurance agent and insurance underwriter, act as a futures commission merchant, and engage in merchant banking. Permissible activities also include activities that the Board and the Secretary of the Treasury jointly determine to be financial in nature or incidental to financial activities and activities that the Federal Reserve determines are complementary to a financial activity and do not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. During 2002, the Federal Reserve continued its efforts to ensure that supervisory policies applied to banking institutions are consistent with the provisions of GLBA.

In its role as holding company supervisor, the Federal Reserve in 2002 continued to host cross-sector meetings with representatives of the banking agencies, securities and commodities and futures authorities, and state insurance commissions. Cross-sector forums provide an opportunity for multiple supervisors (both federal and state) to discuss issues of common interest and to enhance communication and cooperation. Topics discussed in 2002 included corporate gov-



ernance, the initiatives of the Securities and Exchange Commission in implementing the Sarbanes–Oxley Act, and other topics of mutual interest across the sectors.

### Sarbanes–Oxley Act

In October 2002, the Federal Reserve issued a supervisory letter (SR letter 02–20) to give banking organizations information on the provisions of the Sarbanes–Oxley Act that set forth standards for audits, financial reporting and disclosure, and corporate governance at public companies. The provisions apply to public companies, including banks and bank holding companies, that have a class of securities registered under section 12 of the Securities Exchange Act of 1934 or are otherwise required to file periodic reports under section 5(d) of the 1934 act. The Federal Reserve staff is working with the other banking agencies to clarify the applicability of Sarbanes–Oxley to banking organizations. The staff is also considering the need for additional standards to reaffirm the important duties and responsibilities of banking organizations’ boards of directors and executive officers.

### Efforts to Enhance Transparency

The Federal Reserve has long supported sound accounting policies and meaningful public disclosure by banking and financial organizations to improve market discipline and foster stable financial markets. Effective market discipline can serve as an important complement to bank supervision and regulation. The more informative the information released by financial institutions, the better the evaluation of counterparty risks by market participants can be and the better their adjustments to the availability and pricing of funds will be.

Thus, transparency can promote efficiency in financial markets and sound practices by banks. The Federal Reserve also seeks to strengthen audit and control standards for banks; the quality of management information and financial reporting is dramatically affected by internal control systems, including internal and external audit programs.

During 2002, the Federal Reserve Board commented on a proposed Financial Accounting Standards Board (FASB) standard concerning special-purpose entities. The Board supports FASB’s objective to increase transparency, particularly with respect to off-balance-sheet risk exposures that special-purpose entities can pose to organizations and market participants.

To further advance objectives related to transparency, the Federal Reserve works with other regulators, the accounting profession, and a wide variety of market participants, both domestically and internationally. During 2002, the Federal Reserve also worked with the Securities and Exchange Commission to coordinate an enforcement action against an institution for deficiencies in public and regulatory reports and internal controls. Additionally, the Federal Reserve provided guidance to financial organizations that faced possible interruption in audit services as a result of problems at a large accounting firm.

### Bank Holding Company Regulatory Financial Reports

The Federal Reserve requires that U.S. bank holding companies submit periodic regulatory financial reports. These reports, the FR Y–9 series and the FR Y–11 and FR 2314 series for non-bank subsidiaries, provide information essential to the supervision of the organizations and the formulation of regula-

tions and supervisory policies. The Federal Reserve also uses the information in responding to requests from the Congress and the public for information on bank holding companies and their nonbank subsidiaries.

The FR Y-9 series of reports provides standardized financial statements for the consolidated bank holding company. The reports are used to detect emerging financial problems, review performance and conduct pre-inspection analysis, monitor and evaluate risk profiles and capital adequacy, evaluate proposals for bank holding company mergers and acquisitions, and analyze the holding company's overall financial condition. The nonbank subsidiary series of reports aids the Federal Reserve in determining the condition of bank holding companies that are engaged in nonbanking activities and in monitoring the volume, nature, and condition of their nonbanking subsidiaries.

In March 2002, several revisions to the FR Y-9C report were implemented to make it consistent with revisions to the bank Call Report and to conform to changes in generally accepted accounting principles. Also, the relevance of the FR Y-9 series of reports was improved by revising the existing items and adding new items related to new activities and other developments that may expose institutions to new or different types of risk. In addition, a new report (FR Y-9ES) was created to collect information annually from bank holding companies that are employee stock ownership plans.

In December 2002, the nonbank reporting framework for non-functionally-regulated nonbank subsidiaries of U.S. bank holding companies was streamlined.<sup>6</sup> The revised framework provides

essential information for supervising and regulating nonbank subsidiaries and reduces burden. Under the new framework, bank holding companies file a detailed report (FR Y-11 or FR 2314) for their more-significant nonbank subsidiaries quarterly or annually, depending on total assets or other reporting criteria. Bank holding companies must also file, annually, an abbreviated, four-item report (FR Y-11S or FR 2314S) for their smaller nonbank subsidiaries. The smallest nonbank subsidiaries, nearly three-fifths of all nonbank subsidiaries, are now exempt from all filing requirements.

In addition, functionally regulated nonbank subsidiaries generally are no longer required to file individual nonbank subsidiary reports with the Federal Reserve. In keeping with provisions of the Gramm-Leach-Bliley Act, the Federal Reserve will rely on reports and information provided to the primary regulator. The Federal Reserve will continue to collect limited information on nonbank subsidiaries of bank holding companies on a consolidated basis in FR Y-9 reports.

### Federal Financial Institutions Examination Council

During 2002, the Federal Reserve continued its active participation as a member of the Federal Financial Institutions Examination Council. Among other activities, the FFIEC revised the bank Call Reports, issued a revised examination framework for information technology service providers, and revised the information systems manual.

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nonbank subsidiaries, which are entities whose primary regulator is an organization other than the Federal Reserve, namely, the Securities and Exchange Commission, the Commodity Futures Trading Commission, state insurance commissioners, or state securities departments.

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6. Non-functionally-regulated nonbank subsidiaries are distinguished from functionally regulated

### *Bank Call Reports*

As the federal supervisor of state member banks, the Federal Reserve, acting in concert with the other federal banking agencies through the FFIEC, requires banks to submit quarterly Reports of Condition and Income (Call Reports). Call Reports are the primary source of data for the supervision and regulation of banks and for the ongoing assessment of the overall soundness of the nation's financial structure. Call Report data, which also serve as benchmarks for the financial information required by many other Federal Reserve regulatory financial reports, are widely used by state and local governments, state banking supervisors, the banking industry, securities analysts, and the academic community.

For the 2002 reporting period, the FFIEC implemented several revisions to the Call Report. The principal revisions included

- Breaking down several existing balance sheet and income statement items into greater detail to facilitate supervision and to implement two new accounting standards
- Collecting new information on the fair value of credit derivatives, the volume of merchant credit card sales, and the amount of past-due loans and leases held for sale.

The FFIEC also revised the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (FFIEC 002), effective with the June 2002 report, to maintain consistency with the Call Report.

In November, the Federal Reserve and the other federal banking agencies proposed a small number of revisions to the Call Report for March 2003 report-

ing. The revisions would add several items related to bank credit card activities, break down two existing items to provide more detail to address safety and soundness considerations, and add a supplement to the report that would enable the agencies to collect a limited amount of data from certain banks in the event of an immediate and critical need for specific information. The proposed revisions also include a few processing changes to implement a new Call Report business model the agencies plan to institute in 2004.

### *Information Technology*

Also in 2002, the FFIEC issued a revised framework for the interagency examination program for information technology service providers. Examinations of these providers of information technology and processing services to financial institutions are conducted by the Federal Reserve or other financial institution supervisory agencies under the Bank Service Company Act. The revised framework is designed to promote a more risk-based rationale for conducting such examinations by identifying and analyzing material supervisory risks to financial institutions that use the services of these companies. It includes risk-focused criteria for determining the examination schedule and the scope of the exams. The revised framework was implemented as a two-year pilot program that began in January 2002.

In addition, in 2002 the FFIEC began to prepare for the issuance of revisions to the FFIEC information systems manual, last updated in 1996. A project plan for the development of individual booklets to replace the current manual's chapters was established. Federal Reserve and other agency examiners participated in field testing the booklets

on technology service providers, information security, and business continuity. Field testing of booklets on outsourcing, audits, electronic banking, wholesale payment systems, retail payment systems, and Fedline is scheduled for early 2003. Booklets on management, development and programming, and operations are scheduled for development in 2003.

### **Supervisory Information Technology**

The Supervisory Information Technology (SIT) function within the Board's Division of Banking Supervision and Regulation facilitates the management of information technology within the Federal Reserve's supervision function. Its goals are to ensure that

- IT initiatives support a broad range of supervisory activities without duplication or overlap
- The underlying IT architecture fully supports those initiatives
- The supervision function's use of technology leverages the resources and expertise available more broadly within the Federal Reserve System
- Practices that maximize supervision's business value and cost effectiveness are identified, analyzed, and approved for implementation.

SIT works through assigned staff at the Board of Governors and the Reserve Banks and through a Systemwide committee structure that ensures that key staff members throughout the Federal Reserve System participate in identifying requirements and setting priorities for IT initiatives.

### **SIT Project Management**

In 2002, the SIT project management staff made significant progress in identifying opportunities for enhancing business value through the use of information technology. In March, the supervision function received approval to implement a Systemwide technology platform for scheduling examination resources. The staff provided substantial resources and leadership in developing a business case and evaluating technology alternatives for the deployment of an enterprise document management system. Staff members also provided substantial assistance and resources to support modernization of the Shared National Credit Program. The modernization is an interagency effort aimed at reducing examination costs and improving the timeliness and reliability of data associated with the review of large, syndicated credit facilities of commercial banks. The staff continued to assess opportunities to improve the delivery of information technology services for supervision in conjunction with efforts of Board and Reserve Bank internal IT providers.

### **National Information Center**

The National Information Center (NIC) is the Federal Reserve's comprehensive repository for supervisory, financial, and banking structure data and documents. NIC includes the National Examination Data (NED) system, which provides supervisory personnel and state banking authorities with access to NIC data, and the Central Document and Text Repository, which contains documents supporting the supervisory process.

In 2002, the NED system was modified in accordance with a policy change regarding the supervision program for small bank holding companies, to com-

plement the web-enabled NED application, and to add functionality that further supports the supervision of banking institutions. Changes to the production application were also made to accommodate changes in the commercial bank Call Report and the bank holding company FR Y-9 reports. A new version of the Central Document and Text Repository was implemented to handle a larger volume of documents.

### **Staff Development**

The Federal Reserve System's staff development program trains staff members at the Board of Governors, the Reserve Banks, and state banking departments who have supervisory and regulatory responsibilities; students from foreign supervisory authorities attend training sessions on a space-available basis. The program's goal is, in part, to provide greater cross training in the agencies. Training is offered at the basic, intermediate, and advanced levels in the four disciplines of bank supervision: bank examinations, bank holding company inspections, surveillance and monitoring, and applications analysis. Classes are conducted in Washington, D.C., and at other locations and are sometimes held jointly with other regulators.

The System also participates in training offered by the FFIEC and by certain other regulatory agencies. The System's involvement includes assisting in the development of basic and advanced training in relation to emerging issues as well as in specialized areas such as trust activities, international banking, information technology, municipal securities dealing, capital markets, payment systems risk, white collar crime, and real estate lending. In addition, the System co-hosts the World Bank Seminar for students from developing countries.

In 2002 the Federal Reserve trained 2,748 students in System schools, 492 in schools sponsored by the FFIEC, and 52 in other schools, for a total of 3,292, including 214 representatives of foreign central banks (table). The number of training days in 2002 totaled 16,824.

The System gave scholarship assistance to the states for training their examiners in Federal Reserve and FFIEC schools. Through this program, 454 state examiners were trained—345 in Federal Reserve courses, 92 in FFIEC courses, and 17 in other courses.

A staff member seeking an examiner's commission is required to take a first proficiency examination, as well as a second proficiency examination in one of three specialty areas: safety and soundness, consumer affairs, or information technology (table). At the end of 2002, the System had 1,234 field examiners, of which 892 were commissioned (table).

### **Regulation of the U.S. Banking Structure**

The Board of Governors administers the Bank Holding Company Act, the Bank Merger Act, the Change in Bank Control Act, and the International Banking Act as they apply to bank holding companies, financial holding companies, member banks, and foreign banking organizations. In doing so, the Federal Reserve acts on a variety of proposals that directly or indirectly affect the structure of U.S. banking at the local, regional, and national levels; the international operations of domestic banking organizations; and the U.S. banking operations of foreign banks.

#### **Bank Holding Company Act**

Under the Bank Holding Company Act, a corporation or similar organization

Training Programs for Banking Supervision and Regulation, 2002

Program	Number of sessions conducted	
	Total	Regional
<i>Schools or seminars conducted by the Federal Reserve</i>		
Core schools		
Banking and supervision elements .....	9	7
Operations and analysis .....	7	5
Bank management .....	4	1
Report writing .....	16	16
Management skills .....	10	10
Conducting meetings with management .....	18	18
Other schools		
Loan analysis .....	5	3
Examination management .....	8	6
Real estate lending seminar .....	2	1
Specialized lending seminar .....	1	0
Senior forum for current banking and regulatory issues .....	2	2
Banking applications .....	1	0
Principles of fiduciary supervision .....	3	1
Commercial lending essentials for consumer affairs .....	3	3
Consumer compliance examinations I .....	2	0
Consumer compliance examinations II .....	2	2
CRA examination techniques .....	2	2
Fair lending examination techniques .....	3	2
Foreign banking organizations .....	3	3
Information systems continuing education .....	2	0
Capital markets seminars .....	13	10
Technology risk integration .....	13	13
Leadership dynamics .....	7	6
Seminar for senior supervisors of foreign central banks <sup>1</sup> .....	1	1
<i>Other agencies conducting courses<sup>2</sup></i>		
Federal Financial Institutions Examination Council .....	34	3
The Options Institute .....	2	2

1. Conducted jointly with the World Bank.

2. Open to Federal Reserve employees.

must obtain the Federal Reserve’s approval before forming a bank holding company through the acquisition of one or more banks in the United States. Once formed, a bank holding company must receive Federal Reserve approval before acquiring or establishing additional banks. The act also identifies other activities permissible for bank holding companies; depending on the circumstances, these activities may or may not require Federal Reserve approval in advance of their commencement.

When reviewing a bank holding company application or notice that requires prior approval, the Federal Reserve

considers the financial and managerial resources of the applicant, the future prospects of both the applicant and the firm to be acquired, the convenience and needs of the community to be served, the potential public benefits, the competitive effects of the proposal, and the applicant’s ability to make available to the Board information deemed necessary to ensure compliance with applicable law. In the case of a foreign banking organization seeking to acquire control of a U.S. bank, the Federal Reserve also considers whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor. Data on deci-

## Results of Proficiency Examinations, 2002

Result	First proficiency exam	Second proficiency exam		
		Safety and soundness	Consumer affairs	Information technology
Passed .....	133	82	29	3
Failed .....	17	15	0	2
<b>Total .....</b>	<b>150</b>	<b>97</b>	<b>29</b>	<b>5</b>

sions regarding domestic and international applications in 2002 are shown in the accompanying table.

Bank holding companies generally may engage in only those activities that the Board has previously determined to be closely related to banking under section 4(c)(8) of the act. Since 1996, the act has provided an expedited prior-notice procedure for certain permissible nonbank activities and for acquisitions of small banks and nonbank entities. Since that time the act also has permitted well-run bank holding companies that satisfy certain criteria to commence certain other nonbank activities on a de novo basis without first obtaining Federal Reserve approval.

Since 2000, the Bank Holding Company Act has permitted the creation of a special type of bank holding company called a financial holding company. Financial holding companies are allowed to engage in a broader range of nonbank activities than are traditional bank holding companies. Among other things, they may affiliate with securit-

ies firms and insurance companies and may engage in certain merchant banking activities. Bank holding companies seeking financial holding company status must file a written declaration with the Federal Reserve System; most declarations are acted upon by one of the Reserve Banks under delegated authority. In 2002, 82 domestic financial holding company declarations and 7 foreign bank declarations were approved.

Financial holding companies do not have to obtain the Board's prior approval to engage in or acquire a company engaged in certain new financial activities that are permissible under the Gramm-Leach-Bliley Act. Instead, the financial holding company must notify the Board within thirty days after commencing the new activity or acquiring a company engaged in the new activity. A financial holding company may also engage in certain other activities that have been determined to be financial in nature or incidental to a financial activity or that are determined to be complementary to a financial activity.

## Trends in Reserve Bank Supervision Levels, 1998–2002

Type of staff	2002	2001	2000	1999	1998
Field examination staff .....	1,234	1,242	1,172	1,216	1,250
Commissioned field staff .....	892	861	786	893	933

Decisions by the Federal Reserve on Domestic and International Applications, 2002

Proposal	Direct action by the Board of Governors			Action under authority delegated by the Board of Governors					Total
				Director of the Division of Banking Supervision and Regulation		Office of the Secretary	Federal Reserve Banks		
	Approved	Denied	Permitted	Approved	Denied	Approved	Approved	Permitted	
Formation of bank holding company .....	6	0	0	0	0	0	144	58	208
Merger of bank holding company .....	2	0	0	0	0	2	28	12	44
Acquisition or retention of bank .....	7	1	0	0	0	2	85	41	136
Acquisition of nonbank .....	0	0	3	0	0	8	0	101	112
Merger of bank .....	7	0	0	0	0	1	78	0	86
Change in control .....	0	0	1	0	0	0	0	160	161
Establishment of a branch, agency, or representative office by a foreign bank .....	2	0	0	19	0	0	0	0	21
Other .....	58	0	0	54	0	88	464	453	1,117
<b>Total .....</b>	<b>82</b>	<b>1</b>	<b>4</b>	<b>73</b>	<b>0</b>	<b>101</b>	<b>799</b>	<b>825</b>	<b>1,885</b>

Bank Merger Act

The Bank Merger Act requires that all proposals involving the merger of insured depository institutions be acted on by the appropriate federal banking agency. If the institution surviving the merger is a state member bank, the Federal Reserve has primary jurisdiction. Before acting on a merger proposal, the Federal Reserve considers the financial and managerial resources of the applicant, the future prospects of the existing and combined institutions, the convenience and needs of the community to be served, and the competitive effects of the proposed merger. It also considers the views of certain other agencies regarding the competitive factors involved in the transaction. During 2002, the Federal Reserve approved 86 merger applications.

When the FDIC, the OCC, or the OTS has jurisdiction over a merger, the Federal Reserve is asked to comment on the competitive factors. By using standard terminology in assessing competitive factors in merger proposals, the four agencies have sought to ensure consistency in administering the Bank Merger Act. The Federal Reserve submitted 515 reports on competitive factors to the other agencies in 2002.

Change in Bank Control Act

The Change in Bank Control Act requires persons seeking control of a U.S. bank or bank holding company to obtain approval from the appropriate federal banking agency before completing the transaction. The Federal Reserve is responsible for reviewing changes in the control of state member banks and



bank holding companies. In its review, the Federal Reserve considers the financial position, competence, experience, and integrity of the acquiring person; the effect of the proposed change on the financial condition of the bank or bank holding company being acquired; the effect of the proposed change on competition in any relevant market; the completeness of information submitted by the acquiring person; and whether the proposed change would have an adverse effect on the federal deposit insurance funds. As part of the process, the Federal Reserve may contact other regulatory or law enforcement agencies for information about acquiring persons.

The appropriate federal banking agencies are required to publish notice of each proposed change in control and to invite public comment, particularly from persons located in the markets served by the institution to be acquired.

In 2002, the Federal Reserve approved 161 changes in control of state member banks and bank holding companies.

### International Banking Act

The International Banking Act, as amended by the Foreign Bank Supervision Enhancement Act of 1991, requires foreign banks to obtain Federal Reserve approval before establishing branches, agencies, commercial lending company subsidiaries, or representative offices in the United States.

In reviewing proposals, the Federal Reserve generally considers whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor. It also considers whether the home country supervisor has consented to the establishment of the U.S. office; the financial condition and resources of the foreign bank and its existing U.S.

operations; the managerial resources of the foreign bank; whether the home country supervisor shares information regarding the operations of the foreign bank with other supervisory authorities; whether the foreign bank has provided adequate assurances that information concerning its operations and activities will be made available to the Board, if deemed necessary to determine and enforce compliance with applicable law; whether the foreign bank has adopted and implemented procedures to combat money laundering and whether the home country of the foreign bank is developing a legal regime to address money laundering or is participating in multilateral efforts to combat money laundering; and the record of the foreign bank with respect to compliance with U.S. law.

In 2002, the Federal Reserve approved 21 applications by foreign banks to establish branches, agencies, and representative offices in the United States.

### Overseas Investments by U.S. Banking Organizations

U.S. banking organizations may engage in a broad range of activities overseas. Many of the activities are conducted indirectly through Edge Act and agreement corporation subsidiaries. Although most foreign investments are made under general consent procedures that involve only after-the-fact notification to the Board, large and other significant investments require the prior approval of the Board. Excluding proposals relating to large domestic mergers, the Board in 2002 approved 23 proposals for significant overseas investments by U.S. banking organizations. The Federal Reserve also approved 1 application to acquire an Edge Act corporation, 1 application to extend the corporate exist-

ence of an existing Edge Act corporation, and 1 application to establish or acquire a new agreement corporation.

### Applications by Member Banks

State member banks must obtain Federal Reserve approval to establish domestic branches, and all member banks (including national banks) must obtain Federal Reserve approval to establish foreign branches. When reviewing proposals to establish domestic branches, the Federal Reserve considers the scope and nature of the banking activities to be conducted. When reviewing proposals for foreign branches, the Federal Reserve considers, among other things, the condition of the bank and the bank's experience in international banking. In 2002, the Federal Reserve acted on new and merger-related branch proposals for 836 domestic branches and granted prior approval for the establishment of 5 new foreign branches.

State member banks must also obtain Federal Reserve approval to establish financial subsidiaries. These subsidiaries may engage in activities that are financial in nature or incidental to financial activities, including securities- and insurance agency-related activities. In 2002, 3 applications for financial subsidiaries were approved.

### Stock Repurchases by Bank Holding Companies

A bank holding company may repurchase its own shares from its shareholders. When the company borrows money to buy the shares, the transaction increases the company's debt and decreases its equity. The Federal Reserve may object to stock repurchases by holding companies that fail to meet certain standards, including the Board's capital adequacy guidelines. In 2002,

the Federal Reserve reviewed 10 stock repurchase proposals by bank holding companies; all were approved by a Reserve Bank under delegated authority.

### Public Notice of Federal Reserve Decisions

Most decisions by the Federal Reserve that involve a bank holding company, a bank merger, a change in control, or the establishment of a new U.S. banking presence by a foreign bank are effected by an order or an announcement. Orders state the decision, the essential facts of the application or notice, and the basis for the decision; announcements state only the decision. All orders and announcements are made public immediately; they are subsequently reported in the Board's weekly H.2 statistical release and in the monthly *Federal Reserve Bulletin*. The H.2 release also contains announcements of applications and notices received by the Federal Reserve but not yet acted on. For each pending application and notice, the related H.2A contains the deadline for comments. In 2002, the Board's web site ([www.federalreserve.gov](http://www.federalreserve.gov)) continued to provide information on orders and announcements.

### Timely Processing of Applications

The Federal Reserve sets internal target time frames for the processing of applications. The setting of targets promotes efficiency at the Board and the Reserve Banks and reduces the burden on applicants. Generally, the length of the target period ranges from 12 days to 60 days, depending on the type of application or notice filed. In 2002, 93 percent of decisions were made within the target time period.

## **Enforcement of Other Laws and Regulations**

The Federal Reserve's enforcement responsibilities also extend to financial disclosures by state member banks; securities credit; and efforts, under the Bank Secrecy Act, to counter money laundering.

### **Financial Disclosures by State Member Banks**

State member banks that issue securities registered under the Securities Exchange Act of 1934 must disclose certain information of interest to investors, including annual and quarterly financial reports and proxy statements. By statute, the Board's financial disclosure rules must be substantially similar to those of the Securities and Exchange Commission. At the end of 2002, 17 state member banks were registered with the Board under the Securities Exchange Act.

### **Securities Credit**

Under the Securities Exchange Act, the Board is responsible for regulating credit in certain transactions involving the purchase or carrying of securities. The Board's Regulation T limits the amount of credit that may be provided by securities brokers and dealers when the credit is used to trade debt and equity securities. The Board's Regulation U limits the amount of credit that may be provided by lenders other than brokers and dealers when the credit is used to purchase or carry publicly held equity securities if the loan is secured by those or other publicly held equity securities. The Board's Regulation X applies these credit limitations, or margin requirements, to certain borrowers and to certain credit extensions, such as credit obtained from foreign lenders by U.S. citizens.

Several regulatory agencies enforce the Board's securities credit regulations. The SEC, the National Association of Securities Dealers, and the national securities exchanges examine brokers and dealers for compliance with Regulation T. With respect to compliance with Regulation U, the federal banking agencies examine banks under their respective jurisdictions; the Farm Credit Administration, the National Credit Union Administration, and the Office of Thrift Supervision examine lenders under their respective jurisdictions; and the Federal Reserve examines other Regulation U lenders.

Since 1990 the Board has published a nonexclusive list of foreign stocks that are eligible for margin treatment at broker-dealers on the same basis as domestic margin securities. In 2002 the foreign list was revised in March and September.

### **Anti-Money Laundering**

The Department of the Treasury's regulation (31 CFR 103) implementing the Currency and Foreign Transactions Reporting Act (commonly referred to as the Bank Secrecy Act, or BSA) requires banks and other types of financial institutions to file certain reports and maintain certain records. These documents record information on persons involved in large currency transactions and on suspicious activity related to possible violations of federal law, including money laundering, terrorism, and other financial crimes. The act is a primary tool in the fight against money laundering; its requirements inhibit money laundering by creating a paper trail of financial transactions that helps law enforcement and regulators identify and trace the proceeds of illegal activity.

In addition to the specific requirements of the Bank Secrecy Act, the

Board's Regulation H (12 CFR 208.63) requires each banking organization supervised by the Federal Reserve to develop a written program for BSA compliance that is formally approved by the institution's board of directors. The compliance program must (1) establish a system of internal controls to ensure compliance with the act, (2) provide for independent compliance testing, (3) identify individuals responsible for coordinating and monitoring day-to-day compliance, and (4) provide training for personnel as appropriate. To monitor compliance, each Reserve Bank designates senior, experienced examiners as BSA and anti-money-laundering contacts. During examinations of state member banks and U.S. branches and agencies of foreign banks, examiners review the institution's compliance with the BSA and determine whether adequate procedures and controls to guard against money laundering are in place.

The Board has a Special Investigations Section in the Division of Banking Supervision and Regulation that conducts financial investigations, provides expertise to the U.S. law enforcement community for investigation and training initiatives, and offers training to various foreign central banks and government agencies; section staff also speak at banking conferences to promote best practices in the industry with respect to anti-money-laundering initiatives. Internationally, section staff have provided anti-money-laundering training and technical assistance to countries in Asia, eastern Europe, South and Central America, and the Caribbean. Staff members have also participated extensively in numerous multilateral anti-money-laundering initiatives such as the Financial Action Task Force and the Basel Committee on Banking Supervision.

In 2002, the Federal Reserve continued to provide expertise and guidance to the BSA Advisory Group, a committee established by the Congress at the Department of the Treasury that seeks to reduce unnecessary burdens created by the BSA and to increase the utility of data gathered under the act to aid regulators and law enforcement. The Federal Reserve also assisted the Treasury Department in providing feedback to financial institutions on the reporting of suspicious activity.

Since the terrorist attacks of September 11, 2001, and continuing through 2002, the Federal Reserve has played an important role in many joint activities with bank supervisory and law enforcement authorities and the banking community, both domestically and abroad, to combat money laundering and terrorist financing. The Federal Reserve Bank of New York created a dedicated e-mail system for financial institutions to report matches on the law enforcement list of "suspected terrorists" and, at the request of law enforcement and pursuant to subpoenas, searched the records of Fedwire for information related to the terrorist acts. In addition, multi-agency teams led by various U.S. government agencies were deployed to foreign countries to analyze bank and other financial records. On several of these occasions, senior Reserve Bank examiners traveled and worked with the teams. In the wake of the terrorist attacks, the FBI formed a multi-agency law enforcement task force to trace the transactions and assets of terrorists; staff of the Special Investigations Section participate in the task force.

To address the mandates of the USA PATRIOT Act, the Federal Reserve issued a number of supervisory letters to all domestic and foreign banking organizations under its supervision on such topics as private and correspondent

## Extensions of Credit by State Member Banks to their Executive Officers, 2001 and 2002

Period	Number	Amount (dollars)	Range of interest rates charged (percent)
<i>2001</i>			
October 1–December 31 .....	727	64,965,000	1.0–20.0
<i>2002</i>			
January 1–March 31 .....	620	65,557,000	2.0–19.8
April 1–June 30 .....	632	69,260,000	3.0–19.8
July 1–September 30 .....	740	78,073,000	2.0–19.8
October 1–December 31 .....	644	72,668,000	2.0–19.8

SOURCE. Call Reports.

banking as well as new information-sharing protocols. The letters described the act's requirements in these areas and the new rules that have been or will be issued.

At the request of Treasury Department staff, and consistent with statutory requirements for consultation, the Federal Reserve continues to actively assist in the development of many other new rules related to the PATRIOT Act. The Federal Reserve's Patriot Act Working Group, which is composed of senior, experienced Bank Secrecy Act/anti-money-laundering examiners from throughout the System, met several times during 2002. The group worked on interim examination procedures relative to the act's provisions and are continuing to develop a new training curriculum for examiners.

### Extensions of Credit to Executive Officers

Under section 22(g) of the Federal Reserve Act, a state member bank must include in its quarterly Call Report information on all extensions of credit by the bank to its executive officers since the date of the preceding report. The accompanying table summarizes this information for 2002.

### Federal Reserve Membership

At the end of 2002, 2,977 banks were members of the Federal Reserve System and were operating 50,095 branches. These banks accounted for 38 percent of all commercial banks in the United States and for 74 percent of all commercial banking offices. ■

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## *Federal Reserve Banks*

The Federal Reserve Banks and their Branches carry out a number of System operations, including operating a nationwide payments system, distributing the nation's currency and coin, and serving as fiscal agent and depository to the United States.

### **Major Initiatives**

During 2002, the Federal Reserve System took a number of significant steps to enhance further its resilience in case of emergency. It worked to ensure market liquidity, continuity of Federal Reserve operations, and effective Federal Reserve communications. In addition, it supported two efforts to increase the resilience of the private sector's financial system infrastructure.

While the Reserve Banks have historically worked to ensure the continuity of their operations, they undertook several projects in 2002 to reassess the adequacy of their business-continuity plans and to make them more robust. The Banks strengthened their ability to provide liquidity by enhancing backup for open market operations and the discount window. As a result, the Federal Reserve is better positioned to provide necessary market liquidity, helping to ensure that payment systems and financial markets can continue to function smoothly during a financial crisis.

In addition, the Reserve Banks evaluated their Fedwire contingency plans, their business-continuity planning process, staff concentration and leadership succession, telecommunications and network contingency, and the physical security of their facilities and personnel. Moreover, the Reserve Banks are better

positioned to meet public demand for cash in the event of an emergency.

During the year, the Reserve Banks and the Board also reviewed and enhanced their mechanisms for crisis communications between the Board, Federal Reserve offices, other government agencies, financial industry participants, System employees, the media, and the general public.

The events of September 11, 2001, illustrated the interdependence among participants in the financial system and the way that business concentration, both market-based and geographic, can intensify disruptions. The New York Reserve Bank contributed to two white papers on these matters that the Board, together with other regulatory agencies, published for comment during the year. One paper discussed sound practices to increase the resilience of critical U.S. financial markets in the face of a regional disaster. The other paper considered potential structural changes in the way settlement services for government securities are provided and presented a framework for discussing issues that need to be further explored. In response to public comments on the latter paper, the Board in November created a private-sector working group to explore ways the clearing banks for government securities could substitute for each other should the services of either be interrupted or terminated. The working group was asked to submit a report to the Board before the end of 2003.

The Reserve Banks also worked to improve the efficiency of their operations through a strategy of standardization and consolidation of a variety of information systems, operations, and

programs. For example, the Reserve Banks are standardizing and consolidating a number of financial management applications for budgeting, cost accounting, and accounts payable. In addition, efforts are under way to move separate human resources information and payroll systems in each of the twelve Districts into common systems located in a single District. The Reserve Banks have also initiated efforts to consolidate their electronic access customer-support function as well as human resources operations into fewer sites. Finally, the Reserve Banks are implementing a standard health insurance program and have adopted a standard prescription drug plan. The expected benefits of these consolidations and standardized programs include lower administrative and operating costs and improved functionality.

### **Developments in Federal Reserve Priced Services**

The Monetary Control Act of 1980 requires that the Federal Reserve set fees for providing “priced services” to depository institutions that, over the long run, recover all the direct and indirect costs of providing the services as well as the imputed costs, such as the income taxes that would have been paid and the return on equity that would have been earned had the services been provided by a private firm. The imputed costs and imputed profit are collectively referred to as the private-sector adjustment factor (PSAF).<sup>1</sup> Over the past ten

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1. In addition to income taxes and the return on equity, the PSAF is made up of three imputed costs: interest on debt, sales taxes, and assessments for deposit insurance by the Federal Deposit Insurance Corporation. Also allocated to priced services are assets and personnel costs of the Board of Governors that are related to priced

years, the Federal Reserve Banks have recovered 98.8 percent of their priced services costs, including the PSAF (table).

Overall, fees charged in 2002 for priced services increased approximately 1.3 percent from 2001.<sup>2</sup> Revenue from priced services amounted to \$916.3 million, other income related to priced services was \$2.1 million, and costs related to priced services totaled \$891.7 million, resulting in net income of \$26.6 million and a recovery rate of 93.3 percent of costs, including the PSAF.<sup>3</sup>

### **Commercial Check Collection Service**

In 2002, operating expenses and imputed costs for the Reserve Banks’ check collection service totaled \$751.2 million, while revenue amounted to \$759.2 million and other income was \$1.7 million, resulting in net income of \$9.7 million. In 2001, by comparison, operating expenses and imputed costs totaled \$754.4 million, while revenue amounted to \$764.7 million and other income was \$28.5 million, resulting in net income of \$38.9 million. The decline in check service revenue in 2002

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services; in the pro forma statements at the end of this chapter, Board expenses are included in operating expenses and Board assets are part of long-term assets.

2. Based on a chained Fisher Ideal price index not adjusted for quality changes.

3. Financial data reported throughout this chapter—revenue, other income, cost, net revenue, and income before taxes—can be linked to the pro forma statements at the end of this chapter. *Other income* is revenue from investment of clearing balances net of earnings credits, an amount termed net income on clearing balances. *Total cost* is the sum of operating expenses, imputed costs (interest on debt, interest on float, sales taxes, and the Federal Deposit Insurance Corporation assessment), imputed income taxes, and the targeted return on equity.

## Priced Services Cost Recovery, 1993–2002

Millions of dollars except as noted

Year	Revenue from services <sup>1</sup>	Operating expenses and imputed costs <sup>2</sup>	Targeted return on equity	Total costs	Cost recovery (percent) <sup>3</sup>
1993 .....	774.5	820.4	17.5	837.9	92.4
1994 .....	767.2	760.2	21.0	781.2	98.2
1995 .....	765.2	752.7	31.5	784.2	97.6
1996 .....	815.9	746.4	42.9	789.3	103.4
1997 .....	818.8	752.8	54.3	807.1	101.5
1998 .....	839.8	743.2	66.8	809.9	103.7
1999 .....	867.6	775.7	57.2	<b>832.9</b>	104.2
2000 .....	922.8	818.2	98.4	916.6	100.7
2001 .....	960.4	901.9	109.2	1,011.1	95.0
2002 .....	918.3	891.7	92.5	984.3	93.3
1993–2002 .....	8,450.5	7,963.0	591.4	8,554.4	98.8

NOTE. In this and other tables in this chapter, components may not sum to totals or yield percentages shown because of rounding. Amount in bold is a restatement due to errors in previously reported data.

1. For the ten-year period, includes revenue from services of \$8,183.0 million and other income and expense (net) of \$267.5 million.

2. For the ten-year period, includes operating expenses of \$7,114.7 million, imputed costs of \$489.7 million, and imputed income taxes of \$265.1 million. Also includes the effect of one-time accounting changes net of taxes of \$74.1 million for 1993 and \$19.4 million for 1995.

3. Revenue from services divided by total costs.

was largely the result of declining volume and customers' moving to lower-margin products. The Reserve Banks handled 16.6 billion checks in 2002, a decrease of 1.9 percent from 2001 (table). The decline in Reserve Bank check volume appears to be consistent with nationwide trends away from the use of checks and toward greater use of electronic payment methods.<sup>4</sup> Although the Reserve Banks took steps to reduce check operating costs in 2002, the reductions were largely offset by

lower-than-expected returns on pension credits.

To address the apparent continuing decline in check volumes, the Reserve Banks are developing a business and operational strategy that will position the service to achieve its financial and payment system objectives over the long term. In 2002, the Banks contracted with a consultant to analyze their check-processing infrastructure. The analysis defined criteria for balancing efficient provision of service in a declining-volume environment with the need to provide an adequate level of service nationwide. The Banks have used these criteria to develop potential options as to the number, location, and operational capabilities of its check-processing sites. Subsequently, the Reserve Banks announced that they are reducing their check service operating costs through a combination of measures: streamlining their check-management structures, reducing staff, decreasing the number of check-processing locations, and increas-

4. The Federal Reserve System's recent retail payments research suggests that the number of checks written in the United States has been declining since the mid-1990s. See Geoffrey R. Gerdes and Jack K. Walton II, "The Use of Checks and Other Noncash Payment Instruments in the United States," *Federal Reserve Bulletin*, vol. 88 (August 2002), pp. 360–74. (The article is available on the Board's web site at [www.federalreserve.gov/pubs/bulletin/default.htm](http://www.federalreserve.gov/pubs/bulletin/default.htm).) During the late 1990s, the volume of checks processed by the Reserve Banks rose, albeit slowly, suggesting that the proportion of interbank checks cleared through the Reserve Banks increased.



## Activity in Federal Reserve Priced Services, 2002, 2001, and 2000

Thousands of items

Service	2002	2001	2000	Percent change	
				2001 to 2002	2000 to 2001
Commercial check .....	16,586,804	16,905,016	16,993,800	-1.9	-.5
Funds transfer .....	117,133	115,308	111,175	1.6	3.7
Securities transfer .....	8,480	6,708	5,666	26.4	18.4
Commercial ACH .....	4,986,152	4,448,361	3,812,191	12.1	16.7
Noncash .....	333	412	519	-19.2	-20.7
Cash transportation .....	9	18	19	-52.5	-7.0

NOTE. Activity in *commercial checks* is the total number of commercial checks collected, including processed and fine-sort items; in *funds transfers* and *securities transfers*, the number of transactions originated on line and off line; in *commercial ACH*, the total number of commercial items processed; in *noncash services*, the number of items

on which fees were assessed; and in *cash transportation*, the number of registered mail shipments and FRB-arranged armored carrier stops.

Amount in bold is restatement of previously reported data.

ing processing capacity in other locations. The Reserve Banks will continue to provide check services nationwide.

The volume of checks for which the Federal Reserve office that serves the depositing bank is not the office that serves the paying bank increased 4.4 percent, from 3.6 billion in 2001 to 3.7 billion in 2002. Of all the checks presented by the Reserve Banks to paying banks, 22.0 percent (approximately 3.6 billion checks) were presented electronically, compared with 21.7 percent in 2001. The Reserve Banks captured images of 8.1 percent of the checks they collected, the same percentage as in 2001.

The Reserve Banks continued in 2002 a check modernization project begun in 2000 to install uniform software and hardware for check processing, check imaging, and check adjustments in all Reserve Bank offices and to give depository institutions web-based access to check services. The Reserve Banks expect to recover the cost of the project over the long run because the modernization effort will increase operating efficiency and make it possible to offer additional services to depository institutions.

### Commercial Automated Clearinghouse Services

Reserve Bank operating expenses and imputed costs for commercial automated clearinghouse (ACH) services totaled \$62.5 million in 2002. Revenue from ACH operations and other income totaled \$71.8 million, resulting in net income of \$9.3 million. The Reserve Banks processed 5.0 billion commercial ACH transactions (worth \$13.1 trillion), an increase of 12.1 percent from 2001.

Consolidation of customer support activities to two Reserve Bank offices was completed during 2002. These two Banks now share responsibility for supporting all ACH operations, including ensuring the timely and accurate processing of payments, maintaining the integrity of the ACH application, monitoring file processing, and responding to customers' questions. Before consolidation, these responsibilities were handled by each of the twelve Reserve Banks.

### Fedwire Funds and National Settlement Services

Reserve Bank operating expenses and imputed costs for the Fedwire Funds

and National Settlement Services totaled \$53.5 million in 2002. Revenue from these operations totaled \$58.6 million, and other income amounted to \$0.1 million, resulting in net income of \$5.2 million.

### *Fedwire Funds Service*

The Reserve Banks' Fedwire Funds Service allows depository institutions to draw on their reserve or clearing balances at the Reserve Banks and transfer funds to other institutions that maintain accounts at the Reserve Banks. In 2002, the number of Fedwire funds transfers originated by depository institutions increased 1.6 percent from 2001, to approximately 117.1 million. The Reserve Banks reduced the transfer fees for each of the volume-based tiers (table). The off-line funds transfer surcharge remained unchanged.<sup>5</sup>

The final phase of consolidation of the operations of the Fedwire Funds Service was completed in May. Also during 2002, the Reserve Banks improved the resilience of the service by increasing the readiness of a third data processing center. In the event of an outage at the primary or secondary site or at both sites, resources at the third site are available to support same-day recovery of Fedwire applications. This enhancement adds to the already robust contingency capabilities provided by the primary and secondary sites. The three sites are distant from each other.

In December, the Board requested comment on a proposal to expand the operating hours for the on-line Fedwire Funds Service. Under the proposal, the

### Fees Paid by Depository Institutions for Selected Federal Reserve Priced Services, 2001 and 2002

Dollars

Item	2001	2002
<b>FEDWIRE FUNDS TRANSFERS, BY VOLUME TIER<sup>1</sup></b>		
Tier ( <i>number of transfers per month</i> ) <sup>2</sup>		
1 (1 to 2,500) .....	.33	.31
2 (2,501 to 80,000) .....	.24	.22
3 (80,001 and more) .....	.16	.15
Off-line surcharge .....	15.00	15.00
<b>NATIONAL SETTLEMENT SERVICES</b>		
Entries, each .....	.95	.80
Files, each .....	12.00	14.00
Minimum per month .....	60-100	60-100
<b>FEDWIRE SECURITIES TRANSFERS</b>		
Account maintenance		
Per issue .....	.45	.41
Per account .....	15.00	15.00
Transfers, each <sup>2</sup> .....		
Off-line surcharge .....	.70	.66
Off-line surcharge .....	25.00	25.00
<b>NONCASH COLLECTION</b>		
Bonds, each .....		
Deposit envelopes ( <i>per envelope of coupons</i> ) <sup>3</sup>		
1-5 .....	4.75	4.75
6-50 .....	2.50	2.50
Cash letters ( <i>flat fee, by number of envelopes of coupons</i> ) <sup>3</sup>		
1-5 .....	7.50	7.50
6-50 .....	15.00	15.00
Return items, each .....	20.00	20.00

1. Rates apply only to their specified volume tiers.

2. Originated and received.

3. Deposits and cash letters may contain no more than 50 envelopes of coupons.

service would open at 9:00 p.m. eastern time (ET), three and one-half hours earlier than the current opening time of 12:30 a.m. ET. The earlier opening time is intended to facilitate the functioning and continued development of the payments system and to increase efficiency and reduce risk in making payments and settlements. The proposal does not affect the Fedwire Securities Service.

5. Depository institutions that do not have an electronic connection to the Fedwire funds transfer system can originate transfers via "off-line" telephone instructions.

### *National Settlement Service*

Private clearing arrangements that exchange and settle transactions may use the Reserve Banks' National Settlement Service to settle their transactions. The Reserve Banks provide settlement services to approximately seventy local and national private arrangements, primarily check clearinghouse associations but also other types of arrangements. In 2002, the Reserve Banks processed more than 415,000 settlement entries for these arrangements.

### Fedwire Securities Service

The Fedwire Securities Service allows participants to electronically transfer securities issued by the U.S. Treasury, federal government agencies, and other entities to other participants in the United States.<sup>6</sup> Reserve Bank operating expenses and imputed costs for providing this service totaled \$21.5 million in 2002. Revenue and other income totaled \$23.8 million, resulting in net income of \$2.3 million. Approximately 8.5 million transfers were processed by the service during the year, an increase of 26.4 percent from 2001. The basic per-transfer fee for transfers originated and received by participants and the monthly account maintenance fees were lowered, while the off-line securities transaction surcharge remained unchanged.

Conversion of Government National Mortgage Association (Ginnie Mae)

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6. The expenses, revenues, and volumes reported here are for transfers of securities issued by federal government agencies, government-sponsored enterprises, and international institutions. When the Reserve Banks provide transfer, account maintenance, and settlement services for U.S. Treasury securities, they are acting as fiscal agents of the United States. The Treasury Department assesses fees on depository institutions for some of these services. For details, see the section "Fiscal Agency Services" later in this chapter.

securities to the Fedwire system was completed in March; the securities are now transferred and settled on the Fedwire Securities Service. The final phase of consolidation of the operations of the Fedwire Securities Service, an effort to reduce costs, was completed in May. Operational support for processing joint custody collateral was also consolidated in May.

Also during 2002, the Reserve Banks increased the readiness of a third data processing center for the Fedwire Securities Service to serve as a backup in the event of an outage at the primary or secondary site or both. Processing resources at the third site are available to support same-day recovery of the Fedwire applications. This enhancement to the third site adds to the already robust contingency capabilities provided by the primary and secondary sites. The three sites are distant from each other.

### Noncash Collection Service

The Reserve Banks provide a service to collect and process municipal bearer bonds and coupons issued by state and local governments (referred to as "non-cash" items). The service, which is centralized at one Federal Reserve office, processed 333,000 noncash transactions in 2002. Operating expenses and imputed costs for noncash operations totaled \$1.5 million in 2002, and revenue totaled \$1.7 million, resulting in net income of \$0.2 million.

### Special Cash Services

The Reserve Banks charge fees for providing special cash-related services, such as packaging currency in a nonstandard way. These services—collectively referred to as "special cash services"—account for a very small

proportion (less than 1 percent) of the total cost of cash services provided to depository institutions by the Reserve Banks. Operating expenses and imputed costs for special cash services totaled \$1.4 million in 2002. Revenue and other income also totaled \$1.4 million, resulting in no net income.

### Float

Federal Reserve float decreased in 2002 to a daily average of -\$318.6 million, from a daily average of \$604.6 million in 2001.<sup>7</sup> The Federal Reserve includes the cost of or income from float associated with priced services as part of the fees for those services.

### Developments in Currency and Coin

The Reserve Banks received 34.7 billion notes from circulation in 2002, a 3.1 percent increase from 2001, and made payments of 35.4 billion notes to circulation in 2002, a 2.9 percent increase from 2001. The Banks received 43.4 billion coins from circulation in 2002, a 9.3 percent increase from 2001, and made payments of 58.6 billion coins to circulation in 2002, a 3.0 percent increase from 2001.

The Reserve Banks enhanced their national business-continuity framework for the cash services function during the year. This effort included the refinement of operating procedures, expansion of the crisis partner network for the Banks, and continuation of cash contingency testing.

Also during the year, the Federal Reserve worked closely with the Bureau of Engraving and Printing as prepara-

tions continued for the introduction of a new currency design, which includes new and enhanced security features.

### Developments in Fiscal Agency and Government Depository Services

The total cost of providing fiscal agency and depository services to the Treasury and other government agencies in 2002 amounted to \$308.5 million, compared with \$285.4 million in 2001 (table). The majority of these costs were incurred on behalf of the Treasury. Treasury-related costs were \$269.4 million in 2002, compared with \$246.5 million in 2001, an increase of 9.3 percent. The cost of providing services to other government agencies was \$39.1 million, compared with \$38.9 million in 2001. In 2002, as in 2001, the Treasury and other government agencies reimbursed the Reserve Banks for costs to provide these services.

#### Fiscal Agency Services

As fiscal agents, the Reserve Banks provide to the Treasury services related to the federal debt. For example, they issue, transfer, reissue, exchange, and redeem marketable Treasury securities and savings bonds; they also process secondary market transfers initiated by depository institutions. Additionally, the Reserve Banks support Treasury and other government agencies in their efforts to modernize government payment and accounting systems.

#### Marketable Treasury Securities

Reserve Bank operating expenses for activities related to marketable Treasury securities (Fedwire Securities Service, TreasuryDirect, marketable issues, and

7. Float results from differences in the timing of exchanges of debits and credits (settlements) between entities in financial transactions.

## Expenses of the Federal Reserve Banks for Fiscal Agency and Depository Services, 2002, 2001, and 2000

Thousands of dollars

Agency and service	2002	2001	2000
DEPARTMENT OF THE TREASURY			
<i>Bureau of the Public Debt</i>			
Savings bonds .....	68,888.3	69,569.8	70,786.7
TreasuryDirect and Treasury coupons .....	33,953.6	<b>36,610.1</b>	<b>42,372.4</b>
Commercial book entry .....	8,830.1	9,998.1	13,924.6
Marketable Treasury issues .....	14,597.6	11,366.8	14,224.3
Computer applications and infrastructure development and support .....	2,349.6	<b>222.4</b>	...
Other services .....	2,385.8	<b>1,255.7</b>	<b>96.8</b>
Total .....	131,005.0	129,022.9	141,404.7
<i>Financial Management Service</i>			
Treasury tax and loan and Treasury general account .....	30,111.0	31,106.0	38,649.0
Government check processing .....	30,284.4	30,310.2	31,866.9
Automated clearinghouse .....	6,280.0	9,665.2	10,799.1
Government agency deposits .....	2,082.2	2,272.9	2,218.8
Fedwire funds transfers .....	201.4	199.2	182.9
Computer applications and infrastructure development and support .....	46,782.6	<b>27,281.3</b>	<b>21,209.6</b>
Other services .....	8,173.1	<b>3,490.2</b>	<b>5,805.8</b>
Total .....	123,914.7	104,324.9	110,732.2
<i>Other Treasury</i>			
Total .....	14,471.2	13,149.8	10,362.8
Total, Treasury .....	269,390.9	246,497.5	262,499.7
OTHER FEDERAL AGENCIES			
Department of Agriculture			
Food coupons .....	10,240.8	13,197.2	16,463.7
U.S. Postal Service			
Postal money orders .....	12,381.6	11,255.0	9,213.5
Miscellaneous agencies			
Other services .....	16,494.1	14,434.0	13,747.1
Total, other agencies .....	39,116.5	38,886.2	39,424.3
Total reimbursable expenses .....	308,507.4	285,383.7	301,924.0

NOTE. Amounts in bold are restatements due to reclassification of previously reported data.

... Not applicable.

Treasury coupons) totaled \$57.4 million, a 1.0 percent decrease from 2001. The Reserve Banks processed 167,000 tenders for Treasury securities (excluding tenders processed by the Treasury, which were previously included in this figure), compared with 181,000 in 2001, and handled 2.5 million reinvestment requests, compared with 2.8 million in 2001.

The Reserve Banks operate two book-entry securities systems for Treasury securities: the Fedwire Securities Service, which provides custody and transfer services, and TreasuryDirect, which

provides custody services only.<sup>8</sup> Almost 98 percent of the total par value of Treasury securities outstanding at year-end 2002 was held by the Fedwire Securities Service. The Reserve Banks in 2002 originated 8.3 million transfers of Treasury securities, a 6.2 percent increase from 2001.

TreasuryDirect customers may sell their securities for a fee through Sell-Direct, a program operated by one of the Reserve Banks. The Bank sold nearly

8. TreasuryDirect was designed for individuals who plan to hold their securities until maturity.

14,000 securities worth \$589.8 million in 2002, compared with nearly 15,000 securities worth \$699.9 million in 2001. It collected more than \$464,000 in fees on behalf of the Treasury, a decrease of 9.1 percent from the almost \$510,000 in fees collected in 2001.

### *Savings Bonds*

Reserve Bank operating expenses for savings bond activities totaled \$68.9 million in 2002, a decrease of 1.0 percent from 2001. The Banks printed and mailed 37.2 million savings bonds on behalf of the Treasury's Bureau of the Public Debt, a 1.5 percent decrease from 2001. They issued nearly 4.7 million new Series I (inflation-indexed) savings bonds and 27.9 million new Series EE savings bonds. In addition, the Banks processed approximately 618,000 redemption, reissue, and exchange transactions, a 9.7 percent increase from 2001. Reserve Bank staff responded to 1.6 million service calls from owners of savings bonds, approximately the same number as in 2001.

### *Depository Services*

The Reserve Banks maintain the Treasury's funds account, accept deposits of federal taxes and fees, pay checks drawn on the Treasury's account, and make electronic payments on behalf of the Treasury.

### *Federal Tax Payments*

Reserve Bank operating expenses related to federal tax payments in 2002 totaled \$30.1 million. The Federal Reserve enhanced the Treasury tax and loan program at midyear by pilot testing the Term Investment Option, whereby the Treasury can place investments with depository institutions for a set term, the

interest rate being determined by auction. This pilot program added approximately \$3.0 million to the Treasury's investment income.

### *Payments Processed for the Treasury*

Reserve Bank operating expenses related to government payments amounted to \$38.8 million in 2002. The Banks processed 883.2 million ACH transactions for the Treasury, a decrease of 1.9 percent from 2001, and nearly 140,000 Fedwire funds transfers, a decrease of 10.2 percent from 2001. They also processed 289.3 million paper government checks, a decrease of 16.3 percent from 2001. In addition, the Banks issued 368,000 fiscal agency checks, a decrease of 15.5 percent from 2001.

During the year, the Reserve Banks assisted Treasury's efforts to facilitate electronic payments to the federal government. The Banks operate Pay.gov, a Treasury program that allows members of the public to pay the government over the Internet. The Banks also operate the Treasury's Paper Check Conversion program, whereby checks written to government agencies are converted at the point of sale into ACH transactions. In 2002, the first full year of operation for both programs, the Reserve Banks originated nearly 215,000 ACH transactions through the programs, a significant increase from the 10,000 originated in 2001.

### *Services Provided to Other Entities*

The Reserve Banks provide fiscal agency and depository services to other domestic and international agencies when they are required to do so by the Secretary of the Treasury or when they are required or permitted to do so by federal statute. One such service is the

provision of food coupon services for the Department of Agriculture. Reserve Bank operating expenses for food coupon services in 2002 totaled \$10.2 million, 22.4 percent lower than in 2001. The Banks redeemed 500.5 million food coupons, a decrease of 14.7 percent from 2001.

As fiscal agents of the United States, the Reserve Banks also process all postal money orders deposited by banks for collection. In 2002, they processed 216.5 million postal money orders, a decrease of 5.6 percent from 2001.

### **Electronic Access**

The Federal Reserve continued in 2002 to improve electronic access for depository institutions and to offer web-based applications for imaging checks, ordering cash, and processing savings bonds. Specifically, the Reserve Banks made the strategic decision to deliver services using web-based technologies in the next two years and to discontinue development of the FedLine for Windows NT operating system. This strategic direction will allow the Banks to provide more-flexible access to the full array of financial information and transaction services, including high-risk Fedwire and ACH, and to improve the quality of financial services.

To complement the move to web-based electronic access, the Reserve Banks plan to consolidate the customer support function for electronic access at each Reserve Bank to two sites during 2003 and 2004. The consolidation is expected to improve the efficiency and consistency of customer support.

### **Information Technology**

Implementation of frame relay technology on the telecommunications network connecting the Reserve Bank offices to

each other and to depository institutions is substantially complete. The technology has improved the speed, reliability, and performance of the depository institutions' electronic connections during contingencies as well as the capacity and flexibility to support new electronic services using web-based technologies.

Also, several major cost-reduction initiatives to centralize or standardize information technology utilities and resources common to the Reserve Banks have begun. Projects are under way to standardize certain local area network components as well as desktop hardware and software to facilitate interoperability, improve network efficiency, and increase productivity. Certain Reserve Banks are supporting common information technology functions such as desktop standardization and management, remote access, and incident response. These initiatives are expected to contribute to a System effort to reduce information technology costs over the long term.

### **Examinations of the Federal Reserve Banks**

Section 21 of the Federal Reserve Act requires the Board of Governors to order an examination of each Federal Reserve Bank at least once a year. The Board engages a public accounting firm to perform an annual audit of the combined financial statements of the Reserve Banks (see the section "Federal Reserve Banks Combined Financial Statements"). The public accounting firm also audits the annual financial statements of each of the twelve Banks. The Reserve Banks use the framework established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in assessing their internal controls over financial reporting, including the safeguarding of assets. Within this framework, each Reserve Bank provides an

assertion letter to its board of directors annually confirming adherence to the COSO standards, and a public accounting firm certifies management's assertion and issues an attestation report to the Bank's board of directors and to the Board of Governors.

The firm engaged for the audits of the individual and combined financial statements of the Reserve Banks for 2002 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled \$1.0 million. To ensure auditor independence, the Board requires that PwC be independent in all matters relating to the audit. Specifically, PwC may not perform services for the Reserve Bank or others that would place it in a position of auditing its own work, making management decisions on behalf of the Reserve Banks, or in any other way impairing its audit independence. In 2002 the Reserve Banks engaged PwC for advisory services totaling \$176,600 for project management advisory services related to the System's check modernization project. The Board believes that these advisory services do not directly affect the preparation of the financial statements audited by PwC and are not incompatible with the services provided by PwC as an independent auditor.

The Board's annual examination of the Reserve Banks in 2002 included a wide range of off-site and on-site oversight activities conducted by the Division of Reserve Bank Operations and Payment Systems. Division staff monitors the activities of each Reserve Bank on an ongoing basis and conducts on-site reviews according to the division's risk-assessment methodology. The 2002 examination also included assessing the efficiency and effectiveness of the internal audit function.

Each year, to assess compliance with the policies established by the Federal

Reserve's Federal Open Market Committee (FOMC), the division also examines the accounts and holdings of the System Open Market Account at the Federal Reserve Bank of New York and the foreign currency operations conducted by that Bank. In addition, a public accounting firm certifies the schedule of participated asset and liability accounts and the related schedule of participated income accounts at year-end. Division personnel follow up on the results of these audits. The FOMC receives the external audit reports and the report on the division's follow-up.

### **Income and Expenses**

The accompanying table summarizes the income, expenses, and distributions of net earnings of the Federal Reserve Banks for 2001 and 2002.

Income in 2002 was \$26,760 million, compared with \$31,871 million in 2001. Expenses totaled \$2,862 million (\$2,071 million in operating expenses, \$156 million in earnings credits granted to depository institutions, \$205 million in assessments for expenditures by the Board of Governors, and \$430 million for the cost of new currency). Revenue from priced services was \$916.3 million.

The profit and loss account showed a net profit of \$2,149 million. The profit was due primarily to unrealized gains on assets denominated in foreign currencies revalued to reflect current market exchange rates. Statutory dividends paid to member banks totaled \$484 million, \$56 million more than in 2001; the increase reflects an increase in the capital and surplus of member banks and a consequent increase in the paid-in capital stock of the Reserve Banks.

Payments to the U.S. Treasury in the form of interest on Federal Reserve notes totaled \$24,496 million in 2002,



Income, Expenses, and Distribution of Net Earnings  
of the Federal Reserve Banks, 2002 and 2001

Millions of dollars

Item	2002	2001
Current income .....	26,760	31,871
Current expenses .....	2,227	2,085
Operating expenses <sup>1</sup> .....	2,071	1,834
Earnings credits granted .....	156	250
Current net income .....	24,533	29,786
Net additions to (deductions from, - ) current net income .....	2,149	-1,117
Assessments by the Board of Governors .....	635	634
For expenditures of Board .....	205	295
For cost of currency .....	430	339
Net income before payments to Treasury .....	26,048	28,035
Dividends paid .....	484	428
Transferred to surplus .....	1,068	518
Payments to Treasury <sup>2</sup> .....	24,496	27,089

1. Includes a net periodic credit for pension costs of \$157 million in 2002 and \$331 million in 2001.

2. Interest on Federal Reserve notes.

down from \$27,089 million in 2001; the payments equal net income after the deduction of dividends paid and of the amount necessary to bring the surplus of the Reserve Banks to the level of capital paid in.

In the “Statistical Tables” section of this volume, table 5 details the income and expenses of each Reserve Bank for 2002, and table 6 shows a condensed statement for each Bank for the years 1914 through 2002. A detailed account of the assessments and expenditures of the Board of Governors appears in the section “Board of Governors Financial Statements.”

### Holdings of Securities and Loans

The Reserve Banks’ average daily holdings of securities and loans during 2002 amounted to \$621,834 million, an increase of \$62,511 million from 2001 (table). Holdings of U.S. government securities increased \$62,795 million, and holdings of loans decreased \$284 million.

The average rate of interest earned on the Reserve Banks’ holdings of government securities declined to 4.11 percent, from 5.46 percent in 2001, and the average rate of interest earned on loans declined to 1.94 percent, from 3.18 percent.

### Volume of Operations

Table 8 in the “Statistical Tables” section shows the volume of operations in the principal departments of the Federal Reserve Banks for the years 1999 through 2002.

### Federal Reserve Bank Premises

In 2002, design work continued for the Dallas Reserve Bank’s new Houston Branch building and the Chicago Bank’s Detroit Branch building. Also, the Board approved the purchase of property for the new Detroit Branch building and a new building program for the Kansas City Bank. The St. Louis Reserve Bank

## Securities and Loans of the Federal Reserve Banks, 2000–2002

Millions of dollars except as noted

Item and year	Total	U.S. government securities <sup>1</sup>	Loans <sup>2</sup>
<i>Average daily holdings<sup>3</sup></i>			
2000 .....	528,139	527,774	365
2001 .....	559,323	558,926	397
2002 .....	621,834	621,721	113
<i>Earnings<sup>4</sup></i>			
2000 .....	32,760	32,737	23
2001 .....	30,536	30,523	13
2002 .....	25,527	25,525	2
<i>Average interest rate (percent)</i>			
2000 .....	6.20	6.20	6.27
2001 .....	5.46	5.46	3.18
2002 .....	4.11	4.11	1.94

1. Includes federal agency obligations.

2. Does not include indebtedness assumed by the Federal Deposit Insurance Corporation.

3. Based on holdings at opening of business.

4. Earnings have not been netted with the interest expense on securities sold under agreements to repurchase.

continued to analyze its long-term planning options for its headquarters facility.

The multiyear renovation program at the New York Reserve Bank's headquarters building continued, including the cleaning and repair of the exterior stonework. The improvement program

for the main chiller plant in the headquarters building was completed, and the annex building in New York City was sold.

At all facilities, security enhancement programs were undertaken as a result of the events of September 11, 2001. ■

## Pro Forma Financial Statements for Federal Reserve Priced Services

Pro Forma Balance Sheet for Priced Services, December 31, 2002 and 2001

Millions of dollars

Item	2002	2001	
<i>Short-term assets</i> (Note 1)			
Imputed reserve requirements on clearing balances .....	1,047.8	860.8	
Investment in marketable securities ..	9,051.3	7,747.3	
Receivables .....	78.7	76.5	
Materials and supplies .....	3.4	3.1	
Prepaid expenses .....	34.8	30.5	
Items in process of collection .....	<u>6,958.6</u>	<u>1,772.1</u>	
Total short-term assets .....	17,174.7		10,490.3
<i>Long-term assets</i> (Note 2)			
Premises .....	475.0	473.0	
Furniture and equipment .....	179.2	176.1	
Leases and leasehold improvements ..	91.2	88.1	
Prepaid pension costs .....	<u>809.2</u>	<u>760.8</u>	
Total long-term assets .....	<u>1,554.6</u>		<u>1,498.0</u>
Total assets .....	18,729.3		11,988.3
<i>Short-term liabilities</i>			
Clearing balances and balances arising from early credit of uncollected items .....	10,550.2	8,524.5	
Deferred-availability items .....	6,886.4	1,855.7	
Short-term debt .....	.0	20.8	
Short-term payables .....	<u>83.9</u>	<u>89.2</u>	
Total short-term liabilities .....	17,520.5		10,490.3
<i>Long-term liabilities</i>			
Long-term debt .....	.0	519.7	
Postretirement/postemployment benefits obligation .....	<u>272.3</u>	<u>257.8</u>	
Total long-term liabilities .....	<u>272.3</u>		<u>777.4</u>
Total liabilities .....	17,792.8		11,267.7
Equity .....	<u>936.4</u>		<u>720.6</u>
Total liabilities and equity (Note 3) ...	18,729.3		11,988.3

NOTE. Components may not sum to totals because of rounding.

The accompanying notes are an integral part of these pro forma priced services financial statements.

## Pro Forma Income Statement for Federal Reserve Priced Services, 2002 and 2001

Millions of dollars

Item	2002	2001
Revenue from services provided to depository institutions (Note 4) .....	916.3	926.5
Operating expenses (Note 5) .....	<u>876.0</u>	<u>814.9</u>
Income from operations .....	40.2	111.7
Imputed costs (Note 6)		
Interest on float .....	-6.8	15.5
Interest on debt .....	.0	32.0
Sales taxes .....	11.4	12.6
FDIC insurance .....	<u>.0</u>	<u>.0</u>
Income from operations after imputed costs .....	35.6	51.6
Other income and expenses (Note 7)		
Investment income .....	148.9	273.3
Earnings credits .....	<u>-146.8</u>	<u>-239.4</u>
Income before income taxes .....	37.7	85.4
Imputed income taxes (Note 8) .....	<u>11.0</u>	<u>26.9</u>
Net income .....	26.6	58.5
MEMO: Targeted return on equity (Note 9) ...	92.5	109.2

NOTE. Components may not sum to totals because of rounding.

The accompanying notes are an integral part of these pro forma priced services financial statements.

## Pro Forma Income Statement for Federal Reserve Priced Services, by Service, 2002

Millions of dollars

Item	Total	Com- mercial check collection	Fedwire funds	Fedwire securities	Com- mercial ACH	Noncash services	Cash services
Revenue from services (Note 4) .....	916.3	759.2	58.6	23.7	71.7	1.7	1.4
Operating expenses (Note 5) .....	<u>876.0</u>	<u>744.3</u>	<u>50.7</u>	<u>20.3</u>	<u>58.0</u>	<u>1.4</u>	<u>1.4</u>
Income from operations .....	40.2	14.9	7.9	3.5	13.7	.2	-0
Imputed costs (Note 6) .....	<u>4.6</u>	<u>2.9</u>	<u>.7</u>	<u>.3</u>	<u>.7</u>	<u>.0</u>	<u>.0</u>
Income from operations after imputed costs .....	35.6	12.0	7.3	3.1	13.0	.2	-0
Other income and expenses, net (Note 7) .....	<u>2.1</u>	<u>1.7</u>	<u>.1</u>	<u>.0</u>	<u>.2</u>	<u>.0</u>	<u>.0</u>
Income before income taxes ..	37.7	13.7	7.4	3.2	13.2	.2	-0
Imputed income taxes (Note 8) .....	<u>11.0</u>	<u>4.0</u>	<u>2.2</u>	<u>.9</u>	<u>3.9</u>	<u>.1</u>	<u>-0</u>
Net income .....	26.6	9.7	5.2	2.3	9.3	.2	-0
MEMO: Targeted return on equity (Note 9) .....	92.5	78.2	5.5	2.2	6.5	.1	.1

NOTE. Components may not sum to totals because of rounding.

The accompanying notes are an integral part of these pro forma priced services financial statements.

## FEDERAL RESERVE BANKS

## NOTES TO PRO FORMA FINANCIAL STATEMENTS FOR PRICED SERVICES

## (1) SHORT-TERM ASSETS

The imputed reserve requirement on clearing balances held at Reserve Banks by depository institutions reflects a treatment comparable to that of compensating balances held at correspondent banks by respondent institutions. The reserve requirement imposed on respondent balances must be held as vault cash or as non-earning balances maintained at a Reserve Bank; thus, a portion of priced services clearing balances held with the Federal Reserve is shown as required reserves on the asset side of the balance sheet. Another portion of the clearing balances is used to finance short-term and long-term assets. The remainder of clearing balances is assumed to be invested in three-month Treasury bills, shown as investment in marketable securities.

Receivables are (1) amounts due the Reserve Banks for priced services and (2) the share of suspense-account and difference-account balances related to priced services.

Materials and supplies are the inventory value of short-term assets.

Prepaid expenses include salary advances and travel advances for priced-service personnel.

Items in process of collection is gross Federal Reserve cash items in process of collection (CIPC) stated on a basis comparable to that of a commercial bank. It reflects adjustments for intra-System items that would otherwise be double-counted on a consolidated Federal Reserve balance sheet; adjustments for items associated with non-priced items, such as those collected for government agencies; and adjustments for items associated with providing fixed availability or credit before items are received and processed. Among the costs to be recovered under the Monetary Control Act is the cost of float, or net CIPC during the period (the difference between gross CIPC and deferred-availability items, which is the portion of gross CIPC that involves a financing cost), valued at the federal funds rate.

## (2) LONG-TERM ASSETS

Consists of long-term assets used solely in priced services, the priced-services portion of long-term assets shared with nonpriced services, and an estimate of the assets of the Board of Governors used in the development of priced services. Effective Jan. 1, 1987, the Reserve Banks implemented the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions* (SFAS 87). Accordingly, the Reserve Banks recognized credits to expenses of \$48.4 million in 2002 and \$101.0 million in 2001 and corresponding increases in this asset account.

## (3) LIABILITIES AND EQUITY

Under the matched-book capital structure for assets, short-term assets are financed with clearing balances in 2002 and short-term payables and short-term debt in 2001. Long-term assets are financed with clearing balances in 2002, and in 2001 with long-term debt and equity in a proportion equal to the ratio of long-term debt to equity for the fifty largest bank holding companies, which are used in the model for the private-sector adjust-

ment factor (PSAF). The PSAF consists of the taxes that would have been paid and the return on capital that would have been provided had priced services been furnished by a private-sector firm. Other short-term liabilities include clearing balances maintained at Reserve Banks and deposit balances arising from float. Other long-term liabilities consist of accrued postemployment and postretirement benefits costs and obligations on capital leases.

## (4) REVENUE

Revenue represents charges to depository institutions for priced services and is realized from each institution through one of two methods: direct charges to an institution's account or charges against its accumulated earnings credits.

## (5) OPERATING EXPENSES

Operating expenses consist of the direct, indirect, and other general administrative expenses of the Reserve Banks for priced services plus the expenses for staff members of the Board of Governors working directly on the development of priced services. The expenses for Board staff members were \$5.1 million in 2002 and \$4.9 million in 2001. The credit to expenses under SFAS 87 (see note 2) is reflected in operating expenses.

The income statement by service reflects revenue, operating expenses, and imputed costs. Certain corporate overhead costs not closely related to any particular priced service are allocated to priced services in total based on an expense-ratio method, but are allocated among priced services based on management decision. Corporate overhead was allocated among the priced services during 2002 and 2001 as follows (in millions):

	2002	2001
Check .....	40.3	43.5
ACH .....	4.1	4.4
Fedwire funds .....	3.3	3.5
Fedwire securities .....	1.9	1.9
Noncash services .....	.1	.1
Special cash services .....	.1	.0
Total .....	49.7	53.4

## (6) IMPUTED COSTS

Imputed costs consist of interest on float, interest on debt, sales taxes, and the FDIC assessment. Interest on float is derived from the value of float to be recovered, either explicitly or through per-item fees, during the period. Float costs include costs for checks, book-entry securities, noncash collection, ACH, and funds transfers.

Interest is imputed on the debt assumed necessary to finance priced-service assets. There was no debt in 2002 because clearing balances fund short-term and long-term debt. The sales taxes and FDIC assessment that the Federal Reserve would have paid had it been a private-sector firm are among the components of the PSAF (see note 3).

Float cost or income is based on the actual float incurred for each priced service. Other imputed costs are allocated among priced services according to the ratio of operating expenses less shipping expenses for each ser-

vice to the total expenses for all services less the total shipping expenses for all services.

The following list shows the daily average recovery of actual float by the Reserve Banks for 2002 in millions of dollars:

Total float	-9.3
Unrecovered float	<u>68.6</u>
Float subject to recovery	-77.9
Sources of recovery of float	
Income on clearing balances	-8.2
As-of adjustments	-309.3
Direct charges	430.8
Per-item fees	-809.8

Unrecovered float includes float generated by services to government agencies and by other central bank services. Float recovered through income on clearing balances is the result of the increase in investable clearing balances; the increase is produced by a deduction for float for cash items in process of collection, which reduces imputed reserve requirements. The income on clearing balances reduces the float to be recovered through other means. As-of adjustments and direct charges refer to float that is created by interterritory check transportation and the observance of non-standard holidays by some depository institutions. Such float may be recovered from the depository institutions through adjustments to institution

reserve or clearing balances or by billing institutions directly. Float recovered through direct charges and per-item fees is valued at the federal funds rate; credit float recovered through per-item fees has been subtracted from the cost base subject to recovery in 2002.

#### (7) OTHER INCOME AND EXPENSES

Consists of investment income on clearing balances and the cost of earnings credits. Investment income on clearing balances represents the average coupon-equivalent yield on three-month Treasury bills applied to the *total* clearing balance maintained, adjusted for the effect of reserve requirements on clearing balances. Expenses for earnings credits granted to depository institutions on their clearing balances are derived by applying the average federal funds rate to the *required* portion of the clearing balances, adjusted for the net effect of reserve requirements on clearing balances.

#### (8) INCOME TAXES

Imputed income taxes are calculated at the effective tax rate derived from the PSAF model (see note 3).

#### (9) RETURN ON EQUITY

The after-tax rate of return on equity that the Federal Reserve would have earned had it been a private business firm, as derived from the PSAF model (see note 3).

## *The Board of Governors and the Government Performance and Results Act*

Under the Government Performance and Results Act of 1993 (GPRA), federal agencies are required to prepare, in consultation with the Congress and outside stakeholders, a strategic plan covering a multiyear period and to submit annual performance plans and performance reports. Though not covered by the act, the Board of Governors is voluntarily complying with many of the act's mandates.

### **Strategic and Performance Plans and Performance Report**

The Board's current strategic plan in the GPRA format, released in December 2001, covers the period 2001–05. The document articulates the Board's mission, sets forth major goals for the period, outlines strategies for achieving those goals, and discusses the environment and other factors that could affect their achievement. The strategic plan also addresses issues that cross agency jurisdictional lines, identifies key quantitative measures of performance, and discusses performance evaluation.

The 2002–03 performance plan and the 2000–01 performance report were posted on the Board's public web site in November 2002 for access by the Congress, the public, and the General Accounting Office. The performance plan sets forth specific targets for some of the performance measures identified in the strategic plan (except those associated with the monetary policy function). The performance plan also describes the operational processes and resources needed to meet those targets

and discusses validation of data and verification of results. The performance report indicates that the Board generally met its goals for 2000–01. A scheduling problem with state bank regulatory agencies was cited as a reason for not meeting all of the goals. Accordingly, the Board is implementing a new scheduling system that will help resolve the problem.

The strategic plan, performance plan, and performance report are available on the Board's public web site ([www.federalreserve.gov/boarddocs/rptcongress/](http://www.federalreserve.gov/boarddocs/rptcongress/)). The Board's mission statement and a summary of the goals and objectives set forth in the strategic and performance plans are given below.

### **Mission**

The mission of the Board is to foster the stability, integrity, and efficiency of the nation's monetary, financial, and payment systems so as to promote optimal macroeconomic performance.

### **Goals and Objectives**

The Federal Reserve has three primary goals with interrelated and mutually reinforcing elements:

#### **Goal**

To conduct monetary policy that promotes the achievement of maximum sustainable long-term growth and the price stability that fosters that goal.

### *Objectives*

- Stay abreast of recent developments and prospects in the U.S. economy and financial markets and in those abroad, so that monetary policy decisions will be well informed
- Enhance our knowledge of the structural and behavioral relationships in the macroeconomic and financial markets, and improve the quality of the data used to gauge economic performance, through developmental research activities
- Implement monetary policy effectively in rapidly changing economic circumstances and in an evolving financial market structure
- Contribute to the development of U.S. international policies and procedures, in cooperation with the Department of the Treasury and other agencies
- Promote understanding of Federal Reserve policy among other government policy officials and the general public.

### **Goal**

To promote a safe, sound, competitive, and accessible banking system and stable financial markets.

### *Objectives*

- Provide comprehensive and effective supervision of U.S. banks, bank and financial holding companies, foreign banking organizations with U.S. operations, and related entities
- Promote overall financial stability, manage and contain systemic risk, and ensure that emerging financial crises are identified early and successfully resolved
- Improve efficiency and effectiveness and reduce burden on supervised institutions

- Promote equal access to banking services
- Administer and ensure compliance with consumer protection statutes relating to consumer financial transactions (Truth in Lending, Truth in Savings, Consumer Leasing, and Electronic Funds Transfer) to carry out congressional intent, striking the proper balance between protection of consumers and burden to the industry.

### **Goal**

To provide high-quality professional oversight of Reserve Bank operations and to foster the integrity, efficiency, and accessibility of U.S. payment and settlement systems.

### *Objectives*

- Develop sound, effective policies and regulations that foster payment system integrity, efficiency, and accessibility
- Produce high-quality assessments of Federal Reserve Bank operations, projects, and initiatives that help Federal Reserve management foster and strengthen sound internal control systems and efficient and effective performance
- Conduct research and analysis that contributes to policy development and increases the Board's and others' understanding of payment system dynamics and risk.

### **Interagency Coordination**

Interagency coordination helps focus efforts to eliminate redundancy and lower costs. As mandated by the Government Performance and Results Act and in conformance with past practice, the Board has worked closely with other federal agencies to consider plans and



strategies for programs, such as bank supervision, that transcend the jurisdiction of each agency. Coordination with the Department of the Treasury and other agencies is evident throughout both the strategic and performance plans. Much of the Board's formal effort to plan jointly has been made through the Federal Financial Institutions Examination Council (FFIEC), a group made up of the five federal agencies that regulate depository institutions.<sup>1</sup> In addition, a coordinating committee of representatives of the chief financial

officers of the five agencies has been created to address and report on issues related to those general goals and objectives that cross agency functions, programs, and activities. This working group has been meeting since June 1997. These and similar planning efforts can eliminate redundancy and significantly lower the government's costs for data processing and other activities, as well as lower depository institutions' costs for complying with federal regulations, while enhancing public access to the data. ■

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1. The FFIEC consists of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. It was established in 1979 pursuant to title X of the Financial Institutions Regulatory and Interest Rate Control Act of 1978. The FFIEC is a formal interagency body empowered to prescribe uniform principles, standards, and report

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forms for the federal examination of financial institutions and to make recommendations to promote uniformity in the supervision of financial institutions. The FFIEC also provides uniform examiner training and has taken a lead in developing standardized software needed for major data collection programs to support the requirements of the Home Mortgage Disclosure Act and the Community Reinvestment Act.

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## *Federal Legislative Developments*

On November 26, 2002, President Bush signed the Terrorism Risk Insurance Act of 2002 into law. Section 301 of that act amended section 11 of the Federal Reserve Act (12 U.S.C. 248) to enhance the Board's ability to respond to emergency situations. Before the amendment, the Federal Reserve Act allowed the Board to take five types of actions only upon the affirmative vote of at least five Board members. Among the actions requiring supermajority approval was Board authorization of a Federal Reserve Bank to extend credit to a nondepository institution in unusual and exigent circumstances under section 13(3) of the Federal Reserve Act. *See* 12 U.S.C. §343; *see also* 12 U.S.C. §§248(b), 347a, and 461(b)(3) and (b)(4).

These five-member voting requirements could have impaired the Board's ability to act in an emergency. The Terrorism Risk Insurance Act amended these requirements in two respects. First, it allows fewer than five Board members, by unanimous vote, to approve any action that would otherwise require a

five-member vote if fewer than five members are in office at the time of the action (that is, if more than two seats on the Board are vacant). Second, it allows those members of the Board that are available to approve a loan to a nondepository institution under section 13(3) of the Federal Reserve Act if these available members unanimously determine that (1) unusual and exigent circumstances exist and the borrower is unable to secure adequate credit accommodations from other sources; (2) action on the loan is necessary to prevent, correct, or mitigate serious harm to the economy or the stability of the U.S. financial system; (3) all available telephonic, telegraphic, and other means have been used to attempt to contact the other members of the Board; and (4) action on the loan request is necessary before the other Board members can be contacted. At least two Board members must be available and participate in the emergency loan approval, and any loan made by a Reserve Bank under this emergency procedure must be payable upon demand. ■

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# *Records*

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## *Record of Policy Actions of the Board of Governors*

### **Regulation A**

Extensions of Credit  
by Federal Reserve Banks

### **Regulation D**

Reserve Requirements  
of Depository Institutions

October 31, 2002—Amendments

The Board amended Regulations A and D to implement new discount window programs, effective January 9, 2003.

Votes for this action: Messrs. Greenspan, Ferguson, and Gramlich, Ms. Bies, and Messrs. Olson, Bernanke, and Kohn.

The revisions to Regulation A replace the adjustment and extended credit programs with new primary and secondary credit programs, reorganize and streamline the rule, and would facilitate a reduction of the primary credit rate in the event of a financial emergency. The Board also amended Regulation D to conform the calculation of penalties for reserve deficiencies, which are based on the discount rate, to the new discount rate framework.

Under the new primary credit program, the Federal Reserve Banks offer very short term credit, at an interest rate above the targeted federal funds rate, as a backup source of liquidity to depository institutions that are in generally sound financial condition. The Reserve Banks establish the primary credit rate at least every two weeks, subject to review and determination by the Board, through the same procedure that had been used to set the adjustment credit

rate. A secondary credit program, with an interest rate initially 50 basis points above the primary credit rate, is available in appropriate circumstances to depository institutions that do not qualify for primary credit.

The revisions are intended to improve the functioning of the discount window and do not indicate a change in the stance of monetary policy. The seasonal credit program, used mainly by small banks that have pronounced seasonal funding needs, remains essentially unchanged.

### **Regulation C**

Home Mortgage Disclosure

January 23, 2002—Amendments

The Board approved amendments to Regulation C, which implements the Home Mortgage Disclosure Act, to expand the amount of data and number of lenders subject to the reporting requirements of the act, effective January 1, 2003.

Votes for this action: Messrs. Ferguson, Meyer, and Gramlich, Ms. Bies, and Mr. Olson.

The Home Mortgage Disclosure Act requires covered lenders to collect, report, and publicly disclose certain data on home purchase and home improvement loans (both loans they originate and those they purchase) and applications that do not result in originations. These data include the race, ethnicity, sex, and income of the applicants and

borrowers and the location of the property. The amendments require, among other things, that lenders report loan-pricing data showing the spread between the annual percentage rate charged for originated loans and the rate on U.S. Treasury securities having comparable maturity periods, if the spread equals or exceeds certain thresholds set by the Board. Lenders are also required to identify loans subject to the Home Ownership and Equity Protection Act and report denials of applications for credit received through certain preapproval programs. In addition, the amendments expand the regulation's coverage of nondepository lenders by adding a dollar-volume test of \$25 million in total home purchase loan originations (including refinancings of home purchase loans) for the preceding year.

The Board published for comment a proposal that reporting thresholds for first-lien loans be set at 3 percentage points above the U.S. Treasury rate and 5 percentage points above that rate for subordinate-lien loans. The Board also requested public comment on requiring lenders to collect, for applications and originated loans, data on whether the application or loan is secured by a first or subordinate lien on a dwelling or is unsecured (the lien status) and requiring lenders to request, for loan applications made by telephone, the race, ethnicity, and sex of the applicant.

#### May 2, 2002—Delay of Effective Date and Interim Amendment

The Board extended the effective date for most of the amendments to Regulation C, which expand the amount of data and number of lenders subject to the reporting requirements of the Home Mortgage Disclosure Act, from January 1, 2003, to January 1, 2004. The Board also adopted an interim amend-

ment to require reporters under the act to use 2000 census data, effective January 1, 2003.

Votes for this action: Messrs. Greenspan, Ferguson, and Gramlich, Ms. Bies, and Mr. Olson.

The Board extended for one year the effective date of amendments approved on January 23, 2002, as discussed above, to give institutions sufficient time to implement the new reporting requirements. The extension allows institutions to fully implement the new rules without jeopardizing the quality and usefulness of the data and without incurring substantial additional implementation costs that could be avoided by a delay in the effective date. The Board also adopted an interim amendment to improve the accuracy and usefulness of the data submitted under the act by requiring reporters to use 2000 census data, effective January 1, 2003.

#### June 3, 2002—Amendments

The Board approved amendments to implement the following proposals made in connection with the January 2002 amendments to Regulation C: establish reporting thresholds for loan-pricing data and require reporting of lien-status data, effective January 1, 2004, and require lenders to request additional information in telephone applications, effective January 1, 2003.

Votes for this action: Messrs. Greenspan, Ferguson, and Gramlich, Ms. Bies, and Mr. Olson.

As discussed above, the Board approved amendments to the data collection requirements of Regulation C on January 23, 2002. It also published for comment proposals that would establish thresholds for reporting loan-pricing

data based on a rate spread (between the annual percentage rate on a loan and the yield on comparable U.S. Treasury securities) of 3 percentage points for first-lien loans and 5 percentage points for subordinate-lien loans; require lenders to report the lien status of applications and originated loans; and require lenders to request the race, ethnicity, and sex of telephone applicants. The Board approved these proposals with the effective dates indicated.

## **Regulation D** Reserve Requirements of Depository Institutions

October 1, 2002—Amendments

The Board amended Regulation D to increase the amount of net transaction accounts at depository institutions to which a lower reserve requirement applies (low reserve tranche) and the amount of reservable liabilities exempt from reserve requirements (reservable liabilities exemption level) for 2003, effective for the reserve computation period beginning November 26, 2002, for institutions reporting weekly.

Votes for this action: Messrs. Greenspan, Ferguson, and Gramlich, Ms. Bies, and Messrs. Olson, Bernanke, and Kohn.

Under the Monetary Control Act of 1980, depository institutions, Edge and agreement corporations, and U.S. agencies and branches of foreign banks are subject to reserve requirements set by the Board. The act directs the Board to adjust annually the amount of the low reserve tranche on the basis of percentage changes in net transaction accounts at all depository institutions over the one-year period ending on the most recent June 30. The growth in total net transaction accounts from June 30,

2001, to June 30, 2002, warranted an increase in the low reserve tranche from \$41.3 million to \$42.1 million, and the Board amended Regulation D accordingly.

The Garn–St Germain Depository Institutions Act of 1982 establishes a zero percent reserve requirement on the first \$2 million of an institution’s reservable liabilities. The act also provides for annual adjustments to that exemption amount based on percentage increases in reservable liabilities at all depository institutions over the one-year period ending on the most recent June 30. The growth in total reservable liabilities from June 30, 2001, to June 30, 2002, warranted an increase in the reservable liabilities exemption level from \$5.7 million to \$6 million, and the Board amended Regulation D accordingly.

For institutions that report weekly, the amendments adjusting the low reserve tranche and the reservable liabilities exemption level are effective for the fourteen-day reserve computation period beginning Tuesday, November 26, 2002, and for the corresponding fourteen-day reserve maintenance period beginning Thursday, December 26, 2002. For institutions that report quarterly, the amendments are effective for the seven-day reserve computation period beginning Tuesday, December 17, 2002, and for the corresponding seven-day reserve maintenance period beginning Thursday, January 16, 2003.

Nonexempt depository institutions that have total reservable liabilities greater than the amount exempted from reserve requirements (\$6 million in 2003) report either weekly or quarterly depending on the amount of their total deposits. To ease the reporting burden on small institutions, the Board requires nonexempt depository institutions with total deposits below a specified level

(nonexempt deposit cutoff level) to report their deposits and reservable liabilities quarterly or less frequently, while larger institutions must report weekly.<sup>1</sup> To reflect the growth of total deposits at all depository institutions from June 30, 2001, to June 30, 2002, the Board increased the nonexempt deposit cutoff level from \$106.9 million to \$112.3 million, to be implemented in September 2003.

Exempt institutions (those with total reservable liabilities equal to or less than the reservable liabilities exemption level of \$6 million in 2003) with at least \$6 million in total deposits may report annually, and exempt institutions with less than \$6 million in total deposits are not required to file deposit reports.

## **Regulation H** Membership of State Banking Institutions in the Federal Reserve System

### May 30, 2002—Amendments

The Board amended Regulation H to include any branch of a bank controlled by an out-of-state bank holding company under the prohibition against using interstate branches primarily for deposit production, effective October 1, 2002.

Votes for this action: Messrs. Greenspan, Ferguson, and Gramlich, Ms. Bies, and Mr. Olson.

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1. All U.S. branches and agencies of foreign banks and Edge and agreement corporations are required to submit the Report of Transaction Accounts, Other Deposits, and Vault Cash (FR 2900) weekly regardless of size. In addition, depository institutions that obtain funds from non-U.S. sources or that have foreign branches or international banking facilities continue to be required to file the Report of Certain Eurocurrency Transactions (FR 2950/FR 2951) at the same frequency as they file the FR 2900 report.

Regulation H implements the provision of the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994 that prohibits a bank from establishing or acquiring a branch outside its home state primarily for the purpose of deposit production. That act also provides guidelines for determining whether the bank is reasonably helping to meet the credit needs of the communities served by the branch. Congress enacted the prohibition to ensure that the authorization for interstate branches would not result in banks' taking deposits from a community without reasonably helping to meet the credit needs of that community.

The Gramm–Leach–Bliley Act of 1999 expands the prohibition against deposit-production offices to include any branch of a bank controlled by an out-of-state bank holding company. The Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency jointly amended their regulations on June 5, 2002, to conform to the expanded prohibition.

## **Regulation H** Membership of State Banking Institutions in the Federal Reserve System

## **Regulation Y** Bank Holding Companies and Change in Bank Control

### January 28, 2002—Amendments

The Board reduced, for state member banks and bank holding companies, the risk weighting in capital standards for certain claims on securities firms, effective July 1, 2002.

Votes for this action: Messrs. Greenspan, Ferguson, Meyer, and Gramlich, Ms. Bies, and Mr. Olson.

The Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision jointly amended their risk-based capital standards for supervised banking and savings institutions on March 27, 2002, to reduce the risk weight applied to certain claims on, and claims guaranteed by, qualifying securities firms incorporated in the United States and in other countries that are members of the Organisation for Economic Co-operation and Development (OECD). The Federal Deposit Insurance Corporation and the Office of Thrift Supervision also conformed their capital standards to those of the other agencies by permitting a zero percent risk weight for certain claims on qualifying securities firms that are collateralized by (1) cash on deposit in the lending institution or (2) securities issued or guaranteed by the U.S. government or its agencies or OECD central governments.

### **Regulation K** International Banking Operations

December 30, 2002—Amendments

The Board amended provisions of Regulation K on international lending supervision to conform to technical changes adopted by the other federal banking agencies, effective February 10, 2003.

Votes for this action: Messrs. Greenspan, Ferguson, and Gramlich, Ms. Bies, and Messrs. Olson, Bernanke, and Kohn.

Subpart D of Regulation K, which implements the International Lending Supervision Act of 1983, governs international lending by state member banks, bank holding companies, and Edge and agreement corporations engaged in banking and specifies when reserves are

required for particular international assets. The amendments conform these provisions to those of the other federal banking agencies by eliminating requirements for a particular accounting method for fees on international loans and requiring instead that institutions follow generally accepted accounting principles (GAAP) for such fees.

### **Regulation W** Transactions between Member Banks and Their Affiliates

October 31, 2002—New  
Regulation

The Board approved new Regulation W, which comprehensively implements sections 23A and 23B of the Federal Reserve Act, effective April 1, 2003.

Votes for this action: Messrs. Greenspan, Ferguson, and Gramlich, Ms. Bies, and Messrs. Olson, Bernanke, and Kohn.

Sections 23A and 23B of the Federal Reserve Act restrict loans by a member bank to its affiliates, asset purchases by a member bank from its affiliates, and certain other transactions between a member bank and its affiliates. The purpose of the statute is to limit a member bank's risk of loss in transactions with affiliates and to limit a member bank's ability to transfer to its affiliates the benefits arising from its access to the federal safety net. Regulation W unifies in one document previous interpretations of sections 23A and 23B as well as new interpretations of the statute, including interpretations that address derivative transactions, intraday extensions of credit, and financial subsidiaries.

The Board also approved a preamble to Regulation W that provides a detailed explanation of the rule. In addition, the Board published for comment a pro-



posed rule that would limit the current exemption from section 23A for certain loan purchases from an affiliate.

## **Policy Statements and Other Actions**

### **February 11, 2002—Statement on Equity Hedging Activities by State Member Banks**

The Board issued a statement indicating that it would not apply section 9 of the Federal Reserve Act to prohibit a state member bank from acquiring equity securities to hedge its bank-permissible equity derivative transactions if such transactions are conducted in accordance with the same restrictions applicable to national banks, effective February 21, 2002.

Votes for this action: Messrs. Greenspan, Ferguson, and Gramlich, Ms. Bies, and Mr. Olson.

Section 9 of the Federal Reserve Act provides that state member banks are subject to the same limitations and conditions on the purchase, sale, underwriting, and holding of investment securities and stock that apply to national banks. The Office of the Comptroller of the Currency has determined that national banks may acquire equity securities to hedge their exposure to customer-driven equity derivative transactions lawfully entered into by the bank. Such transactions may include equity swaps, equity-index swaps, equity-index deposits, and equity-linked loans. Accordingly, the statement provides that the Board would not apply section 9 of the act to prohibit a state member bank from purchasing equity securities to hedge risks arising from equity derivative transactions entered into by the bank with an unaffili-

ated third party if such purchases are made under the same conditions and restrictions applicable to national banks. A state member bank must receive the prior approval of the Board's Director of the Division of Banking Supervision and Regulation to engage in equity hedging activities and must conduct its equity derivative and equity hedging activities in accordance with applicable law.

### **April 5, 2002—System Regulations for Federal Reserve Law Enforcement Officers**

The Board approved regulations governing the exercise of law enforcement authority by designated Federal Reserve System personnel, effective June 7, 2002.

Votes for this action: Messrs. Greenspan, Ferguson, and Gramlich, Ms. Bies, and Mr. Olson.

The USA PATRIOT Act of 2001 amended section 11 of the Federal Reserve Act to provide federal law enforcement authority for protection personnel at the Federal Reserve Banks, and for special agents in the Protective Services Unit and security officers at the Board. The implementing regulations, which were subsequently approved by the Attorney General of the United States in accordance with the act, authorize designated on-duty personnel to carry firearms when protecting System personnel, property, or operations; make arrests for violations of federal law; and obtain law enforcement information. The regulations also contain specific training requirements and rules governing the use of law enforcement authority. The Board delegated authority to each Reserve Bank to designate law enforcement personnel.

### April 18, 2002—Joint Agency Statement on Parallel-Owned Banking Organizations

The Board approved an interagency statement on the potential risks posed by parallel-owned banking organizations and the supervisory approach to address those risks, effective April 23, 2002.

Votes for this action: Messrs. Greenspan, Ferguson, and Gramlich, Ms. Bies, and Mr. Olson.

The Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision jointly issued a statement on parallel-owned banking organizations on April 23, 2002. A parallel-owned banking organization is created when a U.S. depository institution and a foreign bank are both controlled directly or indirectly by one person or a group of persons rather than by a bank or thrift holding company subject to supervision by a federal regulator. Accordingly, each of the organization's banks is supervised by only the regulatory authority for the home country of the bank. The interagency statement contains guidance on identifying parallel-owned banking organizations, reviews the risks associated with them, and discusses actions that the agencies may take to minimize those risks. It also describes the agencies' approach to applications and notices filed by U.S. depository institutions in parallel-owned banking organizations.

### August 13, 2002—Policy Statement on Payments System Risk

The Board decided not to adopt two proposed changes to its payments system risk policy that would (1) lower self-assessed net debit caps and eliminate two-week average caps and

(2) reject all payments with settlement-day finality that would cause an institution to exceed its daylight overdraft capacity level.

Votes for this action: Messrs. Greenspan, Ferguson, and Gramlich, Ms. Bies, and Messrs. Olson, Bernanke, and Kohn.

These proposed changes were among several modifications to its payments system risk policy that the Board had published for comment in June 2001 after a broad review of the policy. An institution's net debit cap refers to the maximum dollar amount of uncollateralized daylight overdrafts that it may incur in its Federal Reserve account. A daylight overdraft occurs when a depository institution's Federal Reserve account is in a negative position at any time during the business day.

Although the Board chose not to implement the two proposals in the foreseeable future, it will continue to analyze the benefits and potential drawbacks of a third proposed modification: a two-tiered pricing system for daylight overdrafts in which institutions that pledge collateral to the Federal Reserve Banks would pay a lower fee on their collateralized daylight overdrafts than on their uncollateralized daylight overdrafts.

### Discount Rates in 2002

During 2002, the Board of Governors approved one change in the basic discount rate charged by the Federal Reserve Banks. On November 6, the basic rate was reduced by  $\frac{1}{2}$  percentage point to a level of  $\frac{3}{4}$  percent. The rates for seasonal and extended credit, which were recalculated biweekly in accordance with market-related formulas, exceeded the basic rate by different amounts during the year. On October 31,

the Board approved new discount window programs, effective January 9, 2003.

### Basic Discount Rate

The Board's decisions on the basic discount rate were made against the background of the policy actions of the Federal Open Market Committee (FOMC) and related economic and financial developments. These developments are reviewed more fully in other parts of this Report, including the minutes of the FOMC meetings held in 2002.

#### *Reduction in the Basic Rate in November 2002*

Before November 6, the Board reviewed, but took no action on, requests by a number of Federal Reserve Banks to raise or lower the basic discount rate. The Board's decision on November 6 was consistent with its practice in recent years generally to adjust the basic rate when the FOMC makes changes to its target for the federal funds rate. Underlying the decisions on both rates in 2002 was the persistence of a high degree of uncertainty about the outlook for continued economic recovery in the context of an uneven pace of expansion and, particularly over the summer and fall, a predominance of downside risks to the economy. By early November, generally disappointing information on the performance of the economy seemed to presage a longer-lasting spell of subpar economic growth than had been anticipated earlier. Although the stance of monetary policy was already accommodative, the FOMC and the Board on November 6 approved relatively sizable reductions of  $\frac{1}{2}$  percentage point in the target rate for the federal funds rate and the basic discount rate to enhance the prospects of a strengthening economic

recovery over the coming year. There were no further decisions on the basic discount rate in 2002.

### Structure of Discount Rates

The basic discount rate was the rate normally charged on loans to depository institutions for short-term adjustment credit, and it continued to be set on the basis of general monetary policy considerations. The Federal Reserve Banks provided two other types of discount window credit: (1) seasonal credit, whose purpose was to assist smaller institutions in managing liquidity needs that arose from regular seasonal swings in loans and deposits, and (2) extended credit, which was available in appropriate circumstances to depository institutions that experienced somewhat longer-term liquidity needs. The rates on both types of credit were calculated every two weeks in accordance with formulas based on market interest rates. Under those formulas, the rates charged for seasonal credit in 2002 were somewhat higher than the basic discount rate, and the rate on extended credit was 50 basis points higher than that for seasonal credit. During 2002, the rate for seasonal credit ranged from a high of 1.85 percent to a low of 1.30 percent, and the rate for extended credit ranged from a high of 2.35 percent to a low of 1.80 percent. At the end of 2002, the structure of discount rates was as follows: a basic rate of 0.75 percent for short-term adjustment credit and rates of 1.30 percent for seasonal credit and 1.80 percent for extended credit.

### Board Votes

Under the Federal Reserve Act, the boards of directors of the Federal Reserve Banks are required to establish rates on loans to depository institutions

at least every fourteen days and must submit the rates to the Board of Governors for review and determination. During 2002, the Reserve Banks submitted, on the same schedule, requests to renew the formulas based on short-term market interest rates for calculating the rates on seasonal and extended credit. Votes on the reestablishment of the formulas for these flexible rates are not shown in this summary. All votes taken by the Board of Governors during 2002 were unanimous.

*Vote on the Basic Discount Rate*

*November 6, 2002.* Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of New York, Dallas, and San Francisco to reduce the basic discount rate by  $\frac{1}{2}$  percentage point to  $\frac{3}{4}$  percent. The same decrease was approved for the remaining Federal Reserve Banks, effective November 7, 2002.

Votes for this action: Messrs. Greenspan, Ferguson, and Gramlich, Ms. Bies, and Messrs. Olson, Bernanke, and Kohn.

*New Discount Window Programs*

On October 31, 2002, the Board amended its Regulation A to establish two new forms of discount window credit, primary and secondary credit, to replace adjustment and extended credit, effective January 9, 2003. Primary credit will be made available for very short terms as a backup source of liquidity to depository institutions that, in the judg-

ment of the lending Federal Reserve Bank, are in generally sound financial condition. Primary credit will be extended at a rate above the federal funds rate to be established at least every two weeks, subject to the Board's review and determination. By applying an above-market rate and restricting eligibility to generally sound institutions, the primary credit program is expected to substantially reduce the need for the Federal Reserve to review the funding situations of borrowers and monitor their use of borrowed funds. Secondary credit will be available in appropriate circumstances to depository institutions that do not qualify for primary credit. When the new programs were approved, the Board expected that Reserve Banks would initially establish a primary credit rate at a level 100 basis points above the federal funds target rate and a secondary credit rate at a level 50 basis points above the primary rate.<sup>2</sup> The seasonal credit program was not affected by these changes. The rate on seasonal credit will continue to be set by a formula based on market interest rates.

Votes for this action: Messrs. Greenspan, Ferguson, and Gramlich, Ms. Bies, and Messrs. Olson, Bernanke, and Kohn. ■

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2. On January 7, 2003, the Board of Governors approved requests by the twelve Reserve Banks to establish primary credit rates of  $\frac{2}{4}$  percent and secondary credit rates of  $\frac{2}{4}$  percent, which were 100 basis points and 150 basis points respectively above the FOMC's target rate for the federal funds rate.

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## *Minutes of Federal Open Market Committee Meetings*

The policy actions of the Federal Open Market Committee, contained in the minutes of its meetings, are presented in the ANNUAL REPORT of the Board of Governors pursuant to the requirements of section 10 of the Federal Reserve Act. That section provides that the Board shall keep a complete record of the actions taken by the Board and by the Federal Open Market Committee on all questions of policy relating to open market operations, that it shall record therein the votes taken in connection with the determination of open market policies and the reasons underlying each policy action, and that it shall include in its annual report to the Congress a full account of such actions.

The minutes of the meetings contain the votes on the policy decisions made at those meetings as well as a résumé of the information and discussions that led to the decisions. The summary descriptions of economic and financial conditions are based on the information that was available to the Committee at the time of the meetings rather than on data as they may have been revised later.

Members of the Committee voting for a particular action may differ among themselves as to the reasons for their votes; in such cases, the range of their views is noted in the minutes. When members dissent from a decision, they are identified in the minutes and a summary of the reasons for their dissent is provided.

Policy directives of the Federal Open Market Committee are issued to the Federal Reserve Bank of New York as the Bank selected by the Committee to

execute transactions for the System Open Market Account. In the area of domestic open market operations, the Federal Reserve Bank of New York operates under three sets of instructions from the Federal Open Market Committee: an Authorization for Domestic Open Market Operations, Guidelines for the Conduct of System Open Market Operations in Federal Agency Issues, and a Domestic Policy Directive. (A new Domestic Policy Directive is adopted at each regularly scheduled meeting.) In the foreign currency area, the Committee operates under an Authorization for Foreign Currency Operations, a Foreign Currency Directive, and Procedural Instructions with Respect to Foreign Currency Operations. These policy instruments are shown below in the form in which they were in effect at the beginning of 2002. Changes in the instruments during the year are reported in the minutes for the individual meetings.

### **Authorization for Domestic Open Market Operations**

In Effect January 1, 2002

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent domestic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities, including securities of the Federal Financing Bank, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the

United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices, and, for such Account, to exchange maturing U.S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement; provided that the aggregate amount of U.S. Government and Federal agency securities held in such Account (including forward commitments) at the close of business on the day of a meeting of the Committee at which action is taken with respect to a domestic policy directive shall not be increased or decreased by more than \$12.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;

(b) To buy U.S. Government securities and obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account;

(c) To sell U.S. Government securities and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States to dealers for System Open Market Account under agreements for the resale by dealers of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers.

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes the Federal Reserve Bank of New York to lend on an overnight basis U.S. Government securities held in the System Open Market Account to dealers at rates that shall be determined by competitive bidding but that in no event shall be less than 1.0 percent per annum of the market value of the securities lent. The Federal Reserve Bank of New York shall apply reasonable limitations on the total amount of a specific issue that may be auctioned, and on the amount of securities that each dealer may borrow. The Federal Reserve Bank of New York may reject bids which could facilitate a dealer's ability to control a single issue as determined solely by the Federal Reserve Bank of New York.

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York (a) for System Open Market Account, to sell U.S. Government securities to such foreign and international accounts on the bases set forth in paragraph 1(a) under agreements providing for the resale by such accounts of those securities within 65 business days or less on terms comparable to those available on such transactions in the market; and (b) for New York Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph 1(b), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and foreign and international accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

4. In the execution of the Committee's decision regarding policy during any intermeeting period, the Committee authorizes and directs the Federal Reserve Bank of New York, upon the instruction of the Chairman of the Committee, to adjust somewhat

in exceptional circumstances the degree of pressure on reserve positions and hence the intended federal funds rate. Any such adjustment shall be made in the context of the Committee's discussion and decision at its most recent meeting and the Committee's long-run objectives for price stability and sustainable economic growth, and shall be based on economic, financial, and monetary developments during the intermeeting period. Consistent with Committee practice, the Chairman, if feasible, will consult with the Committee before making any adjustment.

### **Guidelines for the Conduct of System Open Market Operations in Federal Agency Issues**

In Effect January 1, 2002

1. System open market operations in Federal agency issues are an integral part of total System open market operations designed to influence bank reserves, money market conditions, and monetary aggregates.

2. System open market operations in Federal agency issues are not designed to support individual sectors of the market or to channel funds into issues of particular agencies.

### **Domestic Policy Directive**

In Effect January 1, 2002<sup>1</sup>

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with reducing the federal funds rate to an average of around 1¾ percent.

The Committee also approved the sentence below for inclusion in the press statement to be released shortly after the December 11, 2001, meeting:

1. Adopted by the Committee at its meeting on December 11, 2001.

Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks continue to be weighted mainly toward conditions that may generate economic weakness in the foreseeable future.

### **Authorization for Foreign Currency Operations**

In Effect January 1, 2002

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to the extent necessary to carry out the Committee's foreign currency directive and express authorizations by the Committee pursuant thereto, and in conformity with such procedural instructions as the Committee may issue from time to time:

A. To purchase and sell the following foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the U.S. Treasury, with the U.S. Exchange Stabilization Fund established by Section 10 of the Gold Reserve Act of 1934, with foreign monetary authorities, with the Bank for International Settlements, and with other international financial institutions:

Canadian dollars	Mexican pesos
Danish kroner	Norwegian kroner
Euro	Swedish kronor
Pounds sterling	Swiss francs
Japanese yen	

B. To hold balances of, and to have outstanding forward contracts to receive or to deliver, the foreign currencies listed in paragraph A above.

C. To draw foreign currencies and to permit foreign banks to draw dollars under the reciprocal currency arrangements listed in paragraph 2 below, provided that drawings by either party to any such arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

D. To maintain an overall open position in all foreign currencies not exceeding \$25.0 billion. For this purpose, the overall open position in all foreign currencies is defined as the sum (disregarding signs) of net positions in individual currencies. The net position in a single foreign currency is defined as holdings of balances in that currency, plus outstanding contracts for future receipt, minus outstanding contracts for future delivery of that currency, i.e., as the sum of these elements with due regard to sign.

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for the System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Bank of Canada .....	2,000
Bank of Mexico .....	3,000

Any changes in the terms of existing swap arrangements, and the proposed terms of any new arrangements that may be authorized, shall be referred for review and approval to the Committee.

3. All transactions in foreign currencies undertaken under paragraph 1.A. above shall, unless otherwise expressly authorized by the Committee, be at prevailing market rates. For the purpose of providing an investment return on System holdings of foreign currencies, or for the purpose of adjusting interest rates paid or received in connection with swap drawings, transactions with foreign central banks may be undertaken at nonmarket exchange rates.

4. It shall be the normal practice to arrange with foreign central banks for the coordination of foreign currency transactions. In mak-

ing operating arrangements with foreign central banks on System holdings of foreign currencies, the Federal Reserve Bank of New York shall not commit itself to maintain any specific balance, unless authorized by the Federal Open Market Committee. Any agreements or understandings concerning the administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

5. Foreign currency holdings shall be invested to ensure that adequate liquidity is maintained to meet anticipated needs and so that each currency portfolio shall generally have an average duration of no more than 18 months (calculated as Macaulay duration). When appropriate in connection with arrangements to provide investment facilities for foreign currency holdings, U.S. Government securities may be purchased from foreign central banks under agreements for repurchase of such securities within 30 calendar days.

6. All operations undertaken pursuant to the preceding paragraphs shall be reported promptly to the Foreign Currency Subcommittee and the Committee. The Foreign Currency Subcommittee consists of the Chairman and Vice Chairman of the Committee, the Vice Chairman of the Board of Governors, and such other member of the Board as the Chairman may designate (or in the absence of members of the Board serving on the Subcommittee, other Board members designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee, his alternate). Meetings of the Subcommittee shall be called at the request of any member, or at the request of the Manager, System Open Market Account ("Manager"), for the purposes of reviewing recent or contemplated operations and of consulting with the Manager on other matters relating to his responsibilities. At the request of any member of the Subcommittee, questions arising from such reviews and consultations shall be referred for determination to the Federal Open Market Committee.

7. The Chairman is authorized:

A. With the approval of the Committee, to enter into any needed agreement or



understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the Treasury;

B. To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on policy matters relating to foreign currency operations;

C. From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Policies.

8. Staff officers of the Committee are authorized to transmit pertinent information on System foreign currency operations to appropriate officials of the Treasury Department.

9. All Federal Reserve Banks shall participate in the foreign currency operations for System Account in accordance with paragraph 3 G(1) of the Board of Governors' Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

## Foreign Currency Directive

### In Effect January 1, 2002

1. System operations in foreign currencies shall generally be directed at countering disorderly market conditions, provided that market exchange rates for the U.S. dollar reflect actions and behavior consistent with the IMF Article IV, Section 1.

2. To achieve this end the System shall:

A. Undertake spot and forward purchases and sales of foreign exchange.

B. Maintain reciprocal currency ("swap") arrangements with selected foreign central banks.

C. Cooperate in other respects with central banks of other countries and with international monetary institutions.

3. Transactions may also be undertaken:

A. To adjust System balances in light of probable future needs for currencies.

B. To provide means for meeting System and Treasury commitments in particular

currencies, and to facilitate operations of the Exchange Stabilization Fund.

C. For such other purposes as may be expressly authorized by the Committee.

4. System foreign currency operations shall be conducted:

A. In close and continuous consultation and cooperation with the United States Treasury;

B. In cooperation, as appropriate, with foreign monetary authorities; and

C. In a manner consistent with the obligations of the United States in the International Monetary Fund regarding exchange arrangements under the IMF Article IV.

## Procedural Instructions with Respect to Foreign Currency Operations

### In Effect January 1, 2002

In conducting operations pursuant to the authorization and direction of the Federal Open Market Committee as set forth in the Authorization for Foreign Currency Operations and the Foreign Currency Directive, the Federal Reserve Bank of New York, through the Manager, System Open Market Account ("Manager"), shall be guided by the following procedural understandings with respect to consultations and clearances with the Committee, the Foreign Currency Subcommittee, and the Chairman of the Committee. All operations undertaken pursuant to such clearances shall be reported promptly to the Committee.

1. The Manager shall clear with the Subcommittee (or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding \$300 million on any day or \$600 million since the most recent regular meeting of the Committee.

B. Any operation that would result in a change on any day in the System's net posi-

tion in a single foreign currency exceeding \$150 million, or \$300 million when the operation is associated with repayment of swap drawings.

C. Any operation that might generate a substantial volume of trading in a particular currency by the System, even though the change in the System's net position in that currency might be less than the limits specified in 1.B.

D. Any swap drawing proposed by a foreign bank not exceeding the larger of (i) \$200 million or (ii) 15 percent of the size of the swap arrangement.

2. The Manager shall clear with the Committee (or with the Subcommittee, if the Subcommittee believes that consultation with the full Committee is not feasible in the time available, or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding \$1.5 billion since the most recent regular meeting of the Committee.

B. Any swap drawing proposed by a foreign bank exceeding the larger of (i) \$200 million or (ii) 15 percent of the size of the swap arrangement.

3. The Manager shall also consult with the Subcommittee or the Chairman about proposed swap drawings by the System and about any operations that are not of a routine character.

### **Meeting Held on January 29–30, 2002**

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, January 29, 2002, at 2:30 p.m. and continued on Wednesday, January 30, 2002, at 9:00 a.m.

*Present:*

Mr. Greenspan, Chairman  
Mr. McDonough, Vice Chairman  
Ms. Bies  
Mr. Ferguson  
Mr. Gramlich  
Mr. Jordan  
Mr. McTeer  
Mr. Olson  
Mr. Santomero  
Mr. Stern

Messrs. Broaddus, Guynn, Moskow,  
and Parry, Alternate Members  
of the Federal Open Market  
Committee

Mr. Hoenig, Ms. Minehan, and  
Mr. Poole, Presidents of the  
Federal Reserve Banks of  
Kansas City, Boston, and St. Louis  
respectively

Mr. Kohn, Secretary and Economist  
Mr. Bernard, Deputy Secretary  
Mr. Gillum, Assistant Secretary  
Ms. Smith, Assistant Secretary  
Mr. Mattingly, General Counsel  
Mr. Baxter,<sup>2</sup> Deputy General Counsel  
Ms. Johnson, Economist  
Mr. Reinhart, Economist  
Mr. Stockton, Economist

Mr. Connors, Ms. Cumming,  
Messrs. Howard, Lindsey,  
Ms. Mester, Messrs. Oliner,  
Rolnick, Rosenblum, Sniderman,  
and Wilcox, Associate Economists

Mr. Kos, Manager, System Open  
Market Account

Mr. Winn, Assistant to the Board,  
Office of Board Members,  
Board of Governors

Mr. Skidmore, Special Assistant to the  
Board, Office of Board Members,  
Board of Governors

Messrs. Ettin and Madigan, Deputy  
Directors, Divisions of Research  
and Statistics and Monetary  
Affairs respectively, Board of  
Governors

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2. Attended Tuesday session only.

Mr. Simpson, Senior Adviser, Division of Research and Statistics, Board of Governors

Messrs. Slifman and Struckmeyer, Associate Directors, Division of Research and Statistics, Board of Governors

Messrs. Kamin<sup>3</sup> and Whitesell, Deputy Associate Directors, Divisions of International Finance and Monetary Affairs respectively, Board of Governors

Messrs. Gagnon<sup>3</sup> and Reifschneider,<sup>3</sup> Assistant Directors, Divisions of International Finance and Research and Statistics respectively, Board of Governors

Mr. Small,<sup>3</sup> Section Chief, Division of Monetary Affairs, Board of Governors

Mr. Morton,<sup>4</sup> Senior Economist, Division of International Finance, Board of Governors

Messrs. Lebow<sup>4</sup> and Williams,<sup>3</sup> Senior Economists, Division of Research and Statistics, Board of Governors

Messrs. Ahearn<sup>3</sup> and Wright,<sup>3</sup> Economists, Division of International Finance, Board of Governors

Mr. Zakrajšek,<sup>4</sup> Economist, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Office of Board Members, Board of Governors

Mr. Lyon, First Vice President, Federal Reserve Bank of Minneapolis

Messrs. Beebe, Eisenbeis, Fuhrer, Goodfriend, Hakkio, Hunter, Ms. Krieger, and Mr. Rasche, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Atlanta, Boston, Richmond, Kansas City, Chicago, New York, and St. Louis respectively

In the agenda for this meeting, it was reported that advices of the election of the following members and alternate members of the Federal Open Market Committee for the period commencing January 1, 2002, and ending December 31, 2002, had been received and that these individuals had executed their oaths of office.

The elected members and alternate members were as follows:

William J. McDonough, President of the Federal Reserve Bank of New York, with Jamie B. Stewart, Jr., First Vice President of the Federal Reserve Bank of New York, as alternate.

Anthony M. Santomero, President of the Federal Reserve Bank of Philadelphia, with J. Alfred Broaddus, Jr., President of the Federal Reserve Bank of Richmond, as alternate.

Jerry L. Jordan, President of the Federal Reserve Bank of Cleveland, with Michael H. Moskow, President of the Federal Reserve Bank of Chicago, as alternate.

Robert D. McTeer, Jr., President of the Federal Reserve Bank of Dallas, with Jack Guynn, President of the Federal Reserve Bank of Atlanta, as alternate.

Gary H. Stern, President of the Federal Reserve Bank of Minneapolis, with Robert T. Parry, President of the Federal Reserve Bank of San Francisco, as alternate.

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3. Attended portion of meeting relating to the discussion of monetary policy near the zero bound on nominal interest rates.

4. Attended portion of meeting relating to the above discussion and to the Committee's review of the economic outlook.

By unanimous vote, the following officers of the Federal Open Market Committee were elected to serve until

the election of their successors at the first regularly scheduled meeting of the Committee after December 31, 2002, with the understanding that in the event of the discontinuance of their official connection with the Board of Governors or with a Federal Reserve Bank, they would cease to have any official connection with the Federal Open Market Committee:

Alan Greenspan	Chairman
William J. McDonough	Vice Chairman
Donald L. Kohn	Secretary and Economist
Normand R.V. Bernard	Deputy Secretary
Gary P. Gillum	Assistant Secretary
Michelle A. Smith	Assistant Secretary
J. Virgil Mattingly, Jr.	General Counsel
Thomas C. Baxter, Jr.	Deputy General Counsel
Karen H. Johnson	Economist
Vincent R. Reinhart	Economist
David J. Stockton	Economist

Thomas A. Connors, Christine Cumming, David H. Howard, David E. Lindsey, Loretta J. Mester, Stephen D. Oliner, Arthur J. Rolnick, Harvey Rosenblum, Mark S. Sniderman, and David W. Wilcox, Associate Economists

By unanimous vote, the Federal Reserve Bank of New York was selected to execute transactions for the System Open Market Account until the adjournment of the first regularly scheduled meeting of the Committee after December 31, 2002.

By unanimous vote, Dino Kos was selected to serve at the pleasure of the Committee as Manager, System Open Market Account, on the understanding that his selection was subject to being satisfactory to the Federal Reserve Bank of New York.

*Secretary's note:* Advice subsequently was received that the selection of Mr. Kos

as Manager was satisfactory to the board of directors of the Federal Reserve Bank of New York.

By unanimous vote, the Authorization for Domestic Open Market Operations was reaffirmed in the form shown below.

### Authorization for Domestic Open Market Operations (Reaffirmed January 29, 2002)

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent domestic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities, including securities of the Federal Financing Bank, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices, and, for such Account, to exchange maturing U.S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement; provided that the aggregate amount of U.S. Government and Federal agency securities held in such Account (including forward commitments) at the close of business on the day of a meeting of the Committee at which action is taken with respect to a domestic policy directive shall not be increased or decreased by more than \$12.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting.

(b) To buy U.S. Government securities and obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly autho-

rized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account.

(c) To sell U.S. Government securities and obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States to dealers for System Open Market Account under agreements for the resale by dealers of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers.

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes the Federal Reserve Bank of New York to lend on an overnight basis U.S. Government securities held in the System Open Market Account to dealers at rates that shall be determined by competitive bidding but that in no event shall be less than 1.0 percent per annum of the market value of the securities lent. The Federal Reserve Bank of New York shall apply reasonable limitations on the total amount of a specific issue that may be auctioned, and on the amount of securities that each dealer may borrow. The Federal Reserve Bank of New York may reject bids which could facilitate a dealer's ability to control a single issue as determined solely by the Federal Reserve Bank of New York.

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York (a) for System Open Market Account, to sell U.S. Government securities to such foreign and international accounts on the bases set forth in paragraph 1(a) under agreements providing for the resale by such accounts of those securities in 65 business days or less on terms comparable to those available on such transactions in the market; and (b) for New York

Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph 1(b), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and foreign and international accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

4. In the execution of the Committee's decision regarding policy during any intermeeting period, the Committee authorizes and directs the Federal Reserve Bank of New York, upon the instruction of the Chairman of the Committee, to adjust somewhat in exceptional circumstances the degree of pressure on reserve positions and hence the intended federal funds rate. Any such adjustment shall be made in the context of the Committee's discussion and decision at its most recent meeting and the Committee's long-run objectives for price stability and sustainable economic growth, and shall be based on economic, financial, and monetary developments during the intermeeting period. Consistent with Committee practice, the Chairman, if feasible, will consult with the Committee before making any adjustment.

By unanimous vote, the Committee approved until the Committee's first regularly scheduled meeting in 2003 a further extension of the temporary suspension of paragraphs 3 to 6 of the Guidelines for the Conduct of System Open Market Operations in Federal Agency Issues. For the year ahead, the Guidelines therefore continued to read as shown below:

#### Guidelines for the Conduct of System Open Market Operations in Federal Agency Issues (Reaffirmed January 29, 2002)

1. System open market operations in Federal agency issues are an integral part of total System open market operations designed to

influence bank reserves, money market conditions, and monetary aggregates.

2. System open market operations in Federal agency issues are not designed to support individual sectors of the market or to channel funds into issues of particular agencies.

By unanimous vote, the Authorization for Foreign Currency Operations was reaffirmed in the form shown below.

**Authorization for Foreign Currency Operations  
(Reaffirmed January 29, 2002)**

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to the extent necessary to carry out the Committee’s foreign currency directive and express authorizations by the Committee pursuant thereto, and in conformity with such procedural instructions as the Committee may issue from time to time:

A. To purchase and sell the following foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the U.S. Treasury, with the U.S. Exchange Stabilization Fund established by Section 10 of the Gold Reserve Act of 1934, with foreign monetary authorities, with the Bank for International Settlements, and with other international financial institutions:

Canadian dollars	Mexican pesos
Danish kroner	Norwegian kroner
Euro	Swedish kronor
Pounds sterling	Swiss francs
Japanese yen	

B. To hold balances of, and to have outstanding forward contracts to receive or to deliver, the foreign currencies listed in paragraph A above.

C. To draw foreign currencies and to permit foreign banks to draw dollars under the reciprocal currency arrangements listed in paragraph 2 below, provided that drawings by either party to any such arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee,

because of exceptional circumstances, specifically authorizes a delay.

D. To maintain an overall open position in all foreign currencies not exceeding \$25.0 billion. For this purpose, the overall open position in all foreign currencies is defined as the sum (disregarding signs) of net positions in individual currencies. The net position in a single foreign currency is defined as holdings of balances in that currency, plus outstanding contracts for future receipt, minus outstanding contracts for future delivery of that currency, i.e., as the sum of these elements with due regard to sign.

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements (“swap” arrangements) for the System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Bank of Canada .....	2,000
Bank of Mexico .....	3,000

Any changes in the terms of existing swap arrangements, and the proposed terms of any new arrangements that may be authorized, shall be referred for review and approval to the Committee.

3. All transactions in foreign currencies undertaken under paragraph 1.A. above shall, unless otherwise expressly authorized by the Committee, be at prevailing market rates. For the purpose of providing an investment return on System holdings of foreign currencies, or for the purpose of adjusting interest rates paid or received in connection with swap drawings, transactions with foreign central banks may be undertaken at nonmarket exchange rates.

4. It shall be the normal practice to arrange with foreign central banks for the coordination of foreign currency transac-

tions. In making operating arrangements with foreign central banks on System holdings of foreign currencies, the Federal Reserve Bank of New York shall not commit itself to maintain any specific balance unless authorized by the Federal Open Market Committee. Any agreements or understandings concerning the administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

5. Foreign currency holdings shall be invested to ensure that adequate liquidity is maintained to meet anticipated needs and so that each currency portfolio shall generally have an average duration of no more than 18 months (calculated as Macaulay duration). When appropriate in connection with arrangements to provide investment facilities for foreign currency holdings, U.S. Government securities may be purchased from foreign central banks under agreements for repurchase of such securities within 30 calendar days.

6. All operations undertaken pursuant to the preceding paragraphs shall be reported promptly to the Foreign Currency Subcommittee and the Committee. The Foreign Currency Subcommittee consists of the Chairman and Vice Chairman of the Committee, the Vice Chairman of the Board of Governors, and such other member of the Board as the Chairman may designate (or in the absence of members of the Board serving on the Subcommittee, other Board members designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee, his alternate). Meetings of the Subcommittee shall be called at the request of any member, or at the request of the Manager, System Open Market Account ("Manager"), for the purposes of reviewing recent or contemplated operations and of consulting with the Manager on other matters relating to his responsibilities. At the request of any member of the Subcommittee, questions arising from such reviews and consultations shall be referred for determination to the Federal Open Market Committee.

7. The Chairman is authorized:

A. With the approval of the Committee, to enter into any needed agreement or understanding with the Secretary of the Treasury about the division of responsibility for

foreign currency operations between the System and the Treasury;

B. To keep the Secretary of the Treasury fully advised concerning System foreign currency operations and to consult with the Secretary on policy matters relating to foreign currency operations;

C. From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Policies.

8. Staff officers of the Committee are authorized to transmit pertinent information on System foreign currency operations to appropriate officials of the Treasury Department.

9. All Federal Reserve Banks shall participate in the foreign currency operations for System Account in accordance with paragraph 3 G(1) of the Board of Governors' Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

By unanimous vote, the Foreign Currency Directive was reaffirmed in the form shown below.

### Foreign Currency Directive (Reaffirmed January 29, 2002)

1. System operations in foreign currencies shall generally be directed at countering disorderly market conditions, provided that market exchange rates for the U.S. dollar reflect actions and behavior consistent with the IMF Article IV, Section 1.

2. To achieve this end the System shall:

A. Undertake spot and forward purchases and sales of foreign exchange.

B. Maintain reciprocal currency ("swap") arrangements with selected foreign central banks.

C. Cooperate in other respects with central banks of other countries and with international monetary institutions.

3. Transactions may also be undertaken:

A. To adjust System balances in light of probable future needs for currencies.

B. To provide means for meeting System and Treasury commitments in particular currencies and to facilitate operations of the Exchange Stabilization Fund.

C. For such other purposes as may be expressly authorized by the Committee.

4. System foreign currency operations shall be conducted:

A. In close and continuous consultation and cooperation with the United States Treasury;

B. In cooperation, as appropriate, with foreign monetary authorities; and

C. In a manner consistent with the obligations of the United States in the International Monetary Fund regarding exchange arrangements under the IMF Article IV.

By unanimous vote, the Procedural Instructions with Respect to Foreign Currency Operations, in the form shown below, were reaffirmed.

#### Procedural Instructions with Respect to Foreign Currency Operations (Reaffirmed January 29, 2002)

In conducting operations pursuant to the authorization and direction of the Federal Open Market Committee as set forth in the Authorization for Foreign Currency Operations and the Foreign Currency Directive, the Federal Reserve Bank of New York, through the Manager, System Open Market Account ("Manager"), shall be guided by the following procedural understandings with respect to consultations and clearances with the Committee, the Foreign Currency Subcommittee, and the Chairman of the Committee. All operations undertaken pursuant to such clearances shall be reported promptly to the Committee.

1. The Manager shall clear with the Subcommittee (or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding \$300 million on any day or \$600 million since the most recent regular meeting of the Committee.

B. Any operation that would result in a change on any day in the System's net position in a single foreign currency exceeding \$150 million, or \$300 million when the operation is associated with repayment of swap drawings.

C. Any operation that might generate a substantial volume of trading in a particular currency by the System, even though the change in the System's net position in that currency might be less than the limits specified in I.B.

D. Any swap drawing proposed by a foreign bank not exceeding the larger of (i) \$200 million or (ii) 15 percent of the size of the swap arrangement.

2. The Manager shall clear with the Committee (or with the Subcommittee, if the Subcommittee believes that consultation with the full Committee is not feasible in the time available, or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding \$1.5 billion since the most recent regular meeting of the Committee.

B. Any swap drawing proposed by a foreign bank exceeding the larger of (i) \$200 million or (ii) 15 percent of the size of the swap arrangement.

3. The Manager shall also consult with the Subcommittee or the Chairman about proposed swap drawings by the System and about any operations that are not of a routine character.

On January 17, 2002, copies of the continuing rules, regulations, and other instructions of the Committee had been distributed with the advice that, in accordance with procedures approved by the Committee, they were being called to the Committee's attention before the January 29–30 organization meeting to give members an opportunity to raise any questions they might have concerning them. Members were asked to indicate if they wished to have any of the instruments in question placed on the agenda for consideration at this meeting, and no requests for consideration were received. Accordingly, all of these instruments remained in effect in their existing form.

By unanimous vote, the minutes of the meeting of the Federal Open Market



Committee held on December 11, 2001, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period December 11, 2002, to January 29, 2002. By unanimous vote, the Committee ratified these transactions.

At this meeting, members discussed staff background analyses of the implications for the conduct of policy if the economy were to deteriorate substantially in a period when nominal short-term interest rates were already at very low levels. Under such conditions, while unconventional policy measures might be available, their efficacy was uncertain, and it might be impossible to ease monetary policy sufficiently through the usual interest rate process to achieve System objectives. The members agreed that the potential for such an economic and policy scenario seemed highly remote, but it could not be dismissed altogether. If in the future such circumstances appeared to be in the process of materializing, a case could be made at that point for taking preemptive easing actions to help guard against the potential development of economic weakness and price declines that could be associated with the so-called "zero bound" policy constraint.

The Committee then turned to a discussion of the economic and financial outlook and the implementation of monetary policy over the intermeeting period ahead.

The information reviewed at this meeting indicated that economic activity probably steadied in the fourth quarter after a sizable drop in the summer. Final demand appeared to have increased appreciably, reflecting strength in consumer spending and a smaller decline in business purchases of durable equipment and software. However, businesses met a good part of the pickup in final demand through a large runoff of inventories, and as a consequence manufacturing activity and payroll employment continued to weaken late in the year, though at a slower pace. Falling energy prices and widespread discounting of goods held down consumer price inflation.

The labor market deteriorated somewhat further in December, and the unemployment rate continued to climb, to 5.8 percent. Private nonfarm payrolls fell considerably, with manufacturing again experiencing the largest job losses, but the decrease was less than in previous months and aggregate hours worked by private production workers leveled out after six months of decline. Recent data on initial claims for unemployment insurance pointed to a further moderation in employment losses in January.

Industrial production edged down in December after having fallen sharply in previous months. A number of industries experienced further reductions in output, with weakness most pronounced in consumer nondurables and business equipment. In contrast, motor vehicle assemblies rose to a still higher rate, presumably in response to the robust sales of the preceding two months, and the production of semiconductors and computers continued to strengthen. The rate of utilization of total manufacturing capacity declined a little further in December, and the average rate

for the fourth quarter was at its lowest quarterly level since 1983.

Growth of consumer spending strengthened considerably late in the year after a slow advance in the third quarter. A surge in purchases of motor vehicles in response to attractive financing incentives was a key factor in the pickup, but expenditures on goods other than motor vehicles evidently also accelerated slightly. By contrast, spending on services expanded at a reduced pace, owing at least in part to relatively low demand for residential heating services.

Despite unseasonably warm and dry autumn weather, residential construction slowed somewhat in the fourth quarter. For the year as a whole, though, homebuilding and home sales remained relatively brisk as very low mortgage rates tended to offset the effects of a weakening job market and sluggish growth in personal income. An apparent consequence of reduced income growth and of lower equity prices was a change in the mix of single-family homebuilding, with less emphasis on construction of high-priced homes.

Business expenditures on durable equipment and software contracted less rapidly in the fourth quarter, and monthly data indicated that such spending might be bottoming out late in the year despite further decreases in business output and continuing weakness in corporate cash flows. Business purchases of motor vehicles accounted for some of the improvement, and expenditures for computers and related equipment apparently recorded a small gain. Elsewhere, though, acquisitions of communications equipment were still on a downward trend, and business spending in sectors other than high technology and transportation remained weak. Non-residential construction declined sharply further in the fourth quarter despite

favorable weather over much of the country. Spending on industrial structures plunged, reflecting low capacity utilization in manufacturing and rising vacancy rates. Office building activity also fell as increasing amounts of available space and uncertainties regarding rents and property values weighed on the office market.

Nonfarm inventory liquidation apparently was very rapid in the fourth quarter, but inventory-sales ratios remained elevated in an environment of weak sales. The book value of manufacturing and trade inventories plunged in October and November (latest data), but progress in getting inventory overhangs under control was limited. In manufacturing, the sector's stock-ships ratio persisted at a high level despite continuing sizable rundowns in inventories since the spring. Wholesalers apparently stepped up their runoffs of excess stocks in recent months, yet the aggregate inventory-sales ratio for the sector had fallen only slightly since mid-year. Retailers made greater progress in reducing inventories, and despite relatively sluggish sales the sector's inventory-sales ratio dropped considerably and appeared to be at a fairly comfortable level.

The U.S. trade deficit in goods and services narrowed slightly on balance in October and November (latest data) from the third-quarter level (adjusted to exclude large, one-time payments by foreign insurers related to the events of September 11) as the value of imports for the two-month period fell by more than the value of exports. The available information suggested further slight slippage of economic activity in the foreign industrial countries in the fourth quarter. The Japanese economy remained very weak, economic activity in the euro area and Canada seemed to have contracted, and growth in the

United Kingdom apparently slowed. There were some indications, however, of a brighter economic outlook ahead in the euro area, Canada, and the United Kingdom that would result in part from monetary easing actions that their respective central banks had taken. Economic conditions in the major emerging-market countries were mixed. There were increasing signs of a recovery in developing Asia, especially in some of the countries that had been hurt by the global high-tech slump, but conditions in Latin America remained relatively weak, with the Argentine economy having deteriorated further.

Consumer price inflation was quite low at year-end. With energy prices declining, both the consumer price index (CPI) and the personal consumption expenditure (PCE) chain-type price index edged down on balance in November and December. Moreover, excluding the effects of volatile oil prices, core consumer price inflation was held down late in the year by widespread discounting of goods. Consumer price inflation as measured by the core PCE index declined somewhat on a year-over-year basis, while core CPI inflation increased slightly in 2001. At the producer level, core prices for finished goods changed little in November and December, and the index for core producer inflation slowed noticeably last year. With regard to labor costs, growth of average hourly earnings of production or nonsupervisory workers picked up in November and December, but the average wage increase for the year was moderate and slightly less than that for 2000.

At its meeting on December 11, 2001, the Committee adopted a directive that called for implementing conditions in reserve markets consistent with a decrease of 25 basis points in the intended level of the federal funds rate,

to about 1¾ percent. The members also agreed that the balance of risks remained weighted toward conditions that could generate economic weakness in the foreseeable future. The members noted that there were preliminary signs of some abatement of the contractionary forces acting on the economy, but they believed that a subpar economic performance was likely to persist for a time. They also recognized that the stance of policy was already quite accommodative and that much of the effect of recent monetary easing actions was yet to be felt. In the circumstances, they saw a modest further reduction of the federal funds rate as providing some added insurance against a more extended contraction of the economy at little risk of a pickup in inflation.

Federal funds traded at rates close to the Committee's target level of 1¾ percent during the intermeeting period. The Committee's action had been widely anticipated, but the financial markets evidently interpreted the announcement as indicating that the FOMC's assessment of the economic outlook was weaker than had been assumed. Corporate announcements of downward revisions to forecasts of future revenues and capital spending also contributed to some marking down by market participants of prospects for economic activity. Yields on Treasury coupon securities declined slightly over the intermeeting period, risk spreads on corporate debt securities changed little, and major indexes of equity prices edged lower on balance.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the major foreign currencies increased somewhat on balance over the intermeeting period and reached its highest level since the mid-1980s. Weakness of the Japanese yen was an important factor in that rise, as market

participants focused on continuing problems in the Japanese economy and on comments by Japanese officials that seemed to signal a willingness to accept a weaker value for the yen. The dollar also appreciated slightly against the euro, perhaps reflecting a market view that the U.S. economy was likely to lead the rebound from the global slowdown. In addition, the exchange value of the dollar increased slightly in terms of an index of the currencies of other important trading partners, in part because of the depreciation of the Argentine peso.

Growth of M2 slowed slightly in December from November's robust pace and moderated considerably further in the early weeks of January. The brisk expansion of liquid deposits over recent months had been associated with the effects of mortgage refinancing activity and the substantial decline in the opportunity costs of such deposits that was related to previous easing actions. The currency component of M2 also had been strong in the latter part of 2001, largely the result of a pickup in demand for U.S. currency abroad. The debt of the domestic nonfinancial sectors was estimated to have expanded at a slightly slower rate in December, reflecting some moderation in business debt financing, a slightly slower pace of household borrowing, and little net borrowing by the federal government.

The staff forecast prepared for this meeting suggested that economic activity likely would start to turn up early in 2002 as inventory liquidation tapered off, and would gather strength only gradually. The monetary ease and fiscal stimulus already in place would provide impetus for the recovery, though the wealth effects of earlier reductions in equity prices, sluggish growth abroad, and the dollar's strength would tend to offset some of that support for a time. The gradual strengthening of the recov-

ery would be associated with a marked slowing in the contraction of business capital investment and the added consumer purchasing power arising from recent declines in oil prices. Economic expansion was projected to strengthen appreciably by the second half of 2002 and subsequently, as the climate for business fixed investment continued to improve and as a strengthening of foreign economies led to somewhat greater demand for U.S. exports. The unemployment rate would begin to edge down. Subpar expansion over the next few quarters was expected to foster an appreciable further easing of pressures on resources and some moderation in core consumer price inflation.

In the Committee's discussion of current and prospective economic conditions, members commented that the recent information was more positive than they had anticipated and seemed on the whole to indicate that economic activity was bottoming out and a recovery might already be under way. Important impetus to economic activity in the period immediately ahead likely would be provided by a turnaround in inventory investment following several quarters of increasingly large liquidation that had culminated in the outsized decline in inventories reported for the fourth quarter. Looking beyond the near term, members expressed considerable uncertainty about the prospective strength of final demand. The stimulus from fiscal and monetary actions taken in 2001, the impetus to growth from the inducement to new investment provided by improving technology, and the persisting uptrend in household spending would support the economic recovery. However, household spending had been relatively robust during the cyclical downturn and likely had only limited room for a pickup over coming quarters, and intense competitive pressures could

well constrain profits, investment, and equity prices. As a result, the members were concerned that the acceleration in final demand could be modest, at least for a time. Against this background, the prospects for continued low inflation remained favorable, given the currently reduced utilization of resources and indeed the prospect for some added slack should economic growth remain below potential in coming quarters, as many members anticipated. Moreover, the further passthrough of earlier declines in energy prices would continue to ease pressures on prices and costs more generally throughout the economy.

In preparing for the semi-annual monetary policy report to the Congress, the Board members and Reserve Bank presidents provided their individual projections for the growth of GDP, civilian unemployment, and consumer price inflation for the year 2002. They projected that the economy would begin to recover this year from the generally mild downturn experienced in 2001, but the pace of expansion would pick up only gradually and the unemployment rate would climb somewhat further. The central tendency of their forecasts of growth in real GDP for 2002 was  $2\frac{1}{2}$  to 3 percent, measured as the change between the fourth quarter of 2001 and the fourth quarter of 2002, while their forecasts of the civilian unemployment rate in the fourth quarter of the year were centered on 6 to  $6\frac{1}{4}$  percent. The forecasts of consumer price inflation this year, as measured by the PCE chain-type price index, were narrowly clustered around  $1\frac{1}{2}$  percent.

With regard to the prospective course of the projected recovery, members generally anticipated that a positive swing in inventory investment abetted by further growth in consumer spending would provide an important upward

thrust to the expansion over the nearer term. The inventory correction that had occurred over the past year was of a magnitude that would inevitably result in a reduced rate of liquidation and an eventual restocking unless, contrary to current expectations, consumer spending were to weaken markedly. The accompanying fillip to production and incomes would have positive feedback effects over time on household expenditures and business investment. The extent and timing of the turnaround in inventory investment for the economy as a whole were subject to a considerable degree of uncertainty, but members noted that some firms already appeared to have adjusted their inventories to what they viewed as acceptable levels, and there were indications that some manufacturing firms were making efforts to rebuild inventories in the context of improving orders. More generally, however, business firms appeared to have remained very cautious in setting their inventory investment plans.

The evidence of unexpected strength in overall final demand indicated by the just-released GDP report was supported by anecdotal commentary from around the nation. Regional economic reports were somewhat mixed in that declining activity still characterized conditions in some areas, but the pace of the declines appeared to have moderated in those areas and improved conditions were noted in other parts of the country. Business sentiment, while still quite depressed in some areas, was described in many reports as having shifted toward cautious optimism.

Concerning prospective developments in final demand in major sectors of the economy, several members underscored what they viewed as the key role of household expenditures. Such spending had held up remarkably well in the face of major adverse developments,

including sharp declines in stock market wealth and rising unemployment, that were exacerbated by the events of September 11. But with households remaining confident about the future and equity prices having rebounded from their post-attack declines, sustained growth in household expenditures was seen as a likely prospect. Such spending also would be supported in part by some strengthening or less weakness in other important sectors of the economy. Some members nonetheless cited a number of potential negatives relating to the prospects for consumer spending, including the possibility of adverse effects on consumer confidence of further anticipated increases in unemployment and the risk that generally disappointing business profits or more widespread downward restatements of reported profits might generate sizable declines in stock market prices and consumer wealth. Moreover, the unusually large sales of motor vehicles and to a degree other durable goods during the closing months of 2001 might have borrowed to some extent from sales in coming months. On balance, the positive and negative factors bearing on the outlook for consumer spending suggested that moderate growth was a reasonable expectation.

Residential construction expenditures, like household spending for consumer goods and services, had held up well despite the cyclical downturn in employment and sizable net losses in stock market wealth. Low mortgage interest rates and, in recent months, favorable weather conditions had provided vital support to this sector of the economy. Recent housing activity, including record sales in some areas, suggested persisting underlying strength in residential construction. Even so, the large additions to the supply of new homes in earlier years tended to indi-

cate that additional impetus, if any, from housing construction would be limited over the next several quarters.

The outlook for business capital expenditures was improving, but anecdotal reports suggested that business executives were still notably cautious in formulating their spending plans, and indications of accelerating capital investment were still quite limited. In the high-tech sector, positive signs were noted in the demand for computers and peripherals, but the outlook for communications equipment was still very negative. Business spending for other equipment was also expected to remain soft. On balance, the capital investment sector seemed likely to retard the overall advance in economic activity during the quarters immediately ahead as many firms continued to pare excess capacity and businesses awaited clearer indications of rising demand and profits. Beyond the nearer term, however, the favorable outlook for productivity growth and related profit opportunities pointed to a revival of robust capital spending. Indeed, past experience suggested that once a rebound in capital spending took hold it easily could exceed current forecasts of moderate acceleration.

Fiscal policy would continue to provide substantial stimulus to the economy this year in light of the ongoing effects of the tax reduction measures enacted in 2001 and the sharp increase in federal government spending in train. This outlook did not incorporate the possible enactment of further tax cut legislation, whose prospects now seemed to be remote. A partial offset to federal government stimulus was the likelihood of considerably reduced spending growth at the state and local government levels, where numerous government entities were experiencing severe budget strains associated

with recession-related weakness in tax revenues.

The external sector of the economy was seen as a source of some potential downside for the domestic economy in the period just ahead. Generally weak foreign economies and the recent strength of the dollar in foreign exchange markets were expected to continue to restrain U.S. exports. Economic recoveries in many foreign nations seemed likely over the course of this year, but the strength of those recoveries was subject to considerable uncertainty, and the risk that serious difficulties in some important economies might spread could not be overlooked. Recovery abroad, notably in some key U.S. trading partners, would be tied to an important extent to the course of U.S. economic activity and would not be providing much impetus to U.S. exports over coming quarters. At this point signs of an upturn in foreign trade were not entirely lacking, notably in some high-tech goods, but those indications were still very limited.

Inflation was likely to remain quite subdued. Indeed, core inflation could well edge lower. The indirect effects of the declines that had occurred in energy prices would continue to hold down other input prices and be passed on more fully to final purchasers. More generally, the low rate of resource utilization anticipated over the year ahead, rising productivity, and highly competitive market pricing could be expected to moderate price pressures. Against that background, members continued to view the greater risks to the economy as those relating to concerns about economic activity rather than prices.

In the Committee's discussion of policy for the intermeeting period ahead, all the members agreed that recent developments argued for keeping the stance of policy unchanged at this time. Monetary

policy had been eased substantially over the past year, and, with the real federal funds rate at an unusually low level, policy seemed well positioned to support an economic recovery as the forces restraining demand abated. In fact, a growing number of indicators pointed to a reduction in the pressures holding back the economy and to an emerging business recovery. In these circumstances, a pause seemed desirable to monitor the still-incomplete effects of the Committee's easing over the past year—a significant part of which had been implemented in recent months—and the contours of the turnaround in economic activity.

All the members indicated that they could support the issuance of a public statement indicating that the risks remained tilted toward economic weakness. Although the economy was probably strengthening, a variety of factors could well keep the pace of expansion below the rate of growth of potential for a while, even at the current policy stance. Moreover, inflation was running at a fairly low rate and quite possibly would edge down a little further over coming quarters. In these circumstances, the risk to achieving the Committee's objective for fostering sustainable economic growth seemed to be greater than to its objective of maintaining reasonable price stability. In the view of a few members, an argument could be made for moving to a balanced-risks statement, given that they could envisage developments that could strengthen the economy beyond their current forecasts. However, they agreed that a shift to balanced risks in conjunction with an unchanged policy stance could at this point be misread in financial markets as an indication of a much more optimistic view of the economic outlook than the members currently entertained. Such an interpretation might foster unwarranted

and counterproductive adjustments in financial markets. In any event, emerging economic conditions in line with the members' current forecasts would provide ample opportunity to shift to a balanced-risks statement at a future meeting when it might be more clearly appropriate.

At the conclusion of this discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 1¾ percent.

The votes encompassed approval of the sentence below for inclusion in the press statement to be released shortly after the meeting.

Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks continue to be weighted mainly toward conditions that may generate economic weakness in the foreseeable future.

Votes for this action: Messrs. Greenspan, McDonough, Ms. Bies, Messrs. Ferguson, Gramlich, Jordan, McTeer, Olson, Santomero, and Stern. Vote against this action: None. Absent and not voting: Mr. Meyer.

## Disclosure Policy

In accordance with the Committee's routine practice of reviewing its rules and regulations at its first regular meet-

ing of each year, the members discussed their policies regarding the extent of the information that is released to the public about its discussions and decisions along with the timing of the release of such information. They noted that the changes in disclosure policy and practices implemented in recent years, including the announcement of policy actions and brief explanations of the basis for those actions, have served both the Federal Reserve and the public well. They also believed that it would be appropriate to explore whether there might be scope for some further evolution in the Committee's policies in the direction of greater transparency, though additional study and analysis would be needed. They agreed to discuss the issues further at a future meeting.

It also was agreed that the next meeting of the Committee would be held on Tuesday, March 19, 2002.

The meeting adjourned at 12:30 p.m. on January 30, 2002.

Donald L. Kohn  
Secretary

## Meeting Held on March 19, 2002

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, March 19, 2002, at 9:00 a.m.

### *Present:*

Mr. Greenspan, Chairman  
Mr. McDonough, Vice Chairman  
Ms. Bies  
Mr. Ferguson  
Mr. Gramlich  
Mr. Jordan  
Mr. McTeer  
Mr. Olson  
Mr. Santomero  
Mr. Stern



Messrs. Broaddus, Guynn, Moskow, and Parry, Alternate Members of the Federal Open Market Committee

Mr. Hoenig, Ms. Minehan, and Mr. Poole, Presidents of the Federal Reserve Banks of Kansas City, Boston, and St. Louis respectively

Mr. Kohn, Secretary and Economist  
Mr. Bernard, Deputy Secretary  
Mr. Gillum, Assistant Secretary  
Ms. Smith, Assistant Secretary  
Mr. Mattingly, General Counsel  
Ms. Johnson, Economist  
Mr. Reinhart, Economist  
Mr. Stockton, Economist

Mr. Connors, Ms. Cumming, Messrs. Howard and Lindsey, Ms. Mester, Messrs. Oliner, Rolnick, Rosenblum, Sniderman, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Mr. Winn, Assistant to the Board, Office of Board Members, Board of Governors

Messrs. Ettin and Madigan, Deputy Directors, Divisions of Research and Statistics and Monetary Affairs respectively, Board of Governors

Mr. Whitesell, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Mr. Simpson, Senior Adviser, Division of Research and Statistics, Board of Governors

Mr. English, Assistant Director, Division of Monetary Affairs, Board of Governors

Mr. Skidmore, Special Assistant to the Board, Office of Board Members, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Office of Board Members, Board of Governors

Ms. Pianalto and Mr. Stewart, First Vice Presidents, Federal Reserve Banks of Cleveland and New York respectively

Messrs. Beebe, Eisenbeis, Fuhrer, Goodfriend, Hakkio, Hunter, and Rasche, Senior Vice Presidents, Federal Reserve Banks of San Francisco, Atlanta, Boston, Richmond, Kansas City, Chicago, and St. Louis respectively

Ms. Hargraves, Vice President, Federal Reserve Bank of New York

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on January 29–30, 2002, were approved.

By notation vote completed on March 19, 2002, the members of the Federal Open Market Committee voted unanimously to accept the Report of Examination of the System Open Market Account conducted as of the close of business on November 14, 2001, by the Division of Reserve Bank Operations and Payment Systems of the Board of Governors.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period January 30, 2002, through March 18, 2002. By unanimous vote, the Committee ratified these transactions.

At this meeting the staff requested Committee guidance on the priorities, given limited staff resources, it should attach to further studies of the feasibility of outright purchases for the System Open Market Account (SOMA) of mortgage-backed securities guaranteed by the Government National Mortgage Association (GNMA-MBS) and the addition of foreign sovereign debt securities to the list of collateral eligible for U.S. dollar repurchase agreements by the System. Such alternatives could prove useful if outstanding Treasury debt obligations were to become increasingly scarce relative to the necessary growth in the System's portfolio, and the Committee had previously requested initial staff exploration of these options. Noting that many of the staff engaged in these studies were also involved in contingency planning, which had been intensified after the September 11 attacks, the consensus of the members was to give the highest priority to such planning. All the members preferred continued reliance to the extent feasible on direct Treasury debt for outright System transactions, and they were persuaded that budget developments over the last year meant that constraints on Treasury debt supplies would not become as pressing an issue as soon as they had previously thought. Still, given the inherent uncertainty of budget forecasts, the likely significant needs for large SOMA operations in coming years and the lead times needed to implement new procedures, the Committee decided that the study of alternative market instruments should go forward once it was possible to do so without impeding the contingency planning effort. With regard to the two proposed alternatives for broadening the System's options for open market operations, the members instructed the staff to give a higher priority to further exami-

nation of outright purchases of GNMA-MBS. Although these securities have a number of shortcomings as an outright investment vehicle from the System's perspective, the market for GNMA-MBS was well developed and the securities were guaranteed by the full faith and credit of the U.S. government.

The Committee then turned to a discussion of the economic and financial outlook and the conduct of monetary policy over the intermeeting period ahead.

The information reviewed at this meeting indicated that economic activity had turned up in the final quarter of last year and strengthened further since then. Consumer spending on goods other than motor vehicles was brisk in the early part of this year, business purchases of equipment and software appeared to be beginning to recover from their marked decline of last year, and housing starts turned back up. Amid signs that most firms had worked down their inventories to more comfortable levels, industrial production increased slightly after having declined for nearly a year and a half, and payroll employment appeared to be bottoming out. Inflation remained low despite some firming of energy prices.

Private nonfarm payroll employment moved up in February, retracing part of January's drop. Layoffs in manufacturing slowed further, the construction industry added back some workers in February, and the retail trade and services sectors continued to hire in both months. The unemployment rate edged down again in February to 5.5 percent, and initial claims for unemployment insurance continued to drop.

Industrial production increased somewhat in January and February after a steep decline from its June 2000 peak. Manufacturing output rose in both months, and the factory operating rate

moved up slightly from its low level at year-end. The pickup in manufacturing this year was spread across several major industries, including chemicals, computers and semiconductors, paper, and tobacco. In addition, output of communications equipment steadied after having plunged for more than a year. In contrast, production of motor vehicles and parts changed little over January and February after a surge late in 2001.

Consumer spending remained strong in the early part of the year, despite a sizable drop in purchases of light vehicles in January that was followed by a rebound in February as manufacturers switched from attractive financing terms to cash rebates. Outlays for retail items other than motor vehicles expanded further in February after the large increases recorded in the two prior months. Outlays for services continued to rise moderately in January (latest data). Consumer purchases were supported by a sizable gain in disposable personal income in January, and readings on consumer sentiment were close to their historical averages.

Residential construction had been very strong in the past several months, with new starts reaching their highest level in almost two years. The strength in homebuilding was associated in part with unusually warm and dry weather, but very low mortgage rates also continued to play an important role.

Business spending on durable equipment and software appeared to be turning upward after a marked moderation in the fourth quarter of the steep decline recorded in the two previous quarters. Shipments and orders of nondefense capital goods were unexpectedly strong in January. There were signs of recovery in the high-tech sector, with shipments of computers and peripherals increasing for a fifth straight month, but shipments of communications equipment turned

down in January after a December bounce. Shipments in most other sectors recorded increases and were particularly robust for machinery, engines, and turbines. Business demand for motor vehicles remained mixed, with fleet sales of light vehicles higher and purchases of medium and heavy trucks somewhat weaker. Nonresidential construction remained in a slump, with spending on new office buildings and industrial structures down sharply in an environment of elevated vacancy rates.

The pace of liquidation of manufacturing and trade inventories, excluding motor vehicles, slowed in January after a very rapid rundown in the fourth quarter, and with sales higher the aggregate inventory–sales ratio declined to its lowest level since midyear 2000. Manufacturers' stocks were drawn down sharply further in January, and the sector's stock-to-shipments ratio fell appreciably. At the wholesale level, the rate of inventory runoff slowed somewhat, but the sector's inventory–sales ratio declined further. The level of inventories at the retail level increased somewhat despite a rise in sales, and the sector's aggregate inventory–sales ratio was at an historically low level.

The U.S. trade deficit in goods and services widened somewhat in January. The value of exports changed little but the value of imports rose appreciably, to about the November level. The available information indicated that economic activity in the foreign industrial countries showed little net change in the fourth quarter. The Canadian economy rebounded from a weak third quarter, but economic expansion in the United Kingdom nearly came to a halt in the fourth quarter, economic activity in the euro area slipped a little, and the Japanese economy recorded a steep drop. There were indications, however, of a gradually improving economic outlook

in several of these economies in the first quarter as a consequence of previous monetary policy easing actions that their respective central banks had taken and from the effects of an improved economic performance in the United States. Among the major emerging-market countries, the exports of a number of Asian economies were benefiting from the nascent recovery in high-tech industries around the world. In Latin America, although Argentina remained in a steep downward trend, the Mexican and Brazilian economies seemed to be recovering from weakness in the fourth quarter.

Consumer price inflation picked up a bit in January as energy prices posted their first increase since September. However, on a year-over-year basis, core price inflation as measured by the consumer price index leveled out at a moderate rate, while core PCE (personal consumption expenditure) price inflation declined appreciably. Labor costs also appeared to have decelerated recently. The employment cost index for hourly compensation in private industry rose moderately in the fourth quarter of last year and for the year as a whole. Both the salary and benefits components recorded slightly smaller increases last year. Average hourly earnings of production and nonsupervisory workers advanced only slightly in January and February of this year, and the average wage increase during the twelve months through February was slightly lower than that for the twelve-month period ending in February 2001.

At its meeting on January 29–30, 2002, the Committee adopted a directive that called for implementing conditions in reserve markets consistent with keeping the intended level of the federal funds rate at 1¾ percent. The members noted that policy had been eased substantially over the past year and that the

inflation-adjusted federal funds rate was at an unusually low level. As a result, policy was positioned to support an economic recovery as forces restraining aggregate demand abated. Nonetheless, the members agreed that there were factors that might keep the pace of expansion below the rate of growth of potential for a while, and thus the balance of risks continued to be tilted toward economic weakness in the foreseeable future.

The federal funds rate remained close to the Committee's target level of 1¾ percent during the intermeeting period. However, short-term market rates increased slightly over the intermeeting interval, and yields on longer-term Treasury instruments and high-grade corporate bonds rose by more. The rise in rates was sparked initially by market participants' reading of the Committee's press statement as suggesting greater-than-expected optimism about the economy going forward. That assessment was subsequently strengthened by data on spending and output released during the intermeeting interval that came in well above market expectations. Speculative-grade bond yields fell somewhat in reaction to the improved economic outlook and the perceived reduction of credit risk. Most major indexes of equity prices moved up sharply on the bullish economic reports.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the major foreign currencies eased slightly on balance over the intermeeting period. The dollar fell more against the yen than the euro despite negative economic news from Japan and the disappointing reaction to the Japanese government's announcement of an "anti-deflation" package. The exchange value of the dollar changed little in terms of an index of the currencies of other important trading partners, in part

because of the further depreciation of the Argentine peso.

Expansion of M2 rebounded somewhat in February from January's lackluster rate, but growth in the early part of the year was down sharply from the robust pace of late last year. The slowdown apparently was related to the ebbing effect of earlier declines in opportunity costs of holding M2 assets and to the shift of large amounts of money from retail money market funds into bond and equity mutual funds as concerns about volatility in financial markets eased. Reduced demand for mortgage refinancing also seemed to have contributed to the deceleration of M2. The debt of the domestic nonfinancial sectors was estimated to have increased at a relatively slow rate in January, reflecting weak demand for business debt financing and little net borrowing by the federal government.

The staff forecast prepared for this meeting suggested that economic activity was expanding briskly in the early months of the year after having turned up and increased modestly in the fourth quarter. Elevated household spending and a shift from inventory liquidation to accumulation would provide significant impetus for the recovery in the context of the substantial monetary ease and fiscal stimulus already in place. Moreover, the recently enacted federal incentive for new business equipment investment along with the outlook for continued robust gains in productivity were expected to help boost business capital spending. At the same time, still-depressed equity prices, limited growth abroad, and the dollar's strength would tend to hold down the pace of recovery. On balance, recent developments suggested that the course of final sales now had a more positive contour over the forecast horizon and that resource utilization would rise somewhat more than

anticipated earlier despite higher projected growth in structural productivity. Even so, overall activity would remain below estimates of the economy's potential output for some time, and the persistence of underutilized resources was expected to keep downward pressure on core price inflation.

In the Committee's discussion of current and prospective economic developments, members commented that the decidedly positive information received over the intermeeting period provided strong evidence that an economic recovery was now under way, though its prospective strength remained subject to substantial uncertainty. In this regard it was noted that the economy was undergoing significant structural changes and those changes were adding to the usual difficulty of projecting the trajectory of economic activity after a turning point. Unexpected strength in household expenditures, much reduced weakness in business capital spending, and substantial slowing in inventory liquidation had produced an earlier upturn in economic activity than many had anticipated. A further strengthening of inventory investment would probably generate appreciable further growth in business activity over the quarters just ahead. Once the ongoing inventory correction was completed, however, it was not clear to what extent final demand in key sectors of the economy, notably business capital investment, would provide support for further economic growth. While the members agreed that the stimulative fiscal and monetary policies currently in place would undergird further economic expansion, most continued to anticipate a relatively subdued rate of expansion that would only gradually erode current margins of underutilized productive resources. The members viewed the outlook for core price inflation as still quite benign, largely

reflecting the ample availability of labor and other producer resources to accommodate rising economic activity and the favorable prospects for further robust growth in productivity.

Anecdotal commentary from around the country was somewhat less positive on the whole than the recent macroeconomic data for the nation. Business conditions were reported to be improving in most areas and industries, but the pickup was uneven, with continued weakness still characterizing numerous industries. Many business contacts, although somewhat less pessimistic about the economic outlook, still did not appear to be anticipating a strong upturn this year. Gradual recovery was reported in the depressed tourism and travel industries. The manufacturing sector, where much of the economy's weakness had been concentrated, was displaying increased signs of stabilizing, with activity actually picking up in a number of industries and some firms anticipating increases in their payrolls over the next several months after experiencing large declines. However, employers in manufacturing and other sectors of the economy generally remained cautious in their hiring policies and in their plans for capital spending.

In their discussion of developments in key expenditure sectors of the economy, members commented that inventory investment was likely to remain a pivotal factor in the nearer-term performance of the economy. Firms had moved rapidly to correct earlier inventory imbalances. Data indicating a very large drawdown of inventories in the fourth quarter and further, albeit much diminished, liquidation in January along with anecdotal commentary suggested that inventories were now close to desired levels in many industries, notably in the retail sector, and the swing toward smaller drawdowns was giving

a boost to industrial production. Looking ahead, inventory investment likely would turn toward accumulation as business firms facing brisk demand and depleted stocks stepped up their new orders, providing a source of significant strength in fostering economic recovery over the near term.

A major uncertainty in the economic outlook was the extent to which growth in final demand by households and business firms would provide ongoing support for the expansion as the impetus from inventory investment dissipated. The prospects for consumer spending remained favorable against the backdrop of a solid uptrend in disposable incomes associated to an important extent with an improving employment picture, robust underlying growth in labor productivity, and the further phase-in of personal income tax cuts enacted in 2001. Consumer confidence had improved considerably in recent months and consumer expenditures had displayed surprising strength. Members nonetheless cited some negatives in the outlook for consumer spending including the possibilities that a negative stock market wealth effect stemming from large earlier declines and the somewhat elevated rate of unemployment would weigh on consumer confidence. Importantly, because consumer spending for automobiles and other consumer durables had been well maintained through the extended period of economic weakness, further gains in such expenditures were likely to be limited over coming quarters in contrast to the typical surge in past economic recoveries. Moreover, energy price increases, especially if they were to become more pronounced, would tend to hold back household spending. On balance, members saw moderate further growth in consumer spending as a reasonable prospect for coming quarters.

After a lull during the fall of 2001, housing activity had displayed renewed vigor in recent months, in part as a consequence of widely favorable weather conditions. Indeed, single-family construction was described as a particularly bright sector in a number of local economies. Looking ahead, the favorable factors affecting consumer spending more generally along with relatively low mortgage interest rates were expected to sustain a high level of housing expenditures this year. In keeping with the outlook for consumer durables, however, a long period of active housing construction suggested that significant additional strength in housing was unlikely in coming quarters.

The members generally viewed business fixed investment spending as the key to the strength of economic activity once the thrust from inventory restocking had run its course. The outlook for business capital expenditures would be governed to an important extent by business expectations regarding sales and profits. After the steep declines in business investment over the past year, anecdotal reports from around the country provided scattered indications of an upturn but no evidence at this point of any broad-based improvement. According to such reports and despite the strength of recent economic statistics, which had boosted the economic forecasts of many observers, business confidence remained at a low level, evidently reflecting a weak outlook for profits in the business community in the context of strong competitive pressures. Negative factors bearing on the outlook for investment in capital equipment included the persistence of large margins of excess capacity in many industries. The outlook for commercial and other nonresidential construction seemed even less promising, at least for the next several quarters, given high

vacancy rates in commercial structures in many parts of the nation. Members nonetheless cited some positives in this outlook that included the favorable effects on incentives to purchase capital equipment stemming from the outlook for relatively rapid growth in productivity and the recent passage of legislation providing a temporary tax incentive for investments in equipment and software. On balance, a substantial pickup in overall capital spending seemed likely to be delayed in the absence of surprising strength in final demand, but a wide range of possible outcomes could not be ruled out for this key sector of the economy.

Several members referred to the currently high degree of fiscal policy stimulus, which had been augmented by recent legislation. Much of the added stimulus from the investment incentive component of that legislation was not likely to be felt for some period and might occur at a time when the economy would already be expanding at a solid pace. Federal spending was increasing rapidly and its growth could taper off more slowly than current budget estimates implied. An at least partially offsetting factor was the prospect that state and local government expenditures would increase at a reduced pace this year amid widespread budget pressures that had emerged as tax receipts weakened along with the economy. However, some reports indicated that spending on local infrastructure projects was continuing at a solid pace in some parts of the nation.

Members saw a number of downside risks from potential developments abroad. In particular, concern was expressed about heightened tensions in the Middle East and their possible impact on oil markets and the cost of energy. For a variety of reasons, oil prices already had risen appreciably

since the start of the year. With regard to the outlook for foreign trade, members reported some indications of an improving volume of trade with some Asian nations. However, the nation's net export position could deteriorate further when much of the impetus to world economic growth was coming from the U.S. economy.

The members expected price pressures to remain relatively contained over the next several quarters in the context of what they anticipated would be only a gradual reduction of the excess capacity in labor and product markets as the recovery progressed. Moreover, the prospects of relatively robust growth in productivity in a highly flexible and competitive economy likely would moderate the extent of any potential buildup in inflationary pressures in the future. Members nonetheless mentioned some potential negatives in this outlook, notably the possibility of rising wage pressures as labor markets became more fully employed and upward price pressures stemming from increasing steel, energy, and insurance costs.

In the Committee's discussion of policy for the intermeeting period ahead, all the members supported a proposal to maintain an unchanged policy stance, with the target for the federal funds rate staying at 1¾ percent. While the economy currently appeared to be expanding at a fairly vigorous pace, the advance importantly reflected a temporary swing in inventory investment and considerable uncertainty surrounded the outlook for final demand over the quarters ahead. Against this background, the members judged the currently accommodative stance of monetary policy to be appropriate for now, especially in light of the relatively high unemployment rate, low capacity utilization rates in numerous industries, and quiescent inflation pressures.

Looking ahead, however, the stance of policy would need to be adjusted at some point to provide less stimulus as the members gained more confidence that the recovery was becoming better entrenched and the risks had shifted toward rising inflationary pressures. The need to adjust monetary policy during the early stages of a recovery presented a special challenge with regard to its timing and extent in that raising rates prematurely or too precipitately could weaken or abort the recovery, while waiting too long could risk a pickup in inflationary pressures later. Members concluded that the Committee would be in a better position to assess the appropriate timing of a policy change at the May meeting when it would have more information to gauge the economy's performance in two critical areas, namely developments relating to inventory investment and the implications of trends in sales and profits for capital investment. A reference to the Committee's currently accommodative policy stance in the press announcement to be issued shortly after this meeting would alert the public to the need to firm policy at some point in the future.

All the members indicated that they could accept a proposal to move the balance of risks statement from potential weakness to a neutral position. It was clear that significant downside risks remained in the economy even apart from any major unanticipated shocks to business and consumer confidence, but in light of the strength of the recent economic information nearly all the members agreed that a balanced risks statement now best represented their consensus regarding the economic outlook over the foreseeable future. Members noted that a neutral statement did not preclude a tightening policy move should the latter seem warranted by rapidly evolving economic conditions.



At the conclusion of this discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 1¾ percent.

The vote encompassed approval of the sentence below for inclusion in the press statement to be released shortly after the meeting:

Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks are balanced with respect to prospects for both goals in the foreseeable future.

Votes for this action: Messrs. Greenspan, McDonough, Ms. Bies, Messrs. Ferguson, Gramlich, Jordan, McTeer, Olson, Santomero, and Stern. Votes against this action: None.

### Disclosure Policy

By unanimous vote, the Committee approved a proposal to include the vote on monetary policy in the press statement released after every meeting, beginning with this meeting. In addition to identifying the voters, the press release would indicate the policy preferences of dissenters, if any. Such information could prove useful to market participants, who on occasion had employed indirect and frequently misleading information to gauge the Committee's vote before it was released

as part of the minutes after the next meeting.

It was agreed that the next meeting of the Committee would be held on Tuesday, May 7, 2002.

The meeting adjourned at 1:30 p.m.

Donald L. Kohn  
Secretary

### Meeting Held on May 7, 2002

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, May 7, 2002, at 9:00 a.m.

#### *Present:*

Mr. Greenspan, Chairman  
Mr. McDonough, Vice Chairman  
Ms. Bies  
Mr. Ferguson  
Mr. Gramlich  
Mr. Jordan  
Mr. McTeer  
Mr. Olson  
Mr. Santomero  
Mr. Stern

Messrs. Broaddus, Guynn, Moskow,  
and Parry, Alternate Members  
of the Federal Open Market  
Committee

Mr. Hoenig, Ms. Minehan, and  
Mr. Poole, Presidents of the  
Federal Reserve Banks of  
Kansas City, Boston, and  
St. Louis respectively

Mr. Kohn, Secretary and Economist  
Mr. Bernard, Deputy Secretary  
Mr. Gillum, Assistant Secretary  
Ms. Smith, Assistant Secretary  
Mr. Mattingly, General Counsel  
Mr. Baxter, Deputy General Counsel  
Ms. Johnson, Economist  
Mr. Reinhart, Economist  
Mr. Stockton, Economist

Mr. Connors, Ms. Cumming,  
Messrs. Howard and Lindsey,  
Ms. Mester, Messrs. Oliner,  
Rolnick, Rosenblum, and Wilcox,  
Associate Economists

Mr. Kos, Manager, System Open  
Market Account

Messrs. Ettin and Madigan, Deputy  
Directors, Divisions of Research  
and Statistics and Monetary  
Affairs respectively, Board of  
Governors

Messrs. Slifman and Struckmeyer,  
Associate Directors, Division  
of Research and Statistics,  
Board of Governors

Mr. Whitesell, Deputy Associate  
Director, Division of Monetary  
Affairs, Board of Governors

Mr. Clouse, Assistant Director,  
Division of Monetary Affairs,  
Board of Governors

Mr. Simpson, Senior Adviser, Division  
of Research and Statistics,  
Board of Governors

Mr. Skidmore, Special Assistant  
to the Board, Office of Board  
Members, Board of Governors

Ms. Low, Open Market Secretariat  
Assistant, Office of Board  
Members, Board of Governors

Mr. Barron, First Vice President,  
Federal Reserve Bank of Atlanta

Messrs. Eisenbeis, Fuhrer, Goodfriend,  
Hakkio, Hunter, Judd, and  
Ms. Perelmuter, Senior Vice  
Presidents, Federal Reserve  
Banks of Atlanta, Boston,  
Richmond, Kansas City, Chicago,  
San Francisco, and New York  
respectively

Messrs. Altig and Coughlin, Vice  
Presidents, Federal Reserve  
Banks of Cleveland and St. Louis  
respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on March 19, 2002, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period March 19, 2002, through May 6, 2002. By unanimous vote, the Committee ratified these transactions.

By unanimous vote, the Committee approved the extension for one year beginning in December 2002 of the System's reciprocal currency ("swap") arrangements with the Bank of Canada and the Bank of Mexico. The arrangement with the Bank of Canada is in the amount of \$2 billion equivalent and that with the Bank of Mexico in the amount of \$3 billion equivalent. Both arrangements are associated with the Federal Reserve's participation in the North American Framework Agreement. The early vote to renew the System's participation in the swap arrangements maturing in December relates to the provision that each party must provide six months prior notice of an intention to terminate its participation.

The Committee then turned to a discussion of the economic and financial outlook and the conduct of monetary policy over the intermeeting period ahead.

The information reviewed at this meeting indicated that economic activity expanded rapidly early in the year. Consumer spending increased moder-

ately after large gains around the turn of the year, business outlays on durable equipment and software apparently steadied after a long decline, and single-family housing activity persisted at a relatively high level. Industrial production picked up in response to the advance in final demand and a slowdown in the runoff of excess inventory stocks. The demand for labor began to firm in April. Available information suggested that labor productivity had risen substantially in the first quarter. Although the recent surge in energy prices boosted headline consumer inflation in the first quarter, core measures of inflation had trended lower over the past year.

Private nonfarm payroll employment turned up in April after having posted small declines in February and March and steep reductions earlier. Job gains in April were spread across a wide range of industries. The services sector registered a sizable increase, with much of that rise occurring in the temporary-help industry that provides many of its workers to the manufacturing sector. In addition, layoffs continued to slow in the manufacturing sector, and some industries recorded their first solid advances in employment in more than a year. By contrast, the construction industry posted another large job decline as hiring again fell short of the usual seasonal rise. Despite the pickup in private payrolls, the unemployment rate rose to 6.0 percent in April, perhaps reflecting to an important extent the incentives created by the new federal program of extended unemployment benefits for some jobless workers to continue, or resume, looking for work.

Industrial production increased for a third straight month in March after the lengthy decline from its June 2000 peak. In the manufacturing sector, output in the first quarter retraced a little more

than half of its fourth-quarter plunge. The gain was widespread across market groups and industries. High-tech equipment, notably computers and semiconductors, and motor vehicles and parts led the upturn with very large increases, while the telecommunications and aircraft industries weakened sharply further. Capacity utilization in manufacturing continued to rise in March from its low level at year-end, but at the end of the first quarter it was still substantially below its long-run average.

Consumer spending was well maintained in the first quarter, supported by sizable gains in disposable income. Demand for light motor vehicles remained robust, though somewhat below the fourth-quarter pace, in an environment of continued aggressive manufacturer pricing and low financing rates. Expenditures on a wide range of other consumer goods and services expanded briskly.

Residential housing activity surged in the first three months of the year, evidently spurred by unusually mild winter weather and low mortgage rates. Starts of single-family homes reached a twenty-three-year high in February before moderating somewhat in March, but multifamily starts were only slightly above the relatively slow pace in 2001. New home sales moderated a bit in the first quarter from the very strong pace of the fourth quarter, while quarterly sales of existing homes rose on the strength of a record high in February.

Business outlays for durable equipment and software had changed little thus far this year following the steep decline recorded in 2001. Spending on computer equipment continued to rise rapidly in the first quarter, and outlays for communications equipment generally stabilized after a large and lengthy decline. By contrast, business purchases of both motor vehicles and aircraft

slowed sharply. In the nonresidential construction sector, investment slumped in office buildings, industrial structures, lodging facilities, and in drilling and mining. Moreover, available information indicated that this sector would remain depressed: Vacancy rates for office and industrial buildings continued to rise, with deterioration in the office sector especially pronounced in areas dominated by high-tech firms, and property values and rents for retail space and warehouses weakened.

The pace of liquidation of manufacturing and trade inventories slowed sharply in January and February after a notably large contraction in the fourth quarter, and the aggregate inventory-sales ratio declined a bit further. Stocks of manufacturers continued to fall through March (latest data). Wholesalers also continued to reduce their inventories during January and February (latest data), and the sector's inventory-sales ratio dropped further. At the retail level, stocks jumped in January and February, but almost all of the increase occurred at automotive dealers. The inventory-sales ratio for retail trade edged up over the two months but was still at a relatively low level.

The U.S. trade deficit in goods and services widened in January and February, reflecting a considerably larger expansion in the value of imports than in that of exports. The rise in imports related in part to the royalties and license fees paid to the International Olympics Committee for the rights to broadcast the Winter Olympic Games. With regard to economic activity abroad, the available information indicated that, on balance, foreign economic output had rebounded in the first quarter. The economies of the technology-sensitive Asian countries had already turned up in the fourth quarter and seemed to have grown rapidly in the

early months of the year. The Canadian economy appeared to have expanded robustly in the first quarter, and economic activity in Europe evidently had turned upward. By contrast, available indicators suggested that the Japanese economy was still contracting, though at a less rapid rate.

Although higher energy prices continued to push up headline consumer price inflation in March, inflation had moved downward over the past twelve months. Both the overall consumer price index (CPI) and the personal consumption expenditure (PCE) chain-linked index decelerated significantly over the past year. Moreover, excluding their volatile food and energy components, both measures of inflation also fell over the past year. At the producer level, prices for finished goods echoed the pattern of consumer prices: Both total and core finished goods inflation decelerated on a year-over-year basis. Labor cost growth, as measured by hourly compensation in private industry, also appeared to have slowed a bit over the latest twelve-month period.

At its meeting on March 19, 2002, the Committee adopted a directive that called for maintaining conditions in reserve markets consistent with keeping the intended level of the federal funds rate at 1¾ percent. With the economy expanding at a significant pace, the Committee now saw the risks to achieving its long-term goals as balanced. Members noted that the impetus for the economic advance was to a large extent a temporary swing in inventory investment rather than a clear and substantial upswing in final demand. As a result, the outlook for the economy remained somewhat uncertain, and the current accommodative stance of policy continued to be viewed as appropriate. The members contemplated, however, that the stance of monetary policy

would have to become less accommodative once clearer evidence emerged that a healthy expansion was firmly established.

The federal funds rate remained close to the Committee's target level of  $1\frac{3}{4}$  percent during the intermeeting period. However, doubts about the strength of the recovery owing to the tone of the Committee's press statement along with mixed incoming data on final demand, announcements of weaker-than-expected corporate earnings, and heightening tensions in the Middle East prompted declines in yields on short- to intermediate-term Treasury securities. Yields on investment-grade bonds tended to edge higher, however, in the wake of concerns about the transparency of the accounting statements of some firms. Most major indexes of equity prices moved down sharply in response to the outlook for a weaker economic recovery and the adverse implications for corporate profits of economic and other developments.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the major foreign currencies eased somewhat over the intermeeting period. Much of the dollar's decline occurred late in the period in response to the mixed character of U.S. economic data and relatively small declines in benchmark longer-term yields abroad. The dollar rose slightly on average in terms of an index of the currencies of other important trading partners, in part because of the further depreciation of the Argentine peso.

M2 and M3 contracted in March and April. The declines evidently reflected in part the rising opportunity costs of holding M2 assets as yields on the components of M2 declined in lagged response to the earlier easing of monetary policy and fostered transfers out of M2 funds, especially from retail money

market funds to stock and bond mutual funds. Reduced demand for mortgage refinancing and lower nonwithheld federal payments also contributed importantly to the weakness in the broad monetary aggregates.

The staff forecast prepared for this meeting suggested that the expansion in economic activity was slowing substantially in the current quarter but would pick up in the second half of the year and continue at a moderate pace next year. An emerging shift by businesses from inventory liquidation to some replenishment of stocks would help boost activity over the next several quarters, but the ongoing recovery would depend increasingly on growth in spending by households and businesses. Such spending would be fostered by the monetary ease and fiscal stimulus already in place and abetted by vigorous anticipated growth in structural productivity, which would support household incomes and business investment incentives. With a relatively robust contour for the course of final sales over the forecast horizon, the pressure on resources would rise somewhat despite the anticipated higher growth of structural productivity. Nonetheless, activity would remain below the economy's potential for a period ahead and the persistence of underutilized resources was expected to contribute to damped core consumer price inflation.

In the Committee's discussion of current and prospective economic developments, members commented that recently available statistical data and anecdotal reports suggested that the expansion in business activity was continuing. However, it had slowed considerably from its pace earlier in the year when it had received substantial impetus from a marked slowing in the runoff of inventories. How much final demand would strengthen going forward was

still uncertain. A pause in the expansion was not an unusual development during the early stages of a cyclical recovery, and the members generally viewed a pickup in growth as a reasonable expectation. The currently stimulative stance of both fiscal and monetary policy would tend to undergird final demand, especially in the context of an economy that had exhibited a marked degree of resilience and strength in underlying productivity growth that would bolster household incomes and provide incentives for business capital spending. Members noted, however, that an already high level of consumer spending pointed to more limited than usual scope for further growth in such spending, and gloomy business sentiment in the face of disappointing sales and profits raised a question about the extent to which business investment would help to lift final demand over coming quarters. Given growth in economic activity broadly in line with current expectations, inflation was likely to remain benign for some time in the context of an apparently strong uptrend in structural labor productivity, excess capacity in many labor and product markets, and a related absence of pricing power in generally very competitive markets.

In their review of developments and prospects in key expenditure sectors of the economy, members commented that household spending had continued to be well maintained. In the consumer area, recent anecdotal reports provided a somewhat mixed, but on the whole positive, picture of consumer spending across the nation. Sales of motor vehicles had moderated after a surge during the closing months of 2001, but they remained relatively high and other consumer outlays had continued to increase. Looking ahead, some growth in overall consumer spending appeared likely in association with the now more firmly

entrenched economic expansion. However, the pickup likely would be limited inasmuch as household spending had remained elevated through the period of economic weakness. Members commented that such an outlook was subject to uncertainties in both directions. On the upside, faster-than-anticipated growth could well materialize in an environment of monetary and fiscal policy ease and of gradually firming labor markets and rising productivity that would be boosting income growth. On the other hand, employment growth had been very sluggish to date, with employers remaining quite cautious in their hiring practices, and continued softness in labor markets could damp consumer confidence. The run-up in energy prices also was a negative for household purchasing power.

Household expenditures on new homes were likewise at an elevated level, although members reported weakness in some price segments and geographic areas of the housing market. In general, however, housing displayed ongoing strength in response to low mortgage rates, with rising prices in many areas, and the downside risks to this sector of the economy appeared to be limited. At the same time, members anticipated that growth, if any, in homebuilding activity would be subdued over the next several quarters after an extended period of strong expansion.

The members generally viewed business fixed investment as the key sector that would determine the strength of the expansion. Such investment had contracted further in the first quarter, but the decline was the smallest in a year. Looking ahead, the members anticipated a sluggish and delayed upturn in capital expenditures in the next few quarters against the backdrop of persistently gloomy business sentiment and large margins of excess capacity in numerous

industries. Many business contacts commented on their unwillingness to expand capacity until they saw persuasive evidence of growing sales and profits. Accordingly, much of their current investment spending was focused on cost-saving equipment and software in an effort to bolster profits in a stable price environment that made it difficult to pass on rising costs. The recent passage of temporary legislation that permitted a partial acceleration of tax expensing was expected to provide some impetus to capital investments, but the legislation appeared to have had little effect thus far. With regard to the outlook for nonresidential construction, members saw little prospect of any material increase in such construction over the next several quarters, given widespread anecdotal and statistical reports of high vacancy rates and excess capacity.

The markedly reduced pace of inventory liquidation in the first quarter of the year accounted for much of the step-up in GDP growth in that quarter and provided a strong indication that the period of inventory liquidation under way for more than a year probably was coming to an end. Indeed, anecdotal reports suggested that efforts to rebuild inventories were now being undertaken in a number of industries, such as steel and motor vehicles, and one regional survey indicated that businesses planned to accumulate inventories over the next six months. However, businesses remained quite cautious about the outlook for sales, and many firms might also be in the process of adapting to much reduced levels of inventories in relation to sales rather than restoring earlier inventory-sales ratios. A shift to inventory stocking in the near term, possibly in the current quarter, was seen as a reasonable expectation, but with numerous firms having already moved production into

closer alignment with sales, members anticipated much less impetus to overall economic activity from inventories over coming quarters.

Recent and immediately prospective legislation had increased the fiscal stimulus in the federal budget, and members commented that the current dynamics of the budget process could result in larger increases in government spending than foreseen in recent budget estimates. In this regard some expressed concern about the longer-term implications of what they saw as a decline in fiscal discipline. At the state and local government levels, however, deteriorating fiscal positions in 2001 had impelled many states and localities to curb spending and raise various taxes and fees.

Although foreign economic activity appeared to be picking up to some extent and the dollar had edged lower, net exports were expected to remain a negative factor in the growth of the domestic economy. Members cited anecdotal reports that tended to support statistical evidence of strengthening economies in Europe and a number of developing Asian nations. Nonetheless, given a recovery in U.S. domestic demand approximating their current forecasts, growth in imports likely would exceed that of exports by a wide margin over the forecast horizon.

The outlook for inflation remained favorable. Nearly all measures of total and core prices had decelerated over the past year, and in the context of forecasts implying a continued sizable gap between actual and potential output, the risk that inflationary pressures would intensify significantly over coming quarters appeared to be quite limited; indeed, inflation might edge a bit lower in the early stages of the expansion. The deceleration in labor costs over the past several quarters, evidence of a

surprisingly strong uptrend in structural labor productivity, low and stable inflation expectations, and the widespread absence of pricing power in highly competitive markets were signs that upside inflation risks in the period ahead were relatively small. The members recognized nonetheless that there were upward pressures on costs in a number of areas. These included significant increases in energy costs in recent months, evidence of an upturn in some industrial prices, sharp increases in many insurance costs, continuing upward pressures on medical costs, and modest recent declines in the foreign exchange value of the dollar. With the stance of monetary policy currently quite accommodative, the members saw the need for careful monitoring of the potential for rising inflation pressures as the economic recovery gained momentum.

In the Committee's discussion of policy for the intermeeting period ahead, all the members agreed on the desirability of maintaining an unchanged policy stance, with the target federal funds rate staying at  $1\frac{3}{4}$  percent. The economic recovery was clearly continuing, but its rate of advance had moderated considerably and the economy's future course was subject to a marked degree of uncertainty. While the longer-term outlook for a strengthening economy remained favorable, a firming of policy at this time would be premature and would incur an undue risk to a healthy expansion. The members recognized that monetary policy exerted its effects with a considerable lag and that the current stance of policy probably was inconsistent with the Committee's inflation objective over time. However, current inflation pressures were subdued and were expected to remain so for a considerable period, thereby providing adequate opportunity to evaluate ongoing

developments and tighten policy as needed later.

All the members favored the retention of a neutral balance of risks statement to be released shortly after this meeting. Against the longer-term inflation risks inherent in the current stance of policy, the members weighed the possibility that the expansion could be relatively subdued for a time, damping prices further and failing to reduce margins of underutilized resources. In any event, a neutral statement regarding the risks to the economy in the foreseeable future would not preclude a preemptive tightening adjustment in the stance of policy stance should new evidence bearing on the strength of the expansion and the outlook for inflation warrant such a policy move.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around  $1\frac{3}{4}$  percent.

The vote encompassed approval of the sentence below for inclusion in the press statement to be released shortly after the meeting:

Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks are balanced with respect to prospects for both goals in the foreseeable future.



Votes for this action: Messrs. Greenspan, McDonough, Ms. Bies, Messrs. Ferguson, Gramlich, Jordan, McTeer, Olson, Santomero, and Stern. Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, June 25–26, 2002.

The meeting adjourned at 12:15 p.m.

Donald L. Kohn  
Secretary

### Meeting Held on June 25–26, 2002

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, June 25, 2002, at 2:30 p.m. and continued on Wednesday, June 26, 2002, at 9:00 a.m.

*Present:*

Mr. Greenspan, Chairman  
Mr. McDonough, Vice Chairman  
Ms. Bies  
Mr. Ferguson  
Mr. Gramlich  
Mr. Jordan  
Mr. McTeer  
Mr. Olson  
Mr. Santomero  
Mr. Stern

Messrs. Broaddus, Moskow, and Parry,  
Alternate Members of the Federal  
Open Market Committee

Mr. Hoenig, Ms. Minehan, and  
Mr. Poole, Presidents of the  
Federal Reserve Banks of  
Kansas City, Boston, and St. Louis  
respectively

Mr. Kohn, Secretary and Economist  
Mr. Bernard, Deputy Secretary  
Mr. Gillum, Assistant Secretary  
Ms. Smith, Assistant Secretary  
Mr. Mattingly, General Counsel  
Ms. Johnson, Economist

Mr. Reinhart, Economist  
Mr. Stockton, Economist

Mr. Connors, Ms. Cumming,  
Messrs. Howard and Lindsey,  
Ms. Mester, Messrs. Oliner,  
Rolnick, Rosenblum, Sniderman,  
and Wilcox, Associate Economists

Mr. Kos, Manager, System Open  
Market Account

Messrs. Ettin and Madigan, Deputy  
Directors, Divisions of Research  
and Statistics and Monetary  
Affairs respectively, Board  
of Governors

Messrs. Slifman and Struckmeyer,  
Associate Directors, Division  
of Research and Statistics,  
Board of Governors

Messrs. Freeman<sup>5</sup> and Whitesell,  
Deputy Associate Directors,  
Divisions of International Finance  
and Monetary Affairs respectively,  
Board of Governors

Mr. English, Assistant Director,  
Division of Monetary Affairs,  
Board of Governors

Messrs. Reifschneider<sup>6</sup> and Wascher,<sup>6</sup>  
Assistant Directors, Division  
of Research and Statistics,  
Board of Governors

Mr. Simpson, Senior Adviser, Division  
of Research and Statistics,  
Board of Governors

Mr. Brayton,<sup>6</sup> Ms. Dynan,<sup>5</sup>  
Messrs. Lebow<sup>6</sup> and Roberts,<sup>6</sup>  
Senior Economists, Division  
of Research and Statistics,  
Board of Governors

Mr. Bomfim,<sup>5</sup> Senior Economist,  
Division of Monetary Affairs,  
Board of Governors

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5. Attended portion of meeting relating to the discussion of economic developments.

6. Attended portion of meeting relating to a special agenda discussion of inflation.

Mr. Skidmore, Special Assistant to the Board, Office of Board Members, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Office of Board Members, Board of Governors

Mr. Barron, First Vice President, Federal Reserve Bank of Atlanta

Messrs. Eisenbeis, Fuhrer, Goodfriend, Hakkio, Hunter, Judd, Ms. Krieger, and Mr. Rasche, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Boston, Richmond, Kansas City, Chicago, San Francisco, New York, and St. Louis respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on May 7, 2002, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on recent developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period May 7, 2002, through June 24, 2002. By unanimous vote, the Committee ratified these transactions.

The Committee voted unanimously to update its longstanding authorization for the Federal Reserve Bank of New York to enter into agreements that would enable another Federal Reserve Bank to conduct System open market operations on a temporary basis in an emergency after designation by the Committee or the Chairman.

The Committee then turned to a discussion of the economic and financial outlook and the conduct of monetary policy over the intermeeting period ahead.

The information reviewed at this meeting indicated that economic activity continued to expand in recent months, though at a slower pace than earlier in the year. Consumer purchases, residential housing outlays, and government spending recorded smaller gains, but business investment in durable equipment and software appeared to be leveling out after a long decline. Industrial production continued to pick up. Employment had risen a little, but not enough to lower the unemployment rate, and labor productivity seemed to be trending sharply upward. The surge in energy prices this year had boosted headline inflation, but core measures of inflation had trended lower.

Private nonfarm payroll employment edged up in April and May after a slowdown in the first quarter in the pace of layoffs and job separations. Hiring was relatively brisk in the services sector in the April–May period, with most of the advances occurring in the temporary-help industry. Manufacturing payrolls recorded small declines in both months, while the number of jobs in construction steadied in May after a large drop in April. The civilian unemployment rate moved down somewhat, to 5.8 percent in May, but the average rate for the April–May period remained above the level in the two previous quarters.

Industrial production rose for a fifth straight month in May. In manufacturing, output increases in April and May continued to be spread widely across market groups and industries. The high-tech sector, notably computers and semiconductors, and the motor vehicles and parts sector remained strong, while the telecommunications and aircraft indus-

tries weakened further. Capacity utilization in manufacturing in May was a little above its depressed level at year-end, but substantially below its long-run average.

Growth of consumer spending slowed appreciably in April and May from the brisk pace of the first quarter. Retail sales slumped in May after a sizable rise in April, largely reflecting weaker spending at apparel stores and general merchandise outlets and an apparent pause in purchases of light motor vehicles after an April surge. Real outlays on services in April (latest data) were unchanged.

Residential housing activity remained elevated during April and May. Housing starts jumped in May after a small decline in April. The strength in starts over the two months evidently reflected the persistence of very positive home-buying attitudes arising at least in part from low mortgage rates. In May, sales of new single-family homes established a new record high, and sales of existing single-family homes were only slightly below the peak reached in the first quarter.

The decline in business outlays for durable equipment and software had moderated further in the first quarter, and the available information suggested that spending on equipment and software was turning upward in the second quarter. Shipments of nondefense capital goods other than aircraft rose in April and May; shipments of computers and peripherals remained strong, shipments of communications equipment were still weak, and shipments of other durable goods continued to advance. In the nonresidential construction sector, outlays for office and industrial structures, lodging facilities, and public utilities declined substantially. In addition, expenditures for drilling and mining continued to drop. By contrast, construc-

tion of retail space, warehouses, and institutional structures picked up.

Liquidation of manufacturing and trade inventories continued in April at about the pace of the first quarter, and the aggregate inventory-sales ratio declined further. In manufacturing, the rate of liquidation slowed substantially, and the aggregate stock-shipments ratio for the sector was at a very low level. Wholesalers ran down their inventories in April at a somewhat faster rate than in the first quarter; the sector's inventory-sales ratio fell sharply further to a relatively low level. Retailers boosted their stocks slightly in April, with all of the increase occurring at automotive dealers. The sector's aggregate inventory-sales ratio edged up in April but remained relatively low.

The U.S. trade deficit in goods and services widened somewhat in April from both the March and the first-quarter levels, as the value of imports increased significantly more than that of exports. The rise in imports from March to April reflected higher prices for imported oil along with greater demand for a wide range of goods. The monthly step-up in exports was also broadly spread across categories of goods. With regard to economic activity abroad, the available information indicated that, on balance, foreign economic output had rebounded in the first half of the year, though the pace of recovery was uneven across regions and countries. Australia, Canada, and emerging Asia had experienced strong growth; the euro area also was expanding, but at a slower rate; and Japan appeared to have experienced a limited upturn in its economy. In South America, Brazil's economy was expanding but its financial markets had come under considerable stress, and elsewhere on the continent economic activity was generally weak, particularly in Argentina and Venezuela.

Both the consumer price index and the personal consumption expenditure chain-linked index indicated that consumer price inflation was moderate during the April–May period. Moreover, both measures showed that core price inflation during the first five months of the year had been a bit lower than in 2001. At the producer level, prices for core finished goods changed little over April and May and decelerated on a year-over-year basis. Labor costs, as measured by the average hourly earnings of production or nonsupervisory workers, also decelerated.

At its meeting on May 7, 2002, the Committee adopted a directive that called for maintaining conditions in reserve markets consistent with keeping the intended level of the federal funds rate at  $1\frac{3}{4}$  percent, and it also retained a neutral balance of risks statement. The Committee's press statement, with its language indicating that the Committee remained uncertain about the extent and timing of the strengthening of final demand, was viewed by market participants as expressing less confidence in the strength of the recovery than had been expected, and yields on Treasury securities declined slightly in response. Subsequently, investors became more risk averse in reaction to a mixture of economic data releases, growing geopolitical tensions, further warnings about terrorism, and additional revelations regarding questionable corporate accounting practices. Yields on Treasury securities dropped somewhat on net over the period, rates on lower-quality bonds rose, and equity prices fell sharply further. The federal funds rate remained close to the Committee's target level of  $1\frac{3}{4}$  percent during the intermeeting period.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the major foreign currencies

dropped somewhat over the intermeeting period. The dollar's decline against the major foreign currencies occurred as questions about the strength of U.S. economic recovery and corporate earnings and the related lowering of expectations for near-term monetary tightening led to concerns that net foreign capital inflows might not be consistent with a stable exchange value for the dollar in the context of growing U.S. net international indebtedness. By contrast, the dollar rose slightly on average in terms of an index of the currencies of other important trading partners, notably the currencies of several Latin American countries that were experiencing political and economic problems.

Growth of the broad monetary aggregates picked up in May owing to the unwinding of distortions from final tax payments and, apparently, to falling equity prices. The heightened volatility of equity markets may have enhanced the attractiveness of safe and liquid M2 assets, including liquid deposits and retail money market funds.

The staff forecast prepared for this meeting suggested that the expansion of economic activity would pick up in the last half of the year from the sluggish pace of the second quarter and reach a relatively brisk pace next year. The considerable monetary ease and fiscal stimulus already in place and the continuing sizable gains in productivity would provide significant impetus for spending, though weakness in equity prices would tend to offset some of that support. With business capital stocks moving closer to desired levels, investment spending would be boosted by a gradually improving outlook for sales and profits, low financing costs, and the temporary federal tax incentive for investment in new equipment and software. A more robust contour for final sales over the forecast horizon would

lead to somewhat greater pressure on resource margins, despite the expected strong growth of structural productivity, though the level of activity would remain below the economy's potential for some time. The persistence of underutilized resources was expected to foster some moderation in core price inflation.

In the Committee's discussion of current and prospective economic conditions, members commented that there had been little change since the May meeting in the factors bearing on what they viewed as a favorable outlook for a pickup in the expansion. Although financial markets, and perhaps business and household confidence, had been shaken by revelations of accounting irregularities, the economy had continued to expand and the prospects for accelerating aggregate demand remained positive. Some members observed, however, that they had expected to see firmer indications of a strengthening recovery by the time of this meeting. The degree of impetus from decelerating inventory liquidation and growth in final demand had moderated during the spring, and anecdotal and other evidence indicated that the performance of various industries and firms had remained uneven. Looking ahead, the timing and strength of an upturn in the expansion remained subject to considerable uncertainty, but in the absence of major further adverse shocks to confidence the members anticipated that economic activity would accelerate over coming months to a pace in the vicinity of, and perhaps somewhat above, the rate of growth of the economy's potential. In support of this view, members cited the accommodative stance of both fiscal and monetary policy and the continuation of impressive growth in productivity that should buttress household incomes

and spending and encourage a pickup in business investment. The strength in productivity also would help to hold down cost and price pressures and, given an economic expansion and resource utilization in line with the members' forecasts, would reinforce the prospect that core price inflation would remain low.

In preparation for the midyear monetary policy report to Congress, the members of the Board of Governors and the presidents of the Federal Reserve Banks submitted individual projections of the growth of GDP, the rate of unemployment, and the rate of inflation for the years 2002 and 2003. The forecasts of the rate of expansion in real GDP had central tendencies of  $3\frac{1}{2}$  to  $3\frac{3}{4}$  percent for 2002, implying growth in the second half of the year at a rate close to that currently estimated for the first half, and  $3\frac{1}{2}$  to 4 percent for 2003. These rates of growth were expected to keep the civilian rate of unemployment in a central tendency of  $5\frac{3}{4}$  to 6 percent in the fourth quarter of 2002 before it fell to  $5\frac{1}{4}$  to  $5\frac{1}{2}$  percent by the fourth quarter of 2003. Forecasts of the rate of inflation, as measured by the chain-type price index for personal consumption expenditures, pointed to little change from recent inflation levels and were centered on a range of  $1\frac{1}{2}$  to  $1\frac{3}{4}$  percent for both this year and 2003.

With imbalances in inventories apparently largely worked off and the contribution of inventory investment to the expansion likely diminishing in coming quarters, final demand would play its usual primary role in determining the strength of the expansion. In that regard, consumer spending was seen as likely to provide some continuing, though moderate, impetus to the growth of the economy. A favorable factor in this outlook cited by members was the ability and willingness of households to extract siz-

able financing resources for consumer and other expenditures by drawing on the appreciated equity in their homes in one form or another. The ample availability of credit to most consumers was another positive factor. Although consumer confidence as measured by national surveys recently had declined somewhat from relatively elevated levels, reports of strength in motor vehicle sales and in other retail sales in several parts of the nation in recent weeks suggested that consumer spending was continuing to be well maintained. The members recognized that a typical recovery-period surge in consumer spending was unlikely inasmuch as expenditures had registered solid growth through the economic downturn, implying an absence of significant pent-up demands. Moreover, forecasts of even moderate growth in spending were subject to downside risks emanating, for example, from possible further shocks to confidence and household wealth should weakness in stock prices persist, and from political turmoil overseas and threats of terrorism at home.

Homebuilding, though down after an unsustainable surge earlier in the year, had been well maintained in recent months. Recent statistics supported by widespread anecdotal reports pointed to persisting strength in housing activity, though there were indications of softness in high-priced homes in at least some parts of the country. Looking forward, members expected a high level of home construction to continue. A key factor in this outlook was the ready availability of mortgage financing to most borrowers at very attractive rates. Members also referred to growing population pressures, abetted by sizable immigration, on increasingly scarce buildable land in numerous areas. On balance, however, given its already robust level, housing was not seen as

likely to provide much added stimulus to the expansion.

A pickup in business spending was viewed as a key to sustained solid growth, and questions about the timing and strength of such a pickup was a major source of uncertainty about the pace of the expansion in coming quarters. The preconditions for a robust advance in investment spending appeared to be largely in place, including the evident progress over the past several quarters in adjusting capital stocks to desired levels, the temporary tax incentive, and the need for competitive reasons to take advantage of the availability of increasingly productive equipment. In fact, recent orders and shipments data suggested an upturn in spending for new equipment, but the improvement was still quite limited, unevenly distributed across industries, and not yet firmly indicative of a sustained advance. While the members expected further gains in spending on equipment, they continued to report widespread pessimism among their business contacts, though exceptions had begun to emerge, and the persistence of a high degree of caution that was leading business executives to defer numerous investment projects until they saw more conclusive evidence of stronger sales and profits.

The outlook for nonresidential construction activity remained bleak amid indications of a widespread overhang of available space and attendant declines in rents and property values. Indeed, the drop in such construction did not appear to have run its course for the nation as a whole. Even so, the ongoing adjustment of nonresidential capacity to demand had been substantial in recent quarters and likely would give way to a modest recovery during the year ahead.

For the economy as a whole, the liquidation of business inventories appeared

to be near completion in the current quarter, and some rebuilding in association with forecasts of moderate expansion in sales seemed a likely prospect for coming quarters. The restocking was expected to proceed gradually, given the probable persistence of a relatively high degree of uncertainty and caution in the business community. Such an outlook implied that inventory investment would supply positive but limited impetus to the expansion over the forecast horizon.

The federal tax cuts and large increases in federal spending legislated over the past year were expected to provide support for aggregate demand over the projection period. Some members expressed concern, however, about what they perceived to be the erosion of long-term fiscal discipline and increasing prospects that federal deficits would persist even after the economy recovered, with adverse effects on the domestic savings available for investment. Concurrently, however, at the state and local government level where budget flexibility was more limited, sizable budgetary shortfalls likely would hold down expenditures and induce some tax increases, with restraining effects over a period of time.

With regard to the outlook for the external sector of the economy, the sizable decline in the foreign exchange value of the dollar since the start of the year had given rise to market forecasts of appreciable further depreciation. The factors that governed the exchange value of the dollar were complex, and historically forecasts of trends in exchange rates had not been reliable. To the extent that the depreciation of the dollar was not reversed or that it continued, it would of course tend to boost net exports. Exports would in any event be likely to strengthen somewhat as a consequence of the evidently improving economies of a number of the nation's

important trading partners. Indeed, members provided anecdotal reports of better export markets for a number of U.S. products. At the same time, however, severe problems being experienced by a number of large countries in South America raised the specter of a deepening financial crisis within that region and the possibility of more widespread contagion.

Given their anticipation of strong productivity growth and continuing slack in labor and other markets, members expected inflation to remain low over the next several quarters. An underlying factor in the good inflation performance of recent years and its extension into the future was the continuing absence of pricing power throughout the economy, evidently related in part to increased price competition in markets around the world stemming from globalization. Members cited examples of rising prices for a few products, notably steel, and the possibility that energy prices might raise costs. They also referred to the potential for upward pressure on prices associated with the recent depreciation of the dollar. Nonetheless, with rising productivity and moderate wage gains likely continuing to help hold down unit labor costs, the outlook for subdued inflation remained promising, especially for the nearer term.

The discussion of the inflation outlook was held against the backdrop of an earlier consideration at this meeting of the factors behind the decline in inflation in the 1990s and the value of structural models for forecasting inflation. Most Committee members, while acknowledging the deficiencies of structural models, viewed them as useful in their efforts to understand how the inflation process was changing and also as input to inflation forecasts. The members saw greater productivity growth, changing labor markets, and increased

competition in product markets as having played a part along with monetary policy in lowering inflation. They agreed that more research—across countries as well as across time—was needed before they could become more confident about the value and stability of such models.

In the Committee's discussion of policy for the intermeeting period ahead, all the members agreed that recent developments argued for maintaining an unchanged policy stance, with the target for the federal funds rate remaining at  $1\frac{3}{4}$  percent. The members saw favorable prospects for a significant acceleration in the expansion from the reduced pace in the current quarter, but considerable uncertainty still surrounded the timing and strength of the pickup. In the current situation, retention of the currently accommodative policy stance was desirable to counter the lingering effects of financial and other shocks to the economy that were continuing to exert a depressing impact on output and resource use. Inflation was still edging down, inflation expectations appeared to be low and stable, and going forward the members' forecasts for growth and productivity implied that unit costs and prices would remain subdued for some time.

A number of members noted that the current policy stance was too accommodative to be consistent over time with the Committee's objectives of price stability and maximum sustainable economic growth. Economic performance in line with their current forecasts would at some point require an adjustment to policy toward a less accommodative stance once more definitive indications of sustained strengthening started to emerge. And given the lags in monetary policy such an adjustment would probably need to be made at a time when the incoming economic information was

still somewhat mixed. Still, in current circumstances, there was little risk of triggering an increase in inflation by waiting for a better reading on the course of the economy. Some members were concerned that markets might not fully appreciate the inevitability of eventual policy tightening. However, others pointed out that market participants seemed to have little doubt about the Committee's determination to keep inflation low and in that context markets were likely to anticipate Committee action once incoming information suggested it was becoming appropriate.

The members said that they could see risks on both sides of their forecasts, which indicated that growth would pick up and inflation would remain low over coming quarters at the current stance of policy. Accordingly, they agreed to retain an assessment of balanced risks to their long-term objectives in the Committee's post-meeting press release. Such a statement would not be an impediment to adjusting policy should a significant and unanticipated change in economic conditions materialize in the near term.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around  $1\frac{3}{4}$  percent.

The vote encompassed approval of the sentence below for inclusion in the



press statement to be released shortly after the meeting:

Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks are balanced with respect to prospects for both goals in the foreseeable future.

Votes for this action: Messrs. Greenspan, McDonough, Ms. Bies, Messrs. Ferguson, Gramlich, Jordan, McTeer, Olson, Santomero, and Stern. Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, August 13, 2002.

The meeting adjourned on June 26, 2002, at 11:40 a.m.

Vincent R. Reinhart  
Secretary

### Meeting Held on August 13, 2002

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, August 13, 2002, at 9:00 a.m.

*Present:*

Mr. Greenspan, Chairman  
Mr. McDonough, Vice Chairman  
Mr. Bernanke  
Ms. Bies  
Mr. Ferguson  
Mr. Gramlich  
Mr. Jordan  
Mr. Kohn  
Mr. McTeer  
Mr. Olson  
Mr. Santomero  
Mr. Stern

Messrs. Broaddus, Guynn, Moskow,  
and Parry, Alternate Members  
of the Federal Open Market  
Committee

Mr. Hoenig, Ms. Minehan, and  
Mr. Poole, Presidents of the  
Federal Reserve Banks of  
Kansas City, Boston, and  
St. Louis respectively

Mr. Reinhart, Secretary and Economist  
Mr. Bernard, Deputy Secretary  
Mr. Gillum, Assistant Secretary  
Ms. Smith, Assistant Secretary  
Mr. Mattingly, General Counsel  
Ms. Johnson, Economist  
Mr. Stockton, Economist

Mr. Connors, Ms. Cumming,  
Messrs. Howard and Lindsey,  
Ms. Mester, Messrs. Oliner,  
Rolnick, and Wilcox, Associate  
Economists

Mr. Kos, Manager, System Open  
Market Account

Mr. Winn, Assistant to the Board,  
Office of Board Members,  
Board of Governors

Messrs. Ettin and Madigan, Deputy  
Directors, Divisions of Research  
and Statistics and Monetary  
Affairs respectively, Board  
of Governors

Messrs. Slifman and Struckmeyer,  
Associate Directors, Divisions  
of Research and Statistics,  
Board of Governors

Mr. Whitesell, Deputy Associate  
Director, Division of Monetary  
Affairs, Board of Governors

Mr. Clouse, Assistant Director,  
Division of Monetary Affairs,  
Board of Governors

Mr. Simpson, Senior Adviser, Division  
of Research and Statistics,  
Board of Governors

Mr. Skidmore, Special Assistant  
to the Board, Office of Board  
Members, Board of Governors

Ms. Low, Open Market Secretariat  
Assistant, Office of Board  
Members, Board of Governors

Messrs. Connolly and Stewart,  
First Vice Presidents, Federal  
Reserve Banks of Boston and  
New York

Messrs. Goodfriend, Hakkio, Hunter,  
and Rasche, Senior Vice  
Presidents, Federal Reserve  
Banks of Richmond, Kansas City,  
Chicago, and St. Louis  
respectively

Messrs. Bryan, Cox, and Cunningham,  
Ms. Hargraves,  
Messrs. Rudebusch and Tootell,  
Vice Presidents, Federal Reserve  
Banks of Cleveland, Dallas,  
Atlanta, New York, San Francisco,  
and Boston respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on June 25–26, 2002, were approved.

By unanimous vote, Vincent R. Reinhart was elected as Secretary and Economist of the Committee for the period until the first regularly scheduled meeting in 2003.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period June 26, 2002, through August 12, 2002. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook and the conduct of monetary policy over the intermeeting period ahead.

The information reviewed at this meeting indicated that economic activity expanded only slightly in the second quarter. Businesses added a bit to their inventory positions after an extended period of sizable declines, but final sales changed little: business capital spending weakened somewhat further while growth in consumer spending, residential housing expenditures, and government outlays slowed. The scant information available for the third quarter, principally July's very strong motor vehicle sales, suggested that domestic demand was still recovering but relatively sluggishly. Industrial production had continued to advance since the first quarter, but the demand for labor services had increased only slightly and the unemployment rate had risen. Importantly, labor productivity continued on a strong upward trend. Overall price inflation had fallen sharply over the past year, largely reflecting developments in the food and energy sectors, and core inflation had eased a little.

Private nonfarm payroll employment inched up in July after a mild increase in June, though aggregate hours worked by production or nonsupervisory workers declined steeply. The help-supply portion of the services sector and the construction industry recorded substantial net job losses over the June–July period, but manufacturing registered its smallest payroll decline in two years in July, and hiring was relatively brisk in services other than help-supply. The civilian unemployment rate edged up in June, to 5.9 percent, and was unchanged in July.

Industrial production jumped in June, and gains in output were widespread across market groups and industries. However, the limited available information indicated that output leveled out in July after six consecutive months of increases. Capacity utilization in manu-

facturing moved a little higher in June but remained substantially below its long-run average.

Retail sales were relatively brisk in June and July despite plunging equity prices and an apparently marked erosion in consumer confidence. Households spent heavily on motor vehicles in response to incentives offered by auto manufacturers, and their expenditures on other retail categories were generally well maintained.

Residential housing activity remained strong in the second quarter, buoyed by a very favorable mortgage financing environment. The pace of homebuilding in the quarter continued well above that seen during the past few years even though single-family housing starts in June did not reach the elevated May level. Sales of new single-family homes in June remained at a record high, but sales of existing homes declined noticeably. In the multifamily sector, June starts were in the lower end of their range over recent quarters. Market conditions in the condominium and cooperative apartment portion of the housing sector appeared to be favorable, but rising vacancy rates and weaker rents apparently hindered the rental apartment segment.

Business investment in equipment and structures declined further in the second quarter as the continuing downturn in nonresidential construction more than offset a pickup in business spending for durable equipment and software. Despite gradually improving fundamentals—rising output and profits, new tax incentives, and a low cost of capital—firms remained cautious about stepping up their investments in equipment and software, and recent data on orders and shipments of nondefense capital goods coupled with anecdotal reports suggested further lackluster gains in spending in coming months. In

the nonresidential construction sector, outlays for office, industrial, and other structures, lodging facilities, and public utilities declined substantially further. By contrast, construction of institutional structures was up again in the second quarter.

Nonfarm inventory investment turned slightly positive in the second quarter after several quarters of heavy liquidation. Success in pruning inventories had resulted in inventory–sales ratios that generally were at very low levels across the manufacturing, wholesale, and retail sectors. There appeared to be only a few industries with still sizable inventory overhangs.

The U.S. trade deficit in goods and services widened further in May and for the April–May period. The expansion of the deficit over the two months reflected a sharp rise in the value of imports that exceeded a sizable gain in the value of exports. The step-up in imports was spread widely across almost all the major trade categories, with notable increases in motor vehicles, consumer goods, and machinery. The advance in exports was primarily in automotive parts, industrial supplies, and capital equipment. With regard to economic activity abroad, the available information, which is released in many cases only with a considerable lag, indicated that foreign economic output generally continued to rebound during the first half of the year, though the pace of recovery was uneven across regions and countries. Growth was strong in Canada, the United Kingdom, and emerging Asia, but expansion in the euro area and Japan remained sluggish, owing to continued weakness in final domestic demand. In South America, economic and financial conditions had deteriorated significantly during the intermeeting period, especially in Brazil and Uruguay, and economic activity remained

particularly weak in Argentina and Venezuela.

Consumer price inflation trended down over the past year. Much of the drop reflected developments in the food and energy sectors, but core inflation also eased a little. In May and June, both the consumer price and the chain-weighted personal consumption indexes exhibited little change in total and core prices. Moreover, at the producer level, inflation in core finished goods was at a low rate in the May–June period and the past twelve months. With regard to labor costs, the employment cost index for hourly compensation of private industry workers increased at a somewhat faster rate during the three months ended in June, reflecting a surge in benefit costs. From a somewhat longer perspective, however, growth of compensation costs over the twelve months ended in June was the same as in the previous twelve-month period.

At its meeting on June 25–26, 2002, the Committee adopted a directive that called for maintaining conditions in reserve markets consistent with keeping the intended level of the federal funds rate at  $1\frac{3}{4}$  percent, and it also retained a neutral balance of risks statement. There was little market reaction to the Committee's rate decision or its statement. Instead, market participants focused their attention on further revelations of corporate malfeasance, fears that more earnings restatements would be announced in the run-up to the August 14 deadline for certifying corporate financial statements, and concerns that second-half corporate earnings might prove disappointing. In this environment, equity prices plunged before recovering somewhat later in the intermeeting period; on net, the major broad equity indexes were down substantially. Yields on Treasury securities also fell markedly on balance in volatile

trading, as investors sought a safe haven for their funds and trimmed their expectations about the path for the intended federal funds rate in coming quarters. However, doubts about corporate balance sheets and the prospects for earnings growth led to steep increases in corporate debt yields, particularly for lower-quality issues.

In foreign exchange markets, the trade-weighted value of the dollar changed little on balance in terms of the major foreign currencies over the intermeeting period, though early in the period the dollar declined sharply against those currencies amid further disclosures of U.S. corporate accounting irregularities and concerns about the strength of the U.S. recovery. Against the background of a similar combination of disappointing concerns, European stock prices dropped more than those in the United States, while Japanese equity prices declined less as incoming data seemed to point to a mild pickup of economic activity in Japan. Across all the major industrial economies, investors tended to shift funds toward less risky instruments and to lower their expectations for policy rates. The dollar also was little changed on balance against the index of currencies of other important trading partners, even though several South American countries were experiencing difficult financial and political problems.

Borrowing by domestic nonfinancial businesses had been weak recently, likely reflecting deteriorating conditions in credit markets and reduced requirements for funds to finance capital spending projects. Growth of M2 surged in July in association with large inflows to liquid deposits and retail money market funds.

The staff forecast prepared for this meeting suggested that, in light of weaker-than-expected incoming eco-

conomic data, the expansion of economic activity would pick up gradually over the next year and a half from the very sluggish pace of the second quarter. The considerable monetary ease and fiscal stimulus already in place and the continuing sizable gains in structural productivity would provide significant impetus for spending, though the persisting volatility and weakness in equity prices would tend to offset some of that support. Inventory overhangs appeared to have been largely eliminated and business capital stocks to have moved closer to desired levels. As a consequence, a gradually improving outlook for sales and profits, low financing costs, and the temporary federal tax incentive for investment in new equipment and software were expected to boost business investment spending. However, a less robust pickup in final sales was now expected over the forecast period, which would put somewhat less pressure on resource margins than had been anticipated previously, and the level of activity would remain below the economy's potential for a somewhat longer time. The persistence of underutilized resources was expected to foster some moderation in core price inflation.

In the Committee's discussion of current and prospective economic developments, members commented that much of the incoming information on economic activity had been disappointing, and many indicated that they had marked down their growth forecasts for the months ahead. Even so, with recent weakness concentrated in volatile high-frequency data that might well prove to be transitory and with business and consumer confidence unlikely to deteriorate further in the absence of a major shock to the economy, members continued to place favorable odds on an underlying outlook of strengthening expansion. Factors cited for this positive outlook

included the stimulative stances of fiscal and monetary policy, the apparent completion in most industries of efforts to bring inventories and capital facilities into desired alignment with expected sales, and the support to consumer incomes and business incentives provided by the continued rise in structural productivity. Further gains in productivity and the prospect for relatively contained demand pressures on resources, which were likely to be somewhat more limited for a time than members had anticipated earlier, would contribute to keeping price inflation subdued.

A number of members commented on financial developments that appeared to be holding back the pace of the expansion. While prices in equity markets had turned up from their recent lows, the cumulative losses in financial wealth incurred since early 2000 clearly were having an adverse impact on expenditures by households and the higher cost of equity capital was inhibiting business investment. The declines in equity prices had been accompanied by a heightened degree of risk aversion that had led to widened credit spreads in financial markets and the curtailment of credit availability to potential borrowers whose repayment prospects were viewed as questionable. To an extent that was difficult to determine, the current skittishness in debt and equity markets reflected lender and investor reactions to the ongoing revelations of corporate governance failures. Those reactions, which were proving to be more severe and probably would be longer-lasting than many had anticipated, appeared to be contributing to more cautious business spending and hiring, at least temporarily. It was unclear when the associated uncertainties would diminish and confidence would begin to rebuild, though the outlook might come into better focus

after the mid-August SEC deadline for the certification of financial statements by corporate executives. On the positive side, home mortgage financing remained widely available at low interest rates and was providing important support to household spending. More generally, interest costs had declined for borrowers with acceptable credit ratings, and the overall condition of the banking system remained sound with bank credit widely available. Moreover, for many households, the negative wealth effects stemming from losses on equities were offset, at least to some extent, by continuing increases in home equity values. These ongoing factors suggested to some members that the effects of the financial restraints on economic activity might be fairly limited at this point.

In their review of demand prospects in key sectors of the economy, members noted that household spending was continuing to play a key role in sustaining the expansion. Retail sales, buttressed by strength in motor vehicles, had been well maintained in recent months despite survey evidence of declining consumer confidence. The extraction of funds from increases in home equity evidently remained an important source of financing for household expenditures, especially including outlays for home modernization. Looking ahead, the anticipated pickup in employment and related gains in incomes, undergirded by continued robust growth in structural productivity, was seen as supporting further expansion in consumer spending. Some members commented, however, that the declines in equity wealth and the possible persistence of turmoil in equity markets might continue to restrain the pickup in consumer expenditures in the months ahead.

In the housing sector, low mortgage interest rates remained a key factor in

sustaining homebuilding activity at a relatively elevated level. Housing markets continued to exhibit strength across much of the country, with few indications of any moderation except for sales of high-priced homes. It was noted that, in the absence of an unanticipated downturn in general economic activity, underlying pressures for housing as the population expanded coupled with the scarcity of viable homebuilding sites in urban areas likely would preclude any substantial decline in housing activity or housing prices in the foreseeable future.

The weakness in business fixed investment was still a depressant on overall economic activity, though the decline in business outlays had abated since the latter part of 2001; indeed, spending for equipment and software had edged up in the second quarter. With excess stocks of capital inventories seemingly worked down to more acceptable levels in many industries and with expansion in final sales expected to become more firmly established, an acceleration in spending for equipment and software was likely in store. As they had at earlier meetings, however, members observed that business sentiment remained extraordinarily cautious on the whole and that business firms in most industries continued to direct their investment spending primarily toward enhancing the productivity of their operations rather than also increasing capacity. Exceptions cited by members included the enlargement of production facilities by some firms in industries that were currently enjoying vigorous demand, such as producers of motor vehicles. How soon the gloom surrounding the outlook for a pickup in sales and profits and the associated concerns in financial markets would dissipate was subject to substantial uncertainty, but increasing needs for capital as the economy continued to expand, further

growth in investment opportunities in conjunction with the uptrend in structural productivity, and the temporary tax incentive provision for equipment and software likely would support a sustained recovery in investment expenditures over coming quarters that would provide essential impetus for lifting economic growth.

The prospects for an upturn in non-residential construction appeared to many to be more bleak. Reports from around the nation pointed to high, and in many areas still rising, vacancy rates for commercial and industrial space, and hotel construction continued to be held down by the problems afflicting the travel industry. Against this backdrop, overall nonresidential building activity seemed likely to decline further over the next several quarters.

Business inventories edged up in the second quarter after declining persistently since early 2001. Indeed, the strengthening was sufficient to account for the small advance in GDP in the latest quarter. With inventories now apparently close to desired levels in many sectors of the economy and reportedly below such levels for some retailers, the expected strengthening in final sales would probably foster some inventory accumulation over coming quarters, thereby adding impetus to the projected growth of the economy.

Government spending also was expected to provide ongoing stimulus to the expansion, especially given the prospects for further spending initiatives in forthcoming federal legislation. In addition, already enacted income tax cuts and the tax expensing provision for certain investment outlays would help to support both consumer and business expenditures. Concurrently, though, state and local governments facing large shortfalls in revenues in a sluggish economy were holding down the overall

growth in their expenditures. Anecdotal reports suggested, however, that sizable spending on a variety of construction projects was continuing, financed in part through bond issues. On balance, the government sector was expected to remain a positive factor in the economic recovery.

The depreciation of the dollar and overall strengthening in foreign economic activity were projected to foster moderate added growth in U.S. exports over the next several quarters. However, recent developments, including indications of weaker-than-projected economic recovery in Europe, growing questions about the outlook for several important economies in South America, and the continued sluggish performance of the Japanese economy, threatened to limit the improvement in exports, at least over the nearer term. Providing a partial counterweight were anecdotal reports indicating sizable growth in U.S. exports to a number of Asian countries.

The outlook for inflation remained very favorable in the context of continuing slack in labor markets and robust growth in structural productivity. Under these conditions, increases in trend unit labor costs were likely to remain subdued over the next several quarters despite likely further escalation in the cost of worker healthcare benefits. Indeed, the risks of any significant run-up in inflation appeared to have receded, and more time than anticipated earlier was likely to elapse before the expansion reached a pace that would begin to reduce margins of underutilized labor and other producer resources. Even so, examples of rising cost and price pressures were not entirely absent. In addition to healthcare insurance costs, these pressures included insurance costs more generally, steel prices, some materials costs, and, in association with the dollar's depreciation, some upward

pressures on import prices. On balance and barring a major supply shock to the economy, members saw little reason for concern about the prospect of an increase in inflation in the foreseeable future.

In the Committee's discussion of policy for the intermeeting period ahead, all the members were in favor of an unchanged policy stance consistent with retaining a target rate of 1¾ percent for the federal funds rate. Although some economic and financial indicators had deteriorated since the June meeting and the members generally had scaled down their economic forecasts, they continued to see favorable prospects for a strengthening economy over time. To be sure, a further significant weakening in economic prospects—for example, that might be associated with additional deterioration in financial markets—might well call for a policy response, but for now the members viewed the current degree of monetary accommodation as appropriately calibrated to provide the stimulus needed to foster a solid expansion that would bring the economy to fuller resource utilization.

All the members indicated that they could accept, and most said they preferred, a proposal to shift the Committee's assessment of the risks to the economy from the currently neutral statement to one that was tilted toward weakness in the foreseeable future. A few expressed a preference to retain the current balanced risks statement for the press release to be issued shortly after this meeting. In support of this view, they underscored the considerable uncertainty surrounding the outlook for financial and economic conditions and the prospect that many observers in financial markets could misread a shift in the Committee's assessment of the risks to the outlook as a signal that the

Committee was contemplating easing in the near term. All the members agreed, however, on the desirability of communicating in some form—whether in the text of the post-meeting press release or through a shift in the risks statement or both—their view that the expansion recently had been less robust than expected and that for the foreseeable future the risks of a more extended period of subpar growth had increased while those of inflation had declined. Several also commented that while the shift under consideration might raise expectations of some easing in coming months, those expectations and related market adjustments would be shaped principally by the tenor of the incoming economic information.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 1¾ percent.

The vote encompassed approval of the sentence below for inclusion in the press statement to be released shortly after the meeting:

Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future.



Votes for this action: Messrs. Greenspan, McDonough, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Jordan, Kohn, McTeer, Olson, Santomero, and Stern. Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, September 24, 2002.

The meeting adjourned at 12:40 p.m.

Vincent R. Reinhart  
Secretary

### Meeting Held on September 24, 2002

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, September 24, 2002, at 9:00 a.m.

*Present:*

Mr. Greenspan, Chairman  
Mr. McDonough, Vice Chairman  
Mr. Bernanke  
Ms. Bies  
Mr. Ferguson  
Mr. Gramlich  
Mr. Jordan  
Mr. Kohn  
Mr. McTeer  
Mr. Olson  
Mr. Santomero  
Mr. Stern

Messrs. Broaddus, Guynn, Moskow, and Parry, Alternate Members of the Federal Open Market Committee

Mr. Hoinig, Ms. Minehan, and Mr. Poole, Presidents of the Federal Reserve Banks of Kansas City, Boston, and St. Louis respectively

Mr. Reinhart, Secretary and Economist  
Mr. Bernard, Deputy Secretary  
Mr. Gillum, Assistant Secretary  
Mr. Mattingly, General Counsel

Mr. Baxter, Deputy General Counsel  
Ms. Johnson, Economist  
Mr. Stockton, Economist

Messrs. Connors, Howard, and Lindsey, Ms. Mester, Messrs. Oliner, Rolnick, Rosenblum, Sniderman, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Messrs. Ettin and Madigan, Deputy Directors, Divisions of Research and Statistics and Monetary Affairs respectively, Board of Governors

Messrs. Slifman and Struckmeyer, Associate Directors, Division of Research and Statistics, Board of Governors

Mr. Whitesell, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Mr. Clouse, Assistant Director, Division of Monetary Affairs, Board of Governors

Mr. Simpson, Senior Adviser, Division of Research and Statistics, Board of Governors

Mr. Skidmore, Special Assistant to the Board, Office of Board Members, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Moore, First Vice President, Federal Reserve Bank of San Francisco

Messrs. Eisenbeis, Fuhrer, Hakkio, Judd, Lacker, and Steindel, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Boston, Kansas City, San Francisco, Richmond, and New York respectively

Messrs. Coughlin, Elsasser, and Sullivan, Vice Presidents, Federal Reserve Banks of St. Louis, New York, and Chicago respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on August 13, 2002, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period August 13, 2002, through September 23, 2002. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook and the conduct of monetary policy over the intermeeting period ahead.

The information reviewed at this meeting indicated that the economy continued to expand in the third quarter, though the tenor of incoming reports was mixed. Data on household and business spending had been solid for the most part, and residential construction remained high. Motor vehicle production provided a sizable boost to economic activity, but other factory output changed little on net. Employment continued to expand unevenly, while labor productivity remained on a strong upward trend. Overall price inflation had fallen over the past year, reflecting favorable developments in the food and energy sectors and a decline in core inflation.

Aggregate labor market conditions had been mixed in recent months. While nonfarm payroll employment registered further small gains in July and August, the aggregate hours worked by production or nonsupervisory workers declined on balance over the two-month period. The manufacturing and retail trade sectors registered sharp job losses in August, but those were more than offset by hiring in the services and construction sectors. A hefty increase in government jobs at the federal, state, and local levels also boosted payroll employment. The civilian unemployment rate fell to 5.7 percent in August despite advances in claims for unemployment insurance.

Industrial production declined in August, largely offsetting July's rise. Excluding motor vehicles, manufacturing output was unchanged in both July and August after sizable advances in the first half of the year. Production in the high-tech sector jumped in August, the manufacture of aircraft and parts fell further, and output in the remainder of the industrial sector was mixed. Capacity utilization in manufacturing changed little in August and was substantially below its long-run average.

Retail sales remained relatively brisk in August despite further decreases in stock prices and consumer confidence. Households boosted their already high level of spending on motor vehicles in response to zero percent financing and larger cash incentives offered by auto manufacturers, and household purchases of goods other than motor vehicles continued to advance at a moderate pace. According to the latest available data, outlays for services rose moderately in July.

Residential housing activity slowed a little in July and August from the robust pace of the second quarter as further declines in mortgage rates apparently helped to support housing activity in

an environment of sluggish employment and diminishing household wealth. Starts of single-family units fell in August to their lowest rate since last November, while starts in the multi-family sector in the July–August period were at their average rate for the first half of the year. Sales of new single-family homes posted a record high in July, and the inventory of unsold new homes remained low. Sales of existing single-family homes in July partially retraced a large drop in June.

Based on the limited information available, business investment in equipment and software seemed to be advancing at a solid pace in the third quarter. This reflected an acceleration in spending that was associated importantly with notably stronger motor vehicle sales and a halt to the contraction in aircraft expenditures. Outside the transportation sector, outlays on equipment continued to expand at a moderate pace; in addition, the level of orders in July (latest data) moved above shipments for the first time since early last year, and the backlog of unfilled orders edged up. Nonresidential construction activity remained on a steep downtrend in July, with further reductions of spending in all major categories except office buildings.

The book value of manufacturing and trade inventories excluding motor vehicles registered a second straight monthly gain in July after many months of heavy liquidation. Despite the rise in stocks, gains in sales and shipments drove inventory–sales ratios to even lower levels across the manufacturing, wholesale, and retail sectors. Survey and anecdotal information suggested that few industries were burdened with sizable inventory overhangs.

The U.S. trade deficit in goods and services narrowed appreciably in July after two quarters of large increases.

The smaller deficit in July reflected continued strong expansion of the value of exports coupled with a decrease in the value of imports. The step-up in goods exports occurred mostly in motor vehicles and aircraft, while the gain in exports of services was spread across travel and other private services. The decline in imports was concentrated in consumer and capital goods, royalties, and license fees. The very limited available information on economic activity abroad in the third quarter suggested continued sluggish expansion in the euro area and Japan, moderate growth in the United Kingdom, further brisk recovery in Canada, and ongoing recovery in emerging Asia. Conditions in South America remained fragile: Economic activity was still very weak in Argentina and Venezuela, and the Brazilian economy had been adversely affected by the turbulence in financial markets, though those markets had stabilized recently. By contrast, Mexico experienced brisk growth in the second quarter.

Despite a slight pickup in consumer price inflation in August, the increase in consumer prices (measured by either the consumer price index or the chain-indexed personal consumption expenditure index) for the year ending in August was considerably smaller than that for the previous twelve-month period. Much of the drop in inflation reflected developments in the food and energy sectors, but core inflation also declined noticeably. Producer prices for core finished goods likewise signaled a drop in inflation over the last year. With regard to labor costs, average hourly earnings of production or nonsupervisory workers decelerated sharply over the twelve months ended in August, reflecting the effects of both the rise in unemployment and the drop in consumer price inflation.

At its meeting on August 13, 2002, the Committee retained a directive that

called for maintaining conditions in reserve markets consistent with keeping the intended level of the federal funds rate at 1¾ percent, but it shifted from a statement of a neutral balance of risks to one that was tilted toward economic weakness in the foreseeable future. Market participants read the tilt and the wording of the announcement as indicating that economic activity in the coming months likely would be weaker than had been expected, and some short-term interest rates eased slightly while broad indexes of equity prices moved lower. The following day's deadline for the recertification of corporate financial statements passed uneventfully and equity markets rallied. Subsequently, however, a weaker tone to incoming data on production and employment, a gloomier outlook for business profits, and heightening tensions over Iraq seemed to lead investors to revise down their outlook for the economy. Over the intermeeting period, intermediate- and longer-term Treasury security yields and broad equity indexes fell considerably on balance.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the major foreign currencies appreciated slightly on balance over the intermeeting period as projections for growth of foreign industrial countries, particularly Germany and Japan, were marked down more than those for the United States. The dollar moved within narrow ranges against most major currencies but rose somewhat against the yen and the currencies of other important trading partners.

M2 growth remained elevated in August, though somewhat below July's rapid pace. Much of the strength of the aggregate's liquid components likely was associated with the continuing historically low opportunity costs of holding such deposits, the recent surge

in mortgage refinancing activity, and the safe haven provided from volatile equity prices. Borrowing by domestic nonfinancial businesses remained weak, likely reflecting reduced requirements for funds to finance capital spending projects and perhaps the improved tone in the corporate bond market and a modest increase in the issuance of corporate debt.

The staff forecast prepared for this meeting suggested that, in light of weaker-than-expected incoming economic data, the expansion of economic activity would pick up more gradually but would still reach a relatively brisk pace late next year. The considerable monetary ease and fiscal stimulus already in place, continuing gains in structural productivity, and improving business confidence would provide significant impetus for spending. Inventory overhangs appeared to have been largely eliminated, and business capital stocks appeared to have moved closer to desired levels. As a consequence, a gradually improving outlook for sales and profits, low financing costs, and the temporary federal tax incentive for investment in new equipment and software were expected to boost business investment spending. However, a less robust pickup in final sales was now expected over the forecast period, which would put somewhat less pressure on resource margins than had been anticipated previously, and the level of activity would remain below that of the economy's potential for a longer time. The persistence of underutilized resources was expected to foster some moderation in core price inflation.

In the Committee's discussion of current and prospective economic conditions, members commented that economic growth appeared to have picked up in the third quarter but that the most recent information had been mixed, rais-

ing questions about whether the pace of the expansion going forward would be strong enough to erode margins of underutilized labor and capital resources. For now, a high degree of business caution in the context of substantial uncertainties, exacerbated recently by apparently increased concerns about the geopolitical outlook, continued to restrain business investment and hiring. Even so, the economy appeared to be well positioned for solid gains over time in light of the progress that had been made in bringing inventories and capital stocks into better alignment with sales, the stimulus provided by accommodative fiscal and monetary policies, and the implications of the strong uptrend in productivity for profitable investment opportunities and growth in consumer incomes. With the growth of economic activity nonetheless expected to remain below the economy's potential for some time, pressures on labor and other resources would be limited and in turn wage and price increases likely would continue to edge lower.

In their review of developments in and prospects for key sectors of the economy, members commented that household spending had continued to be well maintained. Buttressed by exceptional strength in sales of motor vehicles, consumer spending had displayed solid growth during the summer months. While survey indicators of consumer confidence had declined this year, the high levels of consumer spending on homes, motor vehicles, and other big-ticket items were, in the view of at least some members, perhaps a better gauge of consumer confidence. The value of homes had continued to rise in most areas, and unusually low interest rates were inducing people to refinance mortgages and in the process to extract and spend some of the embedded equity

gains. Increasing home equity values probably were also providing some counterweight to the impact on consumer spending of the negative wealth effects associated with the declines in stock market prices since the spring of 2000. Other positive factors cited as helping to undergird the persisting strength in consumer spending included reductions in federal income tax rates; the availability of financing for consumer durable goods at relatively attractive interest rates, including zero interest rates for selected motor vehicles; and the cumulative effects of productivity gains on current and expected real consumer incomes. Looking ahead, sales of motor vehicles likely would moderate to some extent over coming months from their currently unsustainable levels, and some members referred to indications of slower growth in retail sales in late summer and somewhat downbeat forecasts for coming months reported by a number of retailer contacts. Moreover, the absence of significant growth in employment, should it persist, could at some point have significant adverse repercussions on consumer spending. On balance, consumer spending was seen as likely to remain a positive but possibly a more limited source of support for the expansion over the next several quarters.

In the context of sustained growth in incomes, low mortgage interest rates, by facilitating the extraction of homeowners' equity, had played a key role in inducing a high level of spending on residential structures and home improvement expenditures. Tending to confirm currently available data on housing activity, members cited persisting anecdotal reports of robust home sales and residential construction in many regions, though indications of softening were noted in some areas and market segments, particularly in the

high-price sector of the housing market. Some members questioned whether generally rising housing prices and elevated levels of refinancings would persist. However, given the anticipated continuation of accommodative conditions in mortgage markets and forecasts of rising incomes, the overall outlook for housing remained favorable.

Business fixed investment remained a significant question mark in the outlook for economic expansion. Recent readings on business spending for equipment and software pointed to gradual improvement, but nonresidential construction activity continued to be severely depressed in many areas. It was unclear whether the recent strength in orders and shipments signaled a significant acceleration in capital outlays, and in this regard the new information that would become available in the next few weeks might provide important evidence on the outlook for capital spending and thus for the performance of the economy more generally. At least for now, however, anecdotal reports suggested that a high degree of caution continued to characterize business investment decisions in the face of an elevated level of uncertainty. Much of the current spending for equipment and software reportedly represented replacement demand largely associated with the short useful lives of various types of equipment, and there appeared to be little spending that would entail capital deepening. At the same time, several positive factors in the outlook for capital spending could be cited including the greater productivity of new capital equipment, the temporary accelerated expensing tax incentives, generally strong business cash positions, and the relatively rapid depreciation of existing capital equipment. For the present, however, business contacts widely reported that because of prevailing uncertainties they were

deferring major investment initiatives until they saw clear evidence of an increased need for capital to meet growing demand.

Business firms appeared to be in the process of moving from inventory liquidation to accumulation, and the available evidence suggested that inventory positions were getting tighter. Accordingly, prospective growth in final demand would have to be met through increased production. And as demand rose over the next several quarters, businesses were expected to accumulate inventories to maintain desired inventory–sales ratios, adding in the process some limited impetus to the growth of GDP.

The growth of economic activity in most major foreign countries appeared to be falling below expectations earlier in the year, with adverse implications for U.S. exports. Among those nations, only Canada had experienced a robust economic recovery thus far this year. Current forecasts continued to anticipate strengthening activity abroad, but as in the case of the U.S. economy substantial uncertainties surrounded the timing and pace of the improvement.

In the context of limited demand pressures on labor and other resources, current forecasts continued to point to quite low and perhaps declining inflation over the next several quarters, although there appeared to be significant crosscurrents in the outlook for prices. Rapid increases in healthcare and other insurance costs and the lagged passthrough of large increases in oil prices would tend to maintain upward pressure on prices. Tending to oppose those forces, though, were the effects on resource use of an extended period of economic activity below the economy's potential as well as the effects of robust productivity gains on costs, apparently declining inflation expectations, and the per-

sistent absence of pricing power in highly competitive markets. Indeed, the members did not rule out the emergence of appreciably lower inflation. In this regard, some observed that a significant decline in inflation from current levels could imply an unwelcome tightening of monetary policy in real terms. In addition, further sizable disinflation that resulted in a nominal inflation rate near zero could create problems for the implementation of monetary policy through conventional means in the event of an adverse shock to the economy that called for negative real policy interest rates.

In the Committee's discussion of policy for the intermeeting period ahead, all but two of the members endorsed a proposal to maintain an unchanged policy stance. In the view of all the members, current forecasts clearly were subject to the risk that economic growth would not be sufficient to reduce excess capacity in labor and capital markets. However, the members who favored a steady policy course noted that the recent data on household and business spending had been a bit stronger than expected and that a number of factors pointed to solid growth over time. In these circumstances, they believed that in the context of prevailing uncertainties more evidence of subpar expansion was desirable before policy was eased further. It was noted in this regard that the information that would become available over the next several weeks should provide an improved basis for assessing the recent anecdotal reports from around the nation that pointed to a possibly slowing expansion. Several members indicated that if compelling evidence of a weak economy were to materialize they would be prepared to ease promptly. Two members preferred an immediate easing action because they were persuaded by what they viewed as

already strong evidence of a persisting unsatisfactory, and perhaps weakening, economic performance. While the current stance of policy was already accommodative, they felt that greater stimulus was now called for to foster an acceptable pace of economic expansion.

All the members agreed that the risks to the economy remained tilted toward weakness and that such an assessment needed to be incorporated in the statement to be released shortly after today's meeting. The members also accepted a proposal to add a reference in the statement regarding what they viewed as recently heightened geopolitical risks that appeared to constitute a major source of the uncertainty currently prevailing in the economy. The addition was not intended to signal that any particular policy response would be forthcoming in the event of a crisis. Rather, consistent with its usual practice, the Committee would assess the implications of any such development for the domestic economy before deciding on an action. Indeed, if the geopolitical uncertainties were to ease significantly along with what already were apparently diminishing concerns about corporate governance issues, the resulting improvement in business and consumer sentiment could generate a more robust economic expansion.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the

federal funds rate at an average of around 1¾ percent.

The vote encompassed approval of the sentence below for inclusion in the press statement to be released shortly after the meeting:

Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks continue to be weighted mainly toward conditions that may generate economic weakness in the foreseeable future.

Votes for this action: Messrs. Greenspan, McDonough, Bernanke, Ms. Bies, Messrs. Ferguson, Jordan, Kohn, Olson, Santomero, and Stern. Votes against this action: Messrs. Gramlich and McTeer.

Messrs. Gramlich and McTeer dissented because they preferred to ease monetary policy at this meeting. The economic expansion, which resumed almost a year ago, had recently lost momentum, and job growth had been minimal over the past year. With inflation already low and likely to decline further in the face of economic slack and rapid productivity growth, the potential cost of additional stimulus seemed low compared with the risk of further weakness.

It was agreed that the next meeting of the Committee would be held on Wednesday, November 6, 2002.

The meeting adjourned at 1:30 p.m.

### Notation Vote

By notation vote completed on September 30, 2002, the Committee authorized Vice Chairman McDonough to accept the “Decoration of Merit” honor to be awarded by the government of Argentina.

Votes for this action: Messrs. Greenspan, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Jordan, Kohn, McTeer, Olson, Santomero, and Stern. Votes against this action: None. Abstention: Mr. McDonough.

Vincent R. Reinhart  
Secretary

### Meeting Held on November 6, 2002

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Wednesday, November 6, 2002, at 9:00 a.m.

#### *Present:*

Mr. Greenspan, Chairman  
Mr. McDonough, Vice Chairman  
Mr. Bernanke  
Ms. Bies  
Mr. Ferguson  
Mr. Gramlich  
Mr. Jordan  
Mr. Kohn  
Mr. McTeer  
Mr. Olson  
Mr. Santomero  
Mr. Stern

Messrs. Broadus, Guynn, Moskow,  
and Parry, Alternate Members  
of the Federal Open Market  
Committee

Mr. Hoenig, Ms. Minehan, and  
Mr. Poole, Presidents of the  
Federal Reserve Banks of  
Kansas City, Boston, and  
St. Louis respectively

Mr. Reinhart, Secretary and Economist  
Mr. Bernard, Deputy Secretary  
Mr. Gillum, Assistant Secretary  
Ms. Smith, Assistant Secretary  
Mr. Mattingly, General Counsel  
Mr. Baxter, Deputy General Counsel  
Ms. Johnson, Economist  
Mr. Stockton, Economist



Messrs. Howard, Lindsey, Ms. Mester, Messrs. Oliner, Rosenblum, Sniderman, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Messrs. Ettin and Madigan, Deputy Directors, Divisions of Research and Statistics and Monetary Affairs respectively, Board of Governors

Messrs. Slifman and Struckmeyer, Associate Directors, Division of Research and Statistics, Board of Governors

Messrs. Kamin and Whitesell, Deputy Associate Directors, Divisions of International Finance and Monetary Affairs respectively, Board of Governors

Mr. Clouse, Assistant Director, Division of Monetary Affairs, Board of Governors

Mr. Simpson, Senior Adviser, Division of Research and Statistics, Board of Governors

Mr. Nelson,<sup>7</sup> Senior Economist, Division of Monetary Affairs, Board of Governors

Mr. Skidmore, Special Assistant to the Board, Office of Board Members, Board of Governors

Mr. Forte,<sup>7</sup> Senior Technical Editor, Division of Research and Statistics, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Varvel, First Vice President, Federal Reserve Bank of Richmond

Mr. Lang, Executive Vice President, Federal Reserve Bank of Philadelphia

Messrs. Eisenbeis, Fuhrer, Goodfriend, Hakkio, Hunter, Judd, Ms. Perelmuter, and Mr. Rasche, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Boston, Richmond, Kansas City, Chicago, San Francisco, New York, and St. Louis respectively

Mr. Peach, Vice President, Federal Reserve Bank of New York

Mr. Weber, Senior Research Officer, Federal Reserve Bank of Minneapolis

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on September 24, 2002, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period September 24, 2002, through November 5, 2002. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook and the conduct of monetary policy over the intermeeting period ahead.

The information reviewed at this meeting suggested that economic growth had slowed from the moderate pace of the third quarter. Residential construction activity remained high, but

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7. Attended portion of meeting relating to the discussion of alternatives to holding Treasury securities in the System Open Market Account.

consumer spending had softened and business investment was still sluggish. Industrial production had slipped in recent months and private payroll employment had changed little, while labor productivity remained on a strong upward trend. Overall price inflation had fallen over the past year, reflecting both favorable developments in the food and energy sectors and a continuing decline in core inflation.

Aggregate labor market conditions weakened further in October. Private nonfarm payroll employment declined in September and October after four previous months of modest gains in hiring. The number of jobs in manufacturing and related industries continued to fall, with losses widely spread. The construction, transportation, and utilities industries also registered further job losses. By contrast, the services sector continued to expand despite job reductions in the help-supply industry, and the strong housing market and mortgage refinancing activity led to brisk hiring in the finance, insurance, and real estate industries. Total hours worked by private production workers moved down in October, and initial claims for unemployment insurance were at a relatively elevated rate. The civilian unemployment rate rose to 5.7 percent in October.

Industrial production decreased slightly further in September, and available weekly information pointed to another reduction in output in October. Softness in the manufacturing sector was widespread. In the high-tech sector, output continued to rise, but much less rapidly than earlier in the year. Motor vehicle assemblies ebbed a little from the robust third-quarter pace. Elsewhere in manufacturing, production weakened in many categories, including commercial aircraft, non-auto consumer goods, and various types of business equipment. Capacity utilization in manufac-

turing edged lower in September and was substantially below its long-run average.

In the context of limited gains in personal income and declining consumer confidence, retail sales weakened in September after two months of robust increases. The earlier gains were fueled mainly by very large manufacturer discounts on 2002 models of motor vehicles. Incentives on 2003 models were smaller in September, and consumer response was tepid. Retail sales of non-auto goods also decreased in September after having registered only modest growth in July and August. Outlays for services edged up in September.

Residential housing activity, supported by mortgage rates near historical lows, remained very strong in September despite an environment of sluggish employment and declining household wealth. Starts of single-family units reached a twenty-three year high in September, and starts in the multifamily sector were a little above their average since January of this year. Sales of new homes edged up to a record level in September, and sales of existing homes continued to be brisk, though a little below the exceptional pace of the first half of the year. The strength of housing demand was also reflected in further rapid gains in home prices.

Business fixed investment edged up in the third quarter, as a pickup in expenditures for equipment and software nearly offset a further sharp decline in spending on nonresidential structures. The return to positive growth of spending for equipment and software was led by robust business outlays for computers and peripheral equipment and for motor vehicles. By contrast, investment in telecommunications equipment and aircraft remained on a steep downward trend. Nonresidential construction activity also continued to decline rapidly,

with considerable further reductions in all major categories.

The book value of manufacturing and trade inventories excluding motor vehicles registered consecutive gains in July and August after months of heavy liquidation. Despite the recent accumulation, inventory–sales ratios in most industries were at, or near, historic lows.

The U.S. trade deficit in goods and services widened in August, and the average deficit for July and August was virtually unchanged from that for the second quarter. The value of both imports and exports changed little in the July–August period. The available information on economic activity abroad in the third quarter suggested mixed results. Canada apparently grew briskly, and the United Kingdom recorded further moderate economic expansion. In the euro area and Japan, growth appeared to be weakening. The pace of recovery in most of emerging Asia also appeared to have slowed, though China evidently remained on a path of robust expansion. In South America, economic conditions generally remained fragile. Economic activity was still very weak in Argentina and Venezuela, and the Brazilian economy continued to be adversely affected by uncertainties concerning the economic policies of the incoming government. Mexico has been largely unaffected by the financial and political problems of major South American countries, but it nonetheless experienced slower economic growth in the third quarter.

Consumer price inflation continued to trend downward in September. The rise in consumer prices for the year ending in September was considerably smaller than that for the previous twelve-month period. While much of that drop reflected developments in the food and energy sectors, core inflation also declined noticeably. Judged by con-

sumer surveys, slower price increases over the past year apparently led consumers to lower their expectations of near-term inflation. At the producer level, prices for core finished goods likewise decelerated over the twelve months ended in September. With regard to labor costs, growth in average hourly earnings of production or nonsupervisory workers declined significantly over the twelve months ended in September, evidently reflecting the effects of both the rise in unemployment and the drop in consumer price inflation.

At its meeting on September 24, 2002, the Committee adopted a directive that called for maintaining conditions in reserve markets consistent with keeping the federal funds rate around 1¾ percent, and it also retained a balance of risks statement that was tilted toward economic weakness in the foreseeable future. Market participants had anticipated the unchanged policy stance and risk assessment, but the inclusion in the policy announcement of a reference to heightened geopolitical risks led to downward revisions to expectations for the future path of the federal funds rate. The subsequent release of better-than-expected news on profits for several major corporations buoyed equity prices and lifted market interest rates and predicted policy rates. Later in the intermeeting period, weaker-than-anticipated economic data along with press reports suggesting that the FOMC was inclined to ease by year-end led again to downward revisions of the expected path of the federal funds rate target. Over the intermeeting period as a whole, broad equity indexes registered sizable gains and intermediate- and longer-term bond yields increased somewhat.

The dollar traded in a narrow range in foreign exchange markets during the intermeeting period. It depreciated slightly in terms of an index of major

foreign currencies and was little changed on balance against the currencies of other important trading partners.

M2 grew more moderately on average in September and October, with aggregate spending apparently softening, the effects of past monetary easing actions wearing off, and significantly weaker foreign demand for currency emerging. By contrast, the high level of mortgage refinancing activity provided a continuing boost to deposit growth.

The staff forecast prepared for this meeting suggested that, in light of further weaker-than-expected incoming economic data, the expansion of economic activity would be relatively muted for some time. Moreover, current and prospective sluggish economic growth among major trading partners would damp U.S. exports, and businesses and households were likely to hold their spending down while faced with the possibility of a military conflict as well as persisting concerns about the near-term course of economic activity and corporate earnings. Nonetheless, those restraining influences were expected to abate over time and economic activity strengthen gradually. The considerable monetary ease and fiscal stimulus already in place, continuing gains in structural productivity, and anticipated improvement in business confidence would provide significant impetus for spending. Inventory overhangs already had been largely eliminated, and business capital stocks had moved closer to desired levels. As a consequence, a slowly improving outlook for sales and profits, low financing costs, and the temporary federal tax incentive for investment in new equipment and software were expected to boost business investment spending. Even so, a less robust pickup in final sales was now expected over the forecast period, which would put somewhat

less pressure on resource margins than had been anticipated previously, and the level of activity would remain below the economy's potential for a longer time. The persistence of underutilized resources was expected to foster a slight moderation in core price inflation.

In the Committee's discussion of current and prospective economic conditions, members commented that the recent data on the performance of the economy had been disappointing and had tended to confirm widespread anecdotal indications that economic growth had slowed to a pace well below that experienced earlier in the year. Even so, the members acknowledged that the economy had displayed remarkable resiliency over the past year despite being subjected to severe adverse shocks. While the latter clearly had taken their toll on confidence, notably in the business sector, consumer spending had held up relatively well. Business investment expenditures continued to be constrained by a high degree of uncertainty and related caution. Looking beyond the near term, the members anticipated that as the prevailing uncertainties began to diminish, the economy's resiliency abetted by broadly accommodative monetary and fiscal policies and the continuation of a strong uptrend in productivity would underpin a gradual economic recovery. Indeed, some members commented that an even more robust recovery could not be ruled out in the absence of further major shocks to confidence. With pressures on labor and other resources expected to be limited over coming quarters, inflation was likely to remain subdued and perhaps even to edge a little lower.

In their review of developments and prospects in key expenditure sectors of the economy, members noted that consumer spending appeared to have decelerated since midsummer, while an

anticipated and hopefully compensating strengthening in business investment had not yet materialized. Factors cited by the members that appeared to help account for the recent softness in consumer demand included substantial decreases in equity wealth, declining consumer confidence in the context of geopolitical and other uncertainties, the waning effects of earlier income tax cuts, and the failure of the most recent round of motor vehicle sales incentives to maintain the extraordinary level of sales seen during the summer. Looking ahead, some members referred to subdued expectations among their retailer contacts regarding the upcoming holiday season, with sales prospects likely to be held back at least marginally by the lingering effects of the recent West Coast dock strike on the availability of merchandise. There also was some question as to whether funds extracted from rising home equity values would continue to provide as important a source of financing for purchases of consumer durables as they had for some time unless mortgage interest rates declined from their already low levels. Members also mentioned a number of favorable factors bearing on the longer-term outlook for consumer spending. These included the prospect of strengthening consumer confidence if geopolitical uncertainties began to dissipate, the gradual diminution of the negative wealth effects from earlier stock market declines, and importantly the outlook for continued robust growth in structural labor productivity and its favorable effects over time on wages and salaries.

High and persisting uncertainty and concomitant aversion to risk among business executives apparently continued to hold down business investment spending. While such expenditures remained at a high level, members saw

few signs of a significant pickup in the nearer term. Apart from notably adverse business sentiment and disappointing growth in sales and profits, factors that were curbing capital expenditures cited by members included persisting capital overhangs stemming from what were now seen as excessive earlier buildups in equipment and software and substantial idle capacity in many industrial and commercial structures. Some divergence of opinion was expressed regarding the overall extent of capital overhangs, though it was clearly evident in some industries and in high vacancy rates in nonresidential buildings in many areas of the country. Looking to the future, the timing and strength of a decisive upturn in capital expenditures, a key factor in the outlook for some improvement in the performance of the overall economy, would depend critically on the dissipation of prevailing uncertainties, including those associated with geopolitical risks, and increasing prospects for profits. In the latter regard, it was suggested that in the context of rising productivity, profits could prove to be stronger than many now expected, with favorable implications for cash flows and in turn investment activity.

Cautious business attitudes and expectations of sluggish sales over coming months were inducing business firms to continue to hold down what were already generally lean inventories. Nonetheless, some members commented that inventory accumulation was likely to provide some limited impetus to the economy over the next several quarters to the extent that an acceleration in economic activity occurred and businesses sought to maintain an acceptable balance between their inventories and sales. Indeed, with inventories at unusually low levels in many industries, efforts to rebuild such inventories appeared inevitable.

Housing activity had remained at a generally elevated level in recent months and in the context of low mortgage interest rates likely would continue to provide important support to the economy over the forecast period. Most regional reports indicated persisting strength in the housing sector, though there was evidence of modestly flagging activity in some areas. In this regard, it was noted that the declining trend in mortgage interest rates probably would not continue once forecasts of a strengthening economic expansion began to materialize. Indeed, the rise in bond yields since the September meeting associated with the improvement in the stock market had induced a small increase in mortgage rates from their very low levels. At some point the extraordinary levels of cash-outs from mortgage refinancings and home sales would undoubtedly moderate, with adverse implications for spending on home improvements and consumer durables more generally. Still, household spending probably would continue to be supported by the increases in income and wealth associated with strengthening economic expansion and rising productivity.

Members commented that fiscal policy remained accommodative, but an analysis cited at this meeting suggested that the stimulus embodied in current legislation had diminished considerably since earlier in the year. Reference also was made to the partial expensing provision of the tax legislation enacted in March of this year, which was seen as a positive but not in itself a compelling factor in inducing expenditures on business equipment and software. Some members observed that further federal tax cuts, should they be enacted, would likely take effect too late to foster much added spending over the year ahead. At the state and local government levels,

efforts to control very large deficits likely would lead to tax and spending legislation that would offset at least part of the remaining stimulus inherent in the federal budget.

Members commented that little if any stimulus could be expected from the export sector of the economy in light of current and prospective shortfalls in the economic performance of important U.S. trading partners. Indeed, recent forecasts incorporated downward revisions to the growth of overall foreign economic activity.

With the economy evidently on a lower-than-anticipated growth path and with slack in labor and product markets at elevated levels, members anticipated that inflation would remain quite subdued over the year ahead even in the context of some anticipated acceleration in economic activity. Indeed, the prospect of some persisting slack in resource use over coming quarters pointed to further disinflation. In this regard, some members referred to the possibility, which they viewed as remote, of a period of deflation in the event of a strongly negative demand shock.

In the Committee's discussion of policy for the intermeeting period ahead, all the members favored a proposal to reduce the target for the intended federal funds rate by 50 basis points to 1¼ percent. While the current stance of monetary policy was still accommodative and was providing important support to economic activity, the members were concerned that the generally disappointing data since the previous meeting, reinforcing the general thrust of the anecdotal evidence in recent months, pointed to a longer-lasting spell of subpar economic performance than they had anticipated earlier. In the circumstances, a relatively aggressive easing action could help to ensure that the current soft spot in the economy would prove to be tem-

porary and enhance the odds of a robust rebound in economic activity next year. A further reason cited by some members for a sizable easing move related to their perceptions of a diminishing stimulus from earlier policy easing actions and indications that overall financial conditions, including bank lending terms, had become more restrictive this year even though the nominal federal funds rate target had not been changed since late 2001. The members agreed that monetary policy could do little to improve the performance of the economy in the near term, but some emphasized that a 50 basis point easing likely would feed through to some degree to market interest rates, with favorable implications for spending next year.

Members commented that the potential costs of a policy easing action that later proved not to have been needed were quite limited in that there was little risk that such a move would foster inflationary pressures under likely economic conditions over the next several quarters. Moreover, the policy easing could readily be unwound without significant effects on financial markets if the reversal appeared to be warranted by growing pressures on resources in a strengthening economy. In contrast, a failure to take an action that was needed because of a faltering economic performance would increase the odds of a cumulatively weakening economy and possibly even attendant deflation. An effort to offset such a development, should it appear to be materializing, would present difficult policy implementation problems.

All the members indicated that, in light of the contemplated 50 basis point easing action, they could support a shift in the Committee's assessment of the risks to the economy from tilted toward economic weakness to balanced for the foreseeable future, although some

voiced reservations about the need for such a shift. The economy probably would continue to underperform in the period immediately ahead, but in the absence of unpredictable adverse shocks this sluggish performance was more likely to be balanced by subsequent economic strength in light of the policy action. A 50 basis point move would tend to have a more pronounced effect than usual in financial markets, at least initially, because it would be largely unexpected and would come after an extended hiatus in implementing policy changes. In the view of many members, retaining the assessment that the risks were tilted toward weakness would raise the odds of an overreaction in financial markets, which might well misread the Committee's decision as a sign that the members were more concerned about the potential for greater economic weakness than was in fact the case and that therefore the Committee currently saw a likely need for further easing later. Some members saw a lesser risk of such a development, partly because of widespread market expectations that even with a sizable reduction in the intended federal funds rate the Committee would not change its assessment of unbalanced risks to the economy in present circumstances. Although they had at least a marginal preference for retaining the current tilt toward weakness, these members were willing to accept a balanced statement in light of the uncertainties that surrounded prospective market reactions. While the possible market response was not a primary factor determining the desirability of a policy action, the Committee needed to take it into account in gauging the potential effects of particular policy moves.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise,

to execute transactions in the System Account in accordance with the following domestic policy directive:

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with reducing the federal funds rate to an average of around 1¼ percent.

The vote encompassed approval of the sentence below for inclusion in the press statement to be released shortly after the meeting:

Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks are balanced with respect to prospects for both goals in the foreseeable future.

Votes for this action: Messrs. Greenspan, McDonough, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Jordan, Kohn, McTeer, Olson, Santomero, and Stern. Votes against this action: None.

### Use of Alternative Assets in Open Market Operations

At this meeting the Committee provided further guidance to the staff on priorities for the continuing study of alternatives to Treasury securities in the conduct of System open market operations. At its meeting in March of this year, the Committee had reaffirmed its preference for the use of Treasury securities to implement the System's monetary policy, contingent upon the continued availability of a sufficient outstanding volume of such obligations to accommodate the System's very large operations. As was already apparent at the time of the March meeting, fiscal policy develop-

ments made it clear that earlier concerns about a contracting supply of securities in the U.S. government securities market would not likely impose constraints on the System's open market operations in the near term.

Even so, the members expressed a consensus in favor of continuing to study alternatives to Treasury obligations for potential future use. Pursuant to the Committee's instructions in March, the staff had activated its study of the possible employment of mortgage-backed securities guaranteed by the Government National Mortgage Association (Ginnie Maes) in outright System open market operations. Such obligations were already being utilized for temporary additions to the System's portfolio through repurchase agreements. During their discussion at this meeting, the members recognized that outright purchases of Ginnie Maes for permanent additions to the System's portfolio would present a number of difficulties and would require extensive preparations for their effective integration, if deemed desirable at a later date, into the conduct of outright System open market operations. Still, in view of their possible advantages in helping to meet SOMA portfolio objectives at some point in the future, the Committee instructed the staff to continue to focus available resources on the possible use of Ginnie Maes for such operations. The Committee also decided to discontinue further consideration of the possible use of foreign sovereign debt obligations as collateral for repurchase agreements in light of the problems that were envisaged in the employment of such securities.

At this meeting the Committee also reviewed work that had been done on the potential use of an auction credit facility (ACF) that could serve as a partial substitute for Treasury or other



securities. In addition, the Committee reviewed a study that considered whether an ACF might be adapted for use in a contingency (CACF) as a full substitute for open market operations. Many of the members commended the staff for its careful assessment of the potential for such operations. The members concluded, however, that significant resources should not be assigned at this time to the further study of these alternatives to open market operations given the prospects for an enlarged supply of Treasury obligations, the decision to focus on Ginnie Maes, and the introduction of a new discount window program, the System's primary credit facility, scheduled for implementation in early 2003. In addition, the CACF had been made unnecessary by the implementation of contingency plans and backup facilities since September 2001. The members concurred with the staff's recommendation that the staff studies prepared for the Committee in January 2001, when it discussed in detail various alternatives to holding U.S. government securities, should be released to the public after light editing was completed.

It was agreed that the next meeting of the Committee would be held on Tuesday, December 10, 2002.

The meeting adjourned at 1:55 p.m.

Vincent R. Reinhart  
Secretary

### Meeting Held on December 10, 2002

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, December 10, 2002, at 9:00 a.m.

*Present:*

Mr. Greenspan, Chairman  
Mr. McDonough, Vice Chairman  
Mr. Bernanke  
Ms. Bies  
Mr. Ferguson  
Mr. Gramlich  
Mr. Jordan  
Mr. Kohn  
Mr. McTeer  
Mr. Olson  
Mr. Santomero  
Mr. Stern

Messrs. Broadbuss, Guynn, Moskow,  
and Parry, Alternate Members  
of the Federal Open Market  
Committee

Mr. Hoenig, Ms. Minehan, and  
Mr. Poole, Presidents of the  
Federal Reserve Banks of  
Kansas City, Boston, and  
St. Louis respectively

Mr. Reinhart, Secretary and Economist  
Mr. Bernard, Deputy Secretary  
Mr. Gillum, Assistant Secretary  
Ms. Smith, Assistant Secretary  
Mr. Mattingly, General Counsel  
Ms. Johnson, Economist  
Mr. Stockton, Economist

Mr. Connors, Ms. Cumming,  
Messrs. Howard and Lindsey,  
Ms. Mester, Messrs. Oliner,  
Rolnick, Rosenblum, Sniderman,  
and Wilcox, Associate Economists

Mr. Kos, Manager, System Open  
Market Account

Messrs. Ettin and Madigan, Deputy  
Directors, Divisions of Research  
and Statistics and Monetary  
Affairs respectively, Board of  
Governors

Messrs. Slifman and Struckmeyer,  
Associate Directors, Division  
of Research and Statistics,  
Board of Governors

Mr. Whitesell, Deputy Associate  
Director, Division of Monetary  
Affairs, Board of Governors

Mr. Clouse, Assistant Director,  
Division of Monetary Affairs,  
Board of Governors

Mr. Simpson, Senior Adviser, Division  
of Research and Statistics, Board  
of Governors

Mr. Skidmore, Special Assistant to the  
Board, Office of Board Members,  
Board of Governors

Ms. Low, Open Market Secretariat  
Assistant, Division of Monetary  
Affairs, Board of Governors

Ms. Holcomb, First Vice President,  
Federal Reserve Bank of Dallas

Messrs. Eisenbeis, Fuhrer, Goodfriend,  
Green, Hakkio, and Rasche,  
Senior Vice Presidents, Federal  
Reserve Banks of Atlanta, Boston,  
Richmond, Chicago, Kansas City,  
and St. Louis respectively

Messrs. Elsasser and Furlong, Vice  
Presidents, Federal Reserve Banks  
of New York and San Francisco  
respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on November 6, 2002, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and securities issued or fully guaranteed by federal agencies during the period November 6, 2002, through December 9, 2002. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic and financial outlook and the conduct of monetary policy over the intermeeting period ahead.

The information reviewed at this meeting suggested that economic growth had been sluggish on balance since midsummer. Housing demand remained strong, but business fixed investment was still in the doldrums and consumer spending had flagged in late summer before apparently picking up somewhat in the autumn. Payroll employment had changed little since midyear, and industrial production still seemed to be on a downward trend. Most price indexes continued to indicate that inflation had declined over the past year.

Private nonfarm payroll employment remained stagnant in the third quarter and edged down in October and November. Job losses in manufacturing were again large in the two months, and employment declined in construction and in the wholesale and retail trade industries. By contrast, services (except help-supply) and the finance, insurance, and real estate grouping recorded further solid gains. The unemployment rate rose to 6 percent in November, a level more consonant with other recent labor market indicators. Labor productivity in the nonfarm business sector continued to climb briskly, with the advance over the last four quarters being the largest since 1973.

Industrial production dropped sharply further in October, with roughly half of the decline related to a slowdown in motor vehicle assemblies and the manufacture of related parts. The rest of the manufacturing sector also was weak on balance, with output down in almost all market groups. The high-tech sector was an exception, although the rise in output of computers and semiconductors in

October was smaller than earlier in the year and the production of communications equipment continued to fall. Consistent with the poor performance of industrial production, capacity utilization in manufacturing fell again in October and remained substantially below its long-run average.

Against the backdrop of smaller gains in disposable personal income and low readings on consumer confidence, growth of consumer spending had been quite sluggish in the last several months. Much of the weakness reflected a falloff in spending on new motor vehicles in September and October, largely because of reduced manufacturer discounts. Apart from motor vehicles, personal consumption expenditures picked up in October following two months of softness. Increases in outlays for services in September and October remained modest and about equal to the average rate of rise earlier in the year.

Housing starts dropped moderately in October, which was an unusually wet month across much of the country. However, residential housing activity had been very strong on balance this year despite an environment of sluggish employment and declining household wealth. Mortgage rates near historical lows had provided important support for single-family housing demand, and sales of new and existing homes had remained buoyant. In the multifamily sector, starts plunged in October to the slowest pace in almost six years. While some of the decline likely was attributable to inclement weather, apartment vacancy rates had risen significantly over the past year, perhaps partly in response to the single-family housing boom.

Business spending on equipment and software increased moderately in the third quarter, but the recent monthly pattern of data on shipments and orders for nondefense capital goods, along

with anecdotal reports from businesses, signaled renewed weakness. Shipments of nondefense capital goods rebounded in October, led by a rise in computing equipment. In contrast, shipments of communications equipment plunged. Construction in the nonresidential sector slowed sharply further in the third quarter, but a few signs, including a rise in activity in October, suggested some moderation in the rate of decline.

The aggregate book value of manufacturing inventories changed little in October: declines in stocks of many types of durable goods were offset by modest stockbuilding of nondurables, and the ratio of stocks to shipments remained very low. Anecdotal information suggested that disruptions of West Coast dock operations stemming from a labor dispute had been quite small.

The U.S. trade deficit in goods and services changed little in September and the third quarter. The available information on economic activity abroad in the third quarter indicated that economic expansion remained moderate in the United Kingdom and sluggish in the euro area. Economic growth subsided somewhat from elevated second-quarter rates in Canada, Japan, and emerging Asia. Economic conditions in South America were generally still fragile.

Core consumer price inflation, as measured by the consumer price index (CPI) and the chain-weighted personal consumption expenditure (PCE) index, continued to trend lower in October. Inflation, in terms of both indexes, was down over the last twelve months when compared with the previous twelve-month period. At the producer level, core price inflation for finished goods over the twelve months ended in October was at a very low rate. With regard to labor costs, average hourly earnings of production or nonsupervisory workers increased moderately in November,

and the growth in those earnings over the last twelve months fell considerably, evidently reflecting the slack in labor markets.

At its meeting on November 6, 2002, the Committee adopted a directive that called for lowering the target for the intended federal funds rate by 50 basis points, to 1¼ percent. The Committee also agreed that, in light of the decision to ease, it would be appropriate to indicate in the press release that the risks were balanced for the foreseeable future. Market participants had expected a 25 basis point cut and retention of a statement of risks toward weakness. The unexpectedly large reduction in the federal funds rate target led to an initial decline in Treasury coupon yields. That drop was reversed when market participants apparently focused on the shift to balanced risks and concluded that the odds of pronounced economic weakness had fallen. The subsequent release of better-than-expected economic data and earnings news provided reassurance to investors, though more mixed economic reports became available late in the intermeeting period. Over the period as a whole, major equity indexes registered mixed changes, and yields on longer-term Treasury bonds increased somewhat. In private debt markets, rates on investment-grade debt issues eased a little, and those on speculative-grade bonds fell considerably more.

The dollar appreciated slightly in terms of an index of major foreign currencies, principally against the yen, and changed little against the currencies of other important trading partners. The dollar edged lower against most major currencies in the aftermath of the policy easing on November 6, but those losses were subsequently retraced after the release of U.S. economic data that were seen as suggesting relatively better economic conditions in the United States.

M2 growth slowed a little in November from October's elevated pace. The further advance again was concentrated in liquid deposits. The low level of opportunity costs and heavy mortgage financing continued to support the demand for liquid assets.

The staff forecast prepared for this meeting suggested that the expansion of economic activity would be relatively muted over the near term. Faced with heightened geopolitical tensions as well as persisting concerns about the near-term course of economic activity and corporate earnings, businesses and households were likely to hold down their spending, and the outlook for continued sluggish economic growth among most major trading partners would damp U.S. exports. However, those restraining influences were expected to abate over time, and the considerable monetary ease and fiscal stimulus already in place, continuing strong gains in structural productivity, and anticipated improvement in business confidence would provide significant impetus to spending. Inventory overhangs had been largely eliminated and business capital stocks had moved closer to desired levels. As a consequence, a slowly improving outlook for sales and profits, low financing costs, and the temporary federal tax incentive for investment in new equipment and software were expected to provide a gradual boost to business investment spending. The persistence of underutilized resources was expected to foster a slight moderation in core price inflation.

In the Committee's discussion of current and prospective economic conditions, members noted that the recent information had continued on the whole to suggest quite sluggish economic growth. Uncertainties about the outlook remained substantial, and downside risks stemming from potential shocks,

notably those associated with a high level of geopolitical risks, could not be dismissed. Nonetheless, the behavior of financial markets in recent weeks suggested that investor concerns about an actual downturn in the economy had diminished, as data on economic developments took on a more mixed tone after having been somewhat negative for some time. The improvement in financial markets reinforced the members' expectations that a gradual strengthening of the economic expansion was likely over coming quarters, with the growth in economic activity gaining momentum over time in the absence of major adverse shocks to business and consumer confidence. Their assessment took account of the currently very accommodative stance of monetary policy, likely further fiscal policy stimulus, and the positive effects on business and consumer spending of a strong uptrend in labor productivity. With regard to the outlook for inflation, the gap between actual and potential output was anticipated to diminish only slowly unless aggregate demand expanded much more rapidly than the members currently foresaw. Given the persistence of limited pressures on resources, cost and price increases were expected to remain subdued and possibly to edge lower.

The improvement of overall conditions in financial markets had provided an additional positive element to the economic outlook. The improvement began before the November meeting and had been given added impetus by the Committee's sizable easing at that meeting. The general calming of financial markets was reflected in some decline in risk spreads from very high levels and sizable new issuance in private bond markets; in equity markets, issuance had edged up and stock prices, though recently declining somewhat, were still

well above the lows of early October. Some of this improvement in financial markets seemed to be related to apparently lessening concerns about new revelations of corporate governance issues as a result of the passage of time without further significant incidents. In addition, many business firms had continued to enhance their prospects for rising profits through productivity improvements and debt restructurings that were strengthening their balance sheets and liquidity. Concurrently, indicators of credit quality in the household sector appeared to have remained essentially stable. Reference also was made to the continued robust growth in reserve and money measures.

The better tone in financial markets might also have been signaling a modest reduction in uncertainty and risk aversion among business executives from the extraordinarily elevated levels that had been constraining investment spending. Lingering excess capacity in a number of industries undoubtedly was continuing to inhibit new investment outlays as well. The members agreed that a pickup in capital spending remained the essential factor in the outlook for substantial strengthening of economic activity. On the positive side, spending for business equipment had turned up since early this year, and with efforts to reduce excess capacity seemingly well under way or completed in many industries, further firming in such capital expenditures was anticipated as the year 2003 progressed. However, nonresidential building was expected to continue to lag, especially given high vacancy rates in industrial and office structures in many major markets.

The household sector of the economy had continued to provide major support to the recovery in economic activity. The increase in consumer spending evidently had moderated in the current

quarter, largely as a result of a decline in sales of motor vehicles from an extraordinary pace during the summer. However, the latest information on retail sales, including anecdotal reports, pointed to some improvement in recent weeks, and key measures of consumer confidence had turned up from their recent lows. While some uncertainty surrounded the prospects for consumer spending, members cited continued sizable increases in income, more stable wealth-to-income ratios, and the ongoing stimulus of equity extractions from housing as favorable factors in the outlook for consumer expenditures.

Housing activity had continued to display solid overall strength, though members mentioned weakness in multifamily construction and the high-end sector of the single-family market. Historically low mortgage interest rates along with rising incomes evidently were continuing to sustain the robust demand for housing. In addition, large extractions of equity from appreciated housing values continued to foster not only added consumer spending but also improvement in the financial condition of many households through debt consolidation and repayments and reduced interest charges. However, there were anecdotal indications of decreasing refinancing activity in the housing sector.

The outcome of the recent Congressional elections had fostered expectations that fiscal policy might be more expansive than previously anticipated, although the size, timing, and composition of federal budget initiatives were subject to substantial uncertainty. Members commented that added fiscal stimulus might prove to be a useful complement to an accommodative monetary policy in the period immediately ahead when economic activity was likely to remain below the economy's potential. In this regard, some observed that addi-

tional stimulus on the federal level would be an offset to measures that were being taken by numerous state and local governments to address severe budget deficits. At the same time, a number of members expressed the hope that new fiscal legislation would not endanger the prospects for federal budget discipline over the longer run, given the desirability of supporting national saving and capital accumulation.

With regard to the external sector, members commented that the growth of the nation's important trading partners had remained sluggish, and there seemed to be little basis for anticipating any appreciable impetus to the U.S. economy from significant strengthening in demand for U.S. exports. Indeed, economic growth abroad was widely viewed as dependent to a significant extent on the performance of the U.S. economy. Conditions in some major Latin American countries were especially problematic, and adverse developments there could have negative repercussions on international financial markets and trade.

Members believed that the economy probably would continue to operate with significant margins of slack in both labor and product markets. Moreover, in an environment characterized by highly competitive markets and the absence of pricing power, business firms would persist in their efforts to hold down or reduce costs, with favorable implications for productivity. In these circumstances, inflation pressures could be expected to remain subdued and some further disinflation might well occur. In this regard, members commented that appreciable disinflation seemed unlikely, but if that were to occur it could present difficult problems for monetary policy. One member noted, however, that declining inflation or even some deflation in the context of rapid

growth in productivity could turn out to be relatively benign.

In the Committee's discussion of policy for the intermeeting period ahead, all the members endorsed a proposal to retain the current stance of policy. The members agreed that, given what was now a quite accommodative policy following the relatively aggressive easing move in November, monetary policy was well positioned to support a strengthening economic expansion in line with their expectations for coming quarters. Although it was uncertain how long the current period of below-par growth would persist, the economic outlook remained subject to upside as well as downside risks. Indeed, all the members also supported the retention of the current balanced-risks statement in the post-meeting press release, with some commenting that recent developments had established a firmer basis for such a risk assessment than at the November meeting when it was adopted. The November easing had contributed to some improvement in financial markets that, in conjunction with prospects for further stimulus from fiscal policy, should bolster the anticipated acceleration of economic activity. At the same time, the members saw little risk of any significant increase in inflationary pressures over the foreseeable future. Against this background, the members concluded that there was no need to change the stance of monetary policy; they would continue to assess emerging economic and financial developments, retaining the flexibility to adjust monetary policy as emerging conditions might warrant.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 1¼ percent.

The vote encompassed approval of the sentence below for inclusion in the press statement to be released shortly after the meeting:

Against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the Committee believes that the risks are balanced with respect to prospects for both goals in the foreseeable future.

Votes for this action: Messrs. Greenspan, McDonough, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Jordan, Kohn, McTeer, Olson, Santomero, and Stern. Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, January 28–29, 2003.

The meeting adjourned at 12:05 p.m.

Vincent R. Reinhart  
Secretary

## Litigation

During 2002, the Board of Governors was a party in three lawsuits or appeals filed that year and was a party in seven other cases pending from previous years, for a total of ten cases; in 2001, the Board had been a party in a total of twenty cases. None of the lawsuits or appeals filed in 2002 raised questions under the Bank Holding Company Act. As of December 31, 2002, six cases were pending.

### Litigation under the Gramm–Leach–Bliley Act

*Trans Union LLC v. Federal Trade Commission, et al.*, No. 01-5202 (D.C. Circuit, filed June 4, 2001), was an appeal of a district court order upholding challenged provisions of the inter-agency rule Privacy of Consumer Financial Information (145 F. Supp. 2d 6, April 30, 2001). On July 16, 2002, the court of appeals affirmed the district court's decision upholding the regulation (295 F.3d 42).

### Other Actions

*Sedgwick v. United States*, No. 02-5378 (D.C. Circuit, filed November 26, 2002), is an appeal of the dismissal of appellant's claim for a declaratory judgment under the Federal Tort Claims Act and the Constitution regarding the banking agencies' alleged failure to intervene on his behalf in civil litigation involving a regulated institution.

*Albrecht v. Board of Governors*, No. 02-5235 (D.C. Circuit, filed October 18, 2002), is an appeal of a district court order dismissing a challenge to the pension funding method applicable

to certain Board employees under the Board's retirement plan.

*Caesar v. United States*, No. 02-0612 (EGS) (D. District of Columbia, removed on April 1, 2002, from the Superior Court of the District of Columbia), is an action seeking damages for personal injury.

*Community Bank & Trust v. United States*, No. 01-571C (Court of Federal Claims, filed October 3, 2001), is an action challenging on constitutional grounds the failure to pay interest on reserve accounts held at Federal Reserve Banks.

*Laredo National Bancshares, Inc. v. Whalen v. Board of Governors*, No. 01-CV-134 (S. D. Texas, removed on September 5, 2001, from Webb County, Texas, district court), was a third-party petition seeking indemnification or contribution from the Board in connection with a claim asserted against defendant Whalen that alleged tortious interference with a contract. On September 27, 2002, the district court dismissed all claims against the individual third-party defendants, granted the United States' motion to substitute the United States for the third-party defendants, and dismissed all claims against the Board and the United States.

*Radfar v. United States*, No. 1:01CV1292 (D. District of Columbia, filed June 11, 2001), was an action under the Federal Tort Claims Act for injury on Board premises. On October 3, 2002, the action was dismissed on the stipulation of the parties.

*Artis v. Greenspan*, No. 01-0400 (D. District of Columbia, filed February 22, 2001), is an employment discrimination action. An identical action, No. 99-2073



(EGS) (D. District of Columbia, filed August 3, 1999), was consolidated with this action on August 15, 2001.

*Howe v. Bank for International Settlements*, No. 00CV12485 (RCL) (D. Massachusetts, filed December 7, 2000), was an action seeking damages in connection with gold market activities and the repurchase by the Bank for International Settlements of its privately owned

shares. On March 26, 2002, the district court granted the defendants' motion to dismiss the action.

In *Fraternal Order of Police v. Board of Governors*, No. 98-3116 (D. District of Columbia, filed December 22, 1998), plaintiffs seek a declaratory judgment regarding the Board's labor policy governing Federal Reserve Banks. ■

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*Federal Reserve System  
Organization*

## Board of Governors

December 31, 2002

### Members

	<i>Term expires January 31,</i>
Alan Greenspan, of New York, <i>Chairman</i> <sup>1</sup> .....	2006
Roger W. Ferguson, Jr., of Massachusetts, <i>Vice Chairman</i> <sup>1</sup> .....	2014
Edward M. Gramlich, of Virginia ..	2008
Mark W. Olson, of Maryland .....	2010
Susan S. Bies, of Tennessee .....	2012
Ben S. Bernanke, of New Jersey ....	2004
Donald L. Kohn, of Virginia .....	2016

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Lynn S. Fox, <i>Assistant to the Board</i>
Michelle A. Smith, <i>Assistant to the Board</i>
Winthrop P. Hambley, <i>Deputy Congressional Liaison</i>
John Lopez, <i>Special Assistant to the Board</i>
Rosanna Pianalto-Cameron, <i>Special Assistant to the Board</i>
David Skidmore, <i>Special Assistant to the Board</i>

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Scott G. Alvarez, <i>Associate General Counsel</i>
Richard M. Ashton, <i>Associate General Counsel</i>
Kathleen M. O'Day, <i>Associate General Counsel</i>
Stephanie Martin, <i>Assistant General Counsel</i>
Ann Misback, <i>Assistant General Counsel</i>
Stephen L. Siciliano, <i>Assistant General Counsel</i>

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Cary K. Williams, <i>Assistant General Counsel</i>

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Margaret M. Shanks, <i>Assistant Secretary</i>

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Normand R.V. Bernard, <i>Special Assistant to the Board</i>

1. The designations as Chairman and Vice Chairman expire on June 20, 2004, and October 5, 2003, respectively, unless the service of these members of the Board shall have terminated sooner.

## Board of Governors—Continued

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*Board of Governors—Continued*

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Barry R. Snyder, *Inspector General*

Donald L. Robinson, *Deputy Inspector  
General*

## *Federal Open Market Committee*

December 31, 2002

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GARY H. STERN, President, Federal Reserve Bank of Minneapolis

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JACK GUYNN, President, Federal Reserve Bank of Atlanta

MICHAEL H. MOSKOW, President, Federal Reserve Bank of Chicago

ROBERT T. PARRY, President, Federal Reserve Bank of San Francisco

JAMIE B. STEWART, JR., First Vice President, Federal Reserve Bank of New York

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NORMAND R.V. BERNARD, *Deputy Secretary*

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MARK S. SNIDERMAN, *Associate Economist*

DAVID W. WILCOX, *Associate Economist*

DINO KOS, *Manager, System Open Market Account*

During 2002 the Federal Open Market Committee held eight regularly scheduled meetings (see “Minutes of Federal Open Market Committee Meetings” in this volume.)

## Federal Advisory Council

December 31, 2002

### Members

District 1—DAVID A. SPINA, *Chairman and Chief Executive Officer*, State Street Corporation, Boston, Massachusetts

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District 5—L.M. BAKER, JR., *Chairman and Chief Executive Officer*, Wachovia Corporation, Winston-Salem, North Carolina

District 6—L. PHILLIP HUMANN, *Chairman, President, and Chief Executive Officer*, SunTrust Banks, Inc., Atlanta, Georgia

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District 8—DAVID W. KEMPER, *Chairman, President, and Chief Executive Officer*, Commerce Bancshares, Inc., St. Louis, Missouri

District 9—R. SCOTT JONES, *Vice Chairman*, Associated Bank Minnesota, Red Wing, Minnesota

District 10—CAMDEN R. FINE, *President and Chief Executive Officer*, Midwest Independent Bank, Jefferson City, Missouri

District 11—RICHARD W. EVANS, JR., *Chairman and Chief Executive Officer*, Frost National Bank, San Antonio, Texas

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L.M. BAKER, JR., *Vice President*

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WILLIAM J. KORSVIK, *Co-Secretary*

The Federal Advisory Council, which is composed of one representative of the banking industry from each of the twelve Federal Reserve Districts, is required by the Federal Reserve Act to meet in Washington at least four times each year and is authorized by the act to consult with, and advise, the Board of Governors on all matters within the jurisdiction of the Board. The council met on January 31–February 1, May 2–3, September 5–6, and December 5–6, 2002. The Board met with the council on February 1, May 3, September 6, and December 6, 2002.

## Consumer Advisory Council

December 31, 2002

### Members

ANTHONY ABBATE, *President and Chief Executive Officer*, Interchange Bank, Saddle Brook, New Jersey

JANIE BARRERA, *President and Chief Executive Officer*, ACCION Texas, San Antonio, Texas

KENNETH P. BORDELON, *Chief Executive Officer*, E Federal Credit Union, Baton Rouge, Louisiana

TERESA A. BRYCE, *General Counsel*, Nexstar Financial Corporation, St. Louis, Missouri

MANUEL CASANOVA, JR., *Executive Vice President*, International Bank of Commerce, Brownsville, Texas

CONSTANCE CHAMBERLIN, *President and Chief Executive Officer*, Housing Opportunities Made Equal, Richmond, Virginia

ROBERT M. CHEADLE, *Legislative Counsel*, The Chickasaw Tribal Legislature, Ada, Oklahoma

ROBIN COFFEY, *Vice President*, Harris Trust and Savings Bank, Chicago, Illinois

LESTER WM. FIRSTENBERGER, *Attorney at Law*, Pittsfield, New Hampshire

THOMAS FITZGIBBON, *Senior Vice President*, MB Financial Bank, Chicago, Illinois

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EARL JAROLIMEK, *Vice President/Corporate Compliance Officer*, Community First Bankshares, Fargo, North Dakota

J. PATRICK LIDDY, *Director of Compliance*, Fifth Third Bancorp, Cincinnati, Ohio

RUHI MAKER, *Senior Attorney*, Law Office of Rochester, Rochester, New York

OSCAR MARQUIS, *Attorney*, Hunton and Williams, Park Ridge, Illinois

PATRICIA MCCOY, *Professor of Law*, Massachusetts Institute of Technology, Cambridge, Massachusetts

JEREMY NOWAK, *Chief Executive Officer*, The Reinvestment Fund, Philadelphia, Pennsylvania

ELIZABETH RENUART, *Staff Attorney*, National Consumer Law Center, Boston, Massachusetts

DEBRA S. REYES, *President*, Neighborhood Lending Partners, Inc., Tampa, Florida

BENSON ROBERTS, *Vice President for Policy*, Local Initiatives Support Corporation, Washington, District of Columbia

AGNES BUNDY SCANLAN, *Managing Director and Chief Compliance Officer*, FleetBoston Financial, Boston, Massachusetts

RUSSELL SCHRADER, *Senior Vice President and Assistant General Counsel*, Visa U.S.A., San Francisco, California

FRANK TORRES III, *Legislative Counsel*, Consumers Union, Washington, District of Columbia

HUBERT VAN TOL, *Co-Director*, Fairness in Rural Lending, Sparta, Wisconsin

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Director of Corporate Citizenship  
Capital One Financial Corporation  
Falls Church, Virginia

RONALD REITER, *Vice Chair*  
Supervising Deputy Attorney General  
California Department of Justice  
San Francisco, California

The Consumer Advisory Council was established pursuant to the 1976 amendments to the Equal Credit Opportunity Act to advise the Board of Governors on consumer financial services. It is composed of academics, state and local government officials, representatives of the financial industry, and representatives of consumer and community interests. The council met with members of the Board on March 14, June 27, and October 24, 2002.



## *Thrift Institutions Advisory Council*

December 31, 2002

### **Members**

JOHN B. DICUS, *President*, Capitol Federal Savings Bank, Topeka, Kansas

RONALD S. ELIASON, *President and Chief Executive Officer*, Utah Community Federal Credit Union, Provo, Utah

KAREN L. MCCORMICK, *President and Chief Executive Officer*, First Federal Savings and Loan Association, Port Angeles, Washington

JAMES F. MCKENNA, *President and Chief Executive Officer*, North Shore Bank, FSB, Brookfield, Wisconsin

CHARLES C. PEARSON, JR., *Co-Chairman and Chief Executive Officer*, Waypoint Bank, Harrisburg, Pennsylvania

KEVIN E. PIETRINI, *President and Chief Executive Officer*, Queen City Federal Savings Bank, Virginia, Minnesota

HERBERT M. SANDLER, *Chairman and Chief Executive Officer*, World Savings Bank, FSB, Oakland, California

WILLIAM J. SMALL, *Chairman and Chief Executive Officer*, First Federal Bank, Defiance, Ohio

EVERETT STILES, *President and Chief Executive Officer*, Macon Bank, Franklin, North Carolina

DAVID L. VIGREN, *President and Chief Executive Officer*, ESL Federal Credit Union, Rochester, New York

MARK H. WRIGHT, *President and Chief Executive Officer*, USAA Federal Savings Bank, San Antonio, Texas

### **Officers**

MARK H. WRIGHT, *President*

KAREN L. MCCORMICK, *Vice President*

The Thrift Institutions Advisory Council, which is composed of representatives from credit unions, savings and loan associations, and savings banks, consults with, and advises, the Board of Governors on issues pertaining to the thrift industry and on various other matters within the Board's jurisdiction. The members of the council met with the Board on March 1, July 12, and December 13, 2002.

## Federal Reserve Banks and Branches

December 31, 2002

### Officers

BANK or Branch	Chairman <sup>1</sup> Deputy Chairman	President First Vice President	Vice President in charge of Branch
BOSTON <sup>2</sup> .....	William O. Taylor James J. Norton	Cathy E. Minehan Paul M. Connolly	
NEW YORK <sup>2</sup> .....	Peter G. Peterson Gerald M. Levin	William J. McDonough Jamie B. Stewart, Jr.	
Buffalo .....	Patrick P. Lee		Barbara L. Walter <sup>3</sup>
PHILADELPHIA .....	Charisse R. Lillie Glenn A. Schaeffer	Anthony M. Santomero William H. Stone, Jr.	
CLEVELAND <sup>2</sup> .....	David H. Hoag Robert W. Mahoney	Jerry L. Jordan Sandra Pianalto	
Cincinnati .....	George C. Juilfs		Barbara B. Henshaw
Pittsburgh .....	Charles E. Bunch		Robert B. Schaub
RICHMOND <sup>2</sup> .....	Jeremiah J. Sheehan Wesley S. Williams, Jr.	J. Alfred Broaddus, Jr. Walter A. Varvel	
Baltimore .....	George L. Russell, Jr.		William J. Tignanelli <sup>3</sup>
Charlotte .....	James F. Goodman		Dan M. Bechter <sup>3</sup>
ATLANTA.....	John F. Wieland Paula Lovell	Jack Guynn Patrick K. Barron	James M. McKee <sup>3</sup>
Birmingham .....	V. Larkin Martin		Lee C. Jones
Jacksonville.....	Marsha G. Rydberg		Christopher L. Oakley
Miami.....	Rosa Sugranes		James T. Curry III
Nashville.....	Beth Dortch Franklin		Melvyn K. Purcell <sup>3</sup>
New Orleans.....	R. Glenn Pumpelly		Robert J. Musso <sup>3</sup>
CHICAGO <sup>2</sup> .....	Robert J. Darnall W. James Farrell	Michael H. Moskow Gordon R.G. Werkema	
Detroit .....	Timothy D. Leuliette		Glenn Hansen <sup>3</sup>
ST. LOUIS.....	Charles W. Mueller Walter L. Metcalf, Jr.	William Poole W. LeGrande Rives	
Little Rock.....	A. Rogers Yarnell II		Robert A. Hopkins
Louisville .....	J. Stephen Barger		Thomas A. Boone
Memphis.....	Russell Gwatney		Martha Perine Beard
MINNEAPOLIS.....	Ronald N. Zwiag Linda Hall Whitman	Gary H. Stern James M. Lyon	
Helena .....	Thomas O. Markle		Samuel H. Gane

## Federal Reserve Banks and Branches—Continued

BANK or Branch	Chairman <sup>1</sup> Deputy Chairman	President First Vice President	Vice President in charge of Branch
KANSAS CITY .....	Terrence P. Dunn Richard H. Bard	Thomas M. Hoenig Richard K. Rasdall	
Denver .....	Robert M. Murphy		MaryAnn F. Hunter <sup>3</sup>
Oklahoma City .....	Patricia B. Fennell		Dwayne E. Boggs
Omaha .....	Bob L. Gottsch		Steven D. Evans
DALLAS .....	H.B. Zachry, Jr. Patricia M. Patterson	Robert D. McTeer, Jr. Helen E. Holcomb	
El Paso .....	Gail S. Darling		Sammie C. Clay
Houston .....	Edward O. Gaylord		Robert Smith III <sup>3</sup>
San Antonio .....	Ron R. Harris		James L. Stull <sup>3</sup>
SAN FRANCISCO .....	Nelson C. Rising George M. Scalise	Robert T. Parry John F. Moore	
Los Angeles .....	William D. Jones		Mark L. Mullinix <sup>4</sup>
Portland .....	Nancy Wilgenbusch		Richardson B. Hornsby
Salt Lake City .....	H. Roger Boyer		Andrea P. Wolcott
Seattle .....	Boyd E. Givan		David K. Webb <sup>3</sup>

NOTE. A current list of these officers appears each month in the *Federal Reserve Bulletin*.

1. The Chairman of a Federal Reserve Bank serves, by statute, as Federal Reserve Agent.

2. Additional offices of these Banks are located at Windsor Locks, Connecticut; Utica at Oriskany, New

York; East Rutherford, New Jersey; Columbus, Ohio; Charleston, West Virginia; Columbia, South Carolina; Indianapolis, Indiana; Milwaukee, Wisconsin; Des Moines, Iowa; and Peoria, Illinois.

3. Senior Vice President

4. Executive Vice President

### Conference of Chairmen

The chairmen of the Federal Reserve Banks are organized into the Conference of Chairmen, which meets to consider matters of common interest and to consult with, and advise, the Board of Governors. Such meetings, attended also by the deputy chairmen, were held in Washington on May 29 and 30, and on December 4 and 5, 2002.

The members of the Executive Committee of the Conference of Chairmen during 2002 were Peter G. Peterson, chair; Charisse R. Lillie, vice chair; and Robert J. Darnall, member.

On December 5, 2002, the conference elected its Executive Committee for 2003; it named Robert J. Darnall as chair, Wesley S. Williams, Jr., as vice chair, and Ronald N. Zweig as the third member.

### Conference of Presidents

The presidents of the Federal Reserve Banks are organized into the Conference of Presidents, which meets periodically to consider matters of common interest and to consult with, and advise, the Board of Governors.

J. Alfred Broaddus, Jr., President of the Federal Reserve Bank of Richmond, served as chair of the conference in 2002, and Michael H. Moskow, President of the Federal Reserve Bank of Chicago, served as its vice chair. Betty M. Fahed, of the Federal Reserve Bank of Richmond, served as its secretary, and Valerie J. Van Meter, of the Federal Reserve Bank of Chicago, served as its assistant secretary.

On October 29, 2002, the conference elected Michael H. Moskow as its chair for 2003–04, and elected Cathy E. Minehan,

President of the Federal Reserve Bank of Boston, as its vice chair.

### **Conference of First Vice Presidents**

The Conference of First Vice Presidents of the Federal Reserve Banks was organized in 1969 to meet periodically for the consideration of operations and other matters.

Paul M. Connolly, First Vice President of the Federal Reserve Bank of Boston, served as chair of the conference in 2002, and Walter A. Varvel, First Vice President of the Federal Reserve Bank of Richmond, served as its vice chair. David K. Park, of the Federal Reserve Bank of Boston, served as its secretary, and Janice E. Clatterbuck, of the Federal Reserve Bank of Richmond, served as its assistant secretary.

### **Directors**

The following list of directors of Federal Reserve Banks and Branches shows for each director the class of directorship, the director's principal organizational affiliation, and the date the director's term expires. Each Federal Reserve Bank has a nine-member board: three Class A and three Class B directors, who are elected by the stockholding member banks, and three Class C directors, who are appointed by the Board of Governors of the Federal Reserve System.

Class A directors represent the stockholding member banks in each Federal Reserve District. Class B and Class C directors represent the public and are chosen with due, but not exclusive, consideration to the interests of agriculture, commerce, industry, services, labor, and consumers; they may not be officers, directors, or employees of any bank or bank holding company. In addition, Class C directors may not be stockholders of any bank or bank holding company.

For the election of Class A and Class B directors, the Board of Governors classifies the member banks of each Federal Reserve District into three groups. Each group, which comprises banks with similar capitalization, elects one Class A director and one Class B director. Annually, the Board of Governors designates one of the Class C directors as chair of the board and Federal Reserve Agent of each District Bank, and it designates another Class C director as deputy chair.

Federal Reserve Branches have either five or seven directors, a majority of whom are appointed by the parent Federal Reserve Bank; the others are appointed by the Board of Governors. One of the directors appointed by the Board is designated annually as chair of the board of that Branch in a manner prescribed by the parent Federal Reserve Bank.

For the name of the chair and deputy chair of the board of directors of each Reserve Bank and of the chair of each Branch, see the preceding table, "Officers of Federal Reserve Banks and Branches."

## Directors

BANK or Branch Director	Title	Term expires Dec. 31
<b>DISTRICT 1—BOSTON</b>		
<i>Class A</i>		
David S. Outhouse .....	President and Chief Executive Officer, First and Ocean National Bank, Newburyport, Massachusetts	2002
Richard C. White .....	Chairman, President, and Chief Executive Officer, Community National Bank, Derby, Vermont	2003
Lawrence K. Fish .....	Chairman, President, and Chief Executive Officer, Citizens Financial Group, Inc., Providence, Rhode Island	2004
<i>Class B</i>		
Orit Gadiesh .....	Chairman, Bain & Company, Inc., Boston, Massachusetts	2002
Sherwin Greenblatt .....	Past President, Bose Corporation, Framingham, Massachusetts	2003
Blenda J. Wilson .....	President and Chief Executive Officer, Nellie Mae Education Foundation, Quincy, Massachusetts	2004
<i>Class C</i>		
William O. Taylor .....	Chairman Emeritus, The Boston Globe, Boston, Massachusetts	2002
James J. Norton .....	Vice President, AFL-CIO, Washington, D.C.	2003
Samuel O. Thier, M.D. ....	President and Chief Executive Officer, Partners HealthCare System, Inc., Boston, Massachusetts	2004
<b>DISTRICT 2—NEW YORK</b>		
<i>Class A</i>		
George W. Hamlin IV .....	President and Chief Executive Officer, The Canandaigua National Bank and Trust Company, Canandaigua, New York	2002
Sanford I. Weill .....	Chairman and Chief Executive Officer, Citigroup Inc., New York, New York	2003
Jill M. Considine .....	Chairman and Chief Executive Officer, The Depository Trust Company, New York, New York	2004
<i>Class B</i>		
Ann M. Fudge .....	Former Executive Vice President, Kraft Foods, Inc., and Former President, Coffee and Cereals Division, Tarrytown, New York	2002
Jerry I. Speyer .....	President and Chief Executive Officer, Tishman Speyer Properties, New York, New York	2003
Ronay Menschel .....	Chairman, Phipps Houses, New York, New York	2004
<i>Class C</i>		
Albert J. Simone .....	President, Rochester Institute of Technology, Rochester, New York	2002
Gerald M. Levin .....	Retired Chief Executive Officer, AOL Time Warner Inc., New York, New York	2003
Peter G. Peterson .....	Chairman, The Blackstone Group, New York, New York	2004

**Directors—Continued**

BANK or Branch Director	Title	Term expires Dec. 31
<i>Buffalo Branch</i>		
<i>Appointed by the</i>		
<i>Federal Reserve Bank</i>		
Geraldine C. Ochocinska ...	Director, Region 9, UAW, Buffalo, New York	2002
Peter G. Humphrey .....	President and Chief Executive Officer, Financial Institutions, Inc., Warsaw, New York	2003
Maureen Torrey Marshall ..	Co-Owner, Torrey Farms, Inc., Elba, New York	2003
Emerson L. Brumback .....	Executive Vice President, M&T Bank Corp., Buffalo, New York	2004
<i>Appointed by the</i>		
<i>Board of Governors</i>		
Patrick P. Lee .....	Chairman and Chief Executive Officer, IMC, Inc., Buffalo, New York	2002
Katherine E. Keough .....	President, St. John Fisher College, Rochester, New York	2003
Marguerite D. Hambleton ..	President and Chief Executive Officer, AAA Western and Central New York, Williamsville, New York	2004
DISTRICT 3—		
PHILADELPHIA		
<i>Class A</i>		
Frank Kaminski, Jr. ....	Retired Chairman, Atlantic Central Bankers Bank, Camp Hill, Pennsylvania	2002
Robert J. Vanderslice .....	President and Chief Operating Officer, Pennsville National Bank, Pennsville, New Jersey	2003
Walter E. Daller, Jr. ....	Chairman, President, and Chief Executive Officer, Harleysville National Corporation, Harleysville, Pennsylvania	2004
<i>Class B</i>		
Robert E. Chappell .....	Chairman and Chief Executive Officer, Penn Mutual Life Insurance Co., Horsham, Pennsylvania	2002
Doris M. Damm .....	President and Chief Executive Officer, ACCU Staffing Services, Cherry Hill, New Jersey	2003
P. Coleman Townsend, Jr. ..	Chairman and Chief Executive Officer, Townsend, Inc., Wilmington, Delaware	2004
<i>Class C</i>		
Ronald J. Naples .....	Chairman and Chief Executive Officer, Quaker Chemical Corporation, Conshohocken, Pennsylvania	2002
Glenn A. Schaeffer .....	President Emeritus, Pennsylvania Building and Construction Trades Council, Harrisburg, Pennsylvania	2003
Charisse R. Lillie .....	Chair, Litigation Department, Ballard Spahr Andrews & Ingersoll, Philadelphia, Pennsylvania	2004

BANK or Branch Director	Title	Term expires Dec. 31
<b>DISTRICT 4—CLEVELAND</b>		
<i>Class A</i>		
Tiney M. McComb .....	Chairman and President, Heartland BancCorp, Gahanna, Ohio	2002
Stephen P. Wilson .....	President and Chief Executive Officer, Lebanon Citizens National Bank, Lebanon, Ohio	2003
John R. Cochran .....	Chairman and Chief Executive Officer, FirstMerit Corporation, Akron, Ohio	2004
<i>Class B</i>		
David L. Nichols .....	President and Chief Operating Officer, Rich's/Lazarus/Goldsmith's, Atlanta, Georgia	2002
Cheryl L. Krueger-Horn .....	President and Chief Executive Officer, Cheryl&Co., Westerville, Ohio	2003
Wayne R. Embry .....	Former President and Chief Operating Officer, Cleveland Cavaliers, Cleveland, Ohio	2004
<i>Class C</i>		
Phillip R. Cox .....	President and Chief Executive Officer, Cox Financial Corporation, Cincinnati, Ohio	2002
Robert W. Mahoney .....	Retired Chairman and Chief Executive Officer, Diebold, Incorporated, Canton, Ohio	2003
David H. Hoag .....	Former Chairman, The LTV Corporation, Cleveland, Ohio	2004
<i>Cincinnati Branch</i>		
<i>Appointed by the</i>		
<i>Federal Reserve Bank</i>		
V. Daniel Radford .....	Executive Secretary-Treasurer, Cincinnati AFL-CIO Labor Council, Cincinnati, Ohio	2002
Mary Ellen Slone .....	Chief Executive Officer and Chairman, Meridian Communications, Lexington, Kentucky	2002
Bick Weissenrieder .....	Chairman of the Board and Chief Executive Officer, Hocking Valley Bank, Athens, Ohio	2003
James H. Booth .....	President, Czar Coal Corporation, Lovely, Kentucky	2004
<i>Appointed by the</i>		
<i>Board of Governors</i>		
George C. Juilfs .....	Chairman and Chief Executive Officer, SENCORP, Newport, Kentucky	2002
Charles Whitehead .....	President, Ashland Inc. Foundation, Covington, Kentucky	2003
Herbert R. Brown .....	Senior Vice President, Western and Southern Life Insurance Company, Cincinnati, Ohio	2004
<i>Pittsburgh Branch</i>		
<i>Appointed by the</i>		
<i>Federal Reserve Bank</i>		
Georgia Berner .....	President, Berner International Corp., New Castle, Pennsylvania	2002
Peter N. Stephans .....	Chairman and Chief Executive Officer, Trigon Incorporated, McMurray, Pennsylvania	2002

**Directors—Continued**

BANK or Branch Director	Title	Term expires Dec. 31
Kristine N. Molnar .....	President and Chief Executive Officer, WesBanco Bank, Inc., Wheeling, West Virginia	2003
Michael J. Hagan .....	President and Chief Executive Officer, Iron and Glass Bank, Pittsburgh, Pennsylvania	2004
<i>Appointed by the Board of Governors</i>		
Charles E. Bunch .....	President and Chief Operating Officer, PPG Industries, Inc., Pittsburgh, Pennsylvania	2002
James I. Mitnick .....	Senior Vice President, Turner Construction Company, Pittsburgh, Pennsylvania	2003
Robert O. Agbede .....	President and Chief Executive Officer, Advanced Technology Systems, Inc., Pittsburgh, Pennsylvania	2004
<b>DISTRICT 5—RICHMOND</b>		
<i>Class A</i>		
Fred L. Green III .....	Chairman, President, and Chief Executive Officer, The National Bank of South Carolina, Columbia, South Carolina	2002
William W. Duncan, Jr. ....	President and Chief Executive Officer, St. Michaels Bank, St. Michaels, Maryland	2003
Eddie Canterbury .....	President and Chief Executive Officer, Logan Bank & Trust Company, Logan, West Virginia	2004
<i>Class B</i>		
W. Henry Harmon .....	President and Chief Executive Officer, Triana Energy, LLC, Charleston, West Virginia, and Union Drilling, Inc., Bridgeville, Pennsylvania	2002
James E. Haden .....	President and Chief Executive Officer, Martha Jefferson Hospital, Charlottesville, Virginia	2003
Joe Edens .....	Chairman, Edens & Avant, Columbia, South Carolina	2004
<i>Class C</i>		
Jeremiah J. Sheehan .....	Retired Chairman, Reynolds Metals Company, Richmond, Virginia	2002
Wesley S. Williams, Jr. ....	Partner, Covington & Burling, Washington, D.C.	2003
Irwin Zazulia .....	Retired President and Chief Executive Officer, Hecht's, Arlington, Virginia	2004
<b>Baltimore Branch</b>		
<i>Appointed by the Federal Reserve Bank</i>		
Dyan Brasington .....	President, Technology Council of Maryland, Rockville, Maryland	2002
William L. Jews .....	President and Chief Executive Officer, CareFirst BlueCross BlueShield, Owings Mills, Maryland	2003
Kenneth C. Lundeen .....	President, C. J. Langenfelder & Son, Inc., Baltimore, Maryland	2003
Donald P. Hutchinson .....	President and Chief Executive Officer, SunTrust Bank, Maryland, Baltimore, Maryland	2004



BANK or Branch Director	Title	Term expires Dec. 31
<i>Appointed by the Board of Governors</i>		
George L. Russell, Jr. ....	Law Offices of Peter G. Angelos, Baltimore, Maryland	2002
William C. Handorf .....	Professor of Finance, School of Business and Public Management, The George Washington University, Washington, D.C.	2003
Owen E. Herrnstadt .....	Director, International Department, International Association of Machinists and Aerospace Workers, AFL-CIO, Upper Marlboro, Maryland	2004
Charlotte Branch		
<i>Appointed by the Federal Reserve Bank</i>		
Lucy J. Reuben .....	Provost and Vice Chancellor for Academic Affairs, North Carolina Central University, Durham, North Carolina	2002
Elleveen T. Poston .....	President, Quality Transport, Inc., Lake City, South Carolina	2003
Cecil W. Sewell, Jr. ....	Chairman Emeritus, RBC Centura Banks, Inc., Rocky Mount, North Carolina	2003
William H. Nock .....	President and Chief Executive Officer, Sumter National Bank, Sumter, South Carolina	2004
<i>Appointed by the Board of Governors</i>		
Michael A. Almond .....	President and Chief Executive Officer, Charlotte Regional Partnership, Charlotte, North Carolina	2002
Jim Lowry .....	President, High Point Chevrolet Jeep, High Point, North Carolina	2003
James F. Goodmon .....	President and Chief Executive Officer, Capitol Broadcasting Company, Inc., Raleigh, North Carolina	2004
DISTRICT 6—ATLANTA		
<i>Class A</i>		
Richard G. Hickson .....	Chairman and Chief Executive Officer, Trustmark Corporation, Jackson, Mississippi	2002
William G. Smith, Jr. ....	President and Chief Executive Officer, Capital City Bank Group, Inc., Tallahassee, Florida	2003
James F. Beall .....	Chairman, President, and Chief Executive Officer, Farmers & Merchants Bank, Centre, Alabama	2004
<i>Class B</i>		
Egbert L. J. Perry .....	Chairman and Chief Executive Officer, The Integral Group, LLC, Atlanta, Georgia	2002
John Dane III .....	President and Chief Executive Officer, Trinity Yachts LLC, New Orleans, Louisiana	2003
Suzanne E. Boas .....	President, Consumer Credit Counseling Service of Greater Atlanta, Inc., Atlanta, Georgia	2004

**Directors—Continued**

BANK or Branch Director	Title	Term expires Dec. 31
<i>Class C</i>		
John F. Wieland .....	Chief Executive Officer and Chairman, John Wieland Homes and Neighborhoods, Inc., Atlanta, Georgia	2002
Paula Lovell .....	President, Lovell Communications, Inc., Nashville, Tennessee	2003
David M. Ratcliffe .....	President and Chief Executive Officer, Georgia Power Company, Atlanta, Georgia	2004
<i>Birmingham Branch</i>		
<i>Appointed by the Federal Reserve Bank</i>		
W. Charles Mayer III .....	Senior Executive Vice President, Alabama Banking Group Head, Commercial Banking Group Head, AmSouth Bank, Birmingham, Alabama	2002
Hundley Batts, Sr. ....	Owner and Managing General Agent, Hundley Batts & Associates, Huntsville, Alabama	2003
James Austin Vickery .....	International Representative, Laborers' International Union of North America, Gadsden, Alabama	2003
John B. Barnett III .....	Chairman, The Monroe County Bank, Monroeville, Alabama	2004
<i>Appointed by the Board of Governors</i>		
V. Larkin Martin .....	Managing Partner, Martin Farm, Courtland, Alabama	2002
W. Miller Welborn .....	President, Welborn and Associates, Inc., Lookout Mountain, Tennessee	2003
Catherine Sloss Crenshaw ..	President, Sloss Real Estate Group, Inc., Birmingham, Alabama	2004
<i>Jacksonville Branch</i>		
<i>Appointed by the Federal Reserve Bank</i>		
Jerry M. Smith .....	Chairman and President, First National Bank of Alachua, Alachua, Florida	2002
Robert L. Fisher .....	President and Chief Executive Officer, MacDill Federal Credit Union, Tampa, Florida	2003
Michael W. Poole .....	Principal, Poole Carbone Eckbert, Inc., Winter Park, Florida	2003
Harvey R. Heller .....	President, Heller Brothers Packing Corp., Winter Garden, Florida	2004
<i>Appointed by the Board of Governors</i>		
Marsha G. Rydberg .....	Partner, The Rydberg Law Firm, Tampa, Florida	2002
William E. Flaherty .....	Retired Chairman, Blue Cross and Blue Shield of Florida, Inc., Jacksonville, Florida	2003
Julie K. Hilton .....	Vice President and Co-Owner, Paradise Found Resorts & Hotels, Panama City Beach, Florida	2004

BANK or Branch Director	Title	Term expires Dec. 31
<i>Miami Branch</i>		
<i>Appointed by the Federal Reserve Bank</i>		
D. Keith Cobb .....	Managing Director, Cobb Consulting Group, Ft. Lauderdale, Florida	2002
James W. Moore .....	Managing Partner, Riverside Capital, LLC, Fort Myers, Florida	2002
Miriam Lopez .....	President and Chief Executive Officer, TransAtlantic Bank, Miami, Florida	2003
Rudy E. Schupp .....	Consultant, Florida Operations, Wachovia, N.A., North Palm Beach, Florida	2004
<i>Appointed by the Board of Governors</i>		
Mark T. Soddors .....	President, Lakeview Farms, Inc., Pahokee, Florida	2002
Brian E. Keeley .....	President and Chief Executive Officer, Baptist Health South Florida, Coral Gables, Florida	2003
Rosa Sugranes .....	Chairman, Iberia Tiles Corp., Miami, Florida	2004
<i>Nashville Branch</i>		
<i>Appointed by the Federal Reserve Bank</i>		
Michael B. Swain .....	President and Chief Executive Officer, First National Bank of Oneida, Oneida, Tennessee	2002
Emil Hassan .....	Senior Vice President, North American Manufacturing, Purchasing, Quality and Logistics, Nissan North America, Inc., Smyrna, Tennessee	2003
James W. Spradley, Jr. ....	President, Standard Candy Company, Inc., Nashville, Tennessee	2003
Sam O. Franklin III .....	Chairman, SunTrust Bank, Nashville, Nashville, Tennessee	2004
<i>Appointed by the Board of Governors</i>		
Beth Dortch Franklin .....	President and Chief Executive Officer, Star Transportation, Inc., Nashville, Tennessee	2002
Whitney Johns Martin .....	Chairman and Chief Executive Officer, Capital Across America, Nashville, Tennessee	2003
F. Rodney Lawler .....	Co-Founder and Chief Executive Officer, Lawler-Wood, LLC, Knoxville, Tennessee	2004
<i>New Orleans Branch</i>		
<i>Appointed by the Federal Reserve Bank</i>		
C. R. Cloutier .....	President and Chief Executive Officer, MidSouth Bank, Lafayette, Louisiana	2002
Teri G. Fontenot .....	President and Chief Executive Officer, Woman's Hospital, Baton Rouge, Louisiana	2003
David Guidry .....	President and Chief Executive Officer, Guico Machine Works, Inc., Harvey, Louisiana	2003
David E. Johnson .....	Chairman and Chief Executive Officer, The First Bancshares, Inc., and the First National Bank of South Mississippi, Hattiesburg, Mississippi	2004

**Directors—Continued**

BANK or Branch Director	Title	Term expires Dec. 31
<i>Appointed by the Board of Governors</i>		
R. Glenn Pumpelly .....	President and Chief Executive Officer, Pumpelly Oil Inc., Sulphur, Louisiana	2002
Ben Tom Roberts .....	Senior Executive Vice President/Owner, Roberts Brothers, Inc., Realtors, Mobile, Alabama	2003
Dave Dennis .....	President, Specialty Contractors & Assoc., Inc., Gulfport, Mississippi	2004
<b>DISTRICT 7—CHICAGO</b>		
<i>Class A</i>		
William A. Osborn .....	Chairman and Chief Executive Officer, Northern Trust Corporation and The Northern Trust Company, Chicago, Illinois	2002
Robert R. Yohanan .....	Managing Director and Chief Executive Officer, First Bank & Trust, Evanston, Illinois	2003
Alan R. Tubbs .....	President, Maquoketa State Bank and Ohnward Bancshares Inc., Maquoketa, Iowa	2004
<i>Class B</i>		
Connie E. Evans .....	President and Chief Executive Officer, WSEP Ventures, Chicago, Illinois	2002
Jack B. Evans .....	President, The Hall-Perrine Foundation, Cedar Rapids, Iowa	2003
James H. Keyes .....	Chairman and Chief Executive Officer, Johnson Controls, Inc., Milwaukee, Wisconsin	2004
<i>Class C</i>		
Robert J. Darnall .....	Retired Chairman and Chief Executive Officer, Inland Steel Industries, Inc., Chicago, Illinois	2002
W. James Farrell .....	Chairman and Chief Executive Officer, Illinois Tool Works Inc., Glenview, Illinois	2003
Miles D. White .....	Chairman and Chief Executive Officer, Abbott Laboratories, Abbott Park, Illinois	2004
<b>Detroit Branch</b>		
<i>Appointed by the Federal Reserve Bank</i>		
Irma B. Elder .....	President, Elder Ford, Troy, Michigan	2002
Mark T. Gaffney .....	President, Michigan AFL-CIO, Lansing, Michigan	2002
David J. Wagner .....	Chairman, Fifth Third Bank, Grand Rapids, Michigan	2003
Robert E. Churchill .....	Chairman and Chief Executive Officer, Citizens National Bank, Cheboygan, Michigan	2004
<i>Appointed by the Board of Governors</i>		
Edsel B. Ford II .....	Board Director, Ford Motor Company, Dearborn, Michigan	2002
Timothy D. Leuliette .....	President and Chief Executive Officer, Metaldyne, Plymouth, Michigan	2003
Irvin D. Reid .....	President, Wayne State University, Detroit, Michigan	2004

BANK or Branch Director	Title	Term expires Dec. 31
<b>DISTRICT 8—ST. LOUIS</b>		
<i>Class A</i>		
Lunsford W. Bridges .....	President and Chief Executive Officer, Metropolitan National Bank, Little Rock, Arkansas	2002
Bradley W. Small .....	President and Chief Executive Officer, The Farmers and Merchants National Bank, Nashville, Illinois	2003
Lewis F. Mallory, Jr. ....	Chairman and Chief Executive Officer, National Bank of Commerce, Starkville, Mississippi	2004
<i>Class B</i>		
Joseph E. Gliessner, Jr. ....	Executive Director, New Directions Housing Corp., Louisville, Kentucky	2002
Robert L. Johnson .....	Chairman and Chief Executive Officer, Johnson Bryce, Inc., Memphis, Tennessee	2003
Bert Greenwalt .....	Partner, Greenwalt Company, Hazen, Arkansas	2004
<i>Class C</i>		
Gayle P. W. Jackson .....	Managing Director, FondElec Clean Energy Group, Inc., St. Louis, Missouri	2002
Walter L. Metcalfe, Jr. ....	Chairman, Bryan Cave LLP, St. Louis, Missouri	2003
Charles W. Mueller .....	Chairman and Chief Executive Officer, Ameren Corporation, St. Louis, Missouri	2004
<b>Little Rock Branch</b>		
<i>Appointed by the Federal Reserve Bank</i>		
David R. Estes .....	President and Chief Executive Officer, First State Bank, Lonoke, Arkansas	2002
Everett Tucker III .....	Chairman, Moses Tucker Real Estate, Inc., Little Rock, Arkansas	2002
Raymond E. Skelton .....	Regional President, U.S. Bank, N.A., Little Rock, Arkansas	2003
Lawrence A. Davis, Jr. ....	Chancellor, University of Arkansas at Pine Bluff, Pine Bluff, Arkansas	2004
<i>Appointed by the Board of Governors</i>		
A. Rogers Yarnell II .....	President, Yarnell Ice Cream Co., Inc., Searcy, Arkansas	2002
Vacancy .....		2003
Vick M. Crawley .....	Plant Manager, Baxter Healthcare Corporation, Mountain Home, Arkansas	2004
<b>Louisville Branch</b>		
<i>Appointed by the Federal Reserve Bank</i>		
Thomas W. Smith .....	President, Thomas W. Smith & Associates, Inc., Danville, Kentucky	2002
Marjorie Z. Soyugenc .....	Executive Director and Chief Executive Officer, Welborn Foundation, Evansville, Indiana	2002
Frank J. Nichols .....	Chairman, President, and Chief Executive Officer, Community Financial Services, Inc., Benton, Kentucky	2003

**Directors—Continued**

BANK or Branch Director	Title	Term expires Dec. 31
David H. Brooks .....	Chairman and Chief Executive Officer, Stock Yards Bank & Trust Company, Louisville, Kentucky	2004
<i>Appointed by the Board of Governors</i>		
J. Stephen Barger .....	Executive Secretary-Treasurer, Kentucky State District Council of Carpenters, Frankfort, Kentucky	2002
Norman E. Pfau, Jr. ....	President and Chief Executive Officer, Geo. Pfau's Sons Company, Inc., Jeffersonville, Indiana	2003
Cornelius A. Martin .....	President and Chief Executive Officer, Martin Management Group, Bowling Green, Kentucky	2004
<i>Memphis Branch Appointed by the Federal Reserve Bank</i>		
James A. England .....	Chairman, President, and Chief Executive Officer, Decatur County Bank, Decaturville, Tennessee	2002
Tom A. Wright .....	Chairman, President, and Chief Executive Officer, Enterprise National Bank, Memphis, Tennessee	2002
E. C. Neelly III .....	Management Consultant, First American National Bank, Iuka, Mississippi	2003
Walter L. Morris, Jr. ....	President, H&M Lumber Co., Inc., West Helena, Arkansas	2004
<i>Appointed by the Board of Governors</i>		
Mike P. Sturdivant, Jr. ....	Partner, Due West, Glendora, Mississippi	2002
Russell Gwatney .....	President, Gwatney Companies, Memphis, Tennessee	2003
Gregory M. Duckett .....	Senior Vice President and Corporate Counsel, Baptist Memorial Health Care Corporation, Memphis, Tennessee	2004
<b>DISTRICT 9— MINNEAPOLIS</b>		
<i>Class A</i>		
Roger N. Berglund .....	Chairman and President, Dakota Western Bank, Bowman, North Dakota	2002
Dan M. Fisher .....	Chief Information Officer, Community First Bankshares, Inc., Fargo, North Dakota	2003
Kay Clevidence .....	President, Farmers State Bank, Victor, Montana	2004
<i>Class B</i>		
Rob L. Wheeler .....	Vice President, Wheeler Mfg. Co., Inc., Lemmon, South Dakota	2002
D. Greg Heineman .....	Chairman, Williams Insurance Agency, Sioux Falls, South Dakota	2003
Jay F. Hoeschler .....	President, Hoeschler Corporation, La Crosse, Wisconsin	2004

BANK or Branch Director	Title	Term expires Dec. 31
<i>Class C</i>		
Linda Hall Whitman .....	Chief Executive Officer, QuickMedx, Inc., Minneapolis, Minnesota	2002
Ronald N. Zwieg .....	President, United Food & Commercial Workers, Local 653, Plymouth, Minnesota	2003
Frank L. Sims .....	Corporate Vice President, Transportation Cargill, Inc., Wayzata, Minnesota	2004
Helena Branch		
<i>Appointed by the Federal Reserve Bank</i>		
Emil W. Erhardt .....	Chairman and President, Citizens State Bank, Hamilton, Montana	2002
Marilyn F. Wessel .....	Dean and Director, Museum of the Rockies, Bozeman, Montana	2002
Richard E. Hart .....	President, Senior Lender, and Director, Mountain West Bank, Kalispell, Montana	2003
<i>Appointed by the Board of Governors</i>		
William P. Underriner .....	President, Underriner Motors, Billings, Montana	2002
Tom Markle .....	President and Chief Executive Officer, Markle's Inc., Glasgow, Montana	2003
DISTRICT 10— KANSAS CITY		
<i>Class A</i>		
Dennis E. Barrett .....	Vice Chairman, FirstBank Holding Company of Colorado, Lakewood, Colorado	2002
Bruce A. Schriefer .....	President, Bankers' Bank of Kansas, Wichita, Kansas	2003
Jeffrey L. Gerhart .....	President and Chief Executive Officer, First National Bank, Newman Grove, Nebraska	2004
<i>Class B</i>		
Paula Marshall-Chapman ...	Chief Executive Officer, The Bama Companies, Inc., Tulsa, Oklahoma	2002
Hans C. Helmerich .....	President and Chief Executive Officer, Helmerich & Payne, Inc., Tulsa, Oklahoma	2003
Frank Moore .....	President, Spearhead Ranch Company, Douglas, Wyoming	2004
<i>Class C</i>		
Rhonda Holman .....	Vice President, Kauffman Center for Entrepreneurial Leadership at the Ewing Marion Kauffman Foundation, Kansas City, Missouri	2002
Terrence P. Dunn .....	President and Chief Executive Officer, J. E. Dunn Construction Company, Kansas City, Missouri	2003
Richard H. Bard .....	Founder and Manager, IdeaSpring, LLC, Denver, Colorado	2004

**Directors—Continued**

BANK or Branch Director	Title	Term expires Dec. 31
<i>Denver Branch</i>		
<i>Appointed by the Federal Reserve Bank</i>		
Virginia K. Berkeley .....	President, Colorado Business Bank N. A., Denver, Colorado	2002
John W. Hay III .....	President, Rock Springs National Bank, Rock Springs, Wyoming	2003
Kathryn A. Paul .....	President, Delta Dental Plan of Colorado, Denver, Colorado	2003
Thomas Williams .....	President and Chief Executive Officer, Williams Group LLC, Golden, Colorado	2004
<i>Appointed by the Board of Governors</i>		
Kathleen Avila .....	Managing Member, Avila Retail Development & Management, Albuquerque, New Mexico	2002
Robert M. Murphy .....	President, Sandia Properties Ltd., Co., Albuquerque, New Mexico	2003
James A. King .....	Chief Executive Officer, BT, Inc., Riverton, Wyoming	2004
<i>Oklahoma City Branch</i>		
<i>Appointed by the Federal Reserve Bank</i>		
Robert A. Funk .....	Chairman and Chief Executive Officer, Express Personnel Services International, Oklahoma City, Oklahoma	2002
Russell W. Teubner .....	Founder and Director, Esker, Inc., Stillwater, Oklahoma	2003
Robert R. Gilbert III .....	President and Chief Operating Officer, The F&M Bank & Trust Company, Tulsa, Oklahoma	2004
W. Carlisle Mabrey III .....	President and Chief Executive Officer, Citizens Bank & Trust Co., Okmulgee, Oklahoma	2004
<i>Appointed by the Board of Governors</i>		
J. Clifford Hudson .....	Chairman and Chief Executive Officer, Sonic Corp., Oklahoma City, Oklahoma	2002
Patricia B. Fennell .....	Executive Director, Latino Community Development Agency, Oklahoma City, Oklahoma	2003
Vacancy .....		2004
<i>Omaha Branch</i>		
<i>Appointed by the Federal Reserve Bank</i>		
Judith A. Owen .....	President and Chief Executive Officer, Wells Fargo Bank Nebraska, N.A., Omaha, Nebraska	2002
Frank L. Hayes .....	President, Hayes & Associates, L.L.C., CPAs, Omaha, Nebraska	2003
H. H. Kosman .....	Chairman, President, and Chief Executive Officer, Platte Valley National Bank, Scottsbluff, Nebraska	2003
Cynthia Hardin Milligan ...	Dean, College of Business Administration, University of Nebraska-Lincoln, Lincoln, Nebraska	2004



BANK or Branch Director	Title	Term expires Dec. 31
<i>Appointed by the Board of Governors</i>		
Bob L. Gottsch .....	Vice President, Gottsch Feeding Corporation, Hastings, Nebraska	2002
A. F. Raimondo .....	Chairman and Chief Executive Officer, Behlen Mfg. Co., Columbus, Nebraska	2003
Timothy Sandos .....	Former Vice President and State Executive Officer- Nebraska, Qwest Communications, Omaha, Nebraska	2004
DISTRICT 11—DALLAS		
<i>Class A</i>		
Kenneth T. Murphy .....	Chairman, President, and Chief Executive Officer, First Financial Bankshares, Inc., Abilene, Texas	2002
Matthew T. Doyle .....	Vice Chairman and Chief Executive Officer, Texas First Bank, Texas City, Texas	2003
David S. Barnard .....	Chairman, National Bank, Gatesville, Texas	2004
<i>Class B</i>		
Malcolm Gillis .....	President, Rice University, Houston, Texas	2002
Judy Ley Allen .....	Partner, Allen Investments, Houston, Texas	2003
Julie Spicer England .....	Vice President, Texas Instruments, Dallas, Texas	2004
<i>Class C</i>		
Patricia M. Patterson .....	President, Patterson Investments, Inc., Dallas, Texas	2002
H. B. Zachry, Jr. ....	Chairman and Chief Executive Officer, H. B. Zachry Company, San Antonio, Texas	2003
Ray L. Hunt .....	Chairman, President, and Chief Executive Officer, Hunt Consolidated, Inc., Dallas, Texas	2004
El Paso Branch		
<i>Appointed by the Federal Reserve Bank</i>		
Melissa W. O'Rourke .....	President, Charlotte's Inc., El Paso, Texas	2002
James D. Renfrow .....	President and Chief Executive Officer, The Carlsbad National Bank, Carlsbad, New Mexico	2002
Ron C. Helm .....	Owner, Helm Cattle Company, Van Horn, Texas	2003
F. James Volk .....	President and Chief Executive Officer, State National Bank, El Paso, Texas	2004
<i>Appointed by the Board of Governors</i>		
James Haines .....	Director and Vice Chairman, El Paso Electric Company, El Paso, Texas	2002
Gail Darling .....	President, Gail Darling Inc., El Paso, Texas	2003
Cecilia O. Levine .....	President, MFI International Mfg., LLC, USA/Mexico Strategic Alliance, El Paso, Texas	2004

**Directors—Continued**

BANK or Branch Director	Title	Term expires Dec. 31
<i>Houston Branch</i>		
<i>Appointed by the Federal Reserve Bank</i>		
Ray B. Nesbitt .....	President (Retired), Exxon Chemical Company, Houston, Texas	2002
Priscilla D. Slade .....	President, Texas Southern University, Houston, Texas	2002
Alan R. Buckwalter III .....	Chairman and Chief Executive Officer, Chase J.P. Morgan Bank, South Region, Houston, Texas	2003
Richard W. Weekley .....	Chairman, Weekley Development Company, Houston, Texas	2004
<i>Appointed by the Board of Governors</i>		
Lupe Fraga .....	President and Chief Executive Officer, Tejas Office Products, Inc., Houston, Texas	2002
Vacancy .....		2003
Edward O. Gaylord .....	Chairman, Jacintoport Terminal Company, Houston, Texas	2004
<i>San Antonio Branch</i>		
<i>Appointed by the Federal Reserve Bank</i>		
Mary Rose Cardenas .....	Vice President, Cardenas Motors, Inc., Brownsville, Texas	2002
Daniel B. Hastings, Jr. ....	President and Owner, Daniel B. Hastings, Inc., Laredo, Texas	2002
Arthur R. Emerson .....	Chairman and Chief Executive Officer, Groves Rojas Emerson, San Antonio, Texas	2003
R. Tom Roddy .....	Chairman Clear Lake National Bank, San Antonio, Texas	2004
<i>Appointed by the Board of Governors</i>		
Patty Puig Mueller .....	Vice President-Finance, Mueller Energetics Corp., Corpus Christi, Texas	2002
Marvin L. Ragsdale .....	President, Iron Workers District Council of the State of Texas, Georgetown, Texas	2003
Ron R. Harris .....	President and Chief Executive Officer, Pervasive Software, Inc., Austin, Texas	2004
<b>DISTRICT 12— SAN FRANCISCO</b>		
<i>Class A</i>		
E. Lynn Caswell .....	Chairman and Managing Director, Zurich American Trust Co., AG, Laguna Niguel, California	2002
Richard C. Hartnack .....	Vice Chairman, Union Bank of California, Los Angeles, California	2003
Richard W. Decker, Jr. ....	Chairman and Co-Founder, Belvedere Capital Partners, LLC, San Francisco, California	2004

BANK or Branch Director	Title	Term expires Dec. 31
<i>Class B</i>		
Robert S. Attiyeh .....	Senior Vice President, Chief Financial Officer (Retired), and Consultant, Amgen, Inc., Thousand Oaks, California	2002
Barbara L. Wilson .....	Idaho and Regional Vice President (Retired), Qwest Corporation, Boise, Idaho	2003
Jack McNally .....	Business Manager (Retired), IBEW Local Union 1245, and Principal, JKM Consulting, Sacramento, California	2004
<i>Class C</i>		
George M. Scalise .....	President, Semiconductor Industry Association, San Jose, California	2002
Nelson C. Rising .....	Chairman and Chief Executive Officer, Catellus Development Corporation, San Francisco, California	2003
Sheila D. Harris .....	Director, Arizona Department of Housing, Phoenix, Arizona	2004
Los Angeles Branch <i>Appointed by the Federal Reserve Bank</i>		
John H. Gleason .....	Regional President, California and Texas, Del Webb Group, Phoenix, Arizona	2002
Linda Griego .....	Managing Partner, Engine Co. No. 28, Los Angeles, California	2003
D. Linn Wiley .....	President and Chief Executive Officer, Citizens Business Bank, Ontario, California	2003
Russell Goldsmith .....	Chairman and Chief Executive Officer, City National Bank, Beverly Hills, California	2004
<i>Appointed by the Board of Governors</i>		
Lori R. Gay .....	President, Los Angeles Neighborhood Housing Services, Inc., Los Angeles, California	2002
Lonnie Kane .....	President, Karen Kane, Inc., Los Angeles, California	2003
William D. Jones .....	Chairman, President, and Chief Executive Officer, CityLink Investment Corporation, San Diego, California	2004
Portland Branch <i>Appointed by the Federal Reserve Bank</i>		
L. Martin Brantley .....	President and General Manager (Retired), Oregon's 12-KPTV, Portland, Oregon	2002
Vacancy .....		2002
Peter O. Kohler .....	President, Oregon Health & Science University, Portland, Oregon	2003
George J. Passadore .....	Chairman-Oregon, Wells Fargo Bank, Portland, Oregon	2004

**Directors—Continued**

BANK or Branch Director	Title	Term expires Dec. 31
<i>Appointed by the Board of Governors</i>		
Nancy Wilgenbusch .....	President, Marylhurst University, Marylhurst, Oregon	2002
Patrick Borunda .....	Principal, The Navigator Group, Vancouver, Washington	2003
Karla S. Chambers .....	Vice President, Stahlbush Island Farms, Inc., Corvallis, Oregon	2004
Salt Lake City Branch		
<i>Appointed by the Federal Reserve Bank</i>		
Maria Garciaz .....	Executive Director, Salt Lake Neighborhood Housing Services, Inc., Salt Lake City, Utah	2002
J. Pat McMurray .....	President and Chief Executive Officer, Idaho Region, Wells Fargo, Boise, Idaho	2002
Peggy A. Stock .....	President Emeritus, Westminster College, Salt Lake City, Utah	2003
Curtis H. Harris .....	Chairman, President, and Chief Executive Officer, Barnes Banking Company, Kaysville, Utah	2004
<i>Appointed by the Board of Governors</i>		
H. Roger Boyer .....	Chairman, The Boyer Company, Salt Lake City, Utah	2002
William C. Glynn .....	President, Intermountain Industries, Inc., Boise, Idaho	2003
Gary L. Crocker .....	Chairman, ARUP Laboratories, Salt Lake City, Utah	2004
Seattle Branch		
<i>Appointed by the Federal Reserve Bank</i>		
James C. Hawkanson .....	Chairman (Retired), The Commerce Bank of Washington, N.A., Seattle, Washington	2002
Mary E. Pugh .....	President, Pugh Capital Management, Inc., Seattle, Washington	2002
Betsy Lawer .....	Vice Chair and Chief Operating Officer, First National Bank Alaska, Anchorage, Alaska	2003
Peter H. van Oppen .....	Chairman and Chief Executive Officer, Advanced Digital Information Corp., Redmond, Washington	2004
<i>Appointed by the Board of Governors</i>		
Boyd E. Givan .....	Senior Vice President and Chief Financial Officer (Retired), The Boeing Company, Seattle, Washington	2002
David W. Wyckoff .....	Chairman and Chief Executive Officer, Wyckoff Farms, Inc., Grandview, Washington	2003
Mic R. Dinsmore .....	Chief Executive Officer, Port of Seattle, Seattle, Washington	2004

## Members of the Board of Governors, 1913–2002

### Appointed Members

Name	Federal Reserve District	Date initially took oath of office	Other dates <sup>1</sup>
Charles S. Hamlin	Boston	Aug. 10, 1914	Reappointed in 1916 and 1926. Served until Feb. 3, 1936. <sup>2</sup>
Paul M. Warburg	New York	Aug. 10, 1914	Term expired Aug. 9, 1918.
Frederic A. Delano	Chicago	Aug. 10, 1914	Resigned July 21, 1918.
W.P.G. Harding	Atlanta	Aug. 10, 1914	Term expired Aug. 9, 1922.
Adolph C. Miller	San Francisco	Aug. 10, 1914	Reappointed in 1924. Reappointed in 1934 from the Richmond District. Served until Feb. 3, 1936. <sup>2</sup>
Albert Strauss	New York	Oct. 26, 1918	Resigned Mar. 15, 1920.
Henry A. Moehlenpah	Chicago	Nov. 10, 1919	Term expired Aug. 9, 1920.
Edmund Platt	New York	June 8, 1920	Reappointed in 1928. Resigned Sept. 14, 1930.
David C. Wills	Cleveland	Sept. 29, 1920	Term expired Mar. 4, 1921.
John R. Mitchell	Minneapolis	May 12, 1921	Resigned May 12, 1923.
Milo D. Campbell	Chicago	Mar. 14, 1923	Died Mar. 22, 1923.
Daniel R. Crissinger	Cleveland	May 1, 1923	Resigned Sept. 15, 1927.
George R. James	St. Louis	May 14, 1923	Reappointed in 1931. Served until Feb. 3, 1936. <sup>3</sup>
Edward H. Cunningham	Chicago	May 14, 1923	Died Nov. 28, 1930.
Roy A. Young	Minneapolis	Oct. 4, 1927	Resigned Aug. 31, 1930.
Eugene Meyer	New York	Sept. 16, 1930	Resigned May 10, 1933.
Wayland W. Magee	Kansas City	May 18, 1931	Term expired Jan. 24, 1933.
Eugene R. Black	Atlanta	May 19, 1933	Resigned Aug. 15, 1934.
M.S. Szymczak	Chicago	June 14, 1933	Reappointed in 1936 and 1948. Resigned May 31, 1961.
J.J. Thomas	Kansas City	June 14, 1933	Served until Feb. 10, 1936. <sup>2</sup>
Marriner S. Eccles	San Francisco	Nov. 15, 1934	Reappointed in 1936, 1940, and 1944. Resigned July 14, 1951.
Joseph A. Broderick	New York	Feb. 3, 1936	Resigned Sept. 30, 1937.
John K. McKee	Cleveland	Feb. 3, 1936	Served until Apr. 4, 1946. <sup>2</sup>
Ronald Ransom	Atlanta	Feb. 3, 1936	Reappointed in 1942. Died Dec. 2, 1947.
Ralph W. Morrison	Dallas	Feb. 10, 1936	Resigned July 9, 1936.
Chester C. Davis	Richmond	June 25, 1936	Reappointed in 1940. Resigned Apr. 15, 1941.
Ernest G. Draper	New York	Mar. 30, 1938	Served until Sept. 1, 1950. <sup>2</sup>
Rudolph M. Evans	Richmond	Mar. 14, 1942	Served until Aug. 13, 1954. <sup>2</sup>
James K. Vardaman, Jr.	St. Louis	Apr. 4, 1946	Resigned Nov. 30, 1958.
Lawrence Clayton	Boston	Feb. 14, 1947	Died Dec. 4, 1949.
Thomas B. McCabe	Philadelphia	Apr. 15, 1948	Resigned Mar. 31, 1951.
Edward L. Norton	Atlanta	Sept. 1, 1950	Resigned Jan. 31, 1952.
Oliver S. Powell	Minneapolis	Sept. 1, 1950	Resigned June 30, 1952.
Wm. McC. Martin, Jr.	New York	April 2, 1951	Reappointed in 1956. Term expired Jan. 31, 1970.
A.L. Mills, Jr.	San Francisco	Feb. 18, 1952	Reappointed in 1958. Resigned Feb. 28, 1965.
J.L. Robertson	Kansas City	Feb. 18, 1952	Reappointed in 1964. Resigned Apr. 30, 1973.
C. Canby Balderston	Philadelphia	Aug. 12, 1954	Served through Feb. 28, 1966.
Paul E. Miller	Minneapolis	Aug. 13, 1954	Died Oct. 21, 1954.

## Appointed Members—Continued

Name	Federal Reserve District	Date initially took oath of office	Other dates <sup>1</sup>
Chas. N. Shepardson	Dallas	Mar. 17, 1955	Retired Apr. 30, 1967.
G.H. King, Jr.	Atlanta	Mar. 25, 1959	Reappointed in 1960. Resigned Sept. 18, 1963.
George W. Mitchell	Chicago	Aug. 31, 1961	Reappointed in 1962. Served until Feb. 13, 1976. <sup>2</sup>
J. Dewey Daane	Richmond	Nov. 29, 1963	Served until Mar. 8, 1974. <sup>2</sup>
Sherman J. Maisel	San Francisco	Apr. 30, 1965	Served through May 31, 1972.
Andrew F. Brimmer	Philadelphia	Mar. 9, 1966	Resigned Aug. 31, 1974.
William W. Sherrill	Dallas	May 1, 1967	Reappointed in 1968. Resigned Nov. 15, 1971.
Arthur F. Burns	New York	Jan. 31, 1970	Term began Feb. 1, 1970. Resigned Mar. 31, 1978.
John E. Sheehan	St. Louis	Jan. 4, 1972	Resigned June 1, 1975.
Jeffrey M. Bucher	San Francisco	June 5, 1972	Resigned Jan. 2, 1976.
Robert C. Holland	Kansas City	June 11, 1973	Resigned May 15, 1976.
Henry C. Wallich	Boston	Mar. 8, 1974	Resigned Dec. 15, 1986.
Philip E. Coldwell	Dallas	Oct. 29, 1974	Served through Feb. 29, 1980.
Philip C. Jackson, Jr.	Atlanta	July 14, 1975	Resigned Nov. 17, 1978.
J. Charles Partee	Richmond	Jan. 5, 1976	Served until Feb. 7, 1986. <sup>2</sup>
Stephen S. Gardner	Philadelphia	Feb. 13, 1976	Died Nov. 19, 1978.
David M. Lilly	Minneapolis	June 1, 1976	Resigned Feb. 24, 1978.
G. William Miller	San Francisco	Mar. 8, 1978	Resigned Aug. 6, 1979.
Nancy H. Teeters	Chicago	Sept. 18, 1978	Served through June 27, 1984.
Emmett J. Rice	New York	June 20, 1979	Resigned Dec. 31, 1986.
Frederick H. Schultz	Atlanta	July 27, 1979	Served through Feb. 11, 1982.
Paul A. Volcker	Philadelphia	Aug. 6, 1979	Resigned August 11, 1987.
Lyle E. Gramley	Kansas City	May 28, 1980	Resigned Sept. 1, 1985.
Preston Martin	San Francisco	Mar. 31, 1982	Resigned April 30, 1986.
Martha R. Seger	Chicago	July 2, 1984	Resigned March 11, 1991.
Wayne D. Angell	Kansas City	Feb. 7, 1986	Served through Feb. 9, 1994.
Manuel H. Johnson	Richmond	Feb. 7, 1986	Resigned August 3, 1990.
H. Robert Heller	San Francisco	Aug. 19, 1986	Resigned July 31, 1989.
Edward W. Kelley, Jr.	Dallas	May 26, 1987	Resigned Dec. 31, 2001.
Alan Greenspan	New York	Aug. 11, 1987	Reappointed in 1992.
John P. LaWare	Boston	Aug. 15, 1988	Resigned April 30, 1995.
David W. Mullins, Jr.	St. Louis	May 21, 1990	Resigned Feb. 14, 1994.
Lawrence B. Lindsey	Richmond	Nov. 26, 1991	Resigned Feb. 5, 1997.
Susan M. Phillips	Chicago	Dec. 2, 1991	Served through June 30, 1998.
Alan S. Blinder	Philadelphia	June 27, 1994	Term expired Jan. 31, 1996.
Janet L. Yellen	San Francisco	Aug. 12, 1994	Resigned Feb. 17, 1997.
Laurence H. Meyer	St. Louis	June 24, 1996	Term expired Jan. 31, 2002.
Alice M. Rivlin	Philadelphia	June 25, 1996	Resigned July 16, 1999.
Roger W. Ferguson, Jr.	Boston	Nov. 5, 1997	Reappointed in 2001.
Edward M. Gramlich	Richmond	Nov. 5, 1997	
Susan S. Bies	Chicago	Dec. 7, 2001	
Mark W. Olson	Minneapolis	Dec. 7, 2001	
Ben S. Bernanke	Atlanta	Aug. 5, 2002	
Donald L. Kohn	Kansas City	Aug. 5, 2002	

## Appointed Members—Continued

Name	Term
<i>Chairmen</i> <sup>3</sup>	
Charles S. Hamlin	Aug. 10, 1914–Aug. 9, 1916
W.P.G. Harding	Aug. 10, 1916–Aug. 9, 1922
Daniel R. Crissinger	May 1, 1923–Sept. 15, 1927
Roy A. Young	Oct. 4, 1927–Aug. 31, 1930
Eugene Meyer	Sept. 16, 1930–May 10, 1933
Eugene R. Black	May 19, 1933–Aug. 15, 1934
Marriner S. Eccles	Nov. 15, 1934–Jan. 31, 1948 <sup>4</sup>
Thomas B. McCabe	Apr. 15, 1948–Mar. 31, 1951
Wm. McC. Martin, Jr.	Apr. 2, 1951–Jan. 31, 1970
Arthur F. Burns	Feb. 1, 1970–Jan. 31, 1978
G. William Miller	Mar. 8, 1978–Aug. 6, 1979
Paul A. Volcker	Aug. 6, 1979–Aug. 11, 1987
Alan Greenspan	Aug. 11, 1987– <sup>5</sup>
<i>Vice Chairmen</i> <sup>3</sup>	
Frederic A. Delano	Aug. 10, 1914–Aug. 9, 1916
Paul M. Warburg	Aug. 10, 1916–Aug. 9, 1918
Albert Strauss	Oct. 26, 1918–Mar. 15, 1920
Edmund Platt	July 23, 1920–Sept. 14, 1930
J.J. Thomas	Aug. 21, 1934–Feb. 10, 1936
Ronald Ransom	Aug. 6, 1936–Dec. 2, 1947
C. Canby Balderston	Mar. 11, 1955–Feb. 28, 1966
J.L. Robertson	Mar. 1, 1966–Apr. 30, 1973
George W. Mitchell	May 1, 1973–Feb. 13, 1976
Stephen S. Gardner	Feb. 13, 1976–Nov. 19, 1978
Frederick H. Schultz	July 27, 1979–Feb. 11, 1982
Preston Martin	Mar. 31, 1982–Apr. 30, 1986
Manuel H. Johnson	Aug. 4, 1986–Aug. 3, 1990
David W. Mullins, Jr.	July 24, 1991–Feb. 14, 1994
Alan S. Blinder	June 27, 1994–Jan. 31, 1996
Alice M. Rivlin	June 25, 1996–July 16, 1999
Roger W. Ferguson, Jr.	Oct. 5, 1999–

NOTE. Under the original Federal Reserve Act, the Federal Reserve Board was composed of five appointed members, the Secretary of the Treasury (ex-officio chairman of the Board), and the Comptroller of the Currency. The original term of office was ten years; the five original appointed members had terms of two, four, six, eight, and ten years. In 1922 the number of appointed members was increased to six, and in 1933 the term of office was raised to twelve years. The Banking Act of 1935 changed the name to the Board of Governors of the Federal Reserve System and provided that the Board be composed of seven appointed members; that the Secretary of the Treasury and the Comptroller of the Currency continue to serve until Feb. 1, 1936; that the appointed members in

office on Aug. 23, 1935, continue to serve until Feb. 1, 1936, or until their successors were appointed and had qualified; and that thereafter the terms of members be fourteen years and that the designation of Chairman and Vice Chairman of the Board be for four years.

1. Date following “Resigned” and “Retired” denotes final day of service.

2. Successor took office on this date.

3. Before Aug. 23, 1935, Chairmen and Vice Chairmen were designated Governor and Vice Governor.

4. Served as Chairman Pro Tempore from February 3, 1948, to April 15, 1948.

5. Served as Chairman Pro Tempore from March 3, 1996, to June 20, 1996.

**Ex-Officio Members**

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Name	Term
<i>Secretaries of the Treasury</i>	
W.G. McAdoo	Dec. 23, 1913–Dec. 15, 1918
Carter Glass	Dec. 16, 1918–Feb. 1, 1920
David F. Houston	Feb. 2, 1920–Mar. 3, 1921
Andrew W. Mellon	Mar. 4, 1921–Feb. 12, 1932
Ogden L. Mills	Feb. 12, 1932–Mar. 4, 1933
William H. Woodin	Mar. 4, 1933–Dec. 31, 1933
Henry Morgenthau, Jr.	Jan. 1, 1934–Feb. 1, 1936
<i>Comptrollers of the Currency</i>	
John Skelton Williams	Feb. 2, 1914–Mar. 2, 1921
Daniel R. Crissinger	Mar. 17, 1921–Apr. 30, 1923
Henry M. Dawes	May 1, 1923–Dec. 17, 1924
Joseph W. McIntosh	Dec. 20, 1924–Nov. 20, 1928
J.W. Pole	Nov. 21, 1928–Sept. 20, 1932
J.F.T. O'Connor	May 11, 1933–Feb. 1, 1936

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## *Statistical Tables*

1. Statement of Condition of the Federal Reserve Banks,  
by Bank, December 31, 2002 and 2001

Millions of dollars

Item	Total		Boston	
	2002	2001	2002	2001
<b>ASSETS</b>				
Gold certificate account .....	11,039	11,045	533	546
Special drawing rights certificate account .....	2,200	2,200	115	115
Coin .....	988	1,047	45	54
<i>Loans</i>				
To depository institutions .....	40	34	0	2
Other .....	0	0	0	0
Securities purchased under agreements to resell (triparty) .....	39,500	50,250	0	0
<i>Federal agency obligations</i>				
Bought outright .....	10	10	1	1
Held under repurchase agreements .....	0	0	0	0
<i>U.S. Treasury securities</i>				
Bought outright <sup>1</sup> .....	629,406	551,675	36,062	33,146
Held under repurchase agreements .....	0	0	0	0
Total loans and securities .....	668,956	601,969	36,062	33,149
Items in process of collection .....	11,498	3,829	1,002	317
Bank premises .....	1,542	1,512	91	91
<i>Other assets</i>				
Denominated in foreign currencies <sup>2</sup> .....	16,913	14,559	964	757
Other <sup>3</sup> .....	20,112	20,819	973	1,076
Interdistrict settlement account .....	0	0	-6,558	-2,362
<b>Total assets</b> .....	<b>733,249</b>	<b>656,980</b>	<b>33,227</b>	<b>33,743</b>
<b>LIABILITIES</b>				
Federal Reserve notes outstanding (issued to Bank) .....	759,256	751,540	32,969	35,614
Less: Notes held by Federal Reserve Bank .....	104,983	139,783	4,065	3,808
Federal Reserve notes, net .....	654,273	611,757	28,905	31,806
Securities sold under agreements to repurchase .....	21,091	...	1,208	...
<i>Deposits</i>				
Depository institutions .....	22,541	17,478	1,212	626
U.S. Treasury, general account .....	4,420	6,645	0	0
Foreign, official accounts .....	136	61	2	2
Other <sup>4</sup> .....	1,156	828	61	40
Total deposits .....	28,254	25,012	1,274	668
Deferred credit items .....	10,666	3,131	832	283
Other liabilities and accrued dividends <sup>5</sup> .....	2,205	2,395	135	149
<b>Total liabilities</b> .....	<b>716,488</b>	<b>642,295</b>	<b>32,355</b>	<b>32,906</b>
<b>CAPITAL ACCOUNTS</b>				
Capital paid in .....	8,380	7,373	436	418
Surplus .....	8,380	7,312	436	418
Other capital accounts .....	0	0	0	0
<b>Total liabilities and capital accounts</b> .....	<b>733,249</b>	<b>656,980</b>	<b>33,227</b>	<b>33,743</b>
<b>FEDERAL RESERVE NOTE STATEMENT</b>				
Federal Reserve notes outstanding .....	759,256	751,540	...	...
Less: Held by Bank not subject to collateralization .....	101,559	138,000 <sup>6</sup>	...	...
<b>Collateralized Federal Reserve notes</b> .....	<b>657,696</b>	<b>613,539</b>	...	...
<i>Collateral for Federal Reserve notes</i>				
Gold certificate account .....	11,039	11,045	...	...
Special drawing rights certificate account .....	2,200	2,200	...	...
Other eligible assets .....	0	0	...	...
U.S. Treasury and federal agency securities .....	644,458	600,294 <sup>6</sup>	...	...
<b>Total collateral</b> .....	<b>657,696</b>	<b>613,539<sup>6</sup></b>	...	...

For notes see end of table.



1. Statement of Condition of the Federal Reserve Banks,  
by Bank, December 31, 2002 and 2001—Continued

Millions of dollars

Item	Atlanta		Chicago	
	2002	2001	2002	2001
<b>ASSETS</b>				
Gold certificate account .....	926	871	1,080	1,028
Special drawing rights certificate account .....	166	166	212	212
Coin .....	103	113	126	117
<i>Loans</i>				
To depository institutions .....	8	7	6	15
Other .....	0	0	0	0
Securities purchased under agreements to resell (triparty) .....	0	0	0	0
<i>Federal agency obligations</i>				
Bought outright .....	1	1	1	1
Held under repurchase agreements .....	0	0	0	0
<i>U.S. Treasury securities</i>				
Bought outright <sup>1</sup> .....	44,816	37,935	74,069	62,482
Held under repurchase agreements .....	0	0	0	0
Total loans and securities .....	44,825	37,943	74,076	62,497
Items in process of collection .....	748	149	1,169	526
Bank premises .....	279	281	116	105
<i>Other assets</i>				
Denominated in foreign currencies <sup>2</sup> .....	1,231	1,046	1,827	1,333
Other <sup>3</sup> .....	1,258	1,278	1,980	2,005
Interdistrict settlement account .....	-1,692	7,088	-14,583	6,071
<b>Total assets</b> .....	<b>47,844</b>	<b>48,934</b>	<b>66,004</b>	<b>73,895</b>
<b>LIABILITIES</b>				
Federal Reserve notes outstanding (issued to Banks) .....	59,126	65,085	63,905	74,543
Less: Notes held by Federal Reserve Banks .....	16,757	18,763	7,397	6,424
Federal Reserve notes, net .....	42,368	46,323	56,508	68,119
Securities sold under repurchase agreements .....	1,502	...	2,482	...
<i>Deposits</i>				
Depository institutions .....	1,735	1,169	3,943	3,498
U.S. Treasury, general account .....	0	0	0	0
Foreign, official accounts .....	2	2	3	3
Other <sup>4</sup> .....	133	37	123	44
Total deposits .....	1,870	1,208	4,069	3,544
Deferred credit items .....	972	138	997	386
Other liabilities and accrued dividends <sup>5</sup> .....	182	196	232	258
<b>Total liabilities</b> .....	<b>46,894</b>	<b>47,864</b>	<b>64,289</b>	<b>72,308</b>
<b>CAPITAL ACCOUNTS</b>				
Capital paid in .....	475	535	858	793
Surplus .....	475	535	858	793
Other capital accounts .....	0	0	0	0
<b>Total liabilities and capital accounts</b> .....	<b>47,844</b>	<b>48,934</b>	<b>66,004</b>	<b>73,895</b>

NOTE. Components may not sum to totals because of rounding.

1. Includes securities loaned—fully guaranteed by U.S. Treasury securities pledged with Federal Reserve Banks—and excludes securities sold and scheduled to be bought

back under matched sale—purchase transactions, which were discontinued in December 2002.

2. Valued daily at market exchange rates.

3. The System total includes depository institution overdrafts of \$3 million for 2002 and \$22 million for 2001.

1.—Continued

St. Louis		Minneapolis		Kansas City		Dallas		San Francisco	
2002	2001	2002	2001	2002	2001	2002	2001	2002	2001
346	343	179	143	309	317	485	477	1,046	1,136
71	71	30	30	66	66	98	98	234	234
59	58	35	31	66	69	163	128	111	144
11	3	7	3	2	3	0	0	5	0
0	0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	1	1
0	0	0	0	0	0	0	0	0	0
22,380	19,884	9,839	1,721	18,605	17,028	13,969	10,001	54,001	55,580
0	0	0	0	0	0	0	0	0	0
22,392	19,888	9,846	1,725	18,608	17,031	13,969	10,001	54,006	55,581
695	215	612	526	870	236	624	202	2,608	267
44	43	127	123	50	49	142	137	176	171
343	291	343	563	440	378	378	398	1,833	1,673
624	655	295	122	526	575	434	385	1,484	1,807
-3,554	721	4,063	12,065	-2,244	-358	14,306	4,041	-43	-7,226
<b>21,021</b>	<b>22,286</b>	<b>15,530</b>	<b>15,329</b>	<b>18,691</b>	<b>18,363</b>	<b>30,599</b>	<b>15,866</b>	<b>61,456</b>	<b>53,788</b>
22,002	24,022	15,088	16,070	19,979	21,077	36,839	33,441	67,131	69,686
3,088	2,586	1,785	2,015	3,854	4,117	8,424	19,062	14,359	20,372
18,914	21,435	13,304	14,055	16,125	16,960	28,416	14,378	52,772	49,314
750	...	330	...	623	...	468	...	1,810	...
480	344	430	460	822	758	727	695	2,273	2,129
0	0	0	0	0	0	0	0	0	0
1	1	1	1	1	1	1	1	3	3
34	22	2	0	33	24	24	31	105	54
514	366	433	462	855	783	752	727	2,381	2,187
346	79	713	457	598	135	505	349	2,584	490
99	107	72	57	88	103	85	83	173	206
<b>20,623</b>	<b>21,988</b>	<b>14,851</b>	<b>15,031</b>	<b>18,289</b>	<b>17,981</b>	<b>30,226</b>	<b>15,538</b>	<b>59,719</b>	<b>52,196</b>
199	149	340	180	201	191	186	164	868	796
199	149	340	118	201	191	186	164	868	796
0	0	0	0	0	0	0	0	0	0
<b>21,021</b>	<b>22,286</b>	<b>15,530</b>	<b>15,329</b>	<b>18,691</b>	<b>18,363</b>	<b>30,599</b>	<b>15,866</b>	<b>61,456</b>	<b>53,788</b>

4. Includes international organization deposits of \$100 million for 2002 and \$127 million for 2001. These deposits are held solely by the Federal Reserve Bank of New York.

5. Includes exchange-translation account reflecting the monthly revaluation at market exchange rates of foreign exchange commitments.

6. Amounts are restatements due to changes in previously reported data.

... Not applicable.

## 2. Federal Reserve Open Market Transactions, 2002

Millions of dollars

Type of security and transaction	Jan.	Feb.	Mar.	Apr.
U.S. TREASURY SECURITIES				
<i>Outright transactions (excluding matched transactions)</i>				
Treasury bills				
Gross purchases .....	2,772	1,042	3,013	1,047
Gross sales .....	0	0	0	0
Exchanges .....	55,521	54,619	48,483	45,376
New bills .....	55,521	54,619	48,483	45,376
Redemptions .....	0	0	0	0
Others within 1 year				
Gross purchases .....	0	2,894	1,455	2,709
Gross sales .....	0	0	0	0
Maturity shift .....	5,850	7,537	0	14,515
Exchanges .....	-5,766	-8,432	0	-15,522
Redemptions .....	0	0	0	0
0 to 5 years				
Gross purchases .....	2,872	1,101	2,181	1,142
Gross sales .....	0	0	0	0
Maturity shift .....	-5,850	-6,283	0	-14,515
Exchanges .....	5,766	7,679	0	15,522
5 to 10 years				
Gross purchases .....	0	334	637	1,670
Gross sales .....	0	0	0	0
Maturity shift .....	0	-501	0	0
Exchanges .....	0	753	0	0
More than 10 years				
Gross purchases .....	582	1,054	291	210
Gross sales .....	0	0	0	0
Maturity shift .....	0	-753	0	0
Exchanges .....	0	0	0	0
All maturities				
Gross purchases .....	6,226	6,425	7,577	6,777
Gross sales .....	0	0	0	0
Redemptions .....	0	0	0	0
Net change in U.S. Treasury securities .....	6,226	6,425	7,577	6,777

2.—Continued

May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Total
3,524	3,656	4,838	529	750	0	250	0	21,421
0	0	0	0	0	0	0	0	0
70,978	53,015	45,828	63,083	53,314	62,947	51,394	53,374	657,931
70,978	53,015	45,828	63,083	53,314	62,947	51,394	53,374	657,931
0	0	0	0	0	0	0	0	0
2,826	0	1,104	445	1,286	0	0	0	12,720
0	0	0	0	0	0	0	0	0
6,714	0	11,052	8,987	11,174	6,143	3,688	0	0
-9,031	0	-14,183	-5,040	-15,189	-5,435	-1,419	0	0
0	0	0	0	0	0	0	0	0
1,439	0	1,755	1,921	0	0	0	339	12,748
0	0	0	0	0	0	0	0	0
-1,620	0	-11,052	-629	-11,174	-6,143	-2,380	0	0
8,639	0	13,283	3,396	15,189	5,435	1,308	0	0
259	542	577	690	51	0	0	314	5,074
0	0	0	0	0	0	0	0	0
-5,094	0	0	-6,714	0	0	722	0	0
391	0	900	1,645	0	0	111	0	0
0	0	63	80	0	0	0	0	2,280
0	0	0	0	0	0	0	0	0
0	0	0	-1,645	0	0	-2,030	0	0
0	0	0	0	0	0	0	0	0
8,048	4,198	8,336	3,665	2,087	0	250	653	54,242
0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0
8,048	4,198	8,336	3,665	2,087	0	250	653	54,242

## 2. Federal Reserve Open Market Transactions, 2002—Continued

Millions of dollars

Type of security and transaction	Jan.	Feb.	Mar.	Apr.
<b>FEDERAL AGENCY OBLIGATIONS</b>				
<i>Outright transactions</i>				
Gross purchases .....	0	0	0	0
Gross sales .....	0	0	0	0
Redemptions .....	0	0	0	0
Net change in agency obligations .....	0	0	0	0
<b>TEMPORARY TRANSACTIONS</b>				
<i>Repurchase agreements<sup>1</sup></i>				
Gross purchases .....	118,550	101,749	70,850	102,200
Gross sales .....	131,300	104,750	75,849	100,200
<i>Matched sale–purchase agreements</i>				
Gross purchases .....	407,791	367,906	393,273	436,936
Gross sales .....	404,296	368,060	393,151	437,881
<i>Reverse repurchase agreements<sup>2</sup></i>				
Gross purchases .....	0	0	0	0
Gross sales .....	0	0	0	0
Net change in temporary transactions .....	–9,255	–3,155	–4,877	1,056
<b>Total net change in System Open Market Account .....</b>	<b>–3,030</b>	<b>3,270</b>	<b>2,700</b>	<b>7,833</b>

NOTE. Sales, redemptions, and negative figures reduce holdings of the System Open Market Account; all other figures increase such holdings. Components may not sum to totals because of rounding.

1. Cash value of agreements, which are collateralized by U.S. government and federal agency securities.

2. Cash value of agreements, which are collateralized by U.S. Treasury securities.



2.—Continued

May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Total
0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0
106,426	98,850	68,750	84,000	93,500	72,000	113,501	112,750	1,143,126
109,926	94,850	81,250	80,500	94,750	77,250	101,501	101,750	1,153,876
466,807	447,555	513,400	495,729	449,250	429,029	378,381	195,565	4,981,624
469,046	448,330	511,902	497,031	449,986	425,399	377,535	175,820	4,958,437
0	0	0	0	0	0	0	231,272	231,272
0	0	0	0	0	0	0	252,363	252,363
-5,738	3,225	-11,002	2,198	-1,986	-1,620	12,847	9,654	-8,654
<b>2,310</b>	<b>7,423</b>	<b>-2,666</b>	<b>5,863</b>	<b>101</b>	<b>-1,620</b>	<b>13,096</b>	<b>10,307</b>	<b>45,588</b>

3. Federal Reserve Bank Holdings of U.S. Treasury and Federal Agency Securities,  
December 31, 2000–02

Millions of dollars

Description	December 31			Change	
	2002	2001	2000	2001 to 2002	2000 to 2001
U.S. TREASURY SECURITIES					
<b>Held outright</b> <sup>1</sup> .....	<b>629,406</b>	<b>574,863</b>	<b>532,815</b>	<b>54,543</b>	<b>42,048</b>
<i>By remaining maturity</i>					
<i>Bills</i>					
1–90 days .....	153,311	136,695	130,710	16,616	5,985
91 days to 1 year .....	73,372	68,567	69,143	4,805	–576
<i>Notes and bonds</i>					
1 year or less .....	96,827	83,785	73,812	13,042	9,973
More than 1 year through 5 years .....	172,758	153,158	132,792	19,600	20,366
More than 5 years through 10 years .....	53,300	53,338	55,461	–38	–2,123
More than 10 years .....	79,840	79,320	70,896	520	8,424
<i>By type</i>					
Bills .....	226,682	205,262	199,854	21,420	5,408
Notes .....	297,893	265,941	240,177	31,952	25,764
Bonds .....	104,832	103,660	92,784	1,172	10,876
FEDERAL AGENCY SECURITIES					
<b>Held outright</b> <sup>1</sup> .....	<b>10</b>	<b>10</b>	<b>130</b>	<b>0</b>	<b>–120</b>
<i>By remaining maturity</i>					
1 year or less .....	10	0	0	10	0
More than 1 year through 5 years .....	0	10	130	–10	–120
More than 5 years through 10 years .....	0	0	0	0	0
More than 10 years .....	0	0	0	0	0
<i>By issuer</i>					
Federal Home Loan Banks .....	0	0	0	0	0
Federal National Mortgage Association .....	10	10	130	0	–120
TEMPORARY TRANSACTIONS					
<b>Repurchase agreements</b> <sup>2</sup> .....	<b>39,500</b>	<b>50,250</b>	<b>43,375</b>	<b>–10,750</b>	<b>6,875</b>
<b>Matched sale–purchase agreements</b>					
Foreign official and international accounts .....	0	23,188	21,112	–23,188	2,076
Dealers .....	0	0	0	0	0
<b>Reverse repurchase agreements</b> <sup>3</sup>					
Foreign official and international accounts .....	21,091	0	0	21,091	0
Dealers .....	0	0	0	0	0

NOTE. Components may not sum to totals because of rounding.

1. Excludes the effects of temporary transactions—repurchase agreements and matched sale–purchase agreements (MSPs).

2. Cash value of agreements, which are collateralized by U.S. government and federal agency securities.

3. Cash value of agreements, which are collateralized by U.S. Treasury securities.

4. Number and Annual Salaries of Officers and Employees of the Federal Reserve Banks, December 31, 2002

Federal Reserve Bank (including Branches)	President	Other officers		Employees			Total	
	Salary (dollars) <sup>1</sup>	Number	Salaries (dollars) <sup>1</sup>	Number		Salaries (dollars) <sup>1</sup>	Number	Salaries (dollars) <sup>1</sup>
				Full-time	Part-time			
Boston .....	247,500	74	10,151,114	1,111	152	63,320,113	1,338	73,718,727
New York .....	313,300	260	42,919,160	2,896	65	183,014,637	3,222	226,247,097
Philadelphia .....	224,300	57	7,533,500	1,120	50	51,228,840	1,228	58,986,640
Cleveland .....	244,500	55	7,015,525	1,317	43	57,433,719	1,416	64,693,744
Richmond .....	242,400	90	11,104,700	1,894	93	88,778,343	2,078	100,125,443
Atlanta .....	267,900	92	12,117,100	1,981	33	84,533,525	2,107	96,918,525
Chicago .....	272,700	95	12,630,586	1,943	72	104,536,952	2,111	117,440,238
St. Louis .....	228,700 <sup>2</sup>	75	8,874,497	1,172	76	51,492,774	1,324	60,595,971
Minneapolis .....	254,100	42	5,587,900	1,163	120	54,199,997	1,326	60,041,997
Kansas City .....	248,600	71	8,993,500	1,544	58	71,205,673	1,674	80,447,773
Dallas .....	240,200	55	6,767,400	1,340	67	60,871,423	1,463	67,879,023
San Francisco .....	327,800	76	11,444,250	2,125	44	121,423,179	2,246	133,195,229
Federal Reserve Information Technology .....	0	29	3,981,500	694	9	49,766,522	732	53,748,022
Office of Employee Benefits .....	0	6	1,117,250	26	0	1,870,401	32	2,987,651
<b>Total .....</b>	<b>3,112,000</b>	<b>1,077</b>	<b>150,237,982</b>	<b>20,326</b>	<b>882</b>	<b>1,043,676,098</b>	<b>22,297</b>	<b>1,197,026,080</b>

1. Annualized salary liability based on salaries in effect on December 31, 2002.

2. The annualized salary for the President of the Federal Reserve Bank of St. Louis was reported incorrectly

as \$218,000 in table 4 of the 2001 Annual Report. The correct annualized salary was \$218,600.

## 5. Income and Expenses of the Federal Reserve Banks, by Bank, 2002

Thousands of dollars

Item	Total	Boston	New York	Philadelphia	Cleveland
<b>CURRENT INCOME</b>					
Loans .....	2,197	33	47	7	213
U.S. Treasury and federal agency securities .....	25,524,901	1,458,648	10,397,780	984,126	1,409,402
Foreign currencies .....	271,904	15,409	55,833	8,247	24,242
Priced services .....	916,252	53,983	100,154	45,672	66,456
Other .....	44,860	1,190	27,125	880	1,552
<b>Total .....</b>	<b>26,760,113</b>	<b>1,529,263</b>	<b>10,580,938</b>	<b>1,038,932</b>	<b>1,501,865</b>
<b>CURRENT EXPENSES</b>					
Salaries and other personnel expenses .....	1,342,260	79,730	252,819	65,558	68,413
Retirement and other benefits ..	363,660	38,401	123,407	23,909	25,904
Net periodic pension costs <sup>1</sup> .....	-155,062	170	-156,844	120	167
Fees .....	67,352	4,244	5,621	1,250	3,789
Travel .....	57,719	2,555	6,515	2,012	3,696
Software expenses .....	110,683	4,391	11,735	2,645	10,361
Postage and other shipping costs .....	85,830	1,841	4,747	1,537	2,129
Communications .....	14,143	2,233	1,952	361	718
Materials and supplies .....	52,155	3,000	8,986	3,475	3,085
<i>Building expenses</i>					
Taxes on real estate .....	29,310	4,739	4,391	1,556	-451
Property depreciation .....	78,985	4,698	13,638	3,223	6,325
Utilities .....	30,892	2,628	5,495	2,523	2,058
Rent .....	37,033	802	13,441	320	394
Other .....	31,984	945	5,869	1,433	2,790
<i>Equipment</i>					
Purchases .....	26,284	2,108	3,384	1,305	1,407
Rentals .....	35,723	1,252	1,834	748	307
Depreciation .....	107,661	5,098	15,564	5,279	5,113
Repairs and maintenance .....	93,156	6,151	9,554	5,203	5,976
Earnings-credit costs .....	155,939	10,518	50,293	8,416	12,214
Other .....	67,230	4,138	12,231	3,099	3,698
Recoveries .....	-77,915	-12,948	-8,927	-2,692	-2,614
Expenses capitalized <sup>2</sup> .....	-18,950	-758	-4,795	-735	-1,163
<b>Total .....</b>	<b>2,536,073</b>	<b>165,934</b>	<b>380,911</b>	<b>130,546</b>	<b>154,315</b>
Reimbursements .....	-308,995	-25,357	-69,250	-20,049	-25,606
Net expenses .....	2,227,078	140,578	311,661	110,498	128,709

For notes see end of table.

5.—Continued

Richmond	Atlanta	Chicago	St. Louis	Minneapolis	Kansas City	Dallas	San Francisco
11	111	579	303	532	202	69	90
1,833,772	1,772,097	2,926,105	896,686	306,580	751,643	529,587	2,258,474
65,150	19,780	29,094	5,515	5,825	7,070	6,158	29,581
80,322	125,385	107,553	52,560	53,126	70,427	62,663	97,952
2,212	1,767	3,876	963	321	601	555	3,819
<b>1,981,467</b>	<b>1,919,140</b>	<b>3,067,208</b>	<b>956,026</b>	<b>366,384</b>	<b>829,944</b>	<b>599,031</b>	<b>2,389,915</b>
171,467	124,472	125,025	65,440	63,947	90,381	76,707	158,300
-139,475	44,305	45,324	39,423	35,902	38,514	33,243	54,803
245	164	142	142	130	158	135	211
25,485	6,844	6,564	794	6,289	1,588	1,663	3,220
7,700	6,779	6,027	2,966	3,969	4,183	3,300	8,018
43,704	5,061	11,643	4,181	2,747	3,284	3,950	6,979
3,713	47,709	4,458	2,845	3,021	4,329	2,483	7,016
1,526	1,186	1,806	907	721	727	919	1,087
6,163	5,805	4,962	3,410	1,786	3,202	3,544	4,736
1,918	3,892	2,833	383	3,790	603	2,502	3,153
7,095	10,074	6,597	4,288	4,161	4,014	5,967	8,905
2,898	2,726	2,347	1,612	1,677	1,321	2,190	3,419
14,353	890	2,743	1,028	142	1,471	1,272	178
3,740	3,138	5,271	999	1,464	764	2,662	2,909
3,725	2,618	2,732	1,548	1,546	1,617	1,633	2,662
27,637	858	896	196	764	235	238	759
29,373	10,193	7,669	4,575	3,915	6,007	4,366	10,509
18,819	11,976	9,473	3,911	3,540	3,362	5,190	10,000
20,328	6,806	19,946	3,392	3,575	5,469	3,689	11,294
9,536	6,477	7,340	3,293	3,076	4,254	4,051	6,038
-26,858	-3,598	-5,521	-1,735	-807	-1,534	-6,203	-4,478
-3,156	-1,256	-701	-665	-549	-1,528	-531	-3,113
<b>229,936</b>	<b>297,117</b>	<b>267,575</b>	<b>142,934</b>	<b>144,808</b>	<b>172,421</b>	<b>152,970</b>	<b>296,605</b>
-36,300	-13,223	-11,282	-38,277	-22,468	-15,959	-11,610	-19,617
193,637	283,894	256,293	104,657	122,340	156,462	141,361	276,988

## 5. Income and Expenses of the Federal Reserve Banks, by Bank, 2002—Continued

Thousands of dollars

Item	Total	Boston	New York	Philadelphia	Cleveland
<b>PROFIT AND LOSS</b>					
Current net income .....	24,533,035	1,388,686	10,269,277	928,434	1,373,156
<i>Additions to and deductions from (-) current net income<sup>3</sup></i>					
Profits on sales of U.S. Treasury and federal agency securities .....	76,527	4,512	30,852	3,063	4,377
Profits on foreign exchange transactions .....	2,082,516	119,799	424,785	62,129	193,518
Other additions .....	3,484	4	3,235	1	3
Total additions .....	2,162,527	124,315	458,872	65,194	197,899
Losses on sales of U.S. Treasury and federal agency securities .....	0	0	0	0	0
Losses on foreign exchange transactions .....	0	0	0	0	0
Interest expense on reverse repurchase agreements ....	-13,068	-749	-5,144	-503	-721
Other deductions .....	-118	0	-82	-2	-2
Total deductions .....	-13,186	-749	-5,225	-504	-724
Net addition to or deduction from (-) current net income .....	2,149,341	123,566	453,647	64,689	197,175
Cost of unreimbursed Treasury services .....	13	0	13	0	0
<i>Assessments by Board</i>					
Board expenditures <sup>4</sup> .....	205,111	11,443	42,920	6,098	18,179
Cost of currency .....	429,568	22,487	177,353	15,310	21,611
Net income before payment to U.S. Treasury .....	26,047,684	1,478,321	10,502,637	971,716	1,530,542
Dividends paid .....	483,596	25,830	103,843	13,810	41,266
Payments to U.S. Treasury (interest on Federal Reserve notes) .....	24,495,490	1,434,682	10,093,923	946,441	1,451,626
Transferred to/from surplus ....	1,068,598	17,809	304,871	11,465	37,650
Surplus, January 1 .....	7,311,522	418,391	1,504,031	221,361	664,687
Surplus, December 31 .....	8,380,120	436,200	1,808,902	232,826	702,337

NOTE. Components may not sum to totals because of rounding.

1. Reflects the effect of Financial Accounting Standards Board Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions* (SFAS 87). The System Retirement Plan for employees is recorded on behalf of the System on the books of the Federal Reserve Bank of New York, resulting in a reduction in expenses of \$157,159 thousand. The Benefit Equalization Retirement Plan and the Supplemental Employees Retirement Plan are recorded by each Federal Reserve Bank.

2. Includes expenses for labor and materials capitalized and depreciated or amortized as charges to activities in the periods benefited.

3. Includes reimbursement from the U.S. Treasury for uncut sheets of Federal Reserve notes, gains and losses on the sale of Reserve Bank buildings, counterfeit currency that is not charged back to the depositing institution, and stale Reserve Bank checks that are written off.

4. For additional details, see the chapter "Board of Governors Financial Statements."

5.—Continued

Richmond	Atlanta	Chicago	St. Louis	Minneapolis	Kansas City	Dallas	San Francisco
1,787,830	1,635,246	2,810,915	851,369	244,044	673,481	457,671	2,112,927
5,134	5,332	8,804	2,744	624	2,322	1,513	7,250
497,533	151,846	228,679	42,341	38,067	54,179	45,396	224,243
5	69	10	0	21	8	21	106
502,671	157,247	237,493	45,085	38,713	56,509	46,930	231,599
0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0
-1,020	-926	-1,538	-465	-204	-386	-290	-1,122
-8	-13	-1	-1	-1	-2	-4	-1
-1,028	-938	-1,540	-466	-205	-388	-294	-1,123
501,643	156,308	235,953	44,619	38,507	56,121	46,636	230,477
0	0	0	0	0	0	0	0
49,899	14,135	21,687	4,401	4,786	5,221	4,488	21,854
31,701	32,022	48,058	15,044	9,848	11,929	9,828	34,378
2,207,873	1,745,398	2,977,124	876,542	267,918	712,452	489,990	2,287,171
120,193	27,873	49,156	11,179	18,777	11,785	10,372	49,511
1,771,878	1,776,865	2,863,517	815,379	27,580	690,973	457,352	2,165,275
315,802	-59,340	64,451	49,984	221,561	9,694	22,267	72,386
1,757,409	534,584	793,150	149,052	118,076	190,959	164,015	795,807
2,073,211	475,244	857,601	199,035	339,637	200,652	186,282	868,193

## 6. Income and Expenses of the Federal Reserve Banks, 1914–2002

Thousands of dollars

Federal Reserve Bank and period	Current income	Net expenses	Net additions or deductions (–) <sup>1</sup>	Assessments by Board of Governors	
				Board expenditures	Costs of currency
<i>All Banks</i>					
1914–15 .....	2,173	2,018	6	302	...
1916 .....	5,218	2,082	–193	192	...
1917 .....	16,128	4,922	–1,387	238	...
1918 .....	67,584	10,577	–3,909	383	...
1919 .....	102,381	18,745	–4,673	595	...
1920 .....	181,297	27,549	–3,744	710	...
1921 .....	122,866	33,722	–6,315	741	...
1922 .....	50,499	28,837	–4,442	723	...
1923 .....	50,709	29,062	–8,233	703	...
1924 .....	38,340	27,768	–6,191	663	...
1925 .....	41,801	26,819	–4,823	709	...
1926 .....	47,600	24,914	–3,638	722	1,714
1927 .....	43,024	24,894	–2,457	779	1,845
1928 .....	64,053	25,401	–5,026	698	806
1929 .....	70,955	25,810	–4,862	782	3,099
1930 .....	36,424	25,358	–93	810	2,176
1931 .....	29,701	24,843	311	719	1,479
1932 .....	50,019	24,457	–1,413	729	1,106
1933 .....	49,487	25,918	–12,307	800	2,505
1934 .....	48,903	26,844	–4,430	1,372	1,026
1935 .....	42,752	28,695	–1,737	1,406	1,477
1936 .....	37,901	26,016	486	1,680	2,178
1937 .....	41,233	25,295	–1,631	1,748	1,757
1938 .....	36,261	25,557	2,232	1,725	1,630
1939 .....	38,501	25,669	2,390	1,621	1,356
1940 .....	43,538	25,951	11,488	1,704	1,511
1941 .....	41,380	28,536	721	1,840	2,588
1942 .....	52,663	32,051	–1,568	1,746	4,826
1943 .....	69,306	35,794	23,768	2,416	5,336
1944 .....	104,392	39,659	3,222	2,296	7,220
1945 .....	142,210	41,666	–830	2,341	4,710
1946 .....	150,385	50,493	–626	2,260	4,482
1947 .....	158,656	58,191	1,973	2,640	4,562
1948 .....	304,161	64,280	–34,318	3,244	5,186
1949 .....	316,537	67,931	–12,122	3,243	6,304
1950 .....	275,839	69,822	36,294	3,434	7,316
1951 .....	394,656	83,793	–2,128	4,095	7,581
1952 .....	456,060	92,051	1,584	4,122	8,521
1953 .....	513,037	98,493	–1,059	4,100	10,922
1954 .....	438,486	99,068	–134	4,175	6,490
1955 .....	412,488	101,159	–265	4,194	4,707
1956 .....	595,649	110,240	–23	5,340	5,603
1957 .....	763,348	117,932	–7,141	7,508	6,374
1958 .....	742,068	125,831	124	5,917	5,973
1959 .....	886,226	131,848	98,247	6,471	6,384
1960 .....	1,103,385	139,894	13,875	6,534	7,455
1961 .....	941,648	148,254	3,482	6,265	6,756
1962 .....	1,048,508	161,451	–56	6,655	8,030
1963 .....	1,151,120	169,638	615	7,573	10,063
1964 .....	1,343,747	171,511	726	8,655	17,230
1965 .....	1,559,484	172,111	1,022	8,576	23,603
1966 .....	1,908,500	178,212	996	9,022	20,167
1967 .....	2,190,404	190,561	2,094	10,770	18,790
1968 .....	2,764,446	207,678	8,520	14,198	20,474
1969 .....	3,373,361	237,828	–558	15,020	22,126

For notes see end of table.



6.—Continued

Dividends paid	Payments to U.S. Treasury		Transferred to surplus (section 13b)	Transferred to surplus (section 7)
	Statutory transfers <sup>2</sup>	Interest on Federal Reserve notes		
217	...	...	...	...
1,743	...	...	...	...
6,804	1,134	...	...	1,134
5,541	...	...	...	48,334
5,012	2,704	...	...	70,652
5,654	60,725	...	...	82,916
6,120	59,974	...	...	15,993
6,307	10,851	...	...	-660
6,553	3,613	...	...	2,546
6,682	114	...	...	-3,078
6,916	59	...	...	2,474
7,329	818	...	...	8,464
7,755	250	...	...	5,044
8,458	2,585	...	...	21,079
9,584	4,283	...	...	22,536
10,269	17	...	...	-2,298
10,030	...	...	...	-7,058
9,282	2,011	...	...	11,021
8,874	...	...	...	-917
8,782	...	...	-60	6,510
8,505	298	...	28	607
7,830	227	...	103	353
7,941	177	...	67	2,616
8,019	120	...	-419	1,862
8,110	25	...	-426	4,534
8,215	82	...	-54	17,617
8,430	141	...	-4	571
8,669	198	...	50	3,554
8,911	245	...	135	40,327
9,500	327	...	201	48,410
10,183	248	...	262	81,970
10,962	67	...	28	81,467
11,523	36	75,284	87	8,366
11,920	...	166,690	...	18,523
12,329	...	193,146	...	21,462
13,083	...	196,629	...	21,849
13,865	...	254,874	...	28,321
14,682	...	291,935	...	46,334
15,558	...	342,568	...	40,337
16,442	...	276,289	...	35,888
17,712	...	251,741	...	32,710
18,905	...	401,556	...	53,983
20,081	...	542,708	...	61,604
21,197	...	524,059	...	59,215
22,722	...	910,650	...	-93,601
23,948	...	896,816	...	42,613
25,570	...	687,393	...	70,892
27,412	...	799,366	...	45,538
28,912	...	879,685	...	55,864
30,782	...	1,582,119	...	-465,823
32,352	...	1,296,810	...	27,054
33,696	...	1,649,455	...	18,944
35,027	...	1,907,498	...	29,851
36,959	...	2,463,629	...	30,027
39,237	...	3,019,161	...	39,432

## 6. Income and Expenses of the Federal Reserve Banks, 1914–2002—Continued

Thousands of dollars

Federal Reserve Bank and period	Current income	Net expenses	Net additions or deductions (–) <sup>1</sup>	Assessments by Board of Governors	
				Board expenditures	Costs of currency
1970.....	3,877,218	276,572	11,442	21,228	23,574
1971.....	3,723,370	319,608	94,266	32,634	24,943
1972.....	3,792,335	347,917	–49,616	35,234	31,455
1973.....	5,016,769	416,879	–80,653	44,412	33,826
1974.....	6,280,091	476,235	–78,487	41,117	30,190
1975.....	6,257,937	514,359	–202,370	33,577	37,130
1976.....	6,623,220	558,129	7,311	41,828	48,819
1977.....	6,891,317	568,851	–177,033	47,366	55,008
1978.....	8,455,309	592,558	–633,123	53,322	60,059
1979.....	10,310,148	625,168	–151,148	50,530	68,391
1980.....	12,802,319	718,033	–115,386	62,231	73,124
1981.....	15,508,350	814,190	–372,879	63,163	82,924
1982.....	16,517,385	926,034	–68,833	61,813	98,441
1983.....	16,068,362	1,023,678	–400,366	71,551	152,135
1984.....	18,068,821	1,102,444	–412,943	82,116	162,606
1985.....	18,131,983	1,127,744	1,301,624	77,378	173,739
1986.....	17,464,528	1,156,868	1,975,893	97,338	180,780
1987.....	17,633,012	1,146,911	1,796,594	81,870	170,675
1988.....	19,526,431	1,205,960	–516,910	84,411	164,245
1989.....	22,249,276	1,332,161	1,254,613	89,580	175,044
1990.....	23,476,604	1,349,726	2,099,328	103,752	193,007
1991.....	22,553,002	1,429,322	405,729	109,631	261,316
1992.....	20,235,028	1,474,531	–987,788	128,955	295,401
1993.....	18,914,251	1,657,800	–230,268	140,466	355,947
1994.....	20,910,742	1,795,328	2,363,862	146,866	368,187
1995.....	25,395,148	1,818,416	857,788	161,348	370,203
1996.....	25,164,303	1,947,861	–1,676,716	162,642	402,517
1997.....	26,917,213	1,976,453	–2,611,570	174,407	364,454
1998.....	28,149,477	1,833,436	1,906,037	178,009	408,544
1999.....	29,346,836	1,852,162	–533,557	213,790	484,959
2000.....	33,963,992	1,971,688	–1,500,027	188,067	435,838
2001.....	31,870,721	2,084,708	–1,117,435	295,056	338,537
2002.....	26,760,113	2,227,078	2,149,328	205,111	429,568
<b>Total, 1914–2002.....</b>	<b>594,417,190</b>	<b>42,492,506</b>	<b>4,378,548</b>	<b>3,568,694</b>	<b>6,851,034</b>
<i>Aggregate for each Bank, 1914–2002</i>					
Boston.....	32,275,936	2,857,036	160,569	145,739	394,515
New York.....	202,526,500	6,360,769 <sup>4</sup>	1,460,696	882,397	2,331,851
Philadelphia.....	22,370,492	2,329,674	105,590	153,563	265,160
Cleveland.....	37,468,955	2,702,150	236,225	249,593	412,717
Richmond.....	46,000,087	3,766,672	144,329	394,978	567,281
Atlanta.....	30,459,421	4,335,205	358,501	284,947	412,472
Chicago.....	74,551,863	5,448,459	572,925	428,964	810,225
St. Louis.....	20,723,931	2,188,134	74,585	92,904	253,781
Minneapolis.....	9,732,977	2,068,590	74,234	107,309	107,030
Kansas City.....	22,223,280	2,774,287	125,301	127,656	252,836
Dallas.....	27,466,412	2,780,416	402,746	201,661	298,097
San Francisco.....	68,617,336	4,881,114	662,846	498,980	745,068
<b>Total.....</b>	<b>594,417,190</b>	<b>42,492,506</b>	<b>4,378,548</b>	<b>3,568,694</b>	<b>6,851,034</b>

NOTE. Components may not sum to totals because of rounding.

... Not applicable.

1. For 1987 and subsequent years, includes the cost of services provided to the Treasury by Federal Reserve Banks for which reimbursement was not received.

2. Represents transfers made as a franchise tax from 1917 through 1932; transfers made under section 13b of the Federal Reserve Act from 1935 through 1947; and transfers made under section 7 of the Federal Reserve Act for 1996 and 1997.

6.—Continued

Dividends paid	Payments to U.S. Treasury		Transferred to surplus (section 13b)	Transferred to surplus (section 7)
	Statutory transfers <sup>2</sup>	Interest on Federal Reserve notes		
41,137	...	3,493,571	...	32,580
43,488	...	3,356,560	...	40,403
46,184	...	3,231,268	...	50,661
49,140	...	4,340,680	...	51,178
52,580	...	5,549,999	...	51,483
54,610	...	5,382,064	...	33,828
57,351	...	5,870,463	...	53,940
60,182	...	5,937,148	...	45,728
63,280	...	7,005,779	...	47,268
67,194	...	9,278,576	...	69,141
70,355	...	11,706,370	...	56,821
74,574	...	14,023,723	...	76,897
79,352	...	15,204,591	...	78,320
85,152	...	14,228,816	...	106,663
92,620	...	16,054,095	...	161,996
103,029	...	17,796,464	...	155,253
109,588	...	17,803,895	...	91,954
117,499	...	17,738,880	...	173,771
125,616	...	17,364,319	...	64,971
129,885	...	21,646,417	...	130,802
140,758	...	23,608,398	...	180,292
152,553	...	20,777,552	...	228,356
171,763	...	16,774,477	...	402,114
195,422	...	15,986,765	...	347,583
212,090	...	20,470,011	...	282,122
230,527	...	23,389,367	...	283,075
255,884	5,517,716	14,565,624	...	635,343
299,652	20,658,972	0	...	831,705
343,014	17,785,942	8,774,994	...	731,575
373,579	0	25,409,736	...	479,053
409,614	0	25,343,892	...	4,114,865
428,183	0	27,089,222	...	517,580
483,596	0	24,495,490	...	1,068,598
<b>5,986,552</b>	<b>44,113,958</b>	<b>483,309,206</b>	<b>-4</b>	<b>12,473,792<sup>3</sup></b>
258,431	2,579,504	25,577,909	135	623,235
1,488,080	17,307,161	172,945,225	-433	2,672,148
264,879	1,312,118	17,775,458	291	374,939
433,911	2,827,043	30,091,201	-10	988,575
715,222	3,083,928	34,535,320	-72	3,081,086
452,324	2,713,230	21,850,351	5	769,388
703,616	4,593,811	61,904,183	12	1,235,517
156,577	1,833,837	15,971,723	-27	301,585
189,630	416,227	6,432,657	65	485,704
207,085	1,249,703	17,419,748	-9	317,276
311,869	1,510,802	22,440,242	55	326,015
804,928	4,686,594	56,365,188	-17	1,298,326
<b>5,986,552</b>	<b>44,113,958</b>	<b>483,309,206</b>	<b>-4</b>	<b>12,473,792<sup>3</sup></b>

3. The \$12,473,792 thousand transferred to surplus was reduced by direct charges of \$500 thousand for charge-off on Bank premises (1927), \$139,300 thousand for contributions to capital of the Federal Deposit Insurance Corporation (1934), \$4 thousand net upon elimination of section 13b surplus (1958), and \$106,000 thousand (1996), \$107,000 thousand (1997), and \$3,752,000 thousand (2000) transferred to the Treasury

as statutorily required; and was increased by transfer of \$11,131 thousand from reserves for contingencies (1955), leaving a balance of \$8,380,120 thousand on December 31, 2002.

4. This amount is reduced \$2,653,914 thousand, which is related to the System Retirement Plan. See note 1, table 5.

## 7. Acquisition Costs and Net Book Value of Premises of the Federal Reserve Banks and Branches, December 31, 2002

Thousands of dollars

Federal Reserve Bank or Branch	Acquisition costs				Net book value	Other real estate <sup>3</sup>
	Land	Buildings (including vaults) <sup>1</sup>	Building machinery and equipment	Total <sup>2</sup>		
BOSTON .....	22,074	102,508	17,448	142,030	91,350	...
NEW YORK .....	19,853	198,609	49,615	268,077	180,477	...
Buffalo .....	888	5,113	3,662	9,663	4,829	...
PHILADELPHIA .....	2,561	67,471	10,783	80,814	49,590	...
CLEVELAND .....	3,112	118,732	23,275	145,118	118,565	...
Cincinnati .....	2,247	19,190	9,652	31,089	14,244	...
Pittsburgh .....	1,658	14,092	11,753	27,503	19,743	...
RICHMOND .....	10,051	68,019	35,797	113,868	79,932	...
Baltimore .....	6,482	27,271	4,929	38,682	23,536	...
Charlotte .....	3,130	28,233	4,891	36,254	25,749	...
ATLANTA .....	22,770	148,994	15,571	187,335	181,488	...
Birmingham .....	7,110	45,481	3,239	55,830	53,262	...
Jacksonville .....	1,730	18,489	3,011	23,231	16,118	48
Miami .....	3,746	15,013	3,876	22,635	14,132	...
Nashville .....	629	3,673	3,197	7,498	3,743	...
New Orleans .....	3,776	8,489	4,320	16,584	10,617	...
CHICAGO .....	4,994	132,171	17,734	154,900	102,980	...
Detroit .....	4,565	8,945	3,814	17,325	12,743	...
ST. LOUIS .....	700	30,497	9,021	40,218	22,337	...
Little Rock .....	1,148	7,278	2,982	11,408	8,834	...
Louisville .....	800	4,761	2,068	7,629	4,309	...
Memphis .....	1,136	7,783	4,151	13,069	8,895	...
MINNEAPOLIS .....	14,581	103,282	13,494	131,358	116,293	...
Helena .....	2,621	9,640	937	13,198	10,447	...
KANSAS CITY .....	2,416	20,848	9,404	32,668	15,102	...
Denver .....	3,188	8,798	5,068	17,054	9,917	...
Oklahoma City .....	646	11,328	3,493	15,467	8,904	...
Omaha .....	6,535	12,080	2,359	20,974	16,388	...
DALLAS .....	29,049	107,984	20,375	157,408	124,835	...
El Paso .....	262	3,476	1,018	4,756	2,503	...
Houston .....	0	7,145	0	7,145	7,145	26,667
San Antonio .....	482	7,584	2,825	10,892	7,192	...
SAN FRANCISCO .....	15,600	89,732	19,536	124,868	80,569	...
Los Angeles .....	4,981	67,489	11,429	83,899	60,048	...
Portland .....	2,884	12,199	3,251	18,334	13,886	...
Salt Lake City .....	495	9,546	2,113	12,154	8,867	...
Seattle .....	380	13,220	4,699	18,298	12,867	...
<b>Total .....</b>	<b>209,278</b>	<b>1,565,166</b>	<b>344,790</b>	<b>2,119,234</b>	<b>1,542,435</b>	<b>26,716</b>

NOTE. Components may not sum to totals because of rounding.

1. Includes expenditures for construction at some offices, pending allocation to appropriate accounts.

2. Excludes charge-offs of \$17,699 thousand before 1952.

3. Covers acquisitions for banking-house purposes and Bank premises formerly occupied and being held pending sale.

... Not applicable.

8. Operations in Principal Departments of the Federal Reserve Banks, 1999–2002

Operation	2002	2001	2000	1999
<i>Millions of pieces (except as noted)</i>				
Currency processed .....	34,208	33,740	31,505	<b>29,032</b>
Currency destroyed .....	8,363	7,850	8,179	7,257
Coin received <sup>1</sup> .....	4,621	6,321	5,138	6,719
Checks handled				
U.S. government checks .....	289	346	262	288
Postal money orders .....	216	229	230	226
Other .....	16,587	<b>16,905</b>	16,994	17,075
Government securities transfers .....	17	15	14	13
Transfer of funds .....	115	112	108	103
Automated clearinghouse transactions				
Commercial .....	4,986	4,448	3,812	3,344
Government .....	883	900	838	809
Food stamps redeemed .....	500	587	686	1,158
<i>Millions of dollars</i>				
Currency processed .....	565,302	540,746	542,567	444,234
Currency destroyed .....	92,511	86,298	112,164	82,951
Coin received <sup>1</sup> .....	602	767	666	778
Checks handled				
U.S. government checks .....	307,627	333,849	282,791	306,077
Postal money orders .....	30,161	30,461	30,036	29,118
Other .....	15,033,298	<b>14,853,072</b>	13,849,084	13,788,037
Government securities transfers .....	228,907,121	<b>212,343,034</b>	188,133,178	179,486,282
Transfer of funds .....	405,761,750	423,606,365	379,756,389	343,381,658
Automated clearinghouse transactions				
Commercial .....	13,135,350	12,707,247	11,619,954	10,862,424
Government .....	2,711,384	2,528,562	2,404,491	2,233,279
Food stamps redeemed .....	2,543	2,989	3,414	6,221

NOTE. Amounts in bold are restatements due to errors in previously reported data.

1. Does not include coin activity at Federal Reserve off-site coin terminals.

9. Federal Reserve Bank Interest Rates on Loans to Depository Institutions, December 31, 2002

Reserve Bank	Adjustment credit <sup>1</sup>	Seasonal credit <sup>2</sup>	Extended credit <sup>3</sup>	
			First thirty days of borrowing	After thirty days of borrowing
All Federal Reserve Banks . . . . .	0.75	1.30	0.75	1.80

1. Adjustment credit is available on a short-term basis to help depository institutions meet temporary needs for funds that cannot be met through reasonable alternative sources. Adjustment credit is usually provided at the basic discount rate, but under certain circumstances a special rate or rates above the basic discount rate may be applied. Effective January 9, 2003, the adjustment credit program will be discontinued.

2. Seasonal credit is available to help smaller depository institutions meet regular seasonal needs for funds that cannot be met through special industry lenders and that arise from a combination of expected patterns of movement in their deposits and loans. The discount rate on seasonal credit takes into account rates on market sources of funds and ordinarily is reestablished on the first business day of each two-week reserve maintenance period; however, it is never lower than the discount rate applicable to adjustment credit. Until January 9, 2003, see section 201.3(b) of Regulation A. Effective January 9, 2003, see section 201.4(c) of Regulation A.

3. Extended credit is available to depository institutions if similar assistance is not reasonably available from other sources, when exceptional circumstances or practices involve only a particular institution, or when an institution is experiencing difficulties adjusting to changing market conditions over a longer period of time.

Extended-credit loans outstanding more than thirty days will be charged a flexible rate somewhat above rates on market sources of funds; the rate will always be at least 50 basis points above the discount rate applicable to adjustment credit. The flexible rate is reestablished on the first business day of each two-week reserve maintenance period. At the discretion of the Federal Reserve Bank, the flexible rate may be charged on extended-credit loans that are outstanding less than thirty days. Effective January 9, 2003, the extended credit program will be discontinued.

## 10. Reserve Requirements of Depository Institutions, December 31, 2002

Type of deposit	Requirements	
	Percentage of deposits	Effective date
<i>Net transaction accounts</i> <sup>1</sup>		
\$0 million–\$6 million <sup>2</sup> .....	0	12-26-02
More than \$6 million–\$42.1 million <sup>3</sup> .....	3	12-26-02
More than \$42.1 million <sup>4</sup> .....	10	12-26-02
Nonpersonal time deposits <sup>5</sup> .....	0	12-27-90
Eurocurrency liabilities <sup>6</sup> .....	0	12-27-90

NOTE. Required reserves must be held in the form of deposits with Federal Reserve Banks or vault cash. Non-member institutions may maintain reserve balances with a Federal Reserve Bank indirectly, on a pass-through basis, with certain approved institutions. For previous reserve requirements, see earlier editions of the *Annual Report* or the *Federal Reserve Bulletin*. Under the Monetary Control Act of 1980, depository institutions include commercial banks, savings banks, savings and loan associations, credit unions, agencies and branches of foreign banks, and Edge Act corporations.

1. Transaction accounts include all deposits against which the account holder is permitted to make withdrawals by negotiable or transferable instruments, payment orders of withdrawal, or telephone or preauthorized transfers for the purpose of making payments to third persons or others. However, accounts subject to the rules that permit no more than six preauthorized, automatic, or other transfers per month (of which no more than three may be by check, draft, debit card, or similar order payable directly to third parties) are savings deposits, not transaction accounts.

2. Under the Garn–St Germain Depository Institutions Act of 1982, the Board adjusts the amount of reservable liabilities subject to a zero percent reserve requirement each year for the succeeding calendar year by 80 percent of the percentage increase in the total reservable liabilities of all depository institutions, measured on an annual basis as of June 30. No corresponding adjustment is made in the event of a decrease. The exemption applies only to accounts that would be subject to a 3 percent reserve requirement. Effective with the reserve maintenance period beginning December 26, 2002, for depository institutions that report weekly, and with the reserve maintenance period beginning January 16, 2003, for institu-

tions that report quarterly, the exemption was raised from \$5.7 million to \$6.0 million.

3. The Monetary Control Act of 1980 requires that the amount of transaction accounts against which the 3 percent reserve requirement applies be modified annually by 80 percent of the percentage change in transaction accounts held by all depository institutions, determined as of June 30 each year. Effective with the reserve maintenance period beginning December 26, 2002, for depository institutions that report weekly, and with the reserve maintenance period beginning January 16, 2003, for institutions that report quarterly, the amount was increased from \$41.3 million to \$42.1 million.

4. The reserve requirement was reduced from 12 percent to 10 percent on April 2, 1992, for institutions that report weekly, and on April 16, 1992, for institutions that report quarterly.

5. For institutions that report weekly, the reserve requirement on nonpersonal time deposits with an original maturity of less than 1.5 years was reduced from 3 percent to 1.5 percent for the maintenance period that began December 13, 1990, and to zero for the maintenance period that began December 27, 1990. For institutions that report quarterly, the reserve requirement on nonpersonal time deposits with an original maturity of less than 1.5 years was reduced from 3 percent to zero on January 17, 1991.

The reserve requirement on nonpersonal time deposits with an original maturity of 1.5 years or more has been zero since October 6, 1983.

6. The reserve requirement on eurocurrency liabilities was reduced from 3 percent to zero in the same manner and on the same dates as the reserve requirement on nonpersonal time deposits with an original maturity of less than 1.5 years (see note 5).

## 11. Initial Margin Requirements under Regulations T, U, and X

Percent of market value

Effective date	Margin stocks	Convertible bonds	Short sales, T only <sup>1</sup>
1934, Oct. 1 .....	25-45	...	...
1936, Feb. 1 .....	25-55	...	...
Apr. 1 .....	55	...	...
1937, Nov. 1 .....	40	...	50
1945, Feb. 5 .....	50	...	50
July 5 .....	75	...	75
1946, Jan. 21 .....	100	...	100
1947, Feb. 21 .....	75	...	75
1949, Mar. 3 .....	50	...	50
1951, Jan. 17 .....	75	...	75
1953, Feb. 20 .....	50	...	50
1955, Jan. 4 .....	60	...	60
Apr. 23 .....	70	...	70
1958, Jan. 16 .....	50	...	50
Aug. 5 .....	70	...	70
Oct. 16 .....	90	...	90
1960, July 28 .....	70	...	70
1962, July 10 .....	50	...	50
1963, Nov. 6 .....	70	...	70
1968, Mar. 11 .....	70	50	70
June 8 .....	80	60	80
1970, May 6 .....	65	50	65
1971, Dec. 6 .....	55	50	55
1972, Nov. 24 .....	65	50	65
1974, Jan. 3 .....	50	50	50

NOTE. These regulations, adopted by the Board of Governors pursuant to the Securities Exchange Act of 1934, limit the amount of credit to purchase and carry "margin securities" (as defined in the regulations) when such value is collateralized by securities. Margin requirements on securities are the difference between the market value (100 percent) and the maximum loan value of collateral as prescribed by the Board. Regulation T was

adopted effective October 15, 1934; Regulation U, effective May 1, 1936; and Regulation X, effective November 1, 1971. The former Regulation G, which was adopted effective March 11, 1968, was merged with Regulation U, effective April 1, 1998.

1. From October 1, 1934, to October 31, 1937, the requirement was the margin "customarily required" by the brokers and dealers.



12. Principal Assets and Liabilities and Number of Insured Commercial Banks  
in the United States, by Class of Bank, June 30, 2002 and 2001

Millions of dollars, except as noted

Item	Total	Member banks			Nonmember banks
		Total	National	State	
2002					
ASSETS					
Loans and investments .....	4,798,152	3,755,257	2,673,168	1,082,089	1,042,895
Loans, gross .....	3,594,011	2,852,608	2,056,938	795,670	741,402
Net .....	3,591,278	2,850,558	2,055,165	795,393	740,720
Investments .....	1,204,142	902,649	616,231	286,418	301,493
U.S. Treasury and federal agency securities .....	248,538	153,103	78,284	74,819	95,435
Other .....	955,604	749,546	537,946	211,600	206,058
Cash assets, total .....	263,009	215,087	154,757	60,330	47,922
LIABILITIES					
Deposits, total .....	3,754,435	2,862,152	2,024,281	837,871	892,282
Interbank .....	54,619	44,810	31,320	13,490	9,809
Other transaction .....	605,321	450,257	325,710	124,547	155,064
Other nontransaction .....	3,094,494	2,367,085	1,667,251	699,834	727,409
Equity capital .....	605,538	486,215	345,079	141,135	119,323
Number of banks .....	7,944	3,049	2,101	948	4,895
2001					
ASSETS					
Loans and investments .....	4,561,478	3,527,620	2,508,999	1,018,621	1,033,858
Loans, gross .....	3,523,938	2,775,703	2,022,579	753,124	748,235
Net .....	3,521,844	2,774,486	2,021,670	752,816	747,358
Investments .....	1,037,540	751,917	486,420	265,497	285,623
U.S. Treasury and federal agency securities .....	233,187	148,577	79,672	68,905	84,610
Other .....	804,353	603,340	406,748	196,592	201,013
Cash assets, total .....	257,196	210,439	151,083	59,356	46,757
LIABILITIES					
Deposits, total .....	3,529,783	2,645,449	1,887,121	758,327	884,334
Interbank .....	55,952	47,276	33,538	13,738	8,676
Other transaction .....	607,288	457,860	332,383	125,477	149,428
Other nontransaction .....	2,866,543	2,140,313	1,521,200	619,113	726,230
Equity capital .....	546,344	432,167	302,733	129,434	114,178
Number of banks .....	8,152	3,146	2,172	974	5,006

NOTE. Data are the domestic assets and liabilities (except for those components reported on a consolidated

basis only). Components may not sum to totals because of rounding.

## 13. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items, Year-End 1918–2002 and Month-End 2002

Millions of dollars

Period	Factors supplying reserve funds										
	Federal Reserve Bank credit outstanding								Gold stock <sup>6</sup>	Special drawing rights certificate account	Treasury currency outstanding <sup>7</sup>
	U.S. Treasury and federal agency securities			Loans	Float <sup>3</sup>	All other <sup>4</sup>	Other Federal Reserve assets <sup>5</sup>	Total			
Total	Bought outright <sup>1</sup>	Held under repurchase agreement <sup>2</sup>									
1918.....	239	239	0	1,766	199	294	0	2,498	2,873	...	1,795
1919.....	300	300	0	2,215	201	575	0	3,292	2,707	...	1,707
1920.....	287	287	0	2,687	119	262	0	3,355	2,639	...	1,709
1921.....	234	234	0	1,144	40	146	0	1,563	3,373	...	1,842
1922.....	436	436	0	618	78	273	0	1,405	3,642	...	1,958
1923.....	134	80	54	723	27	355	0	1,238	3,957	...	2,009
1924.....	540	536	4	320	52	390	0	1,302	4,212	...	2,025
1925.....	375	367	8	643	63	378	0	1,459	4,112	...	1,977
1926.....	315	312	3	637	45	384	0	1,381	4,205	...	1,991
1927.....	617	560	57	582	63	393	0	1,655	4,092	...	2,006
1928.....	228	197	31	1,056	24	500	0	1,809	3,854	...	2,012
1929.....	511	488	23	632	34	405	0	1,583	3,997	...	2,022
1930.....	739	686	43	251	21	372	0	1,373	4,306	...	2,027
1931.....	817	775	42	638	20	378	0	1,853	4,173	...	2,035
1932.....	1,855	1,851	4	235	14	41	0	2,145	4,226	...	2,204
1933.....	2,437	2,435	2	98	15	137	0	2,688	4,036	...	2,303
1934.....	2,430	2,430	0	7	5	21	0	2,463	8,238	...	2,511
1935.....	2,431	2,430	1	5	12	38	0	2,486	10,125	...	2,476
1936.....	2,430	2,430	0	3	39	28	0	2,500	11,258	...	2,532
1937.....	2,564	2,564	0	10	19	19	0	2,612	12,760	...	2,637
1938.....	2,564	2,564	0	4	17	16	0	2,601	14,512	...	2,798
1939.....	2,484	2,484	0	7	91	11	0	2,593	17,644	...	2,963
1940.....	2,184	2,184	0	3	80	8	0	2,274	21,995	...	3,087
1941.....	2,254	2,254	0	3	94	10	0	2,361	22,737	...	3,247
1942.....	6,189	6,189	0	6	471	14	0	6,679	22,726	...	3,648
1943.....	11,543	11,543	0	5	681	10	0	12,239	21,938	...	4,094
1944.....	18,846	18,846	0	80	815	4	0	19,745	20,619	...	4,131
1945.....	24,252	24,252	0	249	578	2	0	15,091	20,065	...	4,339
1946.....	23,350	23,350	0	163	580	1	0	24,093	20,529	...	4,562
1947.....	22,559	22,559	0	85	535	1	0	23,181	22,754	...	4,562
1948.....	23,333	23,333	0	223	541	1	0	24,097	24,244	...	4,589
1949.....	18,885	18,885	0	78	534	2	0	19,499	24,427	...	4,598
1950.....	20,778	20,725	53	67	1,368	3	0	22,216	22,706	...	4,636
1951.....	23,801	23,605	196	19	1,184	5	0	25,009	22,695	...	4,709
1952.....	24,697	24,034	663	156	967	4	0	25,825	23,187	...	4,812
1953.....	25,916	25,318	598	28	935	2	0	26,880	22,030	...	4,894
1954.....	24,932	24,888	44	143	808	1	0	25,885	21,713	...	4,985
1955.....	24,785	24,391	394	108	1,585	29	0	26,507	21,690	...	5,008
1956.....	24,915	24,610	305	50	1,665	70	0	26,699	21,949	...	5,066
1957.....	24,238	23,719	519	55	1,424	66	0	25,784	22,781	...	5,146
1958.....	26,347	26,252	95	64	1,296	49	0	27,755	20,534	...	5,234
1959.....	26,648	26,607	41	458	1,590	75	0	28,771	19,456	...	5,311

For notes see end of table.

13.—Continued

Factors absorbing reserve funds												
Cur- rency in cir- cu- la- tion	Reverse re- pur- chase ag- ree- ments <sup>8</sup>	Trea- sury cash hold- ings <sup>9</sup>	Deposits, other than reserves, with Federal Reserve Banks			Other Federal Reserve ac- counts <sup>5</sup>	Re- quired clear- ing bal- ances	Other Federal Reserve li- abilities and capital <sup>5</sup>	Member bank reserves <sup>10</sup>			
			Trea- sury	For- eign	Other				With Federal Reserve Banks	Cur- rency and coin <sup>11</sup>	Re- quired <sup>12</sup>	Ex- cess <sup>12</sup>
4,951	0	288	51	96	25	118	0	0	1,636	0	1,585	51
5,091	0	385	51	73	28	208	0	0	1,890	0	1,822	68
5,325	0	218	57	5	18	298	0	0	1,781	0	0	0
4,403	0	214	96	12	15	285	0	0	1,753	0	1,654	99
4,530	0	225	11	3	26	276	0	0	1,934	0	0	0
4,757	0	213	38	4	19	275	0	0	1,898	0	1,884	14
4,760	0	211	51	19	20	258	0	0	2,220	0	2,161	59
4,817	0	203	16	8	21	272	0	0	2,212	0	2,256	-44
4,808	0	201	17	46	19	293	0	0	2,194	0	2,250	-56
4,716	0	208	18	5	21	301	0	0	2,487	0	2,424	63
4,686	0	202	23	6	21	348	0	0	2,389	0	2,430	-41
4,578	0	216	29	6	24	393	0	0	2,355	0	2,428	-73
4,603	0	211	19	6	22	375	0	0	2,471	0	2,375	96
5,360	0	222	54	79	31	354	0	0	1,961	0	1,994	-33
5,388	0	272	8	19	24	355	0	0	2,509	0	1,933	576
5,519	0	284	3	4	128	360	0	0	2,729	0	1,870	859
5,536	0	3,029	121	20	169	241	0	0	4,096	0	2,282	1,814
5,882	0	2,566	544	29	226	253	0	0	5,587	0	2,743	2,844
6,543	0	2,376	244	99	160	261	0	0	6,606	0	4,622	1,984
6,550	0	3,619	142	172	235	263	0	0	7,027	0	5,815	1,212
6,856	0	2,706	923	199	242	260	0	0	8,724	0	5,519	3,205
7,598	0	2,409	634	397	256	251	0	0	11,653	0	6,444	5,209
8,732	0	2,213	368	1,133	599	284	0	0	4,026	0	7,411	6,615
11,160	0	2,215	867	774	586	291	0	0	12,450	0	9,365	3,085
15,410	0	2,193	799	793	485	256	0	0	13,117	0	11,129	1,988
20,499	0	2,303	579	1,360	356	339	0	0	12,886	0	11,650	1,236
25,307	0	2,375	440	1,204	394	402	0	0	14,373	0	12,748	1,625
28,515	0	2,287	977	862	446	495	0	0	15,915	0	14,457	1,458
28,952	0	2,272	393	508	314	607	0	0	16,139	0	15,577	562
28,868	0	1,336	870	392	569	563	0	0	17,899	0	16,400	1,499
28,224	0	1,325	1,123	642	547	590	0	0	20,479	0	19,277	1,202
27,600	0	1,312	821	767	750	106	0	0	16,568	0	15,550	1,018
27,741	0	1,293	668	895	565	714	0	0	17,681	0	16,509	1,172
29,206	0	1,270	247	526	363	746	0	0	20,056	0	19,667	389
30,433	0	1,270	389	550	455	777	0	0	19,950	0	20,520	-570
30,781	0	761	346	423	493	839	0	0	20,160	0	19,397	763
30,509	0	796	563	490	441	907	0	0	18,876	0	18,618	258
31,158	0	767	394	402	554	925	0	0	19,005	0	18,903	102
31,790	0	775	441	322	426	901	0	0	19,059	0	19,089	-30
31,834	0	761	481	356	246	998	0	0	19,034	0	19,091	-57
32,193	0	683	358	272	391	1,122	0	0	18,504	0	18,574	-70
32,591	0	391	504	345	694	841	0	0	18,174	310	18,619	-135

## 13. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items, Year-End 1918–2002 and Month-End 2002—Continued

Millions of dollars

Period	Factors supplying reserve funds										
	Federal Reserve Bank credit outstanding							Total	Gold stock <sup>6</sup>	Special drawing rights certificate account	Treasury currency outstanding <sup>7</sup>
	U.S. Treasury and federal agency securities			Loans	Float <sup>3</sup>	All other <sup>4</sup>	Other Federal Reserve assets <sup>5</sup>				
Total	Bought outright <sup>1</sup>	Held under repurchase agreement <sup>2</sup>									
1960.....	27,384	26,984	400	33	1,847	74	0	29,338	17,767	...	5,398
1961.....	28,881	30,478	159	130	2,300	51	0	31,362	16,889	...	5,585
1962.....	30,820	28,722	342	38	2,903	110	0	33,871	15,978	...	5,567
1963.....	33,593	33,582	11	63	2,600	162	0	36,418	15,513	...	5,578
1964.....	37,044	36,506	538	186	2,606	94	0	39,930	15,388	...	5,405
1965.....	40,768	40,478	290	137	2,248	187	0	43,340	13,733	...	5,575
1966.....	44,316	43,655	661	173	2,495	193	0	47,177	13,159	...	6,317
1967.....	49,150	48,980	170	141	2,576	164	0	52,031	11,982	...	6,784
1968.....	52,937	52,937	0	186	3,443	58	0	56,624	10,367	...	6,795
1969.....	57,154	7,154 <sup>5</sup>	0	183	3,440	64	2,743	64,584	10,367	...	6,852
1970.....	62,142	62,142	0	335	4,261	57	1,123	67,918	10,732	400	7,147
1971.....	70,804	69,481	1,323	39	4,343	261	1,068	76,515	10,132	400	7,710
1972.....	71,230	71,119	111	1,981	3,974	106	1,260	78,551	10,410	400	8,313
1973.....	80,495	80,395	100	1,258	3,099	68	1,152	86,072	11,567	400	8,716
1974.....	85,714	84,760	954	299	2,001	999	3,195	92,208	11,652	400	9,253
1975.....	94,124	92,789	1,335	211	3,688	1,126	3,312	102,461	11,599	500	10,218
1976.....	104,093	100,062	4,031	25	2,601	991	3,182	110,892	11,598	1,200	10,810
1977.....	111,274	108,922	2,352	265	3,810	954	2,442	118,745	11,718	1,250	11,331
1978.....	118,591	117,374	1,217	1,174	6,432	587	4,543	131,327	11,671	1,300	11,831
1979.....	126,167	124,507	1,660	1,454	6,767	704	5,613	140,705	11,172	1,800	13,083
1980.....	130,592	128,038	2,554	1,809	4,467	776	8,739	146,383	11,160	2,518	13,427
1981.....	140,348	136,863	3,485	1,601	1,762	195	9,230	153,136	11,151	3,318	13,687
1982.....	148,837	144,544	4,293	717	2,735	1,480	9,890	163,659	11,148	4,618	13,786
1983.....	160,795	159,203	1,592	918	1,605	418	8,728	172,464	11,121	4,618	15,732
1984.....	169,627	167,612	2,015	3,577	833	0	12,347	186,384	11,096	4,618	16,418
1985.....	191,248	186,025	5,223	3,060	988	0	15,302	210,598	11,090	4,718	17,075
1986.....	221,459	205,454	16,005	1,565	1,261	0	17,475	241,760	11,084	5,018	17,567
1987.....	231,420	226,459	4,961	3,815	811	0	15,837	251,883	11,078	5,018	18,177
1988.....	247,489	240,628	6,861	2,170	1,286	0	18,803	269,748	11,060	5,018	18,799
1989.....	235,417	233,300	2,117	481	1,093	0	39,631	276,622	11,059	8,518	19,628
1990.....	259,785	241,431	18,354	190	2,566	0	39,880	302,421	11,058	10,018	20,402 <sup>r</sup>
1991.....	288,429	272,531	15,898	218	1,026	0	34,524	324,197	11,059	10,018	21,014 <sup>r</sup>
1992.....	308,517	300,423	8,094	675	3,350	0	30,278	342,820	11,056	8,018	21,447 <sup>r</sup>
1993.....	349,866	336,654	13,212	94	963	0	33,394	384,317	11,053	8,018	22,095 <sup>r</sup>
1994.....	378,746	368,156	10,590	223	740	0	33,441	413,150	11,051	8,018	22,994 <sup>r</sup>
1995.....	394,693	380,831	13,862	135	231	0	33,483	428,543	11,050	10,168	24,003 <sup>r</sup>
1996.....	414,715	393,132	21,583	85	5,297	0	32,222	452,319	11,048	9,718	24,966 <sup>r</sup>
1997.....	455,260	431,420	23,840	2,035	561	0	32,044	489,901	11,047	9,200	25,543 <sup>r</sup>
1998.....	482,854	452,478	30,376	17	1,009	0	37,692	521,573	11,046	9,200	26,270
1999.....	618,784	478,144	140,640	233	407	0	34,799	654,223	11,048	6,200	28,013
2000.....	555,208	511,833	43,375	110	795	0	36,896	593,009	11,046	2,200	31,219
2001.....	601,935	551,685	50,250	34	698	0	36,885	639,552	11,045	2,200	33,195
2002.....	668,916	629,416	39,500	40	832	0	38,574	708,363	11,039	2,200	34,497

13.—Continued

Factors absorbing reserve funds												
Cur- rency in cir- cu- la- tion	Reverse re- pur- chase agree- ments <sup>8</sup>	Trea- sury cash hold- ings <sup>9</sup>	Deposits, other than reserves, with Federal Reserve Banks			Other Federal Reserve ac- counts <sup>5</sup>	Re- quired clear- ing bal- ances	Other Federal Reserve li- abilities and capital <sup>5</sup>	Member bank reserves <sup>10</sup>			
			Trea- sury	For- eign	Other				With Federal Reserve Banks	Cur- rency and coin <sup>11</sup>	Re- quired <sup>12</sup>	Ex- cess <sup>12,13</sup>
32,869	0	377	485	217	533	941	0	0	17,081	2,544	18,988	637
33,918	0	422	465	279	320	1,044	0	0	17,387	2,544	18,988	96
35,338	0	380	597	247	393	1,007	0	0	17,454	3,262	20,071	645
37,692	0	361	880	171	291	1,065	0	0	17,049	4,099	20,677	471
39,619	0	612	820	229	321	1,036	0	0	18,086	4,151	21,663	574
42,056	0	760	668	150	355	211	0	0	18,447	4,163	22,848	-238
44,663	0	1,176	416	174	588	-147	0	0	19,779	4,310	24,321	-232
47,226	0	1,344	1,123	135	563	-773	0	0	21,092	4,631	25,905	-182
50,961	0	695	703	216	747	-1,353	0	0	21,818	4,921	27,439	-700
53,950	0	596	1,312	134	807	0	0	1,919	22,085	5,187	28,173	-901
57,903	0	431	1,156	148	1,233	0	0	1,986	24,150	5,423	30,033	-460
61,068	0	460	2,020	294	999	0	0	2,131	27,788	5,743	32,496	1,035
66,516	0	345	1,855	325	840	0	0	2,143	25,647	6,216	32,044	98 <sup>13</sup>
72,497	0	317	2,542	251	1,419 <sup>14</sup>	0	0	2,669	27,060	6,781	35,268	-1,360
79,743	0	185	2,113	418	1,275 <sup>14</sup>	0	0	2,935	25,843	7,370	37,011	-3,798
86,547	0	483	7,285	353	1,090	0	0	2,968	26,052	8,036	35,197	-1,103 <sup>15</sup>
93,717	0	460	10,393	352	1,357	0	0	3,063	25,158	8,628	35,461	-1,535
103,811	0	392	7,114	379	1,187	0	0	3,292	26,870	9,421	37,615	-1,265
114,645	0	240	4,196	368	1,256	0	0	4,275	31,152	10,538	42,694	-893
125,600	0	494	4,075	429	1,412	0	0	4,957	29,792	11,429	44,217	-2,835
136,829	0	441	3,062	411	617	0	0	4,671	27,456	13,654	40,558	675
144,774	0	443	4,301	505	781	0	117	5,261	25,111	15,576	42,145	-1,442
154,908	0	429	5,033	328	1,033	0	436	4,990	26,053	16,666	41,391	1,328
171,935	0	479	3,661	191	851	0	1,013	5,392	20,413	17,821	39,179	-945
183,796	0	513	5,316	253	867	0	1,126	5,952	20,693			
197,488	0	550	9,351	480	1,041	0	1,490	5,940	27,141			
211,995	0	447	7,588	287	917	0	1,812	6,088	46,295			
230,205	0	454	5,313	244	1,027	0	1,687	7,129	40,097			
247,649	0	395	8,656	347	548	0	1,605	7,683	37,742			
260,456	0	450	6,217	589	1,298	0	1,618	8,486	36,713			
286,963 <sup>r</sup>	0	561	8,960	369	242	0	1,962	8,147	36,696			
307,756 <sup>r</sup>	0	636	17,697	968	1,706	0	3,949	8,113	25,464			
334,701 <sup>r</sup>	0	508	7,492	206	372	0	5,898	7,984	26,181			
365,271 <sup>r</sup>	0	377	14,809	386	397	0	6,332	9,292	28,619	n.a.	n.a.	n.a.
403,843 <sup>r</sup>	0	335	7,161	250	876	0	4,197	11,959	26,592			
424,244 <sup>r</sup>	0	270	5,979	386	932	0	5,167	12,342	24,444			
450,648 <sup>r</sup>	0	249	7,742	167	892	0	6,601	13,829	17,923			
482,327 <sup>r</sup>	0	225	5,444	457	900	0	6,665 <sup>r</sup>	15,500	24,173 <sup>r</sup>			
517,484	0	85	6,086	167	1,605	0	6,784	16,354	19,522			
628,359	0	109	28,402	71	1,261	0	7,482 <sup>r</sup>	17,256	16,545 <sup>r</sup>			
593,694 <sup>r</sup>	0	450	5,149	216	1,382	0	6,332	17,962	12,713			
643,301 <sup>r</sup>	0	425	6,645	61	820	0	8,534	17,083	8,944			
687,418	21,091	367	4,420	136	1,152	0	10,533	18,977	12,004			

## 13. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items, Year-End 1918–2002 and Month-End 2002—Continued

Millions of dollars

Period	Factors supplying reserve funds										
	Federal Reserve Bank credit outstanding							Gold stock <sup>6</sup>	Special drawing rights certificate account	Treasury currency outstanding <sup>7</sup>	
	U.S. Treasury and federal agency securities			Loans	Float <sup>3</sup>	All other <sup>4</sup>	Other Federal Reserve assets <sup>5</sup>				Total
	Total	Bought outright <sup>1</sup>	Held under repurchase agreement <sup>2</sup>								
2002											
Jan. ....	598,886	561,386	37,500	19	4,272	0	37,744	640,921	11,045	2,200	33,471
Feb. ....	602,143	567,644	34,499	68	-912	0	35,404	636,702	11,044	2,200	33,549
Mar. ....	604,866	575,366	29,500	20	-339	0	37,571	642,117	11,044	2,200	33,630
Apr. ....	612,818	581,318	31,500	72	-81	0	38,605	651,415	11,044	2,200	33,710
May ....	615,199	587,199	28,000	124	-618	0	36,674	651,379	11,044	2,200	33,871
June ....	622,693	590,693	32,000	184	-79	0	39,188	661,986	11,044	2,200	33,995
July ....	619,965	600,465	19,500	186	-815	0	39,712	659,047	11,038	2,200	33,995
Aug. ....	625,836	602,836	23,000	330	31	0	37,887	664,083	11,038	2,200	34,247
Sept. ....	625,951	604,201	21,750	177	-332	0	38,246	664,043	11,038	2,200	34,315
Oct. ....	624,375	607,875	16,500	80	-690	0	39,171	662,937	11,038	2,200	34,385
Nov. ....	637,495	608,995	28,500	59	-216	0	37,031	674,368	11,038	2,200	34,441
Dec. ....	668,916	629,416	39,500	40	832	0	38,574	708,363	11,039	2,200	34,497

NOTE. For a description of figures and discussion of their significance, see *Banking and Monetary Statistics, 1941–1970* (Board of Governors of the Federal Reserve System, 1976), pp. 507–23.

Components may not sum to totals because of rounding.

. . . Not applicable.

r. Revised.

n.a. Not available.

1. In 1969 and thereafter, includes securities loaned—fully guaranteed by U.S. government securities pledged with Federal Reserve Banks—and excludes securities sold and scheduled to be bought back under matched sale–purchase transactions. On September 29, 1971, and thereafter, includes federal agency issues bought outright.

2. On December 1, 1966, and thereafter, includes federal agency obligations held under repurchase agreements.

3. In 1960 and thereafter, figures reflect a minor change in concept; see *Federal Reserve Bulletin*, vol. 47 (February 1961), p. 164.

4. Principally acceptances and, until August 21, 1959, industrial loans, the authority for which expired on that date.

5. For the period before April 16, 1969, includes the total of Federal Reserve capital paid in, surplus, other capital accounts, and other liabilities and accrued divi-

dends, less the sum of bank premises and other assets, and is reported as “Other Federal Reserve accounts”; thereafter, “Other Federal Reserve assets” and “Other Federal Reserve liabilities and capital” are shown separately.

6. Before January 30, 1934, includes gold held in Federal Reserve Banks and in circulation.

7. Includes currency and coin (other than gold) issued directly by the Treasury. The largest components are fractional and dollar coins. For details see “Currency and Coin in Circulation,” *Treasury Bulletin*.

8. Collateralized by U.S. Treasury securities.

9. Coin and paper currency held by the Treasury, as well as any gold in excess of the gold certificates issued to the Reserve Bank.

10. In November 1979 and thereafter, includes reserves of member banks, Edge Act corporations, and U.S. agencies and branches of foreign banks. On November 13, 1980, and thereafter, includes reserves of all depository institutions.

In 1984 and thereafter, data on “Currency and coin” and “Required” and “Excess” reserves changed from daily to biweekly basis.

11. Between December 1, 1959, and November 23, 1960, part was allowed as reserves; thereafter, all was allowed.

13.—Continued

Factors absorbing reserve funds												
Cur- rency in cir- cu- la- tion	Reverse re- pur- chase agree- ments <sup>8</sup>	Treasury cash hold- ings <sup>9</sup>	Deposits, other than reserves, with Federal Reserve Banks			Other Federal Reserve ac- counts <sup>5</sup>	Re- quired clear- ing bal- ances	Other Federal Reserve li- a- bil- ities and capital <sup>5</sup>	Member bank reserves <sup>10</sup>			
			Treasury	For- eign	Other				With Federal Reserve Banks	Cur- rency and coin <sup>11</sup>	Re- quired <sup>12</sup>	Ex- cess <sup>12, 13</sup>
631,141	0	415	13,688	162	286	0	8,650	17,385	15,909			
638,325	0	414	5,752	89	254	0	8,872	17,792	11,997			
641,873	0	412	5,692	256	181	0	9,631	18,163	12,784			
645,495	0	393	5,387	111	287	0	9,869	19,202	17,626			
653,796	0	416	5,883	128	207	0	9,810	19,504	8,751			
657,900	0	395	8,116	90	212	0	9,903	20,186	12,421			
661,144	0	377	6,242	164	236	0	9,960	18,940	9,219			
664,116	0	361	4,874	86	194	0	9,922	19,526	12,489			
660,082	0	380	7,879	150	221	0	9,938	19,719	13,226			
663,370	0	397	5,878	89	233	0	10,057	19,720	10,816			
673,822	0	377	4,928	78	253	0	10,281	19,616	12,692			
687,418	21,091	367	4,420	136	1,152	0	10,533	18,977	12,004			

12. Estimated through 1958. Before 1929, data were available only on call dates (in 1920 and 1922 the call date was December 29). Since September 12, 1968, the amount has been based on close-of-business figures for the reserve period two weeks before the report date.

13. For the week ending November 15, 1972, and thereafter, includes \$450 million of reserve deficiencies on which Federal Reserve Banks are allowed to waive penalties for a transition period in connection with bank adaptation to Regulation J as amended, effective November 9, 1972. Allowable deficiencies are as follows (beginning with first statement week of quarter, in millions): 1973—Q1, \$279; Q2, \$172; Q3, \$112; Q4, \$84; 1974—Q1, \$67; Q2, \$58. The transition period ended with the second quarter of 1974.

14. For the period before July 1973, includes certain deposits of domestic nonmember banks and foreign-

owned banking institutions held with member banks and redeposited in full with Federal Reserve Banks in connection with voluntary participation by nonmember institutions in the Federal Reserve System program of credit restraint.

As of December 12, 1974, the amount of voluntary nonmember bank and foreign-agency and branch deposits at Federal Reserve Banks that are associated with marginal reserves are no longer reported. However, two amounts are reported: (1) deposits voluntarily held as reserves by agencies and branches of foreign banks operating in the United States and (2) eurodollar liabilities.

15. Adjusted to include waivers of penalties for reserve deficiencies, in accordance with change in Board policy, effective November 19, 1975.

14. Banking Offices and Banks Affiliated with Bank Holding Companies (BHCs) in the United States, December 31, 2001 and 2002

Type of office	Total	Commercial banks <sup>1</sup>					Nonmember	State-chartered savings banks
		Total	Member		State			
			Total	National				
All banking offices								
<b>BANKS</b>								
<b>Number, Dec. 31, 2001 ..</b>	<b>8,454</b>	<b>8,033</b>	<b>3,056</b>	<b>2,089</b>	<b>967</b>	<b>4,977</b>	<b>421</b>	
<i>Changes during 2002</i>								
New banks .....	83	81	33	29	4	48	2	
Banks converted into branches .....	-261	-253	-121	-70	-51	-132	-8	
Ceased banking operation <sup>2</sup> .....	-47	-36	-19	-10	-9	-17	-11	
Other <sup>3</sup> .....	0	2	28	-8	36	-26	-2	
Net change .....	-225	-206	-79	-59	-20	-127	-19	
<b>Number, Dec. 31, 2002 ..</b>	<b>8,229</b>	<b>7,827</b>	<b>2,977</b>	<b>2,030</b>	<b>947</b>	<b>4,850</b>	<b>402</b>	
<b>BRANCHES AND ADDITIONAL OFFICES</b>								
<b>Number, Dec. 31, 2001 ..</b>	<b>69,876</b>	<b>66,405</b>	<b>49,091</b>	<b>34,727</b>	<b>14,364</b>	<b>17,314</b>	<b>3,471</b>	
<i>Changes during 2002</i>								
New branches .....	1,989	1,879	1,300	909	391	579	110	
Branches converted from banks .....	261	259	148	91	57	111	2	
Discontinued <sup>2</sup> .....	-1,222	-1,137	-878	-542	-336	-259	-85	
Other <sup>3</sup> .....	0	70	434	577	-143	-364	-70	
Net change .....	1,028	1,071	1,004	1,035	-31	67	-43	
<b>Number, Dec. 31, 2002 ..</b>	<b>70,904</b>	<b>67,476</b>	<b>50,095</b>	<b>35,762</b>	<b>14,333</b>	<b>17,381</b>	<b>3,428</b>	
<b>Banks affiliated with BHCs</b>								
<b>BANKS</b>								
<b>Number, Dec. 31, 2001 ..</b>	<b>6,526</b>	<b>6,408</b>	<b>2,583</b>	<b>1,752</b>	<b>831</b>	<b>3,825</b>	<b>118</b>	
<i>Changes during 2002</i>								
BHC-affiliated new banks .....	165	157	49	30	19	108	8	
Banks converted into branches .....	-226	-220	-109	-61	-48	-111	-6	
Ceased banking operation <sup>2</sup> .....	-42	-33	-18	-10	-8	-15	-9	
Other <sup>3</sup> .....	0	1	24	-2	26	-23	-1	
Net change .....	-103	-95	-54	-43	-11	-41	-8	
<b>Number, Dec. 31, 2002 ..</b>	<b>6,423</b>	<b>6,313</b>	<b>2,529</b>	<b>1,709</b>	<b>820</b>	<b>3,784</b>	<b>110</b>	

1. For purposes of this table, banks are entities that are defined as banks in the Bank Holding Company Act as amended and implemented in Federal Reserve Regulation Y. Generally, a bank is any institution that accepts demand deposits and is engaged in the business of making commercial loans or any institution that is

defined as an insured bank in section 3(h) of the FDIC Act. Covers entities in the United States and its territories and possessions (affiliated insular areas).

2. Institutions that no longer meet the Regulation Y definition of bank.

3. Interclass changes and sales of branches.



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*Federal Reserve System Audits*

## *Audits of the Federal Reserve System*

The Board of Governors, the Federal Reserve Banks, and the Federal Reserve System as a whole are all subject to several levels of audit and review. The Board's financial statements, and its compliance with laws and regulations affecting those statements, are audited annually by an outside auditor retained by the Board's Office of Inspector General. The Office of Inspector General also audits and investigates the Board's programs and operations, as well as those Board functions delegated to the Reserve Banks.

The financial statements of the Reserve Banks are also audited annually

by an independent outside auditor. In addition, the Reserve Banks are subject to annual examination by the Board. As discussed in the chapter "Federal Reserve Banks," the Board examination includes a wide range of ongoing oversight activities conducted on and off site by staff of the Board's Division of Reserve Bank Operations and Payment Systems.

Federal Reserve operations are also subject to review by the General Accounting Office. ■

## Board of Governors Financial Statements

The financial statements of the Board for 2002 were audited by KPMG LLP, independent auditors.



2001 M Street, N.W.  
Washington, D.C. 20036

### INDEPENDENT AUDITORS' REPORT ON FINANCIAL STATEMENTS

To the Board of Governors of the  
Federal Reserve System

We have audited the accompanying balance sheets of the Board of Governors of the Federal Reserve System (the Board) as of December 31, 2002 and 2001, and the related statements of revenues and expenses and changes in cumulative results of operations and cash flows for the years then ended. These financial statements are the responsibility of the Board's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Board at December 31, 2002 and 2001, and its results of operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our reports dated March 28, 2003 on our consideration of the Board's internal control over financial reporting and its compliance with laws and regulations. Those reports are an integral part of an audit conducted in accordance with *Government Auditing Standards*, and should be read in conjunction with this report in considering the results of our audit.

**KPMG LLP**

March 28, 2003



KPMG LLP, KPMG LLP, a U.S. limited liability partnership, is a member of KPMG International, a Swiss association.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM  
BALANCE SHEETS

	As of December 31,	
ASSETS	2002	2001
<b>CURRENT ASSETS</b>		
Cash .....	\$ 8,635,164	\$ 40,788,564
Accounts receivable .....	871,626	1,325,065
Prepaid expenses and other assets .....	801,031	866,407
Total current assets .....	10,307,821	42,980,036
<b>PROPERTY AND EQUIPMENT, NET (Note 5) .....</b>	<b>143,971,006</b>	<b>138,895,601</b>
Total assets .....	<b>\$154,278,827</b>	<b>\$181,875,637</b>
<b>LIABILITIES AND CUMULATIVE RESULTS OF OPERATIONS</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable and accrued liabilities .....	\$ 11,450,099	\$ 16,125,797
Accrued payroll and related taxes .....	8,102,710	7,307,754
Accrued annual leave .....	11,873,527	10,732,356
Capital lease payable (current portion) .....	50,546	247,242
Unearned revenues and other liabilities .....	442,066	391,572
Total current liabilities .....	31,918,948	34,804,721
<b>LONG-TERM LIABILITIES</b>		
Capital lease payable (non-current portion) .....	32,153	80,276
Accumulated retirement benefit obligation (Note 2) .....	614,108	651,628
Accumulated postretirement benefit obligation (Note 3) .....	4,917,787	4,555,487
Accumulated postemployment benefit obligation (Note 4) .....	4,299,252	3,591,571
Total long-term liabilities .....	9,863,300	8,878,962
Total liabilities .....	41,782,248	43,683,683
<b>CUMULATIVE RESULTS OF OPERATIONS</b>		
Working capital .....	(21,560,581)	8,422,557
Unfunded long-term liabilities .....	(9,831,147)	(8,798,686)
Net investment in property and equipment .....	143,888,307	138,568,083
Total cumulative results of operations .....	112,496,579	138,191,954
Total liabilities and cumulative results of operations .....	<b>\$154,278,827</b>	<b>\$181,875,637</b>

See accompanying notes to financial statements.

## BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

STATEMENTS OF REVENUES AND EXPENSES  
AND CHANGES IN CUMULATIVE RESULTS OF OPERATIONS

	For the years ended December 31,	
	<u>2002</u>	<u>2001</u>
<b>BOARD OPERATING REVENUES</b>		
Assessments levied on Federal Reserve Banks for Board operating expenses and capital expenditures.....	\$205,110,800	\$295,055,600
Other revenues (Note 6).....	<u>9,039,417</u>	<u>8,747,799</u>
Total operating revenues .....	<u>214,150,217</u>	<u>303,803,399</u>
<b>BOARD OPERATING EXPENSES</b>		
Salaries .....	146,022,212	132,647,612
Retirement and insurance contributions.....	25,560,734	22,277,244
Contractual services and professional fees .....	18,073,228	19,339,948
Depreciation and net losses on disposals.....	12,426,581	10,394,156
Utilities .....	7,218,999	5,880,777
Software .....	6,822,066	5,415,856
Postage and supplies .....	5,961,699	8,252,490
Travel .....	5,925,674	5,037,577
Repairs and maintenance.....	4,666,439	4,201,386
Printing and binding .....	2,026,370	2,095,676
Equipment and facilities rental.....	318,132	3,830,557
Other expenses (Note 6).....	<u>4,823,458</u>	<u>4,157,305</u>
Total operating expenses .....	<u>239,845,592</u>	<u>223,530,584</u>
RESULTS OF OPERATIONS .....	<u>(25,695,375)</u>	<u>80,272,815</u>
<b>ISSUANCE AND REDEMPTION OF FEDERAL RESERVE NOTES</b>		
Assessments levied on Federal Reserve Banks for currency costs .....	429,568,393	338,537,426
Expenses for currency printing, issuance, retirement, and shipping .....	<u>429,568,393</u>	<u>338,537,426</u>
CURRENCY ASSESSMENTS OVER (UNDER) EXPENSES .....	<u>0</u>	<u>0</u>
TOTAL RESULTS OF OPERATIONS .....	(25,695,375)	80,272,815
CUMULATIVE RESULTS OF OPERATIONS, Beginning of year .....	<u>138,191,954</u>	<u>57,919,139</u>
CUMULATIVE RESULTS OF OPERATIONS, End of year .....	<u>\$112,496,579</u>	<u>\$138,191,954</u>

See accompanying notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM  
STATEMENTS OF CASH FLOWS

	For the years ended December 31,	
	2002	2001
CASH FLOWS FROM OPERATING ACTIVITIES		
RESULTS OF OPERATIONS .....	\$(25,695,375)	\$80,272,815
Adjustments to reconcile results of operations to net cash provided by (used in) operating activities:		
Depreciation and net losses on disposals .....	12,426,581	10,394,156
(Increase) decrease in assets:		
Accounts receivable, prepaid expenses, and other assets .....	518,815	(24,805)
Increase (decrease) in liabilities:		
Accounts payable and accrued liabilities .....	(4,675,698)	5,423,057
Accrued payroll and related taxes .....	794,956	1,266,793
Accrued annual leave .....	1,141,171	2,239,628
Unearned revenues and other liabilities .....	50,494	(1,652,588)
Accumulated retirement benefit obligation .....	(37,520)	(43,154)
Accumulated postretirement benefit obligation .....	362,300	489,783
Accumulated postemployment benefit obligation .....	707,681	482,115
Net cash provided by (used in) operating activities .....	(14,406,595)	98,847,800
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from disposals .....	5,200	119,013
Capital expenditures .....	(17,507,186)	(80,886,996)
Net cash provided by (used in) investing activities .....	(17,501,986)	(80,767,983)
CASH FLOWS FROM FINANCING ACTIVITIES		
Capital lease payable .....	(244,819)	(133,505)
Net cash provided by (used in) financing activities .....	(244,819)	(133,505)
NET INCREASE (DECREASE) IN CASH .....	(32,153,400)	17,946,312
CASH BALANCE, Beginning of year .....	40,788,564	22,842,252
CASH BALANCE, End of year .....	\$ 8,635,164	\$40,788,564

See accompanying notes to financial statements.

## BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

## NOTES TO FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2002 AND 2001

## (1) SIGNIFICANT ACCOUNTING POLICIES

*Organization*—The Federal Reserve System was established by Congress in 1913 and consists of the Board of Governors (Board), the Federal Open Market Committee, the twelve regional Federal Reserve Banks, the Federal Advisory Council, and the private commercial banks that are members of the System. The Board, unlike the Reserve Banks, was established as a federal government agency and is supported by Washington staff numbering about 1,700, as it carries out its responsibilities in conjunction with other components of the Federal Reserve System.

The Board is required by the Federal Reserve Act to report its operations to the Speaker of the House of Representatives. The Act also requires the Board each year to order a financial audit of each Federal Reserve Bank and to publish each week a statement of the financial condition of each such Reserve Bank and a consolidated statement for all of the Reserve Banks. Accordingly, the Board believes that the best financial disclosure consistent with law is achieved by issuing separate financial statements for the Board and for the Reserve Banks. Therefore, the accompanying financial statements include only the operations and activities of the Board. A combined financial statement for the Federal Reserve Banks are included in the Board's annual report to the Speaker of the House of Representatives.

*Basis of Accounting*—The financial statements have been prepared on the accrual basis of accounting.

*Revenues*—Assessments for operating expenses and additions to property are based on expected cash needs. Amounts over or under assessed due to differences between actual and expected cash needs flow into "Cumulative Results of Operations" during the year.

*Issuance and Redemption of Federal Reserve Notes*—The Board incurs expenses and assesses the Federal Reserve Banks for currency printing, issuance, retirement, and shipping of Federal Reserve Notes. These assessments and expenses are separately reported in the statements of revenues and expenses because they are not Board operating transactions.

*Property and Equipment*—The Board's property, buildings and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over the estimated useful lives of the assets, which range from 3 to 10 years for furniture and equipment and from 10 to 50 years for building equipment and structures. Upon the sale or other disposition of a depreciable asset, the cost and related accumulated depreciation are removed from the accounts and any gain or loss is recognized.

*Estimates*—The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and

expenses during the reporting period. Actual results could differ from those estimates.

*Reclassifications*—Certain 2001 amounts have been reclassified to conform with the 2002 presentation.

## (2) RETIREMENT BENEFITS

Substantially all of the Board's employees participate in the Retirement Plan for Employees of the Federal Reserve System (System Plan). The System Plan is a multi-employer plan which covers employees of the Federal Reserve Banks, the Board, and the Plan Administrative Office.

Employees of the Board who entered on duty prior to 1984 are covered by a contributory defined benefits program under the System Plan. Employees of the Board who entered on duty after 1983 are covered by a non-contributory defined benefits program under the System Plan. Contributions to the System Plan are actuarially determined and funded by participating employers at amounts prescribed by the System Plan's administrator. Based on actuarial calculations, it was determined that employer funding contributions were not required for the years 2002 and 2001, and the Board was not assessed a contribution for these years. Excess Plan assets are expected to continue to fund future years' contributions. Because the plan is part of a multi-employer plan, information as to vested and nonvested benefits, as well as plan assets, as it relates solely to the Board, is not readily available.

A relatively small number of Board employees participate in the Civil Service Retirement System (CSRS) or the Federal Employees' Retirement System (FERS). The Board matches employee contributions to these plans. These defined benefit plans are administered by the Office of Personnel Management. The Board's contributions to these plans totaled \$327,000 and \$308,000 in 2002 and 2001, respectively. The Board has no liability for future payments to retirees under these programs, and it is not accountable for the assets of the plans.

Employees of the Board may also participate in the Federal Reserve System's Thrift Plan. Under the Thrift Plan, members may contribute up to a fixed percentage of their salary. Board contributions are based upon a fixed percentage of each member's basic contribution and were \$7,185,000 and \$5,540,000 in 2002 and 2001, respectively.

Effective January 1, 1996, Board employees covered under the System Plan are also covered under a Benefits Equalization Plan (BEP). Benefits paid under the BEP are limited to those benefits that cannot be paid from the System Plan due to limitations imposed by Sections 401(a)(17), 415(b) and 415(e) of the Internal Revenue Code of 1986. Pension costs attributed to the BEP reduce the pension costs of the System Plan. Activity for the BEP for 2002 and 2001 is summarized in the following table:

	<u>2002</u>	<u>2001</u>
<i>Change in benefit obligation</i>		
Projected benefit obligation at beginning of year ..	\$ 2,125	\$ 1,804
Service cost .....	3,363	450
Interest cost .....	561	112
Plan participants' contributions .....	0	0
Plan amendments .....	2,852	0
Actuarial (gain)/loss .....	3,965	(241)
Benefits paid .....	<u>0</u>	<u>0</u>
Projected benefit obligation at end of year .....	<u>\$ 12,866</u>	<u>\$ 2,125</u>
<i>Change in plan assets</i>		
Fair value of plan assets at beginning of year .....	\$ 0	\$ 0
Actual return on plan assets .....	0	0
Employer contributions .....	0	0
Plan participants' contributions .....	0	0
Benefits paid .....	<u>0</u>	<u>0</u>
Fair value of plan assets at end of year .....	<u>\$ 0</u>	<u>\$ 0</u>
<i>Reconciliation of funded status at end of year</i>		
Funded status .....	\$ (12,866)	\$ (2,125)
Unrecognized net actuarial (gain)/loss .....	(297,773)	(329,169)
Unrecognized prior service cost .....	(1,050,946)	(1,170,405)
Unrecognized net transition (asset)/obligation .....	<u>747,477</u>	<u>850,071</u>
Postretirement benefit liability .....	<u>\$ (614,108)</u>	<u>\$ (651,628)</u>
<i>Weighted-average assumptions as of December 31</i>		
Discount rate .....	6.75%	7.00%
Expected asset return .....	N/A	N/A
Salary scale .....	4.25%	4.50%
Corridor .....	10.00%	10.00%
<i>Components of net periodic benefit cost</i>		
Service cost .....	\$ 3,363	\$ 450
Interest cost .....	561	112
Expected return on plan assets .....	0	0
Amortization of prior service cost ..	(116,607)	(116,848)
Recognized actuarial (gain)/loss .....	(27,431)	(29,462)
Amortization of net transition (asset)/obligation .....	<u>102,594</u>	<u>102,594</u>
Net periodic benefit cost .....	<u>\$ (37,520)</u>	<u>\$ (43,154)</u>

(3) POSTRETIREMENT BENEFITS

The Board provides certain life insurance programs for its active employees and retirees. Activity for 2002 and 2001 is summarized in the following table:

	<u>2002</u>	<u>2001</u>
<i>Change in benefit obligation</i>		
Benefit obligation at beginning of year ..	\$ 5,868,425	\$ 4,255,290
Service cost .....	158,179	133,550
Interest cost .....	386,215	345,753
Plan participants' contributions .....	0	0
Plan amendments .....	0	95,993
Actuarial (gain)/loss .....	(63,554)	1,037,839
Benefits paid .....	<u>(214,870)</u>	<u>0</u>
Benefit obligation at end of year .....	<u>\$ 6,134,395</u>	<u>\$ 5,868,425</u>
<i>Change in plan assets</i>		
Fair value of plan assets at beginning of year .....	\$ 0	\$ 0
Actual return on plan assets .....	0	0
Employer contributions ..	213,958	0
Plan participants' contributions .....	0	0
Benefits paid .....	<u>(213,958)</u>	<u>0</u>
Fair value of plan assets at end of year .....	<u>\$ 0</u>	<u>\$ 0</u>
<i>Reconciliation of funded status at end of year</i>		
Funded status .....	\$ (6,134,395)	\$ (5,868,425)
Unrecognized net actuarial (gain)/loss .....	1,126,688	1,216,945
Unrecognized prior service cost .....	89,920	95,993
Unrecognized net transition obligation .....	0	0
Prepaid/(accrued) postretirement benefit liability .....	<u>\$ (4,917,787)</u>	<u>\$ (4,555,487)</u>
<i>Components of net periodic cost for year</i>		
Service cost .....	\$ 158,179	\$ 133,550
Interest cost .....	386,215	345,756
Amortization of prior service cost .....	6,073	0
Amortization of (gains)/losses .....	<u>26,706</u>	<u>10,477</u>
Total net periodic cost .....	<u>\$ 577,173</u>	<u>\$ 489,783</u>



The liability and costs for the postretirement benefit plan were determined using discount rates of 6.75 percent and 7.00 percent as of December 31, 2002 and 2001, respectively. Unrecognized losses of \$1,126,688 and \$1,216,945 as of December 31, 2002 and 2001, respectively, result from changes in the discount rate used to measure the liabilities. Under Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, the Board may have to record some of these unrecognized losses in operations in future years. The assumed salary trend rate for measuring the increase in postretirement benefits related to life insurance was an average of 4.25 percent.

The above accumulated postretirement benefit obligation is related to the Board sponsored life insurance programs. The Board has no liability for future payments to employees who continue coverage under the federally sponsored life and health programs upon retiring. Contributions for active employees participating in federally sponsored health programs totaled \$6,205,000 and \$5,364,000 in 2002 and 2001, respectively.

#### (4) POSTEMPLOYMENT BENEFIT PLAN

The Board provides disability and survivor income benefits to eligible employees after employment but before retirement. Effective January 1, 1994, the Board adopted Statement of Financial Accounting Standards No. 112, *Employers' Accounting for Postemployment Benefits*, which requires that employers providing postemployment benefits to their employees accrue the cost of such benefits. Prior to January 1994, postemployment benefit expenses were recognized on a pay-as-you-go basis.

	<u>2002</u>	<u>2001</u>
<i>Change in benefit obligation</i>		
Benefit obligation at beginning of year .....	\$3,591,571	\$3,109,456
Service cost .....	891,192	755,135
Interest cost .....	166,520	115,142
Plan participants' contributions .....	0	0
Plan amendments .....	0	0
Actuarial (gain)/loss .....	(76,282)	(129,585)
Benefits paid .....	<u>(273,749)</u>	<u>(258,577)</u>
Benefit obligation at end of year .....	<u>\$4,299,252</u>	<u>\$3,591,571</u>
<i>Weighted-average assumptions as of December 31</i>		
Discount rate .....	6.75%	7.00%
Expected asset return ..	N/A	N/A
Salary scale .....	4.25%	4.50%
Corridor .....	10.00%	10.00%

#### (5) PROPERTY AND EQUIPMENT

The following is a summary of the components of the Board's property, buildings and equipment, at cost, net of accumulated depreciation.

	<u>As of December 31,</u>	
	<u>2002</u>	<u>2001</u>
Land and improvements ...	\$ 18,640,314	\$ 18,640,314
Buildings .....	113,309,775	104,403,830
Furniture and equipment .....	37,044,828	54,301,936
Software .....	9,830,112	9,215,280
Construction in process .....	<u>9,467,020</u>	<u>6,901,864</u>
	188,292,049	193,463,224
Less accumulated depreciation .....	<u>(44,321,043)</u>	<u>(54,567,623)</u>
Property and equipment, net ...	<u>\$143,971,006</u>	<u>\$138,895,601</u>

Furniture and equipment includes \$864,000 for capitalized leases as of December 31, 2002 and 2001, respectively. Accumulated depreciation includes \$654,000 and \$510,000 for capitalized leases as of December 31, 2002 and 2001, respectively. The Board paid interest related to these capital leases in the amount of \$15,731 and \$32,201 for 2002 and 2001, respectively.

The Board began the Eccles Building Infrastructure Enhancement Project in July 1999. This \$12.5 million project, scheduled for nineteen phases over three and a half years, includes asbestos removal, lighting and plumbing improvements, cabling and other enhancements. Multiple phases will be in process at the same time.

In 2001, the Board purchased land and building located at 1709 New York Avenue, N.W., Washington, DC. This purchase increased land and improvements by \$17,339,000 and buildings by \$48,727,000 for 2001.

In 2002, fully depreciated furniture and equipment totaling \$22,350,000 was retired.

#### (6) OTHER REVENUES AND OTHER EXPENSES

The following are summaries of the components of Other Revenues and Other Expenses.

	<u>As of December 31,</u>	
	<u>2002</u>	<u>2001</u>
<i>Other revenues</i>		
Data processing revenue .....	\$4,830,600	\$4,427,360
Rent .....	1,996,893	664,537
Subscription revenue .....	810,032	869,595
Reimbursable services to other agencies ...	788,095	568,753
Board sponsored conferences .....	115,965	240,967
National Information Center .....	30,334	25,591
Miscellaneous .....	<u>467,498</u>	<u>1,950,996</u>
Total Other Revenues .....	<u>\$9,039,417</u>	<u>\$8,747,799</u>

*Other expenses*

Tuition, registration, and membership fees .....	\$1,642,013	\$1,472,539
Subsidies and contributions ....	900,049	851,225
Public transportation subsidy .....	745,973	484,618
Meals and representation ...	378,387	438,748
Contingency operations .....	264,232	180,871
Security investigations ....	229,387	108,981
Miscellaneous .....	<u>663,417</u>	<u>620,323</u>
Total Other Expenses .....	<u>\$4,823,458</u>	<u>\$4,157,305</u>

(7) COMMITMENTS

The Board has entered into several operating leases to secure office, training and warehouse space for periods ranging from one to ten years. Minimum future commitments under those leases having an initial or remaining noncancelable lease term in excess of one year at December 31, 2002, are as follows:

2003 .....	\$151,038
2004 .....	157,079
2005 .....	163,363
2006 .....	71,991
	<u>\$543,471</u>

Rental expenses under the operating leases were \$156,000 and \$171,000 in 2002 and 2001, respectively.

(8) FEDERAL FINANCIAL INSTITUTIONS  
EXAMINATION COUNCIL

The Board is one of the five member agencies of the Federal Financial Institutions Examination Council (the "Council"), and currently performs certain management functions for the Council. Activity related to the Board and Council for 2002 and 2001 is summarized in the following table:

	<u>2002</u>	<u>2001</u>
<i>Board paid to the Council:</i>		
Assessments for operating expenses of the Council .....	\$ 300,000	\$ 293,000
Total Board paid to the Council .....	<u>\$ 300,000</u>	<u>\$ 293,000</u>
<i>Council paid to the Board:</i>		
Data processing related services ....	3,350,412	2,788,243
Administrative services .....	<u>69,593</u>	<u>66,117</u>
Total Council paid to the Board .....	<u>\$3,420,005</u>	<u>\$2,854,360</u>

(9) FEDERAL RESERVE BANKS

The Board performs certain transactions for the Reserve Banks in conjunction with its responsibilities for the Federal Reserve System, and the Federal Reserve Banks provide certain administrative functions for the Board. Activity related to the Board and Reserve Banks for 2002 and 2001 is summarized in the following table:

	<u>2002</u>	<u>2001</u>
<i>Board paid to the Reserve Banks:</i>		
Assessments for employee benefits ..	\$ 2,014,839	\$ 1,859,752
Data processing and communication ....	2,154,087	2,469,052
Contingency site .....	<u>264,232</u>	<u>180,871</u>
Total Board paid to the Reserve Banks .....	<u>\$ 4,433,158</u>	<u>\$ 4,509,675</u>
<i>Reserve Banks paid to the Board:</i>		
Assessments for currency costs .....	\$429,568,393	\$338,537,426
Assessments for operating expenses of the Board .....	205,110,800	295,055,600
Data processing .....	<u>1,281,759</u>	<u>1,499,559</u>
Total Reserve Banks paid to the Board .....	<u>\$635,960,952</u>	<u>\$635,092,585</u>



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Washington, D.C. 20036

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL  
OVER FINANCIAL REPORTING

To the Board of Governors of the  
Federal Reserve System

We have audited the financial statements of the Board of Governors of the Federal Reserve System (the Board) as of and for the years ended December 31, 2002 and 2001, and have issued our report thereon dated March 28, 2003. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

In planning and performing our 2002 audit, we considered the Board's internal control over financial reporting by obtaining an understanding of the Board's internal control, determining whether these internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. The objective of our audit was not to provide assurance on internal control. Consequently, we do not provide an opinion on internal control.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in internal control over financial reporting that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. Material weaknesses are conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving internal control and its operation that we consider to be material weaknesses as defined above.

This report is intended solely for the information and use of the Board and management, the U.S. Office of Management and Budget, and the U.S. Congress, and is not intended to be and should not be used by anyone other than these specified parties.

**KPMG LLP**

March 28, 2003



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a member of KPMG International, a Swiss association.



2001 M Street, N.W.  
Washington, D.C. 20036

INDEPENDENT AUDITORS' REPORT ON COMPLIANCE  
WITH LAWS AND REGULATIONS

To the Board of Governors of the  
Federal Reserve System

We have audited the financial statements of the Board of Governors of the Federal Reserve System (the Board) as of and for the years ended December 31, 2002 and 2001, and have issued our report thereon dated March 28, 2003. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

The management of the Board is responsible for complying with laws and regulations applicable to the Board. As part of obtaining reasonable assurance about whether the Board's 2002 financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

The results of our tests of compliance with the laws and regulations described in the preceding paragraph disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the Board and management, the U.S. Office of Management and Budget, and the U.S. Congress, and is not intended to be and should not be used by anyone other than these specified parties.

**KPMG LLP**

March 28, 2003



KPMG LLP, KPMG LLP, a U.S. limited liability partnership, is a member of KPMG International, a Swiss association.

## *Federal Reserve Banks Combined Financial Statements*

The combined financial statements of the Federal Reserve Banks were audited by PricewaterhouseCoopers LLP, independent accountants, for the years ended December 31, 2002 and 2001.



### REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Governors of The Federal Reserve System  
and the Board of Directors of each of The Federal Reserve Banks:

We have audited the accompanying combined statements of condition of The Federal Reserve Banks (the "Reserve Banks") as of December 31, 2002 and 2001, and the related combined statements of income and changes in capital for the years then ended, which have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of The Federal Reserve System. These financial statements are the responsibility of the Reserve Banks' management. Our responsibility is to express an opinion on the financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 3, the combined financial statements were prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of The Federal Reserve System. These principles, policies, and practices, which were designed to meet the specialized accounting and reporting needs of The Federal Reserve System, are set forth in the *Financial Accounting Manual for Federal Reserve Banks* and constitute a comprehensive basis of accounting other than generally accepted accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the combined financial position of the Reserve Banks as of December 31, 2002 and 2001, and the combined results of their operations for the years then ended, in conformity with the basis of accounting described in Note 3.

Washington, D.C.  
March 7, 2003

*PRICEWATERHOUSECOOPERS LLP*

FEDERAL RESERVE BANKS  
COMBINED STATEMENTS OF CONDITION  
December 31, 2002 and 2001

(in millions)

ASSETS	2002	2001
Gold certificates .....	\$ 11,039	\$ 11,045
Special drawing rights certificates .....	2,200	2,200
Coin .....	988	1,047
Items in process of collection .....	10,291	3,188
Loans to depository institutions .....	40	34
Securities purchased under agreements to resell (tri-party) .....	39,500	50,250
U.S. government and federal agency securities, net .....	639,125	561,701
Investments denominated in foreign currencies .....	16,913	14,559
Accrued interest receivable .....	5,470	5,729
Bank premises and equipment, net .....	2,044	2,021
Other assets .....	3,367	3,175
Total assets .....	<u>\$730,977</u>	<u>\$654,949</u>
LIABILITIES AND CAPITAL		
LIABILITIES		
Federal Reserve notes outstanding, net .....	\$654,273	\$611,757
Securities sold under agreements to repurchase .....	21,091	. . .
Deposits		
Depository institutions .....	22,541	17,478
U.S. Treasury, general account .....	4,420	6,645
Other deposits .....	444	287
Deferred credit items .....	9,459	2,490
Interest on Federal Reserve notes due U.S. Treasury .....	838	498
Accrued benefit costs .....	915	882
Other liabilities .....	236	227
Total liabilities .....	<u>714,217</u>	<u>640,264</u>
CAPITAL		
Capital paid-in .....	8,380	7,373
Surplus .....	8,380	7,312
Total capital .....	<u>16,760</u>	<u>14,685</u>
Total liabilities and capital .....	<u>\$730,977</u>	<u>\$654,949</u>

The accompanying notes are an integral part of these combined financial statements.

FEDERAL RESERVE BANKS  
COMBINED STATEMENTS OF INCOME  
for the years ended December 31, 2002 and 2001

(in millions)

	<u>2002</u>	<u>2001</u>
Interest income		
Interest on U.S. government and federal agency securities .....	\$25,525	\$30,523
Interest on investments denominated in foreign currencies .....	272	331
Interest on loans to depository institutions .....	<u>2</u>	<u>13</u>
Total interest income .....	<u>25,799</u>	<u>30,867</u>
Interest expense:		
Interest expense on securities sold under agreements to repurchase .....	13	. . .
Net interest income .....	<u>25,786</u>	<u>30,867</u>
Other operating income		
Income from services .....	916	926
Reimbursable services to government agencies .....	309	286
Foreign currency gains (losses), net .....	2,083	(1,435)
Government securities gains, net .....	77	316
Other income .....	<u>80</u>	<u>108</u>
Total other operating income .....	<u>3,465</u>	<u>201</u>
Operating expenses		
Salaries and other benefits .....	1,532	1,285
Occupancy expense .....	208	204
Equipment expense .....	263	268
Assessments by Board of Governors .....	635	634
Other expenses .....	<u>565</u>	<u>642</u>
Total operating expenses .....	<u>3,203</u>	<u>3,033</u>
Net income prior to distribution .....	<u>\$26,048</u>	<u>\$28,035</u>
Distribution of net income		
Dividends paid to member banks .....	\$ 484	\$ 428
Transferred to surplus .....	1,068	518
Payments to U.S. Treasury as interest on Federal Reserve notes .....	<u>24,496</u>	<u>27,089</u>
Total distribution .....	<u>\$26,048</u>	<u>\$28,035</u>

The accompanying notes are an integral part of these combined financial statements.

**FEDERAL RESERVE BANKS**  
**COMBINED STATEMENTS OF CHANGES IN CAPITAL**  
for the years ended December 31, 2002 and 2001

(in millions)

	Capital paid-in	Surplus	Total capital
Balance at January 1, 2001			
(139 million shares) .....	\$6,997	\$6,794	\$13,791
Net income transferred to surplus .....	...	518	518
Net change in capital stock issued			
(8 million shares) .....	<u>376</u>	<u>...</u>	<u>376</u>
Balance at December 31, 2001			
(147 million shares) .....	\$7,373	\$7,312	\$14,685
Net income transferred to surplus .....	...	1,068	1,068
Net change in capital stock issued			
(20 million shares) .....	<u>1,007</u>	<u>...</u>	<u>1,007</u>
Balance at December 31, 2002			
(167 million shares) .....	<u>\$8,380</u>	<u>\$8,380</u>	<u>\$16,760</u>

The accompanying notes are an integral part of these combined financial statements.

**NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS**

**(1) STRUCTURE**

The twelve Federal Reserve Banks (Reserve Banks) are part of the Federal Reserve System (System) created by Congress under the Federal Reserve Act of 1913 (Federal Reserve Act) which established the central bank of the United States. The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. Other major elements of the System are the Board of Governors of the Federal Reserve System (Board of Governors), the Federal Open Market Committee (FOMC) and the Federal Advisory Council. The FOMC is composed of members of the Board of Governors, the president of the Federal Reserve Bank of New York (FRBNY) and, on a rotating basis, four other Reserve Bank presidents. Banks that are members of the System include all national banks and any state chartered bank that applies and is approved for membership in the System.

Although the Reserve Banks are chartered as independent organizations overseen by the Board of Governors, the Reserve Banks work jointly to carry out their statutory responsibilities. The majority of the assets, liabilities, and income of the Reserve Banks is derived from central bank activities and responsibilities with regard to monetary policy and currency. For this reason, the accompanying combined set of financial statements for the twelve independent Reserve Banks is prepared with adjustments to eliminate interdistrict accounts and transactions.

*Board of Directors*

The Reserve Banks serve twelve Federal Reserve Districts nationwide. In accordance with the Federal Reserve

Act, supervision and control of each Reserve Bank is exercised by a Board of Directors. The Federal Reserve Act specifies the composition of the Board of Directors for each of the Reserve Banks. Each board is composed of nine members serving three-year terms: three directors, including those designated as Chairman and Deputy Chairman, are appointed by the Board of Governors, and six directors are elected by member banks. Of the six elected by member banks, three represent the public and three represent member banks. Member banks are divided into three classes according to size. Member banks in each class elect one director representing member banks and one representing the public. In any election of directors, each member bank receives one vote, regardless of the number of shares of Reserve Bank stock it holds.

**(2) OPERATIONS AND SERVICES**

The System performs a variety of services and operations. Functions include: formulating and conducting monetary policy; participating actively in the payments mechanism, including large-dollar transfers of funds, automated clearinghouse (ACH) operations and check processing; distributing coin and currency; performing fiscal agency functions for the U.S. Treasury and certain federal agencies; serving as the federal government's bank; providing short-term loans to depository institutions; serving the consumer and the community by providing educational materials and information regarding consumer laws; supervising bank holding companies, state member banks and U.S. offices of foreign banking organizations; and administering other regulations of the Board of Governors. The Board of Governors' operating costs are funded through assessments on the Reserve Banks.



## NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

The FOMC establishes policy regarding open market operations, oversees these operations, and issues authorizations and directives to the FRBNY for its execution of transactions. Authorized transaction types include direct purchase and sale of U.S. government and federal agency securities, matched sale–purchase transactions, the purchase of securities under agreements to resell, the sale of securities under agreements to repurchase, and the lending of U.S. government securities. FRBNY is also authorized by the FOMC to hold balances of and to execute spot and forward foreign exchange (F/X) and securities contracts in nine foreign currencies, maintain reciprocal currency arrangements (F/X swaps) with various central banks, and “warehouse” foreign currencies for the U.S. Treasury and Exchange Stabilization Fund (ESF) through the Reserve Banks.

## (3) SIGNIFICANT ACCOUNTING POLICIES

Accounting principles for entities with the unique powers and responsibilities of the nation’s central bank have not been formulated by the Financial Accounting Standards Board. The Board of Governors has developed specialized accounting principles and practices that it believes are appropriate for the significantly different nature and function of a central bank as compared to the private sector. These accounting principles and practices are documented in the *Financial Accounting Manual for Federal Reserve Banks (Financial Accounting Manual)*, which is issued by the Board of Governors. All Reserve Banks are required to adopt and apply accounting policies and practices that are consistent with the *Financial Accounting Manual*.

These combined financial statements have been prepared in accordance with the *Financial Accounting Manual*. Differences exist between the accounting principles and practices of the System and generally accepted accounting principles in the United States of America (GAAP). The primary differences are the presentation of all security holdings at amortized cost, rather than at the fair value presentation requirements of GAAP, and the accounting for matched sale–purchase transactions as separate sales and purchases, rather than secured borrowings with pledged collateral, as is generally required by GAAP. In addition, the Board of Governors and the Reserve Banks have elected not to present a Statement of Cash Flows. The Statement of Cash Flows has not been included, as the liquidity and cash position of the Reserve Banks are not of primary concern to users of these combined financial statements. Other information regarding the Reserve Banks’ activities is provided in, or may be derived from, the Statements of Condition, Income, and Changes in Capital. Therefore, a Statement of Cash Flows would not provide any additional useful information. There are no other significant differences between the policies outlined in the *Financial Accounting Manual* and GAAP.

The preparation of the combined financial statements in conformity with the *Financial Accounting Manual* requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the combined financial statements, and the

reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates. Certain amounts relating to the prior year have been reclassified to conform to the current-year presentation. Unique accounts and significant accounting policies are explained below.

(A) *Gold Certificates*

The Secretary of the Treasury is authorized to issue gold certificates to the Reserve Banks to monetize gold held by the U.S. Treasury. Payment for the gold certificates by the Reserve Banks is made by crediting equivalent amounts in dollars into the account established for the U.S. Treasury. These gold certificates held by the Reserve Banks are required to be backed by the gold of the U.S. Treasury. The U.S. Treasury may reacquire the gold certificates at any time and the Reserve Banks must deliver them to the U.S. Treasury. At such time, the U.S. Treasury’s account is charged and the Reserve Banks’ gold certificate account is lowered. The value of gold for purposes of backing the gold certificates is set by law at \$42 $\frac{1}{2}$  a fine troy ounce.

(B) *Special Drawing Rights Certificates*

Special drawing rights (SDRs) are issued by the International Monetary Fund (Fund) to its members in proportion to each member’s quota in the Fund at the time of issuance. SDRs serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates, somewhat like gold certificates, to the Reserve Banks. At such time, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks’ SDR certificate account is increased. The Reserve Banks are required to purchase SDRs, at the direction of the U.S. Treasury, for the purpose of financing SDR certificate acquisitions or for financing exchange stabilization operations.

(C) *Loans to Depository Institutions*

The Depository Institutions Deregulation and Monetary Control Act of 1980 provides that all depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in Regulation D issued by the Board of Governors, have borrowing privileges at the discretion of the Reserve Banks. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. Loans are evaluated for collectibility, and currently all are considered collectible and fully collateralized. If loans were ever deemed to be uncollectible, an appropriate reserve would be established. Interest is accrued using the applicable discount rate established at least every fourteen days by the Board of Directors of the Reserve Banks, subject to review by the Board of Governors. Reserve Banks retain the option to impose a surcharge above the basic rate in certain circumstances.

## NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

(D) *U.S. Government and Federal Agency Securities and Investments Denominated in Foreign Currencies*

The FOMC has designated the FRBNY to execute open market transactions on its behalf and to hold the resulting securities in the portfolio known as the System Open Market Account (SOMA). In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes and directs the FRBNY to execute operations in foreign markets for major currencies in order to counter disorderly conditions in exchange markets or to meet other needs specified by the FOMC in carrying out the System's central bank responsibilities. Such authorizations are reviewed and approved annually by the FOMC.

In December 2002, matched sale-purchase (MSP) transactions were replaced with securities sold under agreements to repurchase. MSP transactions, accounted for as separate sale and purchase transactions, are transactions in which the FRBNY sells a security and buys it back at the rate specified at the commencement of the transaction. Securities sold under agreements to repurchase are treated as secured borrowing transactions with the associated interest expense recognized over the life of the transaction.

In addition to the aforementioned matched sale-purchase transactions and sales of securities under agreements to repurchase, the FRBNY engages in tri-party purchases of securities under agreements to resell (tri-party agreements). Tri-party agreements are conducted with two custodial banks that manage the clearing and settlement of collateral. Acceptable collateral under tri-party repurchase agreements primarily includes U.S. Government and agency securities, pass-through mortgage securities of GNMA, FHLMC, and FNMA, STRIP securities of the U.S. Government and "stripped" securities of other government agencies. The tri-party agreements are accounted for as financing transactions with the associated interest income accrued over the life of the agreements.

The FRBNY has sole authorization by the FOMC to lend U.S. government securities held in the SOMA to U.S. government securities dealers and to banks participating in U.S. government securities clearing arrangements on behalf of the System, in order to facilitate the effective functioning of the domestic securities market. These securities-lending transactions are fully collateralized by other U.S. government securities. FOMC policy requires FRBNY to take possession of collateral in excess of the market values of the securities loaned. The market values of the collateral and the securities loaned are monitored by FRBNY on a daily basis, with additional collateral obtained as necessary. The securities loaned continue to be accounted for in the SOMA.

F/X contracts are contractual agreements between two parties to exchange specified currencies, at a specified price, on a specified date. Spot foreign contracts normally settle two days after the trade date, whereas the settlement date on forward contracts is negotiated between the contracting parties, but will extend beyond two days from the trade date. The FRBNY generally enters into spot contracts, with any forward contracts generally limited to the second leg of a swap/warehousing transaction.

The FRBNY, on behalf of the Reserve Banks, main-

tains renewable, short-term F/X swap arrangements with two authorized foreign central banks. The parties agree to exchange their currencies up to a pre-arranged maximum amount and for an agreed upon period of time (up to twelve months), at an agreed upon interest rate. These arrangements give the FOMC temporary access to foreign currencies that it may need for intervention operations to support the dollar and give the partner foreign central bank temporary access to dollars it may need to support its own currency. Drawings under the F/X swap arrangements can be initiated by either the FRBNY or the partner foreign central bank, and must be agreed to by the drawee. The F/X swaps are structured so that the party initiating the transaction (the drawer) bears the exchange rate risk upon maturity. The Bank will generally invest the foreign currency received under an F/X swap in interest-bearing instruments.

Warehousing is an arrangement under which the FOMC agrees to exchange, at the request of the Treasury, U.S. dollars for foreign currencies held by the Treasury or ESF over a limited period of time. The purpose of the warehousing facility is to supplement the U.S. dollar resources of the Treasury and ESF for financing purchases of foreign currencies and related international operations.

In connection with its foreign currency activities, the FRBNY, on behalf of the Reserve Banks, may enter into contracts which contain varying degrees of off-balance sheet market risk, because they represent contractual commitments involving future settlement, and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

While the application of current market prices to the securities currently held in the SOMA portfolio and investments denominated in foreign currencies may result in values substantially above or below their carrying values, these unrealized changes in value would have no direct effect on the quantity of reserves available to the banking system or on the prospects for future Reserve Bank earnings or capital. Both the domestic and foreign components of the SOMA portfolio from time to time involve transactions that can result in gains or losses when holdings are sold prior to maturity. Decisions regarding the securities and foreign currencies transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, market values, earnings, and any gains or losses resulting from the sale of such currencies and securities are incidental to the open market operations and do not motivate its activities or policy decisions.

U.S. government and federal agency securities and investments denominated in foreign currencies comprising the SOMA are recorded at cost, on a settlement-date basis, and adjusted for amortization of premiums or accretion of discounts on a straight-line basis. Interest income is accrued on a straight-line basis and is reported as "Interest on U.S. government and federal agency securities" or "Interest on investments denominated in foreign currencies," as appropriate. Income earned on securities lending transactions is reported as a component of "Other income." Gains and losses resulting from sales of securities are determined by specific issues based on average cost. Gains and losses on the sales of U.S. government

## NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

and federal agency securities are reported as “Government securities gains, net.” Foreign-currency-denominated assets are revalued daily at current market exchange rates in order to report these assets in U.S. dollars. Realized and unrealized gains and losses on investments denominated in foreign currencies are reported as “Foreign currency gains (losses), net.” Foreign currencies held through F/X swaps, when initiated by the counterparty, and warehousing arrangements are revalued daily, with the unrealized gain or loss reported as a component of “Other assets” or “Other liabilities,” as appropriate.

*(E) Bank Premises, Equipment, and Software*

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over estimated useful lives of assets ranging from 2 to 50 years. New assets, major alterations, renovations and improvements are capitalized at cost as additions to the asset accounts. Maintenance, repairs and minor replacements are charged to operations in the year incurred. Costs incurred for software, either developed internally or acquired for internal use, during the application stage are capitalized based on the cost of direct services and materials associated with designing, coding, installing, or testing software.

*(F) Federal Reserve Notes*

Federal Reserve notes are the circulating currency of the United States. These notes are issued through the various Federal Reserve agents (the Chairman of the Board of Directors of each Reserve Bank) to the Reserve Banks upon deposit with such agents of certain classes of collateral security, typically U.S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral security tendered by the Reserve Bank to the Federal Reserve agent must be equal to the sum of the notes applied for by such Reserve Bank. In accordance with the Federal Reserve Act, gold certificates, special drawing rights certificates, U.S. government and federal agency securities, securities purchased under agreements to resell, loans to depository institutions, and investments denominated in foreign currencies are pledged as collateral for Federal Reserve notes. The collateral value is equal to the book value of the collateral tendered, with the exception of securities whose collateral value is equal to the par value of the securities tendered and securities purchased under agreements to resell, which are valued at the contract amount. The par value of securities pledged for securities sold under agreements to repurchase is similarly deducted. The Board of Governors may, at any time, call upon a Reserve Bank for additional security to adequately collateralize the Federal Reserve notes. To satisfy the obligation to provide sufficient collateral for outstanding Federal Reserve notes, the Reserve Banks have entered into an agreement that provides that certain assets of the Reserve Banks are jointly pledged as collateral for the Federal Reserve notes of all Reserve Banks. In the event that this collateral is insufficient, the Federal Reserve Act provides that Federal Reserve notes become

a first and paramount lien on all the assets of the Reserve Banks. Finally, as obligations of the United States, Federal Reserve notes are backed by the full faith and credit of the United States government.

The “Federal Reserve notes outstanding, net” account represents Federal Reserve notes outstanding reduced by the Reserve Banks’ currency holdings of \$104,983 million and \$139,783 million at December 31, 2002 and 2001, respectively.

At December 31, 2002, all gold certificates, all special drawing rights certificates, and \$644,458 million of domestic securities and securities purchased under agreements to resell were pledged as collateral. At December 31, 2002, no loans or investments denominated in foreign currencies were pledged as collateral.

*(G) Capital Paid-In*

The Federal Reserve Act requires that each member bank subscribe to the capital stock of the Reserve Bank in an amount equal to 6 percent of the capital and surplus of the member bank. As a member bank’s capital and surplus changes, its holdings of the Reserve Bank’s stock must be adjusted. Member banks are those state-chartered banks that apply and are approved for membership in the System and all national banks. Currently, only one-half of the subscription is paid-in and the remainder is subject to call. These shares are nonvoting with a par value of \$100. They may not be transferred or hypothecated. By law, each member bank is entitled to receive an annual dividend of 6 percent on the paid-in capital stock. This cumulative dividend is paid semiannually. A member bank is liable for Reserve Bank liabilities up to twice the par value of stock subscribed by it.

*(H) Surplus*

The Board of Governors requires Reserve Banks to maintain a surplus equal to the amount of capital paid-in as of December 31. This amount is intended to provide additional capital and reduce the possibility that the Reserve Banks would be required to call on member banks for additional capital. Pursuant to Section 16 of the Federal Reserve Act, Reserve Banks are required by the Board of Governors to transfer to the U.S. Treasury excess earnings, after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in. Surplus was not equated to capital at December 31, 2001 at one Reserve Bank where the amount of additional surplus required exceeded the Bank’s net income.

In the event of losses, or a substantial increase in capital, a Reserve Bank will suspend its payments to the U.S. Treasury until such losses or increases in capital are recovered through subsequent earnings. Weekly payments to the U.S. Treasury may vary significantly.

*(I) Income and Costs Related to Treasury Services*

Reserve Banks are required by the Federal Reserve Act to serve as fiscal agents and depositories of the United States. By statute, the Department of the Treasury is permitted, but not required, to pay for these services.

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

(J) Taxes

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property, which are reported as a component of "Occupancy expense."

(4) U.S. GOVERNMENT AND FEDERAL AGENCY SECURITIES

Securities bought outright are held in the SOMA at the FRBNY.

Total securities held in the SOMA at December 31, 2002 and 2001, that were bought outright, were as follows (in millions):

	<u>2002</u>	<u>2001</u>
Par value		
Federal agency .....	\$ 10	\$ 10
U.S. government		
Bills .....	226,682	182,074
Notes .....	297,893	265,941
Bonds .....	<u>104,832</u>	<u>103,660</u>
Total par value .....	629,417	551,685
Unamortized premiums .....	10,762	11,302
Unaccreted discounts .....	<u>(1,054)</u>	<u>(1,286)</u>
Total .....	<u>\$639,125</u>	<u>\$561,701</u>

The maturity distribution of U.S. government and federal agency securities bought outright and securities purchased under agreements to resell, which were held in the SOMA at December 31, 2002, was as follows (in millions):

Maturities of securities held	U.S. government securities (Par)	Federal agency obligations (Par)	Total
Within 15 days ...	\$ 27,444	\$ . . .	\$ 27,444
16 days to 90 days .	154,225	. . .	154,225
91 days to 1 year ..	141,840	10	141,850
Over 1 year to			
5 years .....	172,758	. . .	172,758
Over 5 years to			
10 years .....	53,300	. . .	53,300
Over 10 years .....	79,840	. . .	79,840
Total .....	<u>\$629,407</u>	<u>\$10</u>	<u>\$629,417</u>

Maturities of securities held	Repurchase agreements (Contract amount)
Within 15 days .....	\$25,500
16 days to 90 days .....	14,000
91 days to 1 year .....	. . .
Over 1 year to 5 years .....	. . .
Over 5 years to 10 years .....	. . .
Over 10 years .....	. . .
Total .....	<u>\$39,500</u>

Securities purchased under agreements to resell at December 31, 2002 and 2001 were \$39,500 million and \$50,250 million, respectively, and consisted entirely of agreements through third party custodial arrangements.

As mentioned in footnote 3, in December 2002, the FRBNY replaced MSP transactions with securities sold under agreements to repurchase. At December 31, 2002, securities sold under agreements to repurchase with a contract amount of \$21,091 million and a par value of \$21,098 million were outstanding. At December 31, 2001, MSP transactions involving U.S. government securities with a par value of \$23,188 million were outstanding. Securities sold under agreements to repurchase and MSP transactions are generally overnight arrangements.

At December 31, 2002 and 2001, U.S. government securities with par values of \$1,841 million and \$7,345 million, respectively, were loaned from the SOMA.

(5) INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES

The FRBNY, on behalf of the Reserve Banks, holds foreign currency deposits with foreign central banks and the Bank for International Settlements, and invests in foreign government debt instruments. Foreign government debt instruments held include both securities bought outright and securities held under agreements to resell. These investments are guaranteed as to principal and interest by the foreign governments.

Total investments denominated in foreign currencies, valued at current exchange rates at December 31, were as follows (in millions):

	<u>2002</u>	<u>2001</u>
European Union Euro		
Foreign currency deposits .....	\$ 5,580	\$ 4,593
Government debt instruments including agreements to resell .....	3,298	2,695
Japanese Yen		
Foreign currency deposits .....	1,789	1,891
Government debt instruments including agreements to resell .....	6,164	5,315
Accrued interest .....	<u>82</u>	<u>65</u>
Total .....	<u>\$16,913</u>	<u>\$14,559</u>

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

The maturity distribution of investments denominated in foreign currencies at December 31, 2002, was as follows (in millions):

<u>Maturities of Investments Denominated in Foreign Currencies</u>	
Within 1 year .....	\$15,611
Over 1 year to 5 years .....	904
Over 5 years to 10 years .....	398
Total .....	<u>\$16,913</u>

At December 31, 2002 and 2001, there were no open foreign exchange contracts or outstanding F/X swaps.

At December 31, 2002 and 2001, the warehousing facility was \$5,000 million, with a zero balance outstanding.

(6) BANK PREMISES AND EQUIPMENT

A summary of bank premises and equipment at December 31 is as follows (in millions):

	<u>2002</u>	<u>2001</u>
Bank premises and equipment		
Land .....	\$ 209	\$ 201
Buildings .....	1,514	1,478
Building machinery and equipment .....	345	329
Construction in progress .....	51	32
Furniture and equipment .....	<u>1,362</u>	<u>1,365</u>
	3,481	3,405
Accumulated depreciation .....	<u>(1,437)</u>	<u>(1,384)</u>
Bank premises and equipment, net .....	<u>\$2,044</u>	<u>\$2,021</u>

Depreciation expense was \$187 million and \$186 million for the years ended December 31, 2002 and 2001, respectively.

Bank premises and equipment at December 31 include the following amounts for leases that have been capitalized (in millions):

	<u>2002</u>	<u>2001</u>
Bank premises and equipment .....	\$15	\$21
Accumulated depreciation .....	<u>(12)</u>	<u>(14)</u>
Capitalized leases, net .....	<u>\$ 3</u>	<u>\$ 7</u>

Certain of the Reserve Banks lease unused space to outside tenants. Those leases have terms ranging from 1 to 13 years. Rental income from such leases totaled \$21 million and \$20 million for the years ended December 31, 2002 and 2001, respectively. Future minimum lease payments under noncancelable agreements in existence at December 31, 2002, were (in millions):

2003 .....	\$17
2004 .....	15
2005 .....	12
2006 .....	9
2007 .....	6
Thereafter .....	<u>21</u>
Total .....	<u>\$80</u>

(7) COMMITMENTS AND CONTINGENCIES

At December 31, 2002, the Reserve Banks were obligated under noncancelable leases for premises and equipment with terms ranging from 1 to approximately 21 years. These leases provide for increased rentals based upon increases in real estate taxes, operating costs, or selected price indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was \$70 million and \$69 million for the years ended December 31, 2002 and 2001, respectively. Certain of the Reserve Banks' leases have options to renew.

Future minimum rental payments under noncancelable operating leases, net of sublease rentals, with terms of one year or more, at December 31, 2002, were (in millions):

	<u>Operating</u>	<u>Capital</u>
2003 .....	\$ 11.0	\$ 6.3
2004 .....	10.2	6.2
2005 .....	8.8	.4
2006 .....	7.4	.4
2007 .....	6.6	. . .
Thereafter .....	<u>\$130.8</u>	. . .
	<u>\$174.8</u>	<u>\$13.3</u>
Amount representing interest . . .		<u>(1.1)</u>
		<u>\$12.2</u>

At December 31, 2002, the Reserve Banks had contractual commitments through the year 2007 totaling \$119.7 million for the maintenance of currency machines and check-processing-related services, \$118.7 million of which has not been recognized. Two Reserve Banks contract for these services on behalf of the System.

Three Reserve Banks have additional contractual commitments through the year 2007 for software maintenance, architectural services, and check transportation services. At December 31, 2002, these contractual commitments totaled \$160.8 million, \$143.7 million of which has not been recognized.

The Reserve Banks are involved in certain legal actions and claims arising in the ordinary course of business. Although it is difficult to predict the ultimate outcome of these actions, in management's opinion, based on discussions with counsel, the aforementioned litigation and claims will be resolved without material adverse effect on the financial position or results of operations of the Reserve Banks.

(8) RETIREMENT AND THRIFT PLANS

*Retirement Plans*

The Reserve Banks currently offer two defined benefit retirement plans to their employees, based on length of service and level of compensation. Substantially all of the Reserve Banks', Board of Governors', and the Plan Administrative Office's employees participate in the

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

Retirement Plan for Employees of the Federal Reserve System (System Plan) and the Benefit Equalization Retirement Plans offered by each individual Reserve Bank (BEP) and certain Bank officers participate in a Supplemental Employee Retirement Plan (SERP).

The System Plan is a multi-employer plan with contributions fully funded by participating employers. Certain Board employees not covered by the Social Security Act also contribute to the plan. No separate accounting is maintained of assets contributed by the participating employers. FRBNY acts as a sponsor of this Plan. The prepaid pension cost includes amounts related to employees participating in the plans from the 12 Reserve Banks, the Board of Governors, and the Plan Administrative Office.

Following is a reconciliation of the beginning and ending balances of the System Plan benefit obligation (in millions):

	<u>2002</u>	<u>2001</u>
Estimated actuarial present value of projected benefit obligation at January 1	\$3,091	\$2,810
Service cost—benefits earned during the period	104	85
Interest cost on projected benefit obligation	226	207
Actuarial loss	126	125
Contributions by plan participants	3	3
Benefits paid	(170)	(139)
Plan amendments	143	...
Estimated actuarial present value of projected benefit obligation at December 31	<u>\$3,523</u>	<u>\$3,091</u>

Following is a reconciliation of the beginning and ending balances of the System Plan assets, the funded status, and the prepaid pension benefit costs (in millions):

	<u>2002</u>	<u>2001</u>
Estimated fair value of plan assets at January 1	\$5,795	\$6,176
Actual return on plan assets	(631)	(245)
Contributions by plan participants	3	3
Benefits paid	(170)	(139)
Estimated fair value of plan assets at December 31	<u>\$4,997</u>	<u>\$5,795</u>
Funded status	\$1,474	\$2,703
Unrecognized prior service cost	223	107
Unrecognized net actuarial loss/(gain)	<u>1,042</u>	<u>(228)</u>
Prepaid pension benefit costs	<u>2,739</u>	<u>2,582</u>

Prepaid pension benefit costs are reported as a component of "Other assets."

The weighted-average assumptions used in developing the pension benefit obligation for the System Plan are as follows:

	<u>2002</u>	<u>2001</u>
Discount rate	6.75%	7.00%
Expected long-term rate of return on plan assets	9.00%	9.00%
Rate of compensation increase	4.25%	4.50%

The components of net periodic pension benefit credit for the System Plan as of December 31 are shown below (in millions):

	<u>2002</u>	<u>2001</u>
Service cost—benefits earned during the period	\$ 104	\$ 85
Interest cost on projected benefit obligation	226	207
Amortization of initial net transition obligation	...	(45)
Amortization of prior service cost	27	16
Recognized net (gain)	...	(44)
Expected return on plan assets	(514)	(550)
Net periodic pension benefit (credit)	<u>\$(157)</u>	<u>\$(331)</u>

Net periodic pension benefit (credit) is reported as a component of "Salaries and other benefits."

The Reserve Banks' projected benefit obligation and net pension costs for the BEP at December 31, 2002 and 2001, and for the SERP at December 31, 2002, and for the years then ended, are not material.

*Thrift Plan*

Employees of the Reserve Banks may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System (Thrift Plan). The Reserve Banks' Thrift Plan contributions totaled \$63 million and \$50 million for the years ended December 31, 2002 and 2001, respectively, and are reported as a component of "Salaries and other benefits."

(9) POSTRETIREMENT BENEFITS OTHER THAN PENSIONS AND POSTEMPLOYMENT BENEFITS

*Postretirement Benefits Other Than Pensions*

In addition to the Reserve Banks' retirement plans, employees who have met certain age and length of service requirements are eligible for both medical benefits and life insurance coverage during retirement.

The Reserve Banks fund benefits payable under the medical and life insurance plans as due and, accordingly, have no plan assets. Net postretirement benefit costs are actuarially determined using a January 1 measurement date.

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

Following is a reconciliation of beginning and ending balances of the benefit obligation (in millions):

	2002	2001
Accumulated postretirement benefit obligation at January 1	\$674	\$644
Service cost—benefits earned during the period	17	16
Interest cost of accumulated benefit obligation	47	47
Actuarial loss	49	54
Contributions by plan participants	4	4
Benefits paid	(37)	(31)
Plan amendments, curtailments, and special termination benefits	(12)	(60)
Accumulated postretirement benefit obligation at December 31	<u>\$742</u>	<u>\$674</u>

Following is a reconciliation of the beginning and ending balances of the plan assets, the unfunded postretirement benefit obligation and the accrued postretirement benefit costs (in millions):

	2002	2001
Fair value of plan assets at January 1	\$ . . .	\$ . . .
Contributions by the employer	33	27
Contributions by plan participants	4	4
Benefits paid	(37)	(31)
Fair value of plan assets at December 31	<u>\$ . . .</u>	<u>\$ . . .</u>
Unfunded postretirement benefit obligation	\$742	\$674
Unrecognized prior service cost	141	146
Unrecognized net actuarial gain/(loss)	(93)	(48)
Accrued postretirement benefit costs	<u>\$790</u>	<u>\$772</u>

Accrued postretirement benefit costs are reported as a component of "Accrued benefit costs."

At December 31, 2002 and 2001, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 6.75 percent and 7.00 percent, respectively.

For measurement purposes, a 9.00 percent annual rate of increase in the cost of covered health care benefits was assumed for 2003. Ultimately, the health care cost trend rate is expected to decrease gradually to 5.00 percent by 2008, and remain at that level thereafter.

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 2002 (in millions):

One percentage point increase      One percentage point decrease

Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs	\$ 9	\$ (8)
Effect on accumulated postretirement benefit obligation	94	(81)

The following is a summary of the components of net periodic postretirement benefit costs for the years ended December 31 (in millions):

	2002	2001
Service cost—benefits earned during the period	\$17	\$16
Interest cost of accumulated benefit obligation	47	47
Amortization of prior service cost	(14)	(9)
Recognized net actuarial loss/(gain)	<u>2</u>	<u>(1)</u>
Net periodic postretirement benefit costs	<u>\$52</u>	<u>\$53</u>

Net periodic postretirement benefit costs are reported as a component of "Salaries and other benefits."

*Postemployment Benefits*

The Reserve Banks offer benefits to former or inactive employees. Postemployment benefit costs are actuarially determined and include the cost of medical and dental insurance, survivor income, disability benefits, and those workers' compensation expenses self-insured by individual Reserve Banks. Costs were projected using the same discount rate and health care trend rates as were used for projecting postretirement costs. The accrued postemployment benefit costs recognized by the Reserve Banks at December 31, 2002 and 2001, were \$121 million and \$110 million, respectively. This cost is included as a component of "Accrued benefit costs." Net periodic postemployment benefit costs included in 2002 and 2001 operating expenses were \$26 million and \$21 million, respectively.

(10) SUBSEQUENT EVENT

In January 2003, the System decided to restructure its check collection operations. The restructuring plans include streamlining the check management structure, reducing staff, decreasing the number of check-processing locations and increasing processing capacity in other locations. The restructuring, which is expected to begin in 2003 and conclude by the end of 2004, will result in the Reserve Banks discontinuing check operations in thirteen offices, increasing check processing capacity in nine offices, and consolidating check adjustment functions in twelve offices. At this time, the Reserve Banks have not developed detailed estimates of the cost of the restructuring plan in the aggregate or for the individual Reserve Banks affected.

## Office of Inspector General Activities

The Board's Office of Inspector General (OIG) functions in accordance with the Inspector General Act of 1978, as amended. In addition to retaining an independent auditor each year to audit the Board's financial statements, the OIG plans and conducts audits and investigations of the Board's programs and operations and its delegated functions at the Federal Reserve Banks. The OIG also reviews existing and proposed legislation and regulations for economy and efficiency. It recommends policies, and it supervises and conducts activities that promote economy and efficiency and that prevent and detect waste, fraud,

and abuse in Board and Board-delegated programs and operations as well as in activities administered or financed by the Board. The OIG keeps the Congress and the Chairman of the Board of Governors fully informed about serious abuses and deficiencies and about the status of any corrective actions.

During 2002, the OIG completed eleven audits, reviews, and other assessments (table) and conducted a number of follow-up reviews to evaluate action taken on earlier recommendations. The OIG also closed twenty-seven investigations and performed numerous legislative and regulatory reviews.

### Completed OIG Audits, Reviews, and Assessments, 2002

Report title	Report number	Month issued
Audit of Board's Government Travel Card Program . . . . .	A0011	January
Audit of the FFIEC's Financial Statements (Years Ended 2000 and 2001) . .	A0115	February
Bond Life Cycle Assessment . . . . .	R0103	February
Audit of the Board's Financial Statements (Years Ended 2000 and 2001) . .	A0115BD	March
Audit of the Board's Use of and Controls over Purchase Cards . . . . .	A0109	May
Review of the Eccles Building Project—Phase 3 . . . . .	R0202	May
Board's Recruiting Process Assessment . . . . .	R0203	May
Review of Integrating Support Services into the Management Division . . . .	R0204	June
Business Process Review of the Board's Publications Program—Phase 3 . . .	R0201	June
Audit of the Board's Information Security Program . . . . .	A0205	September
Report on the Failure of the Oakwood Deposit Bank Company . . . . .	A0202	October



## General Accounting Office Reviews

Under the Federal Banking Agency Audit Act (Public Law 95–320), most of the operations of the Federal Reserve System are under the purview of the General Accounting Office (GAO). In 2002, the GAO completed four reports

on selected aspects of Federal Reserve operations (table). Seven projects concerning the Federal Reserve were in various stages of completion at year-end (table). The reports are available directly from the GAO.

### Completed GAO Reports Relating to the Federal Reserve System, 2002

Report title	Report number	Date issued
Payment Systems: Central Bank Roles Vary, but Goals Are the Same . . . . .	GAO-02-303	2-25-02
Federal Reserve Banks: Areas for Improvement in Computer Controls . . . . .	GAO-02-832R	7-30-02
Federal Reserve System: The Surplus Account . . . . .	GAO-02-939	9-18-02
Federal Reserve System: Update on GAO's 1996 Recommendations . . . . .	GAO-02-774	9-25-02

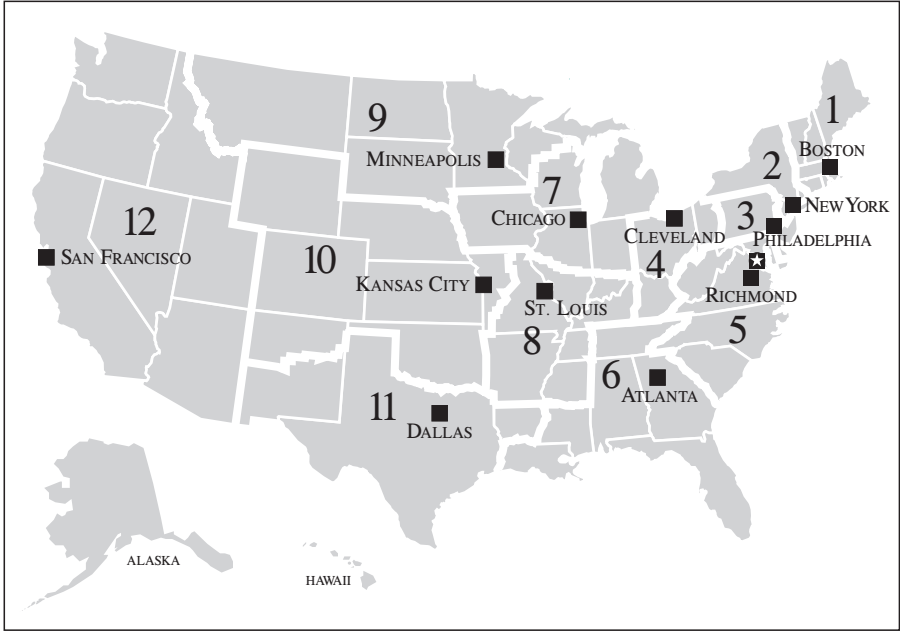
### Active GAO Projects Relating to the Federal Reserve System, Year-End 2002

Subject of project	Date initiated
Supervisory and regulatory policies regarding cyber-threats . . . . .	5-24-02
Business continuity planning and security issues for Fedwire . . . . .	5-30-02
Risk assessment, security, and controls for the pay.gov system . . . . .	7-30-02
Federal Reserve's relationship with U.S. Mint and BEP . . . . .	7-30-02
Prevention and identification of illegal tying . . . . .	9-24-02
Role investment banks play in design and marketing various types of financial transactions . . . . .	10-25-02
Progress with implementing information technology enterprise architectures . . . . .	10-29-02

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*Maps of the  
Federal Reserve System*

# The Federal Reserve System



**LEGEND**

*Both pages*

- Federal Reserve Bank city
- ☒ Board of Governors of the Federal Reserve System, Washington, D.C.

*Facing page*

- Federal Reserve Branch city
- Branch boundary

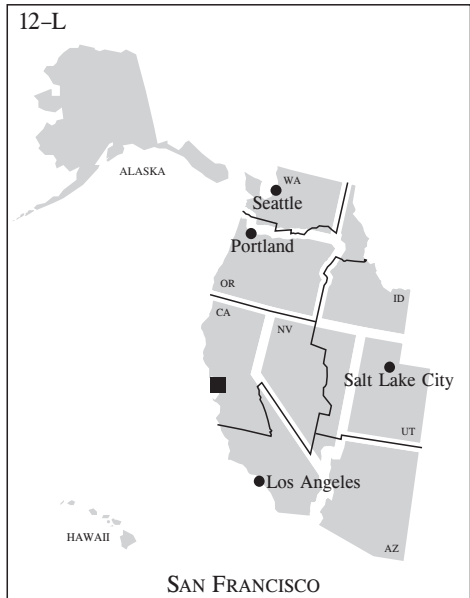
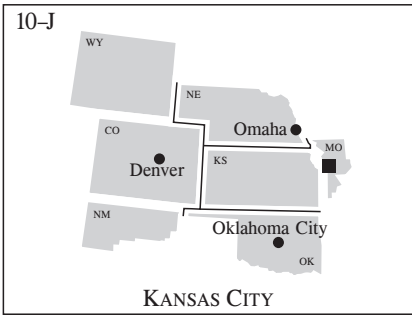
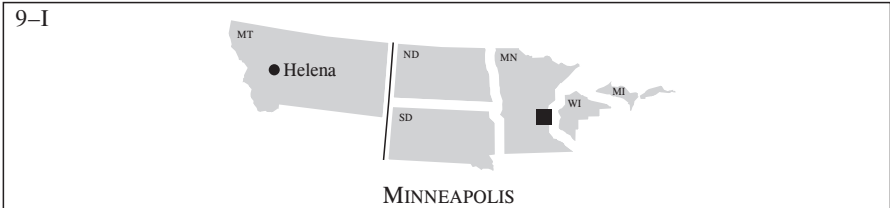
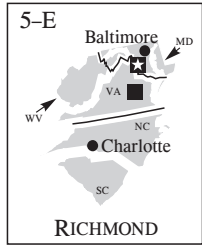
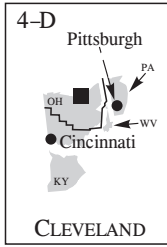
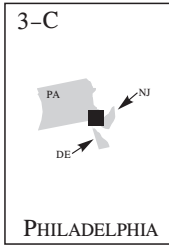
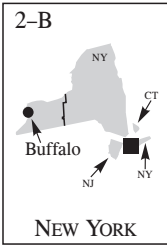
**NOTE**

The Federal Reserve officially identifies Districts by number and by Reserve Bank city (shown on both pages) and by letter (shown on the facing page).

In the 12th District, the Seattle Branch serves Alaska, and the San Francisco Bank serves Hawaii.

The System serves commonwealths and territories as follows: The New York

Bank serves the Commonwealth of Puerto Rico and the U.S. Virgin Islands; the San Francisco Bank serves American Samoa, Guam, and the Commonwealth of the Northern Mariana Islands. The maps show the boundaries within the System as of year-end 2002.





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